

The Age of Income

The growing importance of income investing in turbulent times

Institutional investors are struggling to meet their return and yield objectives in a market characterised by volatile and uncertain capital appreciation and low interest-rates.

In this paper, we look at the income-generating characteristics of equities, bonds and real estate as key elements to achieving competitive total returns and highlight the attractions of a multi-asset income approach. We also include insights from proprietary research into the recent investment experience and expectations of institutional investors, which substantiates the growing importance of income in portfolios.

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Executive Summary

- Income is likely to become a more important driver of total returns as significant debt overhangs impair the growth prospects of many OECD economies.
- Results of an independent survey of 52 major institutional investors across Europe and Asia indicate that most have experienced a fall in yields in recent years and that organisations are putting more emphasis on achieving robust levels of income going forward.
- Low interest rates and bond yields are encouraging a search for yield that forces investors to look beyond government bonds towards assets with more attractive risk-reward characteristics.
- What might have been seen previously as a move up the ‘traditional risk spectrum’ can be characterised as a measured response to a changing risk landscape and a willingness to consider higher yielding assets that look more attractively valued.
- Demographic factors are increasing the demand for income at a time when traditional sources of supply are shrinking. A surge in the number of retirees and increased longevity means more people in retirement for longer, needing more income to maintain their living standards.
- The current market environment offers an opportunity to access attractive yields without *necessarily* taking on significantly more risk in fixed income portfolios, quality focused equity dividend portfolios and commercial real estate portfolios.
- In fixed income, investors are moving away from aggregate benchmarks, seeking strategies that demonstrate a deep understanding of the dynamic nature of absolute risk and an ability to deliver more consistent total returns in a volatile environment.
- For investors who need income, equity dividend yields are attractive, well above their 15-year averages. In the long-run, if dividends are reinvested to augment the capital accumulation rate, equity income is a compelling stable growth strategy for investors who do not require cash distributions. The potential for dividends to grow in real terms is also attractive as an inflation hedge.
- Commercial real estate returns are dominated by income in the longer term, and present conditions allow investors to access yields well above long-term averages.
- The reliance on a single asset class to deliver yield can present concentrated risks to capital. A well structured, risk-aware and dynamic multi-asset approach to income can deliver an attractive solution in the prevailing uncertain environment.

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The age of income

The world economy is undergoing a restructuring: secular growth drivers are reshaping the balance of economic power; the demographics of longevity and aging populations are intensifying the retirement saving imperative; while the financial risk environment has been transformed by the 2008 credit crisis and ongoing sovereign debt crisis.

Already a powerful investment theme, the 'search for yield' is a trend that is set to grow further thanks to influential supply and demand factors.

The search for income – already a powerful investment theme - is set to grow in importance over the next decade and beyond. There are a range of near-term and longer-term drivers:

- low interest rates and bond yields are driving a broader search for yield
- slower economic growth in many developed nations burdened with high debt levels is likely to put greater emphasis on income returns versus capital gains
- two large corrections in stock markets in 10 years have deflated sentiment towards equities, forcing investors to reassess their strategies
- the funding challenges facing governments hamstrung with public debts is likely to lead to responsibility for retirement saving increasingly falling on individuals
- aging populations with people living longer will increase retirement saving
- the need to maintain or grow real income levels during retirement to protect the purchasing power of savings from inflation will support investment in real, income-paying assets.

The investing environment of tomorrow is set to be quite different to the one which investors became accustomed to in the last 25 years.

Last 25 years	Next 25 years?
Preference for capital growth, falling payout ratios	Preference for income, rising payout ratios
Willingness to take on more risk for capital returns	Search for contained volatility and stable yield
Preference for credit, spending, asset wealth	Preference for deleveraging and saving
"Great moderation" led to a mispricing of risk	Reassessment of risk and focus on total return

Institutional investor insights

Greenwich Associates were commissioned to independently survey a range of leading institutional investors in Europe and Asia to find out how organisations were meeting their income needs in a low-yielding environment.

- 52 major institutional investors in Asia and Europe were interviewed in June 2012. Institutions surveyed included leading insurance companies, blue chip corporate and public pension funds, including both defined benefit and defined contribution schemes.
- The purpose of the survey was to understand how pension funds and insurance companies are adapting their investment strategies and changing the asset allocation of their portfolios to achieve sufficient investment income.
- We summarise the main findings of the survey on page 4 and include specific insights throughout the rest of the paper (grey-shaded sections).

Institutional investor survey: principal findings

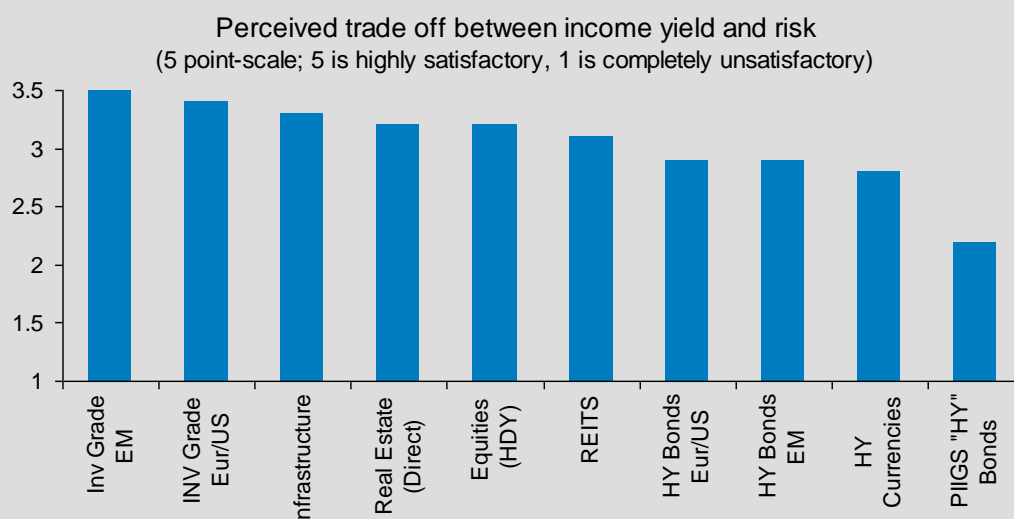
- Institutional investors in both Europe and Asia have put increasing emphasis on achieving regular investment income relative to capital appreciation.
- Realised income yields have fallen among institutional investors. Over the past five years:
 - **75% of European institutional investors reported a decline in income yield**
 - **65% of Asian institutional investors reported a decline in income yield**
- Around half of all institutional investors surveyed had an explicit income yield target. Over half of all institutions with a target failed to meet it over the past 5 years.

	Required Yield (average)	Actual Yield Past 5 Years (average)	Expected Yield Next 5 Years (average)
Asia Institutions	5.2%	5.0%	5.2%
European Institutions	4.2%	3.4%	4.2%

Source: FIL Ltd, Greenwich Associates, June 2012. Average of investors surveyed. Question: What is your required income yield? What has been your actual income yield (past five years)? What is your expected income yield in the next five years? Over the past five years has your income yield changed?

- Institutions are considering a greater range of assets to meet their income needs. Within traditional asset classes, there has been a shift towards investment grade credit (developed and emerging markets), high yield bonds and high dividend equities. Together with real estate investment and infrastructure these are the asset classes considered to provide the most favourable trade-off between income and the risk to the underlying principal.
- Unsurprisingly, credit/sovereign risk in the search for higher investment income was cited most often as the key risk to the principal value of investments. Interest rate risk was next; many Asian insurance companies have increased the duration of at least some of their fixed income investments to increase investment yield.
- The areas that institutions are expecting to turn to for additional income are: investment grade credit, high dividend stocks and high yield bonds. Asian institutions also expect to focus on local currency bonds, which provide higher yields, the potential for currency appreciation relative to developed markets and a perceived lower risk than sovereign/credit bonds from developed markets.

Institutions favouring corporate bonds, equities & real estate



Source: FIL Ltd, Greenwich Associates, Question: Using a 5 point scale from 5 = "highly satisfactory" to 1 = "completely unsatisfactory" how do you rate the trade-off between income yield and the risk associated with each asset class?

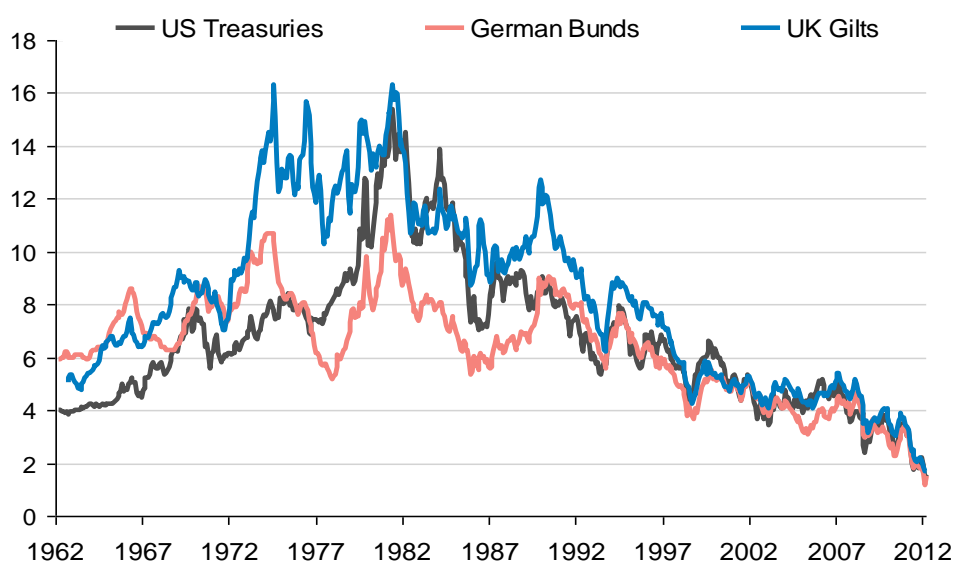
Drivers of income: Where are we now?

The investment environment has changed markedly in recent years. The last decade has been witness to a pronounced credit and asset pricing bubble, a severe financial crisis and market correction, and a debilitating and ongoing sovereign crisis that is redefining investors' perceptions of risk.

Interest rates and bond yields in parts of the developed world seen as most economically and fiscally robust have fallen to record lows (see chart below). Indeed, bond yields have trended down strongly since 1982; the scope for this trend to continue is clearly constrained by such low yields. In an environment of high financial and sovereign risk, investors are increasingly considering the income-generating characteristics of investment grade and high yield bonds, equities and real estate.

There are 'safe havens', but at record low yields

'Safe-haven'
government bond
yields are at record
lows.



Source: DataStream, as at 03.07.12. Based on 10-Year Benchmark Government Bond Yields.

From 'Great Moderation' to 'New Normal'

Income is set to become a more important driver of return. The *Great Moderation* - and the strong capital growth that accompanied it, appears to most, to be over.

*The **Great Moderation** refers to the period from the mid-1980s to mid-2000s when a set of favourable conditions resulted in a noticeable dampening of economic cycle fluctuations (more stable GDP, employment, and less regular recessions).*

At the same time as the Great Moderation was taking place, demographic 'baby boomer' effects increased the number of savers, helping to promote a 'cult of equity' that reached its zenith at the turn of the century. After two severe corrections in under a decade, the equity cult has deflated and the maturing 'baby boomers' are now moving into retirement, necessitating higher weightings in income-paying assets.

The Great Moderation inspired 'new paradigm' thinking that the business cycle was tamed, leading to greater risk-taking and excessive levels of borrowing that laid the foundations for the financial crisis. The remedial actions taken by governments and central banks have dramatically increased debt-to-GDP ratios around the world, tipping some economies into an economic tailspin. History suggests such crises require a multi-year workout. Indeed, some believe the combination of debts, challenged growth prospects, low interest rates and deflationary forces we see today could be sustained for a prolonged period - becoming the '**new normal**' for the foreseeable future.

There is some academic support for this view. The economists, Carmen Reinhart and Kenneth Rogoff investigated the history of financial crises, in particular, the relationship between economic growth and public debt.¹ Their findings support the view that the current debt trajectories in many OECD economies are a significant risk to long-term growth and stability, **with many advanced economies already exceeding the important ‘tipping point’ of 90% debt/GDP**. Japan, Italy, Portugal, Greece, Ireland and the US all have debt-to-GDP levels above this level.

High debt burdens tend to constrain economic growth.

Reinhart and Rogoff found that **debt burdens above 90% are associated with 1% lower average economic growth**. Certainly, the experience so far suggests that record low interest rates and quantitative easing may not be sufficient to reverse the powerful deflationary and deleveraging effects associated with debt overhangs. Indeed, the experience of the Japanese economy shows that even with low interest rates, debt overhangs remain a sustained hindrance to stable economic growth. Japan’s real estate bubble burst twenty years ago, interest rates remain near zero, while bond yields have been stuck in the 1 to 2% range for most of the last fifteen years.

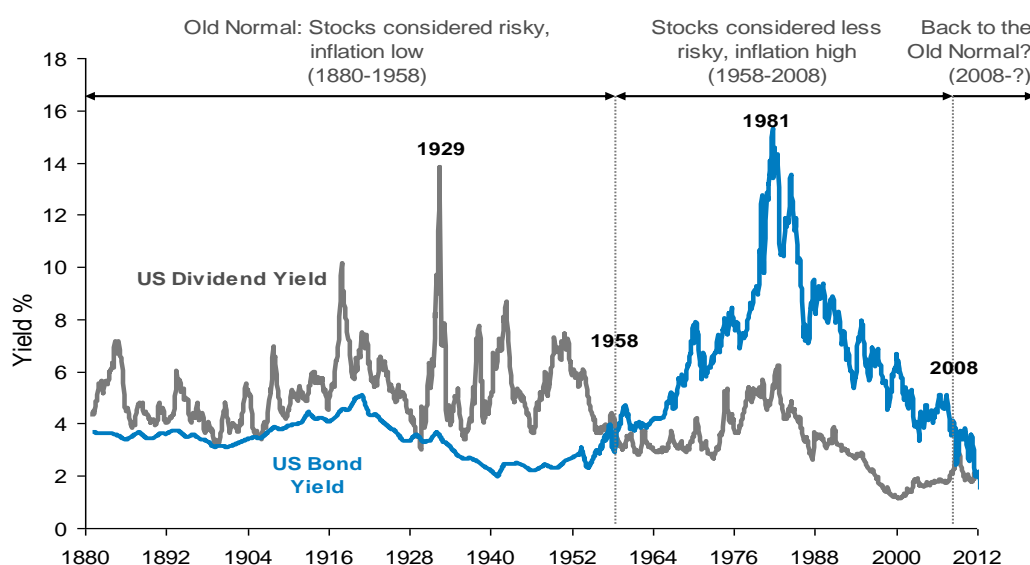
“New Normal”, old routine?

Certain aspects of the ‘new normal’ may be not that different from what has gone before. If the ‘Great Moderation’ was an anomaly within the broad sweep of history, the growing importance of total return can be seen as a move back to the ‘old normal’. For much of the last 50 years, inflation was the principal enemy of policymakers and investors. During most of this time, equity dividend yields were lower than bond yields. However, this state of affairs is not normal at times of low inflation and was uncommon before 1958 (when yields crossed over, see chart below).

Prior to 1958, equity yields were higher than bond yields as inflation was low and risks to capital were considered to be high (for instance, during the World Wars). **Most equity return came through the reinvestment of income**. If we are in a prolonged period of low inflation due to the deflationary impact of debt overhangs and deleveraging, **this pattern may reassert itself**.

Is the “New Normal” a move back to the “Old Normal”?

Have we moved back into an environment where investors demand a higher level of income from stocks to compensate for uncertainty & reduced capital gain expectations?



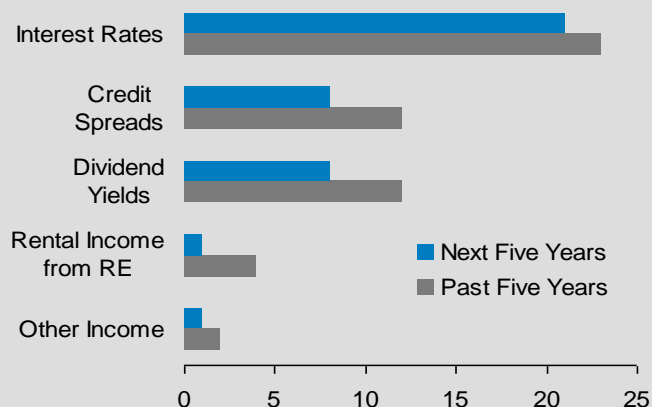
Source: Robert Shiller data, based on S&P Composite Index and US Bond Yield from 1871. <http://www.econ.yale.edu/~shiller/data.htm>

¹ Carmen M. Reinhart & Kenneth S. Rogoff, May 2010. "Growth in a Time of Debt," American Economic Review, American Economic Association, vol. 100(2), pages 573-78.

Shrinking supply forcing a search for yield

As the charts below show, the drivers of the search for yield have become stark. The low interest rates and bond yields in many of the principal OECD economies mean that **traditional sources of income are failing to meet investors' income requirements**. This is encouraging investors to search for yield in other assets with more attractive risk/reward characteristics, such as high yield bonds, real estate, and equities. At the same time as sources of supply are becoming more challenging, the demand for income is likely be supported by some influential demographic trends.

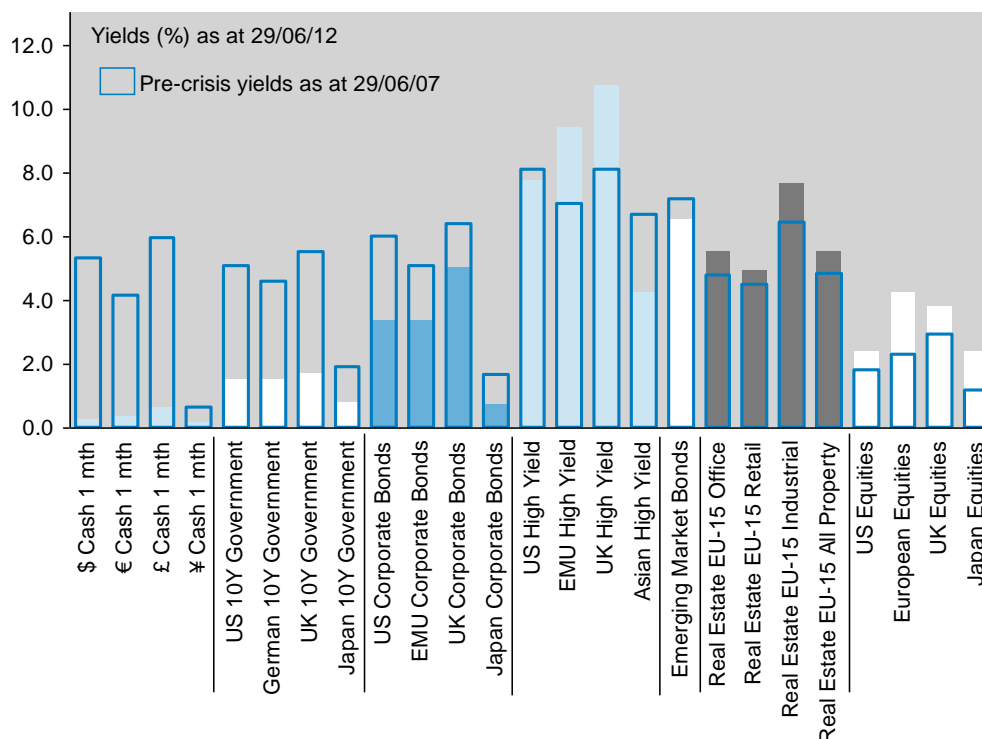
Institutions see low interest rates as the key driver of shortfalls in income



Source: FIL Ltd, Greenwich Associates as at 06.12. Question: Which of the following drivers/sources of income have not met your expectations and have posed challenges in meeting your desired levels of regular income?

The income available across assets

Since the financial crisis the yields on traditional income-generating assets, such as cash and government bonds, have shrunk to historic lows.

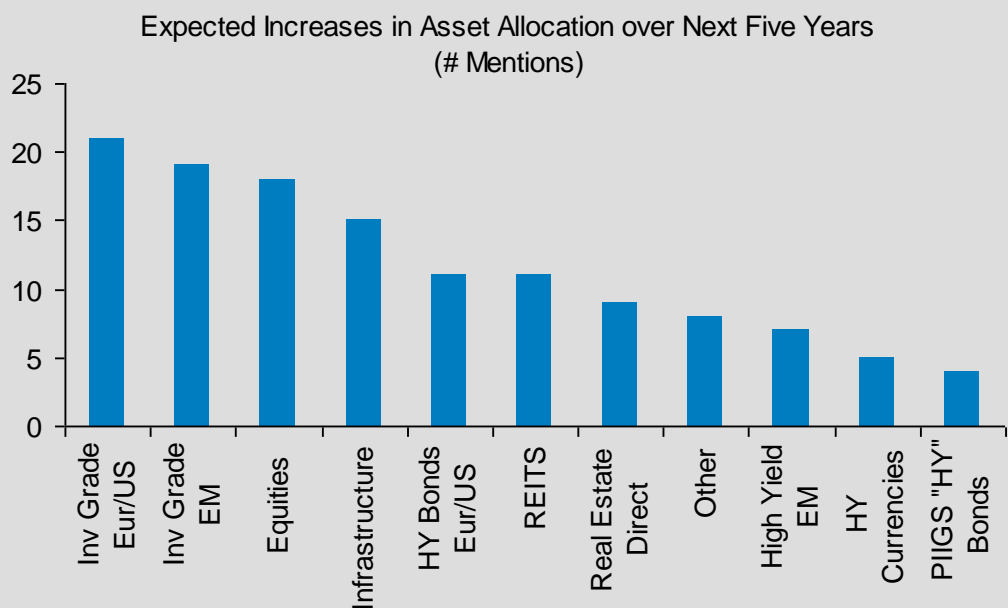


Source: DataStream, as at 29.06.12. The blue line shows the yields available five years previously. Real Estate yields: FIL/CBRE, IPD, end Q1 2012 and Q2 2007.

Moving up the “risk spectrum” or finding better reward for risk?

The changing yield environment over the past five years was reflected in our research findings. Institutional investors showed a greater willingness to consider non-traditional sources of income and a concurrent willingness to gradually shift sources of income up the traditional risk spectrum. We would note that **the fundamental re-pricing of risk that is encouraging the shift to asset categories seen as traditionally risky may not, in reality, increase overall portfolio risk materially**. Non-traditional asset classes are expected to deliver a greater proportion of total return, going forward.

With government bonds unattractive on a risk/return basis due to the ‘fear’ premium associated with the safest bonds, institutional investors have been increasing, and are expecting to increase, exposure to higher-yielding assets. The **most popular area for increased allocations in the next five years is investment grade bonds** (both developed and emerging markets). **Equity income and real estate strategies are also expected to benefit**. High yield bonds were a favourite of certain institutions; their lower ranking is partly due to the fact they are off limits for others.



Source: FIL Ltd, Greenwich Associates, 06.12. Question: Over the next 5 years, to which areas do you expect to increase allocations to improve regular income?

A surge in retirees and greater longevity will mean more pensioners facing longer retirements.

This will support demand for income-focused investments.

Demographic demand: surge in retirees and increased longevity

- The impact of aging and top-heavy populations is significantly increasing the number of retirees globally
- In particular, the influential ‘baby boomer’ generation is now moving towards retirement
- Greater longevity means longer retirements than previously and a greater imperative to maintain real income levels

Higher life expectancies and a surge in the global number of retirees will drive an increased appetite for income over the next 20 years. Demographic trends are a powerful force on economic and investor behaviour.

The global retirement population is set to surge from 800 million in 2011 to 2 billion by 2050, (according to the United Nations).² To this dramatic increase in retirees, we should also recognise

² ‘World Population Aging’ December 2009, United Nations, Dept Economic and Social Affairs.

qualitative pressures - pensioners are now more active in retirement and have higher expectations for living standards.

Average life expectancies have increased markedly in the last fifty years. Individuals being born in developed nations now can expect to live well into their 80s on average. The simple fact that people are living longer means they will require income streams that can support them for longer. This is forcing a major reassessment of how much money/income pensioners need in retirement.

Greater longevity not only raises the bar on retirement income needs, it also requires a material change in how people save for retirement. **Retirement portfolios need to provide stable income streams that are able to deal with the deleterious effects of inflation for retirements that can last over thirty years.**

Reviewing the investment implications of the life cycle model

The traditional life cycle model put forward by Franco Modigliani gave rise to three investing phases: **Accumulation**; **Consolidation**; and **Decumulation** (or dis-saving). Given the demographic demand drivers discussed above, the latter decumulation phase is becoming much more challenging, due to the increases in longevity and the reduction in annuity rates.

While the majority of investment should remain tilted to lower-risk assets, the need is clear for an allocation to 'real' assets like equities and real estate (subject to a tolerance for potential capital fluctuation) that can continue to build the capital base required to generate income over a longer retirement period.

The result is that high-quality, income-generating assets will become more attractive to investors in the consolidation and decumulation phases. Given that it is crucial for a portfolio to go on generating real income in the decumulation period, the idea of retaining some allocation to high-quality, dividend-paying equities should become more prevalent. The move into safe assets is better characterised as a progressive transition - not a point-in-time event undertaken at retirement age.

Income increasing in importance among institutional investors

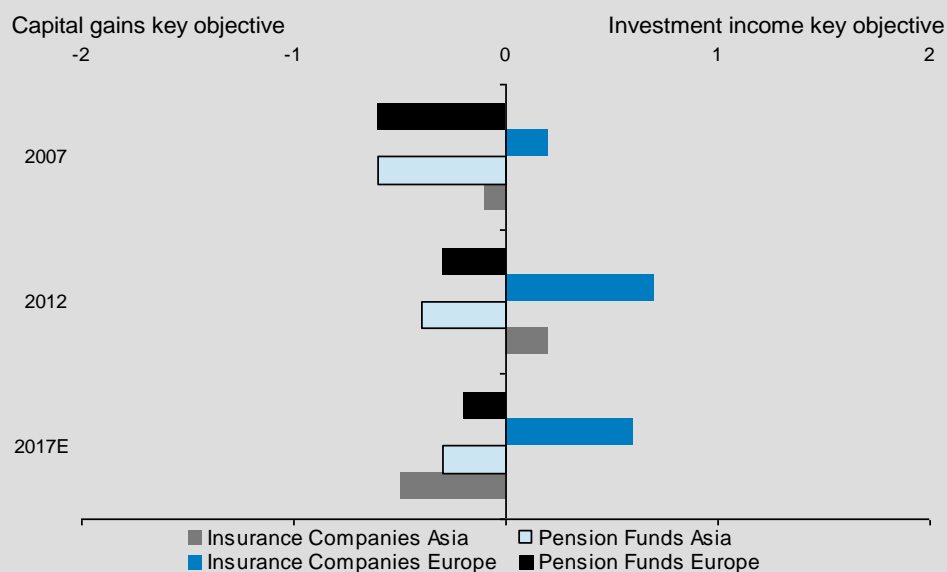
The increasing importance of income within portfolios is borne out by our research among institutional investors. The importance of income has grown relative to capital gains over the last five years for all investor categories surveyed (see chart on p10). It is unsurprising that insurance companies in Europe which have to account for near-term liabilities place the highest emphasis on investment income. European pension funds, while benefiting from a longer-term liability profile than insurance companies, are also placing greater emphasis on income, going forward. Lastly, while Asian institutions remain primarily focused on capital gains, they too see a role for income at present, albeit, insurance companies expect attention to revert to capital growth; perhaps a function of their more constructive longer-term regional outlooks.

While the overall results confirm a growing importance from five years ago, there is a great deal of variation between institutional investors based on their specific circumstances. For instance, while one Asian defined benefit pension fund surveyed enjoyed "a 130% funding ratio and as a result no need for regular investment income to fund payments", this was at odds with the investing imperatives of European insurance companies, which reflected the need for stable income "to meet payouts linked to insurance policies".

The Solvency II review of capital adequacy requirements for the European insurance industry may have significant further implications. The European insurance industry controls around €10 trillion of assets (as at 2009), which equates to around 50% of global insurance assets³. The industry already has the majority of its investments in bonds but there could be significant implications for bond classes once the full impact of the final legislation is known.

³ Swiss Re's Sigma group (No 5/2010 Insurance investment in a challenging global environment)

Importance of regular investment income versus capital gains



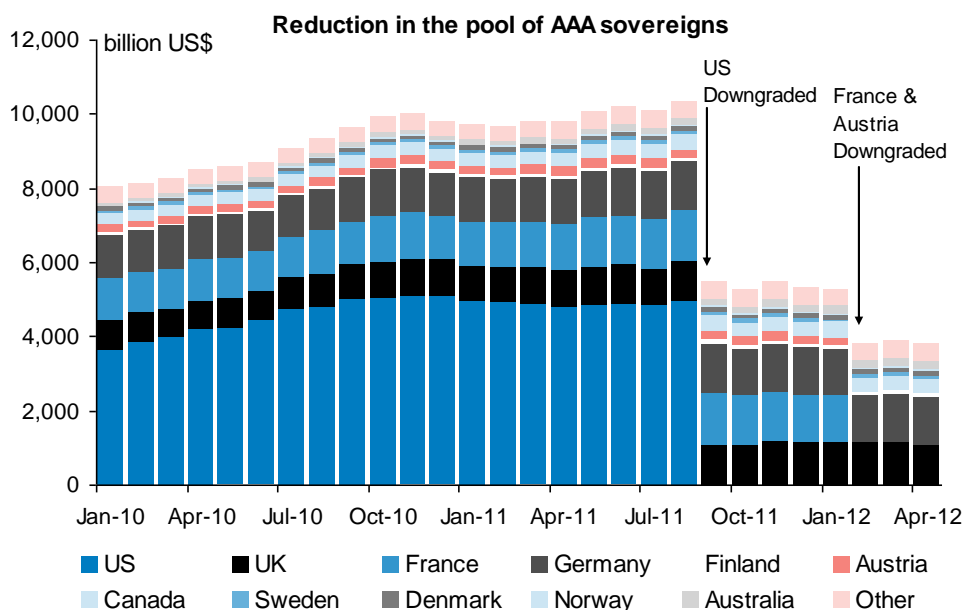
Source: FIL Ltd, Greenwich Associates, 06.12. Research Question: In your overall investment objective, how important is regular investment income versus capital appreciation in 2007, 2012 and expected importance for 2017?

Fixed Income: looking beyond government bonds

Bonds have traditionally provided the first port of call for investors looking for income. However, government bonds now offer low yields relative to their own history, at a time when sovereign risks have increased. The concept of “risk-free” has been shaken, forcing investors to recast their established perceptions about the nature of risk.

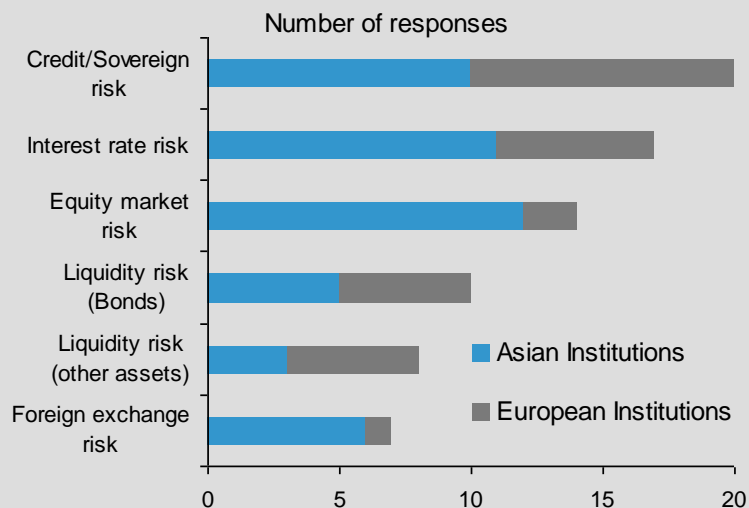
Whilst there has been a huge reduction in the pool of Sovereign debt with AAA status, yields on these downgraded bonds have not risen materially. Indeed, demand for assets considered safe has been significant, putting downward pressure on the yields of US and German bonds, increasing the price of safety. In the periphery of Europe where risk has been dramatically re-priced upwards the experience has been quite the opposite. While the present sovereign issues will eventually moderate, we believe this is likely to be a multi-year process.

The AAA asset pool has shrunk by around 70% in the last twelve months.



Source: Citigroup, as at 05/12. Based on CITI WGBI (AAA) Index.

Institutions most fearful of credit risks



Source: FIL Ltd, Greenwich Associates, 06.12. Question 4b: In which specific area has the risk to the principal value of your portfolio increased as a result of any of the above actions to increase investment income?

Some institutions increasing duration to boost yield

Unsurprisingly credit/sovereign risks were seen as the key risks to portfolios among the institutions we surveyed. Interest rate risk is next. Just under half of the institutions surveyed have increased duration in one or more fixed income strategies to improve the income from their investments. Asian insurance companies were most aggressive in this regard – this may reflect different regulatory treatments and the ability of some institutions to hold a bond to maturity without having to mark-to-market unrealised losses in the short term. The move to increase duration among some institutional investors is reflected in the relatively high ranking of interest rate risk.

The relatively low ranking of liquidity risk is interesting; while it may not be front of mind for investors right now, were financial conditions to deteriorate quickly via some further sovereign or financial shock, liquidity would quickly become the all-consuming risk facing investors.

Source: FIL Ltd, Greenwich Associates

Changes in the risk landscape are forcing investors to review their strategies.

Fortunately, fixed income is a wider, deeper asset class than ever before and there are many opportunities for investors to find attractive income without sacrificing quality by focusing on high-quality issuers, and by taking a flexible approach to bond investing that avoids the concentration risk in aggregate benchmarks. We believe two approaches merit consideration in this dynamic risk environment: a focus on best issuers and a move away from aggregate benchmarks with significant risk concentrations. We look at these in turn below.

Focus on quality - best issuer portfolios

Where should investors go for a more attractive yield and better risk/reward characteristics? A simple move up the risk credit spectrum into corporate bonds can be supported by the fact that corporate fundamentals are generally sound. However, approximately half of the investable universe in Europe is in the currently highly turbulent financial sector. This is encouraging some investors to consider high-yielding bonds and equities. The price of credit default swaps on certain multi-national pharmaceutical and tobacco companies suggests that investments in these companies are as safe as many sovereigns. Nevertheless, many institutional investors will be looking for a lower volatility bond portfolio which goes some way to replacing traditional allocations managed to market weight sovereign and aggregate bond benchmarks.

Portfolios based on “best issuers” can sensibly broaden the ‘safe haven’ universe: first by differentiating between government bonds, investing only in fiscally sound sovereigns, such as Canada and Australia; second, by including the highest-quality investment grade corporate bonds of robust multi-nationals. Such companies benefit from multi-national reach in relation to national regulatory risks, as well as strong cashflows and healthy balance sheets. They offer better credit risk characteristics than many sovereigns and allow investors to offset sovereign concentration risk.

The best issuers approach requires extensive resources in terms of sovereign and credit analysis and intelligent portfolio construction.

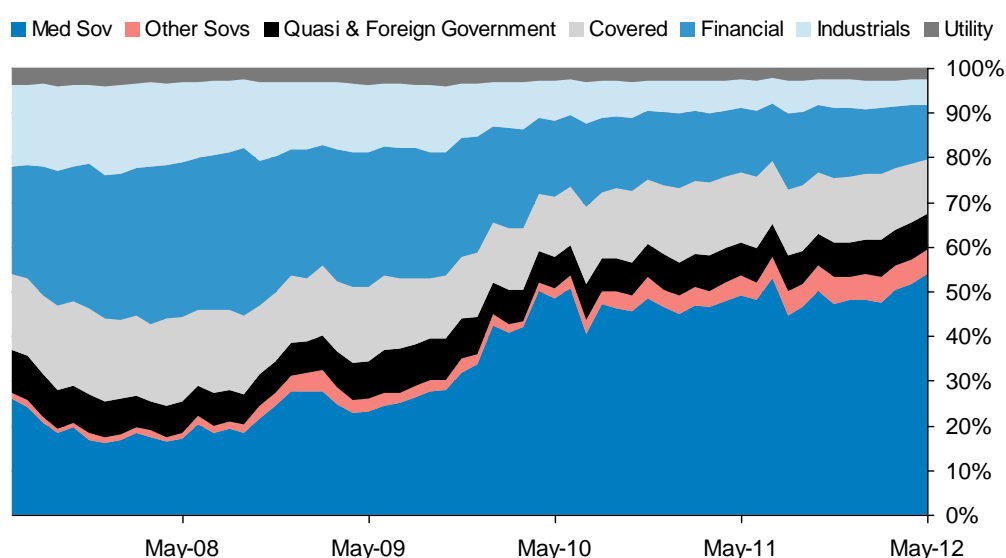
Concentrations of risk and moving away from aggregate benchmarks

Aggregate bond indices and funds benchmarked against them now entail significant concentration risks within sovereign bonds. Around half of the risk in the Bank of America Euro Aggregate Bond Index comes from Mediterranean sovereign bonds (see chart below). More worryingly, the nature of that risk is highly correlated since if one peripheral nation leaves the eurozone, it raises the prospect of contagion effects. Traditional market weight benchmarks no longer reflect the needs of investors in this dynamic risk environment; this strongly encourages the use of alternative benchmarks and strategic approaches.

Our previous white paper, *“The Road to Unconstrained”* (January 2012),⁴ discussed the use of alternatives to market capitalisation benchmarks in the equity space and outlined the benefits of unconstrained approaches that focus on absolute rather than relative risk. In the fixed income landscape, the vulnerabilities of aggregate indices have been laid bare by the financial crisis and the benefits of moving to more flexible, strategic and unconstrained mandates have been made clear.

More flexible approaches are necessary to avoid unwanted concentrations of risk in established benchmarks.

Sources of Risk (Duration Times Spread) in the BoFA Euro Aggregate Index



Source: Bank of America Merrill Lynch. Weighted Duration times Spread (DTS), 30.03.12. DTS is a measure of risk in a credit portfolio that gauges its sensitivity to a relative change in spread.

While aggregate market weight benchmarks still make up the bulk of the bond market, we expect to see greater consideration given to alternatively weighted, high-quality benchmarks, going forward. There will likely be greater interest in less constrained bond portfolios that aim to balance risk and return, as investors move away from products that expose them to indebted governments and

⁴ “The Road to Unconstrained: Why the interest in alternative weighting schemes raises a wider debate about the value of benchmark anchoring”, Fidelity White Paper, January 2012.

institutions. **The divergent performance of bond classes in recent years (see table below) underlines the potential benefit of adopting a flexible, less constrained and strategic allocation approach.**

The importance of an active, strategic approach to fixed income

Bond type	2005	2006	2007	2008	2009	2010	2011	(YTD) 2012
Government	4.95	3.25	5.95	9.26	0.88	3.63	5.84	2.64
Investment Grade	3.69	3.78	3.36	-4.84	16.3	7.35	4.95	4.57
High Yield	3.36	10.8	2.09	-26.63	60.91	15.26	3.16	6.03
Emerging Market	11.97	10.56	6.36	-10.19	27.24	12.5	8.16	3.60
Inflation-Linked	2.44	2.09	8.43	-0.01	9.28	4.62	6.31	3.42
Difference Best-Worst	9.53	8.71	6.34	35.89	60.03	11.63	4.99	3.39

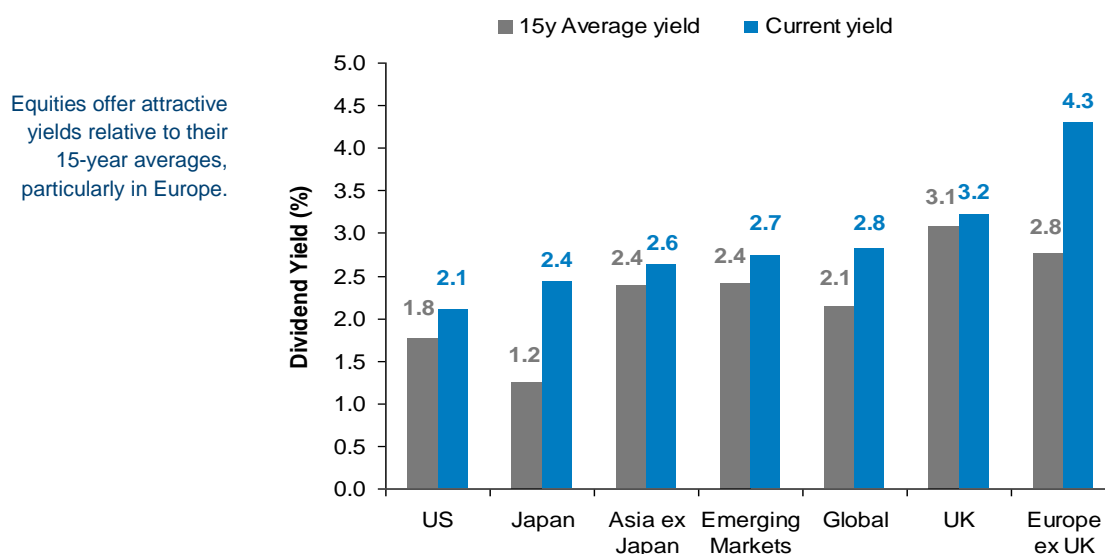
Source: Bloomberg. Calendar returns, YTD 2012 as at 31/05/2012. BofAML Indices, W0G1, G0BC, HW0C, IGOV USD hedged. Barclays Capital World Govt. Inflation-Linked Bond (1 – 10 year) Index USD hedged.

Equity income

In a yield-scarce environment, dividend paying stocks can represent a sensible diversification for income-focused investors. **Critically dividends provide an income stream that grows in real terms and broadly protects against inflation.** Current dividend yield levels are well ahead of their 15-year averages (see chart below), especially in Europe where **currently the equities of over 30% of companies are yielding more than their bonds** (this figure has averaged c.10% in the past 13 years). It is also worth remembering total returns can be significantly enhanced if dividends are re-invested.

In the current environment of lower growth and lower interest rates, the forgotten value of investing in income-generating stocks reasserts itself. The extra returns from dividends can provide a valuable margin of safety against price declines if volatility continues. Furthermore, the evidence suggests that companies with sustainable or growing dividend payments tend to outperform. The fact that many of these proven dividend-payers are high-quality, blue chips with strong balance sheets and high cash flows is also attractive.

Equities offer historically attractive yields



Source: DataStream, as at 25.06.2012. Indices used MSCI Japan, S&P 500, MSCI AC Asia ex Japan, MSCI World, MSCI Emerging Markets, FTSE All Share Index, MSCI Europe ex UK.

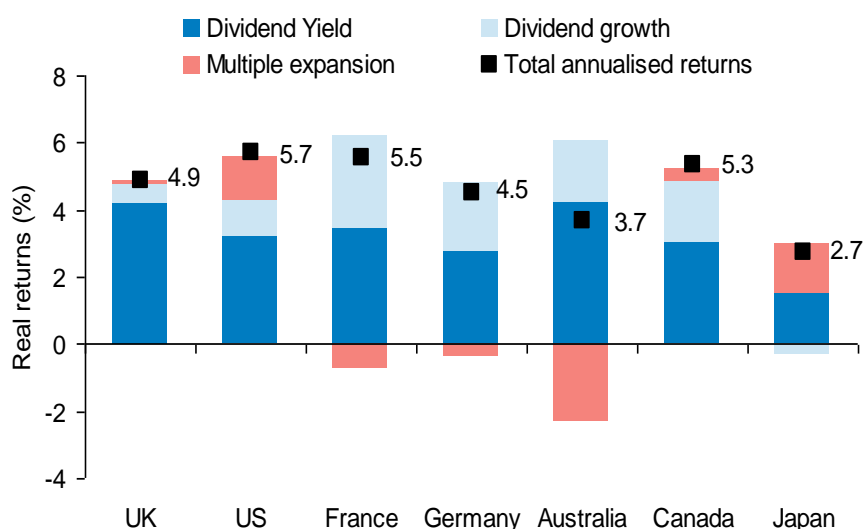
Summary of equity income attractions

- **Good corporate health** - The attractiveness of dividends is boosted by the robust health of the corporate sector. Balance sheets are generally healthy and levels of free cash flow cover indicate that dividend yields are well supported. There is the potential for dividend growth; payout ratios are modest, and at record lows in the US.
- **A defensive, quality tilt** - Equity income strategies have the benefit of being more defensive than the broad market. The income offers a measure of protection to investors against capital losses. Moreover, the companies that pay consistent dividends are often higher-quality, defensive companies, with stable earnings streams.
- **Dividends are more important in a lower growth environment** - In a bull market, when shares might be rising at 10-15% a year, the additional 2-3% yield from dividends is a welcome addition to return. However, when market returns are moderate or when share prices fall, dividends can make all the difference to total returns. In a falling market, a high dividend yield (if the payout is considered sustainable) can support the share price as the income brings in marginal buyers.
- **Valuable when inflation ticks up** - Investors wary of inflation can also take some comfort in equity income strategies. Unlike an investment in bonds where inflation eats away at the real value of the fixed coupon payments, dividends tend to grow in real terms.

Income investing as style rather than an outcome

Equities currently provide attractive income yields. A material benefit of investing in equity income, however, is achieved when dividends are reinvested rather than taken as income. The importance of dividends to total returns is often underestimated. Academic studies evidence that **buying income-generating shares, and reinvesting dividends, is an effective way to invest over the longer-term, given the compounding effect on total returns.**⁵ The chart shows, dividend yield dominates historical total equity returns.

Decomposition of equity returns (Annualised returns since 1970)



Source: SocGen, 31.05.2012. Based on 10-year rolling window averages of MSCI index return, adjusted for inflation and local currencies.

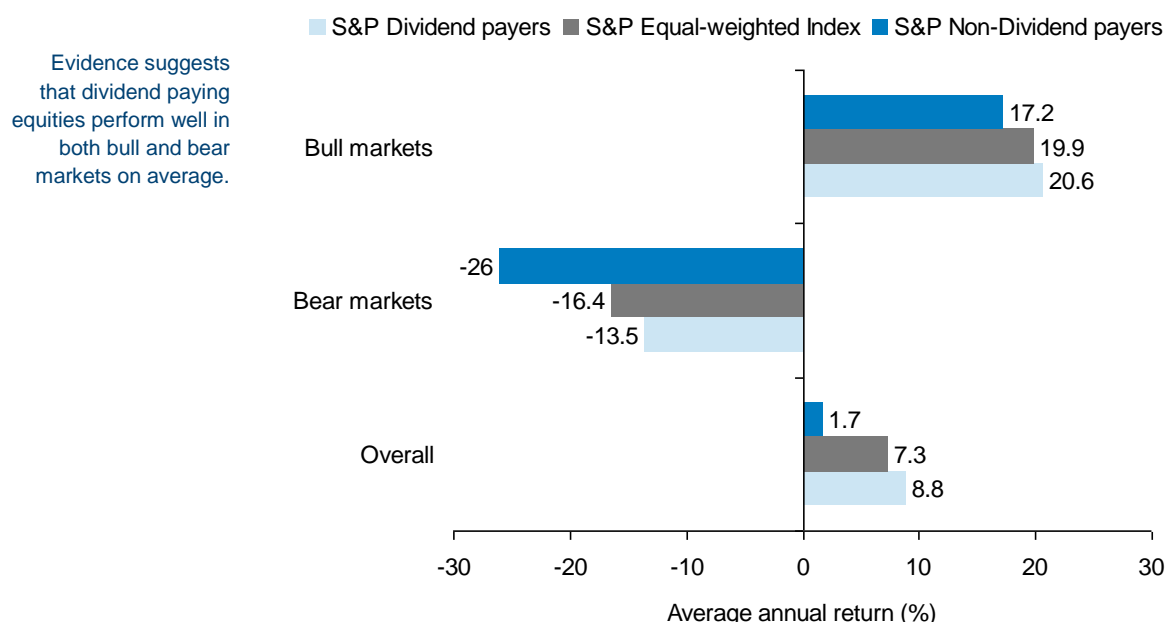
⁵ Academic studies by Dimson, Marsh & Staunton, "Triumph of the Optimists" and Arnott and Asness, "Surprise! Higher Dividends = Higher Earnings Growth" (Financial Analysts Journal Q1, 2003)

Equity income performs in bull and bear markets

Owing to their defensive qualities, it is not surprising that dividend-paying stocks generally tend to outperform in bear markets (as they did in 2011, though not in 2008 when many banks cut their dividends during the financial crisis). This defensive aspect of dividend stocks is a useful feature given the fragility we have seen in markets and the macro issues that have yet to be overcome. Periods of generalised risk aversion afford good entry points for the dividend-focused investor.

What is more surprising is evidence which suggests that dividend-paying stocks also perform strongly on average, in a range of historical bull markets. The chart (below) shows that **in the last 10 bull markets, US dividend-paying stocks outperformed their non-dividend paying counterparts by over 3% a year, on average**. The implication of this is that in the long-run, dividend-payers tend to be better performers than non-dividend payers. One plausible explanation is behavioural; dividend-paying stocks are less likely to be overvalued than non-dividend payers. The latter category includes 'growth' stocks that tend to be more prone to excessive levels of investor optimism.

Equity income performs in bull and bear markets



Source: Ned Davis Research (NDR). Average returns are for S&P 500 stocks and for the period from 31.12.71 to 31.12.10; Note: bull and bear markets are as defined by NDR.

Sustainability of dividends is key

It is a straightforward process to screen for high-yielding stocks within an index and build a portfolio around them. However, this simple quantitative approach fails to recognise that the high yields available on certain shares can be the result of deteriorating fundamentals and collapsing share prices. A high yield alone does not imply value or quality.

This was readily demonstrated in 2008 by the performance of banks. During the financial crisis, bank earnings dropped sharply, by such a degree that dividend payments were no longer sustainable for many US and European companies. At first, the share prices of these banks fell sharply - for a while, they signalled very attractive dividend yields, but any investor buying into this false signal would have been disappointed because the dividends of many banks were subsequently cut back.

Given such risks, **a fundamental approach focused on companies with robust financials and business franchises that allow them to sustain, or grow, their dividends is key**. Such fundamental portfolios that focus on earnings quality and the sustainability of dividends are

materially more attractive for their capacity to outperform than simple, quantitative strategies that screen for high yields, in our opinion.

Dividend distribution and earnings growth: a non trivial relationship

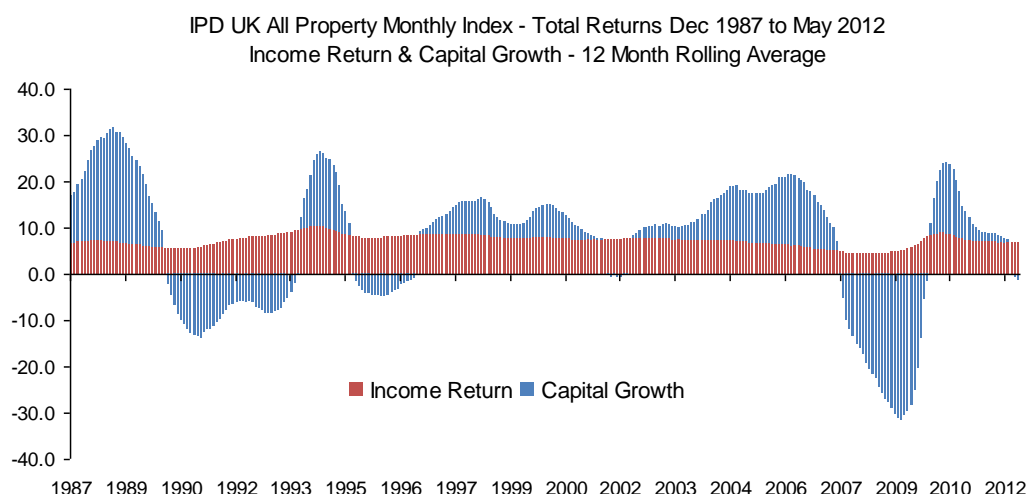
The presumption among some investors that high-dividend paying companies tend to deliver lower earnings growth is flawed, in our opinion. An academic study by Arnott and Asness⁶ reached the opposite conclusion - expected future earnings growth is strongest when current dividend payout ratios are high and weakest when payout ratios are low. The reasons given were that senior management typically pay out larger shares of earnings when they are optimistic the dividend can be sustained. High payout ratios are consistent with more carefully chosen capital spending projects that are also supportive of the share price.

Any simple generalisation of the relationship between dividend distribution and earnings growth is limited by omission of several additional explanatory factors. The importance of deep analytical understanding in a stock selection process is critical to building strong total return portfolios.

Commercial Real Estate

Real estate is often treated with an unwarranted degree of homogeneity. It is typically considered at a geographic or sector level despite the variability in risk and return between individual properties. There is often little attention paid to the fact that investing in commercial property is essentially a bet on future rental growth. **Forecasts of capital return all too often form a simplistic basis for investment decisions.** This is despite the fact that the capital component of total return is volatile and cyclical, whereas the income component is relatively smooth and predictable (see chart below). A better way for investors to think about property is from an income perspective with the option of capital upside.

Smooth income return



Source: IPD, FIL Ltd, as at May 2012.

⁶ Robert D. Arnott and Clifford S. Asness, Financial Analysts Journal January / February 2003.

Attractive location for high-income yields

Real estate is a long term asset class and the current point in the cycle provides an opportunity to access historically high yields. This compensates for some of the traditional risks associated with the asset class such as illiquidity. While current economic conditions are gloomy, property's high income yield provides a good deal of compensation to investors. Given the major corrections in core European property markets are behind us, the prospects for long-term capital appreciation are good. We should see both economic improvement and upward pressure on government bond yields on a 5-year view. A peak in the bond market could provide the trigger for relative outperformance.

European real estate is currently offering yields around 400 basis points in excess of German bunds, though clearly the relative spread has been materially improved by the recent decline in bond yields.

Current conditions
allow investors to
access high,
historically attractive
yields.

These high yields should be particularly attractive to income-focused investors such as pension funds. While they offer an attractive entry point for long-term strategic allocations, there are other supportive catalysts in favour of property. An investment in real estate may also serve as a good inflation hedge; high-quality properties provide income that typically rises in line with inflation.

Income drives return

At the heart of any successful real estate investment process is an understanding that the primary driver of returns is income. In fact, data shows that around two-thirds of total return from real estate is attributable to income. **Over the 25-year period to February 2012, the 12-month rolling average return from investing in the UK real estate market was 9.4%, with 7.3% attributable to income** and 2.1% attributable to capital growth.

A bond market analogy

Property markets in Europe and Asia are very different in nature. **In western European markets, commercial property (particularly prime property) has bond-like characteristics. On the other hand, Asian property markets tend to behave more like equities.**

The analogy bears further inspection. Prime property dominated the initial recovery in real estate post-credit crunch. The major European centres experienced a sharp recovery in prime property in 2009-10, as experienced property investors recognised the value in the market. Prime yields have since contracted materially, while secondary yields have remained relatively high. The outperformance of prime has been partly due to its bond-like qualities and the value that investors place on quality in a volatile environment. Prime property assets are relatively low-yielding (relative to the rest of the market), with reliable income streams - the sort of assets that investors cluster in when uncertainty remains high.

One flight path for what could happen in European commercial property is provided by looking at the corporate bond experience. During the financial crisis in 2008, corporate bond yields increased significantly. As conditions began to improve, investment grade bonds outperformed. However, the bigger opportunity lay in higher-yielding bonds which had suffered more. As it became clear the global economy would emerge from a sharp recession, these were the bonds that stood to benefit most. High-yield bonds became one of the best-performing asset classes on a risk/return basis. It is possible a similar story can unfold in secondary real estate when risk appetite eventually improves.

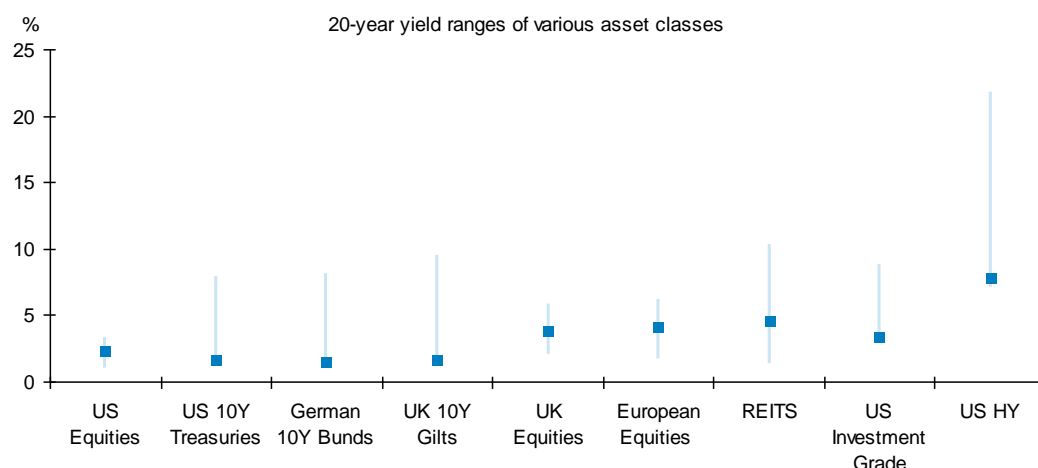
Multi-Asset income

The search for income has become significantly more complex as investors ponder the trade-off between yield and volatility of capital. Given the high premium currently associated with safety, and the range of economic, political, and financial risks associated with risk assets, investing for income in a single asset class is an approach naturally vulnerable to shocks.

An alternative is to consider a multi-asset income approach that invests in a range of assets with different yield, liquidity, volatility, and inflation protection characteristics to achieve a competitive, sustainable income with lower variability in yield. **By blending different asset classes, a dynamic multi-asset approach can deliver lower variability of yield and capital and diversify sources of risk.** Including exposure to real assets (such as commercial real estate) builds in a degree of inflation protection that also helps to mitigate the risk of capital erosion from increasing prices.

Yield environment increases the attraction of a multi-asset approach

Many traditional sources of income offer historically low yields, forcing a wider consideration of assets.



Source: DataStream: 20-year yield ranges for various assets (25.06.92; 25.06.12). Current yield as at 25.06.12.

Striking a balance between risk and return

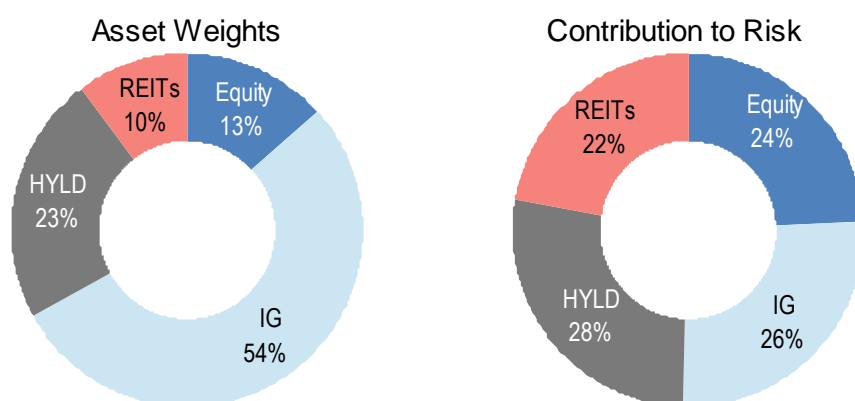
What is the correct strategic asset allocation for a multi-asset income portfolio that seeks to deliver a diversified, stable yield? Interestingly, whether we take a common-sense approach or a risk-focused approach, we get to a very similar outcome. Intuitively, the danger of targeting yield is that we end up with greater exposures to high yield bonds and equities which introduce higher volatility. Similarly, the danger of targeting low volatility is that we end up with a large exposure to investment grade credit and we sacrifice some yield. In both instances, we arrive at portfolios where the strategic asset allocation is essentially driving portfolio risk.

In particular, by including a significant exposure to equity to add yield, we significantly increase the risk of the portfolio. In fact, in an equally weighted portfolio - investing in Asian investment grade bonds; high yield bonds and equities - around 60% of the total portfolio variance would be attributable to the equity component.

A more risk-aware approach is one that identifies a sensible trade-off between the competing objectives of managed volatility and a stable yield; one in which risk management drives strategic asset allocation instead of being driven by it. Risk-parity portfolios, using equal risk contributions (ERC) from each asset class can provide an elegant solution. In an ERC process, asset allocation is determined by ensuring each asset delivers an equal contribution to overall portfolio risk (defined here as variance, see chart on p19). The risk-parity approach can achieve higher Sharpe ratios and is naturally more resistant to equity market downturns than an equally weighted portfolio.

ERC multi-asset portfolio - balanced contribution to risk

Under risk parity, risk drives asset allocation rather than being driven by it.



Source: FIL Ltd, based on an Equal Risks Contributions Asian income portfolio investing in investment grade, high yield bonds, REITs and equities.

Risk parity delivers a diversified, stable yield

We demonstrate the attractions of the risk-parity approach using the example of a 4 asset class ERC portfolio investing in Asian investment grade, high yield bonds, equities, and REITs. We use an Asian portfolio in this example, as a global ERC portfolio would lead to very small allocations to REITs and equities on an asset weight basis.

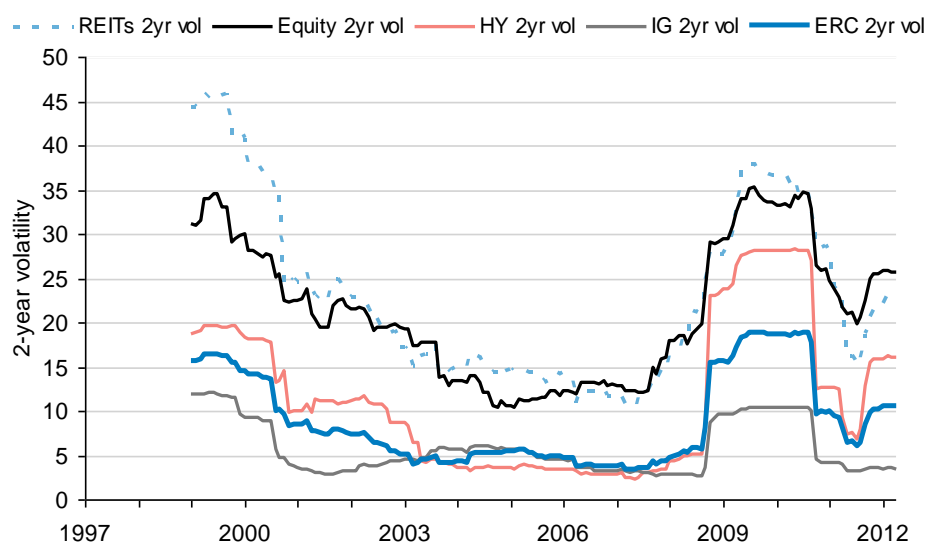
The charts show that this portfolio does indeed deliver an attractive trade-off between yield and volatility. Risk parity informs the strategic asset allocation of the portfolio; however, a dynamic tactical overlay to the strategic framework can also be used to tilt exposure to the most attractive income streams dependent on the market environment.

The first chart below shows that the ERC portfolio delivers less volatility than equities, REITs and high yield bonds.

The second chart (top of p20) shows that the ERC portfolio delivers a higher yield than investment grade, equities and REITs.

ERC multi-asset portfolio: smoothed volatility

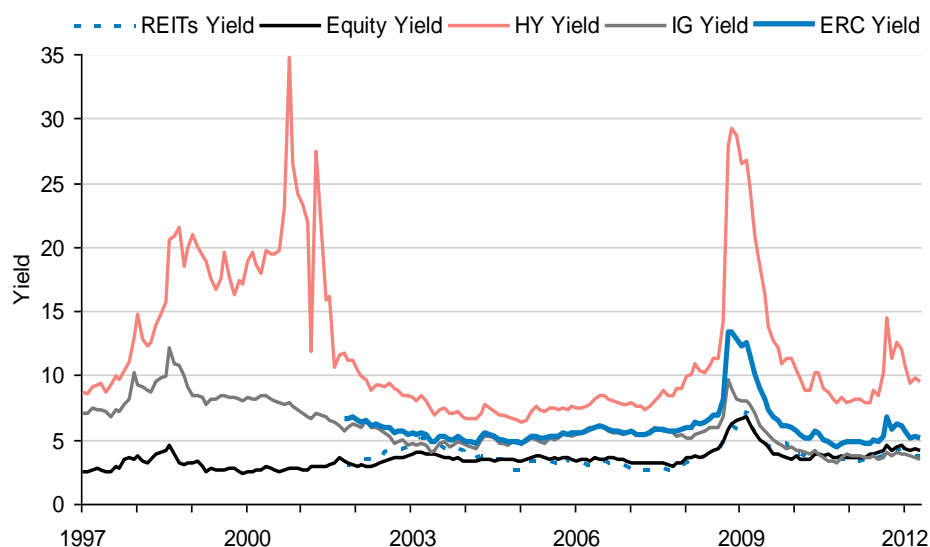
The volatility of the ERC portfolio is generally smoother than high yield bonds, equities and REITs.



Source: FIL Ltd. Based on a Multi-Asset ERC Asian portfolio investing in investment grade, high yield bonds, REITs and Equities.

ERC multi-asset portfolio: blended yield

The ERC portfolio provides a yield in excess of investment grade, equities and REITS.

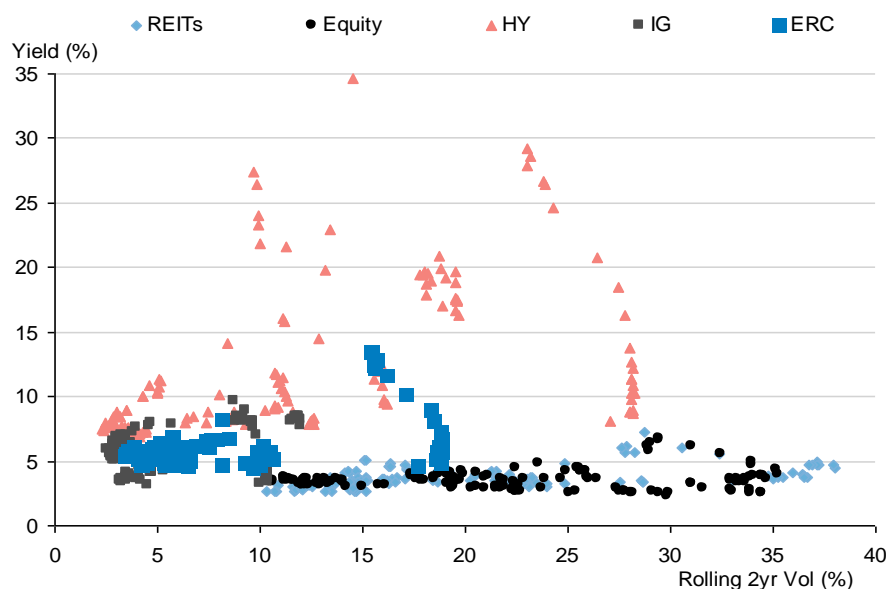


Source: FIL Ltd. Based on a Multi-Asset ERC Asian portfolio investing in investment grade, high yield bonds, REITS and Equities.

The third chart (below) shows the yield/volatility experience over time, demonstrating significant yield variation in high yield bonds and significant volatility in REITS and equities. The ERC Multi-Asset approach delivers a tighter experience on both counts. Investment grade bonds also have an attractive risk/yield trade-off. However, investing solely in this asset class would significantly increase exposure to interest rate risk and potentially limit capital gains at a time when yields are at historical lows.

ERC multi-asset portfolio: attractive risk/return trade-off

The ERC portfolio delivers an attractive risk/yield experience relative to its component asset classes...

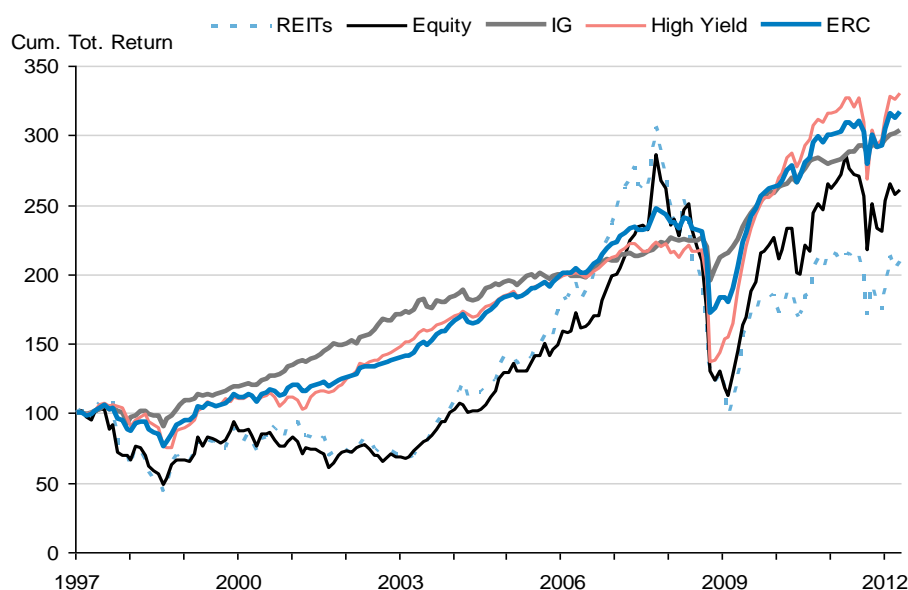


Source: FIL Ltd. Based on a Multi-Asset ERC Asian portfolio investing in investment grade, high yield bonds, REITS and Equities.

Finally, the cumulative return is shown (below) – over the period analysed it is competitive with other assets in a variety of conditions, yet with lower sensitivity to drawdowns than equity, high yield and REITS.

ERC multi-asset portfolio: competitive cumulative return

...and a competitive cumulative return under a variety of economic and market conditions.



Source: FIL Ltd. Based on a Multi-Asset ERC Asian portfolio investing in investment grade, high yield bonds, REITS and Equities.

Multi-asset income summary

In a low yield, low growth world, the challenge facing investors is: how to meet their income needs at an appropriate level of risk? **Diversification offers an efficient route to achieving the investment objective of stable and sustainable yield within a managed risk framework. Risk parity portfolios are particularly well-suited to the prevailing dynamic risk environment** - a characteristic that has prompted greater interest among institutional investors. The risk parity multi-asset approach offers an attractive, risk conscious solution to the fundamental investment dilemma facing investors everywhere - achieving a sensible trade-off between yield and volatility.

Conclusion

Income is a prime contributor to the long term return of all the main financial asset classes; fixed income; commercial real estate and equities. It appears we are in an era where capital returns are much more volatile again – the 'great moderation' looks like it may have been an aberration. As investors adjust to a new investment landscape, this should encourage a greater focus on income-orientated investments.

In the search for attractive yields in fixed income portfolios, we advocate focusing on absolute risk, flexible portfolio construction and best issuers. Within equities, total returns are improved by increasing allocations to stocks with sustainable and strong dividend growth profiles. Finally, with real estate currently providing attractive yields and diversification of risk it is a multi-asset approach that may be of greatest interest to institutional investors aiming to strike an appropriate balance between stability of yield and capital volatility.

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