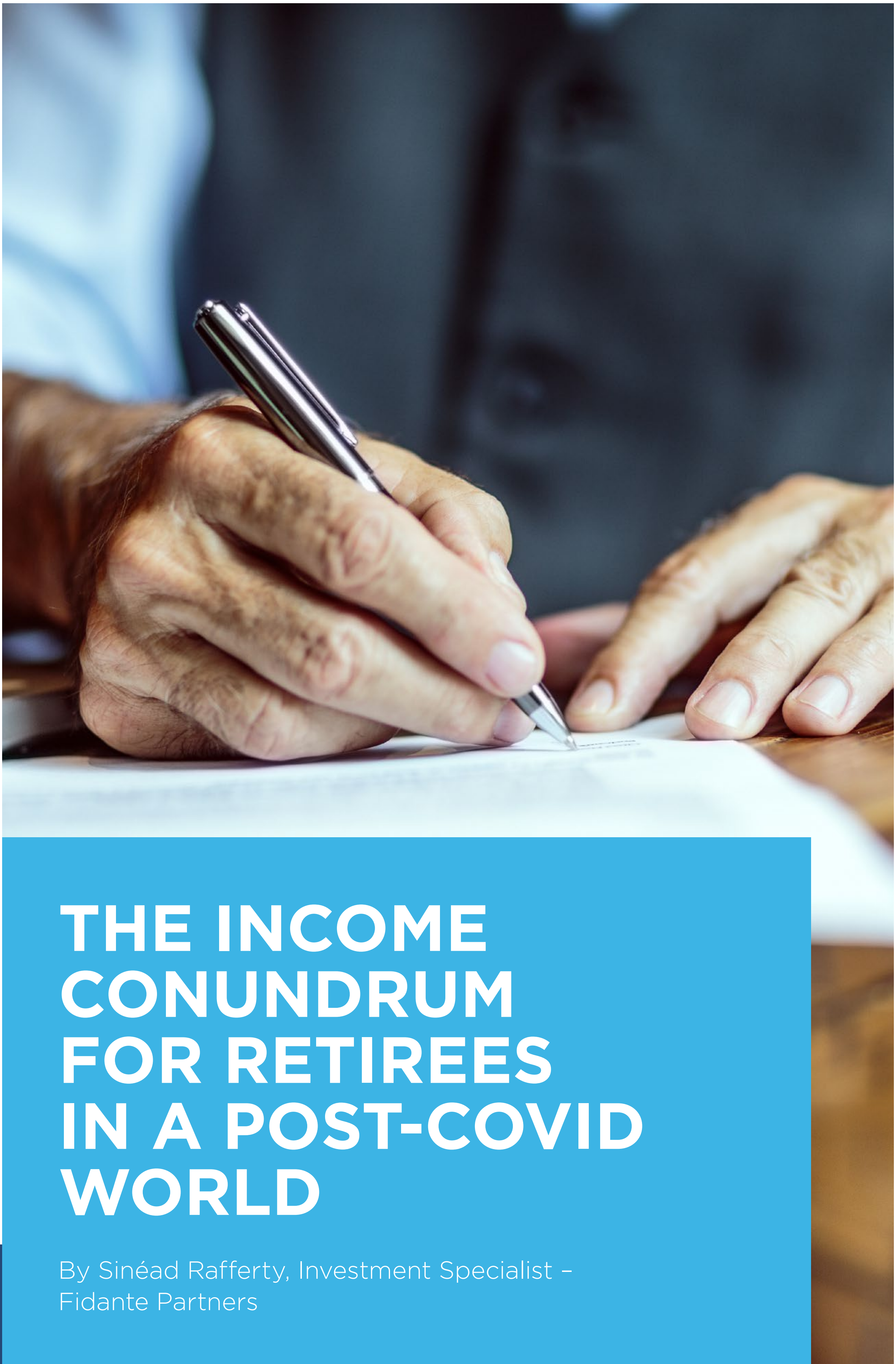

THE INCOME CONUNDRUM FOR RETIREES IN A POST-COVID WORLD

By Sinéad Rafferty, Investment Specialist –
Fidante Partners

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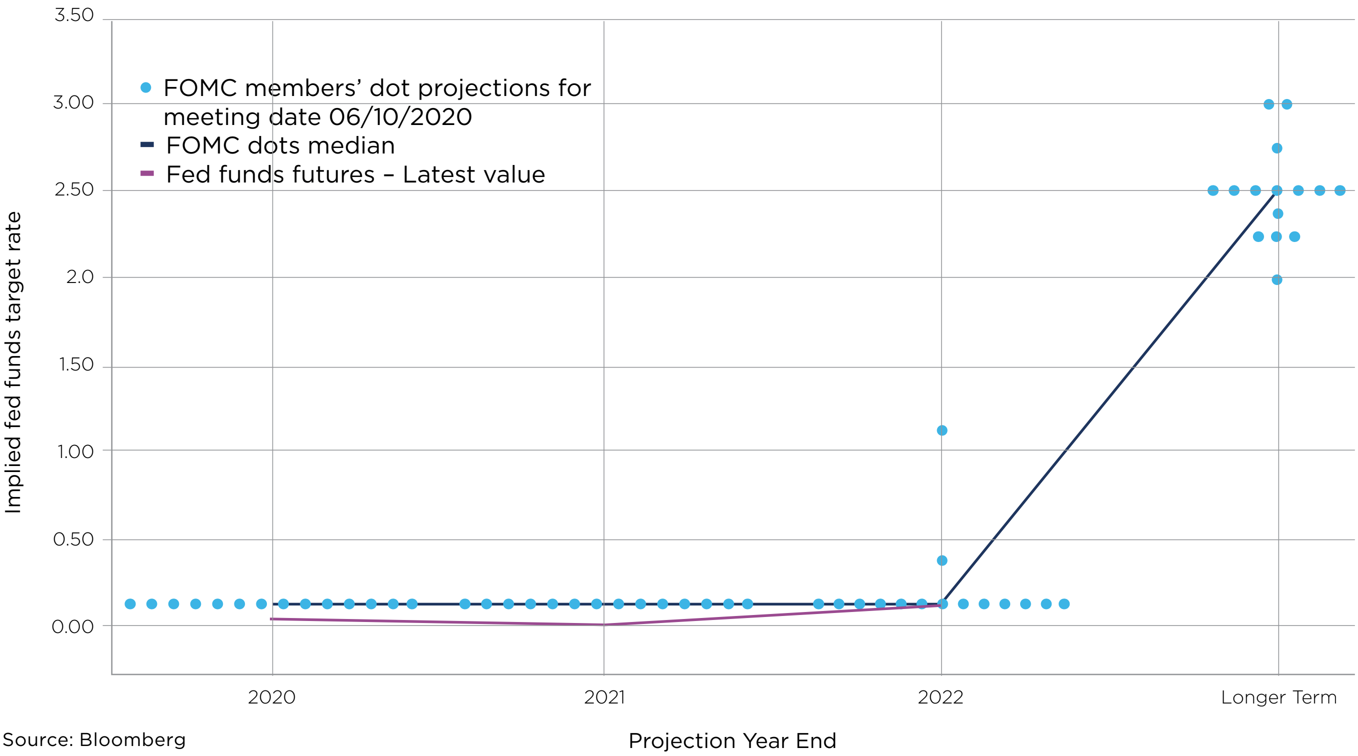
With central bankers around the world committing to keep interest rates low for many years to come, this creates an issue for retirees looking for income. Traditional defensive assets such as cash and fixed income which typically form a large percentage of retiree portfolios are producing levels of income significantly below historical averages.

In Australia, the RBA is keeping the 3-year yield for government bonds at 0.25%, in what is known as yield curve control. Interest rates have been suppressed for the last decade, however what is unique about the current economic climate, is that with inflation yet to emerge and central bankers focused on generating growth and employment, their signalling to the market has moved further out. Lower for much longer!

The Fed's New Dot Plot



Source: Bloomberg

For many retirees this low yielding environment presents a dilemma and could pose several questions:

1. Should a retiree reduce their level of spending?
2. Should they consider a higher allocation to riskier assets such as shares? or
3. Contemplate or be forced to adopt a total return approach to investing and start drawing down their capital.

For many retirees, funding their lifestyle with a combination of capital and income could be the most palatable solution. Depending on the retiree's circumstance, this approach may well be inevitable to meet their minimum withdrawal rate.

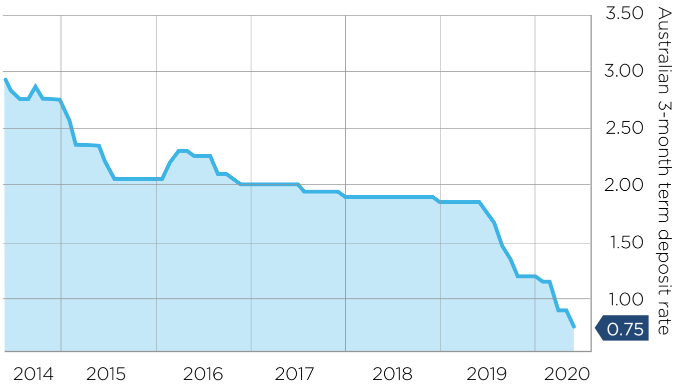
Taking a total return approach and considering the capital return (if relevant) as well as the distribution exposes a retirement portfolio to different considerations and potential risks. Some of these include the need to:

- Decide on an appropriate allocation to cash for liquidity purposes
- Understand the correlation between the assets in your portfolio
- Diversify sources of income across equities, credit and bonds
- Consider the sectoral and geographical exposure of the portfolio

Keeping sufficient cash to meet living expenses

For retirees, cash can provide an important liquidity buffer to meet ongoing expenses. Proponents of the bucket approach to portfolio construction advocate for 2-3 years of living expenses to be kept in cash or short-term deposits. With low interest rates the norm for the last few years and central bankers indicating that this is likely to persist for many more it is tempting to move up the risk curve in search of higher returns. What the recent crisis reminded us is that there are times of market stress whereby the return *of* capital takes precedence over return *on* capital.

Australia 3-month term deposit rates have been declining



Source: Bloomberg

Is your portfolio appropriately diversified?

Bonds typically form the backbone of a defensive portfolio however the correlation between bonds and shares has increased in recent years. This is due to artificially low interest rates which have reduced the diversification benefits for parts of the market such as government bonds. Investing in fixed income now needs a very selective approach to achieve the desired risk-reward trade-off. The size of the global bond market dwarfs that of the share market and the range of opportunities within the asset class are broad. For example, government bonds provide lower risk and lower return whereas high yield credit and private debt provide higher potential return with higher risk. Investors need to consider what building block they are looking to fill in their portfolio. Diversifying within the fixed income market can provide investors with income and more stability in times of market stress.

This can include exploring other parts of the market such as credit, private debt and asset-backed securities. Combining these types of assets with traditional fixed income such as nominal bonds may provide a better risk-adjusted return.

Australian government bond rates have been declining

Source: Bloomberg

Look more broadly across the market for dividend yield

Unlike bonds, whereby coupon payments must be paid unless the issuer defaults, dividends are far from guaranteed. Investors in blue chip stocks often look at the historic yield as a guide to future payouts but if the company's profits fall or it needs to improve its balance sheet these dividends can be cut, deferred or abandoned altogether. Some of the previously high paying stocks on the Australian market have done this in recent months which is troubling for income seeking investors. However, dividends are not annuities and therefore are not guaranteed. In the current recession dividends could be subdued at least in the short-term. Those seeking dividends and franking credits may need to look more broadly across the Australian share market.

Sector concentration is increasing in domestic equities

The Big 4 banks and the major miners represent approximately 28% of the ASX100[1]. The performance of this small number of companies is likely to determine the outcome for many traditional Australian Equity portfolios. By diversifying into global shares, Australian investors can access a more diverse range of industries and sectors and help to reduce home bias. One example is the US market, whose top 5 performing companies, the

1. Source Bloomberg, as at 1 June 2020.

FANG stocks, have increased their dominance during the crisis. They have been more COVID-safe than other sectors, benefitting from trends such as working from home and online purchases. Although emerging, Australian tech companies do not benefit from the sheer size and scale of their global counterparts. Investing in global shares does come with currency risk however, so any allocation must be appropriate for the individual's risk preferences.

Concentration of market cap in the largest stocks has surged as of April 30, 2020.

Source: Compustat, Goldman Sachs Global Investment Research

Taking a global investing approach reduces portfolio exposure to regional or sectoral issues as the pandemic will affect some regions for longer and some sectors profoundly. For example, from the beginning of 2020, the Chinese CSI 300 index is up 15%, bottoming out at -15%, while the S&P500 is down 2% having fallen as low as -31%.[2] Another notable aspect of the crisis is that factor volatility rose more than stock-specific volatility. For example, avoiding the travel sector was more important than whether you chose Flight Centre over Webjet.

Unlike the GFC, when Australian banks offered handsome returns to investors as they sought capital to improve their balance sheets, and the cash rate was much higher, Australian banks are currently well capitalised by comparison and are not offering outsized term deposit rates. Retirees and others looking for income need a different approach and total return investing can help to achieve this outcome while overcoming the behavioural bias of not dipping into the original pool of capital. The adage of diversification becomes even more important as investors must consider whether they have achieved this both within and among asset classes. With no silver bullet apparent and the RBA indicating that low interest rates are here to stay the need for financial advice is greater than ever.

Find out more

For more information, please contact your local Fidante Partners Business Development Manager or call the Fidante Partners Adviser Services Team on 1800 195 853.

2. As at 13 July 2020.