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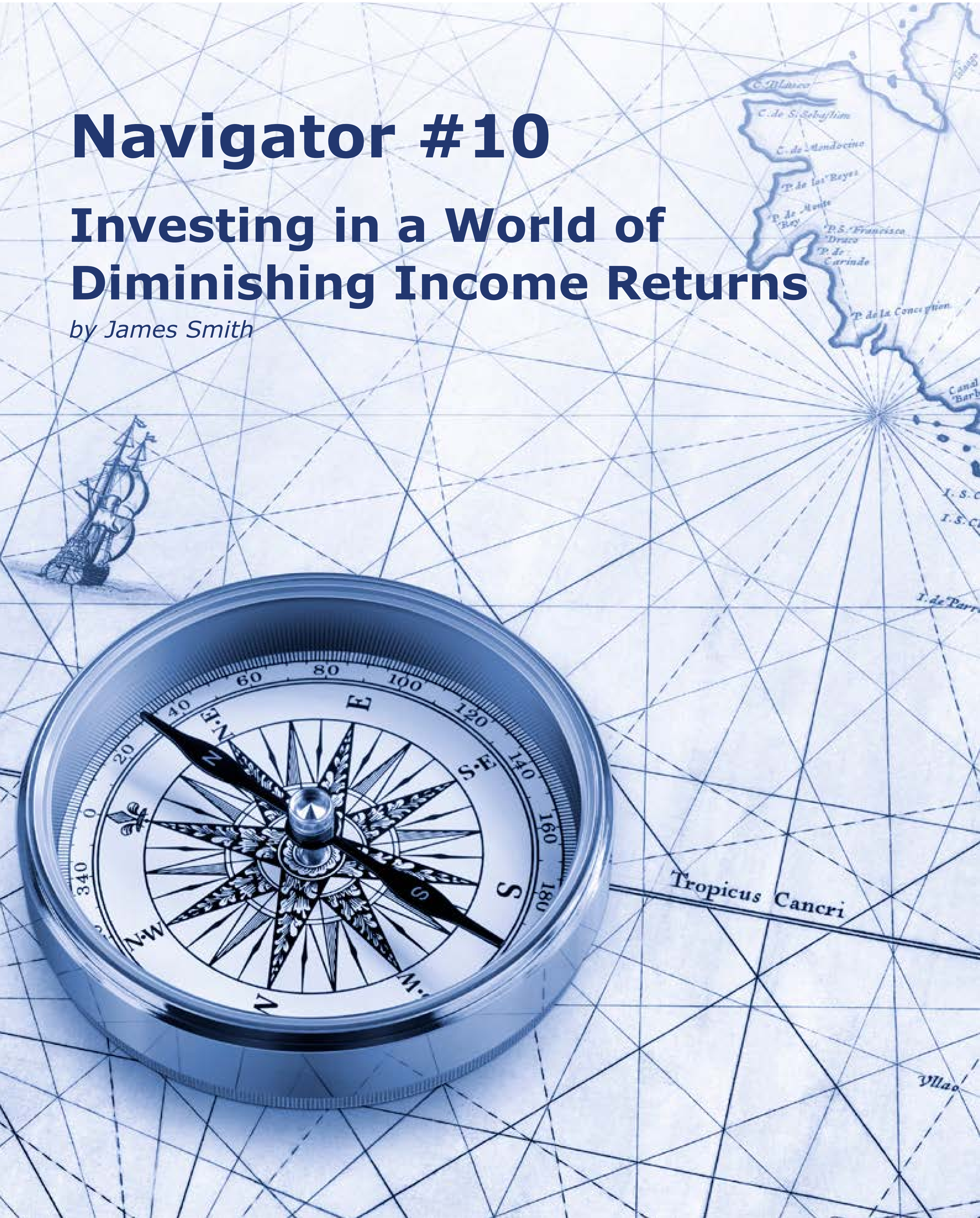



# Navigator #10

## Investing in a World of Diminishing Income Returns

*by James Smith*

Depending on an investor's risk profile and stage of life, income can form a crucial part of the construction and asset allocation of an investment portfolio. When an investor retires (or has a liquidity event such as the sale of a family business), they move away from a salary or profit-derived income and become more reliant on investment-generated income. Then, the composition of their portfolio becomes more profound.

At this time, many investors choose to construct their portfolio with a more conservative risk profile (less growth assets and more defensive, or income producing assets). In the past, a more defensive portfolio would favour income over growth with a traditional 'conservative' portfolio holding around 60% of assets in defensive asset classes (cash, fixed income, credit) and 40% in growth assets (equities & property).  Such a conservative portfolio has historically provided returns of around ~7.5%* pa of which ~4.5% has been income.

For investors seeking capital preservation and peace of mind, the historical draw down of a conservatively constructed portfolio in market corrections has been less severe than a portfolio with a greater bias to growth assets. A healthy balance for those seeking income and security as it provides modest capital growth while maintaining greater focus on capital preservation.

The composition of portfolio returns has changed recently. Over the last few years (in an interest rate, income-reducing environment) a conservative portfolio has seen its income component progressively decline. This was mostly driven by a reduction in fixed income returns, largely priced off the movement of government bonds. A significant problem for an investor who is reliant on the income returns from their investment portfolio with a greater weighting to such assets in their portfolio.

This creates a profound quandary for the investor …

**How does an investor address the reduction of income in a portfolio?**

*Lonsec historical returns 31st January 1995 to 31st March 2019

There are three possible solutions, all with their own nuances and issues:

1. Reduce one's expenditure. This may be hard to do in an environment where the cost of living is on the rise.
2. Eat into capital. This medium-term approach is a reasonable option should the capital base be substantial enough. This pathway is even more appealing given the robust level of asset value growth that should have been achieved over the last five years. One could argue that is what growth is for; providing a buffer should you ever need to supplement your income.
3. Adjust the risk profile. Adjust the risk to a higher mix of 'growth' assets, or equities, to gain income via dividend payments (which have remained relatively stable with regards to overall income).

For the purposes of this article, we will concentrate on point 3.

Increasing the risk profile from a 'conservatively' invested portfolio of ~60% defensive and 40% growth assets to a 'balanced' risk profile of 40% defensive and 60% growth assets to 'chase income' will achieve several things:

- It will likely increase the overall dividend income. This will help offset lower income generated from defensive assets such as cash/term deposits and fixed income investments via a higher exposure to equities.
- It will increase the 'risk' in your portfolio. Your risk will increase as you now have a higher weighting to growth assets. While this provides the potential for higher growth, it also has the potential for higher draw downs (capital losses) in the event of a market incident or an economic slowdown that causes share prices to fall.
- It will increase your exposure to a greater proportion of 'growth' assets. This will happen at a time when valuations are arguably stretched by historical measures (albeit flattered by very low interest rates globally). Is the extra income achieved from a greater share of equities in your portfolio worth the extra risk today? Forever be mindful of risk vs reward.

**Consider the following:**

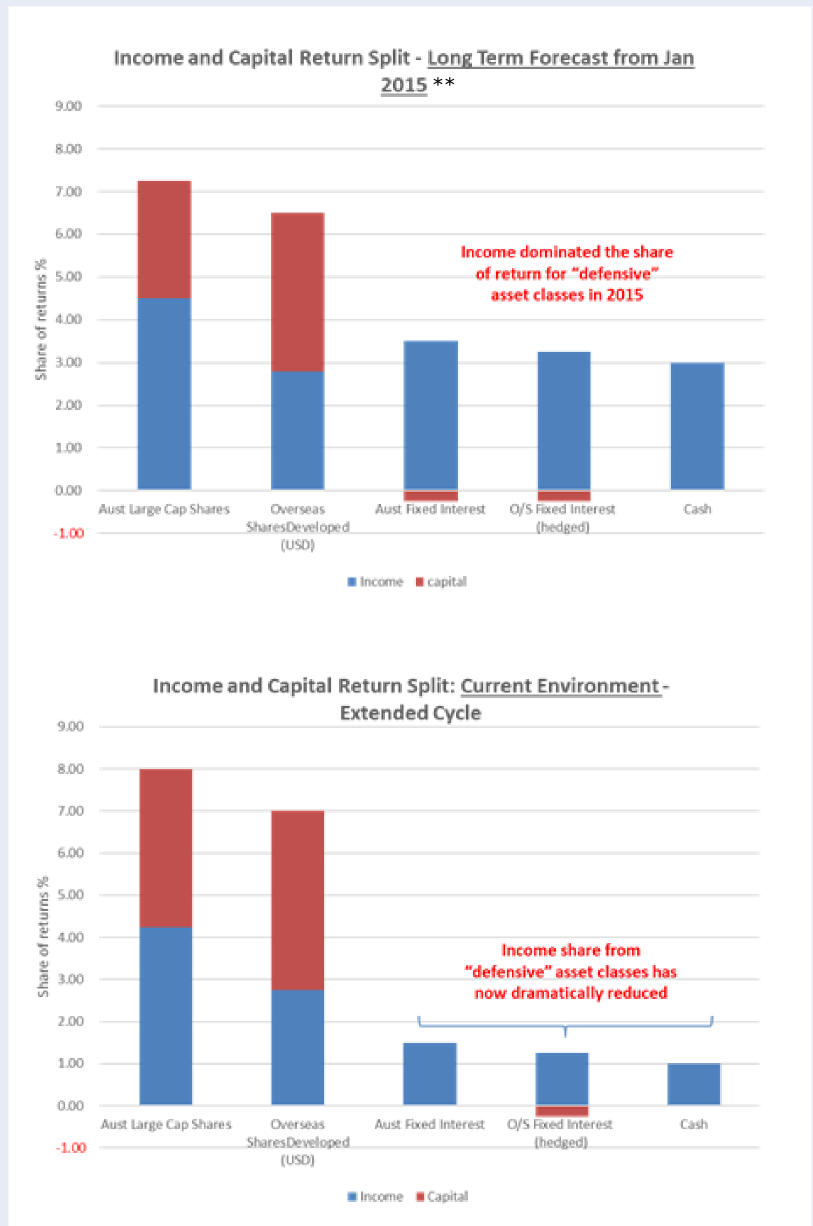
- A conservatively constructed portfolio based on a strategic asset allocation assumption of 60% defensive assets and 40% growth assets is likely to have had a ~20%+ reduction in income from 2015 to now**.

- Australian equities are likely to generate ~4.25% dividend income (large caps) in the current environment (which may look very attractive to investors) however, equities come with the current added risk of elevated valuations relative to history.

- Income generated from a conservatively constructed portfolio is now skewed to 'growth' assets within a portfolio vs. the historical skew to 'defensive' assets.

- Dialing up the risk-weighting of a portfolio to chase income comes with its own set of risks. A greater income (e.g. via dividend paying investments) could provide a greater sting in the tail should investment markets correct. Be careful what you wish for. There is merit in diversification.

- The charts below highlight the changing share of income vs. capital growth for some of the key asset classes between 2015 and now. Pay particular attention to the asset classes on the right of both charts as they help explain the current attraction to equities (LHS).

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# Safe Passage

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