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Income Investment Funds: Taking up the strain?

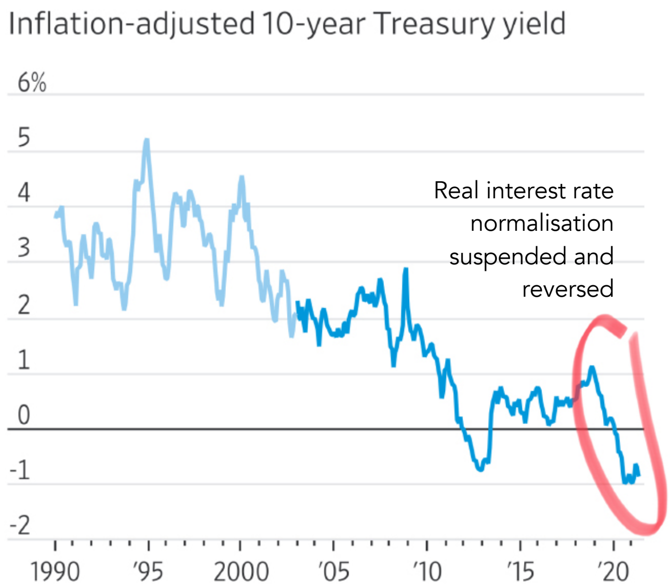
Income is a problem in New Zealand, and not just in the sense of investment income. Its adequacy to meeting an investor's needs is nowadays constantly in doubt. Capital gain or growth, by contrast, has been the primary wealth accumulator for most of the last decade. In the broader New Zealand framework, this is arguably a consequence of governments that have satisfied voters' aspirations by engineering a "capital gains paradise," particularly in the housing market. A range of policies has rewarded those directing their savings into hard assets which are in short supply, and the dissatisfaction that would normally result from sluggish income growth in wages and deposits has been short-circuited.

Nevertheless, there are points in the life cycle where a steady cash income stream is very important. Retirement is obviously one such, but also, periods of study, family-member support, and personal incapacity are times when being able to draw a simple stream of cash on a predictable basis is crucial. Governments have mostly responded with an array of "top-up" payments, but ultimately these increase the taxation burden on other income earners, and simply shift, rather than solve, the problem. In sum, low-interest rate policies in an environment of unchanging (or rising) tax rates creates a major financial strain for many, and enduring policy solutions remain elusive.

Among institutions such as trusts and charities that distribute to beneficiaries or to philanthropic causes, the need for reliable income is greater than ever before. Additionally, a cash income is only meaningful if it exceeds the rate of consumer price inflation. So, banks that offer so-called "premium" interest rates on savings accounts, but charge early-break fees, are merely rowing against a structural tide that makes securing an income stream exceptionally difficult. Interest rate repression policy is a double-edged sword. Central banks, pursuing one emergency measure after another since the GFC, have succeeded in supporting capital gains but, it seems, at the cost of entrenching low- or negative real returns on cash.

Internationally, more exotic asset pools like securitized student loans, royalties, credit card receivables, and insurance policy risks have proliferated. However, these are highly specialized and also introduce very idiosyncratic liquidity risks into portfolios whose owner – the end investor – may not be willing to bear, once a major negative event occurs within those assets. No-one likes "gated" funds with suspended or restructured redemptions in place.

Meantime, in New Zealand, the "number eight wire' solution of buying a rental property (often funded by debt) which yields a positive net cashflow, is reaching the end of its road, hemmed in by inflated valuations and regulatory and tax changes. At the societal level, granting rent subsidies to low-income segments of the population to help pay for accommodation, funded out of general taxation, buys time but is not a sustainable solution. An extreme example of the dilemma is the yield available on simply leasing a patch of central city development land from a council and renting out parking spots. This game probably enjoys one of the best income yields now available from any investment in New Zealand, but it highlights the extent of regulatory, local and contractual or licencing risks that are encouraged by the suboptimal environment we find ourselves in, both as investors and private citizens. Thus, we see an eruption of advertising for "advantaged yield investments."



Source: Wall Street Journal.

Investment innovations (and risks) in the Income universe

Income funds within the funds management industry are bearing this "yield strain," emerging in a plethora of formats, and the sector is something of a mixed bag, with many underlying asset types and qualities involved. What is critical, is ensuring that the funds' manager is skilled at assembling a higher-yielding asset pool that does not compromise on asset quality or on the sustainability of income, but that can still provide a solid stream of distributions to a reliable timetable.

Solutions have arisen in the investment product arena, to attempt to address the gaps that many are now experiencing in their financial wardrobes. The common situation of the elderly, being asset-rich but cash-poor, has given rise to reverse-annuity mortgages, and other residential property-based structures that can generate cashflow, sometimes by consuming accumulated capital. The focus of this article is the targeted funds that take the approach of broadening the investor's underlying asset pool, to lift the income a fund can pay. Most commonly, the existence of Income Funds is a professionalization of the amateur investors' chasing of high-dividend individual stocks. That is a good thing, as the risk faced by individuals seeking out the "yield stocks" unadvised, is that come periods of market volatility, they do not have the fortitude to stay invested and sell out in panic, often losing more on liquidation than they achieved in one (or in several) years' worth of accumulated dividend income.

Additionally, individual investors lack advantages of scale, and so can find themselves paying high brokerage and other commissions that further erode their total returns on exiting their holdings. Events like the CoVid-19 market panic, which hit transportation and travel equities hard, are a case in point. Many investors had previously been drawn into those sectors by their advantageous dividend levels, but have needed to endure sharp price volatility as the price of benefiting from those pay-out streams. Dividend suspensions in times of corporate crisis is an allied risk, to which the non-professional investor may be particularly exposed.

The best model – active, sustainable income asset management

There is really only one way to convincingly address the problems noted above: skilled diversification. The group of available assets from which to build a robust Income Fund solution is well-known. Commercial Real Estate (the Real Estate Investment Trust or Listed Property sector,) quality long-duration assets in Infrastructure whether physical or social, a carefully-chosen and actively-managed set of listed equities from other sectors, and a well-diversified selection of corporate and semi-sovereign bond securities.

Because individual countries' markets can suffer concentrated periods of vulnerability due to idiosyncratic local factors, it is preferable to assemble an Income Fund's asset pool quite widely. However, this principle is complicated in New Zealand, because by global standards our domestic asset pool has enjoyed a "yield premium" compared to other developed markets'. Historically, this has at times reflected inflation differentials, small-country and -currency risk premia, and the simple reality that local investors have a high hurdle rate to go beyond Term Deposits and bank bonds, due to their historically-generous interest rate levels and low perceived credit risk.

For the last few years, however, capital inflows from yield-starved global investors have pushed many NZ yield premia on such bond-like investments lower than even the Australian and the US equivalents. New Zealand went from being a Developed economy with Developing market debt yields, to being one of the pack of countries with negative real (i.e. net of expected inflation) bond yields. While we are not in the unenviable European and Japanese situation of enduring negative nominal yields, the reality for a typical private investor is that we might as well be – an income stream that does not keep pace with inflation, is simply inadequate. Degrees of inadequacy is not a concept on the radar screen, for normal savers operating outside the financial professions, and going backwards is simply going backwards.

All this underscores the importance of employing an asset manager with proven skill in identifying the most robust yield-focussed domestic and international securities. Simply waiting for resumed higher inflation will not necessarily solve the current dilemma. Central Banks may defer raising policy interest rates, or lift them only marginally, if they feel recent years' recovery and extension of capital gains in other asset markets could be seriously impacted by tightening financial conditions. Policy makers greatly fear unleashing fresh deflationary forces akin to those seen for decades in Japan, after the asset price bubble of the 1980s burst. Therefore, any interest rate "normalization" will likely continue to be glacial.

Avoiding undue asset class concentration

While selected listed Property and Equity investments supply much of the investment solution, Japan's experience is a template for why to avoid over-concentrating in those sectors. In addition, a well-balanced Income Fund should also maintain a decent debt security allocation. The reasons go beyond traditional portfolio diversification rationales. Firstly, yields in global bond markets (particularly corporate bonds) are very sensitive to shifting levels of liquidity risk, and also, solvency risk. Therefore, to an attentive active asset manager, holding such instruments in the fund can provide a "bellwether" or a leading indicator of trouble to come, in the other asset classes that are conventionally called "Growth assets."

For instance, the consistency and depth of monitoring provided to credit risk has been shown to signal in advance, deterioration and even major cyclical reversals in shares and property markets. One other factor, which is not so well appreciated, is that in times of trouble, global authorities have been considerably more willing to intervene and "rescue" debt securities, both by adding them to Central Bank balance sheets and by enabling backstops and supportive swaps. This adds in a dimension of "in practice" resilience to the fund, one that is not really predicted by investment theory – in which one non-sovereign asset type is not considered more insulated or insured than others, simply due to a government's additional willingness to underwrite it with taxpayer resources. The legacy of the dozen years' of special interventions made to soothe markets since the GFC, is an investment landscape wherein predicting the "State rescue prospects" of distressed assets now plays a concerningly meaningful role. That alone cautions against illiquid or unsaleable underlying investments for a good quality Income investment vehicle, as they will behave unpredictably in times of stress.

7 rules for Income investment fund design

In summary, when building an Income investment fund, it is crucial to take many variables into account. Some of these principles are:

- Active management, as both agility and security selections are crucial.
- International asset reach, as individual economies like NZ are too concentrated, to be a reasonable basis for generating sustainable income on a multi-decade timeframe.
- Learning the lessons of the past, in terms of not promising return without risk. The claims made for Collateralized Debt Obligations (CDOs), Over-leveraged loan portfolios (CLOs), Consumer Finance Debentures, Subordinated or Unsecured Mortgages and a confetti-shower of marginal "receivables" in the world of commercial securitization need to be scrutinized thoroughly at inception, and consistently throughout the life of the investment product.
- Taxation is a constant, and tax efficiency should be part of product construction. However, products should not be built around a given tax regime, which may change.
- Currency and Foreign Exchange exposure management, for the international assets held is important, as the traditional "hedging premium" available to NZ investors is now minimal.
- Inflation-proofing the fund to some degree is possible by holding assets with performance that historically outpaces unanticipated inflation, and which have innate inflation-hedging characteristics.
- Do not over-complicate the fund with engineered risk-mitigation structures. These are quite expensive, and although they appear to provide security or "insurance" they often either drain the fund return over time due to in-built costs or worse, they fail to function when they are most needed, due to derivates market disruptions in panics.

Managing the "income versus risk trade-off" needs active skill

The global economic situation now prevailing, which renders quality income yield in short supply, is not likely to change soon. Investors should not wait for a still-uncertain period of rising inflation, lifted policy interest rate levels, and positive real returns from bonds to resume. Such a development is far from assured. Furthermore, even if sovereign bond yields move higher domestically and globally, this is likely to usher in a period of rising volatility in the equity sectors that will need careful navigation. An informed assessment is needed, both of the time period for which such volatility may be expected last, and whether the yields being recouped from the asset pool are sufficient to justify that degree of price volatility.

The best template for Income funds balances enhanced yield, with actively monitored asset exposures, and delivers distributions at a fee level which does not erode the investors' return unduly. Investors should scrutinize products carefully, and make sure all these characteristics are satisfied. A good benchmark for gauging attractiveness is the difference between the fund's annual pay-out estimate (minus its fee) and the 6-month Term Deposit rate, which is currently just 0.8% p.a. A net expected return of 1.5% or greater should offset inflation. The total return may prove higher, where assets benefiting from inflation are held within the fund.