InvesTips

Is income investing right for you?

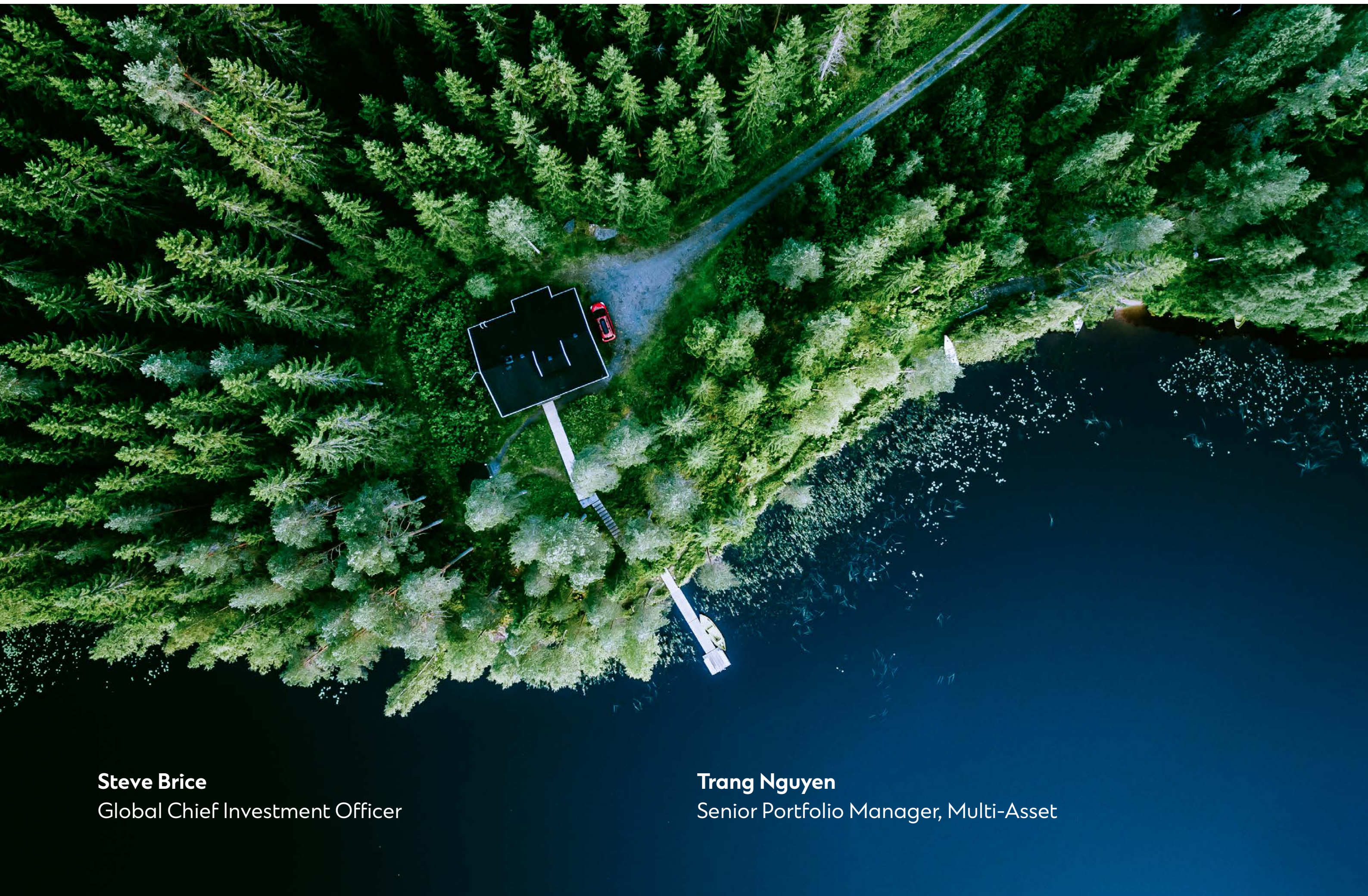
July 2023

7 myths and (historical) truths about income investing

Income investing – which involves investing in different asset classes in order to generate income – has become very popular in recent years.

Initially, this was driven by more than a decade of quantitative easing policies worldwide, which led to a dramatic decline in interest rates and high-quality bond yields. The prolonged low interest rate environment ignited the surge in popularity of this investment strategy. However, the appeal of a stable and reliable income stream has proven persistent, withstanding major shifts in economic regimes and market conditions.

This publication debunks the most common myths and illustrates key historical truths about income investing. By doing so, we seek to provide investors with a better understanding about the risk/return trade-offs and key principles of income investing. More importantly, we hope to address any misconceptions investors might have in favouring an income strategy (versus other approaches such as a total return focused strategy). We believe that having a clear objective and choosing the right investment strategy is the most important decision investors need to make for a successful and fulfilling investing journey.



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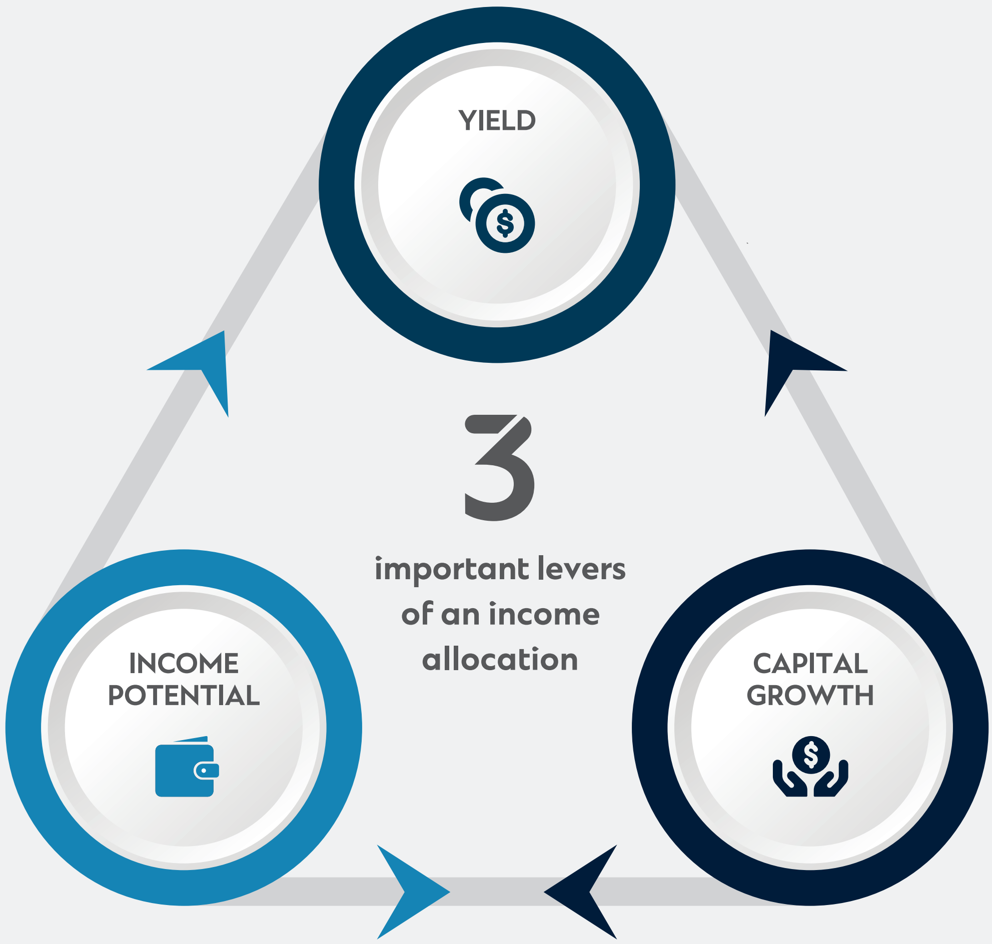
> “If you don’t know where you are going, you’ll end up somewhere else”
>
> – Yogi Berra

Income investing is an investment strategy that focuses on generating a steady stream of income from investments, typically in the form of dividends, interest payments or rental income. The primary objective of income investing is to generate consistent cashflows, often to meet current income needs, supplement retirement income, and/or provide a buffer, both financial and emotional, against market volatility.

An income allocation generally contains three levers: income, capital and yield. While it’s difficult to control all three, an income portfolio prioritizes consistent income and stable capital growth, with yield a function of the two.



Source: Standard Chartered

MYTH

1

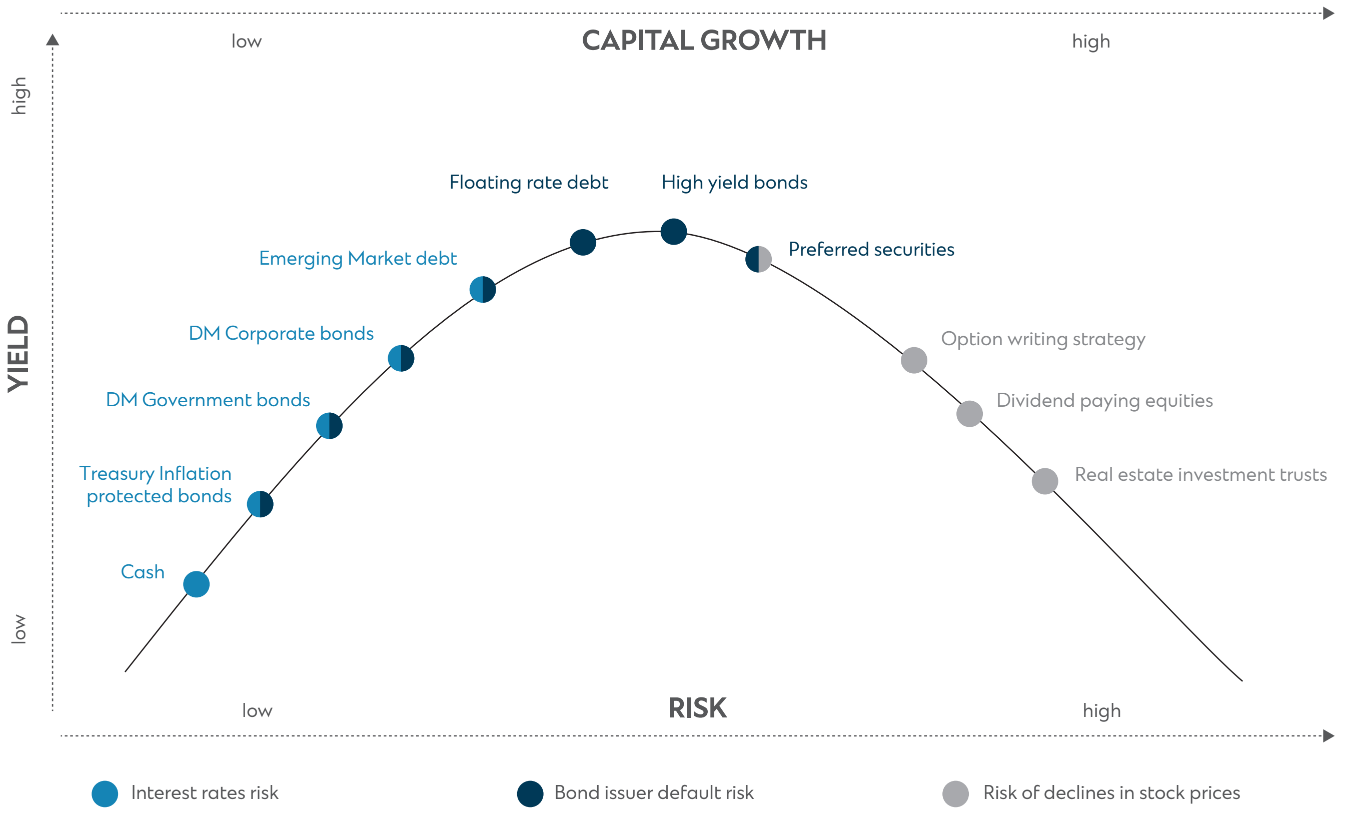
The higher the income, the higher the risk

When investors are focused on capital growth, it is generally understood that one needs to accept higher risks in order to achieve higher returns. However, this does not translate as smoothly when it comes to income investing. In other words, a higher yield may, or may not, require more risk to be taken. For example, a portfolio's income potential can be enhanced through increased exposure to Emerging Market and High Yield bonds, compared to investment-grade government bonds. Such a strategy entails an increase in the overall risk profile of the portfolio. These high-yielding credit assets, characterised by lower credit quality and higher default risks, tend to exhibit greater volatility and are susceptible to larger drawdowns during risk-off environments.

However, some lower income generating assets, such as global high dividend yielding equities and real estate investment trusts (REITs), are more volatile, but often offer comparatively lower income streams. Instead, relative to most fixed income assets, equity-based and equity-like income generators exhibit higher potential for growth in both capital and future income. Consequently, the risk of income assets needs to be assessed comprehensively across several dimensions that incorporate not only income, but also growth.

This perspective underscores the importance of having a more nuanced understanding of the trade-off between income and risk.

Yields vs. capital growth vs. different types of risks across income assets



Source: Standard Chartered

MYTH 2

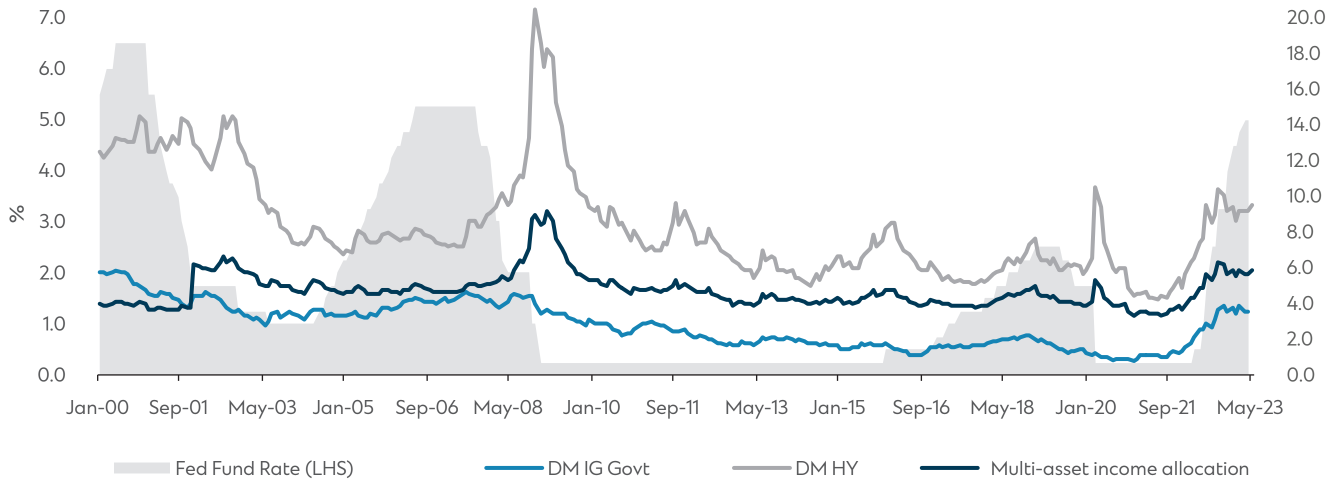
The higher the current yield, the better

It is important to understand that higher yield does not necessarily translate to higher income. The yield level of an investment is determined by its dividend or interest payment relative to its current market price. A higher yield may indicate a higher annual income in percentage terms, but it does not reflect other crucial factors such as the sustainability and consistency of those income payments over time.

There are many drivers behind the changes in the yield percentage of an income asset. Historically, central bank policy has been one of the most important factors. The chart below shows that there can be large fluctuation in an asset's yields during Fed hiking and easing cycles. For this reason, diversification remains an important principle to adhere to in constructing an income portfolio for a sustainable and consistent source of income through the cycles and across different macroeconomic regimes.

A diversified income allocation maintains consistency and sustainability of yields through cycles

Historical YTW, YTM and dividend yields of select income assets (2000 to 2023)



Source: Bloomberg, Standard Chartered. *Multi-asset income allocation is proxied by 16% DM IG Government bonds, 10% DM IG Corporate bonds, 12% DM HY bonds, 22% EM debt and 40% Global High Dividend Equities

MYTH 3

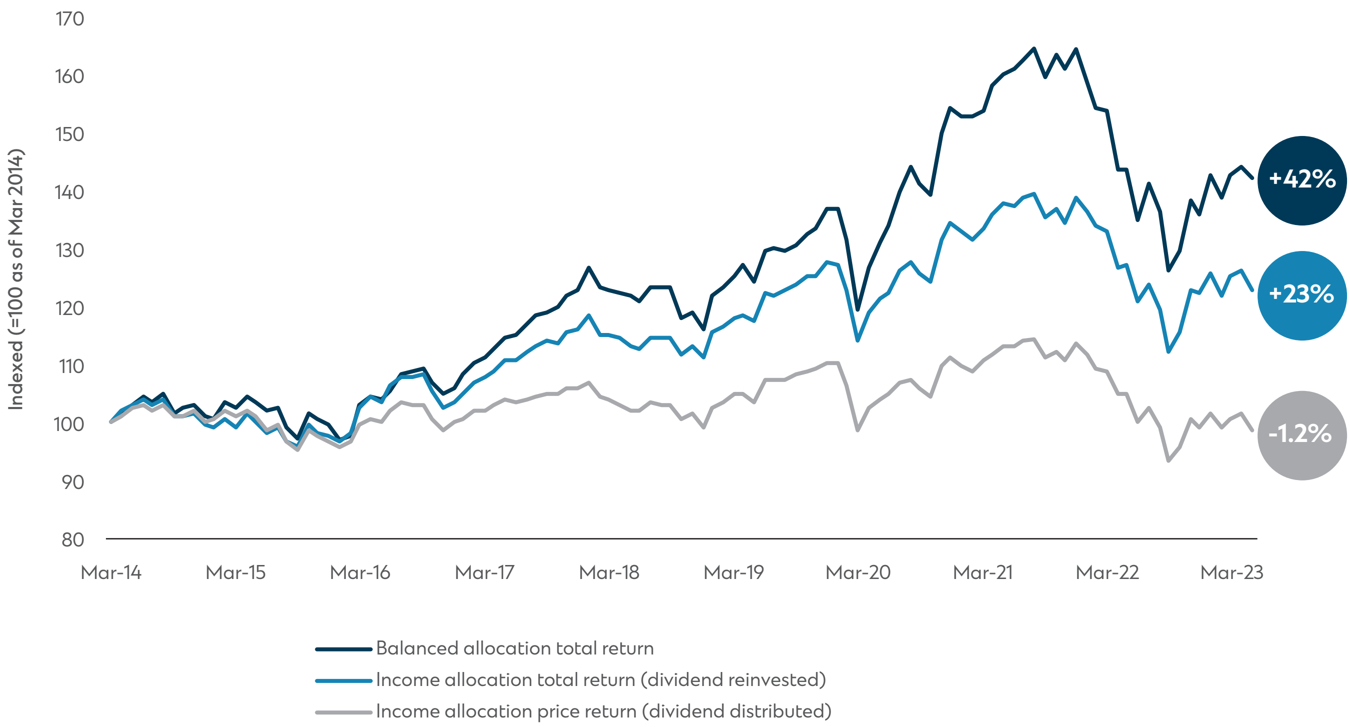
A multi-asset income allocation can produce superior returns (than a total return-based allocation) over the long term

Income strategy is designed to provide a reliable and regular income stream, which is essential for meeting day-to-day expenses and financial obligations. It also offers investors the option to consider reinvesting dividends for capital preservation and wealth accumulation. This can be an excellent way to harness the power of compounding over time. However, we believe that this benefit should not change the primary objective of income investing – regular pay-outs. Economic regime shifts and major market condition changes can impact the relative performance of income assets over the short and long terms. Nevertheless, the positive tilt toward fixed income assets in most income portfolios suggests a structural limitation on their capital growth compared to total-return based portfolios.

Our historical analysis in the figure below indicates that reinvesting unused dividends can be beneficial, thanks to the compounding effects. However, investors aiming to maximise total returns should be better off with a balanced portfolio that has a higher exposure to growth-focused assets. The disparity in total return potential between a diversified income and a balanced portfolios can be significant. Choosing the right investment strategy for a given investment goal is vital for successful planning.

Reinvesting dividends from an income portfolio can be an excellent way to harness the power of compounding. However, this has historically underperformed a balanced portfolio over the long term

Cumulative returns of total return and price return of a diversified income allocation* vs. total return of a balanced allocation** (March 2014 to May 2023)



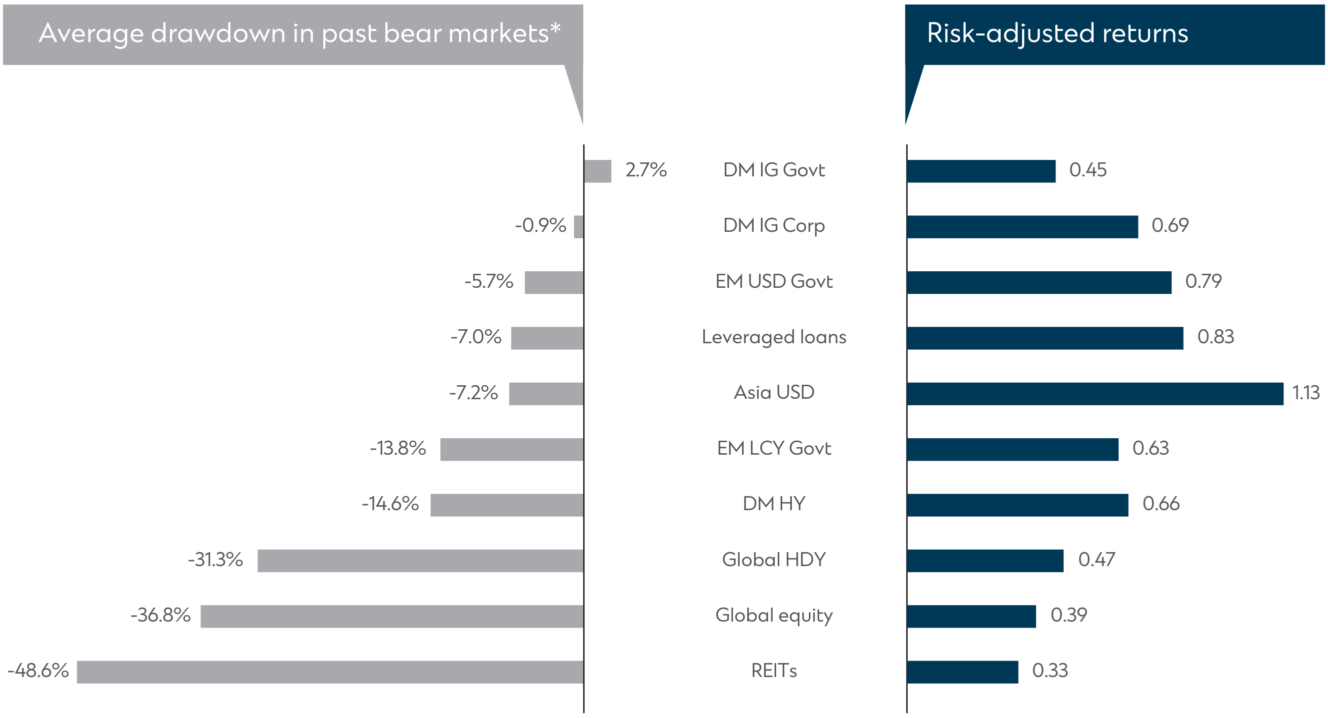
Source: Bloomberg, Standard Chartered
*Balanced allocation is proxied by 30% global bonds, 20% EM debt and 50% global equities
**Income allocation is proxied by 40% global bonds, 20% EM debt, 40% global dividend equities

MYTH 4

Income assets tends to experience lower drawdown during bear markets

Many higher-income assets offer higher risk-adjusted returns than their lower-income peers and especially so versus growth-oriented assets. Yet high dividend-paying equities, high yielding credit and hybrid securities are vulnerable to similar drawdown risk. For example, high dividend equities show much superior risk-adjusted returns to that of traditional equities. However, history shows that both equity styles pulled back in a similar manner and magnitude in the past recessions.

High dividend equities are not immune to market downturns despite much better risk-adjusted returns*



Source: Mercer, Bloomberg, Standard Chartered
*Risk-adjusted return is the return of an investment per unit of risk (measured by standard deviation)

HISTORICAL TRUTH

5

Yield-focused assets tend to underperform growth peers in the recovery phase post-recession

A look back the past recessions show that, compared with most high yielders, growth-oriented assets or total return-based investments may experience faster recovery and enjoy higher upside potential during the recovery phase. As such, historically, a balanced portfolio with larger exposure to growth assets reported much higher average return post recessions, compared to an income portfolio.

This can be due to several factors:

1. Market sentiment and risk appetite: During the recovery phase, investor sentiment tends to improve as economic conditions stabilize. This often leads to a shift in investor preferences towards growth-oriented assets, as investors seek higher returns and are more willing to take on additional risk. Income assets, which are typically perceived as safer and more conservative investments, may not attract the same level of demand for capital appreciation as growth assets.

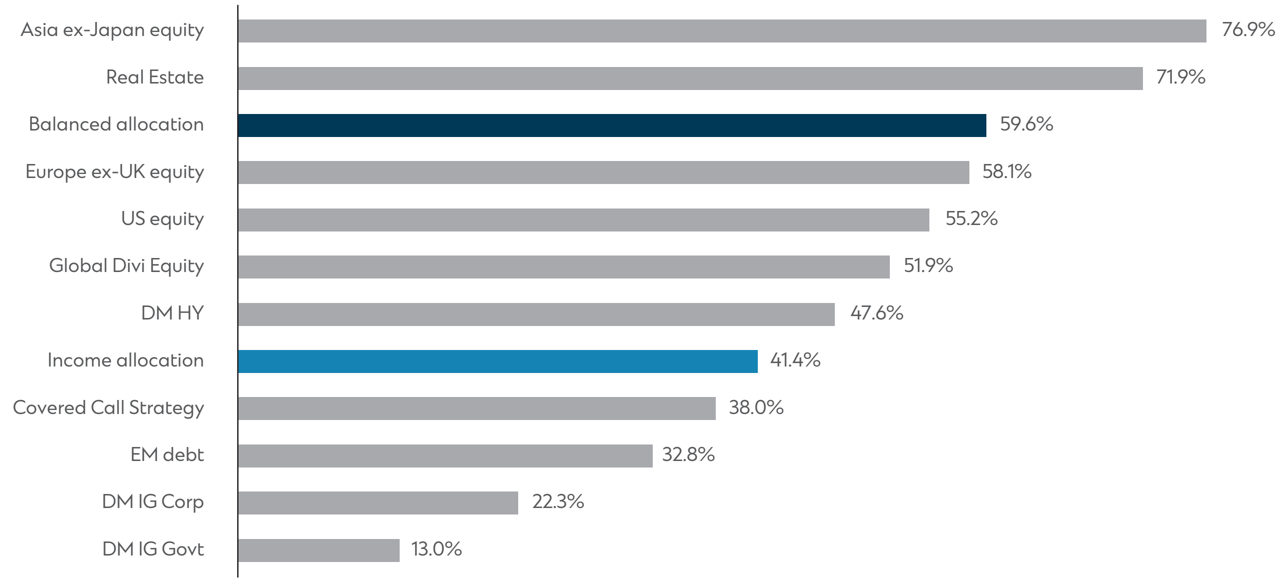
2. Interest Rate Dynamics: In the recovery phase, central banks may adopt monetary policies aimed at stimulating economic growth. These policies often involve lowering interest rates to encourage borrowing and investment. While lower interest rates benefit income assets by reducing borrowing costs and supporting the fixed income market, they can also lead to lower yields on existing income-generating investments. As a result, income assets may experience limited capital appreciation compared to growth assets, which can benefit from lower borrowing costs and increased market demand.

3. Sector and Industry Dynamics: Different sectors and industries have varying sensitivities to economic cycles. Growth-oriented sectors, such as technology, consumer discretionary, or emerging industries, are often more responsive to economic expansion and may experience higher capital appreciation during the recovery phase. Income assets, on the other hand, are generally associated with more stable sectors, such as utilities or consumer staples, which may have lower growth prospects during the recovery phase.

4. Valuation Considerations: During the recovery phase, growth assets may be perceived as having higher growth potential, leading to higher valuations. Income assets, on the other hand, may be viewed as having lower growth prospects and therefore may not experience the same level of capital appreciation. Market participants may assign higher multiples to growth assets based on future earnings expectations, while income assets may be valued more based on their income-generating capacity.

A balanced allocation with positive tilt toward growth assets outperformed a diversified income allocation in the recovery phase post the past recession

Average 12-month returns of various assets and allocations in the recovery phase post the past recessions (2000, 2007, 2020)



Source: Bloomberg, Standard Chartered. An income allocation is proxied by 13% DM IG bonds, 23% DM HY bonds, 26% EM bonds, 35% dividend equities and 3% REITs. A balanced allocation is proxied by 15.5% DM IG bonds, 8.5% DM HY, 16% EM bonds and 60% Global equities

MYTH 6

Inflationary environment tends to favour an income strategy (than a growth-focused total return strategy)

While income assets are often considered as potential hedges against inflation, the value of an income allocation can be eroded quickly in high and very high inflationary environments.

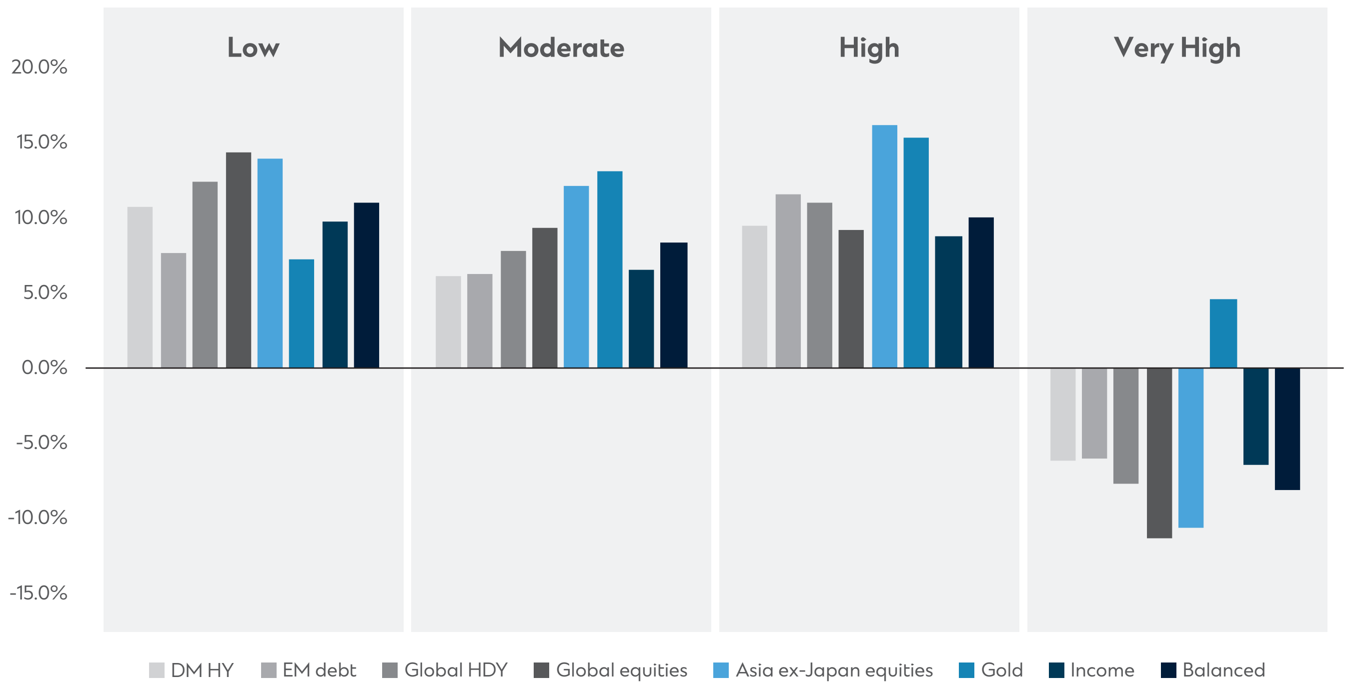
Income assets that have built-in inflation protection features, such as inflation-linked bonds or real estate investments, may potentially perform better in low and moderate inflationary environments. These assets are designed to adjust their income streams or values in response to changes in inflation. However, rising interest rates, driven by high and very high inflation expectations, can negatively impact bond prices, and significantly erode the price return of most risk-on and high beta income assets.

However, contrary to popular belief, growth assets have exhibited strong resilience in the inflationary environment historically. This is especially true with growth stocks with pricing power, strong growth prospects and the ability to pass on increased costs to consumers. Additionally, sectors such as commodities, oil and gold may experience increased demand and benefit from rising prices in periods with rising inflation.

The figure below examines the performance of income and growth-focused assets in different inflationary regimes. Two observations stood out:

- First, a balanced allocation with a clear preference toward growth assets such as Asia ex-Japan and Emerging Market equities outperformed a diversified income allocation in scenarios of low, moderate, and high inflation.
- Second, in very high inflation scenario (CPI greater than 4%), a diversified income portfolio experienced lower drawdown than a balanced allocation. This is likely thanks to the buffer provided by investment dividends and interest payments.

Performances of various assets and allocations in different inflation regimes



Source: Bloomberg, Standard Chartered. Low, moderate, high, and very high inflation scenarios are characterized by periods when CPI level < 2%, CPI between 2-3%, CPI between 3-4% and CPI >4%. An income allocation is proxied by 13% DM IG bonds, 23% DM HY bonds, 26% EM bonds, 35% dividend equities and 3% REITs. A balanced allocation is proxied by 15.5% DM IG bonds, 8.5% DM HY, 16% EM bonds and 60% Global equities

HISTORICAL TRUTH 7

Regular distribution is important, but total returns still matter the most

Distinguishing between regular income distributions and fund performance is essential for a comprehensive understanding of an income fund.

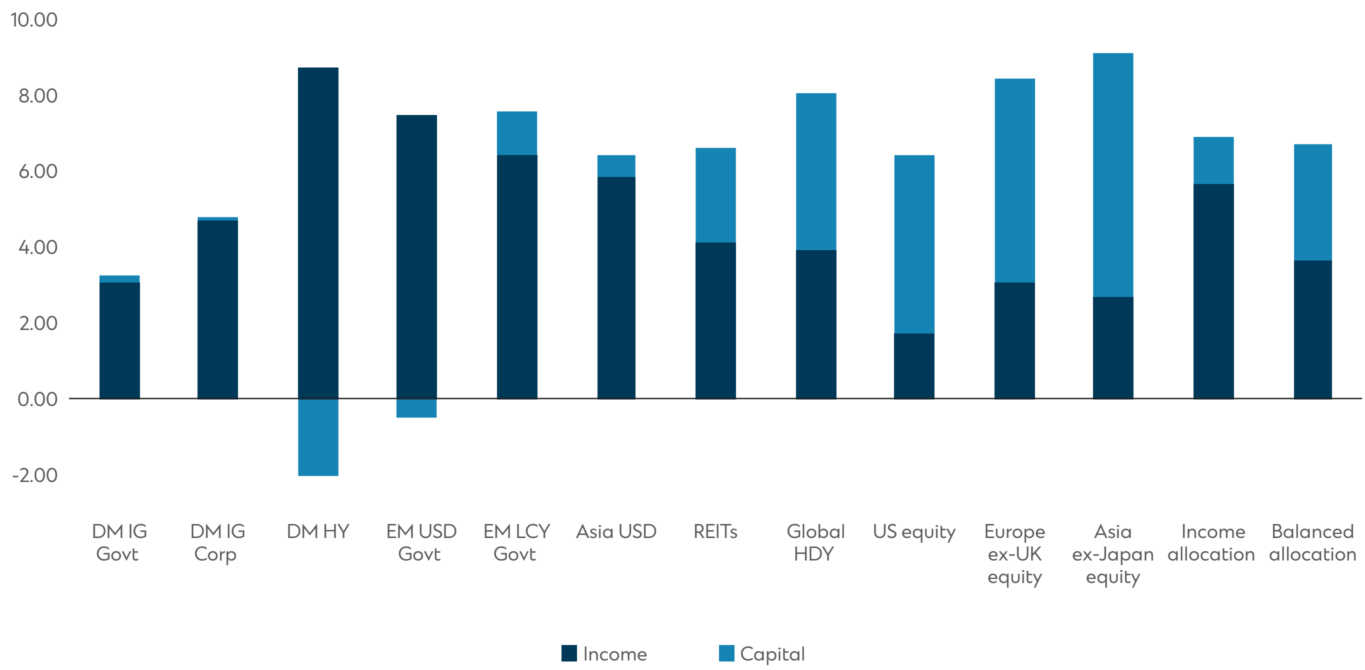
While the appeal of a generous income stream may be enticing, relying solely on interest payments or dividends can prove challenging as asset yields fluctuate throughout economic cycles. Conversely, depending heavily on capital growth for distribution payments can erode the underlying investments, compromising a fund's long-term sustainability and depleting the capital base. To address these concerns, an income portfolio should maintain a balanced exposure to bonds, equity income, and equity-like assets that offer moderate capital appreciation potential. This balanced mix includes dividend-paying equities, preferred securities, and REITs, which not only help grow the capital base but also enhance overall returns and sustain real income levels consistently over the long term.

Evaluating an income fund's distribution policy necessitates scrutiny of its historical performance, income sources, and pay-out ratios. Such analysis provides valuable insights into a fund's ability to generate income beyond capital growth.

Recognising the distinction between income distributions and fund performance empowers investors to make well-informed decisions aligned with their long-term goals.

A robust income portfolio should have a good balance between capital stability and income growth

Breakdown of our 7y long-term return expectations into income and capital components across different assets



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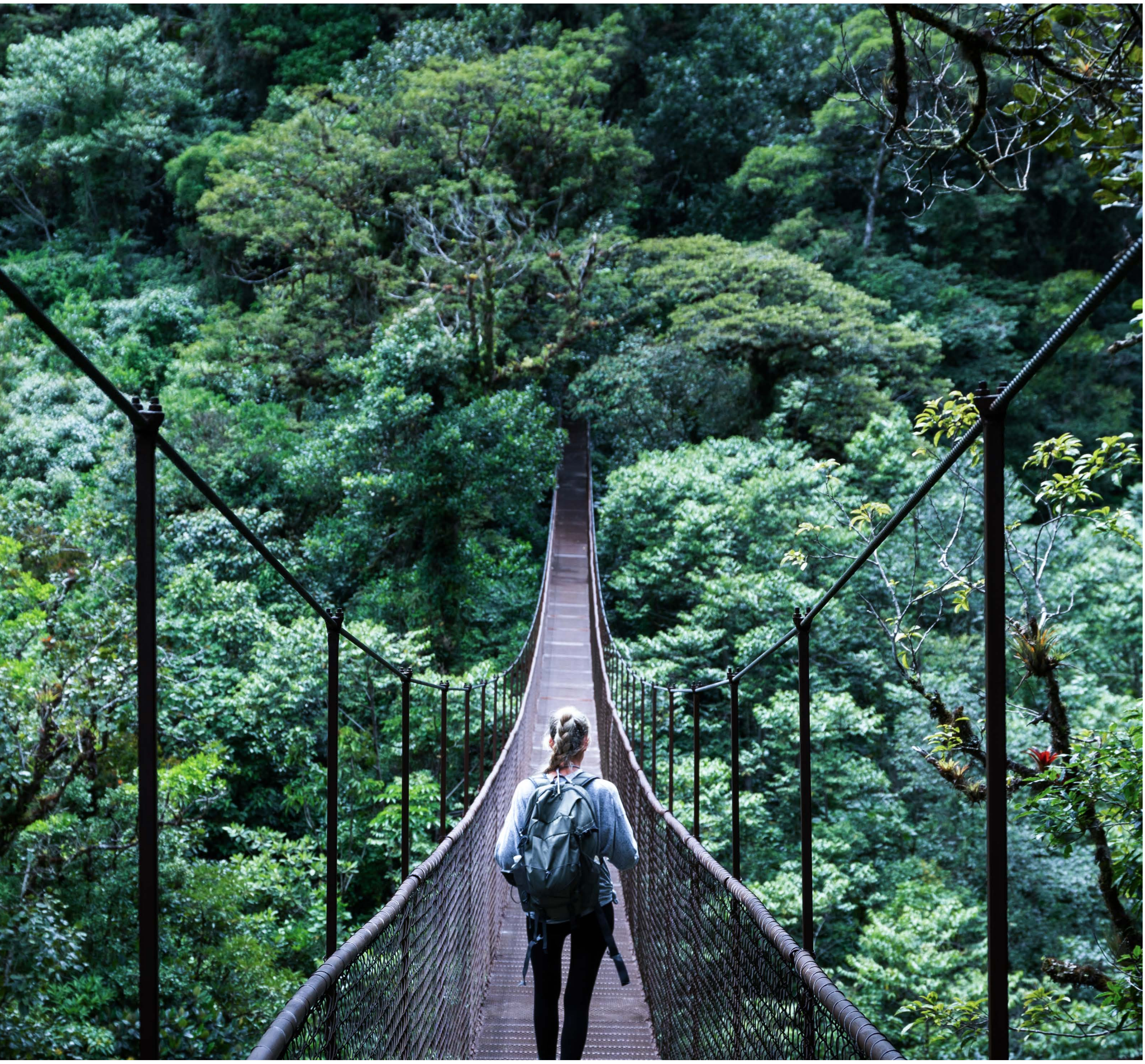
Irrespective of one's stage in the investment life cycle, an income strategy that offers a regular cash flow is undeniably attractive. This appeal can stem from various financial obligations we often have in our daily lives. However, it is crucial not to overlook the purpose and unique characteristics of income investing. By understanding these aspects, investors can ensure their portfolios are optimally positioned around their investment goals.

While it can be tempting to prioritize immediate cash flow needs, a broader perspective that incorporates growth-oriented assets can enhance long-term wealth accumulation. For individual who prioritize growing their wealth over the medium to long-term time horizon, an income portfolio with low to moderate growth potential might not be the most suitable investment strategy. Instead, a balanced portfolio with substantial exposure to growth-oriented assets aligns more closely with their investment objectives.



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