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The hunt for yield during COVID-19

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The search for yield is proving to be an endless challenge for investors during the market crisis brought on by the coronavirus (COVID-19) pandemic. Finding attractive yield has become more difficult than ever as central banks around the globe have coordinated simultaneous interest rate cuts, and companies have reduced dividend payouts due to the economic impact of the lockdowns.

Prior to COVID-19, historic bond yields were already subdued as central banks kept interest rates at ultra-low levels to support the economic recovery after the global financial crisis in 2008.

On 10 June 2020, US Federal Reserve (Fed) chair Jerome Powell stated, "We're not even thinking about thinking about [sic] raising rates … we are strongly committed to using our tools to do whatever we can for as long as it takes." Statements like these reinforce the notion that ultra-low interest rates are here to stay for some time.

Self-managed superannuation funds and not-for-profit organisations that rely on yield to distribute income now face a dilemma. That is, as cash rates and bond yields have been compressed to all-time lows, should they chase yield and move up the risk curve?

This paper discusses how COVID-19 has impacted certain securities which many investors have previously relied upon for income generation, and explores different investment options that offer yield with consideration to the risks involved. Further, it argues that diversification and a focus on strategic asset allocation are essential for generating a sustainable income stream, and considers other asset classes for diversification and reliable income generation.

The great dividend crunch

One of the main advantages of investing in Australian shares is the access to high-dividend-paying companies as well as the benefits of franking credits. Domestic dividend-paying shares can provide substantial yield, especially to retirees and charitable trusts that require yield to generate ongoing income.

Another benefit that makes Australian shares even more attractive includes the tax benefit in the form of franking credits. Dividends for Australian resident companies are paid out of profits which have already been subject to Australian company tax. This means that shareholders receive a rebate for the tax paid by the company on profits distributed as dividends.

The lockdowns brought on by COVID-19 have caused a sudden decline in sales and revenue across most industries, directly impacting profits and the ability of companies to pay out dividends to shareholders. A Bloomberg article 'Australian investors set for biggest payout cuts in a decade' of 15 July 2020 reported that approximately a third of S&P/ASX 100 stocks have already reduced, deferred, suspended or cancelled dividends since the February reporting season.

COVID-19 has not only impacted dividend payouts in Australia but also across the world. Earlier this year, the European Central

Bank recommended that companies in Europe cease dividend payments in order to keep sufficient cash buffers in place. The Fed stopped US banks from increasing dividends or resuming share buybacks through the third quarter of 2020, given the economic uncertainty brought on by COVID-19.

How do income-seeking investors protect themselves from this great dividend crunch? Sound investment strategies involve investing in quality companies with strong balance sheets and sustainable cash flows. Companies with low levels of debt and high cash reserves can weather market turmoils as they can continue their business operations, remain profitable and pay dividends to shareholders.

In order to minimise the risk of drawdowns (which is the peak-to-trough decline during a specific period for a portfolio), it is crucial for investors to diversify their portfolios and reduce concentration risk that comes with holding a single asset class such as Australian shares.

Are hybrids the answer?

Given the uncertainty and volatility in sharemarkets, some investors are considering moving up the capital structure into hybrids. 'Hybrid' is a term used to describe securities that combine elements of fixed interest securities and equity securities. They include preference shares, convertible notes and capital notes.

Hybrids can pay relatively reliable distributions like bonds, however, they often have complex features including options to convert into equity, and uncertain maturities. These features can result in them behaving like equities in some circumstances.

Hybrids usually rank above common equity in the capital structure, but can rank below other forms of fixed income and debt should a company default on its debt obligations (see Figure 1). Unlike fixed income securities such as government or corporate bonds, most hybrids are subordinated and unsecured, meaning that repayment is not collateralised over any asset.

Hybrid securities do not offer the same level of security or ranking in the capital structure compared with other fixed income securities, so it is important for investors to determine if the additional risk is being rewarded through sufficiently higher returns.

Some hybrids may convert to ordinary shares or be written off completely if the issuer experiences financial difficulty. Hybrids may also include terms that allow the issuer to exit the deal or suspend interest payments when they choose. When considering hybrids, investors must look carefully at these terms.

Hybrids should not replace defensive fixed interest securities such as government and corporate bonds as they do not have the same risk-reward characteristics. This is not to say that hybrids should be entirely dismissed. A lower allocation within a well-diversified portfolio can be implemented, provided that the risks and returns of hybrids are well understood.

Higher yield = higher risk?

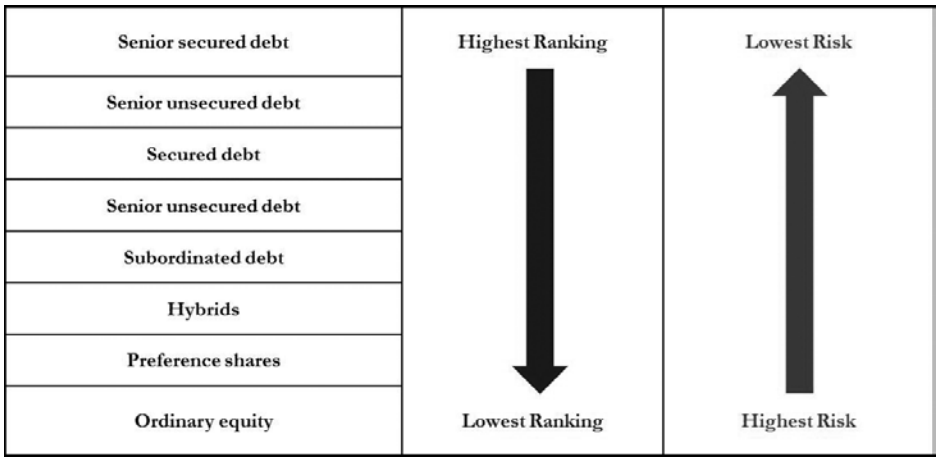
Ten-year Australian Government Bond yields dropped from 1.30% at the beginning of 2020 to below 0.90% in July 2020. With yields starting low and falling to even lower levels, investors are seeking yield elsewhere by moving up the risk curve and investing in 'high-yield' debt such as non-investment-grade corporate credit and junk bonds.

Corporate credit securities are non-treasury fixed interest investments issued by companies to raise capital in the form of debt. Investors holding corporate credit benefit from having priority of payment above equity investors for payment of coupons and repayment of principal. Corporate credit can offer higher yields than cash and term deposits with less volatility than shares and can help diversify a portfolio.

The quote

The best defence against large market drawdowns is to have a well-diversified portfolio with a mixture of uncorrelated asset classes.

Figure 1. Hybrids: risk and capital structure ranking



Source: Koda Capital, Investing for non-profits; Hybrids are not fixed income

Credit agencies such as Standard and Poor's and Moody's assess the credit quality of companies and provide a rating to reflect their creditworthiness. Credit agencies use different designations, consisting of the uppercase/lowercase letters, numbers and plus/minus signs to classify the credit quality rating.

Example

To be considered an investment-grade issue by Standard and Poor's, the security must be rated 'BBB–' or higher. Similarly, for Moody's, the security must be rated 'Baa3' or higher to be considered investment grade (see Table 1).

Table 1. Standard and Poor's and Moody's credit rating scales

Grade	Standard and Poor's	Moody's
Investment grade	AAA	Aaa
	AA+	Aa1
	AA	Aa2
	AA–	Aa3
	A+	A1
	A	A2
	A–	A3
	BBB+	Baa1
	BBB	Baa2
	BBB–	Baa3
Non-investment grade	BB+	Ba1
	BB	Ba2
	BB–	Ba3
	B+	B1
	B	B2
	B–	B3
	CCC+	Caa1
	CCC	Caa2
	CCC–	Caa3
	CC	Ca
	C	
	D	C

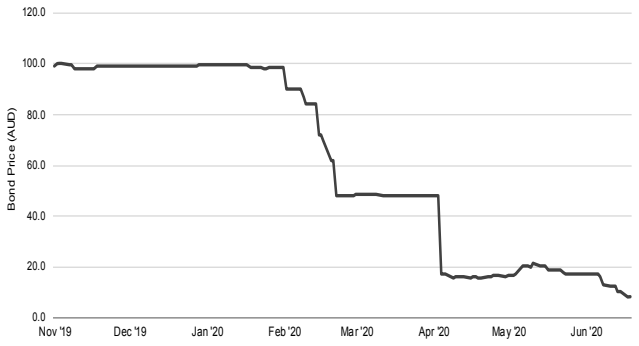
Source: Standard and Poor's Global Ratings Definitions (2020); Moody's Rating Symbols and Definitions (2020)

Non-investment-grade corporate credit can offer investors higher yields compared with investment-grade bonds, however, they have a higher risk of default and missed debt repayments. Credit risk can be mitigated by considering the security's ranking in the capital structure, the company's credit rating, level of gearing and ability to service its debt.

Case Study: Virgin Australia Airlines

In November 2019, Virgin Australia raised $325 million in debt by offering its unsecured notes to investors as the company was seeking to purchase back its own frequent flyer program. Both Standard and Poor's and Moody's rated the Virgin Australia Corporate Bond as non-investment grade from the time of issuance. During the market crisis brought on by COVID-19, these notes plunged in value (see Figure 2) before being suspended from trading when Virgin Australia went into administration.

Figure 2. Virgin Australia: corporate bond price



Source: Bloomberg; Virgin Australia Corporate Bond VAHAU price from Nov 2019 to June 2020

It is difficult for private investors to mitigate risk by holding onto single direct corporate credit positions such as the Virgin Australia corporate bond or even a handful of direct corporate credit positions. Instead, investors can achieve an appropriate spread of risk and return by investing in a diversified managed fund or exchange-traded fund (ETF) that provides exposure to investment-grade corporate credit securities.

Sovereign risk with emerging market bonds

Investors seeking higher yields can also invest in emerging market (EM) bonds. EM bonds are debt securities issued by governments and companies in developing countries. They tend to have higher credit risk and, therefore, offer higher yields than investment-grade government bonds in developed markets. Potential threats include political uncertainty, socioeconomic instability and sovereign default risk.

Returns from EM bonds are generally uncorrelated to other traditional asset classes such as shares and investment-grade bonds. However, the increased debt burden from emerging countries as a result of increased borrowing costs could increase a country's likelihood of default.

Argentina, Brazil, Greece, Russia, and Pakistan are illustrations of countries that have defaulted over the past two decades. More recently, Argentina missed a bond payment in May 2020. This meant that Argentina technically entered default for the ninth time in its history. The perceived credit risk can severely affect a bond's price movement and volatility as shown in the performance of the Argentina 15-year sovereign bond (see Figure 3 on the next page).

During a sovereign default, where a country fails to make an interest or principal payment, the value of the bond does not necessarily disappear overnight. The bonds often continue to trade at sharply reduced prices; the steep discount is often referred to as a 'haircut'. Some of the debt can be written off, and governments often negotiate with bondholders to delay payment.

When investing in EM bonds, investors must consider the likelihood of the country defaulting and perhaps invest in a diversified managed fund or ETF to spread the risk rather than taking concentrated positions in any given EM. Moreover, if investing in EM bonds, a lower allocation should be applied relative to other fixed interest securities.

Figure 3. Argentina 15-year sovereign bond price

Source: Bloomberg, Argentina 15yr Sovereign Bond price from Dec 2016 to June 2020

Real assets and the liquidity premium

Liquidity premium refers to the additional yield demanded by investors when any given security cannot be easily converted into cash for its fair market value. When the liquidity premium is high, the asset is deemed to be illiquid, and investors will want compensation for the additional risk of investing over an extended period.

If income-seeking investors can afford to take on liquidity premium, they could consider adding real assets to their portfolios. Real assets such as direct commercial property and unlisted infrastructure have traditionally provided investors with steady, predictable income streams as well as capital appreciation from growing populations.

However, with the COVID-19 lockdowns, rental income from commercial properties is tumbling as business tenants struggle to pay their leases. When investing in commercial property, investors should look at the property's vacancy rate, lease expiries and tenants' ability to pay rent. For instance, are tenants exposed to sectors facing significant headwinds from COVID-19?

For diversification benefits, investors could consider investing in unlisted property trusts rather than purchasing physical commercial property directly.

This eliminates the concentration risk of being overly exposed to a single illiquid asset, and an unlisted fund can offer exposure to several properties in different regions.

Like commercial property, unlisted infrastructure can offer attractive yields and capital appreciation. Direct infrastructure assets include road networks, airports, rail and ports. Some infrastructure assets such as airports face severe headwinds due to travel bans and low tourism numbers.

When considering unlisted infrastructure, investors should look at investing in funds that offer predictable cash-flows through economic cycles. For instance, some infrastructure funds are investing in broadcast towers, cable and wireless networks and data centres which benefit from an increase in demand for online services.

COVID-19 has structurally changed the way people work and purchase goods and services. When investing in real assets, investors must be selective and choose specialist investment managers with access to unique deal-flow, proven track-records, and who invest in high-quality assets that can weather cyclical market drawdowns.

Private debt: an alternative source of yield

The Australian private debt market was traditionally dominated by the big banks. With stricter regulatory and capital requirements, banks have decided to exit this sector. Bank disintermediation has caused wider funding gaps for capital-deprived businesses which has opened opportunities for investors seeking higher yield.

The power imbalance between borrowers and lenders has meant that lenders can ask for favourable terms and high interest rates. This market inefficiency provides income-seeking investors opportunities to capture high yields through private debt funds. Private debt funds hold several private debt positions with different terms and maturities, and provide investors diversification.

Private debt funds can lend to small-to-medium businesses, property developers and consumers through a broad range of debt instruments across the capital structure, including senior, mezzanine and junior debt. Private debt can also be secured or unsecured and is generally unrated by credit agencies.

Private debt investments are not risk free, as borrowers can default on their loans. For this reason, it is important for investors to select private debt investments that are senior ranked in the capital structure and secured against assets to mitigate default risk. In addition, investors should assess the quality of the borrower's balance sheet, credit history and loan-to-value ratio.

The catch with private debt is its illiquidity and lack of access to quality deal-flow. Most private debt funds have lockups of approximately two years. As a result of this lockup, the capital invested is not readily accessible if other investment opportunities present themselves. For this reason, private debt funds may suit long-term investors who can afford the 'liquidity premium' and do not need immediate access to their funds.

Conclusion

For income-seeking investors, capital preservation is essential since the invested capital is relied upon for generating future income. With greater market uncertainty from the economic ramifications brought on by COVID-19, investors should be aware of the different options for generating income and consider a combination of investments that align with their income objectives, liquidity requirements and risk profile.

Cash-flow forecasting can be helpful for investors to determine whether a portfolio's weighted average yield is enough to cover future income distributions. Investors can rebalance portfolio weightings where necessary to achieve income objectives while being cognisant of the risk-reward trade-offs.

During times of great uncertainty, diversification is more important than ever. The best defence against large market drawdowns is to have a well-diversified portfolio with a mixture of uncorrelated asset classes. This way, investors can protect their capital which will allow them to generate steady streams of income over the long term. **FS**