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Spotlight on Multi-asset

Generating reliable income streams in stormy markets

December 2018

- Market volatility has returned in recent months with both bond and stockmarkets experiencing turbulence
- For investors seeking steady income, a flexible multi-asset strategy can be well-placed to respond to changing asset class relationships
- A dynamic, diversified income solution can target both the income and capital growth sought by pension schemes

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The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Wherever past performance is shown, please note that this is not a guide to future performance.

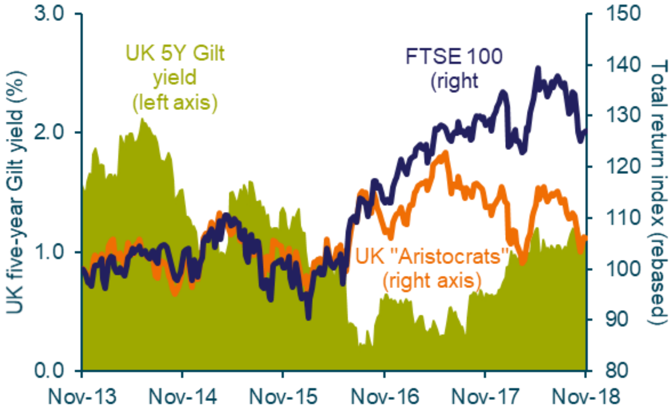
Turbulence undercuts traditional income generation

2018 has been a challenging year for many investors. Those institutional investors, such as defined benefit (DB) pension schemes, seeking to achieve a reliable and growing income from their investments have faced volatility in both equity and bond markets. Stockmarkets have stormed both up and down. The S&P500 hit a new all-time high and set a record for the length of a bull market in August, but then saw the gains for the year-to-date swept away in a handful of trading sessions in October.

The sell-off in stocks has been, in part, due to continuing increases in US bond yields. The bond market sell-off, particularly in developed markets, has now extended for more than two years as major economies have removed ultra-loose monetary policy and, in places, tightened by raising interest rates. Both five-year and ten-year US Treasury yields have been above 3% in recent weeks, and, though increases in government bond yields in the UK and core Europe have been more modest, corporate spread levels have been moving steadily higher during 2018.

The initial source of volatility was primarily concerns about strong US growth leading to further US interest rate increases. Fears that the US economy was in danger of overheating in the first quarter were replaced, in the third quarter, by concerns over the sustainability of robust growth in emerging markets and whether corporate earnings growth was peaking and about to decline.

Figure 1: UK equity relationship with Gilt yields



Source: M&G, Datastream, as at 13 November 2018. UK “Aristocrats” represented by the total return index of the SPDR S&P UK Dividend Aristocrats ETF

Income-producing assets have been particularly hard hit by this environment. The reliable, income-generative bond-proxy sectors of stockmarkets, and the historically-dependable income sources of developed-country government and corporate bonds, have had their capital values undercut during the market setbacks of 2018.

Flexible allocation to combat volatile markets

For pension schemes seeking to generate a reliable, steady income, using these traditional portfolio building-blocks, the volatility has likely been painful. However, volatile conditions and unconventional relationships between asset classes, such as those that have prevailed in the recent past, are well-suited to active multi-asset investment strategies. The freedom to asset allocate dynamically between markets, allows these globally diversified portfolio strategies the prospect of continuing to generate an attractive income yield.

As UK DB schemes focus ever more on generating income from their assets, flexible income solutions that seek relative value from a wide range of assets globally should be best-placed to adapt to changing environments in order to meet these needs.

Identify value first

The clear benefit of using multi-asset solutions to deliver income is that they are not bound to the fortunes of any single asset class so are able to capture the best opportunities from around the world, while avoiding those areas where prospective returns are low.

In building multi-asset portfolios, we aim to identify where asset classes, countries or markets offer real value and to use those value opportunities as strategic foundations for our asset mix. We determine what we consider fair value or “neutrality” for a wide range of assets globally and then compare that with prevailing real yields on assets to create a robust valuation framework.

We combine this rigorous valuation analysis with elements of behavioural finance when implementing the M&G Multi Asset team’s ‘Episode’ investment process.

Supplemented with dynamic allocation

Our approach is based on the recognition that financial markets periodically move irrationally as a consequence of human behaviour. By our definition, ‘Episodes’ are periods when asset prices are influenced by investors’ emotional behaviour rather than fundamental drivers of long-term returns, causing valuation misalignments. They are usually temporary, though not necessarily short-lived, and can present opportunities to adjust strategic allocations or implement tactical ideas.

We seek to identify these points at which temporary changes in sentiment cause a market overreaction that diverges from assets' fundamental values.

Our investment process enables us to quickly respond to opportunities that emerge through volatility. Since January 2018, such periods of volatility have resulted in more attractive valuations in equity markets globally, and in emerging markets across asset classes, allowing us to invest in a diverse basket of assets to generate a reliable, steady income stream.

On occasion this causes us to adjust positions very actively as valuations have changed. For example, in January the rally in share prices materially reduced their attractiveness. The subsequent setbacks, some of which were substantial, threw up some interesting opportunities.

A global view of income assets

Fortunately, a growing global universe of income-bearing assets means that multi-asset managers with an income objective have far more avenues to pursue today than in the past. The corporate bond market has become broader and deeper in the UK and overseas. More global companies are focusing on returning cash to shareholders via dividends and buybacks, and both alternative and emerging markets have also matured significantly.

This means that delivering income does not necessarily mean 'reaching for yields' in ever more risky assets, so long as investors are willing to look across financial markets to source assets offering attractive value. Diversification within asset classes, as well as between them, can enable a manager to target an income yield that can be relied upon, even at times when markets behave unexpectedly.

A good investment strategy is likely to take a detailed investigation of where value lies within each asset class, in order to effectively diversify income sources. For example, we continue to view large parts of the global equity universe positively since, by our assessment, the equity risk premium remains elevated, in both absolute terms and relative to many developed market government bonds.

Bond markets offer very different properties in different countries worldwide. In our view, long-dated US Treasuries – those with at least ten years to maturity – currently offer a combination of attractive diversification properties and relatively high yield. These can be combined with higher yielding government bonds from European and emerging markets for still more robust potential diversification.

Achieving the income outcome

The need for income for DB pension schemes is intensifying as they mature and as increasing numbers of them become cashflow negative, regardless of the uncertainty and asset price volatility prevalent in financial markets. The support, in asset value terms, that a long-term decline in global bond yields provides, appears to have abated and may even be starting to reverse. This suggests that the ability to generate strong returns from simply buying and holding a static mix of traditional asset classes may not be replicable going forward.

A regular, stable and growing income stream, emanating from all of a scheme's assets can be enormously supportive in helping it manage its cashflow profile and meet its obligations. Multi-asset income solutions may be able to provide flexibility in offering both income and growth in the capital base, to reflect the investment goals of DB schemes.

We believe that taking advantage of the diversification benefits associated with a wider opportunity set of multi-asset solutions provides greater scope to deliver outcomes that might previously have been expected from simple traditional combinations of asset classes. This can be enhanced by considering risk management tools such as active currency and duration management in the mix.

Institutional investors, such as pension schemes, will likely need to look across a diverse investable universe for attractive income sources, in order to achieve the outcomes they are targeting. However, targeting a yield level should not incentivise chasing yields in ever riskier assets, simply because they are not available from traditional sources.

Adopting a dynamic, multi-asset approach may provide pension schemes with attractive alternatives for their assets to deliver the outcomes they desire in the current and future market environments.

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