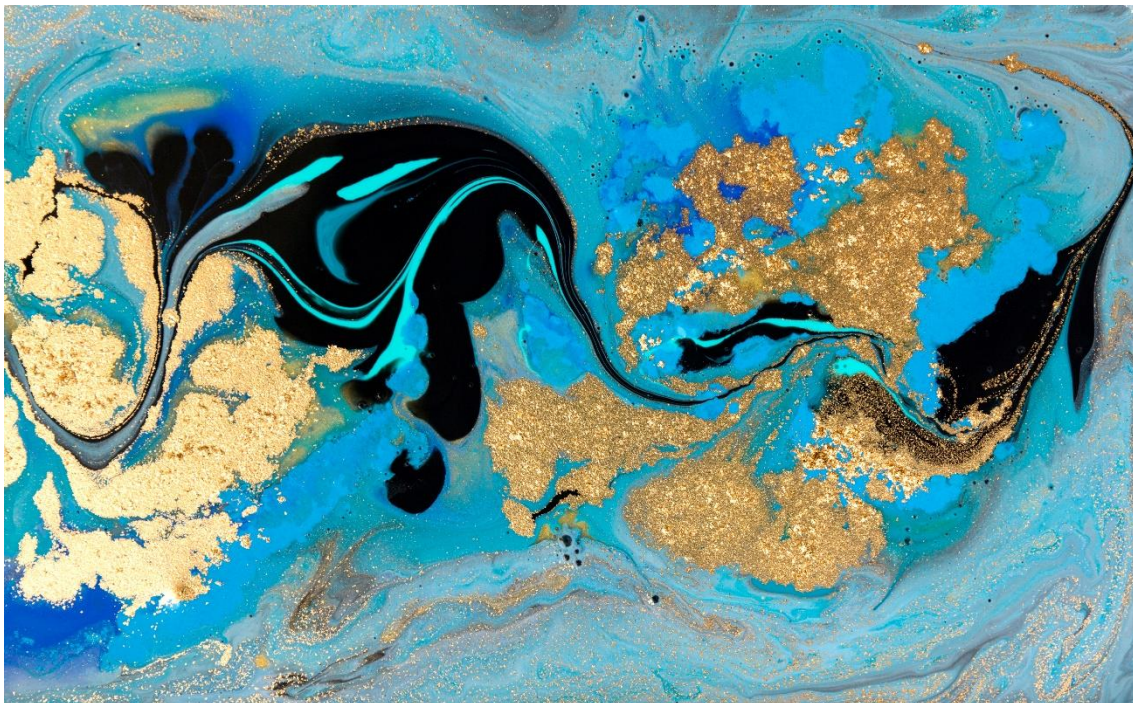


LCP on point 

The Disappearing Dividends Dilemma

June 2020



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Executive summary

Dividend-paying UK shares have been a popular investment for UK savers. But today, only a handful of companies are responsible for the majority of dividends in the UK market and with many cutting their dividends during 2020, this approach to investing for income looks much less attractive than it once did.

A solution to this is to look to switch into the investment strategies that large institutional investors like pension funds have employed. For example, infrastructure, global high-yield, and private credit.

Conclusion for Individual savers

Ask your adviser if your income portfolio depends heavily on the dividends of UK companies.

Look at what is available in the model portfolios of the platform you use – there is a lot of variety here, some still lean heavily on UK shares, others are already making use of the strategies discussed in this paper.

Conclusion for Private Wealth Managers

There is a lot of value to be gained for your clients by including the assets discussed in this paper in income portfolios.

Wealth managers can add value by working with asset managers to define and structure new products to best suit their clients, blend together the best managers (using active management where helpful), and drive great deals on fees.

Conclusion for Industry

The Investment Association (IA) could help by rationalizing the IA income sectors to make them more useful, and accelerating development of vehicles that permit less-liquid securities.

Thought for the future:

With c£260bn+ of UK pension assets entering decumulation in the next decade or so, demand for income generating assets and strategies is likely to increase.

LCP have over 130 investment professionals advising hundreds of institutional investors in the UK and beyond, who are responsible for over £300bn of assets invested around the world. We provide expertise in: asset allocation, manager selection and risk management. LCP is a partnership founded in 1947.

01 Introduction and summary

Can you still invest for income at a time of shrinking dividends?

For many years, UK savers have looked to high-dividend-paying UK shares for income. And for a long time, this approach worked very well. Between 1986 and 2010, high-dividend UK shares paid out annual income of around 4-6% per year on average, while growing capital values at about 5% a year – well ahead of inflation.

But, in recent years, UK savers that have focused on investing in UK companies for income have fared substantially worse than in prior decades, losing 20- 30% of their capital value in the 5 years leading up to March 2020. Even before the Coronavirus rocked global markets, the capital values of these shares had not kept up with inflation in a decade, as the UK market lagged well behind global peers and dividend payments became concentrated into a smaller and smaller number of stocks such as tobacco, oil and pharmaceuticals.

These trends have been reinforced by the current crisis, as growing numbers of firms have cut or cancelled dividends.

All of which creates a dilemma for investors. If they still want to invest for income but find themselves dependent on a narrower and narrower group of UK listed companies with dwindling dividend payouts, where can they turn instead?

The purpose of this paper is to try to answer that question.

Specifically, we look at the approach taken by large scale 'institutional investors' who decide where the trillions of pounds tied up in our pension funds is invested. We ask the question, where do these people invest, and what can individual investors learn from this? In particular, are there ways of investing for income that provide greater diversification and better returns than investing purely in UK equities?

Our case in this paper is that there are several asset classes which could help to address the 'disappearing dividends dilemma'. All rely, to varying degrees, on investing globally rather than just in UK-listed stocks. Some of the asset classes which we discuss will be relatively familiar and may well form part of the existing investment mix of retail investors. Others may be less familiar but also, we believe, offer the potential to generate income in a world where traditional approaches are no longer working.

There is another reason why we believe the investment approaches discussed in this paper merit a closer look. Fundamental shifts in pension saving have taken place in the UK over recent years, with a shift from Defined Benefit funds (where asset allocation is out of an individual's hands) to Defined Contribution (DC), where the responsibility is on individuals to make asset allocation

choices. As more and more DC savers reach retirement, we believe there will be huge additional demand for income-paying investments over coming years, as those who have accumulated pension savings draw on these in retirement.

The Facts and Figures on Drawdown:

Over the next 10-15 years, over 13 million people will reach retirement age, meaning that combined savings of c£260bn will enter decumulation. Data from the FCA¹ shows that in 2018 c£28bn of plan assets entered drawdown in that year.

The same FCA data also shows that three-quarters of those accessing drawdown withdraw at a rate of 4% or more per year, with 40% withdrawing at 8% or more. This sets a high bar for investment strategies to support such withdrawal rates over a 30-year retirement.

It seems clear that demand for income generating investments will only increase.

In the next section we recap the evidence on the growing ‘dividend dilemma’ – the increasing challenges for those who continue to seek income in accumulation or decumulation by investing heavily in the UK stock market. And then we move on to consider three asset classes which could offer an alternative way to generate income, especially in retirement, but with much greater diversification than traditional approaches. For each we explain what each involves, where the money is invested, what is going on ‘under the bonnet’ with each type of investment, the strengths and weaknesses of each form of investment, and how each has performed. In a concluding section we call on institutional asset managers, wealth managers and financial advisers to do more to help the general public access these types of investment where appropriate as part of their overall investment strategy.

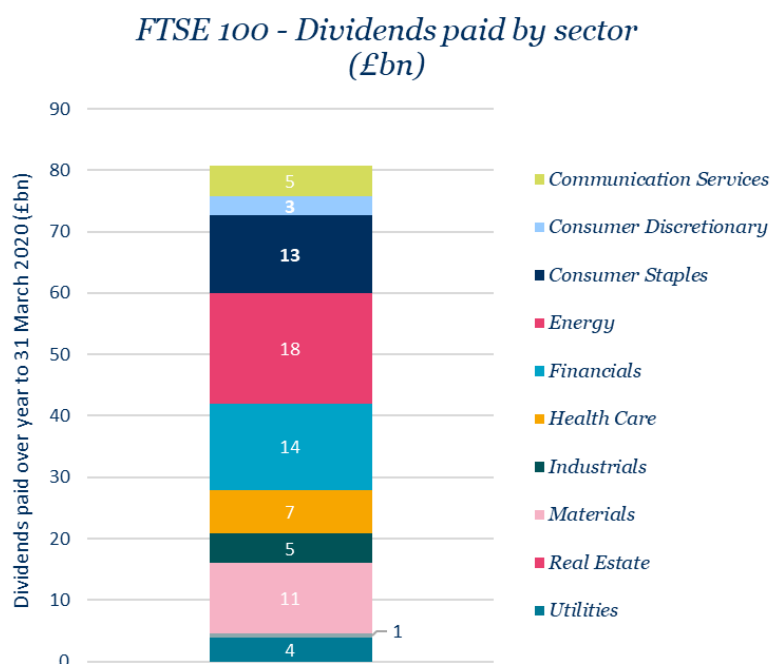
¹ <https://www.fca.org.uk/data/retirement-income-market-data>

02 The Disappearing Dividends Dilemma

There was a time when investing in UK equities seemed an obvious strategy for private investors looking to generate an income with their assets. From the mid 1980s up to the global financial crash, an individual investing in high-dividend UK shares would have enjoyed an annual income from dividends averaging around 5% as well as enjoying substantial real-terms growth in the value of their holdings. In addition, they were investing in household-name companies that were becoming big global players that they felt that they understood and whose fortunes they could follow in the finance pages of the national press.

Since 2010, things have been very different. Those relying on UK equities have often seen the value of their capital fall in real terms, whilst the number of firms paying regular dividends has fallen with dividend payers being increasingly concentrated in a smaller number of sectors. Data from AJ Bell indicates that just 10 stocks are likely to be responsible for two thirds of all dividends in the UK market in 2020.²³

Figure 1 shows where the dividends paid by FTSE 100 companies in the year to March 2020 came from, and illustrates the increasing dependence on a small number of companies and sectors

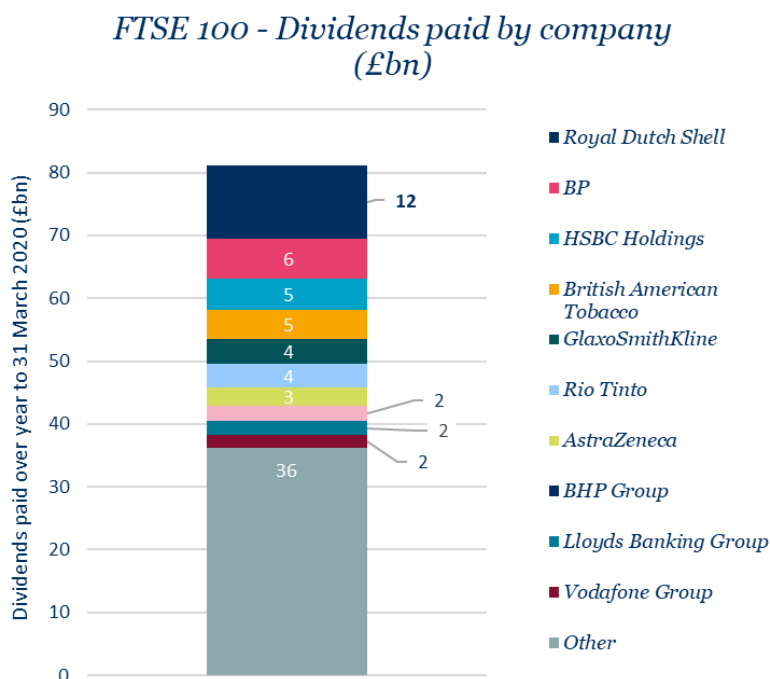


² www.moneyobserver.com/news/just-handful-companies-are-responsible-ftse-100s-dividend-yield-putting-income-investors

³ The FT April 2020 "Dividends, from hero to zero"

Figure 1: UK Dividends paid by FTSE 100 companies over the year to 31 March 2020.
Source: Bloomberg

Further pressure on dividends has come from the Pensions Regulator (TPR) and affects companies whose Defined Benefit pension scheme is in deficit. High profile insolvencies such as BHS and Carillion have created a political storm because, it was argued, shareholders had continued to benefit from substantial dividends whereas the pension fund deficit was accorded a low priority. TPR is now using increasingly strong language about the need to prioritise tackling deficits over paying dividends, with weaker employers in particular now expected to tackle their deficits as a matter of priority.



These trends have been exacerbated by the current crisis which has led to some dramatic changes to dividend policy. For example:

- The Investment Association (IA) has temporarily suspended⁴ the income requirements of funds to be included in its popular UK Income and Global Income fund sectors (consisting of 144 funds with £52bn of assets) – reflecting the difficulty of generating equity income in this environment
- UK banks were told by the Prudential Regulation Authority that it would be inappropriate to be paying dividends at a time when the focus should be on using available capital to lend to struggling businesses;
- Many UK insurers such as RSA, Direct Line and Aviva have decided to cancel planned dividends, though L&G pressed ahead with its planned payout;
- In April 2020, Royal Dutch Shell cut its dividend by two thirds, the first reduction in dividend by the company since the second world war and BT suspended its dividend until 2022, an action it hasn't taken in the last 36 years.

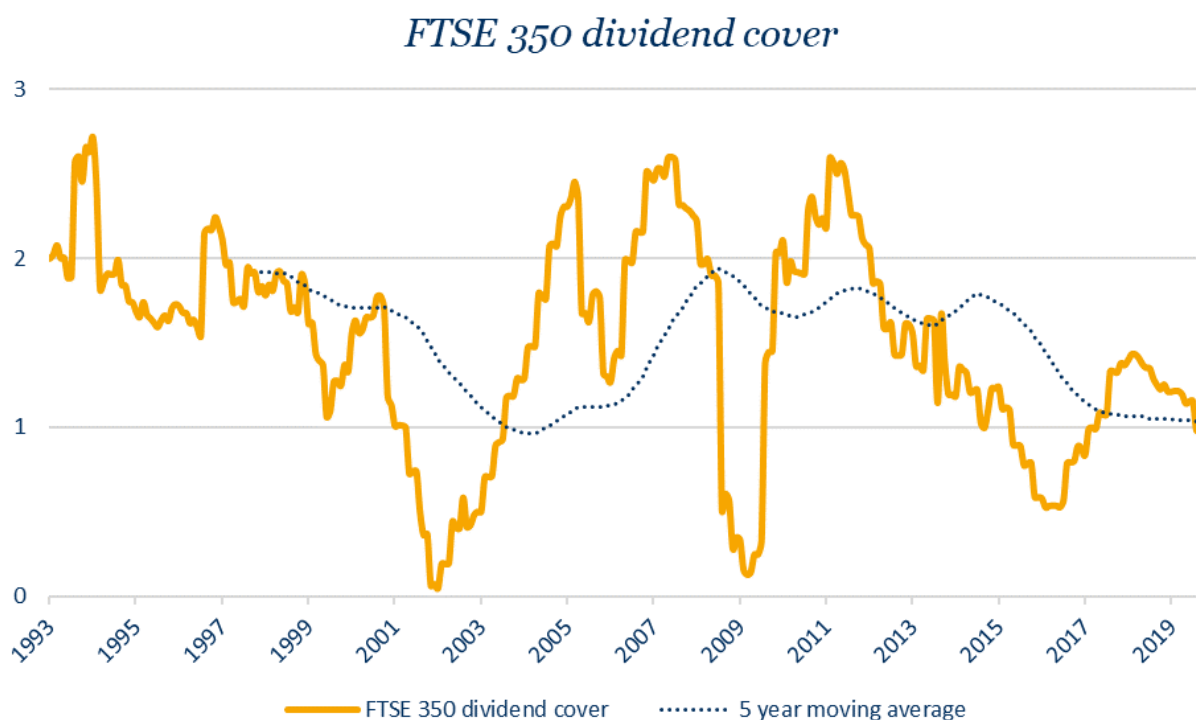
⁴ <https://www.theia.org/media/press-releases/ia-issues-new-guidance-equity-income-sectors-light-covid-19>

- In April 2020 it was estimated that more than 40% of UK companies have cut dividends this year⁵ with the prospect of more to come.

Some of these decisions to cut or suspend dividends are a reflection of the current crisis and are expected to be temporary. But they do provide further examples of the challenges for individual investors of depending exclusively on dividend income from the UK stock market for the regular income they need to support them in retirement. Dividends can and do get cut, and market valuations fluctuate and can remain depressed for years.

Figure 2 shows dividend cover (which is the ratio of net income to dividends) for FTSE 350 companies since the early 1990s. It illustrates the extent to which the ability of such firms to support dividends has fallen, especially over the last decade.

Figure 2: The chart illustrates the declining ability of UK companies to support their dividends. Dividend cover is defined as the ratio of earnings to dividends paid



It is not just the dividend dilemma that troubles income investors. In the 1990s with gilt yields around 8-9% for much of the decade, gilts were issued with coupons such that a £1m retirement pot invested solely in low risk government bonds could have generated substantial income of £80-90k per year⁶ as well as leaving the principal amount intact. As recently as 2007, with yields of around 5% the income would have been around £50k. Today, 10 year gilt yields are below 0.5%⁷, meaning that a £1m portfolio of gilts invested in a recently-issued 2030 gilt would generate less than c£5k per year of income. Those relying on their savings to provide them an income in later life clearly need to look well beyond government bonds in their search for an income they can live off.

⁵ Source: FT, April 2020 "Income seeking investors face an uphill struggle"

⁶ There is a difference between the definitions of yield, coupon and income. See glossary for further details

⁷ 10 year gilts yield was 0.25% as of early May 2020

In the next section of this paper we consider where else investors might be able to find income-generating investments, learning lessons from the investment strategies adopted by some of the largest institutional investors.

Diversification is a core theme throughout this paper. By region, by country, and by industry. The globalisation of the investment industry allows savers to look well beyond the UK - a portfolio of 30 or so UK companies is no longer the best we can do in terms of diversification. Indeed, UK stocks tend to be concentrated in a small number of industries, which brings increased risk. We start with a word of caution – none of the strategies presented are a panacea – a perfect solution to the issues facing income investors. But we do think that some of these approaches can significantly help those looking for an income from their assets over coming years.

03 Three income generators

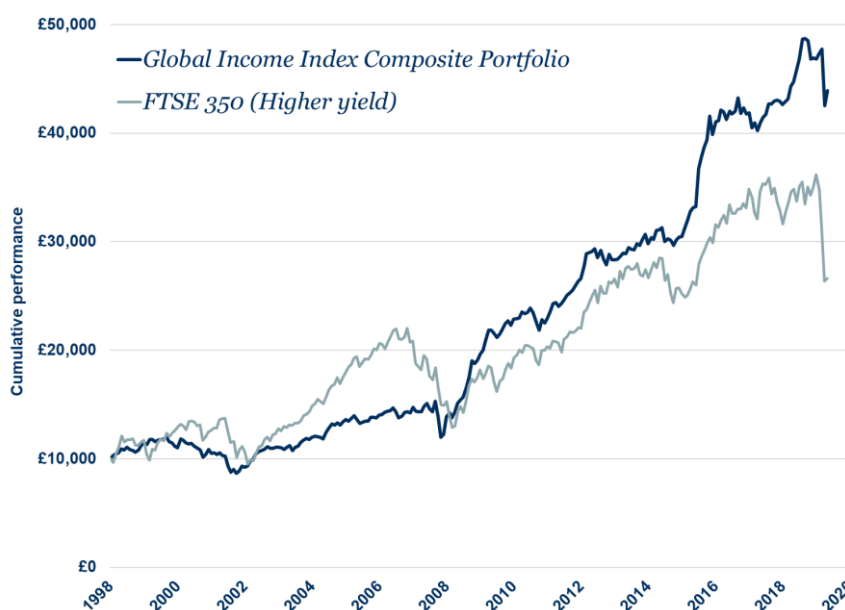
The three approaches we consider here are:

- Investing in infrastructure
- Investing in high-yield debt (including emerging market debt)
- Investing in private debt

As a taster for why these approaches are worth exploring, we show in Figure 3 and the following table, data on the performance of an illustrative ‘composite’ global income portfolio including these types of investment as against the performance of a FTSE 350 high yield equity index. Over the last 20 years, the global income portfolio has substantially outperformed the FTSE-based comparator (by over 2% per year and by 120% in total).

We would stress that the chart shows the performance of a combination of selected indices representing a global income portfolio and does not constitute investment advice. The performance figures are shown before the impact of providers' fees and any scheme specific costs. These fees will have reduced performance from that shown. Past performance is not necessarily a guide to future performance.

Figure 3: Growth of £10,000 invested in (A) a FTSE 350 Higher Yield Equity Index and (B) a Global Income Index Composite Portfolio. Total returns with dividends and income re-invested. Source: MSCI, FTSE, Bloomberg. Calculations: LCP. Returns shown are in GBP.



Returns to 30 April 2020	20 years (% p.a.)	10 years (% p.a.)	Maximum drawdown over last 20 years	Current income yield (%)
'Composite' global income portfolio	6.8%	7.3%	-35.4%	7.2%
UK FTSE 350 Higher Yield Equity Index	4.6%	3.8%	-41.6%	3.6%

Source: FTSE, MSCI, ICE BofA Fixed Income Indices. Calculations: LCP. Data as at 30 April 2020. Dividends re-invested. Returns shown are in GBP. Total Returns with dividends re-invested

Composite Portfolio consists of equal-weighted mix of Global Listed Infrastructure, US High-Yield Bonds, European High-Yield Bond and Emerging Market Corporate Bonds. Returns in GBP.

3.1 Investing in Infrastructure

What is it?

Infrastructure, in its broadest sense, refers to assets associated with the provision of essential services for the functioning of global society. Utilities such as electricity, gas and water are some of the most well-known examples of critical infrastructure. The asset class also includes things like toll roads, ports, pipelines and airports. Institutional investors commonly invest directly into large infrastructure projects that require their money to be tied up for a number of years. Often these assets will require a large up-front investment to develop, which is recouped through a long-term stream of fairly reliable income as the asset becomes operational. Subsequently, there may be further investments to further increase the productive capacity of the asset or extend its life.

Investment in infrastructure can be in the **equity** of companies, or the **debt**. It can also take the form of **listed** securities or **private** assets.

Listed infrastructure allows investors to invest in the shares of companies like Transurban (an Australian toll road developer), Enbridge (a multi-billion dollar Canadian energy firm) or closer to home, National Grid, that have direct exposure to infrastructure related activities and which are listed on the stock market. This provides a way of investing in infrastructure whilst giving the investor full liquidity (as they can sell their shares anytime), without the need to tie up their money for a length of time.

Private infrastructure investment consists of investing in similar types of companies to those described above (power companies, airports, toll roads, pipelines etc) but when the company in question is not listed on the stock market. Typically, the investment manager will buy a stake in such a company, potentially alongside a number of other investors as a consortium. Examples would be Anglian Water (which is owned by a consortium of investment funds) and Manchester Airports Group. The value of the investment will not be determined by its price in the market, but assessed by an independent valuer each quarter.

There are certain advantages to owning private assets as part of a small consortium such as being able to exert a greater influence over the business strategy, and to focus management on the long-term performance. One clear downside is that the assets cannot be sold and turned into cash easily, so these would not be suitable for fund vehicles that allow their investors to buy or sell units on a daily basis.

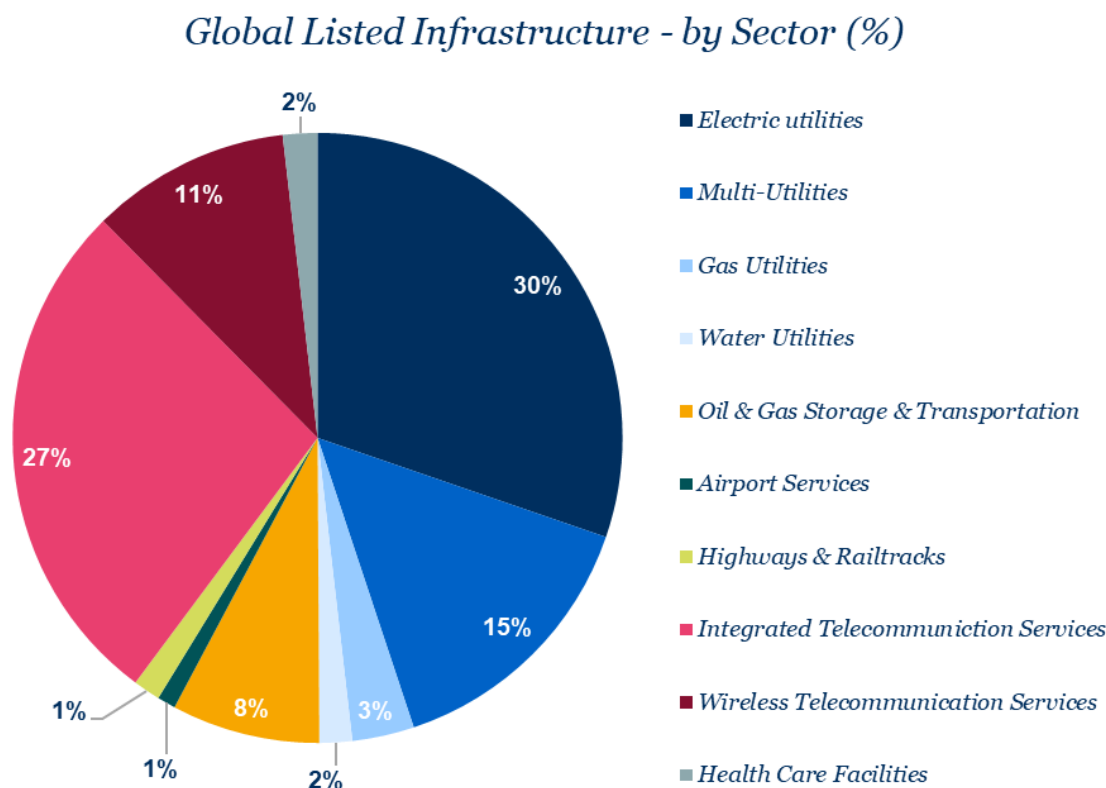
Aside from these points there are a lot of similarities between private and listed infrastructure from an investment perspective.

A typical listed infrastructure portfolio will generally be geographically split between developed regions around the world, though there are options to include emerging markets and these can be found more in the actively managed offerings. North America tends to have the highest allocation, followed by Europe and then Asia.

Stocks are then split between sectors, such as transport, energy, utilities, etc. Each major sector can then be sub-divided` even further – for example, transport can include underlying sectors such as airports, shipping and toll roads.

Figure 4 shows, for an illustrative infrastructure portfolio, the broad mix of sectors in which money may be invested.

Figure 4: Illustrative Split of Global Listed Infrastructure by Sector



Source: MSCI World Infrastructure Total Return Index, as at 30 April 2020

Why invest in it?

Infrastructure assets tend to have long life spans and stable cash flows, earning income from consumers and businesses that need their services even during times of economic hardship. Many of these companies enjoy monopolistic structures, which can enhance revenue visibility and lower financial risk. In addition, these companies are often protected by high barriers to entry, including substantial capital requirements, which means they are unlikely to be undermined in the short-term by new entrants to their markets.

Institutional investors have been benefitting from infrastructure investing for a number of years, especially the large superannuation schemes in Australia that were the pioneers of privately investing in this asset class. Many of the reasons why large investors opt for infrastructure investment would appeal to individual investors. The main difference is that institutions can invest directly in infrastructure projects, whereas individual investors are investing in the shares, or debt, of companies which are wholly or mainly involved in infrastructure projects.

Investing in infrastructure can contribute in several ways to an investment portfolio:

- **Capital growth and income:** We believe a diversified listed infrastructure portfolio should deliver high-growth returns of 5-6% p.a. over the long term. This is broadly in line with our assumptions about the returns on global equities, but comes with lower volatility;
- **Diversification:** Investors seek to spread their risks so that not all of their investments are moving up or down at the same time. Listed infrastructure is usually less subject to the short-term ups and downs of the stock market than general equity investment.
- **Inflation protection:** Large company pension funds are interested in investing in assets which give some protection against fluctuations in inflation. This is because the pensions they have to pay out often fluctuate in line with changes in inflation. But individual investors may also be interested in investments where the return is in some way linked to changes in inflation. Many of the underlying investments in the infrastructure sector are linked to assets which pay an inflation-linked return (e.g. repayments on long-term infrastructure contracts, revenue from toll roads etc) and therefore naturally provide a measure of insulation against rising inflation.

Case study 1: NextEra Energy

NextEra is the largest utility company in the world, based in the US. Founded in 1984 it has c46,000 Mega watts of energy generating capacity (equal to about half of the entire UK) and serves around 10m customers in the US. Nextera is one of the world's largest producers of renewable energy with c24% of its electricity generating coming from wind and solar and 26% from nuclear. It owns onshore windfarms across many states including Texas and North Dakota, and runs 18 solar farms in Florida. It generates annual revenue of c\$16bn and cashflow of \$6.6bn and has a dividend yield of 2.4%.

Case study 2: Transurban – Australian toll road operator

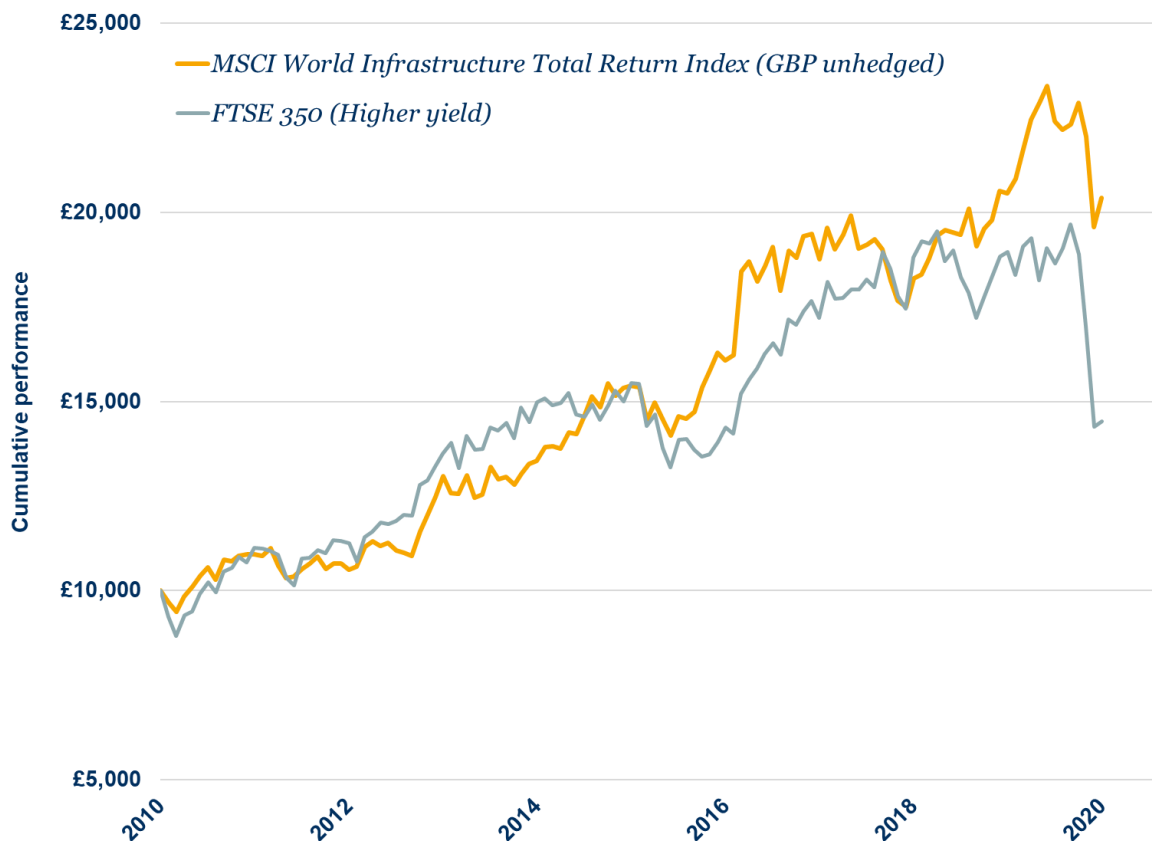
Transurban are one of the largest toll-road operators in the world with 18 toll roads in Australia, the US and Canada and 1.7m daily trips on their roads. They have been running toll roads since the 1990's and the concessions they currently operate have an average remaining life of over 30 years. In their latest reporting period, the company grew traffic volumes by 2% and overall toll revenues by over 8% which contributed to earnings of \$2bn and an annual dividend yield of 5% which has grown steadily in recent years. Transurban have made substantial commitments to renewable energy and sustainability, making them a member of the Dow Jones sustainability and the FTSE4Good indices. The company carries a AAA ESG rating from MSCI.

How has this asset class performed?

Over the long term the returns from listed infrastructure assets have been good as shown in the chart below.

Figure 5: Growth of £10,000 invested in (A) a Global listed infrastructure index and (B) a FTSE 350 Higher Yield Equity Index. Total returns with dividends and income re-invested.

Source: MSCI, FTSE, Bloomberg. Calculations: LCP



Source: FTSE, MSCI. Data to 30 April 2020. Dividends re-invested. Returns shown are in GBP.

A reference index representing listed infrastructure has returned in excess of 7% p.a. over the last ten years. Active managers could have performed better or worse than this. Note this is higher than we would expect from the asset class going forward. This is substantially higher than what UK equity indices have returned, much of this could be attributed to exposure to global stocks which have generally out-performed UK companies over the last decade.

Returns to 30 April 2020	10 years (% p.a.)	5 years (% p.a.)	Maximum drawdown over last 10 years (%)	Current income yield (%)
Global Listed Infrastructure	7.4%	5.7%	-22.1%	4.5%
UK FTSE 350 Higher Yield Equity	3.8%	-1.3%	-27.1%	3.6%

Source: MSCI, FTSE. Calculations: LCP. As at 30 April 2020. Dividends re-invested. Returns shown are in GBP.

The implications of the COVID-19 related lockdowns seen around the world have impacted many of the underlying sectors that make up a typical listed infrastructure portfolio. Regulated utilities such as water, gas and electricity have held up relatively well as their earnings are highly defensive. Transport sectors such as toll roads and airports have taken a significant decline due to the severe drop in car trips and passenger movements. Dividends may be affected in the short term but previous shocks in the transport industry shows that demand should recover in the longer term. The length of lockdown periods will dictate how the next 6-12 months look for these companies. Other areas such as telecommunications and social infrastructure are also proving resilient and are less sensitive to the risks being created by the pandemic. The Global Listed Infrastructure index fell by 12.2% in March 2020, whilst the FTSE 350 (higher yield) fell by 15.6%.

Responsible Investment

In recent years more and more investors have been demanding that their managers pay greater attention to environmental and social factors when making investments, as well as taking a clearer stance on important issues when exercising the votes at company AGMs on behalf of their clients. Managers have responded in a range of ways and increasingly this is an important consideration when selecting managers. For infrastructure managers these considerations are particularly important as the assets in question can have both significantly positive, or negative influence on both the environment and the communities in which they operate. For example, many infrastructure funds are among the biggest investors in renewable energy, and waste recycling businesses. There are also plenty of transport-related assets in portfolios. The physical presence of these assets in the landscape also impacts the communities around them (e.g. ports, pipelines, power stations).

Every manager will be able to “spin” a good story, but it is important when selecting a manager to dig beneath the surface and understand how they are really taking these factors into account. After all, many of these assets are destined to be around for many decades. For more information on responsible investment see LCP’s Responsible Investment Survey 2020.⁸

What are the risks for retail investors of investing in this asset class?

Listed infrastructure involves investing in publicly traded stocks, therefore there are similar risks compared to investing in equities. Short term volatility can be similar to wider equity markets and investors may experience similar levels of negative returns if global equity markets fall in value, however this is less likely over longer time periods.

Investors will need to consider whether they wish to invest passively, by tracking a pre-set index, or whether they would like to invest actively and pass over the investment decisions to a fund manager. A passively managed index option will provide the investor with a broad range of underlying companies and provides the necessary exposure to achieve the various benefits mentioned about investing in listed infrastructure. This option will also be cheaper in terms of ongoing annual management charges. An actively managed fund may provide the opportunity to invest in a more concentrated portfolio of stocks that could outperform a broader index equivalent, however this will attract higher fees and the manager is not guaranteed to outperform the index. In an actively managed fund you are depending on the manager to select the right companies and put together a diversified portfolio.

⁸ <https://www.lcp.uk.com/pensions-benefits/publications/lcp-responsible-investment-survey-2020/>

An additional risk to be aware of here concerns the energy sector. Historically, fossil fuel companies including the likes of Exxon and BP, and the hundreds of other companies that support them have comprised a big part of infrastructure portfolios. Today, renewable energy focused companies like Orsted (Denmark) or Iberdrola (Spain) play a bigger role but there are still likely to be plenty of fossil fuel companies in these portfolios. These companies could be at risk of future carbon taxes, or future regulations on their activities as part of a green energy transition. Many fossil fuel companies are working on ways to reduce their carbon footprint or play a positive role in the transition, so this is not necessarily a bad thing, but it is something to be aware of. Active managers will take this into account when selecting companies, but a passive fund will not.

For which retail investors might this asset class be most suitable?

Listed infrastructure is a growth asset, which younger investors or those with a long-term horizon could benefit from. Investors looking for a reliable income stream, likely those in retirement, could also benefit from listed infrastructure as a significant element of returns come from the cashflow yield generated by the underlying companies. Listed infrastructure companies tend to be reliable dividend-payers so a portfolio would typically have a dividend yield in the range of 4-5% p.a.

Listed infrastructure is not without risks however and can be volatile at times, for example the value of a portfolio of listed infrastructure companies at one point over the last decade fell by over 27%, this should be borne in mind by investors who may be looking for a more cautious approach.

How can retail investors invest in this asset class?

Listed infrastructure is available today through pooled funds, including Exchange Traded Funds (ETFs) as well as actively managed portfolios through investment platforms.

3.2 Investing in High Yield Debt (including Emerging Market Corporate Debt)

What is it?

When companies and countries want to raise money to finance investment and growth, they can do so by taking out loans, or issuing bonds which have to be repaid with interest. Debt of this sort is issued by a broad range of companies (e.g. large companies such as Apple to small business such as a local car dealer) and countries (e.g. large countries such as the US and smaller countries such as Andorra).

Investing in a company's debt, or bonds, is similar, but fundamentally different prospect to investing in the **shares** of the company. A key difference investing in bonds is that you earn your return through interest and principal repayments, as long as the company does not go bust. You are not relying on the company improving its sales or profitability, expanding into new markets or developing new products. Investing in shares carries more potential upside over the longer term, but also subjects investors to the vagaries and whims of the market, which cause share prices to fluctuate.

Investing in debt can be a great fit for investors looking to take income from their assets because of the more reliable way these returns are earned, and this is something that is often under-appreciated by individuals and advisers looking to generate an income from their assets. In a more globalised and efficient investment world, pooled funds and Exchange Traded funds (ETFs) are readily available to make it cheap, efficient and easy for investors to access diversified pools of global investments.

In some ways bond investing is more simple than share investing: if a company survives then you get paid a return equal to whatever yield the bonds had when you purchased them (less expenses), if the company defaults (goes bust) then you receive whatever remains can be salvaged, but usually less than you invested. So bond investing is about avoiding **defaults**, but companies default and go bust all the time, so it is also about ensuring you are being paid enough returns to compensate you for the occasional default that you will experience.

Because the spectrum of bonds that you could invest in is so broad, asset managers typically focus on a particular subsection of the overall market when offering a fund, and this is important. In this case, to target a 'higher yield' we are focusing in on **emerging market debt** and **high yield debt**.

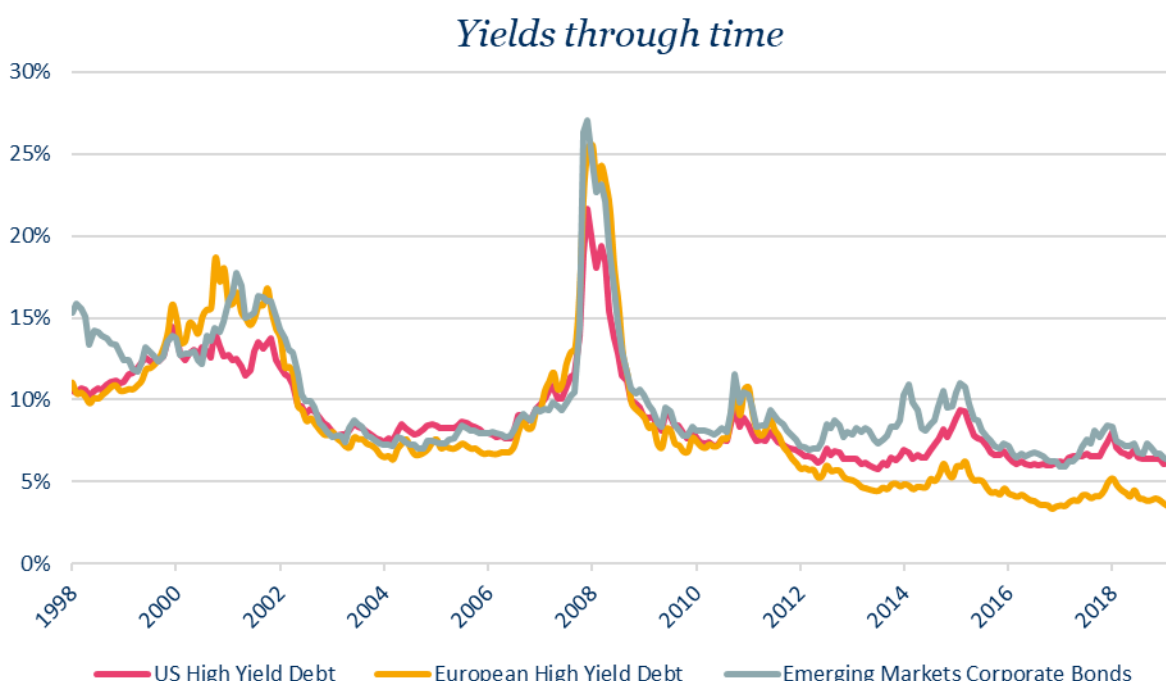
Emerging market debt (as the name implies) involves lending to countries and companies that are located in emerging markets. Emerging markets include countries such as Brazil, India or Turkey. These have more risks attached to them, including political and currency devaluation risks, as well as heightened economic risks, hence why they pay investors a higher yield.

High yield debt involves lending to well established companies but medium sized companies that are large enough to access public debt markets but not as strong financially as the largest blue-chip corporations such as Apple, Nike or Visa. As the companies are often smaller, they are typically less well-known brands although they are still sound businesses. Examples would be US health providers like Tenet and Bausch, or telecoms firms like Sprint.

There is a parallel to be drawn from both markets, which is that in both cases the entities that loans are being made to are well established but not the largest players. This carries more risk than investing with the blue-chip names, as these companies aren't as financially strong, but naturally comes with a higher return to the investor as well. Crucially, if the investor can get a diversified portfolio, of judiciously chosen companies then he or she can reap a good return which more than compensates for the additional risk.

There will be periods of time where high-yield investors experience elevated levels of defaults – the period after 2008 was one such example where defaults reached in excess of 10% per year. Over time the yields on offer from high-yield bonds have more than compensated for the losses incurred in defaults, on average.

Figure 6: This shows how the level of annual yield has varied through time for the three asset classes being discussed. US high-yield debt has consistently offered yields between 5-10%, and occasionally much higher



Source: ICE BofA Fixed Income Indices

Within high yield debt there are two main underlying markets, one in the US and the other in Europe. Managers will often specialise in one or the other as they are distinct markets with their own customs and practices. The US market is very large – it is often underappreciated that California (for example) would be the 4th largest economy in the world if it was a standalone economy. The European market has considerable diversity within it as well with Germany, France, Spain, Italy, Ireland and the Netherlands all having significant numbers of issuers.

Emerging market debt on the other hand will be centred around developing economies. When combined together, the result is a truly global portfolio. Managers will typically construct well diversified portfolios with several hundred positions. This means that exposure to any single company or country is small.

Why invest in it?

The main attraction of this form of investment is the potential to generate a high level of income, albeit with associated risks. Higher yielding debt can be considered an alternative to dividend paying stocks. Funds invested in high yield debt can offer income levels of around 6-7% pa which is higher than many dividends offered by high dividend stocks.

As well as income, higher yielding debt funds offer investors attractive levels of overall return of around 7-9% pa which takes account of potential growth in the capital value of the investment.

Other attractions of this form of investment include the potential for diversification, investing over a range of companies and/or countries and with a different profile of returns to investing in equities or bonds. This debt is also easy to buy and sell which provides investors with ready access to their capital as required.

How has this asset class performed?

Returns in these funds are typically driven primarily by the interest rate set on the loan to the underlying company or country. For example, a 10 year loan to the government in Brazil might have to carry interest rate payments of around 7% pa.

Over the last twenty years, investments in high yielding debt have generally performed well delivering returns in excess of 7%p.a. in many cases they have outperformed an index of global shares and have done so with lower levels of volatility, as shown in the table below.

Returns to 30 April 2020	20 years (% p.a.)	10 years (% p.a.)	Maximum drawdown over last 20 years (%)	Current income yield* (%)
US High Yield	7.7%	7.6%	-18.8%	9.3%
European High Yield	7.0%	5.3%	-33.2%	7.4%
Emerging Market Corporate Bonds	8.3%	7.6%	-28.2%	11.8%
Blend	7.9%	7.0%	-26.7%	9.5%
UK FTSE 350 Higher Yield Equity Index	4.6%	3.8%	-41.6%	3.6%

Source: FTSE, ICE BofA Fixed Income Indices. *As at 30 April 2020. Dividends re-invested. Returns shown are in GBP.

Responsible Investing - Environmental and Social Considerations

One area that investors have been demanding that asset managers pay more attention to in recent years are the environmental and social aspects of the assets they are managing. When it comes to bond investing the considerations here are a little different to equity investing. The first difference is that bonds do not come with voting rights in the same way that company shares do. But bond managers are still able to influence the companies (and countries) they lend to quite considerably as many borrowers need to finance themselves in the markets on an ongoing basis and asset managers can use that leverage to push for certain considerations to be addressed, and to raise standards, for example on things like safety regulations.

Some managers are more thoughtful than others and the range of issues addressed varies. When it comes to emerging markets in particular this is a key consideration as investors may want to understand the manager's attitude to lending to particular governments (such as those with low transparency or involved in controversial conflicts) and how the social implications of particular businesses are impacting on the communities in which they operate and what the manager is doing to try and enforce higher standards. This could be an important factor in selecting a manager.

At the same time, bond managers are becoming clearer on how they factor in the risks of things like climate change to the portfolio itself. As bonds have a defined time horizon over which the investment matures, and pays the investor back, this focuses the mind in terms of the period of time needing analysis. The nature of credit investing itself focuses the manager heavily on the downside risks of default, so it is vital that the manager is taking into account all such risks, including those arising from environmental considerations. One example here are US mid-market oil and gas firms, who have borrowed heavily in the markets. Managers may take a range of views on the financial, and non-financial, risks posed by these companies.

What are the risks of investing in this asset class?

The biggest risk of this type of investment is that of default - that the borrowers will fail and not be able to pay back the loans. In addition, assuming that you are relying on an asset manager to select the borrowers and to structure the investments appropriately there is dependence or risk on the asset manager. There is also some currency risk to be managed as typically the investments will not be in sterling.

As noted above, there may also be issues for those concerned about Environmental, Social or Governance (ESG) issues. Given that asset managers are generally lending to less well-developed economies and smaller companies, ESG considerations are significant. The countries most heavily represented in the market for emerging market debt would include Russia, Ukraine and Turkey. Also, fossil fuel companies are some of the biggest issuers of high-yield debt in the US.

For these reasons, it is important to ensure that asset managers are considering ESG risks within their asset allocation and security selection. It is also necessary to consider the liquidity of this type of investment, which may be reduced at times of stressed markets.

How can retail investors invest in this asset class?

Funds are available to individual investors which invest in these asset classes, but for various reasons they tend to be less popular than the more conservative funds labelled as Sterling Strategic bond or Corporate Bond.

Many individual investors have investments in **strategic bond** funds, which diversify across a range of strategies and countries. Typically, these funds are designed to be a low-risk complement to portfolios so tend to feature substantial allocations to government, and high-grade corporate bonds. They are going to struggle deliver the 5%+ sort of income levels that investors are often looking to generate from their assets. At the time of writing only 8 funds out of more than 80 in the Strategic Bond sector had yields in excess of 5%.

It is important to note that for non tax-sheltered⁹ investment accounts income classified as dividends¹⁰ is taxed more favourably than income classified as interest¹¹. Individuals or wealth managers should take tax advice on the implications of any changes to the composition of their investment income.

⁹ Tax sheltered investment accounts include ISAs and SIPPs in the UK

¹⁰ <https://www.gov.uk/tax-on-dividends>

¹¹ <https://www.gov.uk/apply-tax-free-interest-on-savings>

3.3 Investing in Private Debt

What is it?

When large and medium sized companies borrow money by issuing bonds these can be readily bought and sold in publicly traded bond markets. In the last section we talked about the extra yield available in the bonds of these medium-sized – but still stable – companies. Here we are talking about going further down the size spectrum. Smaller companies also wish to borrow money and they may not have the scale to access the public bond markets in the same way that large or medium sized firms would. Other firms may access these markets but do so only infrequently meaning that their bonds are not easy to buy and sell and hence are avoided by many funds.

Traditionally, these sort of companies would get a loan from the bank. But since the financial crisis of 2008 banks have not been lending to small and medium sized businesses in the same way that they used to as they have been required by regulators to reduce their risk. This has created an opportunity for asset managers to step in and lend money directly to such businesses on behalf of their clients. These **private credit** investments are illiquid, which means they cannot readily be sold on to another investor. This means investors will need to wait to recoup the interest and maturity payments in order to reap their returns which typically takes around 7 years.

Because of the inconvenience of this illiquidity, these sort of investments will typically offer a higher rate of return (or yield) compared to a listed corporate bond, as well as having more protections built in for the end investor.

Private credit is a very broad asset class that includes everything from lending to medium sized growth companies, for example, e-learning providers, telecommunications or medical devices, through to financing for challenged companies in tricky sectors like retailers, bars, restaurants and holiday parks or financing for real estate purchases such as commercial real estate (offices) or infrastructure projects like renewable power.

These funds would typically invest globally. Usually a manager would focus either on the US or Europe, because there are lots of peculiarities to each region that a manager needs to be familiar with to operate. Managers will try to build diversified portfolios of bonds – perhaps 40+ separate issuers.

Managers will often have specialisation in certain areas – some might specialise in loans to commercial real-estate projects, others might specialise in turnarounds of companies in difficulty.

These portfolios can be very diverse in terms of sectors – they might include more economically sensitive sectors such as hotels or rental cars, but also bio-devices, pharmaceuticals, e-learning and software-as-a-service.

Since 2014, institutional investors have been allocating significantly to this asset class as the opportunities became apparent and the yields available in other parts of the bond market fell. Data from Preqin¹² estimates that £100bn of assets per year have flowed into this asset class globally in recent years, with total assets under management of some £700bn globally by 2019, making this a significant global asset class.

¹² <https://docs.preqin.com/samples/2019-Preqin-Global-Private-Debt-Report-Sample-Pages.pdf>

Why invest in it?

The returns from private credit investments come from the interest and maturity payments associated with the lending, and a substantial part of the returns come in the form of a running yield, or income, from the portfolio. Arrangement fees can also be a contributor to returns, and this is different to the public markets. At a time when other sources of income, such as dividends, are harder to come by, this asset class provides an alternative way of generating income, especially for those who are able to tie up their capital for the duration of the loan.

How has this asset class performed?

These investments are typically loans, or bonds. The returns come from the borrowers making their interest and maturity payments on time, not from the value of the securities going up. This is known as a “contractual” return.

Because the returns are dependent on the borrowers making their interest and maturity payments, a key factor here is lending to the right companies that will pay back the loans at a fair rate of interest. This doesn't mean just lending to safe companies though (as safe companies can borrow cheaply and do not pay much interest). The key here is judging the right interest rate for companies to pay and avoiding defaults where possible.

There is a wide variety of different sectors within this broad asset class which vary in terms of the risk and return properties:

- At the less risky end of the spectrum is lending to commercial real-estate type projects. This is usually less risky as if the borrower fails, the lender can take the property as compensation. Any loan that has a “real” asset standing behind it is referred to as real-asset-backed
- At the more risky end of the spectrum you have lenders who are backing turnarounds in businesses or sectors that are particularly challenged, for example the retail sector in the UK. The returns here will be high but so are the risks as the business could fail and the lender be left with very little

This asset class typically offers returns in the range of 7-10% p.a., sometimes more, with most of the returns delivered as a running yield/ income to the portfolio.

What are the risks for retail investors of investing in this asset class?

As noted above, the level of risk in an investment of this sort depends on the types of businesses which are receiving the loans. The biggest risk is that of default – that the borrowers will fail and not be able to pay back the loans. Investors are relying on an asset manager to select the borrowers here and to structure the investments appropriately so there is dependence or risk to the asset manager. There is also some currency risk to be managed as typically the investments will not be in sterling.

Some sectors will have significant economic exposure and will have been challenged by the Covid-19 pandemic of early 2020. This raises both risks and opportunities. For the solid companies with good business models who are going to survive and maybe even prosper there could be an opportunity to lend money at very attractive interest rates and provide an excellent level of income to investors. On the other hand, there is the very real opportunity that some companies will default and fail to pay back the money lent to them in full.

These investments are, by their nature, illiquid and may not be suitable for those who may need to access their capital at short notice. Illiquidity adds an extra risk to investors as their cash may not be readily realisable at all times should they need it urgently for another purpose.

Although rates of return on these investments can be high, they do rely heavily on specialist and active asset management and can therefore have relatively high fees. For retail investors, there aren't many funds available to choose from in this area.

With regard to environmental, social and governance considerations, historically fixed income (bond) managers were not at the forefront of integrating environmental and social considerations as fixed income securities do not come with the right to vote as equities do. However, this has shifted more generally as investors and managers have become aware of ways that fixed income managers can still influence company practices.

Asset managers in this area are dealing with medium or small size companies and may be the sole provider of finance to the company so as such can wield a reasonable amount of influence. Measures we have seen some of the most aware managers taking include ensuring that all parts of a supply chain subscribe to minimum construction and labour standards (e.g. factories in the developing world supplying retail businesses). Another example is in the stance managers taking in dealing with employees in the case of bankruptcies which will inevitably happen from time to time in these high-risk areas.

On the other hand, a sizeable number of companies issuing debt in the private markets are in the oil and energy sector, so whilst not all managers will have exposure to this, it may create a question mark for investors looking to avoid this sector.

For which retail investors might this asset class be most suitable?

The relatively high income generated by this type of investing could make this asset class a valuable feature of a drawdown portfolio allowing a client to draw a good income from a portfolio without the need to liquidate units or hold cash, especially at a time of diminishing dividend income.

How can retail investors invest in this asset class?

Because of the unquoted, illiquid nature of these securities it has been difficult or impossible for most retail investors to make these sort of investments historically, as the rules governing the funds that investors can access usually prohibit or restrict – for good reason – investment in securities that cannot be publicly traded. In order to protect investors and ensure they can access their money.

Investment trusts have been one structure that permits investments in less-liquid securities while still allowing a secondary market in the shares of the trust (albeit frequently at a discount to the net asset value of the holdings, especially in times of stress). Investment trusts can also manage cash to smooth their payouts and maintain a more stable dividend. Investment trusts holding private debt are available to individual investors directly through investment platforms.

Holding illiquid investments in a fund that allows investors to come in and out of the fund on a more frequent basis always carries potential risk as it can result in liquidation runs on the fund if a large number of investors wish to redeem at the same time – this has happened a number of times recently for example with property funds in March 2020 and late-2016, and some high-profile

equity funds in 2019. This underlines how important it is to ensure that less-liquid assets are held in an appropriate type of fund.

For patient retail investors who are able to make long term commitments of assets it is possible for wealth managers and platforms to structure funds appropriately to meet regulatory guidelines, give investors some liquidity and allow some degree of investment in private credit.

One way to address the liquidity issue is through funds that invest in a mix of liquid and less liquid securities, rather than just focusing on the illiquid end. This allows the fund to price at least monthly and satisfy some degree of liquidity through the more liquid holdings. Several such funds exist in the retail investment space, although daily dealing funds tend to remain the most popular.

Research from the Pensions Policy Institute¹³ supports the use of illiquid assets in personal pension arrangements, and a recent government consultation¹⁴ is investigating the possibility of private assets in defined contribution pensions. The Universities Superannuation Scheme (USS), one of the largest investors in the UK has led the way by recently announcing¹⁵ that it was making available its private markets investments, including property, infrastructure and private debt to defined contribution members.

The Investment Association in its 2025 policy document¹⁶ has highlighted the growth of private markets in recent years, including private debt, and the need to evolve fund structures to accommodate these type of assets. All of this suggests that circumstances are coming together to allow these assets to be made available for individual savers.

¹³ <https://www.pensionspolicyinstitute.org.uk/media/3270/20190919-the-dc-future-book-2019.pdf>

¹⁴ <https://www.gov.uk/government/consultations/defined-contribution-pensions-investments-and-consolidation>

¹⁵ <https://www.uss.co.uk/news/all-news/2020/01/uss-becomes-one-of-first-uk-pension-schemes-to-enable-dc-members>

¹⁶ <https://www.theia.org/sites/default/files/2019-06/PolicyPaper-June2019.pdf>

O4 What needs to happen to enable more individual investors to access these asset classes?

In the previous section we have described a selection of asset classes which are familiar to institutional investors but could potentially help individual investors looking to generate regular income from their investments at a time of ‘disappearing dividends’. In this section we consider what would need to happen to make this a reality.

The three broad asset classes or approaches to investing we have described vary considerably in the extent to which they are already readily accessible to retail investors. Most can be accessed in the form of ‘exchange traded funds’ (ETFs) but in most cases there is limited choice, and individual investors will need help in deciding which, if any, are appropriate to them.

Conclusions for individuals

- Ask your adviser how dependent your income portfolio is on UK shares
- Look at the income model portfolios available on your platform and look at their exposure to global equities and higher-yielding bonds. There is a substantial range out there, some model portfolios already make use of some of these assets, others remain dependent on UK equities

Conclusions for Private Wealth Managers

- You can help clients looking to replace lost investment income by advising them on the availability and suitability of the sorts of investments we have described in this paper and considering their inclusion into model portfolios; not all will be suitable in all cases, but generating investment income in a world of declining dividends will require creative thinking on the part of advisers and the wealth management industry;
- Some of the investments discussed may already be present to some degree in portfolios, but a small allocation may not be enough to really benefit
- Wealth managers’ investment teams can add value in two specific ways:
 - 1) By being proactive in setting clear objectives to asset managers for the design of new products that best fit their clients (rather than being “takers” of existing products)

- 2) Blending the products on offer from a variety of managers appropriately to deliver a balanced and diversified portfolio that still benefits from a lot of manager expertise in individual areas

From an investor's perspective they can then have a one-stop income solution, which is easier and more efficient to access. In an environment of pressure from low-cost tracker alternatives, this is an area where private wealth managers can demonstrate their value-add. For wealth managers less familiar with these assets, consultants such as LCP can help with questions like:

- Defining realistic investment outcomes around which to build portfolios
- How to define an appropriate mandate to meet desired outcomes
- How best to blend different strategies
- What the most competitive manager fee-rates are
- How to incorporate Responsible Investment appropriately

Conclusions for industry

- There is a need for regulators to work collaboratively with industry bodies such as the Investment Association to ensure that the vehicles used to deliver these strategies are appropriate and classified in a way that is helpful to end users.
- The benchmarks used to assess client performance (such as the IA Sectors, ABI Mixed Investment indices and Private Client Indices) deserve further scrutiny as these drive behaviour and can embed significant allocations to particular countries and sectors, and restrict the extent of effective global diversification and use of new asset classes.
- A rationalization of the relevant IA sectors seems much needed. The IA sectors are often used by investment advisors as a guide to a fund's characteristics when building portfolios, and they also shape the strategies and products that managers launch as managers will be drawn to launch funds in sectors that are attracting a lot of assets. Currently there exist ten different sectors relating to income¹⁷, half a dozen different sectors relating to bond income including sterling high yield, global bonds and three separate emerging market bond sectors, this seems like too many.
- The popular Sterling Strategic Bond sector (£43bn of assets¹⁸) and Global Bonds (£67bn) seem increasingly unfit for purpose here as these span a very wide range of funds, with many managers erring toward conservatism at the lower risk end. At the time of writing only 8 funds in the Strategic Bond sector (out of 80+) have yield levels of over 5%p.a., and none in the Global Bond sector meet this level of yield, meaning that most funds in these two popular sectors are not investing in a way consistent with generating the sort of income levels we discuss in this paper.

¹⁷ <https://www.theia.org/industry-data/fund-sectors/classification-schematic>

¹⁸ <https://www.theia.org/industry-data/fund-statistics/statistics-by-sector/21>

- Liquidity is rightly a key concern for funds investing in the type of securities discussed in this paper and not all of the investment styles we have profiled are compatible with daily-dealing funds (which is what the majority of funds available to UK individual investors are). Regulators and industry bodies could consider the role of monthly dealing funds in delivering the investment outcomes that savers need; The announcement by the IA in June 2019 of a Long-Term Asset Fund structure¹⁹ is a welcome development in this area.

Investing in emerging market credit or illiquid credit may feel for small investors a world away from simply buying shares in ‘blue chip’ FTSE-100 companies in order to generate a regular income from dividends. But those who advise them can help to ensure that they are aware of the much broader range of types of investment available to them, make an honest appraisal of the risks without falling victim to psychological biases, and can help construct portfolios which better meet their needs in a rapidly changing world.

¹⁹ <https://www.theia.org/media/press-releases/ia-lays-out-vision-future-investment-management-industry>

05 Glossary

Yield – a mathematical calculation of the future earnings generated and realized on an investment over a particular period of time. The calculation includes the interest earned or dividends received from holding a particular security and the value of any maturity payment. The inclusion of the maturity payment in the calculation means that yield can differ technically from the ongoing (or “running”) level of income paid. The yield is expressed as a percentage of the value of the security in question. Yield varies inversely with price of the security (as the price declines, the yield increases – other things being equal – and vice versa).

Income – money (or some equivalent value) that an individual or business physically receives on an ongoing basis, through investing capital. The income will typically be expressed as a percentage of the value of the bond or portfolio in question.

Coupon – annual interest rate paid on a bond, paid from issue date until maturity. Coupons are usually referred to in terms of the coupon rate (the sum of coupons paid in a year divided by the face value of the bond in question). The coupon rate on a bond is fixed at issue and typically does not change. Coupons are typically set around the level of yield prevailing at the time of issue of the bond. If interest rates fall substantially, older bonds with higher coupon levels will tend to trade substantially above par (the bond’s price will be more than £100 for every £100 of maturity payment).

Exchange Traded Fund (ETF) – a type of security that involves a collection of securities — such as stocks—that often tracks an underlying index. They are listed on exchanges and ETF shares trade throughout the day just like ordinary stock.

Dividend Cover – measures the number of times that a company can pay dividends to its shareholders. The dividend coverage ratio is the ratio of the company’s earnings divided by the dividends paid to shareholders over a particular period of time.

Credit rating – quantified assessment of the creditworthiness of a bond. Determines the interest rate at which the bond will need to be repaid.

Investment Grade debt – bonds with a relatively low risk of default. These bonds have credit ratings of BBB- and above from Standard & Poor (“S&P”), or Baa3 and above from Moody’s.

High-yield debt – bonds that pay higher interest rates because they have lower credit ratings than investment-grade bonds. These bonds have credit ratings below BBB- from S&P, or below Baa3 from Moody’s.

Private debt – debt issued by companies which is not available to be publicly traded. Most commonly involves non-bank institutions making loans to private companies or buying those loans on the secondary market.

Default – failure to repay a debt, including interest or principal on a bond.

Contact us

If you would like more information please contact your usual LCP adviser or one of our specialists below.



*Dan Mikulskis,
Partner*

+44 (0)20 3922 1318
Daniel.Mikulskis@lcp.uk.com



*Hishendhra Ravindra,
Partner*

+44(0) 20 7432 6759
Hishendhra.Ravindra@lcp.uk.com

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Lane Clark & Peacock LLP
London, UK
Tel: +44 (0)20 7439 2266
enquiries@lcp.uk.com

Lane Clark & Peacock LLP
Winchester, UK
Tel: +44 (0)1962 870060
enquiries@lcp.uk.com

Lane Clark & Peacock Ireland Limited
Dublin, Ireland
Tel: +353 (0)1 614 43 93
enquiries@lcpireland.com

Lane Clark & Peacock Netherlands
B.V. (operating under licence)
Utrecht, Netherlands
Tel: +31 (0)30 256 76 30
info@lcpnl.com

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