For institutional/adviser use only

Colonial First State
Global Asset Management

# EQUITY INCOME INVESTING:
## A lesson from traditional income assets

Equity Income
June 2018

**Rudi Minbatiwala**, Head of Equity Income
**Jason Moodie**, Senior Portfolio Manager
**Marlon Chan**, Portfolio Manager

Equities have traditionally been referred to as a 'growth' asset class, but are increasingly being considered for their income characteristics. This follows many years of yield compression across traditional income asset classes, to levels that have fallen short of meeting investors' income requirements. At the same time, investment providers have pushed ahead in developing more tailored solutions for post-retirement investors. This trend has further contributed to the increasing penetration of equity income strategies in many clients' portfolios.

In this paper, Rudi Minbatiwala, Head of Equity Income, examines how the income concept is managed in more traditional income asset classes. Lessons learned from understanding how these traditional income assets are analysed are applied in considering some important implications when seeking to generate income from equities. The paper argues that when it relates to equities, income needs to be considered as a long-term concept; a total return focus is critical in order to meet the required outcomes of retirement income strategies.

There is no doubt that the prevailing level of interest rates is an important influence on investors' retirement income strategies. Interest rates globally have fallen significantly over the past decades as central banks responded to the economic fallout of the GFC. Interest rates were lowered to such an extent that yields from traditional income asset classes compressed significantly. With these falling yields, traditional income investments have fallen short of meeting investors' income requirements. There has been a need to identify other investment opportunities to supplement the attractive income that traditional income assets, such as bonds, historically provided. Investors' demand for alternative income investments has seen a proliferation of equity income strategies come to market in the years following the financial crisis.

To better understand some of the implications of generating income from equities, it is worthwhile examining how traditional 'yield' assets are typically managed. The lessons we can learn from thinking deeper about the approaches used in these traditional yield strategies can be valuable when assessing the suitability and sustainability of an equity income strategy over the long term.

## 'Yield' in traditional income assets

The term 'yield' has always been most closely associated with bonds and other similar fixed income assets. In the world of bond investing, two of the most common terms are 'running yield' and 'yield to maturity'. While similar in name, most bond investors understand that the two metrics are entirely separate concepts.

The 'running yield' is a short-term income measure, and simply divides the annual coupon by a bond's current price. The metric certainly provides an insight into the current year cash flow characteristics of a bond, but what information does it provide about the bonds value?

To assess the value of a bond, and hence which bonds are the most attractive investments, investors are more concerned about comparing bonds on the basis of the 'yield to maturity'.

This term is a total return measure, considering all aspects of the investment – most notably the expected change in the capital value and the value of all future coupons. The coupons of bonds are set when they are issued, and otherwise similar bonds that are issued at different times may have coupons that are substantially different.

$$\text{Running Yield: } Y_R = \frac{\text{Annual Coupon}}{\text{Current Bond Price}}$$

$$\text{Yield to Maturity: } Y_M \text{ such that Current Bond Price} = \sum_{i=1}^{n} \frac{\text{Coupon}}{(1+Y_M)^i} + \frac{100}{(1+Y_M)^n}$$

The 'yield to maturity' normalises for both the size of the coupon being paid, as well as the current trading price of the bond to derive a measure for the bond's total return. It is more difficult than the running yield to calculate, but is certainly more informative as a valuation tool. This is why bond managers spend negligible time looking at the 'running yield' on bonds. The investments total return remains the key focus even in traditional income asset classes.

## 'Yield' in equities: the dividend yield

What lessons can equity investors learn from these bond concepts when thinking about equity income strategies? The definition of a 'return objective' for many outcomes-based investment strategies places greater emphasis on the income returns component compared to traditional wealth accumulation strategies. Generating a sustainable level of income in retirement becomes a key priority. This is often described as a shift towards maximisation of income rather than maximising return for a given level of risk.

Given equities are typically regarded as 'growth' assets, this creates a challenge when considering an appropriate strategy for the equities component of an outcomes-based investment solution. The status quo response has been to target an equities mix that tilts towards higher yielding investments to match the overall return objective for these investment solutions. This increased focus on a stock's 'dividend yield' warrants closer examination.

$$\text{Running Yield: } Y_R = \frac{\text{Annual Coupon}}{\text{Current Bond Price}}$$

$$\text{Dividend Yield: } Y_D = \frac{\text{Next Year's Dividends}}{\text{Current Stock Price}}$$

The 'dividend yield' of a stock is simply the expected dividends being paid out by a company over the next year divided by the current share price. The measure is akin to the 'running yield' concept rather than the 'yield to maturity' concept. The 'dividend yield' is a measure of short-term income generation and does not provide any insight into the expected total return that the investor will receive from the investment. Expected changes in the investment's capital value are not considered at all.

So while most bond investors focus on total return outcomes, it is curious that many equity investors seeking enhanced income as part of their retirement investment strategies do not share that focus. Part of the reason for this is that in the equity world it is not easy to calculate a 'yield to maturity' equivalent.

Unlike in bond land, it is difficult to assess what the value of the capital component of equity will be at a later date. With bonds, the yield concept is more applicable because the final capital value is more certain and the variability of the capital value prior to maturity is typically more modest. Bonds have a known maturity value (given they promise to repay their $100 principal) at a specified date in the future. Equity investments do not have a maturity date, nor can we know the future value (share price) with any certainty. Accordingly it is difficult to calculate a 'yield to maturity' equivalent. We can calculate an expected 'holding period return', which seeks to combine the dividend income returns with a forecast of capital returns, although the inherent volatility of share prices means the 'return' is uncertain.

So is the 'dividend yield' concept flawed? It certainly is not. The 'dividend yield' remains a very useful metric to assess the valuation of a company at the prevailing share price, used in conjunction with other valuation tools such as price/earnings ratios, discounted cash flows or book value multiples. The issue is that this simple concept is often misunderstood and therefore applied in the wrong context. When used as a valuation metric, the 'dividend yield' concept implicitly makes several long-term assumptions; the company pays regular dividends, the share price does not move significantly, and that dividends will be maintained or grow at a similar rate to the share price. In reality, both dividends and share prices change regularly over time, making these assumptions invalid over the long term. In fact the 'dividend yield' metric only provides an approximate indication of the amount of income that can be generated for short time frames. As such, it would seem to have limited application for outcomes-based investors concerned about income generation over the long term.

To understand this further, we need to consider the dichotomy that exists between how investors view dividends, both through the lens of continuous 'dividend yield' and through the perspective of discrete dividend payments (generally made twice a year). While both views are valid, the purpose and context in which dividends are being applied is an important consideration in determining which dividend framework is most appropriate.

Consider the sample screen below that seeks to identify sustainable high yield stocks that are large, liquid and which have defensive qualities.

| | Div yield | Franking | Gross yield | DPS growth | ROE | 12-mth price volatility |
|---|---|---|---|---|---|---|
| High Yield Bank | 6.9% | 100% | 9.9% | -4% | 6.1% | 16% |
| High Yield REIT | 6.7% | 0% | 6.7% | 1% | 9.8% | 13% |
| Income Infrastructure | 6.6% | 0% | 6.6% | 2% | 6.9% | 15% |
| Mega Yield Co | 6.2% | 50% | 7.5% | 7% | 7.2% | 16% |
| Big Income Inc | 6.1% | 100% | 8.7% | 3% | 13.5% | 14% |
| Dividends R Us | 6.0% | 33% | 6.9% | 2% | 7.7% | 17% |
| The Income Company | 5.8% | 100% | 8.3% | -4% | 8.8% | 21% |
| FullyFranked.com | 5.8% | 100% | 8.3% | 6% | 10.4% | 18% |
| Income Warehouse | 5.7% | 100% | 8.1% | 5% | 14.6% | 14% |
| Utility Yield Co | 5.6% | 0% | 5.6% | 4% | 15.8% | 15% |

Illustrative purposes only.

Would it be possible to construct an equity portfolio that delivers a 7% annual income distribution from this universe of 'sustainable' high yield stocks? Remember that for Australian clients in the retirement phase, the focus is usually on the gross yield, incorporating the value of franking credits.

Most investors would find this a relatively straightforward exercise given the gross yields available from these shares.

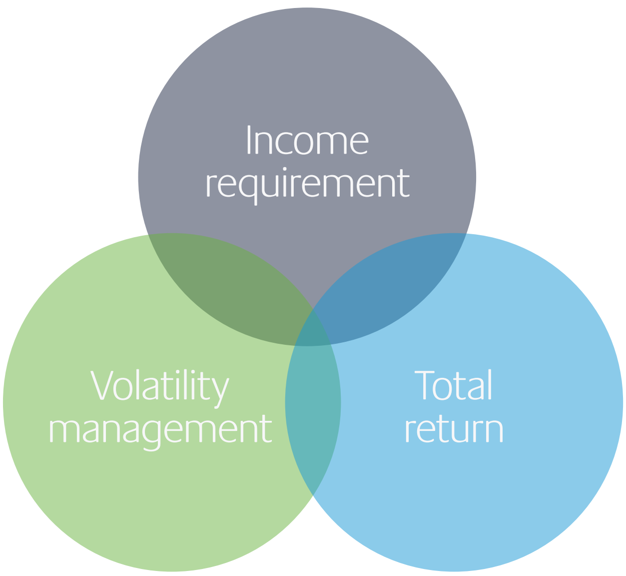
Extending the exercise further, what if we were asked to construct an equity portfolio that delivers a 14% annual income distribution from the same investment universe. Could this be achieved?

Many investors would find this second question more difficult to answer. Some might suggest that gearing or some form of derivative would be necessary in order to achieve the higher distribution.

The fact the second question was more difficult to answer highlights that we need to think more closely about the distinction between yield and income. Post-retirement investors have an increased focus on dividends because they require cash flow from their investments to fund their lifestyle choices. Therefore, it is the discrete dividend payments that are most important for these investors. The focus here is considering dividend payments as an 'event' concept in contrast to the dividend yield, which is a 'continuous' valuation concept.

Constructing an equity portfolio that produces a high income return (like 14% in the above exercise) is readily achievable by simply owning stocks at the time the stocks pay the dividend (and franking credits) and actively rotating through stocks as they pay at different times during the year. Their tax-exempt status would make the implementation of this strategy even easier for retirees.

It may seem easy, but is it sensible? Given that harvesting any equity yield that is required can be readily achieved with limited complication, it is essential that investors carefully consider the merits of simply focusing on income targets for their equity investments. There is a need to understand the role that capital growth plays in generating an attractive income stream from Australian shares over time. It may be counterintuitive, but equity investors aiming to maximise their income return over the long term must maintain a focus on the total returns (that includes capital growth) of the equity market.




## Investing for income by focusing on growth

Strong total returns have the power to drive the delivery of attractive income from equities over time. Each year's capital return provides the base upon which next year's income return is generated. This is the key to long-term dividend and income maximisation. Strategies that screen or tilt towards stocks with 'sustainable yield' simply are unlikely to hold enough of the types of stocks with low current dividend yields but which generate strong total returns and income over time. Given that it is the delivery of a growing income stream on a 'dollar' basis that is of most importance to post-retirement investors, a simple approach that targets stocks with the higher dividend yields may not provide the desired outcome of attractive income over time.

The one issue that has not yet been addressed relates to time horizons. Retirement strategies need to balance the short-term pressure of providing attractive income and minimising investment risk, whilst maintaining a focus on longer-term issues such as inflation and longevity risk. For equity income investors, the immediacy of income is the key appeal of yield-based strategies. In contrast, the discussion on the total return approach to equity income has emphasised that the strategy will maximise income from equities over the long term. How can an equity income strategy maintain a total return focus to maximise long-term income whilst also addressing the need for regular income in the near term?

Equity options play an important role in addressing this issue. The use of equity options in addition to the underlying portfolio of shares can provide the required combination of control and flexibility and jointly address the three investment objectives of income generation, volatility management and attractive total returns.

The starting point is the construction of a diversified portfolio of shares that are expected to deliver attractive total returns for an appropriate level of risk, regardless of their yield characteristics. Once the portfolio has been established, active option overlay strategies can be selectively applied on top of the underlying shares to address the 'return path' (lower volatility) and 'return composition' (higher income) requirements. The actual level of options cover for each share holding will vary, depending on each stock's return forecasts, the manager's confidence in those assumptions, and volatility expectations. The approach can effectively address both long term and current requirements for near-retirement and postretirement investors. Most importantly, the focus on generating attractive total returns from equities is retained and income can be generated from a broader range of shares.

This balanced approach is well suited to many conservative equity investors who are seeking the key features it provides:

- Similar long-term returns to traditional, long only equity funds;
- A lower frequency of capital losses;
- Some cushioning of capital losses when they occur (reducing the size of the 'tail loss'); and
- Meeting investor income requirements for both the current period and over the long term.

Consider some of the questions that most investors are actively considering at the moment:

- How will the changing interest rate environment impact specific stocks, sectors or the market as a whole?
- Do commodities and materials related stocks still represent an attractive entry point for long-term value?
- Who will be the beneficiaries of the changing economic growth drivers in China?
- Are the valuations for companies with defensive earnings too stretched?

An actively managed equity portfolio including the use of options allows investment views relating to any of these types of issues to be reflected in a portfolio, whilst at the same time addressing the requirements of post-retirement investors. A constant focus on these types of forward-looking issues is a critical part of any equity investment strategy, including retirement income funds which require additional considerations regarding the composition of the return.

This is what is meant by maintaining a 'total return' focus: having an investment approach that allows investors to respond and incorporate these issues into their stock selection and portfolio construction framework. The lessons from traditional income asset classes are clear: a focus on total return must remain a key part of any successful investment strategy.

Global yield compression across most asset classes over the past decade has made the task of developing appropriate outcomes-based investment solutions more challenging. As a result, allocations to growth assets will likely have an on-going prominent role in solutions that seek to achieve the desired mix of objectives. It is therefore essential that the issues outlined in this paper are carefully considered when designing the equities component of outcomes-based investment solutions for clients. Some equity income investors view a 'total return' focus as a point of differentiation. In fact we would argue that it should be mandatory for all equity investors, including those seeking higher income from their equity investments.