Psigma
Investment Management

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View from Psigma
"Do You Yield?"

Tom Becket
Chief Investment Officer

Searching for Investment Income in a Zero Rate World

Over the last few years, we have often written about the overvaluation of many assets and the challenges that investors faced over sourcing sustainable investment income. Years of financial repression from central banks and far too much "loose money" chasing too few assets made income hunting for investors in most asset classes barren.

What investors really needed was a "clearing of the decks", a fall in asset values and an increase in yields to ease the negative side effects of the manipulations created by the zero-interest rate world that we lived in.

Fast forward three months and we live in a very different world; on that point I am sure we can all agree. The only element that seems to have remained constant in a world that is barely recognisable from just the start of this year, is the fact that it remains extremely tough for investors to find an attractive and sustainable income stream. In fact, it has got even harder. "How?" you might shout at this hapless scribe. "Markets have fallen, UK equities have been hit hard and I keep on reading about rising yields in corporate bond markets". That's all true, we would have to concede, but it has not led to an improvement in the prospects for those wanting to achieve an income from their investments in mainstream assets.

In our latest View, we will detail what the prospects are for the income generated by our portfolios and suggest some ideas as to how investors can find attractive rates of investment income in some less obvious and "niche" investment markets.

Interest Rates will Remain at Zero

Before we can talk about possible solutions for yield-thirsty investors in the income desert, we must first detail why the prospects for achieving income have not improved in most asset markets and why they have possibly deteriorated further from an already miserly income opportunity. Through history there has nearly always been a plethora of markets and assets that offered a decent yield, but this has now changed. We live in truly unprecedentedly meagre times in terms of generating investment income.

To show how the investment outlook for income-seeking has changed, let's revisit each "core" asset class and reassess the income potential for the years ahead; please allow some mental "wiggle room" in these unprecedented times. Starting with cash, it is becoming increasingly clear that we live in a financial situation where we will not be able to achieve interest on a typical, low-risk bank account for the foreseeable future. Interest rates will not go up for at least the next five years in the developed world (we instead think there is a case to be made that they won't go up for decades). Cash-strapped and debt-laden governments could not afford for rates to increase and "normalise" after the Great Financial Crisis of 2008 (remember how we were told that zero interest rates were a temporary phenomenon) and there is no way they can go up now: governments came into this latest crisis with the cupboards bare and their financial situations are becoming ever more precarious with each passing day. We saw that when the US Federal Reserve pursued a path of gently rising interest rates in 2017-18, and the "wheels fell off" the US economy and markets crashed in the fourth quarter of 2018. They will not want to chance the same thing happening again. Indeed, both the Bank of England and the US Federal Reserve might have again denied the possibility of negative interest rates in the last few days, but we believe such an eventuality is more likely in the short- to medium-term than rising interest rates.

Government Bonds Offer No Return, But Plenty of Risk

In addition to the maintenance of interest rates at close to zero, the ferocious spending response by governments to the cyclical COVID-19 crisis, as well as the structural issues created by the demographic issues of the developed world and China, will mean that government bond yields will need to be suppressed and capped at low rates by central banks. If the traditional relationship between supply and demand were to take place, it is likely that borrowing costs would rise for all governments, which could be disastrous given that debt to GDP ratios are rising exponentially and show no signs of being controlled in the future.

This has now ensured that any income return from government bonds is also basically going to be zero, roughly where current yields on major government bonds are. Indeed the UK Debt Management Office sold new government bonds to investors in the last few days at a negative yield; in simple terms, some investors are currently willing to pay our government to look after their money for them, as has been the case in Japan, Germany and Switzerland (as examples) for the last few years.

In a world where we think that there is a risk that current disinflationary trends and the deflationary shock of COVID-19 ultimately gives way to a return of inflation, then this 0% total return that one "achieves" on cash or government bonds will be more like -3% in real (inflation-adjusted) terms. We would expect these actions from the central bankers to continue for far longer than most are currently forecasting; in fact, we think they will be a permanent feature of the future investment environment. This is a phenomenon that we have consistently guided to over the last few years, as we discussed a transition to the "you ain't seen nothing yet" world. We had been expecting all these actions to eventually occur, but what we were forecasting to arrive in the middle of the decade ahead has come early, accelerated by the COVID-19 crisis.

Stepping up the "Risk Ladder"

In a world where the traditional "risk free" assets of cash and government bonds offer zero returns combined with a high degree of potential inflation risk, investors are forced to look elsewhere and take higher risks to achieve any form of investment income.

The next step up the "risk ladder" would be high-quality or investment-grade corporate bonds. We're afraid that the news here is also not great for investors in their search for attractive and sustainable income opportunities. The combination of the factors discussed so far, as well as the fact that the central banks of the world have given up pretending and are now buying private sector assets, chief amongst them investment-grade corporate bonds, has led to ever lower corporate bond yields over the last few years. As a guide, if an investor were to decide to buy a global investment grade bond index through a "passive" investment fund, then the yield would be around 2.35%. At face value, this yield is not disastrous for an asset class where defaults through history are very rare and when one compares this rate of income to the 0% on offer at the bank or on government bonds. But adjusted for likely fees (e.g. 1%) and potential inflation, this could lead to an annual future real return of around -1.50%, even before one starts to think about the potential losses caused by a rise in borrowing costs.

Fortunately, we don't have to buy an index and we obsessively continue to shy away from such forms of investment in corporate bonds, particularly given higher weightings in "passive" investments are given to those companies that have taken on the largest amount of debt. Our approach in the investment-grade world is to be extremely selective and to focus strictly on sectors and companies where yields are attractive and compensate us for the risks we are taking. Reassuringly, we have been able to find funds where such an approach is employed, and we can achieve yields of close to 3.5%. Whilst such a level of return is far from spectacular, we feel it is adequate compensation for lending money to the highest-quality companies.

Equities for Income?

Some readers would rightly counter the higher quality corporate bond suggestions by asking why UK and global equities are not a better income opportunity at this time. Our view is that the yields currently on offer from UK equities are an "optical illusion". The UK equity market has already experienced dividend cuts of around 40% and we are currently expecting UK equity dividends to be ultimately slashed by 50% in 2020, as companies decide to preserve cash, demonstrate solidarity in these strained financial times or are ordered by the regulators to slash their dividends (the latter point is a positive for bondholders of banks and insurance companies as it boosts cash levels to pay the coupons on their bonds).

Royal Dutch Shell served as the latest illustration of these changing times by reducing their dividend for the first time since the 1940s.

Many more will follow suit and we must realise that these are not "temporary" measures: cut dividends will probably not magically reappear with the hopeful emergence of a COVID-19 vaccine and an eventual economic recovery. We fully expect that companies will suffer from "recency bias" as we emerge from this crisis and will want to keep higher levels of cash on their balance sheets (again, this is good for bondholders). Certainly, there are great investments in the UK equity market, but the dividend pillar has been removed as a valuation support and investors would be wise to tread carefully and be very selective, as we are being at this time.

Is it Time to "Go Global" for Dividends?

Global companies will suffer fewer dividend cuts than their UK-listed peers (as a total percentage), but there will undoubtedly be further pressure in Europe to cut dividends. The consensus expectation is for dividends in Europe to be cut by roughly half, a similar amount that we are forecasting for the UK, in part due to the high weighting of banks and other financial companies in the European index. Elsewhere, there will be less pressure in the US, a market where typically dividends have been less of a focus for companies: currently dividends are forecast to be reduced by roughly 20-25% across the US equity market.

A major issue with the US is that typical dividend paying companies are expensive, as the scramble for dividend opportunities has led investors to bid up those companies' valuations. Perhaps the best prospects for sustainable dividend streams are in "Emerging" Asia and Japan: both markets not normally considered as dividend-focused markets.

The culture of dividends is on the rise in Asia from a low base, with plenty of scope for higher "pay-out" ratios, as companies return a higher proportion of their profits to investors to entice them to buy their shares. Our portfolios' bias towards the equity markets of the East remains in place, not least because of the potential for higher levels of income and a lower chance of dividend cuts than we are seeing in the Western world.

So Where are the Solutions?

Given it is basically impossible to attain the levels of income that investors require through the assets discussed so far, even with our selective approaches in investment-grade bonds and focus on the growing dividend streams in Asia, we must "think differently" and pursue higher risk opportunities.

The good news is that by "thinking outside the box", there are a host of exciting income opportunities for us to exploit for our clients. However, the key message is that we must be highly selective and very nimble.

The best prospects that we can currently identify to achieve a high and sustainable income are in selective credit markets, where there are presently exceptional opportunities on a level with those that we saw in 2008. It is on such investments that we are primarily focusing our attention and where we are convinced that we can create the best long-term income and total returns from any recovery from today's medical, economic and market troubles.

With our higher risk income opportunities, we are chiefly looking at selected higher-risk corporate and consumer credit markets, where default risks have certainly risen, but where such risks are priced into current yields. We have been able to identify specific and selective corporate credit opportunities with high yields and only a short time until those bonds mature. As an example, a key holding within our portfolios is an investment-grade rated, corporate credit focused fund with a yield above 7% and with a total portfolio "duration" to maturity of less than two years. Such opportunities rarely present themselves and we are seeking to take advantage of such specific dislocations created by the recent market turmoil.

Asset-backed or mortgage-backed securities on both sides of the Atlantic have been hit incredibly and undeservedly hard during the recent market volatility, and offer investors high levels of income and almost unrivalled opportunities for capital gains. We own investments in both Europe and the US where yields of around 10% are currently on offer. These yields reflect that risks in the global economy have risen, but in our view provide investors with a prospect that most other markets don't at this time: sustainable income at a fair price in a world where achieving a healthy income from one's investments remains surprisingly challenging.

These markets have been indiscriminately penalised by general investor panic and an overpowering desire by investors to flee to cash; our approach has been to take advantage of the chaos caused by such behaviour and exploit price discrepancies on behalf of our clients.

Conclusion

In our introduction, we stated that we live in an unprecedently challenging time for income investors. We hope that we have explained why this is the case and how low the income levels are on many asset classes that investors have historically used to meet their income requirements. Frankly, we look at the paltry levels of income available on many investments and are fearful for the prospects of investors in many investments, given the importance of income to an investor's overall total return. But just as the investment gods have taken on one hand from some investments, they have given with the other hand to create different investment opportunities.

We have to say that "the future ain't what it used to be", as the famous baseball coach Yogi Berra once said, and investment income is certainly an example of where life has become increasingly problematic. However, by thinking differently, "looking outside of the box", and by being nimble, there are sustainable and attractive levels of income that we can find for our clients. This gives us confidence that we can continue to help our clients achieve their income requirements and to help them meet their investment aspirations for the future.

Tom Becket
Chief Investment Officer

For further insights from our CIO Tom Becket check out the Psigma Voice, our communication platform providng you with a variety of investment and market commentary.

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Psigma
Investment Management

client.services@psigma.com
businessdevelopment@psigma.com
www.psigma.com

@PsigmaIM

company/psigma-investment-management

London

11 Strand,
London,
WC2N 5HR

+44 (0)20 3327 5450

Birmingham

4 Temple Row,
Birmingham,
B2 5HG

+44 (0)121 230 1937

Edinburgh

The Capital Building,
12/13 St Andrew Square,
Edinburgh, EH2 2AF

+44 (0)330 094 0090

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