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TOTAL RETURN VS INCOME INVESTING

Income investing is a popular approach for many retirees, trusts and charities that draw on investments to meet their cash flow needs. PortfolioMetrix does not believe, however, that it is the best long term investment philosophy. This guide details why we believe that over a client's investment career a total return approach is likely to allow for higher withdrawals with less risk of depleting the portfolio.

1 DEFINITIONS

Investment portfolios generally have two forms of return: a capital return that comes from growth of the assets over time and a natural yield which is received from those assets in the form of dividends and interest.

Income Investing
Sometimes referred to as income-focused investing or an income-only approach, income investing concentrates on natural yield (income from the portfolio) and a portfolio is constructed to target a specific yield. Only the income physically produced by the portfolio is withdrawn on a regular basis.

Total Return Investing
Total return investing considers both the income and capital return components of return, and a broadly diversified portfolio is constructed to achieve the highest possible combination of the two. Where regular withdrawals are made, these consist of a combination of the income physically produced by the portfolio and some capital growth, realised through asset sales.

2 THE POPULARITY OF INCOME INVESTING

2.1 Historical Conditions

Historically, income investing has been very popular, particularly in countries like the UK. This has in part been due to a benign income environment where historically high yields meant it was easy to construct a portfolio that generated a good income. But it also reflected a paucity of investment choices in the past. Many of today's lower yielding asset classes such as certain overseas equities and alternative investments (commodities, absolute return funds, private equity) were less accessible or were discouraged through legislation and regulation. For example, in the UK the Trustee Investment Act 1961 (largely repealed and replaced by the Trustee Act 2000) almost entirely restricted charities to invest in UK equities and UK gilts, whilst it was only in 2001 that the UK's Charities Commission relaxed their prescription that charities with permanent endowments only spend income, and allowed them to spend capital.

2.2 Investor Psychology & The Unit Fallacy

Another reason for the popularity of income investing is investor psychology. Retiree and trustee concern about running out of capital is entirely rational – it is after all the biggest risk to any person, trust or endowment that relies on their investment portfolio. However, there is a tendency amongst investors, sometimes subconsciously, to confuse the number of units they hold (be they units of collective schemes or shares of a company or ETF) with their capital (a function of the number of units and the price of those units).

This unit fallacy biases investors towards income investing and away from total return investing in subtle ways.

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Partly this is a lack of awareness that receiving dividends, whilst it may not affect the number of units/shares held, does eat into remaining capital as the price of units/shares will fall just after a buyer becomes ineligible for the dividend. The same is true of bond prices. Dividends and bond coupons aren't free.

The unit fallacy also makes selling units seem painful as there is a belief amongst investors that they own a fixed number of units/shares and thus selling shares or units must necessarily mean they are eating into their capital.

This is a powerful fear, but it is misplaced as depleting capital is far less linked to selling units than one would think. Because shares can split and units can be traded fractionally[1] the number of shares or units held by itself is largely irrelevant – it is only when combined with price per unit that one gets an accurate idea of capital remaining.

A simple (albeit extreme) example demonstrates this in the case of shares. If you had retired early and had been lucky enough to invest in 10,000 shares of Apple at its IPO price of $22 in December 1980 and had sold 500 shares in each of the 36 Decembers since then to help fund your early retirement, you would have sold a total of 18,000 shares as of the end of 2016. And you would still be left with 142,000 shares.

Selling more shares than you originally bought may seem counter intuitive. Doing so and still being left with over 14 times the number you started with seems even crazier. However, this is what would have occurred for you, our lucky investor, as Apple's shares split multiple times over its history: 2 for 1 in each of 1987, 2000 and 2005 and 7 for 1 in 2014 (a 56-fold increase overall).

And out of interest (I said you were lucky), the 500 shares sold at the end of 2016 would have netted you a cool $56,910 at the time based on the share price of $115.82/share, an example of how paying attention to capital growth helps with future income. The 142,000 remaining shares would have been worth almost $16.5m – a clear illustration that capital growth is an extremely effective method of protecting capital.

3 THE CHALLENGE OF INCOME INVESTING TODAY

Yields have been falling since the 1980s and, particularly post 2008 financial crash have now reached levels that shine a spot-light on the rigidities inherent within an income-only approach. The chart below demonstrates the problem of falling yields on traditional investments when compared to a fairly typical spending target of 4%

[1] When selling units in a collective investment scheme, you don't have to sell entire units. It's possible to sell half a unit, or a tenth of a unit, or 0.01 of a unit. Thus one can keep selling units but never run out of them if one keeps selling smaller and smaller amounts. And if the price grows quickly enough, even though the number of units sold is going down, the overall value of the units sold can rise.

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Figure 1: Yields on mainstream assets have been falling

This lack of yield has led to a number of responses from those following an income investing approach, ranging from the benign to the dangerous.

Accepting a Lower Income

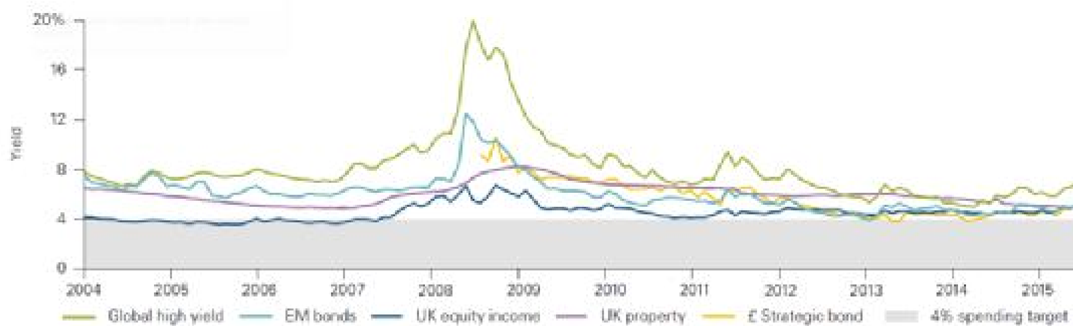
An honest approach, but probably not the optimum one as strong post 2008-09 crisis capital gains could have supported higher withdrawals.

Reaching for Yield

'Reaching for yield' is the phenomenon where higher yielding asset classes are used in the portfolio to keep yields up despite the fact they increase the risk of the portfolio and so lead to a greater chance of capital being depleted. Reaching for yield can take the form of:

- substituting out developed market government bonds for riskier high yield bonds or emerging market bonds
- choosing higher yielding longer dated bonds which are more subjected to interest rate risk
- concentrating the portfolio in higher yielding, but possibly lower quality, equities

Figure 2: Yields for riskier asset classes remain attractive



Past performance is not a reliable indicator of future results.

Notes: Period covers 1 January 2004 to 30 September 2015. UK equity income defined as the FTSE 350 High Yield Index, Global REITs are defined as the FTSE World REIT Index, UK property is defined as the IPD Index, global high yield is defined as the Barclays Global High Yield Index, EM bonds are defined as the Barclays Hard Currency Index, £ strategic bond is defined as the median return from the Morningstar Database. All returns are in sterling terms with income reinvested.

Source: Vanguard calculations, using data from Thomson Reuters Datastream, Macrobond, Barclays Capital and Morningstar, Inc.

Source: Vanguard, *Total-return investing: An enduring solution for low yields*, January 2016

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Figure 3: Reaching for yield can increase concentration risk

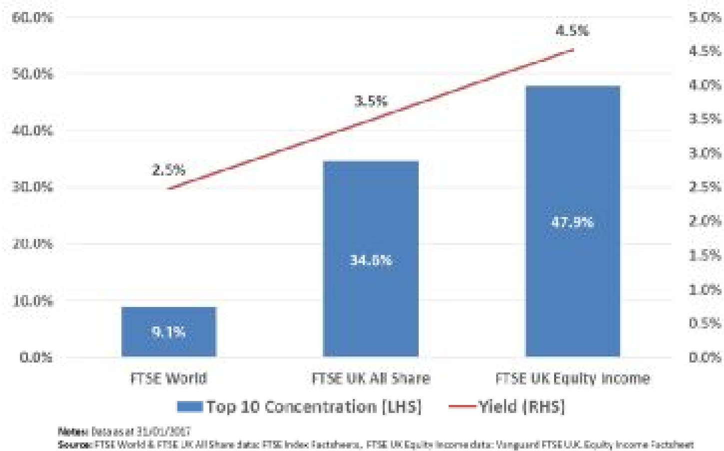
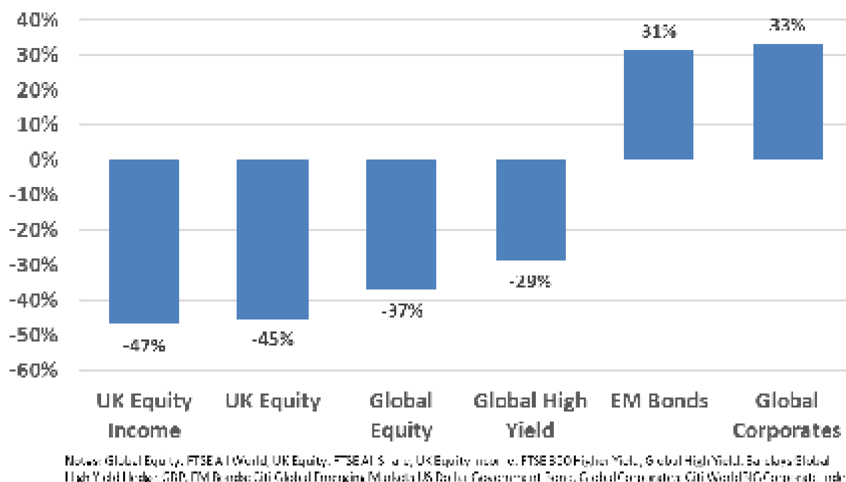


Figure 4: Higher yielding asset classes are generally riskier - Cumulative total returns during the global financial crisis, 12 October 2007 to 9 March 2009



There is also a widespread belief that income is “safe” – in the sense that capital values may fluctuate, income doesn’t. This is only partially true. Income may not fluctuate as much as price, but in riskier asset classes it can still fall drastically. Fidelity and Datastream calculate that dividends on the M SCI World fell 24% over ’08 financial crisis and its immediate aftermath. This would have been an unacceptable drop in income to most investors.

In addition, the MSCI World is an extremely diversified basket of equities so this understates the fall in income many income investors with more concentrated portfolios would have experienced. Investors with the bulk of their exposure to value stocks like banks and miners would have seen their income almost wiped out.

Substituting Capital Growth for Yield

Another technique for enhancing yield is to boost income artificially by sacrificing capital growth. This could be achieved by, for example, sacrificing equity upside by selling call options on equities owned within the portfolio. This isn’t intrinsically a bad thing if the trade is roughly one unit of capital growth for one unit of income, but often too much growth is sacrificed for too little income.

Plundering Capital for Yield

Towards the ‘dark arts’ part of the spectrum for enhancing yield is the technique of dividend or coupon stripping, where a manager buys stocks that are about to pay a dividend. A dividend is duly paid and the price of the stock

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falls to reflect the fact that the investor has received the dividend. At which point the stock is sold in favour of the next stock that is about to pay a dividend. This is a form of robbing Peter to pay Paul – the investor receives a higher yield but is usually worse off overall as their capital value falls and they pay away a lot in trading costs.

4 THE BENEFITS OF TOTAL RETURN INVESTING

There are very sensible arguments put forward by proponents of income investing as to the importance of income in investment portfolios over the long term and the importance of not focusing too heavily on capital gains. Proponents of total return investing don't dispute these arguments, but rather note that both income and capital growth should be considered when designing portfolios. It is the sum of the two, rather than either individually, that should be focused on over the long term.

Most academics and well-respected mutual-fund families, including Vanguard and Fidelity, support total return investing over income investing for the following reasons:

4.1 Greater Diversification and Opportunity Set

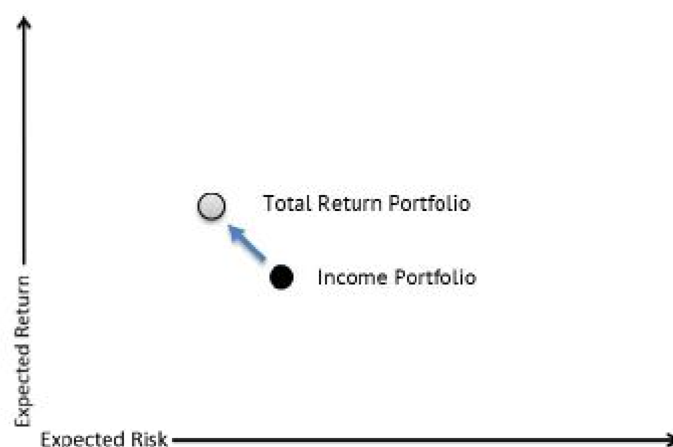
Thinking about both income and capital growth allows for the inclusion within the portfolio of asset classes that pay a low yield (such as commodities and absolute return) and equities that returning capital to investors through share buy backs (where a company buys back its own shares instead of paying a dividend).

If one started with an income portfolio focused on achieving a particular yield target, and relaxed that target, a good manager could select securities with lower yields with one or a number of the following properties:

- Higher total return expectations than existing securities but similar risk
- Lower risk than existing securities but similar total return expectations
- Similar total return expectations and risk to existing securities, but low correlation to existing securities (diversifiers)

Including these new securities has the following effect on the prospective long term returns of the portfolio:

Figure 5: Stylised Example of Relaxing the Income Constraint



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4.2 Greater Tax Efficiency

Individual tax situations are different and highly dependent on tax domicile and personal circumstances. However, quite often capital gains are a tax advantaged relative to income received. This can take the form of lower taxes on capital gains relative to those on dividends/interest payments as well as generous capital gains tax free allowances. A total return approach allows investors to take full advantage of these favourable rates and allowances.

4.3 Control over Withdrawal Timing and Amount

Under income investing, a trust or retiree's spending is dictated by the portfolios natural yield which limits the control they have over the timing and amount of that spending. A total return approach, on the other hand, allows for more flexibility as investors are willing to spend from capital appreciation in the years when the yield on their portfolio falls below their required spending amount. They can also implement more flexible spending strategies that allow them to sell assets that are overweight relative to strategic weights to decrease the number and cost of future rebalancing events.

5 CONCLUSION

PortfolioMetrix believes a total return approach is a better framework for investing than an income investing approach. We believe it results in better diversified and, in aggregate, more tax efficient portfolios which result in investors being able to sustain higher withdrawals with less chance of capital depletion, all whilst being more in control of the timings of their withdrawals.

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APPENDIX: THE PORTFOLIOMETRIX INCOME ORIENTED APPROACH

A fair question to ask is: if PortfolioMetrix believes that total return investing is the best long term investment philosophy, how can we still offer a suit of Income Oriented portfolios?

Firstly, it is important to understand that the PortfolioMetrix Income Oriented portfolios do not follow an income investing approach and don't target a specific yield. They are not income maximising portfolios but are constructed using a total return framework that results in the same asset allocation as our Core Active suite of portfolios (so they do not suffer from the main problems of reaching for yield by over-allocating to higher yielding, but riskier, asset classes).

Where they differ to the Core Active portfolios is that, in order to cater to the preferences of investors who may prefer income to capital gains, the same total return is sought but with a bias to its income component over its capital gains component. Where possible, funds are chosen for the portfolio that emphasis income in their investment processes. In addition, distributing shares classes for all funds are chosen so that any income can be paid out to investors, rather than automatically being reinvested.

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