

# NEWSLETTER

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The progressive decline in investment income that has characterised much of the past decade is set to reach its nadir this year. It is in July, the month following the end of the financial year, when many investment funds pay out their largest amount of income. However, this July, investors may experience a significant drop in income distributions as a result of a combination of the following factors:

- The continued fall in interest rates
- The decline in the value of growth assets in the March quarter, which has removed the majority of capital gains that may have been available for distribution by investment funds
- The reduction in company dividends as a result of falling corporate earnings. Led by banking stocks, Australian dividend payouts are expected to fall by approximately 35% this year.

Associated with the decline in dividends will be a fall in franking credits, which have become an increasingly important source of income for many investors as interest earnings have dwindled.

Interestingly, the change in the pattern of investment returns following the COVID-19 crisis contrasts to that which took place around the time of the Global Financial Crisis (GFC). In the GFC period, income levels proved to be far more stable than capital valuations, with equity prices remaining substantially below pre GFC peaks for many years. In the more recent COVID-19 crisis, equity valuations have bounced back very quickly (at least for now), whereas income levels are likely to be depressed for a longer period.

### Is a change in strategy required?

Before considering whether the fall in income should trigger a review of portfolio strategy, it may be appropriate to assess the reasons why income is considered to be important to investors. Leaving aside any taxation considerations (which tend to benefit returns in the form of capital gains), it could be argued that investors should be ambivalent as to whether investment returns are in the form of income or capital gain. It is the overall level of return (capital gain plus income) that determines the change in the value of a portfolio. If withdrawals are required to fund living expenses, the impact on wealth is the same irrespective of what ratio of return is derived from income or capital gain.

However, many investors pursue income as a portfolio objective. Whilst it could be argued that this pursuit of income as a priority ahead of total return may be irrational, a focus on income can still serve a useful purpose in wealth management. Linking or benchmarking investment income with living expenses can provide a source of discipline in spending and also provide some indication as to the long term sustainability of an investment strategy. By definition, if living expenses are always equal to, or below, investment income, then the investment strategy is infinitely sustainable.

In reality, however, many investors who previously were able to fund living expenses from investment income will no longer be able to do so. For some, the change will be temporary as the current period is hopefully an outlier and higher income will return in future years. For others, the improvement in income in future years will be insufficient and an extended period of low interest rates will require capital withdrawals to be a regular occurrence. Accepting that capital withdrawals will become a necessary evil will shift the focus of impacted investors from income objectives to total return objectives. This is a far healthier approach than the alternative of changing a portfolio strategy and risk profile in order to meet an arbitrary income target.

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Inevitably the pursuit of higher income will lead investors to higher risk investments. Within the fixed interest asset class, this can encourage investors into assets that have a higher level of credit risk where capital loss can occur if corporations or mortgage holders default on their borrowings. Within the equity asset class, this income pursuit can lead to what are termed “dividend traps”. A dividend trap occurs when a stock’s yield appears highly attractive based on past payout levels; however, the reason the yield is attractive is because the market has already priced the stock at a discount on the likelihood of future reductions in earnings and dividends.

### **Income is down but not out**

Given the expectation of continued low interest rates in the years ahead, income on interest bearing investments is unlikely to recover quickly from current lows. However, for growth investments (equities, property and infrastructure) much of the current decline in income should be viewed as temporary. Company earnings and dividend payouts will recover, and Australian equities should return as a relatively high yielding asset class. Dividend yields in the vicinity of 4% over the medium term are a realistic expectation. At least another 1% in franking credits may flow from this. Hence the margin between income earned on Australian shares and that from interest bearing investments is likely to be historically wide - given the current overnight cash interest rate is at the record low level of 0.25%.

Infrastructure is also an asset class that offers some attractiveness from an income perspective. Still trading at valuations some 20% below its pre-COVID level, infrastructure appears cheap on a relative basis. The majority of infrastructure assets (e.g. toll roads, power utilities) produce stable defensive revenue streams and also provide the benefit of often being linked to inflation, which can assist investors in protecting the purchasing power of their income stream.

Hence, for some investors a re-weighting of portfolios away from interest bearing investments towards growth investments may be an appropriate response to current return projections. In a low interest rate world, the role of interest bearing investments may increasingly shift from wealth creation to wealth protection. If a shift towards growth investments is being considered, a total return focus should be taken, incorporating individual risk tolerances and appetite.

Income levels, whilst potentially supporting some important discipline and cash flow management, should not be the primary determinant of an investment strategy.

### **Important Information**

*The following indexes are used to report asset class performance: ASX S&P 200 Index, MSCI World Index ex Australia net AUD TR (composite of 50% hedged and 50% unhedged), FTSE EPRA/NAREIT Developed REITs Index Net TRI AUD Hedged, Bloomberg AusBond Composite 0 Yr Index, Barclays Global Aggregate (\$A Hedged), Bloomberg AusBond Bank Bill Index, S&P ASX 300 A-REIT (Sector) TR Index AUD, S&P Global Infrastructure NR Index (AUD Hedged).*

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