# Indepth | Global search for yield

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Fiona Clarke, Prime Value: Now is a good time to re-enter the market as all the bad news has been factored into prices. **Photo: Arsineh Houspian**

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A spate of innovative investment products designed to lure investors away from cash and back into growth assets have been launched recently.

BT Investment Management, AMP Capital and UBS Global Asset Management have all introduced Australian equity income funds, and Aberdeen is offering its Multi-Asset Real Return Fund targeting returns of CPI plus 5 per cent.

Global giant BlackRock is working on a range of income and multi-asset strategies to be rolled out next year. It follows the retail launch earlier this year of the BlackRock Australian Equity Absolute Return Fund, which targets returns of CPI plus 8 per cent.

These funds aren't of the plain vanilla variety. They don't track traditional indices and they don't focus solely on capital growth. Rather, they aim to meet investors' objectives, targeting those in or near retirement.

The idea is that dividend-paying stocks are higher quality and more stable. For retirees and other investors who need a regular income stream, these stocks and income funds are less risky than growth stocks.

According to the Australian government's 2010 *Intergenerational Report – Australia to 2050: Future Challenges*, there will be 8.1 million people over the age of 65 by 2050, representing 23 per cent of the population compared with 2.6 million people, or 13.3 per cent, in 2006. BT Investment Management estimates that $1 trillion will shift from accumulation phase to retirement phase in the next eight years. It predicts the flow of money from accumulation to decumulation will steadily increase to $66 billion in 2014, $106 billion in 2018 and $135 billion in 2020.

A large percentage of this money will flow straight into self-managed superannuation funds – a major audience for these next-generation Australian share funds.

Fiona Clarke, senior investment analyst at Prime Value, says it's foolishness for investors to exclude Australian equities from their portfolios, especially given Australia looks extremely attractive from an income perspective relative to its peers and has delivered grossed up yields of about 6 to 7 per cent.

Clarke says now is a good time to re-enter the market because the bad news has already been factored into share prices and there's global support for a recovery, with co-ordinated stimulus in September demonstrating the commitment of central banks and policymakers to solving the crisis. "They know the problems exist and they're trying to fix them," she says. "While the situation is particularly bad in Europe, action is being taken, so there won't be much further downside from a long-term perspective, although there will be short-term volatility."

Clarke says Australia is strongly positioned for growth because of its low debt levels and exposure to the emerging markets. Prime Value doesn't currently offer an equity income fund although its flagship Imputation Fund has an income bias.

Tyndall Asset Management's Brad Potter admits that equities currently look cheap compared with bonds, adding that everything looks cheap compared with bonds.

Tyndall is attracted to high-quality, sustainable yield stocks but Potter says it's not accurate to say dividend-paying stocks are higher quality and less volatile than growth stocks.

"Sometimes high-yielding stocks can be value traps," he says. "They could be high-yield because the company is under stress and the share price has fallen, so you can't be simplistic. The focus must be on quality and sustainable yield, not just high-yielding stocks."

NAB Private Bank suggested in its October investment paper that investors remain underweight Australian shares because of concerns about lower earnings growth. Investors should "continue to focus on companies with relatively certain earnings and high dividends", it said.

Clarke understands that investors have been burnt and are scared of growth assets but she believes an income or imputation fund is a cautious way to boost exposure to equities.

"Some investors are quite happy to say no thanks to this asset class altogether but that's not the way to go because we've already experienced the lows and, in a way, an income or imputation fund gives investors the best of both worlds," she says.

BlackRock is currently conducting focus groups with financial planners and research houses as part of its preparations to release sustainable income strategies in the new year.

The funds will be managed by senior portfolio manager Paddy McCrudden and will follow on from the retail launch of two alpha-generating long-short funds managed by Mike McCorry, head of Scientific Australian Equities.

The BlackRock Australian Equity Absolute Return Fund targets returns of CPI plus 8 per cent, and the Australian Equity Opportunities Fund aims to outperform the S&P200 Index by 8 per cent.

There's strong support for both funds, says Scott Phillips, a managing director at BlackRock.

Phillips is not concerned that BlackRock will be too late when it comes to the market with its new products next year.

"It's still early days for income solutions and the theme is right but quality products always rise to the top, so we're not concerned about being first to market," he says.

"Our aim is to meet investors' needs for stable, sustainable income and also educate investors to ensure they understand what we do and the reasons why we invest the way we do."

Later this month, BlackRock is expected to release a global white paper on income, written by an in-house team of PhDs worldwide.

In October, UBS launched its first exchanged-traded fund in Australia. Unlike other passive ETFs, which track traditional indices such as the S&P/ASX200 or MSCI World Index, the UBS IQ Research Preferred Australian Share Fund gives investors access to a diversified portfolio of stocks highly rated by UBS's equity analysts.

It is the first of a number of semi-active ETFs that UBS will launch locally, including a high-yield fund and global equities fund.

The series forms part of the company's strategy to reach a wider segment of Australian investors.

The UBS IQ Research ETF has a quality bias which will see it outperform passive index funds, says Ben Heap, chief executive of UBS Global Asset Management.

“There will be significant growth in the local ETF market because the appetite is there and there was an opportunity for us to do something different and to create an ETF that would deliver a better return than the market alone,” Heap says, citing the success of semi-active ETFs in the United States.

UBS is developing other similarly structured ETFs, including an equity income fund. This follows the launch in May of two low-cost, multi-asset funds: UBS Tactical Beta Fund – Conservative, and UBS Tactical Beta Fund – Growth.

These funds combine passive index investment with an active asset allocation and cost 35 basis points with transaction fees of up to 20 basis points.

The new UBS IQ Research ETF costs 70 basis points and is significantly cheaper than the group’s flagship Australian Shares Fund, with wholesale fees of about 90 basis points.

In the year to September 30, the UBS Australian Share Fund returned 16.8 per cent and the group’s concentrated Halo Fund returned 18.3 per cent against the S&P/ASX200 index which returned 14.6 per cent. However, the funds lagged the benchmark over a three-year time frame.

Heap says the group’s new ETF and the ones to come will be ideal for self-managed superannuation fund trustees who prefer to invest directly in shares and ETFs to bypass platforms and minimise the fees they pay. “There’s increasing pressure on fees and all parts of the value chain are being squeezed,” he says.

However, there’s still a place for traditional managed funds, but pressure is on fund managers to continually innovate during these challenging economic conditions, he says.

Investors can now invest in MLC’s protected capital and protected income solution, which allows them to stay invested in the market knowing that their capital, or retirement income, is protected should the value of their investments fall.

MLC claims MLC Masterkey Investment Protection provides investors with certainty that the retirement plans they put in place will deliver. Protection costs start from 45 basis points, with an average fee of 40 basis points for administration on a portfolio of $150,000.

Ratings house van Eyk Research is generally supportive of Australian equities given the yields on offer but it warns investors to beware of value traps in the high-dividend end of the market.

According to Jonathan Ramsey, the group’s head of asset consulting, the global search for yield has, in some cases, resulted in a “dividend trap” caused by investors pouring into high-dividend paying stocks and driving their price dangerously high.

“In the past, high-income stocks also meant high-quality defensive stocks, but over the past few years we’ve seen investors bid up some high-dividend stocks, so now they look expensive,” he says.

Tyndall’s Potter adds that the banks, a perennial favourite among dividend chasers, currently look expensive on every other measure except yield.

“From a yield perspective they look as cheap as they’ve ever been. That’s more about the fact that bond yields have fallen so significantly,” he says. “With grossed-up yields of around 8 per cent, the banks look very attractive given cash rates of 4 to 5 per cent.”

Ramsey says ultimately investors who want income must accept greater volatility and those who want capital preservation can’t rely on the income stocks to be that stable. He says investors considering these newer equity-based products should understand that globally, everyone is searching for yield because everyone wants high levels of income and low risk. But there’s a real risk that the high levels of income being targeted aren’t sustainable.

“The yields might be there at the moment but where will the growth come from to pay those dividends? These funds were a great idea three years ago and we have to consider them because that’s what investors want, but they need to be careful about valuations,” Ramsey says.

Financial planner Neil Kendall of Brisbane firm Tupicoffs has kept his clients in cash for the last 14 months and they’re likely to stay there for some time. From December 2007 to early 2009, his clients were also fully invested in cash.

He has serious reservations about the wave of new equity-based products being rolled out. “Conceptually these products make sense but it’s the same old thing in a different wrapper. Nothing about the market has changed, it’s just the packaging that has changed and if the market goes down, then investors in these funds will still be in a difficult place,” he says.

“People need to understand that these funds still invest in equities, so if the market goes down they won’t be insulated.”

Kendall says new products must be marketed and labelled correctly to ensure investors don’t get the wrong idea but they should also fully understand the investment risks. He cites CPI-plus funds which target returns on top of inflation as an example of potentially misleading labelling.

“The term CPI-plus has been dangerously used because it’s just a target. It’s what the fund aspires to; it’s not a guarantee. It’s the same as other funds only it’s dressed up nicely,” he says.

At the moment, Kendall says the risk of investing in equities far outweighs the potential reward. For retirees, who don’t have the luxury of time to make up any losses, the effect of losing money could be catastrophic.

He says financial planners have an obligation to clients who are either retired, or nearing retirement, to think tactically and make any necessary changes to generate alpha.

“Keeping a stagnant asset allocation is great for people who will live forever but it won’t work for retirees,” he says.

Asset

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