Hunting for yield: Why passive makes sense for income investors

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Why machine is beating man when it comes to income

Using passive funds for income isn't a new concept. Trackers and ETFs have been used for decades, often more by coincidence than design. Index investing was primarily seen as a growth strategy.

Over the last decade this has changed. Low yields and a shake-up of active income managers have pushed many more investors towards passive vehicles for income and not without good reason. The proliferation of data has allowed passive strategies to become much more sophisticated in their hunt for yield. In fact, many of the strategies traditionally used by active fund managers can now be replicated passively, and at a much lower cost.

This breadth of choice can however be confusing. Adam Laird, Head of ETF Strategy for Northern Europe looks at how to find the right investment for each portfolio.

The choices explained

Option 1: Bonds

Historically, bonds were the mainstay of an income portfolio – are slow and steady cash generators. A bond holder **essentially** owns a loan to a government or company, and is entitled to the regular interest payments.

If you hold an individual US Treasury, you'll know the monetary amount of your income you expect to receive until maturity. But if you buy a bond fund, you're buying dozens – perhaps hundreds – of bonds. The exact composition will change over time – so will the overall income.

For some types of bonds – like inflation linked or floating rate – payments aren't fixed, but will vary according to market rates. And there's always a risk of payments being delayed or missed if the bond issuer gets into problems – even for the highest-rated bonds. It's not that long ago several developed market countries looked more likely to default than companies!

Get your risk right

Bonds are a staple – often a necessity – for a cautious portfolio. In many cases, bonds are a lower risk option than equities. Their interest coupons are more stable than company dividends and bondholders are repaid before shareholders in the event of a company default. But this rule of thumb isn't universally true. Bonds are exposed to different risks than shares.

Interest rates are one of the most prominent. The fixed coupon of a traditional bond is less attractive when interest rates are higher – so bond price falls tend to follow a rate hike. After years of negligible to negative rates across the western world, rate hikes are on the minds of central banks and investors alike. All else equal, longer-dated bonds are more vulnerable to rate changes as there is simply more time for these changes to play out.

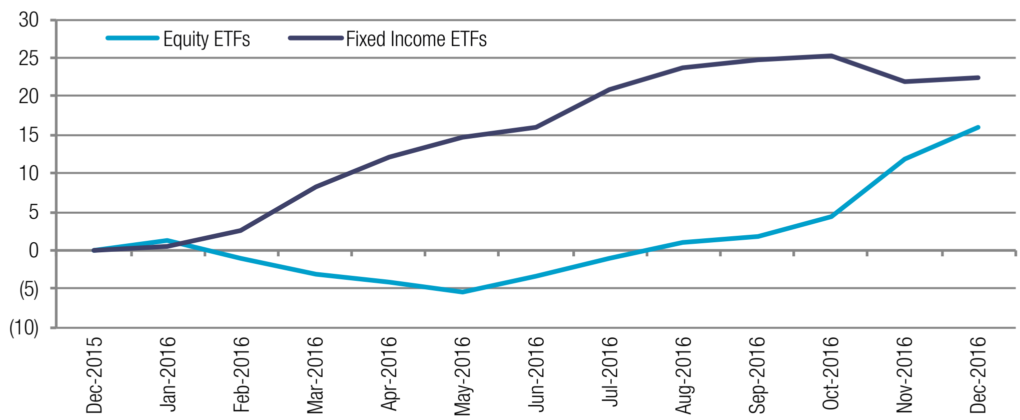
Another risk is credit. A struggling company may not be able to pay the interest due to bondholders, or repay the capital on maturity. Ratings agencies like S&P or Moody's assess the likelihood of an issuer getting into trouble – "high yield" bonds rated BB or below offer investors the possibility of greater return, but at a higher risk.

Why use a passive bond fund?

In some cases, the right solution is to hold an individual bond, which for many a bond fund is preferable. Bond funds are diversified, spreading the risk across a wide range of issues. They give more choice – individual issues often require a large commitment – with minimum investments from a few thousand to a few hundred thousand. Bond funds don't have a maturity date - your money will remain invested until you want to sell.

Passive bond investing has grown a lot in the last few years. In 2016, fixed income ETFs gathered €22bn vs. € 16bn for Equity ETFs.

Growth of fixed income ETFs in 2016 – first time fixed income gathered more than equity

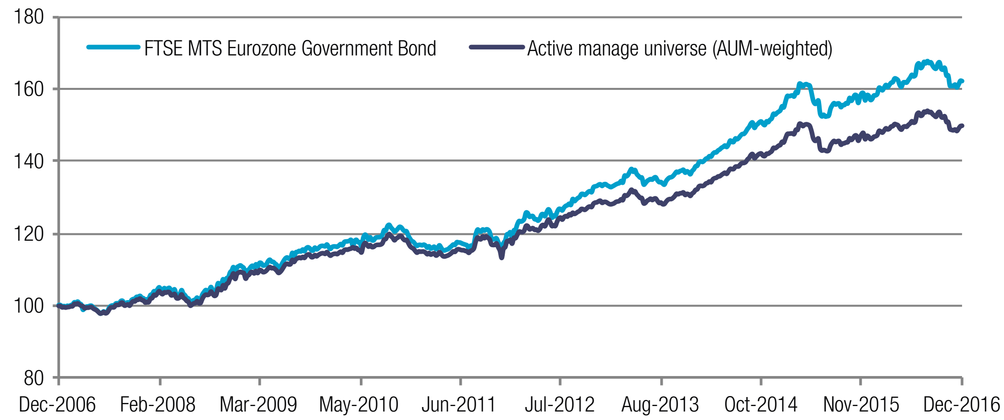


Source: Lyxor ETF, Bloomberg

The reasons to go passive may be most applicable for bonds. When rates are low, you don't want to pay back your whole yield in fees – a typical fixed income ETF might cost 19bps (all fixed income ETFs average) and could go down to 7bps (Lyxor FTSE Actuaries UK Gilts DR UCITS ETF).

And though some bond managers can offer top returns, sadly this isn't the norm. It's perhaps not surprising – it's hard to find relative value in a stable asset like govies, it's tough to compensate the fund for a higher fee. Over 10Y, only 14% of active funds managers in our Euro Govies universe outperformed the benchmark with -0.9% of annualized performance difference.

Active managers under performing govies



Source: Morningstar, Bloomberg

Going overseas...

Let's say you're a UK individual who needs income from your investment. The bulk of your cash flow needs are in pound sterling. A portfolio of UK corporate and government bonds can provide this.

But there are reasons to diversify beyond British shores. Different countries may have higher interest rates, or durations might be lower and therefore the bond values may be less sensitive to rate changes. The hunt for yield might push you towards EUR or USD bonds – which dwarf GBP High Yield issuance. Perhaps to riskier emerging market options where yields and risk can be higher still.

One thing to bear in mind when investing overseas is that changing exchange rates can really affect your returns. For an income investor, there are many currency hedged options, allowing you to offset the risk of changing exchange rates – but remember currencies go up and down, hedging can work for or against you.

Find out more about our outlook for Bond income

What's your flavour

The bond market can get complex quickly. Whereas equities generally work the same way, but the multiplicity of bond issuers and features mean investors can quickly be swamped with choice. But roughly speaking, an income portfolio might incorporate these four elements.

The tortoise: Government bonds

Slow and steady, developed government bonds are the low risk/reward option. The default of a western government is unlikely (though technically not impossible) and so yield on govies is likely to be lower than other types. This might make them less appealing in a yield hungry investor, but government bonds are generally a staple for a conservative or cautious portfolio. For the least risk averse, short maturity government bond ETFs are available. Less time to maturity means lower portfolio duration – which means less sensitivity to rate changes.

The workhorse: Corporate bonds

Issued by companies, high quality corporate bonds can be a dependable income generator. They do involve more credit risk than a government bond– as issuing companies might get into difficulties before the bond's maturity. An ETF allows investors to diversify over dozens even hundreds of issues – spreading that risk.

The hare: High yield and emerging market debt

These racier options have the potential for high returns, but are less dependable than higher quality issues. Generally, high yield bond ETFs invest in debt of companies which are in riskier industries – perhaps younger and less tested. Emerging market bonds are issued by developing countries whose economies or political situation might be less stable. The higher returns here can be appealing, particularly when rates are low and investors are struggling to meet their cashflow targets. But the potential for losses means this area should be held in moderation.

The chameleon: Linkers and floaters

Interest coupons here aren't fixed, rather they change with situations. With linkers the coupon is raised (or lowered) along with inflation– thereby preserving the spending power of the interest payment. A floating rate bond adjusts its coupon as interest rates change – which cushions the bond price when central banks act.

Yields are generally lower for these bonds, but the appeal here is their stability – they're a protective option for uncertain markets.

Option 2: Equity income

In the fund management world, equity income managers are superstars. Some active managers have become recognisable in their own right. But passive equity income is still relatively unknown.

So why hasn't it taken off?

To some extent it has. There's now $7 trillion* in passive income strategies. But that's dwarfed by the assets in active equity income funds. There are a few reasons for this.

First, the allure of the star manager. The size and prominence of equity income managers has long given investors comfort – particularly as some have recorded strong returns. This trust has waned somewhat in recent years, as well known managers have quit for pastures new and high profile funds have struggled.

There were also problems when passive income strategies first appeared. The first generation of strategies were too simplistic – and often concentrated on just a few dozen shares or held large biases towards a few individual sectors. Costs were low, but still much higher than a traditional tracker. More recent launches have tackled these issues head on – focusing on company quality and delivering it without the price tag of an active fund with TER as low as 0.19%.

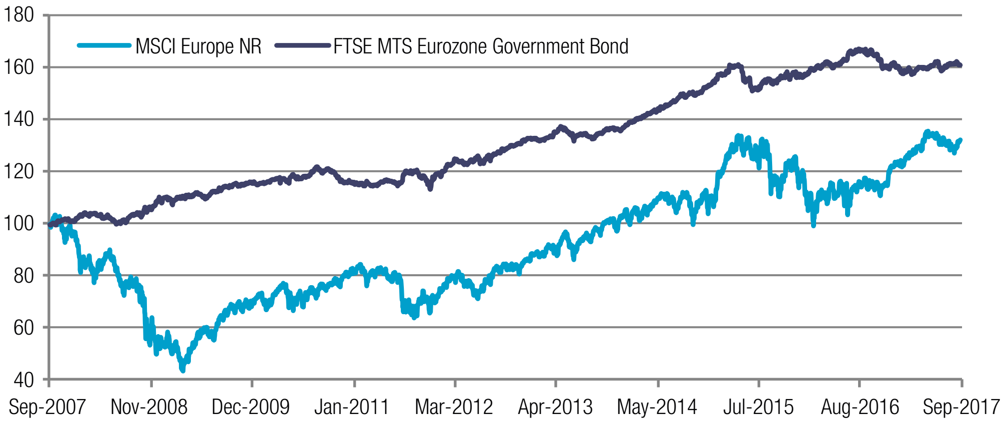
Finding the right place for equity

Equities are often seen as more risky than bonds. This is not universally true, but they do need to be treated differently in a portfolio.

Unlike bond coupons, dividends are not fixed – they can be raised or lowered with a company's performance. So they may be higher than bonds, but they are less dependable. This can be a concern when regular cash flows are relied upon.

Nevertheless, they do offer the potential for higher overall returns. Share prices will rise or fall with the market's sentiment on company or economic prospects. In the long run, equities have returned much more than bonds. But remember there are no guarantees – prices go down as well as up and equities go through large, painful corrections.

Bond vs. Equity performance long term



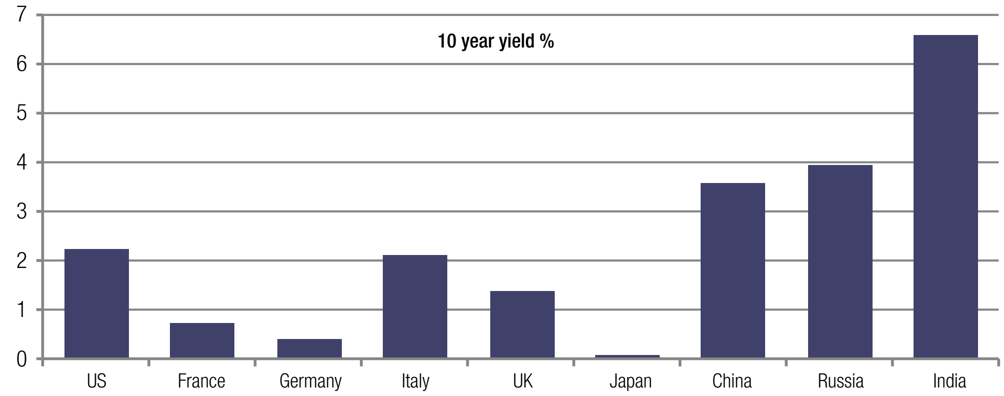
Source: Lyxor ETF, Bloomberg

High yielding vs. Income focused

Broadly speaking, there are two ways to find passive equity income – buying high yielding markets or strategies explicitly focused on income.

The UK or Asia Pacific are generally seen as higher yielding markets. By buying a mainstream index, you will be entitled to the dividend returns of its constituent companies. This is a simple approach, and these markets are available at very low cost. Plus a whole market gives diversification – you spread your portfolio over growth stocks as well simple income producers. But over time, income prospects of a country or region can and will change. Investors need to keep watch to ensure a strategy continues to meet their needs.

Yields of major countries



Source: Lyxor ETF, Bloomberg

certain disadvantages – being concentrated, or biased to a certain sector. The hunt for returns can lead to the "yield trap" – buying struggling companies with high but unsustainable yield. However big data and more transparency means more refined strategies have been launched in recent years, with index providers being able to hone in more precisely on the companies they really want in the portfolio.

Income focused ETFs are a direct way to target dividends, and their yield can be higher when income is a priority. They offer an alternative to an active equity income fund, but without the risk of managers taking a bad call or leaving. And with TERs as low as 0.19%, this is still a very low cost way to access dividends.

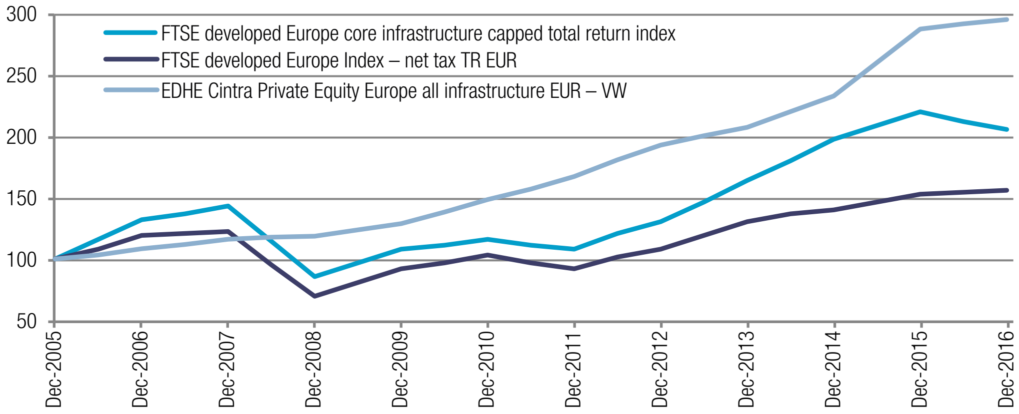
Option 3: Alternatives

Equity and bonds aren't the only way to buy income – a truly diversified portfolio might look at alternative asset classes. Investing directly in property or infrastructure projects is a direct way to access high yielding investments.

But there are downsides. Minimum investment tends to be high – from tens of thousands to millions, making it difficult to buy a diversified portfolio. It can be costly to buy and maintain these projects – stamp duty on property can add up to 15% of purchase costs, while realising cash can be time consuming and costly.

Passive investors might buy into alternative assets with ETFs which invest in Real Estate Investment Trusts (REITs) or listed infrastructure shares. In the short run, these assets can behave like equity, but over the long run these may attract superior yields.

Performance comparison – FTSE Developed Europe Core infrastructure index vs. EDHECintra Priate Equity Europe All Infrastructure



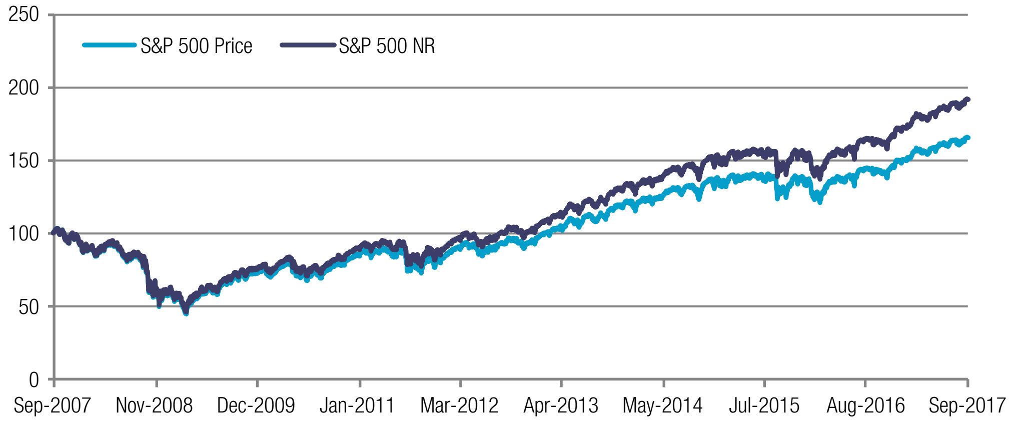
Source: Lyxor ETF, Bloomberg

Choosing passive income: three questions to ask

Do you need the income right now?

The first question is perhaps the most obvious – do you need to draw an income today or are you saving it for later? Regardless of your need, income can be a long run driver of returns. If you want regular cash flow, choose a distributing investment. If you don't, an accumulating share class will roll up income for future capital growth.

Capital returns vs. Total returns]

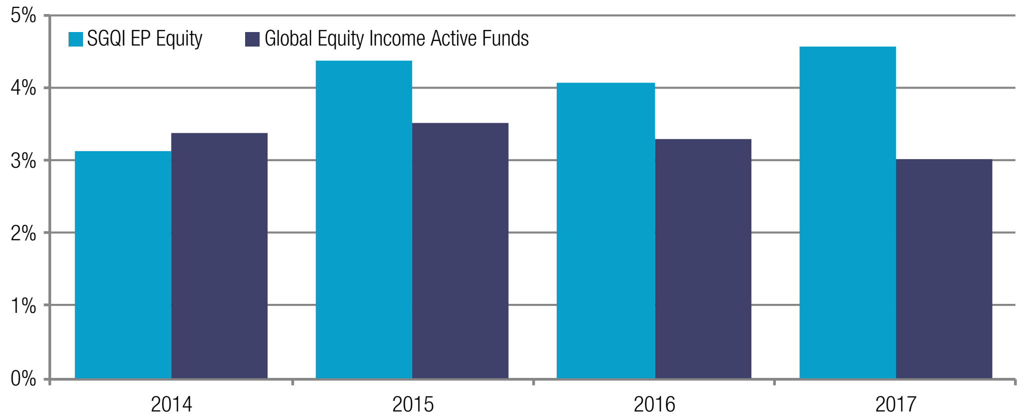


Source: Lyxor ETF, Bloomberg

What's most cost effective?

Reduce your investment costs! This is just as pertinent for income investing as growth. When yields are still low, do not pay away your whole yield in charges. But TERs are just one element of income investing – look at the performance record of a fund to understand what you expect to receive. And remember the costs involved with trading as this can significantly impact your long term returns.

Active funds trail behind passive



Source: Morningstar, Bloomberg

What about interest rates?

Different investment options come with different risks. Government bonds are generally seen as less risky than corporate bonds, equities and high yield bonds are the next step up. But different markets will see different prospects – economically, structurally or from a currency standpoint.

Interest rates are one of the biggest questions currently. Rising rates typically hurt bonds, but higher rates may be a positive for interest rates.

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Where to look right now

Understanding market conditions is the key to making the right choices. To help you in your journey for income we have prepared two pieces of research:

From Andrew Lapthorne, Investing for Income explores the current outlook for global equity income and the search for quality.

From Lyxor's CAR team, Better for bonds, for now is gives an update on the bond landscape, where investors should look to find opportunity in this world of uncertainty

Lyxor's range

To help you find the right solution, Lyxor has broken down the market for income assets into three sections:

Yield staples – Dependable income assets, which might make the core of an income portfolio. In this you'll find high yield equity assets and riskier bonds.

Yield protectors – When you need to control risk, protectors address the problem head on. These may give you some comfort in an uncertain world.

Yield alternatives – Concentrating on a higher alternative asset classes, these can give you a yield boost and add another layer of diversification to your portfolio.

You can find the full breakdown at Lyxor.com