Perpetual

SEEKING YIELD: INVESTMENT INCOME AMID THE TURMOIL

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In March this year, COVID-19 saw the Australian economy grind to a halt and the ASX plunge over 35% in just over a month. The response of central banks in Australia and around the world has been swift and overwhelming – flooding markets with trillions of dollars of bond purchases, sending share prices soaring.

For companies trading in this economy, the share price recovery has masked uncertainty for activity and earnings. The collapse in company revenue – and subsequently dividends – coupled with record low interest rates, has made 2020 a challenging year for investors.

If you're nearing – or in – retirement and rely on investment income from your portfolio, what can you do to keep your retirement on track?

Interest rates at record lows

After two cuts to official interest rates already this year in response to the pandemic, the Reserve Bank of Australia (RBA) has signalled that current ultra-low interest rates are not likely to change for at least the next couple of years.

With the economy still in recession, the RBA may even be closer to reducing interest rates, than raising them. However, with the official interest rate now at just 0.25%, there isn't much room for the RBA to work with.

Instead of heading into the unchartered territory of negative interest rates, the RBA has turned to purchasing Australian Government Securities to prop up the economy. The consequence of this 'quantitative easing' is that share markets have continued to recover, even while the outlook for the broader economy remains challenging.

While markets keep the faith in central banks and follow the old maxim "don't fight the Fed", investors can have confidence in the recovery of the share market in the short to medium term.

APRA, the banks and company dividends

This year, a significant number of companies cancelled or cut dividend payments to protect and repair their balance sheets during the COVID-19 pandemic.

In April, the economic uncertainty even prompted banking regulator, APRA, to ask the big banks – traditionally reliable dividend paying stocks – to cut or even not pay dividends. APRA's more recent guidance in July this year has softened this recommendation, stipulating they distribute no more than 50% of profits, nonetheless dealing a blow to investors who rely on dividends to pay the bills.

While we expect dividend income from the banks and other companies to recover by 2022, how can investors in or near retirement adapt their portfolios to the current environment of reduced investment income – both now and for the long term?

The hunt for yield

For fixed income assets, falling interest rates over the last decade have dragged on investment income.

"It's not surprising that some investors have responded to years of lower cash rates by chasing higher yields in potentially riskier investments," says Andrew Garrett, National Investment Specialist at Perpetual Private.

"One approach is to extend the duration of bonds they hold. The longer the duration, the greater the risk, which is something investors expect to be rewarded for through higher yields," Andrew says.

Investors can also consider increasing the credit risk in a fixed income portfolio. That is, instead of ultra-safe government bonds, corporate bonds generally offer higher yields.

"For either approach it's important to seek financial advice as you're increasing the risk of your portfolio," Andrew notes, "and for higher credit risk, you're also reducing the benefits of diversification as credit risk correlates to equity market risk."

For equity income, investors may be tempted to chase higher yield stocks. The sheer speed of the decline in economic conditions mean that it's not always possible – or wise – to switch from equities where the dividends have been cut. Making hasty changes in response to rare events can exacerbate a bad situation.

Instead, at Perpetual Private, whether we're managing large funds for institutions or individual portfolios for clients, we prefer a 'total return' strategy. We seek assets that generate superior long-term returns, regardless of whether that return arrives as capital growth or dividends/yield.

"So, while you may have an interest and dividends 'first' approach, in times where these aren't enough to meet your income needs, you can prudently withdraw your capital," Andrew said.

To improve the outcome of a total return approach, it's important to focus on adding companies to your portfolio that can generate real growth prospects. Due to the volatile nature of capital growth, it's also important to have a long-term investment horizon. In times when dividend payments and interest do exceed your income needs, you will also need the discipline to reinvest and rebalance your portfolio.

Taking this approach will smooth out investment returns and make your portfolio less susceptible to market fluctuations.

Control what you can

Now is a good time to review your spending plans, particularly for if you're nearing or in retirement. While COVID-19 is making people delay their big trips, other steps you can take to reduce your withdrawals and stay invested during the downturn means you'll have more assets invested to benefit from the inevitable market recovery.

Seek financial advice

"When you see your portfolio go downwards quickly, it can be difficult to not react emotionally and make knee-jerk investment decisions," Andrew concluded. "Remember that history shows markets always rebound, which is one good reason to stay invested for the long haul."

In uncertain and volatile times such as we've seen this year, it's important to speak to your financial adviser before making changes to your portfolio or financial plan.