On the Minds of Investors

April 2019

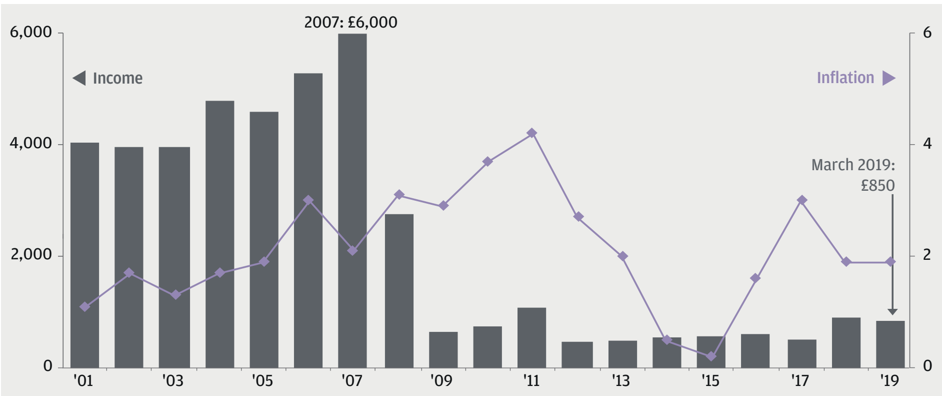
Finding income in a low yield world

Low interest rates and quantitative easing have reduced the income available to investors from cash and government bonds. The low level of rates is expected to continue given the recent dovish shift from the Federal Reserve and the European Central Bank, due to still subdued inflation and slowing growth. In the UK, even if Brexit-related uncertainty were to diminish, the Bank of England would be likely to only raise rates very gradually.

EXHIBIT 1: ANNUAL INCOME GENERATED BY £100,000 IN A THREE-MONTH BANK DEPOSIT

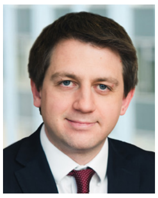
GBP (LHS); % change year on year (RHS)

GTM – UK | 92



Source: Bloomberg, ONS, J.P. Morgan Asset Management. Inflation is the percentage change year on year for UK consumer prices. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - UK*. Data as of 31 March 2019.

AUTHORS



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This low rate environment creates a now all too familiar dilemma for many investors who need an income from their savings. They either have to accept a much lower income than they were used to prior to the Global Financial Crisis, when interest rates were higher, or they have to take more risk to earn a higher income from their investments. This dilemma becomes even trickier the later we move into this economic cycle, as the rising risk of a recession increases the potential for declines in stock and corporate bond prices.

Unfortunately, the risk vs return trade-off isn't one that can be eliminated. So what can an investor who needs income do? While the risk associated with higher yielding investments can't be eliminated, it can be reduced in three ways.

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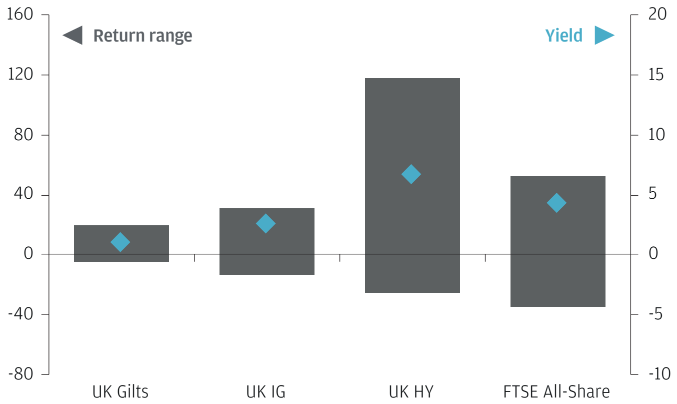
1. Think in decades not days

The first way to reduce risk is to adopt a long time horizon for your investments. If you accept that it's hard to precisely time the peaks and troughs of the market cycle, but that over the long term the global economy and company earnings are likely to keep growing, then riskier investments can make sense as a long-term investment—even towards the end of an economic cycle. In short, if you can buy and hold on to your investments for the long term and ignore swings in their value as long as you continue to receive an income, then that enables you to take a bit more risk and earn a higher income.

EXHIBIT 2: INCOME YIELD AND RANGE OF ASSET CLASS RETURNS

% 12-month rolling return since 1999 (LHS); % yield (RHS)



Source: BAML, Bloomberg Barclays, FTSE, Refinitiv Datastream, J.P. Morgan Asset Management. UK Gilts: Bloomberg Barclays Sterling Gilts ; UK IG: Bloomberg Barclays Sterling Agg. - Corporate ; UK HY: ICE BofAML Sterling High Yield Index. Fixed income yields are yield to maturity. Yield for FTSE All-Share is dividend yield. Returns are based on total return in local currency. Past performance is not a reliable indicator of current and future results. Data as of 31 March 2019.

2. Be selective

If you can take a long-term approach to investing, the second consideration is to focus on the sustainability of the income produced. Some companies might pay a high dividend but have to cut their payout when profits fall during a downturn. Likewise, some companies might pay a high income in return for lending to them, but they may be unable to pay you back in full when profits fall. Some governments might even fall into this latter category, or at least they might struggle to pay you back in a currency that is worth as much in real terms.

For shares, it's important to consider dividend coverage ratios and the sustainability and cyclicality of the company's profits, as well as the yield. Dividend coverage ratios are a measure of company profits divided by the dividend payment, so a company with a high dividend coverage ratio is less likely to have to cut its dividend if profits fall. Companies are generally reluctant to cut dividends where possible but companies with low payout ratios (the inverse of the dividend coverage ratio) can increase the proportion of their earnings that they spend on paying their dividend to avoid having to cut it, whereas those with higher payout ratios have less flexibility.

EXHIBIT 3: FTSE ALL-SHARE EARNINGS AND DIVIDENDS PER SHARE

Index level, rebased to 100 at Jan 1995

Source: Factset, FTSE J.P. Morgan Asset Management. Earnings and dividends per share is based on trailing twelve months. Past performance is not a reliable indicator of current and future results. Data as of 31 March 2019.

It's also important to consider the sustainability and cyclicality of corporate earnings, as a company with a higher dividend coverage ratio could still be more likely to cut its dividend if its profits fell by much more than the company with a lower dividend coverage ratio. For example, a water company is unlikely to see a sharp fall in its earnings during a recession whereas a restaurant chain might. Likewise a DVD rental company might once have been viewed as likely to benefit from people eating out less and staying in to watch films more during a recession, but its earnings were unsustainable in the long term given the shift to online video streaming.

The same principle applies when lending money to companies by investing in corporate debt. This time investors need to consider interest coverage ratios, which are a measure of profits divided by interest payments rather than dividend payments. Again, the sustainability and cyclicality of earnings are also key when considering whether the company will still be able to pay you during a recession. As interest payments have to be made before a company can pay a dividend and debt holders generally have a claim on the company's remaining assets in the event of a bankruptcy, a company's debt is less risky than the same company's equity. However, lending to a highly indebted company with cyclical earnings is not necessarily less risky than investing in the equity of a company with low debt and stable earnings.

So the key for investors who need an income from their savings and can take a long-term investment approach, resisting the temptation to sell during a downturn, is to buy the debt and shares of companies that are able to keep paying you dividends and interest payments, even during a recession. Importantly, it's not just a matter of picking the debt and equity of the highest yielding companies but carefully selecting the highest yielding companies that can keep paying you that yield.

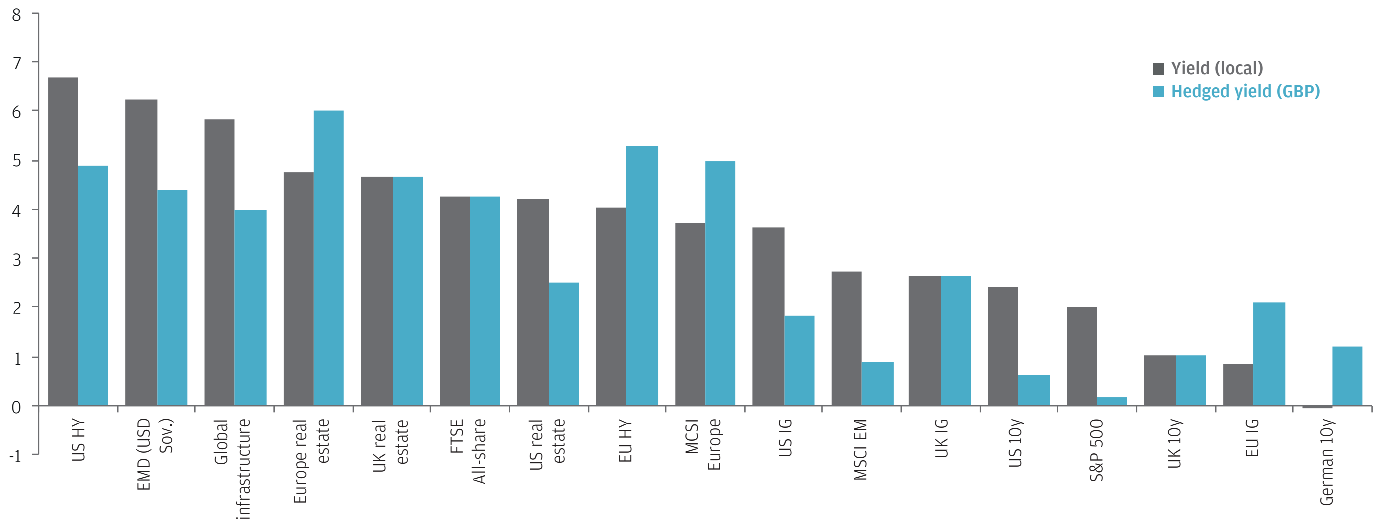
Actively selecting the highest yielding companies that will still be able to pay you an income in a recession is a job for professionals who have the time and skill to analyse financial statements, meet company management and assess the risk to profits in the near and long term. Even professionals might mistakenly pick a company that has to cut its dividend or that can't make its interest payments, but by diversifying across many of their carefully chosen favourite stocks and bonds, they should be able to reduce the risk that the occasional mistake has much of an impact on the overall portfolio.

3. Expand your horizons

Investors looking to maximise both yield and diversification, while also being selective and only picking securities from issuers that can reliably pay them an income, should also seek the widest opportunity set possible. A global approach allows the portfolio manager to select the most reliable income payers from across the whole world. A cross-asset approach also helps to expand the opportunity set to a larger amount of income-producing investments. Investors should consider the yield available on a wide variety of assets from all over the world, taking into account hedging costs to reduce currency risk where appropriate.

EXHIBIT 4: ASSET CLASS YIELDS

% yield



Source: Bloomberg Barclays, BAML, FTSE, MSCI, ODCE, Refinitiv Datasream, Standard & Poor's, J.P. Morgan Asset Management. US HY: BofA/Merrill Lynch US High Yield Constrained; EMD (USD Sov.): J.P. Morgan EMBI Global; Global infrastructure: MSCI Global Infrastructure Asset Index-Low risk; Europe real estate: IPD Global Property Fund Index - Continental Europe; UK real estate: IPD Global Property Fund Index - UK; US real estate: NCREIF-ODCE Index; EU HY: BofA/Merrill Lynch Euro Non-Financial High Yield Constrained; US IG: BofA/Merrill Lynch US High Yield Constrained; UK IG: Bloomberg Barclays Sterling Agg. - Corporate ; EU IG: Bloomberg Barclays Euro Agg. - Corporate. 10-year yields are government bond yields. Equity index yields are dividend yields. Grey bars show yields based on local currencies. Blue bars show yields based on local currency plus the benefit or cost of hedging the local currency risk back to GBP. Hedging cost is annualised and based on three-month currency forwards. Hedging cost for Global infrastructure and MSCI EM based on assumed local currency of USD. Past performance is not a reliable indicator of current and future results. Data is latest available as of 31 March 2019.

Default rates are currently low among high yielding corporate bonds and there are opportunities to be had for selective long-term investors in this asset class. In emerging market debt, there are also various different investment opportunities with differing risk/reward profiles. Local currency sovereign bonds in some emerging markets, for example, offer high real yields relative to developed market government bonds, where in some countries real yields are negative. Furthermore, the dovish shift from the Federal Reserve could allow emerging market central banks to adopt a more accommodative stance. As well as providing opportunities in debt, emerging market equities can be a fertile hunting ground for income. Many emerging market companies are now more focused on corporate governance and distributing cash to shareholders compared to in the past. Away from high yield bonds, emerging market debt and equity markets, investors should also consider the steady and relatively defensive income streams available from real estate and infrastructure investments.

Conclusion

In summary, you can't get away from having to take a bit more risk to earn a higher income than is available on cash and government bonds. But by extending your time horizon, going global, actively selecting the reliable income payers and diversifying across different companies and asset classes you can reduce the risks involved and increase the income from your savings.

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