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Chris McNickle joined Fidelity as Global Head of Institutional in 2011.
In this role, he is responsible for Fidelity's institutional businesses in Europe and Asia which provide investment services to organisations including pension funds and sovereign wealth funds. Chris joined Fidelity from the consulting practice Greenwich Associates, where he spent nine years as a Managing Director, first as Head of Operations then as Sector Leader for Investment Management. Prior to this, Chris worked for a number of major financial institutions, including JP Morgan and Prudential Retirement Services.

THE AGE OF INCOME

Chris McNickle

The search for income – already a powerful investment theme – is set to grow in importance over the next decade and beyond.

Low interest rates and bond yields have diminished traditional sources of income. This is encouraging investors to look beyond government bonds to income-paying assets with more attractive risk-reward characteristics. At the same time as the supply of income has become challenged, demographic trends are likely to increase overall demand for income-generating assets.[1]

The growing importance of income investing is revealed by recent research carried out among Fidelity's institutional investor base. An independent survey of major institutional investors across Europe and Asia, undertaken by Greenwich Associates, indicated that most investors have experienced a fall in yields in recent years, which has led to an increased emphasis on income, going forward, and a greater willingness to consider a wider range of income-paying assets.[2]

There a number of drivers encouraging this shift in investment imperatives. First, the investment environment has changed markedly in recent years. The world economy is in the midst of a fundamental 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 the ongoing sovereign debt crisis.

The crisis 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, 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.

Table 1.

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

Income is likely to become a more important driver of total returns as significant debt overhangs impair the growth prospects of many OECD economies. The Great Moderation – the period from the mid-1980s to mid-2000s when favourable conditions resulted in a noticeable dampening of economic cycle fluctuations (more stable GDP, employment, and less regular recessions) – appears to be over.

Economic cycles have become shorter and more volatile as debt and deleveraging act as a drag on growth. Some economists believe debt burdens above 90% are associated with 1% lower average economic growth.[3] Many advanced economies (Japan, Italy, Portugal, Greece, Ireland and the US) already have debt/GDP ratios that exceed this threshold.

The experience so far suggests 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.

At a time when traditional sources of supply are shrinking, demographic factors are increasing the demand for income. 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 global retirement population is set to surge from 800 million in 2011 to 2 billion by 2050, (according

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to the United Nations)[4]. Average life expectancies have increased markedly in the last 50 years. Individuals being born in developed nations now can expect to live well into their 80s on average. This is forcing a major reassessment of how much money/income pensioners need in retirement.

An asset class perspective

In an environment of high sovereign risk, investors are increasingly considering the income-generating characteristics of investment grade and high yield bonds, equities and real estate. 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.

We believe 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.

Fixed income: looking beyond government bonds

Bonds have traditionally provided the first port of call for investors looking for income. However, the sovereign bond market has now become polarised between high risk issuers (such as those in peripheral Europe) and expensive safe havens. There has been a huge reduction in the pool of sovereign bonds with AAA status, while demand for assets considered safe has been significant, putting downward pressure on the yields of US and German bonds and increasing the price of safety.

There are two strategies which bond investors can consider: 'best issuers' and more flexible, 'strategic' mandates. 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 offer better credit risk characteristics than many sovereigns and allow investors to offset sovereign concentration risk.

Aggregate bond indices and funds benchmarked against them now entail significant concentration risks within sovereign bonds. For instance, around half the risk in the Bank of America Euro Aggregate Bond Index comes from Mediterranean sovereign bonds. As investors move away from products that expose them to indebted governments and institutions, there will be greater interest in more flexible bond portfolios that aim to balance risk and return by investing across a range of bond classes.

Equity income: historically attractive yields

In the current environment of lower growth and lower interest rates, the forgotten value of investing in high-quality income-generating stocks reasserts itself. Current dividend yield levels are well ahead of their 15-year averages – especially in Europe where the equities of over 30% of companies are yielding more than their bonds (this figure has averaged c.10% in the past 13 years).[5] The extra returns from dividends can provide a valuable margin of safety against price declines if volatility continues. 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.

A high yield alone does not necessarily imply value. This was readily demonstrated in 2008 when bank earnings dropped sharply, by such a degree that dividend payments were no longer sustainable for many US and European banks. 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.

Commercial real estate: driven by income returns

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. 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.[6]

Real estate is a long term asset class and the current point in the cycle provides an opportunity to access historically high yields. 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.

The search for income has become significantly more complex as investors ponder the trade-off between yield and volatility of capital.

A 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 from each asset class can provide an elegant solution. In such a process, asset allocation is determined by ensuring each asset delivers an equal contribution to overall portfolio risk. The risk-parity approach can achieve higher Sharpe ratios and is naturally more resistant to equity market downturns than an equally weighted portfolio.

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.[7] **FS**

Notes

1. *Full details can be found in Fidelity's White Paper: The Age of Income: the growing importance of income investing in turbulent times.*
2. *Greenwich Associates interviewed 52 major institutional investors in Asia and Europe in June 2012. Institutions surveyed included leading insurance companies, blue chip corporate and local authority pension funds, including both defined benefit and defined contribution schemes. The full results of the survey can be found in the Fidelity White Paper: "The Age of Income: the growing importance of income investing in turbulent times."*
3. *Carmen M. Reinhart & Kenneth S. Rogoff, 2010. "Growth in a Time of Debt," American Economic Review, American Economic Association, vol. 100(2), pages 573-78, May.*
4. *World Population Aging December 2009, United Nations, Dept Economic and Social Affairs.*
5. *Source: DataStream, current yield v 15 year average yield 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.*
6. *IPD, FIL Ltd, as at May 2012. Based on the IPD UK All Property Index – % 12 month rolling average returns from December 1987 to May 2012.*
7. *More details on the risk parity approach, including volatility, yield and return analysis based on an illustrative Fidelity portfolio, can be found in the Fidelity White Paper, The Age of Income: the growing importance of income investing in turbulent times.*

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