Ashton Reid

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Legg Mason Real Income

Retirees need income to live on but relying on traditional sources like term deposits in a low-inflation low-interest-rate world locks them into downward spiraling income levels even though their costs are still going up. There has to be a better, smarter way, writes **Alex Dunnin**.

Total returns since inception in December 2010 of 22% p.a. of which the income return is 7.7% p.a. and the capital gain is 14.3% p.a. These returns are impressive not just against the broad equity market but against inflation as well, meaning the fund is doing just it was designed to do – deliver robust income returns while simultaneously growing its capital base.

What can you offer clients who want to outperform term deposits without taking on sharemarket volatility? Real assets aren't exotic, they are the hard assets we see and use every day – listed property, utilities and infrastructure and more often than not, consumers pay more each year for their use. That means real assets can potentially increase their revenue base and offer sustainable, inflation-protected income to investors.

The Legg Mason Australian Real Income Fund has recently been added to selected AMP and IOOF APLs and offers a unique combination of real assets unmatched in any other Australian fund. Backed by a Highly Recommended Lonsec rating and a 'Best New Product of the Year' Award by Rainmaker in 2011, the Fund has received increasing interest and usage by Australian advisers. The Fund has achieved the highest rating from a major Australian research house and won the Rainmaker Award in 2011 for the 'Best New Product of the Year'. Since its launch in December 2010 to May 2013, the Fund has returned 22% p.a. with an income return of 7.4% p.a., after fees.

Legg Mason set itself a challenge for themselves when it was becoming all too clear that Baby Boomer retirees were confronting rising living costs like energy and medical bills yet their income was derived from sources going in the other direction.

"That income needs to grow along with the retiree," said Ashton Reid, real income portfolio manager at Legg Mason Australian Equities. "But many financial planners would have put them into bonds or cash where the income stream simply isn't designed to grow."

Reid said the tension point can be illustrated by how the inflation rate confronted by retirees is much higher than regular inflation. In fact due to different spending mix effects, over the past eight years retirees have experienced an additional 4% loss over and above the 26% loss in spending power from rising consumer prices. Over time that gap savagely eats into their buying power.

Comparisons of growth in cost of living versus six monthly income from term deposits over the past year are even more confronting, showing a 19% difference in where income needs have climbed compared to where term deposit rates have fallen.

"Term deposits move up and down in cycles and the income they generate will move with interest rates. For example, today interest rates are going down but retiree costs are still rising each day," he said.

But could Legg Mason design a product to break that nexus? Well they think the answer is yes, and based on the reaction they have stirred with their Real Income Fund, they may well be right.

Design it right, then build it

The first step to assembling a product to fill this void is establishing precisely what needs income investors have – this determines the characteristics this new product should have. While this seems so obvious now, it challenged the convention that fund managers launch products from an existing asset class skill set, rather than building a solution from a blank canvas of what investors actually need.

What then were these characteristics?

Reid said the income needed to grow with the retiree, but to do this the capital base should be able to grow as well.

This income also needed to be sustainable, have minimal volatility and built-in risk. In other words, they had to be confident this income would not only be coming in today but that it would roll in year after year at higher amounts.

The assets the fund was investing into also needed to be liquid and, above all, it needed to be transparent as retirees and Legg Mason had to understand exactly what would be in their portfolio.

"If the GFC showed us anything, it is that we need to know where our money is invested," said Reid.

With these design parameters the team at Legg Mason Australian Equities set about their task like engineers tasked with building a wind shelter for the tropics.

The breakthrough was when they realised that years of research experience had taught them that a specialist portfolio custom selected from the pool of companies listed on the Australian stock exchange could meet these objectives and yet be tough enough to withstand macroeconomic headwinds.

Construction phase

With their designs locked down they set about construction. The sturdy framework would be held together with a 50:50 mix of only the most suitable AREITs combined with listed infrastructure and utilities that included gas and electricity grids, airports, seaports, toll roads and railways. "These are essential assets to the economy that you use every day, they move portfolio exposure away from the business cycle" said Reid.

Drilling down to this list of preferred stocks would obviously require some screening, like filtering out companies that are over-leveraged or that, recalling the initial design specifications, would be unlikely to pay sustainable dividends.

This approach is also benchmark-unaware, yet another benefit. Building what Reid said was a sensible portfolio required Legg Mason to not follow normal index capital weightings but to instead ensure they had high levels of diversification.

This would be achieved by never allowing any stock holding to exceed 7% of the portfolio though in practice a typical holding is in fact much lower at only about 4½%.

"This enabled us to diversify not just across stocks but across the economy," said Reid.

Constraining the portfolio to Australian companies has other benefits as well. "You avoid currency volatility and especially the deflation we are starting to see in overseas countries," he said.

The surprise, said Reid, is not how successful their design and product construction has been but that he believes there is no other product in the market like it.

It leads Reid to speculate that maybe this is because investment managers are usually infrastructure specialists or property specialists, but rarely both. "Other managers may offer infrastructure or AREIT funds because that is their skill. We did it the other way around."

Track record

Design and construction is one thing but the acid test is the result. So what are the numbers like?

Total returns since inception in December 2010 of 22% p.a. of which the income return is 7.7% p.a. and the capital gain is 14.3% p.a. These returns are impressive not just against the broad equity market but against inflation as well, meaning the fund is doing just it was designed to do – deliver robust income returns while simultaneously growing its capital base.

Over the past year to end May 2013 the performance is just as solid. An income return of 7.9% with capital gain of 21%.

The fund's drawdown (peak to through full) of 3.1% compares favourably to the A-REIT and ASX300 indices, at 10% and 15.4% respectively.

Legg Mason Real Income performance to May 2013 (%p.a.)

	3 months	12 months	Since incep (Dec 10)
Dividend Yield	0.40%	7.64%	7.57%
Franking Credit	0.04%	0.21%	0.17%
Income Return	0.44%	7.86%	7.74%
Capital Gain	3.02%	21.02%	14.25%
Total Return*	3.47%	28.92%	22.02%
ASX 300 Total Return	-2.35%	27.27%	8.65%
A-REIT 300 Total Return	1.51%	30.62%	16.09%

** Assumes zero percent tax rate and full ranking benefits realised in tax return.*
Past performance is not indicated of future performance. Returns are quoted before fees.

Who should use it?

The Legg Mason Australian Real Income Fund is purpose built for modern day income investors and Reid said these are precisely the people the fund is aimed at, especially retirees wanting a return above cash but not the risk of the broad sharemarket.

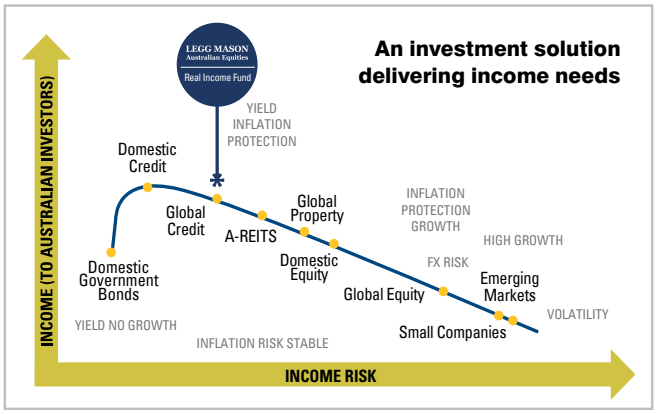
But the success of the fund is not just its appeal to retail investors but smaller institutions looking for a portfolio of property and infrastructure that their scale does not allow them to assemble themselves.

Even larger institutions careful to protect their liquidity management strategies are finding the Legg Mason Australian Real Income Fund worthy of a look.

The multiplicity of uses for the fund is not just because of what is inside it but that because it has been designed to achieve specific characteristics rather than asset weightings, retirees can use it to complement or substitute a high allocation to bonds, said Reid.

To understand why this is the case, Reid explained that in traditional guaranteed annuities, the product operator buys real assets for investors, and sometimes higher risk derivatives, and from that the retiree income stream is paid.

"But with this fund it just makes more sense to do it yourself and then get the upside," said Reid. **FS**



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Investors should seek their own independent professional advice. Applications to invest in the Legg Mason Australian Real Income Fund can be made using an application form comprising part of the current Product Disclosure Statement, which is available from www.leggmason.com.au