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Elston Insights

14th January 2022

Diversifying income generation

- Income from bonds can't keep up with inflation
- Multi-asset income enables a diversified income stream
- Balance required between additional yield and higher level of risk

Through the looking glass: a curiouser new paradigm

Traditionally you bought bonds for income, and equity for risk.

Ironically, now it's the other way round.

The past decade or more has been a challenging period for income investors. Global quantitative easing programmes were launched in response to the global financial crisis of 2008. Further stimulus was prompted as part of the fight against the effects of the COVID pandemic. These policy interventions have suppressed yields for over a decade.

Furthermore, inflation is now surging and is likely to settle at higher levels than pre-Covid. This further undermines the ability of bonds to generate a real income.

The prospect of rising rates limits the appeal of longer-dated higher yielding bonds owing to the higher duration risk (the decline in a bond's value, linked to rises in interest rates).

In the last two years, we have had an extensive period of disruption and change: the pandemic lock-downs, the policy response (stimulus), the economic restart, supply chain disruption, energy crisis, inflation break-out and interest rate cycle "lift off". As a result, we are living in a "curiouser new paradigm" of:

1) negative real yields;
2) the prospect of rising rates
3) uncertainty in the equity markets

Where next for income investors in this new paradigm?

Income from bonds can't keep up with inflation

Negative real yields means that the income from bonds can't keep up with the inflation rate. This means their real value declines.

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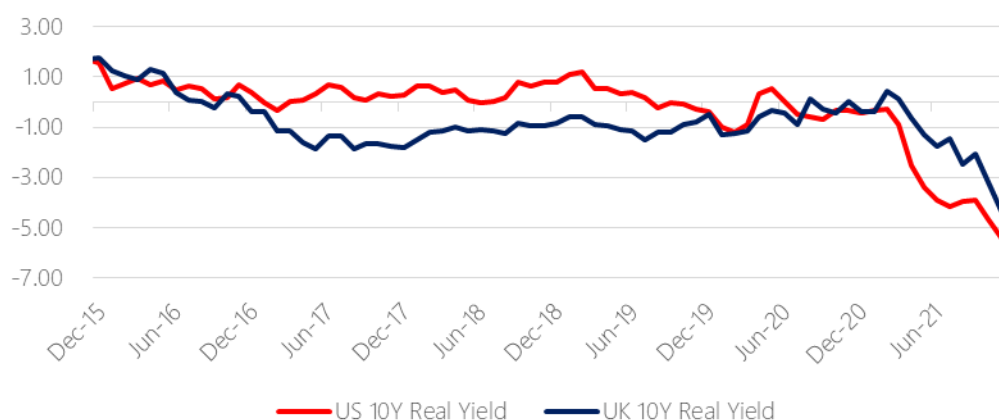
Real yields can be calculated by taking a benchmark (e.g. 10 year) sovereign yield (e.g. for Gilts in the UK), and subtracting that currency's latest inflation rate. In traditional theory, before the era of Zero/Negative Interest Rate Policy, a nominal yield of 5%, and an inflation rate of 2%, resulted in a real yield of 3%. So far, so normal.

But following the Global Financial Crisis, and the arrival of Zero Interest Rate Policy and Quantitative Easing, nominal yields have been suppressed. And as inflation ticks up, real yields move negative. Right now, they are dramatically so.

Fig.1. UK & US Real Yields



Source: Elston research, Bloomberg data

In the context of negative real yields, nominal bonds remain under pressure, so in the "quest for yield" income investors have either:

1) to accept the certainty of losing some money (in real terms) to inflation by investing in nominal bonds; or
2) to uprisk their portfolio and accept equity-level risk to capital in order to receive an income that can keep pace with inflation.

We believe multi-asset income is a potential middle ground.

Multi-asset income enables a diversified income stream

Multi-asset income – a portfolio of equities, bonds and alternative income sources such as property and infrastructure – enables a more diversified income stream, whilst balancing the requirement for additional yield against a more moderate risk budget, relative to equities.

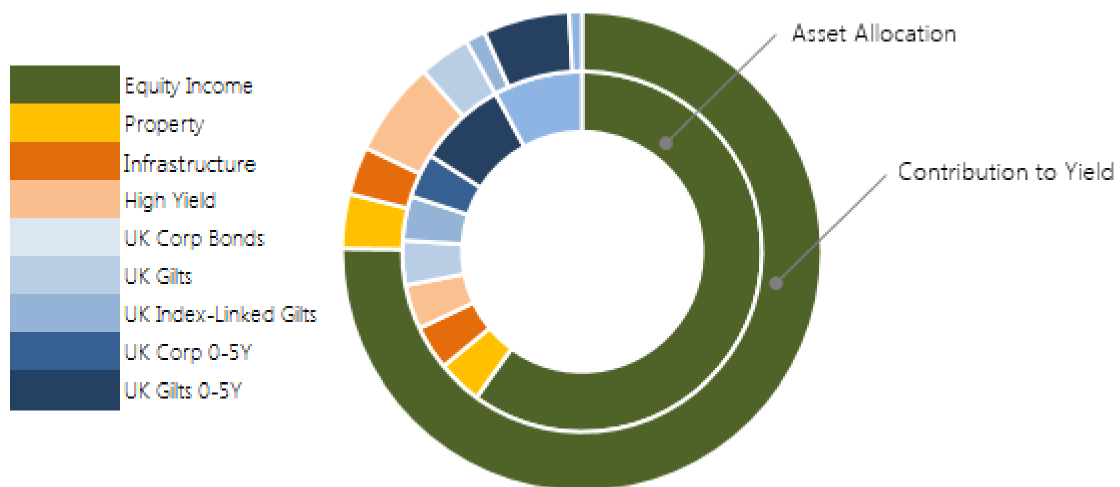
Investors seeking a balanced risk portfolio may typically allocate 60% to equities and 40% to bonds.

In our Multi-Asset Income Index, there is a 60% allocation to equity income – diversified across regional equities: US, UK, Europe, Asia and Emerging Markets.

But there's a need to rethink the 60/40 portfolio to include alternatives, such as real assets (for example property and infrastructure) for diversification. Our strategy includes a 12% allocation to alternative income (property and infrastructure) and high-yield bonds, and a 28% allocation to traditional bonds, of which 16% is <5 year duration to provide stability to the strategy.

Furthermore, in addition to asset allocation diversification, income generation is also diversified, which helps reduce dividend concentration risk. Looking at the contribution to yield of the overall strategy, 75% of the income generated is from equities, 7% from alternative income sources (property and infrastructure), and 18% is generated from bonds.

Fig.2. Diversification by asset class, and by income source (Contribution to Yield)



Source: Elston research, for illustration only, as at December 2021

Balance required between additional yield and higher level of risk

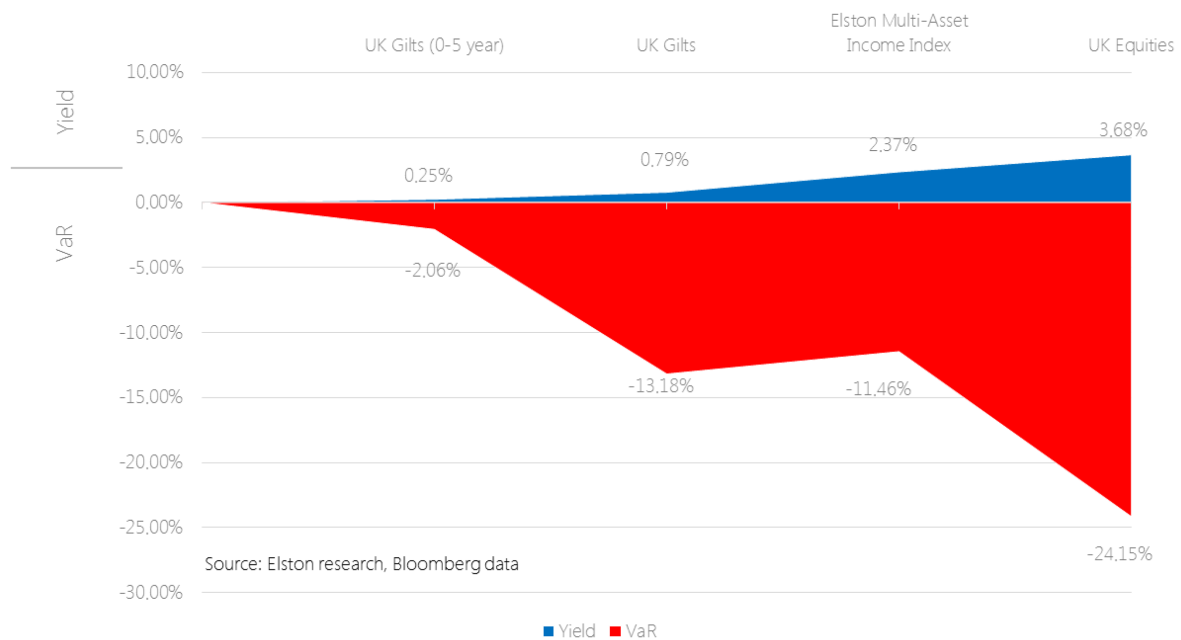
Whilst fixed income investing looks like a sub-optimal option for income-generation, equity income requires a considerable increase in risk appetite and risk budget.

Whereas the downside risk[1] for a UK bond investor is -13.18%, the potential downside risk for a UK equity investor is almost twice that level at -24.15%

The chart below shows both the income yield and the potential downside risk on UK Gilts, our Elston Multi-Asset Income index, and on UK Equities.

[1] We use Value at Risk (95% Confidence) as a downside risk measure

Fig.3. Income yield vs Value at Risk



Source: Elston research, for illustration only, as at December 2021

The combination of risk-reduction (bond allocation) and diversification effect (alternatives allocation), means that the multi-asset income strategy has 47% of the level of risk (as measured by Value at Risk) of UK equities.

The allocation to equities, alternative income (property and infrastructure), and bonds, means that the level of income is 64% of the level of income of Equities.

Overall, the opportunity for Multi-Asset Income to capture 64% of the income, with just 47% of the risk is attractive, from an income/risk efficiency perspective.

Summary

Income investors relying on bonds will not keep pace with inflation.

Income investors investing in equities must accept a high level of risk.

Multi-asset allocation provides a diversified approach to income generation, with a balanced approach to risk.

Henry Cobbe, CFA

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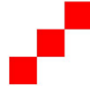

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Our Research & CPD focuses on multi-asset strategies, index funds and ETFs.

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