An enduring solution for low yields

An introduction to Vanguard's approach to Total Return Investing

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- Many retirees focus on the natural yield, or income return, from their investment portfolios as the foundation for what they have available to spend. As the yields for most investments are historically low and forecast to remain low for the next several years, retirees need to rethink how to earn enough income to meet their spending goals.
- As a result, retirees and other income sensitive investors may be tempted to reallocate to higher-yielding investments, such as high yield bonds or equity-income strategies. This can increase the portfolio's risk profile and may not be in the investor's long-term best interest.
- Constructing a portfolio based on total return, as opposed to only its income, has several advantages, including maintaining alignment with the investor's goals and risk tolerance, appropriate portfolio diversification and control over the size and timing of withdrawals. This approach can also help control unintended factor and credit exposures and can increase the portfolio's longevity.

Introduction

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

For many investors, the decision of when to retire includes achieving a "savings target" which is an approximate target portfolio balance that the investor believes will allow them to support their needs in retirement. Many investors spend a majority of their careers focused on this target; so once retired, it can be difficult for investors to spend an amount from their portfolio that may result in its balance dropping below the target – in other words, spend from their principal. Understandably, the result is that many retirees gravitate towards an income-focused approach without realizing the implications.

With an income-focused approach, the investor constructs a portfolio with a natural yield (dividends and interest) consistent with their spending objective. Consequently, their asset allocation and diversification decisions are driven primarily by the natural yield of the investments they select rather than the investor's financial goals, risk tolerance and time horizon.

In a low-yield environment a typical income-focused investor has three broad choices: (1) spend less; (2) reallocate their portfolio to higher yielding investments; or (3) spend from total returns instead of income alone. Given that spending less is generally not a desirable option for most investors, this paper focuses instead on the second and third options.

The appeal and challenges of income-focused investing

Traditionally, many investors have used an income-focused approach to meet their retirement income needs. Some of this has to do with the portfolio imposing discipline on withdrawals and the administrative convenience. Since the income-focused investor is only using the portfolio's natural yield, the portfolio determines both the amount and timing of withdrawals. Thus, there is no need to develop a spending strategy. The preference for an income-focused approach is also rooted in a belief that by spending only the portfolio's natural yield, investors will preserve capital and stand a smaller chance of running out of money in retirement.

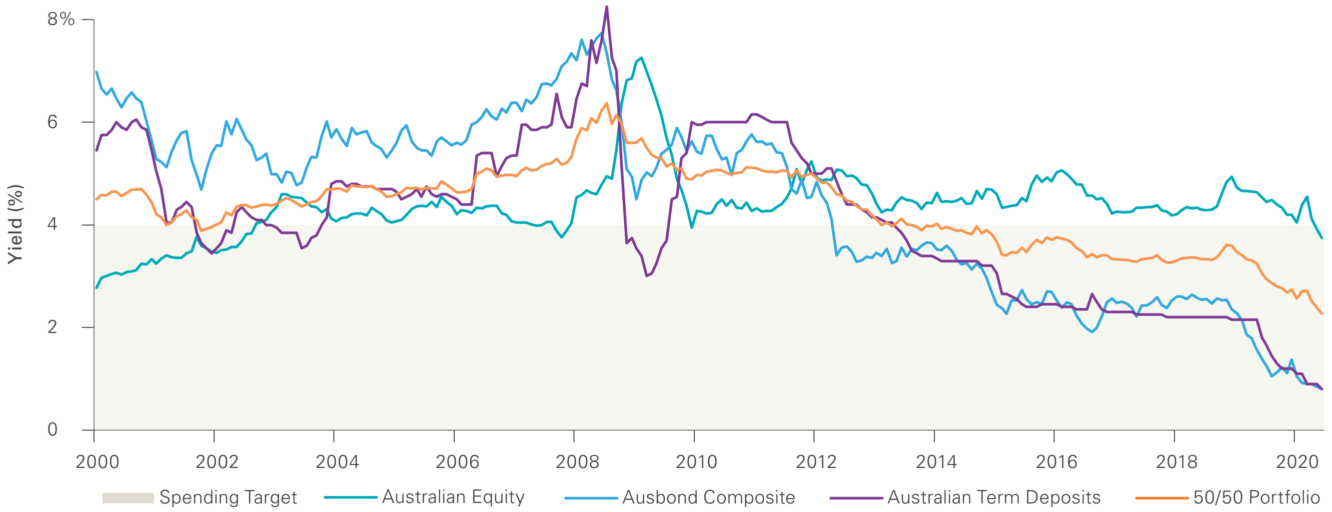
The challenge for an income-focused investor is that yields on traditional bond and balanced portfolios have fallen over the past 20 years, as shown in Figure 1. In today's environment, the yields on the Australian bond markets are below 2% while the yield from Australian diversified 50% equity / 50% bond portfolio hover below 3%.

For an income-focused investor, using the portfolio's natural yield as a guide for how much to spend would have a substantial shortfall relative to a 4% spending goal[1]. This spending gap can be resolved either by overweighting income-producing assets or by spending from the other piece of the total return, capital appreciation. Choosing to close the gap by over-weighting higher-income producing assets involves risks that may have the opposite of the intended consequence, that is, instead of preserving capital, they could be putting it at jeopardy.

In the next section we discuss risks associated with three common yield-focused strategies:

- Allocating to high yield bonds and emerging market bonds;
- Taking on more equity risk; and
- Allocating to high yield equities.

Figure 1. Low yields for the most investments present a challenge for an income-oriented investor



Notes: Australian Equity is represented by the S&P/ASX 200 Index, Australian Bonds are represented by the Bloomberg Australian Composite 0+ Index, Australian Term Deposits are represented by the annual retail deposit rate on $10,000 AUD. The 50/50 portfolio is made up of a 50% allocation to Australian Equities, 25% allocation to Australian Bonds and 25% allocation to Australian Term Deposits.

Source: Vanguard calculations, using data from Factset and RBA.gov.au, data as at 30 June 2020.

1. While the 4% rule of retirement spending is a widely used guideline, the investors need to take their individual circumstances into account when determining a suitable spending strategy.

Allocating to high yield bonds and emerging market bonds

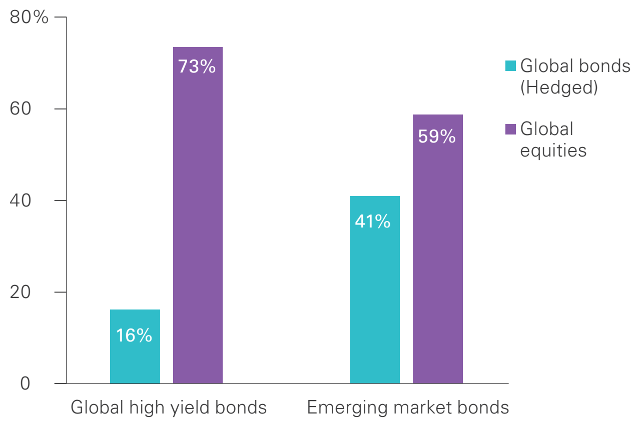
High yield bonds and emerging market bonds can offer attractive yields when compared to more traditional investment-grade bonds. These yields offer potential compensation for the additional risks involved. In the case of high yield bonds, their sub-investment grade ratings indicate a higher probability of default. For bonds issued by emerging market governments and corporations, investors face other non-traditional forms of risk, such as risks stemming from a less developed political system and fluctuations in emerging market currencies.

High yield bonds and emerging market bonds tend to behave more like equities. This is evident in their much higher correlation with global equities than global investment grade bonds, as shown in **Figure 2**. Therefore, these bonds do not diversify the same way as traditional bonds and allocating to them could be considered comparable to changing the asset allocation (equity/bond mix) of the portfolio.

Taking on more equity risk in search of yield

Many investors attempt to increase the yield of their portfolios by shifting the asset allocation toward equity. **Figure 3** demonstrates what may happen if an investor adopts this strategy to maintain the 4% income yield target. Back in 2013, the investor could have used a diversified portfolio (50% Australian equity, 25% Australian bonds and 25% Australian term deposits) to obtain the required level of yield[2]. As the yields for all assets compressed, the investor would have shifted the funds from bonds and term deposits to equity, elevating the risk of the portfolio (excess volatility relative to the balanced portfolio at the start of the period as represented by the blue shaded area). By June 2020 the investor's portfolio would have been a 100% allocated to equity and its risk level would have almost double since 2013.

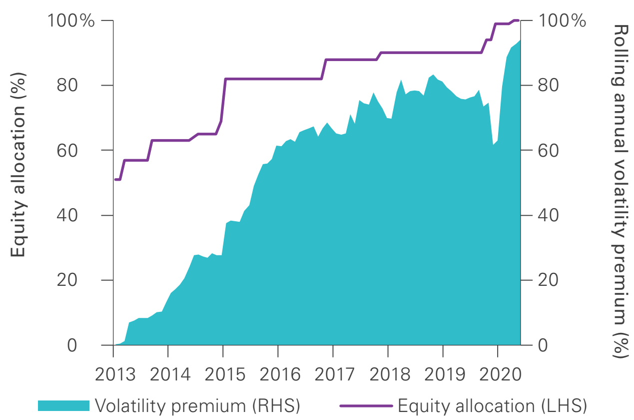
Figure 2. Global high yield bonds and emerging market bonds have higher correlation with equities rather than investment grade bonds



Notes: Global High Yield is defined as the Barclays Global High Yield Index and Emerging Market Bonds are defined as the Barclays USD EM Aggregate Index. Global Equities are defined as the MSCI ACWI IMI Index, and Global Bonds (hedged) are represented by the Barclays Global Aggregate Index (hedged).

Source: Vanguard calculations, using data from Factset; data covers January 1, 2000 to June 30, 2020.

Figure 3. Chasing yield leads to a substantial increase in portfolio risk

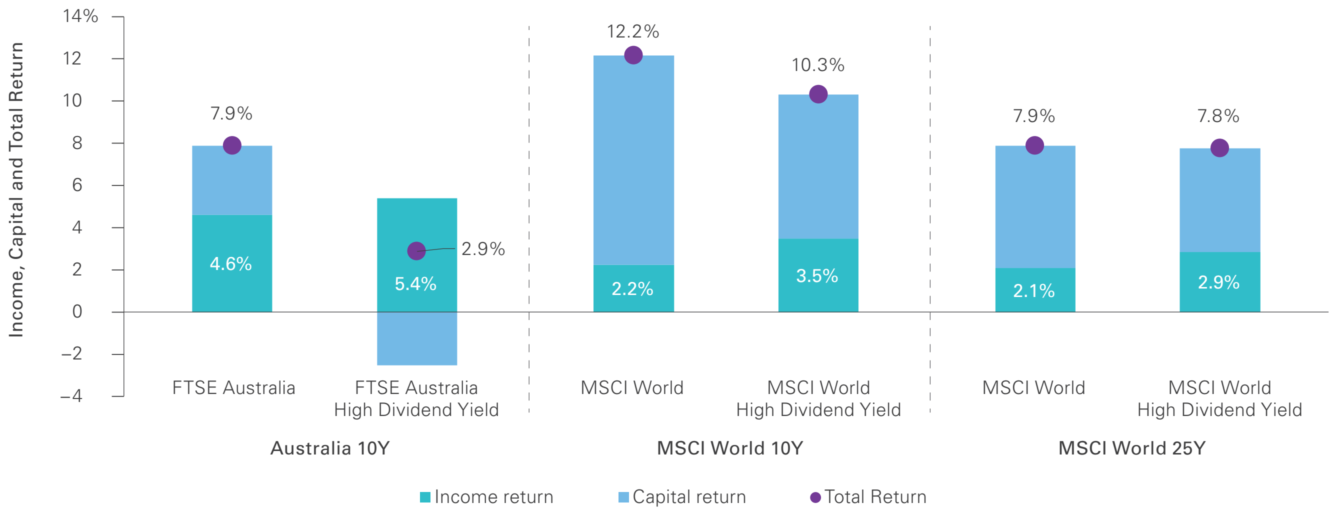


Notes: The line tracks the Australian Equity allocation (S&P/ASX200) required to meet a 4% yield target gross of fees and tax. The remaining portfolio allocation is made up of an even mix of Australian Bonds (Bloomberg Composite 0+) and Term Deposits (Annual retail deposit return rate on $10,000 AUD). The volatility premium compares the rolling annual volatility of the adjusted portfolio with a static 50/25/25 mix of Australian Equities, Australian Bonds and Australian Term Deposits.

Source: Vanguard calculations, using data from Factset and RBA.gov.au, data as at 30 June 2020.

2. In this example we use Australian investment portfolio to avoid additional complexity with calculating currency hedging on yields.

Figure 4. Higher yield does not always translate to higher total return



Source: Vanguard calculations using data from Factset; data is from June 1995 to June 2020.

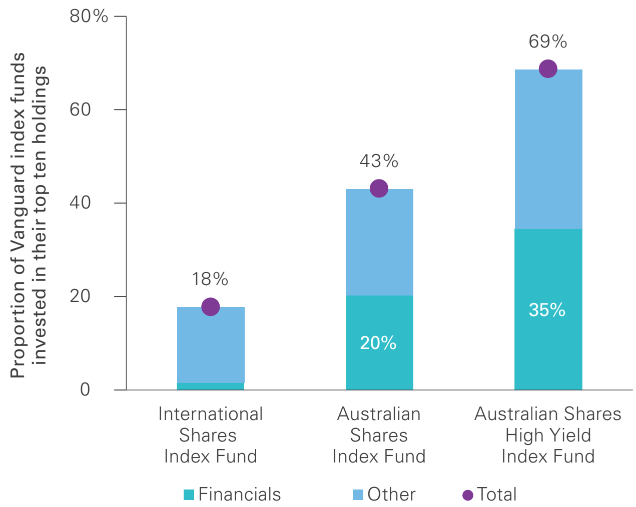
Allocating to high yield equities

A popular rationale for investing in higher dividend-paying equities is that it is perceived that this subset of equities outperforms relative to other equities. But there is no good reason why a firm that is paying higher dividends should generate greater overall returns. This is because, at a fundamental level, the decision to pay, or not to pay, a dividend is a capital budgeting decision. If a company believes it can reinvest its cash in projects with positive net present value, it should do so, putting the cash to work to increase shareholder value. In general, the total returns should not be positively or negatively affected by the actual payout. Figure 4 shows that higher yield is not always associated with higher total return as demonstrated by FTSE Australia Index and FTSE Australia High Dividend Yield Index over the 10 years to 30 June 2020 as well as MSCI World Index and MSCI World High Dividend Yield Index over the 10 years and the 25 years to 30 June 2020.

Another consideration for high yield equity investors is concentration risk. We illustrate this risk in **Figure 5** by showing the proportion of three Vanguard index funds invested in their top ten holdings. The International Shares Index Fund has a relatively small percentage in the top ten holdings of 18%. Concentration increases more than three times to 43% with the Australian Shares Index Fund and even further to 69% with the Australian Shares High Yield Index Fund. This also trickles down to sector biases, as dividend-focused portfolios tend to systematically overweight financials and underweight consumer staples.

Income-oriented strategies have a significant tilt towards value factor. In **Figure 6**, we show a returns-based style analysis of the MSCI World High Dividend Yield Index and MSCI World Index from 2000 to 2020. The dividend-focused index displayed a significant bias toward value stocks, although the persistence of this exposure has been variable through time. Similar returns-based style analysis for the U.S., U.K. and other markets shows very similar results. Investors should be aware of these, potentially unintended, factor tilts that could be introduced to the portfolio by a dividend-focused strategy.

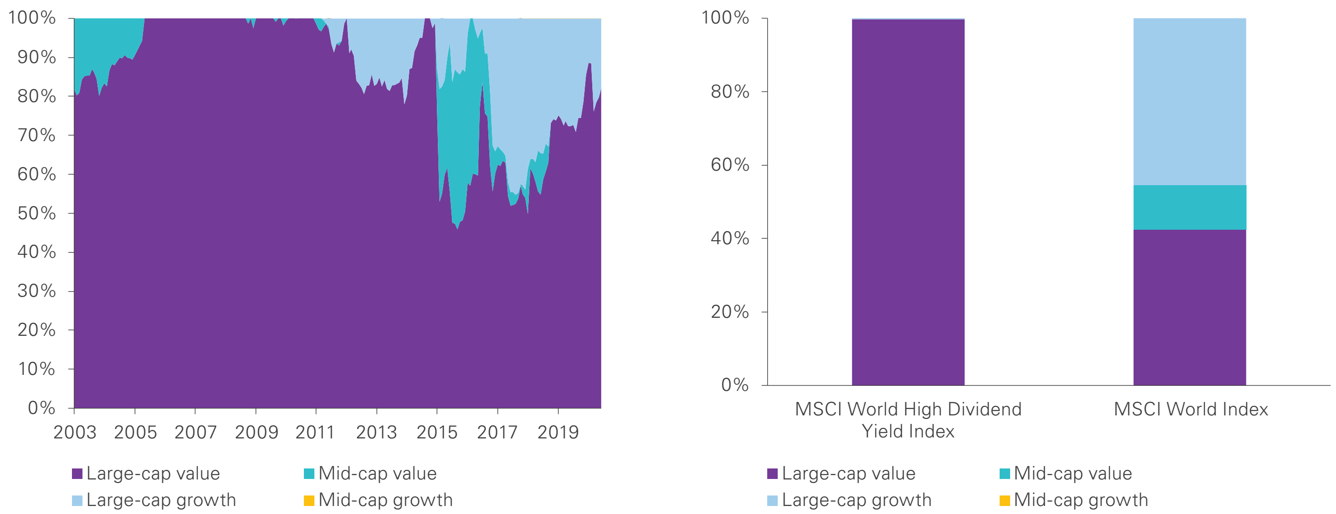
Figure 5. High yield equity portfolios introduce substantial concentration risk



Notes: Data as at 30 June 2020.

Source: Vanguard.

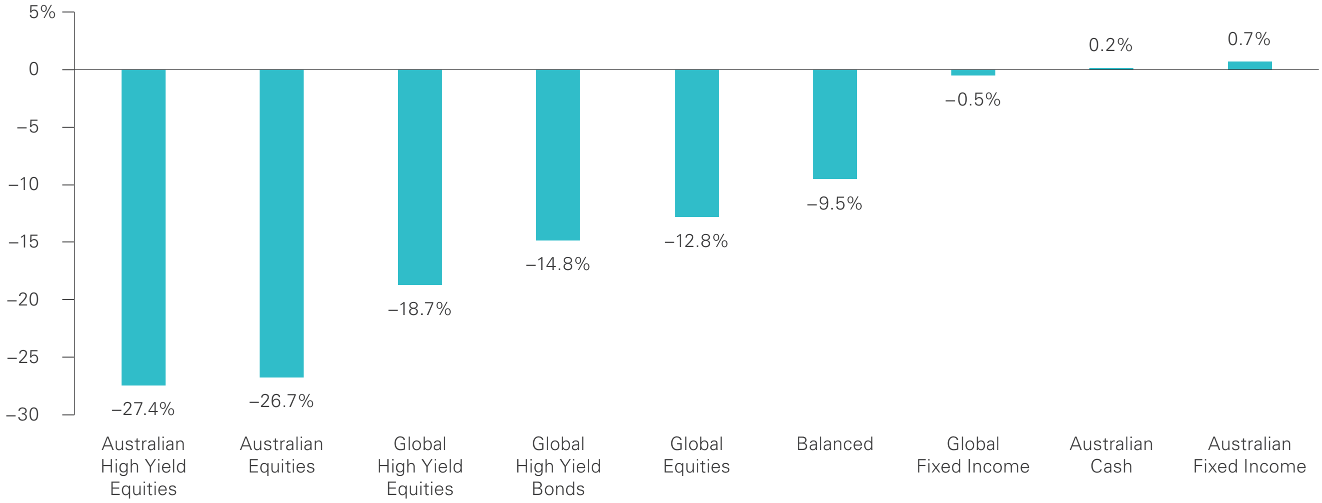
Figure 6: Dividend-focused indices have significant bias toward value



Notes: This style analysis displays the benchmark weights that result from a tracking error minimisation for each index across the set of four MSCI size and style indices (the results are not materially affected by the choice of index provider). Analysis covers the period from January 2000 to June 2020.

Source: Vanguard calculations, using data from Factset.

Figure 7: Cumulative total returns during the Covid-19 crisis, 1 February 2020 to 31 March 2020



Notes: Australian Equities are represented by S&P/ ASX200 Index, Global Equities – MSCI World ex Australia Index, Australian High Yield Equities – FTSE Australia High Dividend Yield Index, Global High Yield Bonds – Bloomberg Barclays High Yield USD Hedged, Australian Fixed Income – Bloomberg AusBond Composite Index, Global Fixed Income – Bloomberg Barclays Global Aggregate Index hedged into AUD, Australian Cash – Bloomberg AusBond Bank Bill Index, Balanced portfolio – a static 20%/30%/15%/35% mix of Australian equities, Global Equities, Australian bonds and Global Bonds. Global equity indices are in AUD terms.

Source: Vanguard calculations, using data from Factset.

A clear way to illustrate the possible unintended consequences associated with allocating to higher yielding assets is to look back to a recent period of market stress, the Covid-19 crisis, shown in Figure 7, when Australian and global equities declined by –26.7% and –12.8%, respectively. There are two important takeaways from the figure. First, Australian and global high yield equities as well as global high yield bonds all suffered considerable losses. Second, it is notable that traditional investment-grade bonds (both global and Australian) provided significant diversification and counter balancing over this period.

Franking credits and other tax considerations

Every dollar paid for management fees, trading commissions, or taxes is a dollar less of potential return. Minimizing investment costs is critical to long-term investing success because contrary to the typical economic relationship between price and value, higher costs do not lead to higher returns.

One of the most significant costs when investing can be taxes incurred when an investor earns interest, dividends, or capital gains. Under current Australian tax law dividends and interest are taxed at the investor's marginal tax rate while capital gains are taxed at a 50% discount rate if an asset is held for at least one year. All else equal, this can be an important consideration, particularly for a high net worth investor.

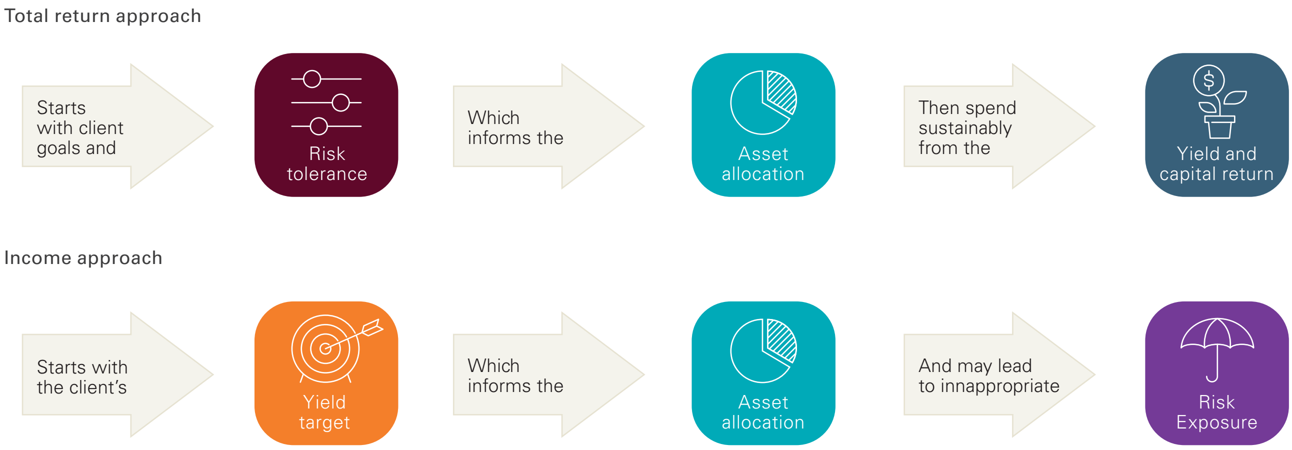
Franking credits are a valuable additional source of return (particularly for non-taxpaying investors), but to maximize this benefit, investors would need to overweight Australian shares – that is, to take on more concentration risk. We advocate for maintaining an appropriate level of diversification as well as holistic risk assessment when making asset allocation decisions.

A better alternative

Total return approach embodies all Vanguard's investment principles and provides a better alternative for investors. As illustrated by **Figure 8**, this approach encourages investors to consider their goals and risk tolerance and then construct the portfolio, matching the asset allocation to their risk-return profile. It helps control risks by using diversification, minimises costs, and remains disciplined with the implementation of the strategy over time.

When accompanied with a prudent spending rule[3], a total return approach provides several advantages compared with an income focused method, including maintaining alignment with the investor's goals and risk tolerance, appropriate portfolio diversification and control over the size and timing of withdrawals. It also helps control unintended factor and credit exposures and can increase the portfolio's longevity.

Figure 8: Thinking about income generation in retirement



Source: Vanguard

3. For Vanguard's research on retirement spending see: Smart, Timothy, Zahm, Nathan, Geysen, Aidan, and Jaconetti, Colleen M., 2018. From *Assets to Income: A Goal-Based Approach to Retirement Spending.* Vanguard Investments Australia Ltd

Conclusion

This paper explains why the total return approach to investing has a number of benefits compared to an income-focused approach for investors looking to meet particular spending objectives.

A total return portfolio approach can help to avoid some of the negative consequences of prioritising a portfolio's income return in pursuit of spending goals, including:

- ▼ Changing the desired asset allocation and compromising on the benefits of diversification;
- ▼ Increased exposure to dividend-focused equities creating a value bias;
- ▼ Substantial increases in portfolio risk associated with chasing additional yield including an increased exposure to high-yield bonds and emerging market bonds which tend to behave more equities than investment-grade bonds;
- ▼ Increased risk of falling short of long-term financial goals.

Vanguard believes the total return approach potentially offers a number of portfolio benefits over an income-focused method, including:

- ▲ Supporting spending needs without elevating risk;
- ▲ Aligning an investor's goals with their risk tolerance;
- ▲ Allowing a flexible spending approach that adapts to the growth of the overall portfolio;
- ▲ Providing appropriate portfolio diversification;
- ▲ Offering control over the size and timing of withdrawals;
- ▲ Increasing the portfolio's longevity;
- ▲ Controlling unintended factor and credit exposures.

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