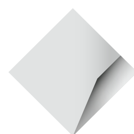
Market Outlook

October 2021

With the current ultra-low interest rates on cash, term deposits and fixed interest securities, many investors might be wondering how they can generate higher levels of regular income from their investments. In this month's *Market Outlook*, we look at some alternative income-generating strategies that investors may wish to consider.



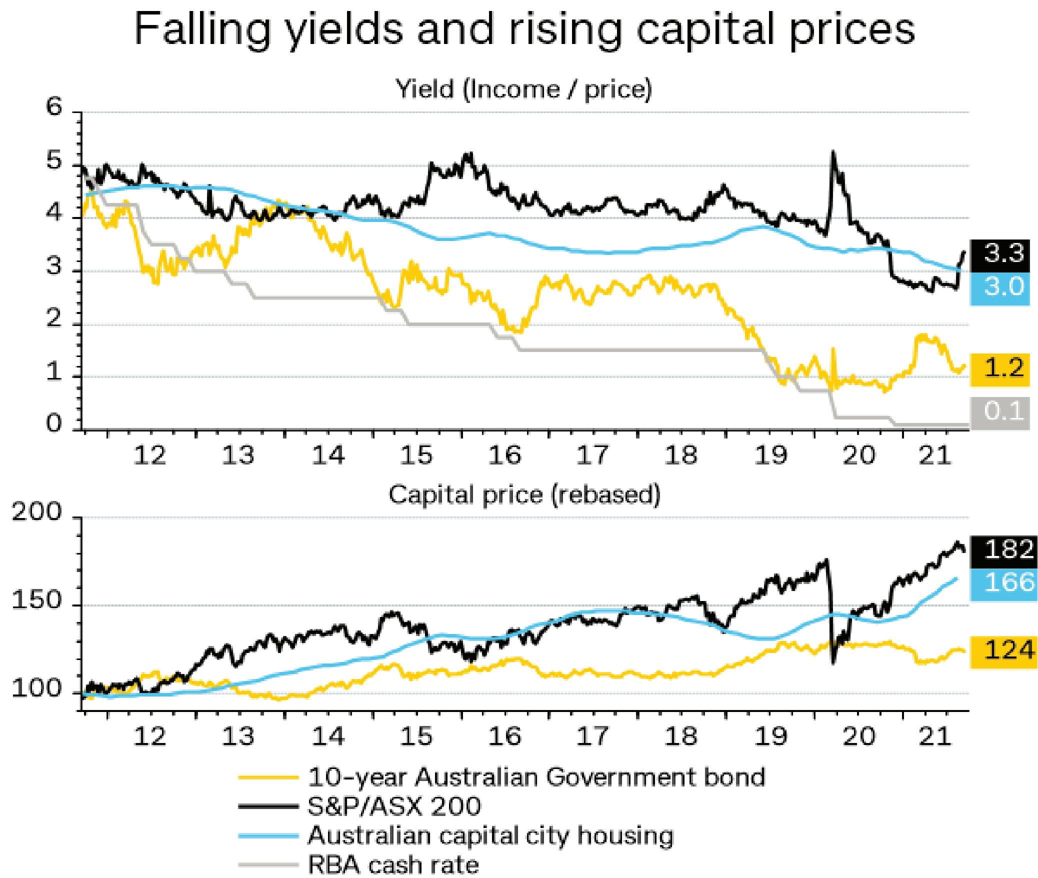
Commonwealth Private

Things you should know: This document is produced by Commonwealth Private Limited ABN 30 125 238 039 AFSL 314018 ("Commonwealth Private"), a wholly owned, but non-guaranteed subsidiary of the Commonwealth Bank of Australia ABN 48 123 123 124 AFSL and Australian credit licence 234945 ("CBA"), and is for distribution within Australia only to Commonwealth Private clients. This document is based on information available at the time of publishing, information which we believe is correct and any opinions, conclusions or forecasts are reasonably held or made as at the time of its compilation, but no warranty is made as to its accuracy, reliability or completeness. To the extent permitted by law, neither Commonwealth Private nor any of its related entities accept liability to any person for loss or damage arising from the use of the information herein. This document has been prepared without taking into account your objectives, financial situation or needs, so before acting on the information herein, you should consider its appropriateness, having regard to your objectives, financial situation and needs and, if necessary, seek advice from a Commonwealth Private Wealth Manager before making any investment decision. Please note that past performance is not a reliable indicator of future performance.

Disinvestment

Historically falling interest rates have been one of the main drivers behind the rise in bond, property and equity prices over recent years. This has increased the value of future income streams such as fixed interest coupons, rental income and share dividends.

The graphs below show the inverse relationship between yield and price, with higher capital values leading to reduced future income yields.



One way to generate income from investments that have risen in value is through regular disinvestment. This is the process of selling or trimming investments at regular intervals to convert unrealised capital gains into extra income. It's effectively the opposite of an income reinvestment, regular contribution and dollar-cost averaging strategy, which investors use to compound capital when they don't need the extra income.

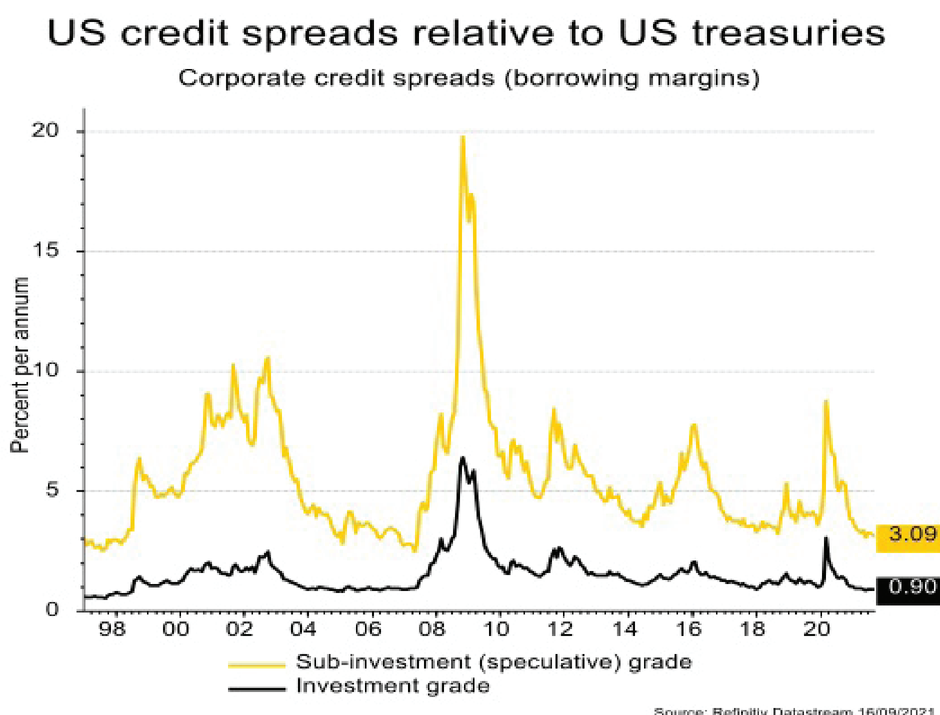
The benefit of regular disinvestment is that it enforces frequent portfolio rebalancing, preventing investments that have risen significantly in value from dominating portfolios and increasing overall portfolio risk. Importantly, it reinforces the discipline of buying low and selling high.

Private credit

Many investors are already familiar with publicly traded credit markets. This is where corporate bonds, floating rate notes and hybrid securities are traded over the counter or on the securities exchange.

Like equity markets, public credit market valuations reflect investor views about the economy and a particular company's financial health. Public credit markets are currently quite expensive, with narrow credit spreads (slim borrowing margins) reflecting optimism that borrower defaults and bankruptcies will remain low in coming years.

Narrow credit spreads can also be expressed as the difference between the corporate bond yield and the treasury bond yield. As the chart below highlights, these spreads reflect significant investor appetite for securities that pay slightly higher yields than government bonds of comparable maturity.



Focusing now on private credit, this is one area of the credit market that has attracted less capital and is less expensive than public credit. Private credit, or direct lending, is a relatively new investment class in Australia, but one with a longer history in Europe and the United States.

Private credit fund managers and loan originators negotiating direct loans with business and consumer borrowers in situations where a bank might have provided a traditional loan. Private loans don't typically trade on any exchange or over-the-counter market, and the lender only gets its money back when the loan is repaid, which could take several years.

Like banks, specialist private credit lenders assess the credit worthiness of the borrower, including loan security and serviceability. Also like banks, these lenders seek to diversify its exposure over different borrowers and sectors to minimise the threat of any single default.

Because the loans are privately negotiated, not rated by a credit ratings agency and not publicly traded, they're often made to smaller borrowers with less credit worthy borrowers who are unable to tap into public markets or obtain traditional bank finance.

Private credit lenders therefore have greater scope to negotiate attractive lending terms and higher rankings in the capital structure. When combined with the specialist nature of the sector, the smaller number of lenders and the lack of a secondary market, private credit investors can expect to earn higher returns than from traditional publicly traded fixed interest securities.

Equity income

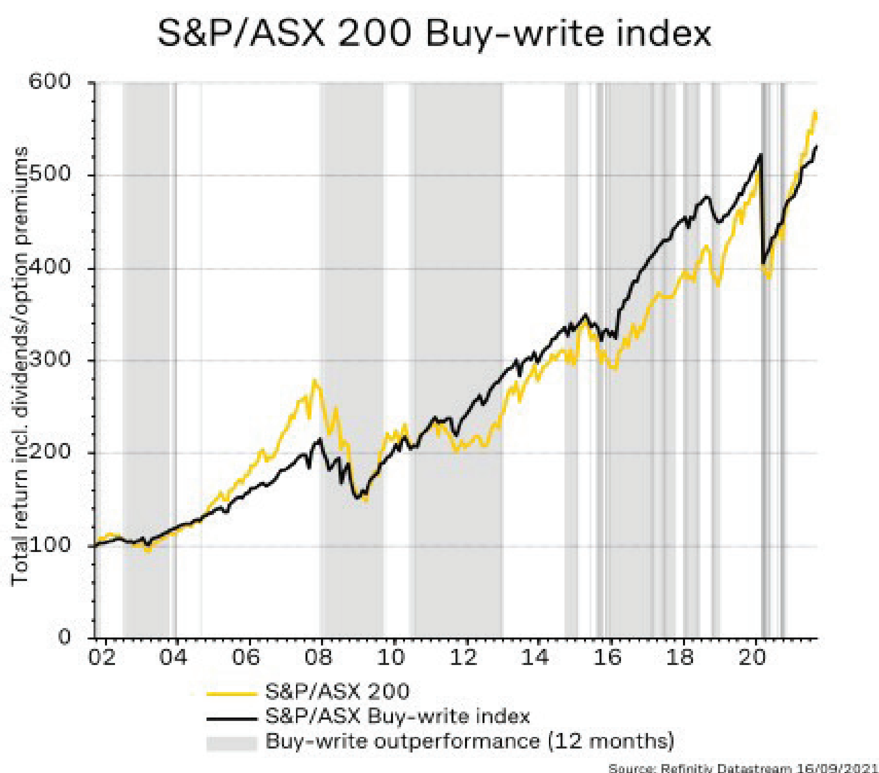
Another way to generate income is to use an equity income strategy. A simple equity income strategy involves buying shares with higher-than-average dividend yields.

The problem with this strategy is that companies that pay out very high dividends are often in low-growth sectors, such as banking or telecommunications. This can lead to a lack of diversification in these types of portfolios. The total value of the portfolio can also be compromised if earnings grow very slowly or even decline. High-dividend yield stocks can also become 'value traps' with the high yield being viewed by investors as cyclical or unsustainable.

A more sophisticated equity income strategy is the buy-write strategy. Also known as a covered call strategy, buy-write strategies involve buying a diversified portfolio of stocks that have sustainable earnings and dividends, and then selling or writing call options over those stocks.

Writing call options is similar to providing an insurance policy to the option buyer; in return for agreeing to cap the price appreciation of each share over an agreed time period, option premiums are earned by the option writer. If the share price rises significantly, the shares are sold to the option buyer at the pre-agreed price. Otherwise, the shares are retained.

Buy-write strategies generate an above-average level of regular income from the option premiums and dividends. But in strongly rising share markets, there's the risk of relinquishing shares in the portfolio at below-market price. In sideways or falling share markets, the buy-write equity income strategy is likely to outperform traditional share portfolios because of the additional option income generated through the premiums.



Conclusion

In our opinion, markets and clients alike are clearly concerned about COVID-19 cases and lockdowns, and what they mean for inflation and interest rates. We're closely monitoring the current situation for potential risks, as well as any potential opportunities for investment portfolios. For now, we remain comfortable with a largely neutral position in growth assets and a higher exposure to cash.