EQUITY INCOME FOR RETIREMENT

Anthony Dickson, Director. First Quarter 2018

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EQUITY INCOME FOR RETIREMENT

BY ANTHONY DICKSON

As the philosopher Eric Hoffer wrote:

'In times of change, learners inherit the earth, whilst the learned find themselves beautifully equipped to deal with a world which no longer exists'

In the world of UK pensions, so completely have the sands shifted, it would probably be easier to list what is staying the same than to list what is changing. For a start, though, the key changes include:

— The ongoing shift from Defined Benefit to Defined Contribution pensions

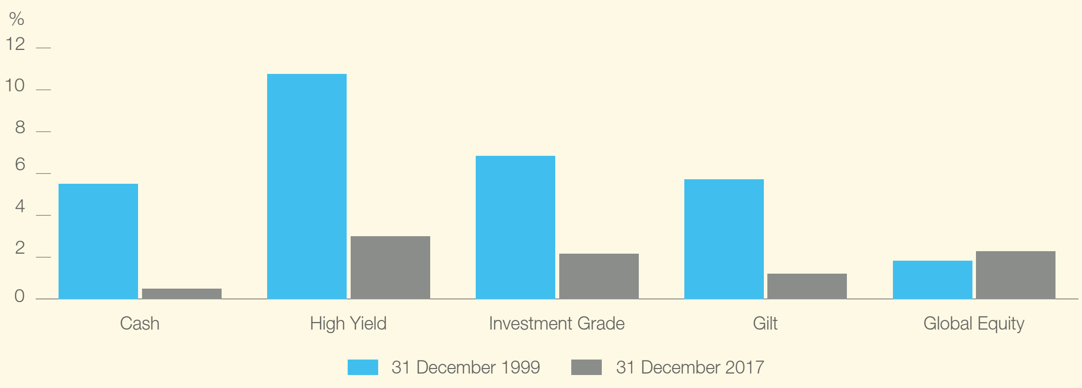
— Ever increasing longevity expectations

— The recent removal of the requirement to purchase annuities

— The inheritability of pensions pots, and

— The evolving relationship between equity and bond yields

21st Century Yields



Source: Bloomberg.

Past Performance is not a guide to future returns.

The changing world of UK Pensions poses a new investment question

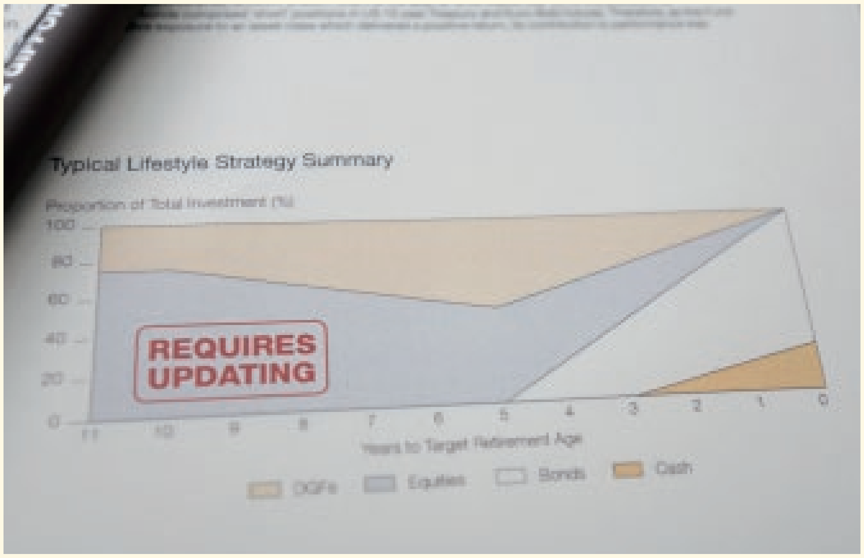
Actively managed equity income strategies, either in isolation or as a part of broader multi-asset income approaches, will be central to the answer

Consultants should reorientate their research and financial institutions should design funds accordingly

Despite wholesale change, in a pensions world which is populated by both legions of the learned and a good sprinkling of learners, there is perhaps a certain amount of un-refreshed thinking. The same holds true amongst equity fund managers too. True, glide paths to annuity purchase which feature automatic switching into gilts and cash are now widely acknowledged as being inappropriate for almost everyone, but it is not yet clear what should be put in their place.

The key question therefore is what investment strategies are now appropriate before and during retirement. Both individuals and the industry as a whole must now consider where they are trying to get to and how to get there.

In considering individual pension fund investment, there has always been a clear distinction between the pre-retirement phase (largely accumulation with increasing protection in the latter stages) and post-retirement (when an income is required). Some of the changes already alluded to may blur this distinction, or at least the assumption that all investments need to be radically different pre- and post-retirement. We should perhaps also assume that the pipework of the pensions industry will eventually permit ‘to and through’ investing (where the same investments can be held throughout without structural impediments or prohibitive costs). Nonetheless, in considering this area afresh it still makes sense to focus on re-examining requirements and strategies in retirement, and then circle back briefly to consider any implications for the pre-retirement phase.



POST-RETIREMENT INVESTING

Equities offer both better long-term growth prospects and higher yields than developed government bonds, but are more volatile and the income they provide is less certain and generally lower than many other asset classes. Because of this a broad consensus is developing that multi-asset investing, whether in a fund or in a mix of assets, will be the way forward in retirement for all but the wealthiest investors.

Multi-asset income approaches, it is hoped, can diversify income streams and reduce volatility. This should fit well with the extension of the income drawdown approach that has been used for many years by wealthier DC investors before the age of 75, where income requirements are met by a mixture of taking the yield from underlying investments and chipping away at capital.

However, drawdown as an approach carries its own challenges and threats. The principal challenge is deciding how much to drawdown in the context of an unknown life expectancy. The principal threat, beyond the otherwise appealing prospect of living for longer than one expects, relates chiefly to the pattern of market returns. This leads to the worrying possibility of poor returns in early years coupled with the significant forced sale of assets into weak markets drastically depleting individual pension pots. Interestingly, if less dramatically, the likelihood of having to sell more assets when prices are low in effect also attacks returns in retirement in the opposite way to which 'pound cost averaging' boosts them as assets are purchased. The dangers and potential disadvantages are arguably intensified once the 'drawdown' or investment period is extended to the whole of pensioners' lives, rather than up until the age of 75.

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There are two main ways by which pensioners can mitigate these risks: reducing volatility and keeping the yield up. The former hopefully means that the prices of the assets which you have to sell don't fall so much in periods of market weakness. The latter helps because it requires the saver to sell fewer assets to meet income requirements, so asset pricing matters less. The dependability of income is also crucial, because any drop in income which accompanied a market crisis, for example, would amplify the disadvantages of forced sales into weak markets if income in the hands of the pensioner is to be maintained.

However, whilst these requirements point towards multi-asset approaches, such strategies also have potential drawbacks: in particular, there is a risk that total returns and income growth are compromised by buying expensive assets and/or assets which don't grow (because they are linked to neither economic nor corporate progress) in the name of diversification.

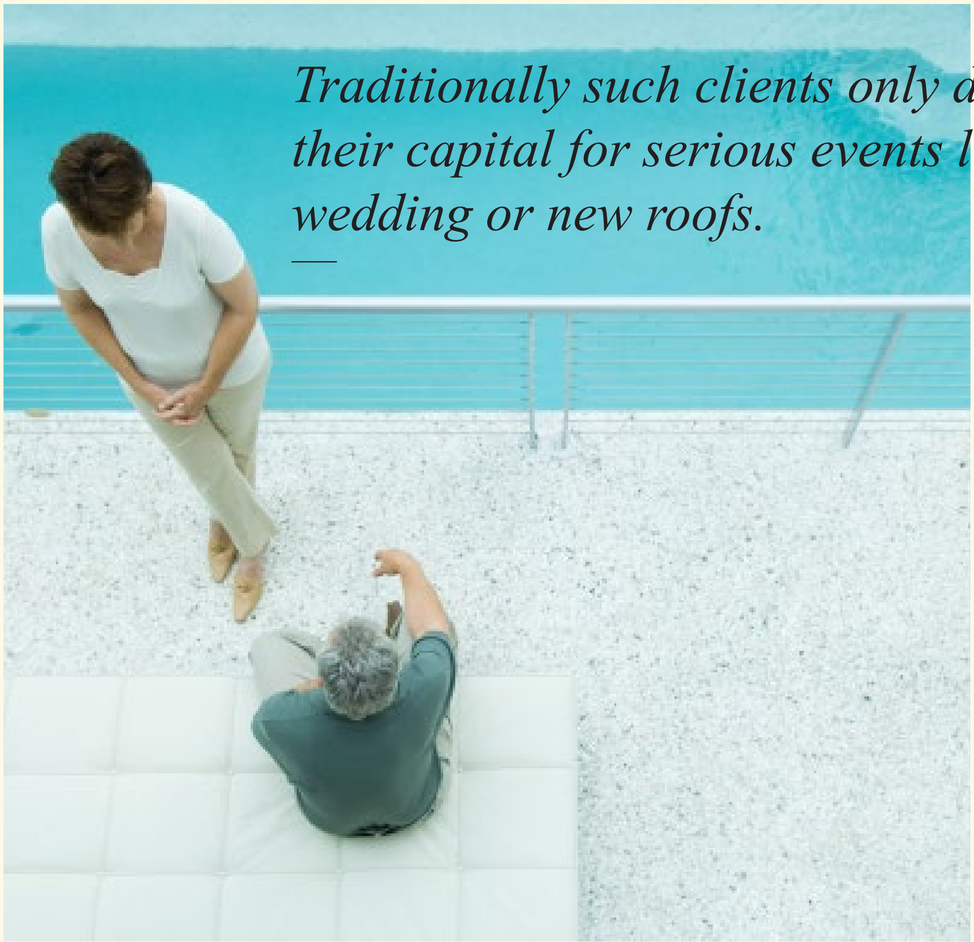
The brave new world for DC investors outlined above is likely to be quite different from the past, both in terms of the mix of assets (whether individually selected or in a fund) or the type of equities that may be most appropriate. Within the broad idea of 'multi-asset income' there is a wide array of potential asset mixes and approaches, with objectives which may include current income, income growth, income dependability, total returns and low volatility to varying degrees.

SUGGESTED APPROACH

Our view is that within any framework it is likely to be helpful to pensioners to try and keep the underlying equity weighting of their investments high to assist long-term returns and income growth, and to facilitate this by utilising global equity income approaches. These would give retirees more income (and possibly slightly less volatility) than mainstream global equity approaches, whilst at the same time benefiting from a broader opportunity set and generally lower concentrations of risk than UK equity income funds.

For the sake of illustration some broad rules of thumb for an individual might be:

1. Invest as much as possible in equities for a given level of required income by investing in a higher-yield global equity approach
2. Make sure that the chosen approach invests in growth equities which can deliver an income which rises in real terms, and that it also has the potential to outperform equities generally
3. Don't focus solely on diversification of income streams between asset classes, but also emphasise dependability within them, particularly within equities
4. Either don't worry at all about capital volatility (if your pot is large enough and produces enough income not to have to be a forced seller of assets at any given point) or reduce your forced selling by achieving a higher and more dependable natural yield, and
5. To the extent that you do have to invest beyond equities to boost starting yield, try and invest chiefly in asset classes that can also maintain the real value of income streams, or which deliver a markedly higher yield than equities



Traditionally such clients only drew down their capital for serious events like a daughter's wedding or new roofs.

This approach or type of fund won't work for everyone: at one extreme of the wealth spectrum, some will continue to invest solely to maximise total returns in retirement. At the other end there will be those whose modest pots permit them to take no risk, and who will therefore buy annuities. Indeed, it may still be the case that partial annuity purchase (to provide a base level of retirement income) remains appropriate for almost everyone. But even where annuities or annuity-like investments remain part of the answer, the approach above should still hold good for the rest of the pot.

From now onwards DC pension pots will come to dwarf the other savings of most investors. Many retirees will harbour a comforting suspicion that their nibbling of lettuce, occasional bouts of exercise, abstention from cigarettes and really very modest alcohol intake will help them live longer than everyone else. Coupled with pensioners' requirement for a reasonable current income, we believe this will lead many to favour approaches built around higher-yielding equities, augmented as required by income from other asset classes. They will also require dependability (to protect them from dramatic fluctuations in income) and growth (to protect them from inflation). Many will still want or need to sell some of their assets to augment their income and help fund their spending requirements in retirement, but a higher natural yield would help protect even these individuals from the potentially injurious impact of forced sales in poor markets.

Lastly, the move towards equity income is likely to be supported by the fact that pensioners may have heirs for whom they wish to provide, and by whom residual pension savings may now be inherited. This extends investment horizons beyond pensioners' lifetimes, and will perhaps bring their attitudes closer to those of many of the wealthy private clients of stockbrokers, who view their wealth as intergenerational and are thus distinctly averse to chipping away at their investments. Traditionally such clients only drew down their capital for serious events like a daughter's wedding or new roofs. The extract from a client email below provides an illustration of this change in mindset.

VOX POP

"For me the new pension rules are a game changer for my SIPP investments. I used to have to buy a security at a low price with a view of selling high to make as large a capital sum as possible – to enable me to buy an annuity. Now I don't need to buy an annuity I'm looking to build a substantial and rising income with investments I hope I never need to sell and that I will die with!

I will reinvest the dividends until I need to replace my earned income and then take them as cash. In short I can't live off the share price but I can and will live off the income."

David, Age 47

IMPLICATIONS FOR FUND MANAGERS AND CONSULTANTS

Investment consultants and fund managers have tended to focus their activities and research in the field of equities either on maximising total returns from equities (from genuine active management) or on eliminating benchmark relative risk and reducing fund management costs by going passive. Many consultants and institutional fund managers regard equity income approaches as poor second cousins at best, albeit enjoying the marginal benefits of a different pattern of performance to other equity approaches and possibly lower volatility.

For the record, we would not concur with the view that income or income growth centred approaches to equity investment are necessarily disadvantaged in total return terms by 'trying to do more than one thing'. We would simply observe here that strong counter-arguments can be made that a clear focus on areas such as cash flows, capital allocation and dependability are actually very helpful in total return terms too – but we'll leave those for another time.

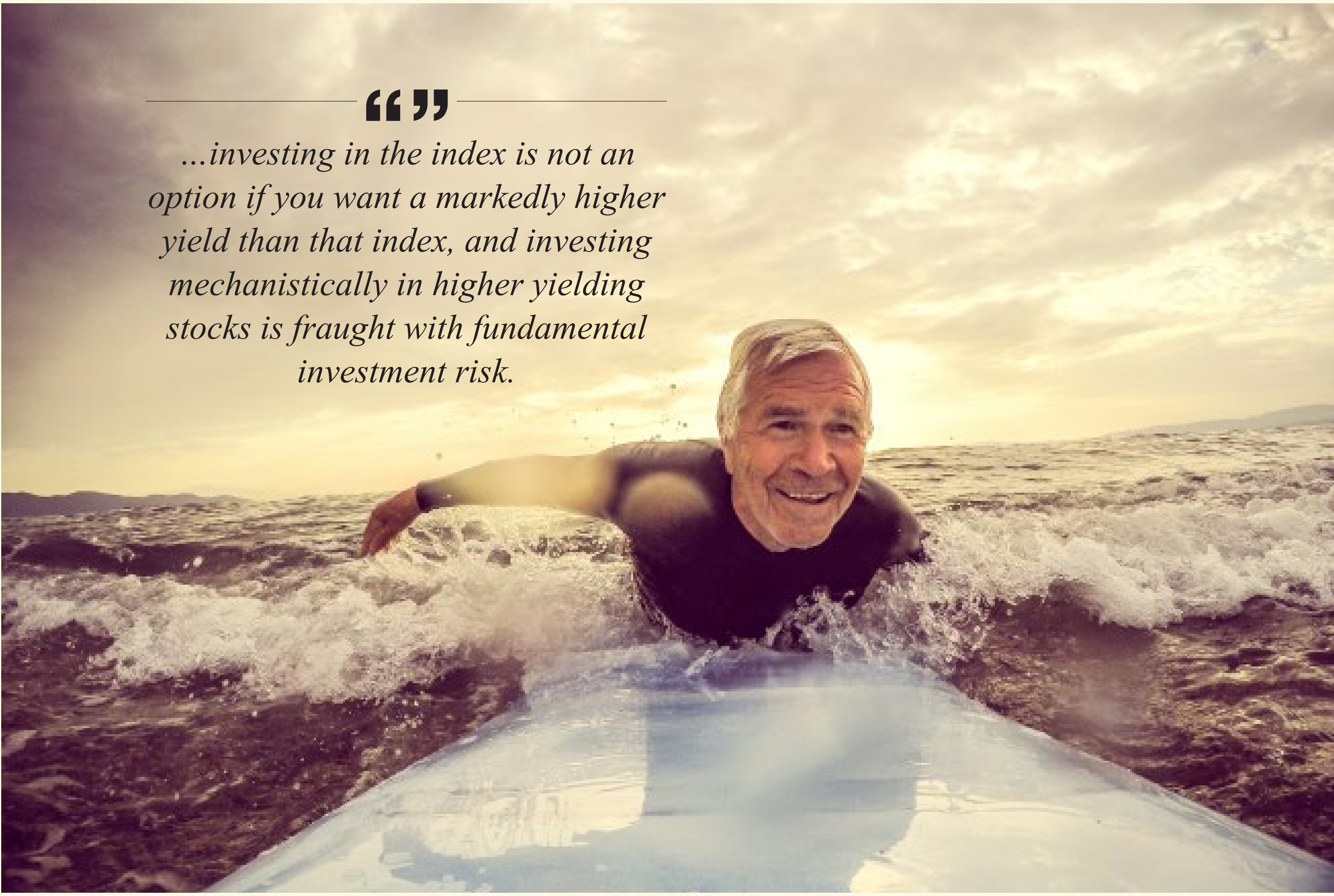
Suffice it to say here that if equity income approaches can deliver attractive total returns, and if dividends are reinvested until they are needed in the manner envisaged in the 'Vox Pop' on the previous page, then it can make perfect sense for equity income approaches to be used in the pre-retirement phase too. Indeed, if the plumbing permits 'to and through' investing, then doing so would also avoid the costs and timing risks associated with changing equity strategies.

Returning to the mindsets in institutional investment, the key point here is that the almost exclusive focus up until now on delivering total returns is unsurprising, as it was completely appropriate for investment consultants' and institutional fund managers' core constituency – large cash flow positive DB pension schemes. The sponsors of these schemes wished above all to lower their contribution rates over the long term by maximising returns (at least before they started focusing increasingly on volatility and on liability matching).

Today, the consensus remains that even mature DB schemes need not consider the level of income produced by their equities. If a pension fund needs to spend more at any stage (i.e. pay out more in benefits) than the income it is earning on its investments, it can just sell some of its liquid investments to do so. Accordingly, the level of equity income can be largely ignored (except perhaps to the extent it contributes to total returns) and the focus can be placed solely on delivering attractive absolute, or relative returns.

However, even if this thinking remains wholly appropriate for DB schemes (which is open to question), at the individual DC pensioner's level the world is different. Given the risks of drawdown, individuals' natural aversion to spending capital, and the importance of income dependability, a different mindset and different investment approaches will be required.

There will, we believe, be a large constituency of individual investors who will require more than 'just' additional returns (important as these remain) out of active equity management. As argued above, they will want to invest wholly or partly in high-yielding equity portfolios with an emphasis on delivering a dependable and growing income. Asset managers will have to provide this and consultants and product providers should be looking for it if they are not already doing so.



> ...investing in the index is not an option if you want a markedly higher yield than that index, and investing mechanistically in higher yielding stocks is fraught with fundamental investment risk.

Part of assembling the jigsaw will be assessing how such equity income approaches fit in with other asset classes in terms not just of returns but also income, income growth and, for some, volatility of capital. A final part of the jigsaw will be controlling costs, an area of intense focus in the DC pensions world. This has tended to advance the case for passive management. All the usual arguments about the nature of investment risk and the potential or otherwise for active managers to improve performance net of fees can be deployed on both sides of the active/passive debate. In a world where equity income has a larger place, however, there is one further consideration. This is that investing in the index is not an option if you want a markedly higher yield than that index, and investing mechanistically in higher yielding stocks is fraught with fundamental investment risk.

In this area therefore, perhaps even more than for equities in general, identifying and utilising capable active managers should help deliver the desired investment outcomes for all our clients.

CURIOUS ABOUT THE WORLD

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