TALARIA

CERTAINTY EMPOWERS YOU

Positioning with income in shifting market conditions, part 1.

September 23, 2021

Almost by definition, market convulsions come as surprises. Sudden government regulation and intervention in China is a fresh example.

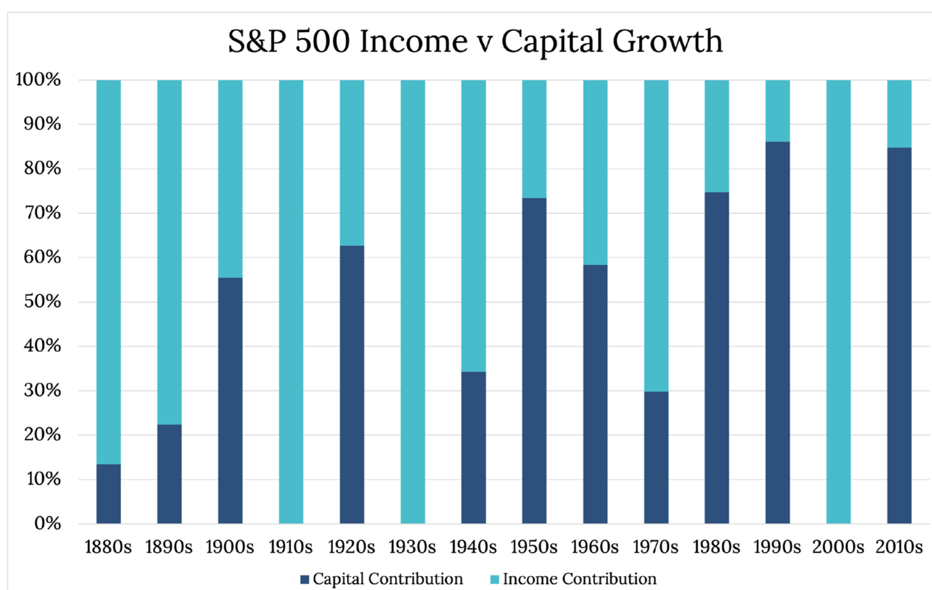
Part of the reason the market can ambush investors continually is because they tend to concentrate on guessing if something will happen instead of thinking about how they are fixed if it does. In economic terms, they focus on forecasting rather than positioning (who owns how much of what).

History is littered with moments where even the most storied investors didn't predict a dramatic shift in market conditions (GFC). So if those whose job it is to analyse all market scenarios cannot be relied on to forecast the future, then it is just common sense to suggest that, rather than gazing into crystal balls, investors would be better off considering how they might be placed if global market conditions were to change abruptly. Perhaps above all they should consider if they are sufficiently diversified.

Diversification is critical to lowering risk and increasing certainty of returns. We believe investors need to diversify in a variety of ways, but for this series will focus on income, particularly away from capital growth.

Total return comprises income and capital growth, and while it is true that investors should care about the level of total return and be indifferent to its composition, in the current climate of high (sometimes extreme) starting valuations, that indifference has become risky. In many ways it has become a code for "I have made so much from capital growth over the last few years that I have no regard for income."

As the chart below shows, income has been a vital contributor to total returns for more than a century, and in some decades including the 2000s, was the sole contributor to total return.



Source: Bloomberg

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So if we agree income is important, now as much as any time in the last century, what are the best ways to find it, and what are the risks of chasing income for its own sake?

Most equity income strategies rely solely on dividends, which offer a number of attractions including sometimes capturing higher inflation through higher dividend growth. Moreover, dividend yielding stocks are rarely longer duration (i.e. expensive growth stocks) and therefore they tend to be less sensitive to rising bond yields. On the subject of which, they can also do better than fixed income which risks capital losses if central banks counter inflation with higher rates.

However, as the economic impact of the pandemic has shown dividends can be unreliable. They are not guaranteed, fluctuate with earnings and can be halted by legislation in extreme circumstances, as we saw in relation to banks around the world last year.

Not only can a dividend only strategy be unreliable, it can also throw up risks as investors seek a shrinking opportunity set (reducing diversity), and the flow on implication that set can have with regards to quality and ESG credentials... as we will discuss in parts 2 and 3.