BRIDGE FUND MANAGERS

5 ARUNDEL CLOSE, KINGSMEAD
OFFICE PARK, DURBAN
PO BOX 3211, DURBAN, 4000
T +27 31 333 6600 | F +27 31 571 0505
WWW.BRIDGEFM.CO.ZA

27 March 2017

Bridge Fund Managers Response to PortfolioMetrix Research Paper - "Total Return vs Income Investing"

We have read with interest the document recently published by PortfolioMetrix entitled "Total Return vs Income Investing". As we understand it from Brandon Zietsman, the CEO of PortfolioMetrix, they produced the document in response to increasing enquiries from financial advisors for them to develop a houseview on the "income investing" philosophy. Since Bridge Fund Managers (previously Grindrod Asset Management) are the only asset manager in South Africa that follows an income investing theme with conviction and persistence, we therefore see this document as a critique on our Payers & Growers® portfolios, rather than a general criticism on income investing.

We also noted that the document contains some aggressive assertions such as "The unit fallacy" and "…those following an income investing approach, ranging from the benign to the dangerous". These comments need to be contextualised. In our opinion, the document also displays a clear misunderstanding of our Income Efficient Portfolios™ which utilises income as one of the components of the portfolios total return, as opposed to income investing which only focusses on income to produce the investment return.

We therefore feel compelled to put our position forward in response to the document as PortfolioMetrix never interviewed Bridge Fund Managers to fully understand our perspective on income investing. Nor did they ask us for any data or analysis to either support or refute the investment case before they arrived at their conclusions and published the document.

We would start out by observing that the opening paragraph of their document could easily be used in our marketing documents. We agree wholeheartedly that any investor should enjoy a total return supported by a combination of both income and capital growth in the long run. We call these the "fundamental sources of return" and they are the very essence of what we do. Both of these are vital components in achieving sustainable, inflation-beating returns. In our opinion, to only focus on capital growth or only on income is folly and sub-optimal. We are therefore on record as saying we are true total return managers as our portfolios always take both elements into account.

The balance of the document and the general critique on income investing therefore has very little relevance to our Payers & Growers® philosophy. To be clear our philosophy recognises that in order to beat inflation in the long run, investors must be exposed to asset classes capable of beating inflation after costs in the long run. The two asset classes most aligned to meeting this long-term objective are equities and real estate.

The reason being that both these asset classes have an inflation-hedging element built into them. Company profits (and resulting dividends) and property leases (and resulting property distributions) move in line with inflation on aggregate. Conversely at present cash and nominal government bonds, while offering above inflation starting yields, are not able to produce any income growth to satisfy a suitable long-term inflation hedge. Long-term holders of these assets will expose both their capital and income to the ravages of inflation in time.

It is for this reason, and with the long-term retirement investor in mind, that we started constructing our portfolios to meet a real and growing need within the market. Income Efficient Portfolios™ have several characteristics namely;

- Reliable income yield (measured by the starting yield)
- Annual growth in portfolio income of close to CPI (produced by the growing stream of dividends and property income)
- Long-term capital growth at or above CPI (capital prices will rise in line with the growing income stream they produce in the medium to long run)

Therefore in our world;

- Each security we own for our clients contributes to producing a portion of the portfolios income (dividend-paying equities, listed property, bonds & a little cash)
- The bulk of the portfolio income is inflation-hedged in the medium and long term (dividend-paying equities & listed property)
- Portfolios are constructed to match a particular initial drawdown rate and sustain that drawdown in real terms (i.e. increase the level of income drawn by at least inflation every year)
- Portfolios remain fully-invested through the cycle (up to 90% in growth assets) to capture the full benefit of growing dividends (higher returns and inflation-hedged income growth).

We do not implement income investing as defined by PortfolioMetrix in this paper (page 1 Definitions). We do not believe in reaching for yield. We do not substitute capital growth for yield. We do not plunder capital for yield. On this point we have no disagreement with them.

We do, however, strongly believe that an investment strategy that incorporates both a regular income and a growing capital base is desirable and useful. In fact our research clearly shows that where portfolios are used to support living annuities, those portfolios that have a higher component of their total return produced by a sustainable and growing income stream, have a much better chance of protecting the capital base (by selling fewer units), than a low yield portfolio. This is especially true in lower or negative-return markets, where the capital base can be eroded at an alarming rate.

We are happy to share this research with PortfolioMetrix and let it be exposed to their research teams' scrutiny.

Additionally, the growing yield better matches the living annuity investor's liability (their cost of living) that is impacted by inflation and does so without heightening other consequences like sequence of return risk which is heighted in a capital drawdown portfolio.

In summary, we strongly believe that Income Efficient Portfolios™ offer significant benefits to long-term retirement investors. We believe the comparison of our Payers & Growers® with income investing as defined by the PortfolioMetrix paper is both inaccurate and misleading for financial advisors. We invite PortfolioMetrix to spend some time with our investment team in order that we can share our philosophy, data and research with them.

I am certain that they will gain a better understanding of why and how we manage client portfolios after such an interaction.

Paul Stewart

Head: Fund Management