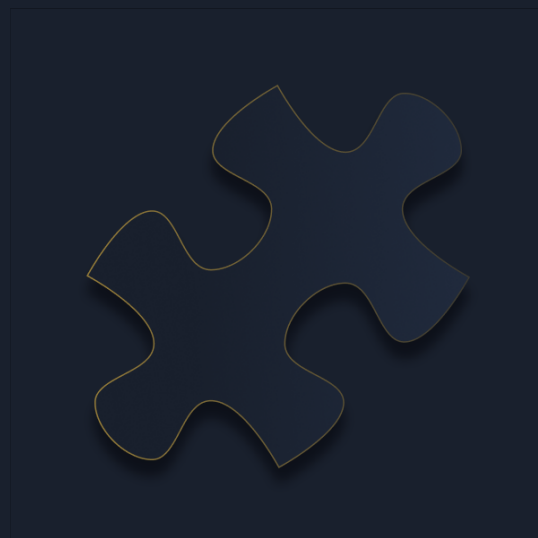


eBook

2020 INCOME SERIES

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SERIES



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James Marlay
Livewire Markets

“Why would you pay a bank to hold your money? It just doesn’t make sense.”

Solving the income puzzle

In 1974 a Hungarian design teacher and puzzle enthusiast assembled his first cube-shaped puzzle and called it the Magic Cube. The puzzler was Erno Rubik, and shortly after his initial creation, Ideal Toy Corp licensed the cube and renamed it The Rubik’s Cube. It is estimated that over 350 million Rubik’s Cubes have been sold, making it the most popular toy in history.

There are 42 quintillion possibilities but only one correct solution for this famous puzzle. It took Erno Rubik a month to figure it out, today there is a guide that teaches you the solution in 45 minutes, and the current Rubik’s Cube world record is just 4.22 seconds. That incredible record is only possible because the puzzle stays the same with no changes to the number, size, shape or colour of the twenty-seven small cubes.

Unfortunately, for many investors the solution to their income needs is getting more challenging over time rather than easier. It really is a puzzle.

We’ve looked in bewilderment at the negative rates experience in offshore markets, particularly in Europe. Why would you pay a bank to hold your money? It just doesn’t make sense.

In Australia, we still have positive interest rates, but that’s just on face value. When you account for inflation, running at 2.2% according to the RBA, you’re losing money by holding cash. This is commonly referred to as the value of an asset in ‘real terms’.

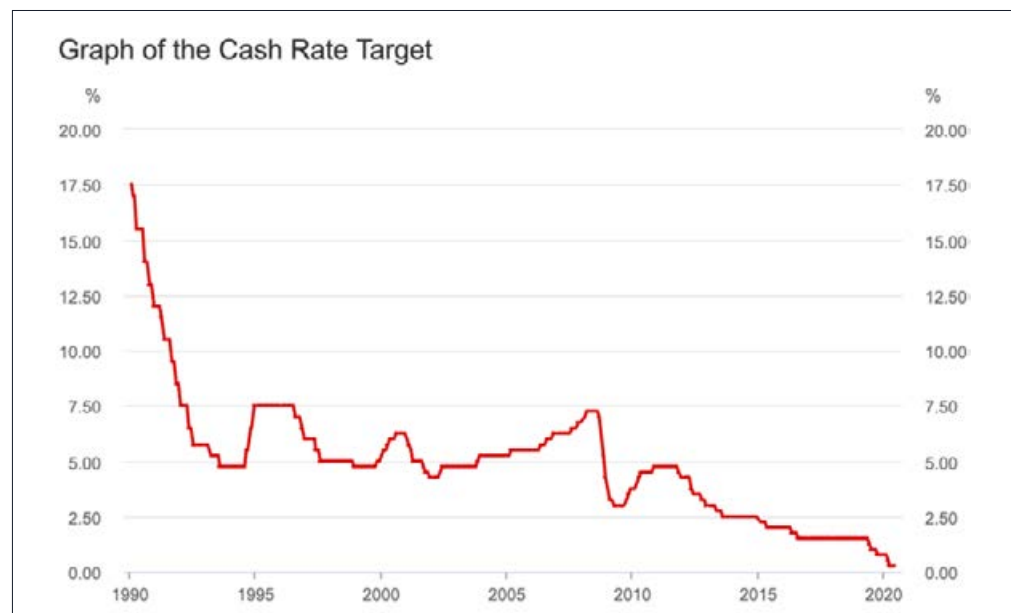


Chart 1 – Cash rate Target

Source: RBA

Piles of cash on the sideline

With that backdrop, I was somewhat surprised at the results from a recent survey of Livewiremarkets.com readers and their investment intentions in the year ahead. What caught my eye was how much cash is sitting on the sidelines, assets effectively losing value. The results showed that roughly 35% of respondents were holding cash levels between 20% and 50%, an additional 14% of investors surveyed are sitting on cash levels above 50%.

I get that people may have raised cash in the sell-off, and I also appreciate that people like the optionality that comes with holding some cash. Individual circumstances vary, but it stood out as a large amount sitting on the sidelines.

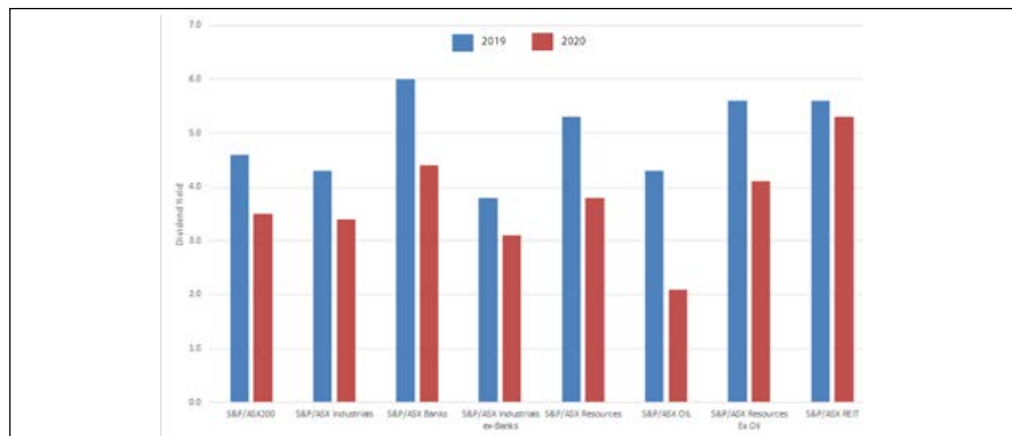


Chart 2 – Market Expectations for dividend yield comparison: May 2019 – May 2020

Source: FactSet & Nikko Asset Management

The results also showed that one in four of investors surveyed currently use term deposits to execute their strategy. I did a quick around the grounds, and the absolute best rate I could find was 2.15% p.a....but you have to lock your cash up for five years, leave it with an institution you've probably never heard of and even then you're still going backwards in 'real terms'. A term deposit at one of the big four will pay you about 0.85% on a 12-month term. Investing \$100,000 for 12 months will leave you with \$98,650, again in 'real terms'.

That's probably why only 6% said they were planning to use term deposits in the year ahead. It would be reasonable to conclude that at least some of the money currently sitting in term deposits will start looking for a new home.

At the other end of the spectrum are the ever-popular fully franked dividends spinning out of Australia's listed companies. The tax incentive is a clear kicker, and there is no doubt that dividends are an essential part of the solution. Share price falls have been tolerated, but in recent times dividend cuts and deferrals have put the spotlight on the Achilles heel of strategies too heavily reliant on dividends.

The chart above highlights the drop in expected dividends across several major sectors. An investor relying on the market for their income should be preparing for a ~22% hit compared to the prior year.

To help investors address these challenges Livewire has produced an educational series titled "Solving the income puzzle". The aim of the series is to help you learn more about the different asset classes that can be used to generate income. There are eight asset classes covered. Some of them, like equities, are well understood and others such as alternatives and private debt are less well known. Each of the submissions has been written by a fund manager that specialises in their respective asset class to provide an expert view of the opportunities and risks.

We've packaged these articles into this eBook and we hope that it proves to be a useful resource in your investing journey.



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Campbell Dawson

Elstree Investment
Management

“We think the way forward is to find a combination of high income, but higher risk investments, that display uncorrelated return outcomes and have different factors driving those return outcomes.”

5 reasons hybrids deserve a spot in your portfolio

Australian income investors used to be lucky. From 1980 to the middle of the last decade, they could achieve returns of more than 3% above the rate of inflation simply by investing in totally safe cash term deposits (this was around 1.5% higher than anywhere else in the world). They didn't need to take investment risk for income

Those days are gone. Term Deposit (TD) rates are now less than the rate of inflation, and income investors are grappling with this new world of having to find income but having to take more risk to get that income. And with the RBA signalling that cash rates will stay low for at least the next 3 years, that problem is not going to go away.

We think the way forward is to find a combination of high income, but higher risk investments, that display uncorrelated return outcomes and have different factors driving those return outcomes. Over a cycle, something will undoubtedly go wrong, but if there is sufficient diversification, the portfolio should still generate returns outcomes well above cash and Term Deposit rates.

How do hybrids fit into a portfolio of income assets?

Hybrids form a very important part of any income portfolio for a number of reasons;

- The credit quality of the issuers, which are mainly banks and other financial institutions, is very high - much higher than a lot of the loan fund alternatives. More importantly, bank income is more diverse than a portfolio of corporate loans, which are entirely reliant on a relatively small number of corporate borrowers paying interest and principal. It will take a very severe recession before the credit quality of the banks becomes concerning.
- Historical returns (and probably prospective returns) of hybrids have not been much lower than equities (refer chart below).
- Return volatility is much lower than equities.
- Unlike many of the loan and bond funds that have been issued on the ASX since 2018, there is an important 'mark to market' mechanism. We are now at the beginning of a recession where it is inevitable that some corporate loans will default (to date however, we're not aware of any write downs in the loan funds). At the same time, there is no market in the underlying loans, very little visibility as to who the loans are made too and an illiquid market in the actual loan vehicle. So, no one has any idea what the "real" NAV should be, let alone whether the loan funds should be trading at a discount or premium to the published NAV. This is not a trivial matter. During the GFC period, the cumulative default rate of "B" rated bonds was over 17%.
- Liquidity of ASX listed hybrids is satisfactory for all small investors.

Why do hybrids work?

The following charts show the risk and return outcomes of ASX listed hybrid market using proprietary data of 20 years from the Elstree Hybrid Index and the All Ordinaries Accumulation Index; The way to read the chart is the vertical axis shows the investment needed at any one point to have an amount of \$1,000 at 30/6/20. Clearly, lower is better, but as the chart shows you have to go back to 2003 before equities (blue line) materially outperformed hybrids (green line), and clearly hybrids are much less volatile than equities. This is because the hybrid return of cash +3% is roughly equivalent to what the broader equity market has returned on an annual basis over the past 50 years.

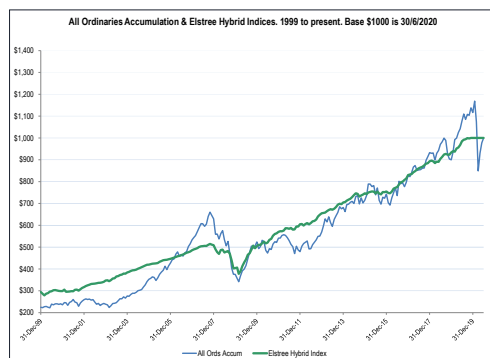


Chart 1 – All Ordinaries Accumulation & Elstree Indices.
Source: Elstree

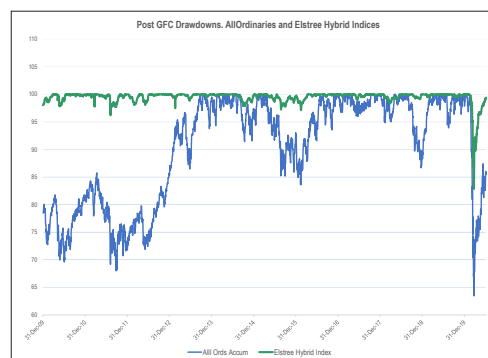


Chart 2 – Post GFC Drawdowns, AllOrdinaries and Elstree Hybrid Indices
Source: Elstree

The drawdown chart (Chart 2) above shows the differences in volatility more clearly. When the vertical axis is at 100, it indicates that the index is at an all time high. Since the GFC, equities (blue line) have had a number of 10% + drawdowns, each of which took a long time to recover, while the maximum drawdown in the hybrid market (green line) was c2% and it was not long in duration. Even the Covid-19 crisis was reasonable for hybrids despite the greater stresses presenting in the system. Hybrids fell by far less than equities and are now back to February 2020 index levels while equities are still c15% off their highs.

Risks

As we mentioned above, there is no return without risk. We see 2 main risks in the hybrid market. The risks are:

- The conversion/non viability issue. We're much more sanguine about the conversion/non viability issue than many commentators. While it will become relevant at some point we don't think it manifests in hybrid security prices until banks become closer to non-viability. We've haven't seen a non-viable Australian bank, but offshore experience tells us that non viability presents when bank ratings approach the "BBB" level (a long way from where Australian banks are now) and share prices fall to a fraction of book value (ie CBA share price falling another 80%).
- However, weak equity markets will affect hybrid prices in the short and medium term along with occasional concerns surrounding the continuation of bank dividend payments and hybrid distribution payments.

Outlook

Historically, when spread margins are 4% or more over cash, there has not been a subsequent 12 month return outcome of less than 4.5% (with the average return in the high single figures). Spread margins over cash are now a little less than 4%, so the prospect of high single digit returns is a little lower. However, we think that spread margins are going to continue to narrow to less than 3% which will, everything being equal, produce near term capital gains (spread margins move in the opposite direction to price). We think, retail investors, who are over exposed to low yielding Term Deposits, faced with an array of uncertain investments including declining dividend yields, problematic loan funds will continue to seek out hybrid securities.

CBA PERLS VII ASX ticker	First Call	Compulsory Exchange	Coupon margin over BBSW	Franked %	PAR value	Current market price
"CBAPD"	15-Dec-22	15-Dec-24	2.80%	100%	\$100	\$99

A security example: PERLSVII (ASX Code "CBAPD").

A typical security is the Commonwealth Bank's PERLS VII issue (ASX coded "CBAPD"). The security has a notional 'maturity date', known as the 'first call date' of 15 December 2022 (it has a compulsory 'exchange date' 2 years later of 15 December 2024). The security pays a quarterly coupon rate of BBSW plus 2.80%. The coupon rate of BBSW plus 2.80% represents the gross coupon which means it is inclusive of franking credits. The current price of c\$99 results in the security generating a yield of around 3.5% which is made up of BBSW of 0.25% + spread margin of 2.8% and capital appreciation of around 0.5% p.a. This compares with a major bank 2 year Term Deposit rate of around 1%.

"So given you are receiving a materially higher rate of return than a Term Deposit, what are you getting paid for and what can go wrong?"

So given you are receiving a materially higher rate of return than a Term Deposit, what are you getting paid for and what can go wrong?

- (i) You can't sell it - Not an issue. The security turns over more than \$50m per month.
- (ii) Its price is volatile - Sometimes. The usual monthly price movement is around \$1. During Covid-19 however, the price fell from \$100 to under \$90 where it stayed for approximately 10 days - it was still under \$96 through until the end of April. It is now \$99.
- (iii) You don't receive coupon payments - Possible. Hybrids provide a safety net for banks to protect depositors. If conditions are sufficiently dire, APRA may force the banks to not pay distributions on hybrids. However, if a bank pays a dividend or its ordinary equity, it has to pay a hybrid distribution and even in these days of bank dividend reticence, there has not yet been a case globally where a major bank has not paid a hybrid dividend (even when the parent bank is prohibited from paying dividends).
- (iv) You don't get your capital back on time: Possible. As part of the bank safety net, PDS' are full of technical clauses about "calls" and "compulsory exchanges", which translated simply means the banks aren't required to pay the hybrid back if conditions are dislocated or sufficiently dire. However, when conditions normalise, banks are heavily incentivised to pay the hybrid back on or before its due date.

Whether the additional return justifies the risk is a question for individual investors and of course, the risk is inversely related to the health of the Australian banking system. However, if an investor can find investments that are less dependent and less correlated to Australian banking risk, the risks highlighted above, become less of an issue and hybrids "work" by providing higher return outcomes.



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Mitch Goldstein

Ares Management
Corporation

*“Together,
these sources of
alternative income
represent a vast,
multi-trillion-dollar
opportunity set.”*

Rethinking Income: Where to find higher yields with stability

Coming into 2020, income investors had been on a “hunt for yield” due to low interest rates globally. Fast forward to the present and the search for income has only intensified as the Covid-19 pandemic has shaped investor sentiment and pushed government and traditional fixed income yields below one percent, and in some cases into negative territory.¹ Additionally, traditional sources of income, such as dividend-paying equities, have become a less reliable source of income during this period.

Against this backdrop, we believe investors should think outside the box and look beyond traditional asset classes for income. We believe the credit markets provide multiple sources of alternative income for investors due to their historically attractive yields, defensive structures and historical risk-return profile. In this piece, we will examine alternative income solutions in today’s credit markets and their role in an investor’s portfolio.

Sources of Alternative Income

There are various opportunities within the credit markets that we view as alternative sources of income. They span the liquidity spectrum, and total returns are typically driven by income. The yields on these asset classes are generally priced at a premium to traditional fixed income due to factors such as credit risk and liquidity. These alternative asset classes can be viewed as a more reliable source of income compared to traditional public equities as the current income component is contractual.

Alternative Income Universe

Corporate Direct Lending (“Direct Lending”)

A transaction where a lending source directly provides a loan to the borrower without the use of an intermediary. This is accomplished by directly engaging with private equity sponsors or owner/operators of middle market companies (generally \$10 - \$150 million of EBITDA or greater) to originate loans. As the asset class has evolved, select managers have been able to execute larger transactions which overlap with the broadly syndicated market.

Illustrative Example – Direct Lending: A private equity firm seeks financing to support their buyout of a market leading software company. The target company provides mission-critical products and has a global, diversified customer base with strong retention rates. The acquisition occurs during a period of elevated market volatility, and sentiment across public and private markets is risk averse. To finance the transaction, the private equity firm approaches an alternative investment manager (the “manager”) with a scaled, experienced direct lending business. The manager has supported the target company historically and has in-depth knowledge of their business model. Additionally, the manager has sufficient assets under management such that it is able to underwrite risk during a period of elevated volatility. Due to market conditions, the manager can negotiate enhanced pricing and tighter documentation as compared to its prior deals with the target company. As such, the private equity firm can execute on its buyout of the software company while the manager is able to finance the company and provide its investors with an attractive, defensively structured source of current income.

Commercial Real Estate First Mortgage Lending (“Real Estate Debt”)

Transactions secured by first lien loans on commercial properties, such as offices, multifamily or industrial properties and located in top markets with strong real estate fundamentals. First mortgage loans are senior in the capital structure, with additional protection from the borrower’s equity and can be structured to provide further principal and yield protection through loan covenants.

Illustrative Example – Real Estate Debt: An institutional investor seeks capital to invest in a commercial real estate property. The property is an office complex located in a large metropolitan city in the U.S., and has financially stable, investment grade companies as tenants. The institutional investor reaches out to an alternative investment manager (the “manager”), typically one they have borrowed from previously, to secure financing. The financing is efficiently priced and structured directly with the institutional investor, resulting in favorable pricing and terms. The result is a high-quality loan negotiated by the manager that generates an attractive and stable coupon with principal protection. The manager negotiates a LIBOR floor, or a minimum rate, which allows the manager to protect against potential decreases in LIBOR.

Alternative Credit

Alternative Credit transactions span public and private markets and are secured by specialty, financial or real assets that generate cash flows upon which the investment relies for repayment. These investments can offer downside protection given ample levels of credit enhancement and robust covenant packages.

Illustrative Example – Alternative Credit: An institutional investor (the “investor”) has existing financing against their diversified portfolio of securities. A bout of market volatility shakes investor sentiment and the traditional lending markets. As a result, the asset manager faces significant liquidity pressures. Through a wide network of relationships, an alternative investment manager (the “manager”) approaches the institutional investor with a refinancing solution. The manager uses their vast resources to underwrite the underlying securities in the investor’s portfolio. The ultimate transaction is a term loan backed by the underlying pool of securities. The loan requires portfolio cash flows be used to repay principal and interest on the loan, has a limited three-year term, and is covenant heavy.

Syndicated Bank Loans (“Bank Loans”)

These are transactions where a below investment grade company obtains a loan from an arranger who then syndicates the loan to investors, such as pension funds and collateralized loan obligations (“CLOs”). Bank loans are traded instruments in the liquid portion of the non-traditional credit market, are typically senior secured, and pay a floating rate coupon.

Illustrative Example– Bank Loans: A private equity owned collision repair company seeks financing to fund their merger with an industry peer. The companies are market leaders in the U.S. and look to the capital markets and direct lenders to finance the merger. The company and its private equity owner have an existing relationship with a direct lender which also has a dedicated liquid credit business and multi-billion-dollar bank loan portfolio. The company is able to secure part of their financing package through a deal with the direct lender and their liquid credit business. The remaining portion of the package is arranged and syndicated by a bank. The bank approaches various firms regarding the bank loan and assigns a tight deadline for demand. The manager is able to leverage their multi-year relationship with the company for enhanced diligence and is able to quickly convey demand to the arranger bank. As a result, the manager is able to receive a favorable allocation of the syndicated bank loan.

These asset classes span the liquidity and return spectrum and are typically defensive structures which sit senior in the capital structure. Covenant packages are typical for the illiquid asset classes, though can exist in the liquid markets as well.

Asset Class	Liquidity	Market Asset Class Gross Target Return
Direct Lending	Illiquid	7-15%
Real Estate Debt	Illiquid	4-14%
Alternative Credit	Varies	4-15%+
Bank Loans	Liquid	5-8%

Table: Targeted Market Asset Class Returns¹
Based on Ares current market observations as of June 30, 2020.¹

Together, these sources of alternative income represent a vast, multi-trillion-dollar opportunity set. The market opportunity has benefitted from secular trends in the banking industry, notably consolidation and regulatory changes, which has decreased the number of banks as well as their appetite to hold leveraged credit assets. Alternative investment managers have stepped in to fill the void.

“Alternative investment managers have stepped in to fill the void.”

Decline of U.S. Banks

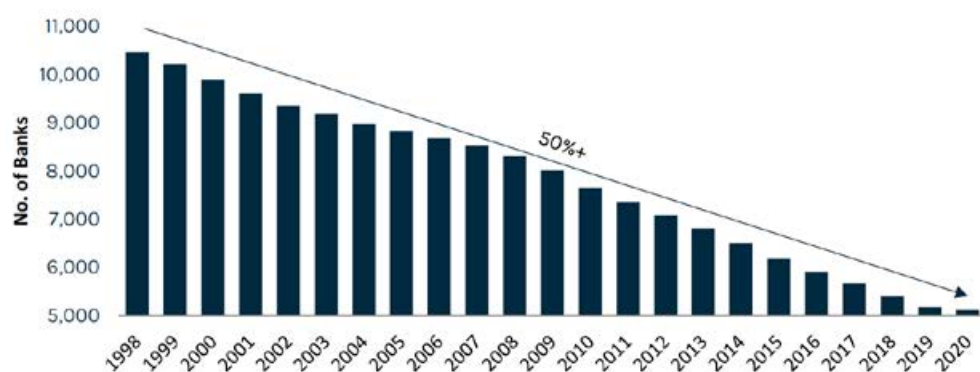


Chart 1 – Decline of U.S. Banks

Source: Federal Deposit Insurance Corporation (FDIC), “Statistics at a Glance: Latest Industry Trends,” March 31, 2020. For illustrative purposes only

Holders of Bank Loans

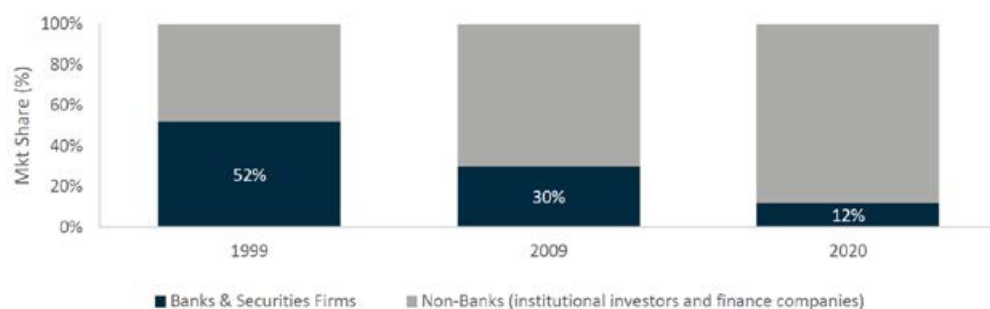


Chart 2 – Holders of Bank Loans

Source: LCD. As of March 31, 2020. For illustrative purposes only. Calendar year 2020 data is for the twelve months ending March 31, 2020.



Where does this fit in my portfolio?

Even though each market has its own unique traits and nuances, the asset classes within the alternative income universe can generally enhance traditional fixed income and equity portfolios in the following ways:

From an income and yield perspective, these assets offer varying premiums relative to traditional fixed income. The below chart provides a tangible example of the current opportunity set in the liquid alternative markets. In the illiquid space additional excess income can also be generated.

Relative Value in Liquid Markets

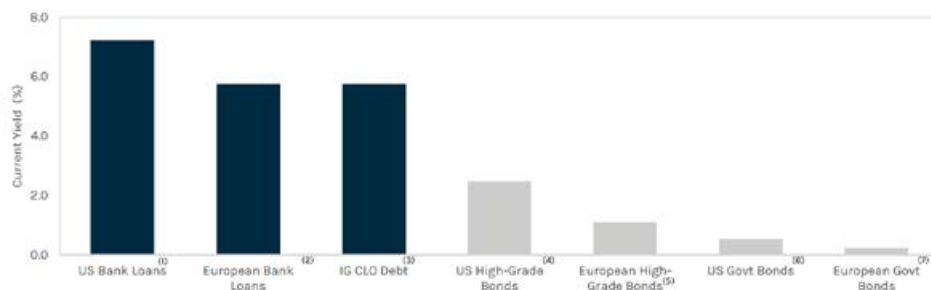


Chart 3 – Relative Value in Liquid Markets. As of May 31, 2020.

Source: (1) Credit Suisse Leveraged Loan Index. (2) Credit Suisse Western European Leveraged Loan Index. (3) JPM CLOIE BBB Post-Crisis. (4) ICE BofA US Corporate Index. (5) ICE BofA Euro Corporate Index. (6) ICE BofA US Treasury & Agency Index (7) ICE BofA European Union Government Bond Index.

Risk and Reward

The benefits of alternative income are not free, and their attractive yields typically come with additional credit risk when compared to traditional fixed income. That said, active managers can mitigate this risk through forensic due diligence and by taking a selective approach to credit allocation. Some managers have been able to successfully execute over time, with low default and loss rates over multiple cycles.

Alternative income assets have demonstrated limited volatility over time. For more liquid markets like bank loans, the attractive income component has contributed to stability and

downside protection relative to traditional asset classes. For example, the bank loan market has been a dependable source of positive returns with only two years of negative returns since 2000². The illiquid nature of direct lending, real estate debt and certain forms of alternative credit enhances the already muted asset level volatility exhibited by the liquid assets. An investor's experience can vary depending on the vehicle used to access these asset classes and the asset allocation mix of the portfolio.

These assets offer limited duration relative to their traditional counterparts as well. Currently, the bank loan market has a duration of 0.91 years compared to 7.27 years for the global fixed income market², and the weighted average life of illiquid alternative assets are typically 3 years.

The combination of attractive yields, low duration and defensive structures have contributed to an attractive risk/return profile over time.

We believe these alternative income assets sit in the "sweet spot" relative to traditional asset classes, offering enhanced yields and total returns when compared to traditional fixed income, and limited volatility when compared to public equities. Returns in these alternative asset classes are primarily driven by coupon, but total return opportunities exist in the more liquid markets as trading volatility year-to-date has increased convexity in these markets. The increased volatility has created opportunities where active managers are able to acquire assets at a discount to their face value, creating an opportunity for capital gains.

Alternative Income: The "Sweet Spot" of the Risk/Reward Spectrum

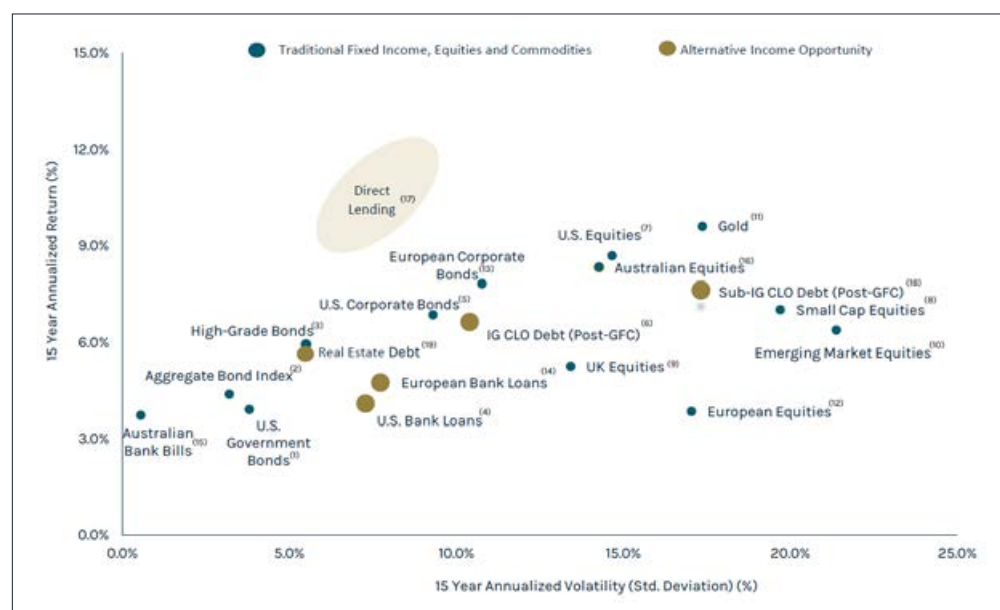


Chart 4– Alternative Income: The "Sweet Spot" of the Risk/Reward Spectrum. As of May 31, 2020

Source: (1) 5Y Treasury Bond. (2) Bloomberg Barclays US Aggregate Bond Index. (3) JPM JULI High Grade Index. (4) Credit Suisse Leveraged Loan Index. (5) JPM US HY Index. (6) JPM CLOIE BBB Post-Crisis. Annualized return since 2012. (7) S&P 500 Total Return. (8) Russell 2000. (9) FTSE 100. (10) Dow Jones EM Stock Index. (11) IAU US Equity. (12) EURO STOXX 50. (13) ICE BofA Euro High Yield Index. (14) Credit Suisse Western European Leveraged Loan Index. (15) Bloomberg AusBond Bank Bill Index. (16) S&P/ASX 200. (17) Based on Ares current market observations. (18) JPM CLOIE BB Post-Crisis. Annualized return since 2012. (19) Giliberto-Levy (G-L) Commercial Mortgage Performance Index

Conclusion

Alternative income assets can be a reliable source of current income for investors looking to fill the void created by low interest rates and corporate fundamental uncertainty triggered by the Covid-19 pandemic. Specific to credit, these asset classes span the liquidity and return spectrum, though their structures share similar defensive characteristics. We believe these assets sit in the “sweet spot” of the risk reward spectrum, generating attractive returns compared to traditional fixed income and reduced volatility compared to equities. There are a number of synergies between these alternative assets, and we believe managers who have invested heavily in origination and capital markets capabilities can create significant competitive advantages. Additionally, we believe that managers with flexible capital have significant competitive advantages in developing creative solutions across a broader spectrum of opportunities.

Footnotes

¹Source: Bloomberg, as of June 19, 2020.

²Source: Bloomberg, Credit Suisse. As of May 31, 2020.

To view Ares Management's full disclaimer, please visit the original article on Livewire here <https://www.livewiremarkets.com/wires/rethinking-income-where-to-find-higher-yields-with-stability>



Mitch Goldstein

Ares Management

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Jason Huljich

Centuria Capital

“Individual real estate assets attract varying levels of income, so investors need to be selective when choosing their investments.”

Opening the door to income

Australians have a love affair with property. But there are a number of ways to own property – and earn an income from it. Two of these include listed real estate investment trusts or REITs and unlisted property funds.

Most REITs were in good shape as Covid-19 hit but that doesn't mean all property classes have performed the same. Retail has taken a significant hit thanks to the ongoing lockdowns and the acceleration of ecommerce, while offices, warehouses and healthcare facilities are still showing strong demand.

Individual real estate assets attract varying levels of income, so investors need to be selective when choosing their investments. Here, I discuss the differences between REITs and unlisted funds, and give a rundown on which sectors look set to shine

Two ways to invest

For the past five months, Australia has experienced an historically low cash rate of 0.25%. While low rates are great for variable household mortgages or other loans, they are wanting for savings accounts, term deposits and any other cash-related investment vehicle.

Across the four major Australian banks, interest rates paid on term deposits held for 12 months and payable on maturity, averaged 0.85%¹. So investors with these types of income-investments might prefer to seek alternative vehicles, such as commercial property, to generate revenue and, subsequently, pay regular, higher returns.

There are two typical ways of investing in commercial property, outside of owning an asset outright: through listed or unlisted funds.

Listed Funds

Property funds listed on an exchange are referred to as Real Estate Investment Trusts (REITs) or Australian REITs (A-REITs). Investors can buy or sell their shares in these funds at any time. This makes them highly liquid.

Unlisted Funds

Unlisted property funds are entities not available on a security exchange, such as the ASX. They are often referred to as property syndicates as they involve the syndication of ownership of a single property or group of properties, to investors. Unlisted funds specify the period an asset or assets will be owned – usually five to seven years – and typically provide monthly or quarterly returns (distributions) based on the net rental income received from the tenants. The fund's assets are typically divested at the end of the term and the funds are returned to investors. There is also the potential for a capital gain. Property funds can also be closed or open-ended.

Closed-ended means the number of units in the fund is fixed. No additional units are issued or redeemed during the term of the fund. This type of fund generally has lower volatility than a listed fund as the assets are usually valued once or twice a year and the unit price is updated at the time of valuation. Centuria's distribution yields for the March 2020 quarter for close-ended funds averaged 6.64% (annualised, based on 31 December 2019 net asset backings).

Open-ended funds are similar, except investors can enter or leave the fund during the duration of the fund, when there is a liquidity facility in place. Investors can withdraw their investment at designated intervals, usually monthly or quarterly. Centuria's distribution yield for the March 2020 quarter for the open-ended fund was 5.28% (annualised).

Key Metrics

When deciding which property fund is best for you, there are several key metrics to consider. These are the drivers that can deliver stable rental income and, therefore increase the likelihood of attractive returns. They include:

Weighted Average Lease Expiry (WALE). The average number of years a property has secured a tenant(s). The more years the better, as it provides greater assurance of rent revenue, which better translates into certainty of returns.

Tenant Profile

The type of tenant renting underlines how effectively it can pay its rent. Tenants whose businesses are resilient against economic or political uncertainty are highly desired. These include government agencies, ASX-listed entities, multinational corporations, large grocery store chains and large medical operators.

Asset Quality and Location

This is especially important if you are investing in a single asset fund. An asset's location and quality determine its desirability and demand from tenants, which can translate into stable income and potential for rental growth.

Trusted Manager

The fund manager is the entity responsible for overseeing the operation and financial management of the properties. Ideally you want a manager that is experienced, has operated throughout several property cycles and has a strong track record of delivering returns to investors.

How the different types of property are performing

Residential

There are no pure residential A-REITs on the ASX. The most common form of ownership is by direct investment. Compared to commercial properties, residential investments typically have shorter leases (usually six to 12 months), ambiguous and inconsistent quality of tenants, higher overheads and lower income returns. According to Domain Group's June 2020 Rent Report², median rental yields for houses across Australia's capital cities were 3.75% and 4.22% for units.

Retail

Isolation and social-distancing restrictions throughout March to June 2020 limited shoppers from physically buying in-store. Consequently, shops have been less likely to meet rental commitments. The Covid-19 period has escalated the growing decline of footfall in retail precincts and according to KPMG there has been an 8.1% cumulative decline throughout three years to March 2020³; and a predicted further fall to 11.7% throughout 2020. Additionally, JLL research showed mall vacancies have reached a 20-year high, rising 5.1% in June 2020 from 3.8% in December 2019.

However, online shopping has steadily increased year-on-year, creating a positive impact on logistics and warehouse property. The graph below illustrates the strength of online shopping. Online retail sales grow on average \$2 billion year-on-year and as at 2019 Year End, reached \$30 billion⁴.

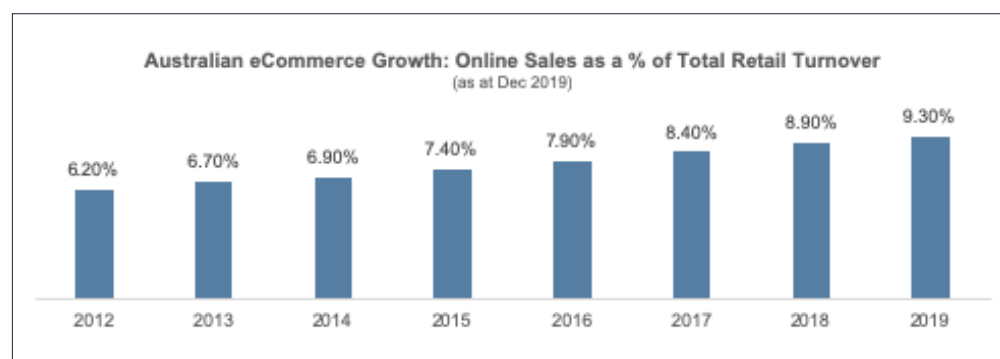


Chart 1 – Australian eCommerce Growth: Online Sales as a % of Total Retail Turnover

Source: JLL Research, NAB

“We don’t believe the recent working from home thematic will significantly affect demand for office space.”

Logistics/Warehouse

These large properties usually house storage, manufacturing and logistics tenants and are typically between 5,000sqm and 20,000sqm. They are generally located along key transport corridors, such as road arterials, rail freight lines, shipping ports and airports. They are usually let on five to seven-year leases though purpose-built facilities attract longer terms. Demand for this asset class has been growing significantly in recent years due to the growth in ecommerce and its need for well-located warehouses to service customers.

According to JLL research, the average vacancy rate across Australia’s Eastern seaboard states was 3.8% at 2019 year end. Throughout 2019, retail accounted for 22% of industrial take-up, behind transport, postal and warehousing.

Office

Offices, particularly large office towers, have benefited from strong investor appetite throughout the past couple of decades. As towers attract multiple tenants, they are well diversified as the ability to generate income usually isn’t reliant on one company. Lease terms are generally between three and 10 years.

In recent weeks, workers have started to return to their offices in most cities. There has been recent negative press coverage regarding future demand, however, we believe offices have a mid to long-term positive outlook. We don’t believe the recent working from home thematic will significantly affect demand for office space.

Healthcare

Healthcare property encompasses medical facilities – from primary care, such as GPs and medical centres; secondary health, such as day hospitals; tertiary health including private hospitals; allied health such as dentists and physiotherapists; and ancillary health, such as pharmacies and childcare provisions. These assets are typically held in unlisted funds.

According to MSCI’s research for the December 2019 year-end, hospital market yields were 6.11% and medical centres, 5.97%. Healthcare assets can attract 10 to 30-year lease lengths, depending on the nature of the asset.

Due to an ageing population’s reliance on medical facilities, as well as rising chronic diseases, such as diabetes, this asset class’ demand looks very likely to continue growing.

Putting property types in perspective

Comparing current income returns shows a convincing argument for investing in real estate property funds, especially when compared with term deposits.

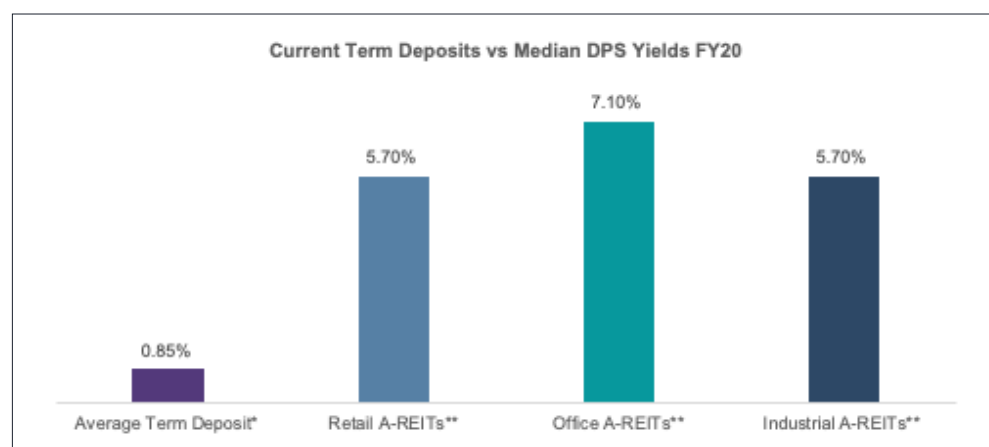


Chart 2 – Current Term Deposits vs Median DPS Yields FY20

Source: *Average across Australia’s four major banks as at 20 July 2020.

**Moelis Research based on Factset, Bloomberg, company disclosures as at 17 July 2020

Conclusion

In summary, while different real estate assets attract varying levels of income, in the current to long-term period, offices, warehouses and healthcare facilities continue to show strong demand. More specifically, they offer a significant premium to term deposits, albeit with higher risks of capital loss. Whether an investor wishes to invest in unlisted fixed term funds, unlisted open-ended funds or a REIT, depends on his or her risk appetite and desire for liquidity.

Footnotes

¹ NAB Term Deposit interest rate for investments of \$5,000 - \$499,999 held for 12 months is 0.95%; CBA Term Deposits interest rate for investments of from \$50,000 to \$1,999,999 held for 12 months is 0.85%; Westpac Term Deposit interest rate for investments of between \$5,000 and \$2,000,000 held for 12 months is 0.85%; ANZ Advanced Notice Term Deposit interest rate for investments of \$5,000 to \$99,999 held for 12 months is 0.75%

² <https://www.domain.com.au/research/rental-report/june-2020/>

³ KPMG Beyond COVID-19 June 2020

⁴ JLL Research Report: Australian Industrial Investment Review & Outlook 2020



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“Historically, bonds tend to be much more stable than shares in market corrections and can be a good diversifier and shock absorber for portfolios.”

A missed opportunity for many Australians

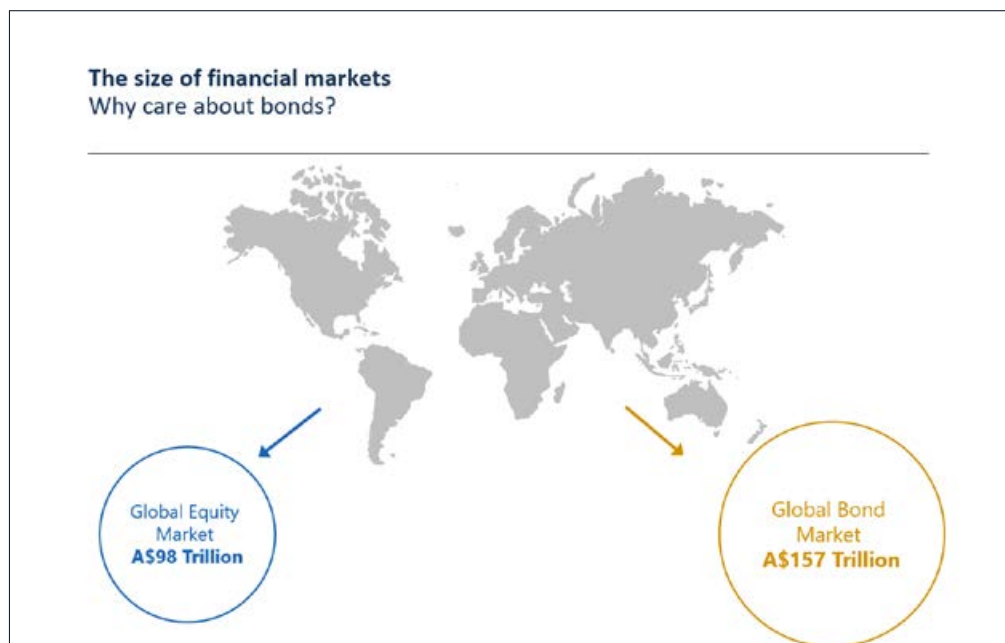


Fig 1 – AUM as of 31 March 2020. Market sizes as of 31 December 2019. Market Values on stock and bond markets are based on estimates and are used for hypothetical purposes only.

Source: PIMCO, Haver Analytics, Bloomberg

In Australia, many investors are familiar with cash, term deposits and equities. However, bonds remain less well understood and under-invested, which could represent a missed opportunity for Australian investors looking for consistent income, defensive attributes and portfolio diversification.

In fact, as you can see in figure 1, the global bond market is actually much larger and more diverse than the global equity market.

Comparing bonds and equities

Corporate bonds can sound complicated, but at their core are quite a simple investment. Companies can raise capital either by borrowing from a bank (which may not be practical for large companies), issuing equity/shares (which is an ownership stake in the company), or issuing bonds to borrow money. A bond is simply a loan with some additional requirements. They pay a fixed interest payment (a ‘coupon’), and the lender (in this case the investor)

	Bonds	Shares
Coupons / dividends	Coupon payment is contractually set – the amount and timing of payments is known	Dividends are paid at the discretion of the company – can be cut or stopped as we have seen recently
Maturity	Bonds have a fixed maturity date where the owner of the bond receives their principal back – this can provide more certainty on price and lower volatility	Shares do not mature – they are perpetual in nature. This provides less certainty around price and can lead to greater volatility
Priority payment	In the event of a bankruptcy or even cash flow problems for a company, bond holders are paid back before equity holders. In many cases bonds are secured against assets like property giving more protection to investors	Shareholders are paid back only once bond holders have been repaid so in the event of a bankruptcy there is a greater chance of losing the entire investment

Let's compare equities to bonds to provide a better understanding of some of the differences. These characteristics can make corporate bonds an attractive option for investors wanting more certainty in terms of income and less variability of returns.

A large and global universe of investments

Because the universe of corporate bonds is so large globally, investors have a large opportunity set when looking to invest in corporate bonds. Bonds are issued by very high quality Australian or global companies (think of Australian banks as an example, where the chance of bankruptcy or default is very low), right through to smaller companies or those in sectors or industries that may be more challenged in the current environment.

For those riskier companies, investors should expect higher interest payments (coupons) as compensation.

In many cases, investors would be familiar with the companies issuing these corporate bonds, and may already own shares in the companies. The difference is that as a bondholder, there is greater certainty in terms of interest payments and in the worst-case scenario (i.e. bankruptcy), bondholders are repaid first.

Let's use the example of the Commonwealth Bank. As you can see in figure 2 on the next page, CBA actually has more money outstanding in bonds than shares, across a wide variety of currencies and many different maturities.

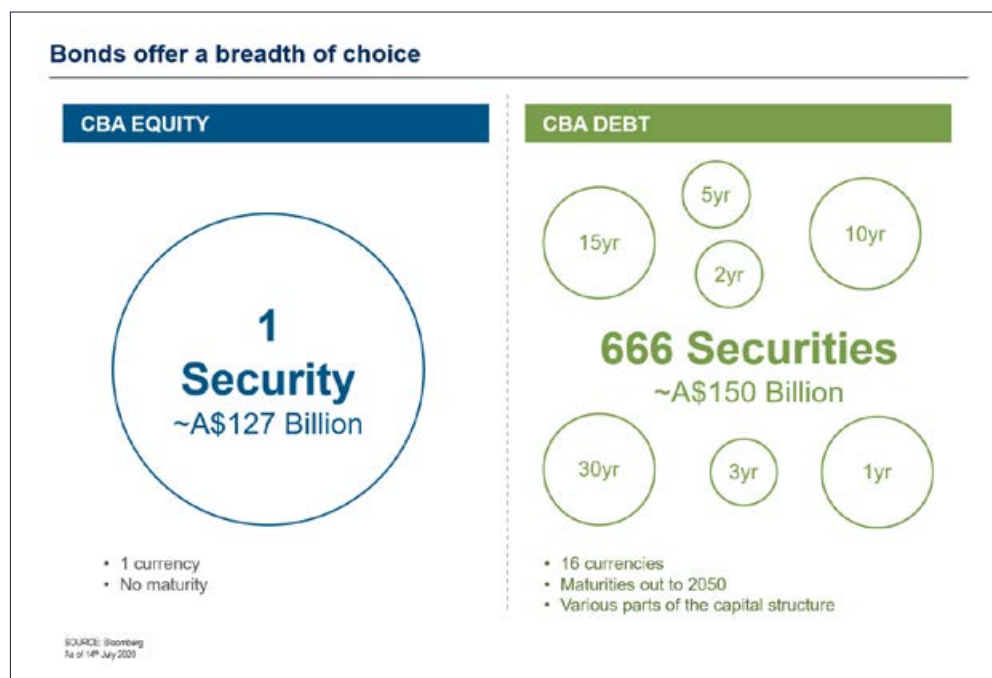


Fig 2 – Bonds Offer a Breadth of Choice. As of 14th July 2020

Source: Bloomberg

Where does this fit in a portfolio?

Corporate bonds can be an attractive option for investors looking for income and returns above cash or term deposits, but with a more stable income stream and less volatility than shares. They offer another way of investing in some of the world's largest and most successful companies, without some of the risks that can come with share investing. Although there is not the same potential for upside as shares, they can provide greater security and consistency.

High quality corporate bonds can provide defensiveness to a portfolio in difficult market environments, consistent income, and diversification from other investments like shares and property.

What returns can you expect?

Most of the expected return from corporate bonds typically comes from the interest – or coupon – payments. They can also provide some capital appreciation because at times the opportunity arises to invest when their price is trading below their maturity value, or sometimes a company may issue a bond (allowing investors to buy it) at a discount to its maturity value. Since bonds repay their principal upon maturity, this can lead to some capital appreciation as the bond moves towards maturity and repays the principal, as well as the income payments received along the way. We saw such a situation arise in March, which has provided an opportunity for investors to lock in attractive income from high quality companies.

For a portfolio of high quality corporate bonds, an investor could expect a return, made up mainly of income payments, of somewhere from 2.5% – 5% per annum.



Fig 3

Source: PIMCO. The information provided above is for illustrative purposes only.

“Often, periods of volatility can lead to attractive opportunities to invest in bonds.”

In figure 3 you can see the example of a bond with a maturity of 4 years, paying a coupon of \$4.50pa. The investor pays \$100 at the start to the company issuing the bond. They then receive the coupon payments each year, and at maturity receive the final coupon payment as well as their principal back.

The level of income or return expected varies depending on the credit quality of the company issuing the bond.

- High quality, investment grade companies, where the risk of default is very low, are currently paying income on average of around 1.5% per annum above what you would expect from owning a government bond.
- For higher yielding companies (those that may not have as strong balance sheets or face more challenges in the current environment) that margin above government bonds is over 6% per annum, but can come with commensurately higher risk and capital volatility.
- For a portfolio of high quality corporate bonds, an investor could expect a return (made up mainly of income payments) of somewhere from 2.5%-5% per annum.

What happens to bonds when markets sell off?

Because of the characteristics we have discussed, bonds tend to be more stable and defensive than other asset classes even in periods where markets are volatile. Although their prices can vary over the short term, income (coupon) payments are still made and because of the certainty of receiving the principal back at maturity, it means that prices do not tend to fluctuate as widely as for riskier investments.

Corporate bonds are a difficult asset class to access for individual investors as the minimum investment amounts are typically too large, and it is a space where PIMCO strongly believes that professional management can add value for investors. This can include searching the global bond universe for the best opportunities with attractive coupons, constructing diversified portfolios so that the risk of default or problems in any individual company is reduced for the portfolio, and importantly carrying out credit research on individual companies to focus on those that are of high quality and mitigate the risk of default.

Often, periods of volatility can lead to attractive opportunities to invest in bonds. For example, in March 2020, we saw the price of corporate bonds fall over the short term, but as noted the coupon payments remain fixed. This provided the chance to lock in income payments from high quality companies at attractive prices.

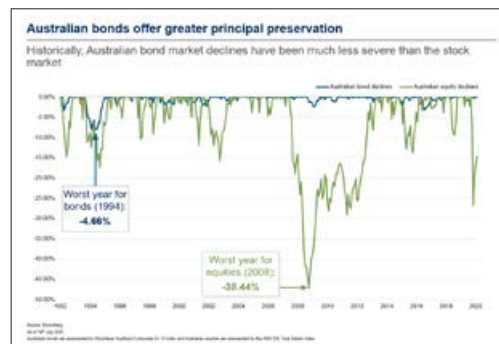


Fig 4 – As of 14th July 2020.
Source: Bloomberg

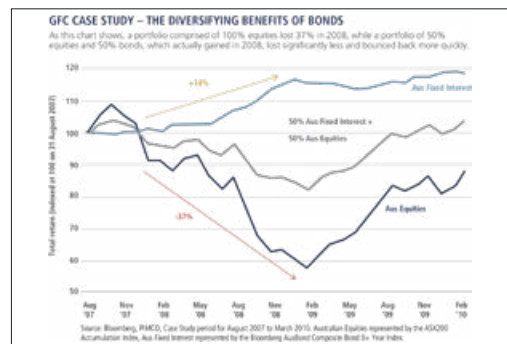


Fig 5 – Case Study period for August 2007 to March 2010
Source: Bloomberg, PIMCO

Historically, bonds tend to be much more stable than shares in market corrections and can be a good diversifier and shock absorber for portfolios, as we can see in figures 4 and 5 above.

This chart shows that a portfolio comprised of 100% equities lost 37% in 2008, while a portfolio of 50% equities and 50% bonds, which actually gained in 2008, lost significantly less and bounced back more quickly.

Overall, corporate bonds can play an important role in client portfolios. They can offer:

1. Defence – lower volatility than shares and more stability through market corrections
2. Income – at their heart bonds are an income investment paying fixed interest payments that can't be varied or cut like share dividends
3. Diversification – from equities, property and other riskier investments in a portfolio



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“Government bonds are the most liquid assets around, and much less susceptible to market volatility than equities.”

Defend and diversify: why bonds are critical in any portfolio

COVID-19 has had many ramifications, including an increase in the number and size of the federal government’s debt programs. While these programs assist people and businesses that are struggling, they also need to be funded – and this is where government bonds come in.

Bonds are the way governments raise money. In the current environment, there’s strong demand for them – especially for the AAA-rated Australian bonds – and for very good reasons. Government bonds are the most liquid assets around, and much less susceptible to market volatility than equities. They also provide certainty over how much income you’ll make over the life of the investment, which is an important confidence boost in uncertain times.

But they have other attributes too. Which I provide a comprehensive overview of here, including where interest-rate movements fit in.

What are government bonds?

When governments spend more than they receive in revenues (taxes), they borrow money to fund expenditures. When a government wants to borrow, they sell (issue) a bond. The bond exists for a set period, e.g. three years or 10 years, and pays a set rate of interest (a coupon) during that period. At the end of the period, the original amount (the principal) is repaid. Bonds can be bought or sold on a market, and prices are set by supply and demand, so values can rise and fall.

The types of bonds available

Government bonds can be issued by any government globally, with the largest and most recognised market being United States Treasury Bonds. In Australia, the government bond market includes three broad groups of issuers:

- Australian Commonwealth Government Bonds (ACGBs) – These are bonds issued by the federal government and currently have an AAA rating. They are the most liquid securities and offer the lowest yield.
- Semi-government bonds (Semis) – These are bonds issued by state governments (such as NSW) and are currently rated AA or AAA. They are slightly less liquid than ACGBs, but offer a higher yield.
- Supranationals (Supras) – These are bonds guaranteed or supported by foreign governments and are typically rated A, AA or AAA. They are the least liquid of the government securities but are the highest yielding.

The government bond market is typically displayed as a yield curve, which is shown in Chart 1. On the horizontal axis are the years to maturity of the bond and on the vertical axis is the yield. Each dot represents a bond on issue.

Australian government bond yield curve

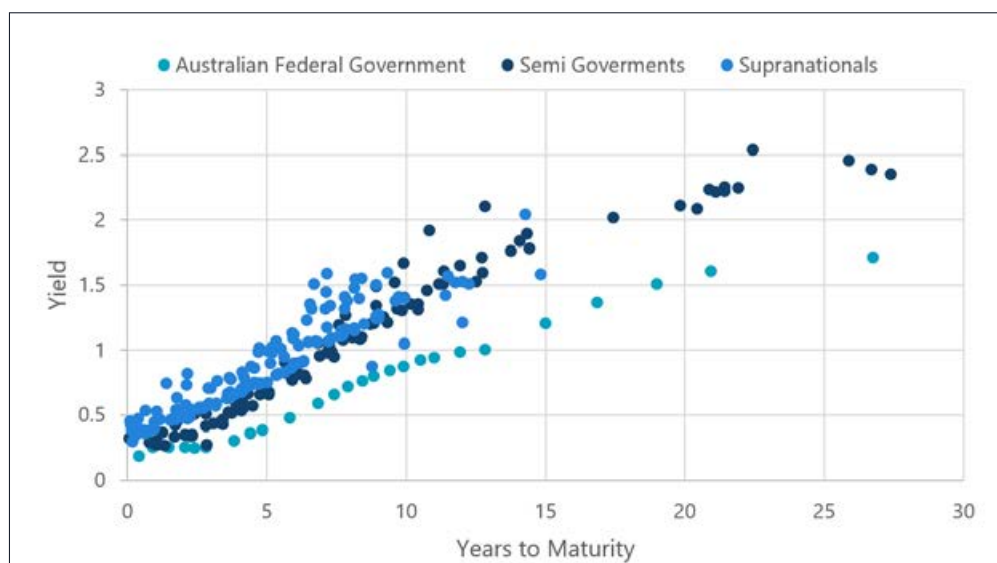


Chart 1 – Australian government bond yield curve

Source: Bloomberg, Nikko AM

The role of government bonds

Government bonds are typically used as a defensive asset and to diversify against adverse moves in riskier assets, such as equities. While government bonds pay lower levels of interest than riskier assets, they are backed by the full faith of the government and hence have minimal risk of not be repaid. Typically when risk markets are performing poorly or economic conditions are recessionary, investors can sell assets with uncertain cash flows (such as equities) in order to move into lower risk investments like government bonds. An example of this can be seen during the March 2020 equity rout, where government bond returns were in low single digits while the ASX Accumulation Index fell over 20%. Furthermore, during this period the government bond market was one of the key asset classes used as a source of liquidity.

Rolling 3-month returns

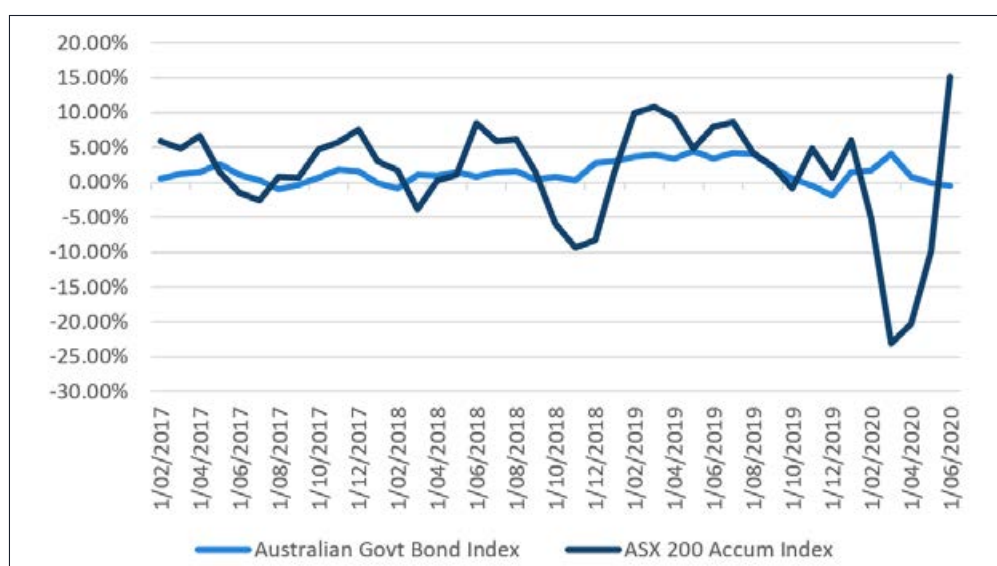


Chart 2 – Rolling 3-month returns

Source: Bloomberg, Nikko AM

Additionally, government bonds can be used as both capital protection and an income generating security. The capital preservation comes from the fact that it's extremely unlikely for a government bond not to repay. This would require the government to default. In Australia, the government has never defaulted on the interest payments on its issued bonds or on the repayment of principal.

On the income side, government bonds pay periodic coupons, which are usually at a higher rate of interest than the cash rate, but a lower rate than riskier assets, such as corporate bonds or equity dividends. This makes them a more stable source of income for investors.

What returns to expect

As the name of the asset class suggests—fixed income—the biggest component of returns over long periods of time will be the income that investors receive, as the capital amount paid at maturity (principal) does not change over time. Chart 3 demonstrates this by comparing the yield at which the government bond index was purchased (on the horizontal axis), with the subsequent annualised 3-year return (vertical axis). The upward sloping chart shows that the yield at which an investor purchases the asset class will go a long way in describing longer term returns.

Year return on government bonds index

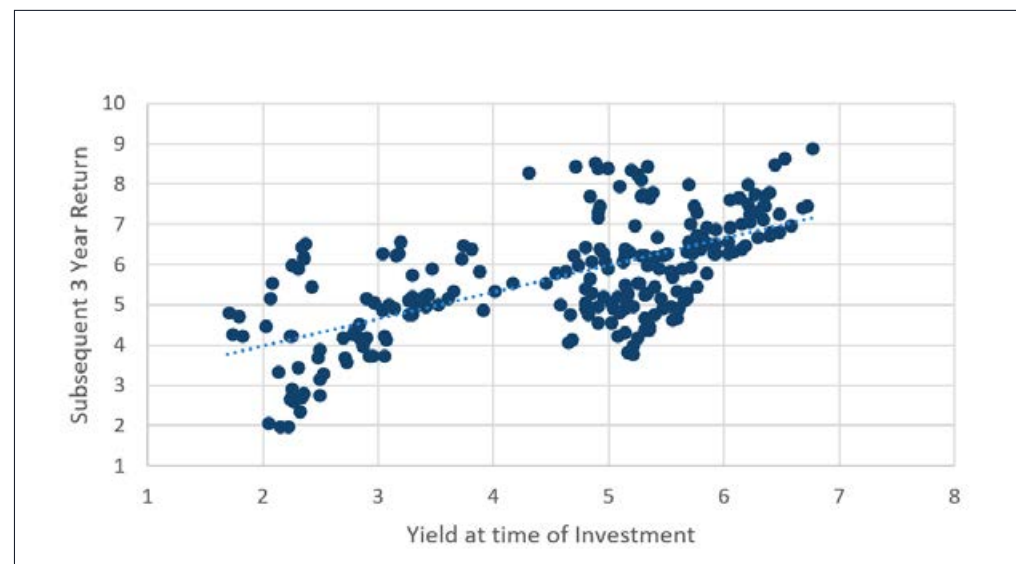


Chart 3 – Year return on government bonds index

Source: Bloomberg, Nikko AM

This is because when a long-term investor buys a government bond, they will know in advance what they are set to receive. For example, if an investor were to buy \$100 of a 5-year bond at par that pays a 2% coupon annually, they would receive \$2 each year for five years and get \$100 back at maturity. Regardless of what interest rates do over that 5-year period, the investor who holds to maturity has a degree of certainty around their expected return—in this example it's ~2%.

Over the shorter term, however, government bond returns are affected by interest rate movements. These interest rate movements will affect the capital price of holdings. The longer the time to maturity the greater the effect.

Here is a simple way to think about it. Imagine if an investor invested \$100 for 10 years at 5% and the day after interest rates rose to 6%. In this scenario, they would receive \$5 p.a. while the market is offering \$6 p.a. If they tried to sell the security (which is offering \$1 p.a. less than the market) they would need to do it at a discount to compensate the buyer for the interest they are giving up. This creates a capital loss.

The longer they had locked in that 5% rate, the more this would cost to exit. Chart 4 shows the estimated price change on different maturity government bonds for a 1% increase in yields.

Estimated price change of a 1% increase in rates

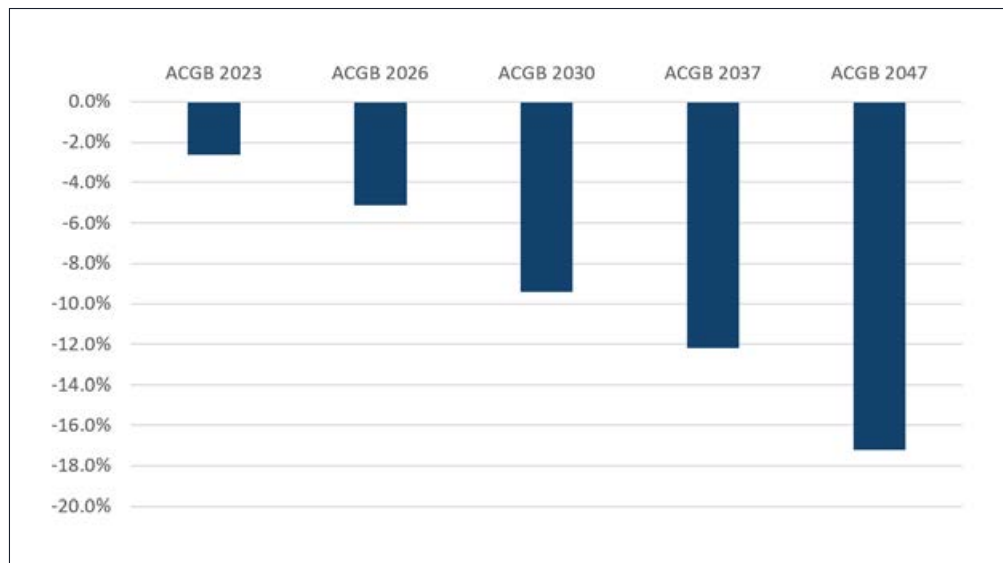


Chart 4 – Estimated price change of a 1% increase in rates

Source: Bloomberg, Nikko AM

Alternatively, if rates fell to 4%, they would have a 5% coupon when the market is only offering 4%. In this case, if they were to sell they would receive a premium—a capital gain.

This is why it's important to understand an investment horizon. Over short periods of time, government bond returns can be relatively volatile. However, over longer periods of time the returns move closer to the yield offered on the securities, as depicted by the return series in Chart 5.

Australian government bond index return

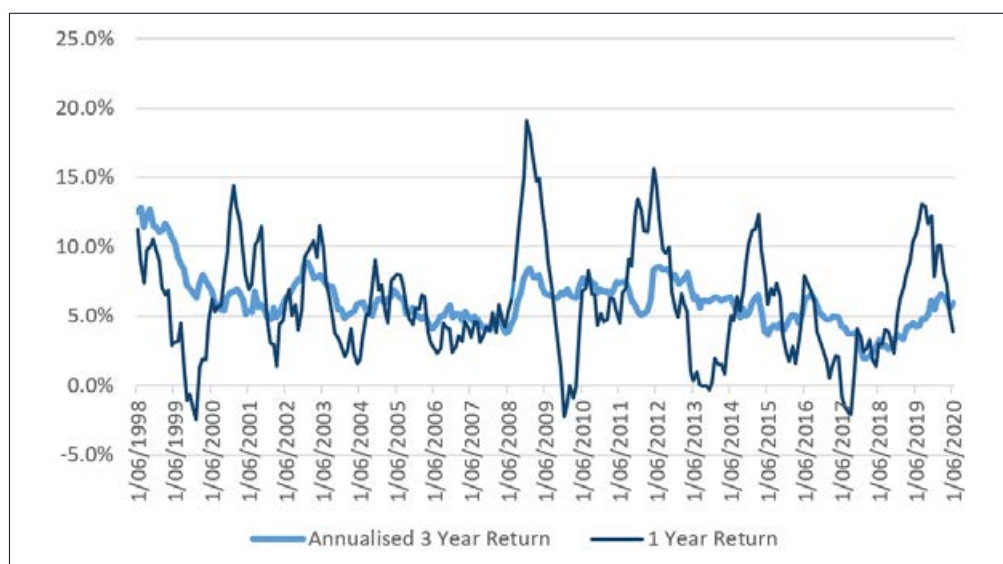


Chart 5 – Australian government bond index return

Source: Bloomberg, Nikko AM

“Government bonds are described as a ‘risk free’ asset and this certainly shows in the returns of the past 20 years.”

One of the most liquid assets in investment markets

In financial literature, government bonds are described as a ‘risk free’ asset and this certainly shows in the returns of the past 20 years. Over this period, there have been only five periods of negative year-on-year returns (1994, 1999, 2010, 2013 and 2017) with the worst return being -7.5%. The typical drawdown has been about -1 to -3%.

Year-on-year returns

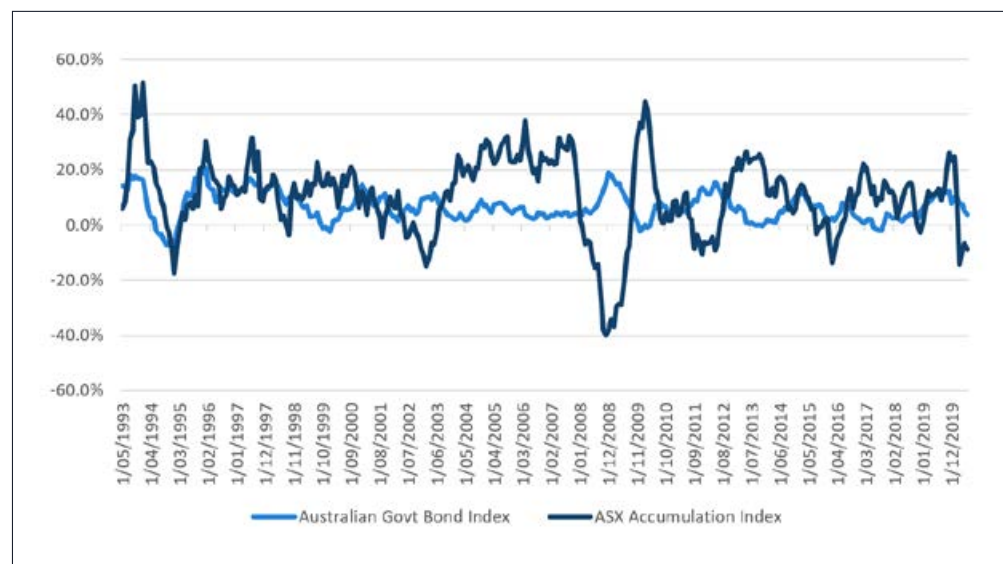


Chart 6 – Year-on-year returns

Source: Bloomberg, Nikko AM

Over this 20-year period, there have only been 24 months of year-on-year negative returns compared to 334 months of positive year-on-year returns.

Number of months with year-on-year returns

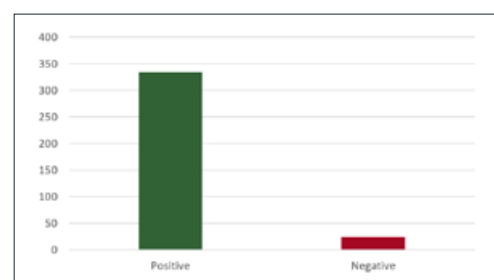


Chart 7 – Number of months with year-on-year returns

Source: Bloomberg, Nikko AM

Asset class returns during the worst periods for bonds

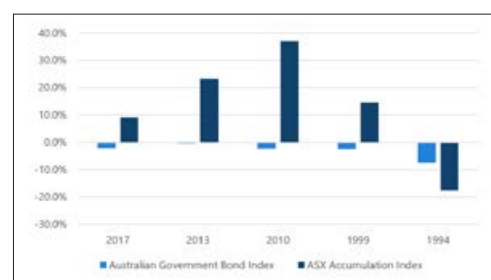


Chart 8 – Asset class returns during the worst periods for bonds

Source: Bloomberg, Nikko AM

Looking forward, the key risk for government bonds will be if interest rates rise quickly and for a prolonged period of time. For interest rates to be rising, it implies a strong economy that would potentially bring with it positive equity market returns. Chart 8 provides an example of how this typically plays out, showing the year-on-year return of both Australian government bonds and the ASX accumulation Index at the point in time when bonds had their worse performance in that year. Only in 1994 did both bonds and equities exhibit negative returns at the same time.

Government bonds are one of the most liquid assets in investment markets, allowing investors to buy and sell hundreds of millions of dollars in value at minimal cost. This is why government bonds were used throughout March this year for raising cash as markets were selling off—they are more liquid and so less expensive to sell.

When thinking of liquidity from extremely liquid to extremely illiquid, at one end would be illiquid real assets such as real estate, which can take months to sell with large commissions involved. At the other extremely liquid end is government bonds, giving investors access to hundreds of millions of dollars in liquidity, which can take only seconds to execute.



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Dr Don Hamson

Plato Investment
Management

“The lucky country has delivered the best market returns over the long run among global peers.”

How Australian equities provide tax-effective income and growth

To most readers, domestic equities is an asset class that needs no introduction. But the fundamental basis of investing in Australian shares can often be overlooked – that is, by purchasing shares you are becoming a part-owner of a businesses and ultimately share in their profits. While markets can be irrational – generally speaking, as profits grow so should the share price and dividends.

So how has owning parts of publicly listed Australian companies fared for Australian investors over the years? The data will tell you that, overall, Australian equities have provided very good long-term returns despite bouts of panic, pain and the odd corporate collapse.

Fellow academics, Dimson, Marsh and Staunton, who published the 2020 Global Investment Returns Yearbook for Credit Suisse estimate that Australian shares have recorded the highest real returns (returns after inflation) of all major equity markets over the period 1900–2019. That is to say at 6.8% p.a over the last 120 years, the lucky country has delivered the best market returns over the long run among global peers.

The same academics also estimate that Australian equities have earned more than 6% p.a. more than bond and cash investments. And because they undertake an international comparison, they don't even factor into account the value of franking credits which have further added to returns for Australian investors over the past 30 odd years.

In my opinion, our taxation system is a compelling (but not the only) reason for many Australian investors, particularly retirees, to consider adding an allocation of actively managed domestic equities to their income generating investment portfolios. I will explain just how much addition income can be generated through franking credits shortly. First, a quick explanation.

What are franking credits?

Franking credits are taxation credits that often accompany dividends paid to investors. They represent a tax credit for the Australian company tax that's already been paid by the company. For large companies, this franking credit is normally based on a 30% company tax rate.

A \$7 fully franked dividend, therefore, carries a \$3 franking credit (being 30% of the pre-tax \$10 profit from which the dividend is paid). These franking credits can be exceptionally valuable for Australian investors, as the credit can be used to offset against personal or superannuation tax payable, and for low tax investors, is refundable. For example, for a pension phase superannuation investor who is subject to a zero-tax rate, the government will actually fully refund franking credits.

Plato estimates that franking credits have added an extra 1.4% p.a. to the share market returns to Australian tax- exempt investors over the past 15 years.

Figure 1 shows the accumulated capital growth, cash dividend and franking credit returns from \$100,000 invested into Australian shares from 1 July 2005 to 30 June 2020, based on the S&P ASX300 Tax Exempt Franking Credit Index.

For tax-exempt investors, Australian shares have generated a total return of 8.1% p.a. over that time, comprised of 2.4% p.a. capital growth, 4.3% p.a. cash dividends and 1.4% p.a. franking credits.

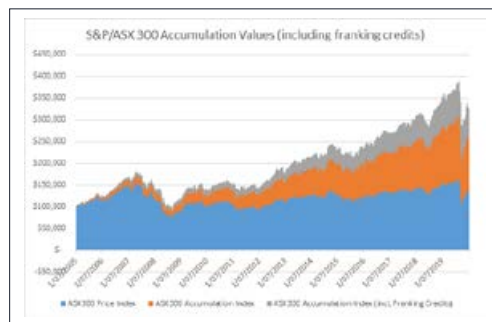


Fig 1 – Asset class returns during the worst periods for bonds
Source: Plato & S&P

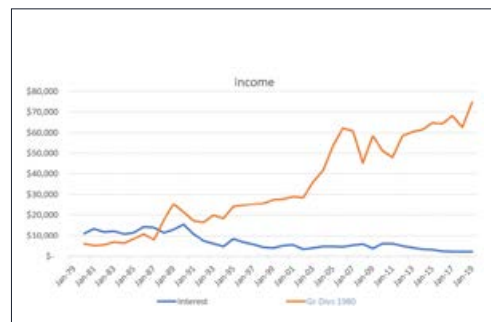


Fig 2 – Asset class returns during the worst periods for bonds
Source: Plato & S&P

Figure 1 also highlights the power of compounding. Annual total returns of 8.1% p.a. have compounded an initial \$100,000 investment to over \$300,000 over 15 years.

To give you a longer-term perspective on investing in Australian equities for income, in figure 2, we have plotted the annual income stream (including franking credits) generated from \$100,000 invested in Australian equities way back at the start of 1980 and up to 2019. For comparison purposes we also plot the income stream from a similar \$100,000 invested in bank bills. Interest rates were double digit in the 1980's and interest income exceeded dividend income until the late 1980's, but after that annual gross dividend income steadily grew to over \$70,000 in 2019.

Note, this is not intended to be a comparison of capital returns, as equities and bank bills have different risk profiles.

So, history tells us, domestic Australian equities, can provide both capital growth and great income potential – a dual role in an investor's portfolio.

Liquidity is also a consideration for many when allocating capital to different asset classes and Australian large cap equities are broadly very liquid investments. Whether one purchases shares direct, or invests via a managed fund, normally one can sell or liquidate those investments and receive the proceeds within 2 days, although some managed funds may have longer settlement periods.

But there are risks

Both graphs above highlight, in parts, just how volatile the ride can be for Australian equity investors in the short-term.

In figure 2 you can see that whilst dividends have steadily grown over the past 40 years, there were periods of lower dividends. Notably dividends fell in the 'recession we had to have' in 1990-1992 and during the GFC in 2008/09. It also highlights that dividends rebounded after these setbacks as the economy improved on the back of fiscal and monetary stimulus.

Most recently, the height of COVID-19 pandemic here in Australia highlighted the risks in short term Australian equity investing. The S&P/ASX 300 Share Price Index fell 36% from its peak in late February to March 23, as panic spread about the impacts of the pandemic. As pandemic concerns have eased, the market has rebounded significantly off its March 23 lows, jumping 31% higher to June 30.

During the 'recession we had to have' and the GFC, dividends fell approximately 30%, and we expect a similar decline in dividends is likely in 2020 due to the economic impacts of COVID-19 pushing Australia into a recession. But the reality is, that income from all asset classes will fall significantly. For example, the Reserve Bank of Australia cut interest rates from 75bp to 25bp in March in response to the pandemic, representing a 67% cut in income on overnight cash.

Making ends meet

Those record-low cash rates have made it, arguably, harder than ever for many investors, particularly retirees, to generate income. But despite volatile times in equity markets strong dividends from Australian shares can help investors make ends meet.

COVID-19 has also highlighted the one free lunch of investment – diversification. Whilst companies like Qantas and Virgin have been impacted by the pandemic, many other companies are doing very well.

Traditionally Australians have looked to the Big Four banks and Telstra for income, but at Plato, we have been looking beyond those for many years.

In a post-lockdown world (at least outside of Melbourne, for now), we are very positive about the profit and dividend outlook for companies like Fortescue Metals (iron ore), Woolworths (groceries), Wesfarmers (Bunnings and Officeworks) and CSL.

Indeed, we believe there is scope for many companies to maintain or increase dividends in the current environment, but one needs to be very discerning. Stock selection will be very important. Separating the wheat from the chaff is key...Or in this case separating strong dividend payers from “dividend traps”.

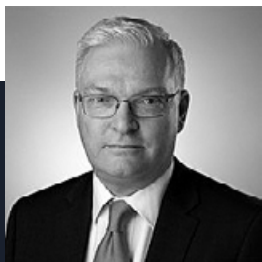
Dividend traps are stocks that have historically paid dividends and may be trading on “good” historical dividend yields, but are likely to have to significantly cut or completely omit dividends for some time. Avoiding dividend traps is key to equity income investing, and we focus a lot of our research effort on avoiding these traps.

Wayne Gretzky, the famous Canadian ice hockey player, famously said: “Skate to where the puck is going, not where it has been.” We have a similar philosophy at Plato with regards to income. Investors need to move their portfolio to where the future income is going to be, rather than what has produced income in the past, but may not be a great opportunity going forward.

By avoiding dividend traps and actively rotating our holdings into companies with the highest likelihood of strong future dividends, the Plato Australian Shares Income Fund has been able to deliver 3.7% pa more gross income than the market since inception (9 September 2011 to 30 June 2020) as well as outperforming the S&P/ASX 200 Index on a total return basis (11.1% total return since inception).

In dollar terms, an initial investment in the Plato Australian Shares Income Fund at the inception date of 9 September 2011 of \$100,000 would have generated gross income of just over \$100,000 (including franking credits) over that time, with a capital value above \$110,000 as at 30 June 2020. This level of income is \$34K above that income generated by the S&P/ASX 200 Index during the last 8 years and 8 months.

While past performance is not an indicator of future performance, what I attempt to highlight is the way a diversified and actively managed portfolio of quality Australian equities could help investors make ends meet from Australian shares, as opposed to just trying to select one or two high yielding stocks, which carries significantly higher levels of risk. This is how we at Plato attempt to help investors solve the ‘income puzzle’.



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Wheelhouse Investment
Partners

“Typically, global equities deliver most of their return via capital growth and not income.”

Using global shares to break your dividend dependency

Global equities are usually added to a portfolio for one reason – to increase diversification. With the Australian equity market representing only 2-3% of global equity exposure, plus very high sector concentrations in the local market, the benefits of global diversification are particularly meaningful for Australian investors.

However, leaving geographical considerations aside, how much diversification is actually being delivered at a sector and factor level? When income is the main consideration, the global equity sectors that generate the highest dividend yields are typically concentrated in the same sectors that dominate the Australian market. As a direct result, ‘going global’ may unwittingly ‘double down’ on these identical high yield sector exposures, albeit in a different geography, and thus fail to maximise the diversification benefit.

One solution to this problem is to introduce an alternate source of income that does not rely upon dividend yields. Buy-Write strategies are an established and well-proven solution to yield generation that breaks the connection with dividend dependency. Global Buy-Write strategies can offer genuine diversification at both the sector and country level as well as providing a regular income stream and an element of capital stability.

One plus one can sometimes equal one

The lack of breadth and resulting sector concentrations of the Australian market are very evident when comparing Australian equities to the Global universe. The very high exposures to Financials and Materials, and low exposures to Technology and a diversified global Health Care exposure are represented below (Health Care represented with and without CSL).

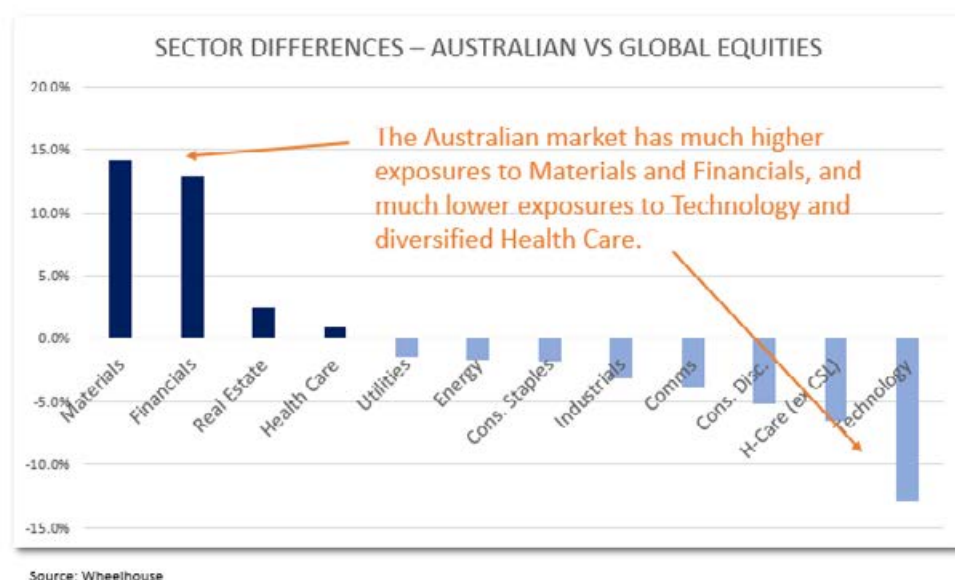


Fig 1 – Health Care represented with and without CSL
Source: Wheelhouse

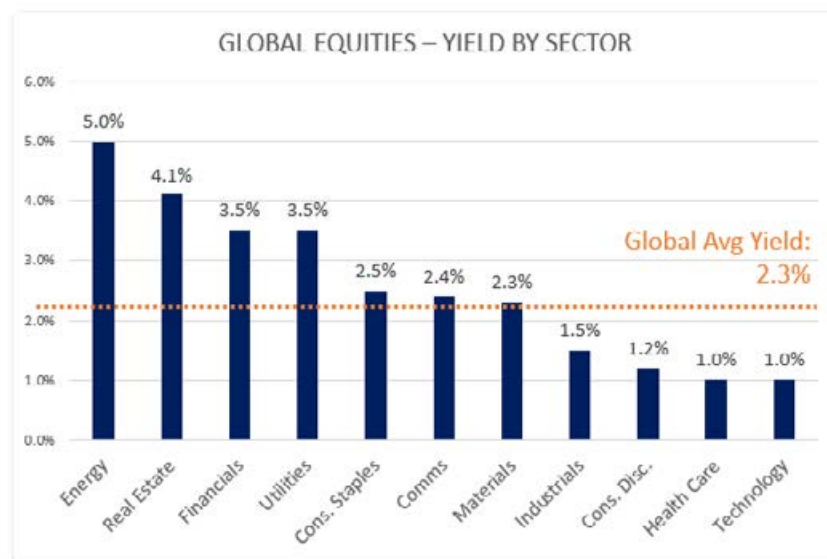


Fig 2 – Global Equities

Source: Wheelhouse

However, as many investors would know, yields on global equities are often less than the local market, especially after franking credits are considered. Respectable yields do exist in global equities, but they tend to be concentrated in a few sectors.

Implicitly this means that global equity income portfolios can often be materially underweight Technology and Health Care, and overweight Financials and Real Estate. These are often the exact same overweight exposures already present in an Australian equity income portfolio. As a result, rather than receiving the full benefit of diversification, an investor may be unintentionally ‘doubling-down’ on these sector concentrations.

Running a strategy that is heavily skewed to high yielding sectors can also give rise to missed opportunities. Take the Technology sector in the US as an example. This sector has been the dominant driver of growth in the US stock market over the past few years. However, because many tech companies pay no dividends, this principal source of return has been largely absent from many global income strategies.

Furthermore, the high-yield sectors of Energy, Real Estate, Utilities and Financials are also highly ‘factor’ dependent. A factor is a clearly identifiable return driver that can often account for most of the sectors return. For example, within the Energy sector, is it more important to simply get your oil price forecast correct, versus picking the best management team, or selecting the lowest cost producer? When sector returns are predominantly factor driven, a rising tide often floats all boats and can dwarf the impact of even the best stock pickers.

Portfolios with high factor concentrations such as commodity prices (for Energy), interest rates (for Real Estate and Financials), and inflation (for Utilities) are nearly always higher risk. By overweighting these sectors in particular, ‘going global’ for an income seeking investor may perversely deliver the exact opposite of what was intended, resulting in a higher risk portfolio with reduced diversification.

“A Buy-Write strategy is designed to simply convert anticipated future capital gains into far more certain, and reliable, income streams.”

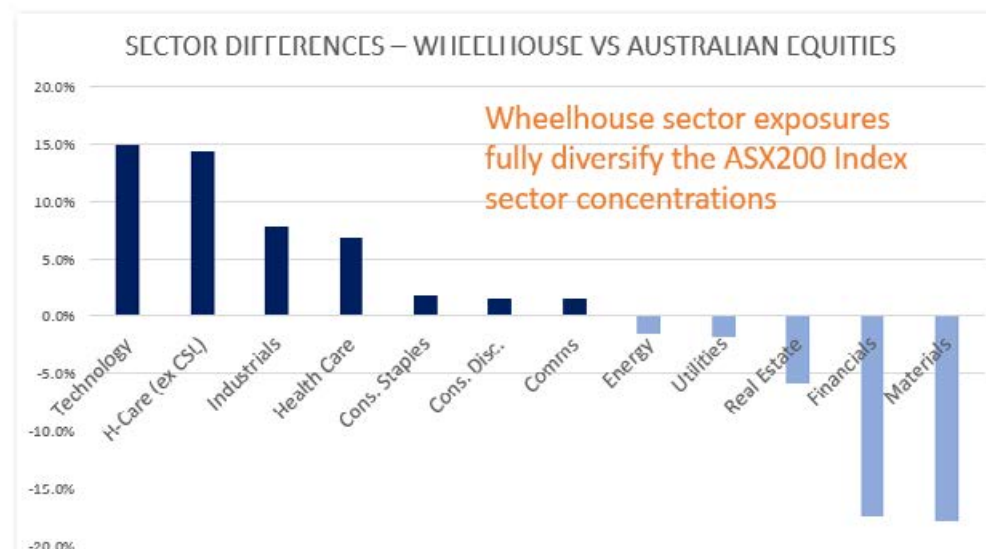


Fig 3 – Sector Differences – Wheelhouse Vs Australian Equities
Source: Wheelhouse

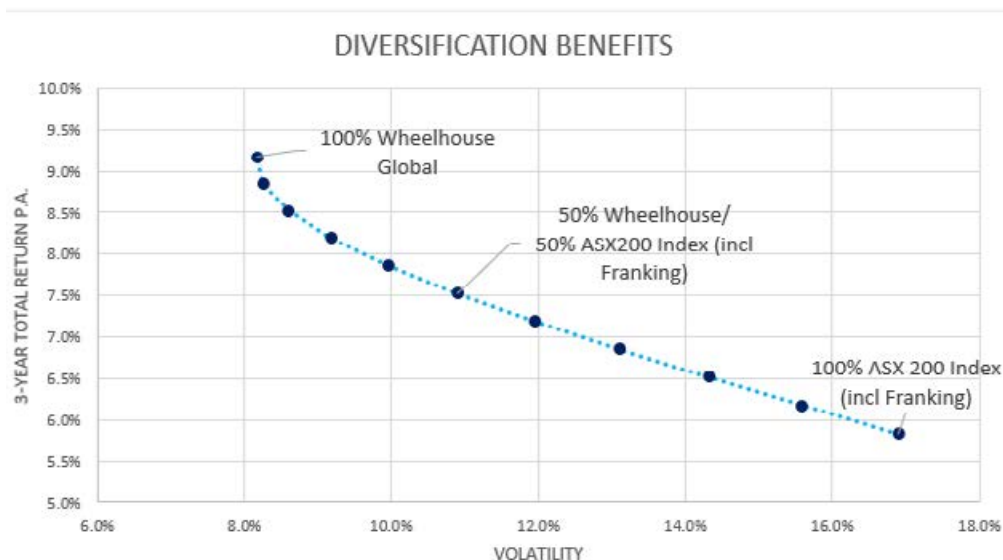


Fig 4 – Diversification Benefits
Source: Wheelhouse

Global Buy-Write strategies as an alternative to traditional Global Equity Income Funds

Global equity Buy-Write portfolios can break the dividend dependency of more traditional GEI funds and thus be fully diversified across all sectors and geographical regions of the global economy.

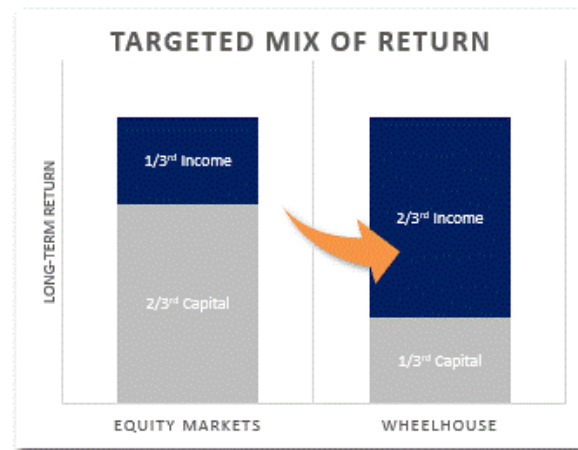
By way of example, the portfolio weights of the Wheelhouse Global Equity Income Fund relative to the ASX200 Index are represented below. Technology and Health Care are overweighted, and Financials, Materials, Real Estate, Utilities and Energy are all underweighted, providing an excellent source of diversification to an investor’s Australian equity portfolio.

Consequently, integrating the returns of both the ASX200 and the Wheelhouse GEI Fund provides clear evidence of improved risk reduction in an investor’s portfolio.

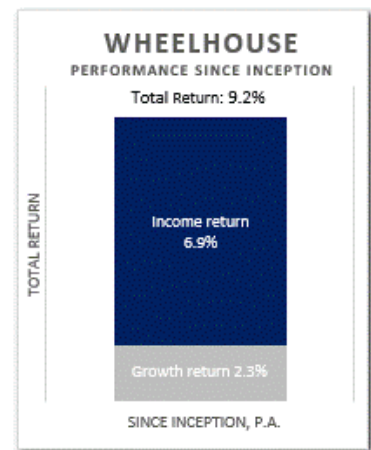
Income Generation

In a simple example of a Buy-Write strategy, an investor buys stock and sells a call option over that stock. The call option is an obligation to sell shares at a predetermined price in the future. As compensation for selling the call option, the investor receives income in the form of option premium. This strategy allows the inclusion of an attractive stock in an investor's portfolio that may have otherwise been excluded if dividend yield was the sole consideration.

In essence, a Buy-Write strategy is designed to simply convert anticipated future capital gains into far more certain, and reliable, income streams. Typically, global equities deliver most of their return via capital growth and not income. At Wheelhouse, our approach seeks to reverse this relationship, with most of the return delivered via income and the remaining contribution from capital growth which is intended to grow the capital base over time.



Source: Wheelhouse



Source: Wheelhouse. Post-fee returns since inception to May 2020

Fig 5 - Post-fee returns since inception to May 2020

Source: Wheelhouse

Capital Stability

In addition to improving diversification, Buy-Write strategies can meaningfully reduce risk. As the option premium is received upfront when the call option is sold, the share needs to fall by more than this amount before any loss is incurred. Thus for smaller moves, Buy-Write strategies can add an element of protection that is independent of the defensive characteristics of the shares themselves.

Safeguarding capital is a key priority for the Wheelhouse strategy, as we recognise that income generation depends upon a stable capital base that has the capacity to grow, and thus allows income streams to grow and keep up with inflation.

At Wheelhouse we take this defensive characteristic one step further via the integration of 'always on' tail protection to further protect capital degradation. Perhaps one for a follow up article, however the year to date performance chart below provides some evidence of the capital stability delivered through the Covid-19 pandemic.



Fig 6 - Post-fee returns since 31 Dec 2019 to 28 May 2020

Source: Wheelhouse, Bloomberg

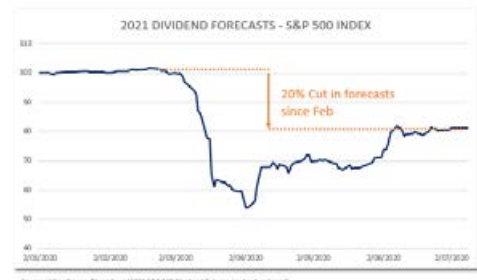


Fig 7 - 2021 S&P 500 Dividend Futures contract

Source: Wheelhouse, Bloomberg

Outlook

Similar to the Australian market, dividend payments on global equities are being reduced too. The chart (figure 7) plots expected dividend payments on the S&P500 Index for 2021, reflecting a 20% reduction in yields. In the years ahead this squeeze on yields may push global equity income strategies even further into the already concentrated high-yield sectors, making true diversification even more difficult to achieve.

This can only increase risk further. In a recent Livewire article, we evaluated the relationship between higher yields and risk, and note the correlation. In the current environment, global Buy-Write strategies offer a well-established alternative that not only add genuine diversification to an Australian portfolio but also generate a reliable income that is unaffected by dividends and reduces risk in a portfolio.



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Omar Kahn

Freehold Investment
Management

“Since the GFC, real estate debt has grown in importance as an asset class.”

A secret weapon for income investors

The World Bank estimates almost 93% of countries will face economic contraction on a per capita basis in 2020 as a result of the pandemic. It is a crisis that has impacted businesses across the spectrum, with a global halt in economic activity. However, while some businesses are being disrupted, others will undoubtedly thrive in the post-crisis recovery.

For investors seeking regular income streams with some capital stability, it has become more difficult. Interest rates have been pushed down further, and the earnings outlook on some companies is unclear. As has been noted already in this series, the post-inflation return to investors in term deposits (TDs) is now negative.

In times of uncertainty, we tend to shift to quality or move further up the capital stack to achieve capital stability and deliver attractive risk adjusted returns.

Understanding private debt

Real estate debt is similar to traditional bank debt. The lender, in Freehold's case this is the fund, provides capital to finance the purchase of a property asset, or the development or redevelopment of a property. In return, the fund (and ultimately investors) receives interest on the loan, which is paid either monthly, quarterly, or capitalised and paid at the end of the loan term.

How the value of an asset, which is the loan security, is determined varies by asset type. If the loan is simply financing the acquisition of land, it is secured against the current or 'as is' value of the property whereas, a construction or redevelopment loan is typically secured against the end value of the project. The end value includes improvements that the loan is being used to finance.

For loans financing residential development land acquisition or construction, the weighted loan-to-value ratio (LVR) for senior secured first mortgages, our area of focus, tends to be between 40% - 60%, and gross interest costs to borrowers between 8% - 12% p.a.

In instances where the purchase of a commercial property is being funded, such as an office building or retail centre, the loan is secured against the market value of the asset and the interest is paid with the underlying asset's rent. Banks continue to be an active lender to commercial property, so usually non-banks finance commercial assets where LVRs are stretched (>65%) or when an asset is being repositioned.

Drivers behind the growing investment in real estate debt

Historically, most real estate developers would approach a traditional bank to obtain funding for their projects, which has led to the banks holding a dominant share of the sector. This was at the time when there were fewer options to source finance through non-bank lenders.

Since the GFC, real estate debt has grown in importance as an asset class. The growth, which continues today, can be attributed to a simple supply-demand equation, involving one key factor - banks are under pressure from APRA to reduce exposure to residential development lending.

APRA warns banks on residential development



Residential developers face a further squeeze on credit as the bank regulator urges lenders to exercise more caution in their commercial property books.

The Australian Prudential Regulation Authority has flagged potential flashpoints within the development sector that could compromise the quality of a residential project and its funding.

"APRA has observed a general tightening of underwriting standards, especially for residential development lending, over the past year or so," the regulator said in a review of commercial property lending.

Updated Mon 7 2020 - 5:30pm
First published at 12:00pm

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Source: Australian Financial Review

Even though the non-bank finance sector in Australia is still relatively small by global standards, where in many comparable jurisdictions the market share is between 20% – 30%, Freehold estimates there is now circa \$10 billion invested across Australian real estate debt deals by the non-bank sector. This figure excludes the direct investments by big super funds and the larger offshore funds.

As shown in the chart below, Australian banks reduced their exposure to real estate development post-GFC, but then reverted and steadily increased their exposure from 2013 to December 2016. The impact of the APRA-imposed restrictions on real estate development is evident in the chart from 2017 onwards. This trend is expected to continue through the COVID-19 recovery period.

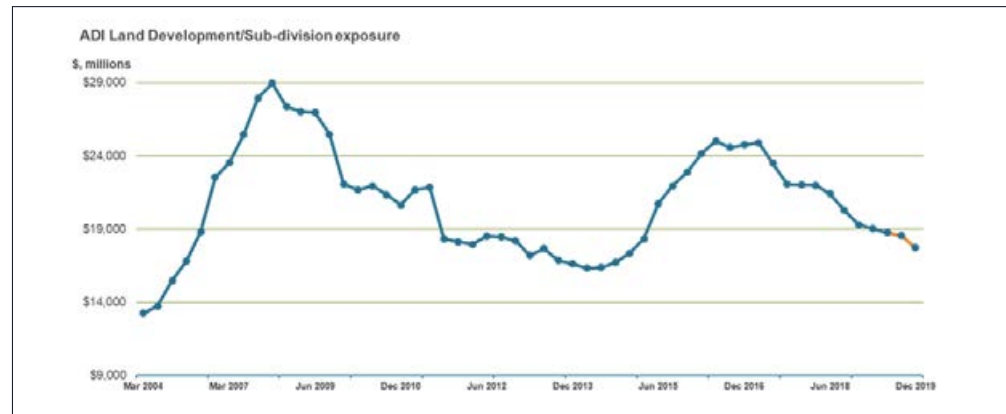


Chart 1 – ADI Land Development/Sub-division exposure

Source: Apra Quarterly Adi Statistics December 2019

Banks have reduced their exposure to real estate debt primarily by increasing conditions or “hoops” developers need to jump through to obtain finance. For example, the equity banks require from developers has doubled since APRA-imposed restrictions (see chart below) in addition to requiring a materially higher pre-sale debt cover on projects.

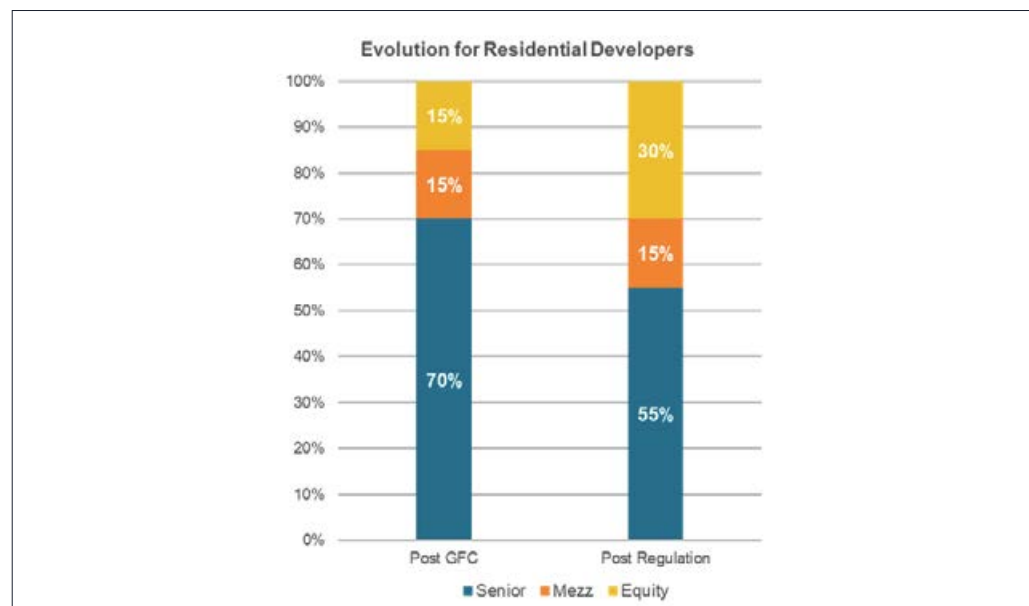


Chart 2 – Evolution for Residential Developers

Source: Freehold Investment Management

What are some examples of securities in this asset class?

Generally speaking, investors have two options when investing – to invest through a unit trust or a debt note. The key difference between the two is that investors in a unit trust receive 100% of the net income the trust generates each financial year. However, the income may fluctuate, and the return isn't fixed.

With a debt note, investors receive a fixed return net of the manager or issuer's margin. In real estate debt, this margin is usually material and doesn't provide investors with a transparent look-through on the gross interest or underlying risk taken by investors.

Within real estate debt, the underlying quality of the loans and project sponsors can vary significantly. Freehold segments the market into three buckets, based on the size of the loan or project, as illustrated in the chart below.

Typical Segment Features	Small	Mid	Large
Loan Size	\$2m – \$7.5m	\$10m - \$70m	\$100m - \$250m
Development Size	<\$10m	>\$20m	>\$100m
Institutional Grade	No	Yes	Yes
Track Record	●	●	●
Sponsor Governance, Sophistication & Maturity	●	●	●
Management Quality & Depth	●	●	●
Outsized Returns	●	●	●

Chart 3 – Typical Segment Features

Source: Freehold Investment Management

In our experience, at the smaller end of the market where loans range between \$2.0 - \$7.5m, project sponsors generally lack an institutional grade track-record and don't have the desired management depth. Whereas, at the other end of the spectrum in large \$100m plus projects, sponsors have significant track-records, governance structures and management depth. However, this end of the market is well-served and often doesn't generate the returns we look for.

Our preferred segment is the mid-market, which is under-served by the major banks and generally represents institutional-grade opportunities. The key focus for Freehold is quality management teams, sponsor governance and maturity whilst also providing superior risk adjusted returns.

Where does this fit in my portfolio?

We have observed asset allocators place real estate debt in fixed income portfolios as well as real estate portfolios. That said, there is a continued debate about whether real estate debt represents fixed income or simply another form of real estate.

Given this debate, a number of people have written on this subject. The literature takes a couple of different perspectives from looking at the type of debt to what it is secured against.

Take for instance Maarten van der Spek. In his 2017 paper in the Journal of Accounting, Finance and Business Studies, van der Spek argues that the key factor is the structure of the debt and the place it sits in the capital stack. He contends that senior secured debt is most akin to fixed income given investors receive a fixed or floating return that has no correlation with investor outcomes for the equity component or the underlying real estate. Whereas mezzanine, is more likely to have investor outcomes correlated to real estate equity. Van der Spek further observed that as leverage was increased (to 70%), the correlation to equity and real estate increased marginally, and naturally, this would seem the logical outcome of instances where senior debt has less equity buffer in the capital stack.

The flipside to van der Spek's argument is reasonably straight forward - that the underlying asset is real estate, so it should naturally sit within real estate portfolios.

The tightening of cap rates globally in recent years has seen many institutional investors allocate to real estate debt. Given the late stage of the real estate cycle and low interest rate environment, investors allocated capital to more defensive real estate debt strategies where they were happy to cede equity upside for enhanced income and downside protection.

What is the return profile?

All of the return generated from real estate debt is in the form of income. Investors do not receive capital gains.

We target a net return of 7% – 8% p.a. in the Freehold Debt Income Fund. Pleasingly, the fund has been performing better delivering a net return of 8.63% p.a. from 1 October 2019 to 31 May 2020 annualised.

While historically the returns generated by the asset class have been higher (see chart below), recently the increased volume of capital allocated to Australian real estate debt has tightened returns. Our view is that over the medium to long-term they will stabilise in our targeted 7 – 8% p.a. range.



Chart 4 – Historical Returns

Source: Freehold Investment Management

Returns note:

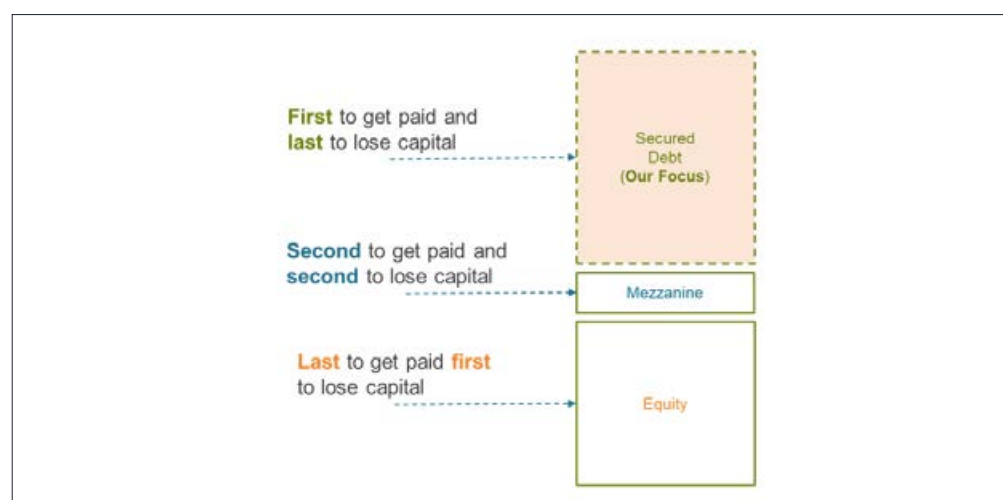
The returns above represent the consolidated cash flows of Senior Debt SPV's. SPV cash flows have not been audited. The following assumptions were made in calculating these returns: i) an average of 10% of the fund would be held in bank deposits for cash management purposes, ii) the total fee load applied was approximately similar to the Freehold Debt Income Fund fees. Past performance is not an indicator of future performance.

What is the risk profile?

Senior secured first mortgage debt sits at the top of the capital stack. This means it is the first to get paid and the last to lose capital should the underlying asset become impaired.

Freehold primarily focuses on senior secure first mortgage debt with conservative LVRs. Where the underlying property becomes impaired, it would have to fall in value by greater than 40% before investors lost any of their principal because our senior debt LVRs generally range between 40% – 60%.

Real estate debt is generally held to maturity, so held at book value, and not marked to market periodically. Therefore, investors don't experience a fluctuation in underlying asset values. Where interest isn't paid on a monthly basis, it is accrued in the net asset value of the portfolio. The accrued interest is paid to investors when the actual interest or cash is received by the fund.



Conclusion

Over the next 6 – 12 months, Freehold expects there will be less housing stock released into what will be a government-stimulated market. We believe this will be positive for the real estate debt sector, as it should protect capital values and encourage new projects to be brought to market.

Positively, these market dynamics are likely to provide an increased number of opportunities for investors. However, a cautionary note, it will be essential to focus on quality, which as we've noted earlier, can vary significantly across the loans and project sponsors.



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