weekly digest

momentum

4 February 2019

Investing for income

Andrew Hardy, CFA

Last month we launched a new multi-asset income sub-fund within the Momentum Harmony Portfolios, our Luxembourg UCITS fund range. We've seen strong demand for this strategy which reflects the low interest rate environment but also a general lack of investment options that deliver a reasonable level of income with only a modest level of risk. While many other income funds carry more underlying risk than the investors may appreciate, if they have jumped to conclusions from the income nomenclature and yield targets, we believe a well-managed multi asset income strategy offers a far safer and more robust solution.

> *"Diversification is the only 'free lunch' when investing"*

Whatever the level of income an investor requires they can and should derive it from a diversified portfolio spread across several asset classes. Diversification is the only 'free lunch' when investing; it enables one to mitigate the specific risks inherent in one asset class - be it stocks, bonds, property or any other - without having to compromise on return potential. Taking this a step further, introducing positions in asset classes with differentiated and less correlated return drivers, such as listed infrastructure or asset backed securities, can significantly enhance income potential whilst further reducing overall risk. The higher yields in such asset classes come hand in hand with less regular market liquidity, which is often a considerable risk but one that can be effectively managed by gaining exposure through listed companies or closed ended vehicles (investment trusts).

> *"Investors should ensure they are adequately compensated for the risks they bear"*

The optimal mix across the gamut of different asset classes can vary significantly over time as relative valuations and fundamental characteristics evolve. For example, so called high yield bonds, issued by companies deemed to have low credit worthiness, usually offer a relatively high yield due to their structurally higher leverage and thus higher default risk. There have been times in recent years when this asset class has offered compelling value despite the higher level of risk, but today we believe many bonds in this area do not offer enough additional yield over higher rated bonds, especially in the US where the economy is closer to the end of this credit cycle than the beginning. It is dangerous to simply chase the highest yields, instead investors should ensure they are adequately compensated for the risks they bear.

> *"Investors looking to maintain a certain level of income into retirement should ensure the capital value of their portfolio remains stable in inflation adjusted terms or better yet grows"*

Yield sustainability is another critical factor to consider. Tempting as it can be to extract more distributions from a portfolio, if the pay-outs exceed the underlying cash generation then something must eventually give – with a single company eventually the dividend gets cut or they must raise more capital, but in a diversified portfolio or fund the effects will often be subtler with capital value gradually being eroded. Many fixed income funds face this risk at present because bond yields are no longer high enough to meet the distributions promised to investors, so some funds which have the flexibility to pay distributions out of capital do just that. Investors looking to maintain a certain level of income into retirement should ensure the capital value of their portfolio remains stable in inflation adjusted terms or better yet grows, otherwise the purchasing power of the dividends may diminish over time.

These various issues can easily combine to result in greater than expected volatility in a portfolio valuation, unreliable or unsustainable distributions or even an inability to liquidate when necessary. At Momentum we carefully navigate and manage these issues in the construction of our income focused portfolios, but investors should also be alive to some of these risks that may be lurking in their portfolio.

Market Focus

- Strong US nonfarm payrolls
- Leading indicators suggest eurozone activity continues to weaken
- Brent crude rallied 1.8%, ending the week at $62.8 per barrel
- Gold ended the week 1.5% higher at $1317.7 per ounce

US

- Nonfarm payrolls in the US increased by 340,000 in January 2019, beating all forecasts. However, the partial federal government shutdown contributed to the uptick in the jobless rate to 4%
- The Federal Reserve held interest rates steady on Wednesday and reaffirmed its position to be patient about further policy tightening in light of recent global economic and financial developments and muted inflation pressures
- The dovish comments made by the Fed helped encourage a decline in longer-term bond yields, with the 10-year Treasury note falling to 2.68%
- The ISM Manufacturing PMI in the US jumped to 56.6 in January 2019 from an upwardly revised 54.3 in December and beating market expectations of 54.2
- US equities rose 1.6% buoyed by strong Q4 2018 earnings results

UK

- The British pound depreciated 0.7% against the U.S. dollar in the week as the House of Commons gave Prime Minister Theresa May a mandate to seek modifications to the withdrawal agreement between the UK and EU. The most contentious issue remains the so-called backstop. European Commission President Juncker warned May that any attempt to reopen Brexit negotiations with the EU will increase the chance of a disorderly Brexit
- UK equities rallied 3.1% in sterling terms while UK Gilts returned 0.5%

Europe

- The eurozone economy grew 0.2% in the final three months of 2018, matching the third quarter rate, which had been the lowest since the second quarter of 2014.
- Italian stocks declined 1.2% on the week as economic data pointed to Italy's economy tipping into recession at the end of last year. The economy shrank by 0.2% in the final three months of 2018, following a 0.1% decline in the third quarter
- The IHS Markit Eurozone Composite PMI dropped to 50.7 in January 2019 from 51.1 in December and below market consensus
- Despite Brexit concerns and Italy's economy slipping into a recession, continental European equities made slight gains, advancing 0.3%

Rest of the World/Asia

- Brent crude was boosted by OPEC oil supply falling in January by the largest amount in two years and the prospect of lower supply from Venezuela after US President Trump imposed sanctions on its oil industry
- Chinese equities advanced 0.6% boosted by upbeat trade discussions with the US

Currency returns					
Asset class/region	Currency	Week ending 01 February	Month to date	YTD 2019	12 months
Developed markets equities					
United States	USD	1.6%	0.1%	8.1%	-2.7%
United Kingdom	GBP	3.1%	0.7%	4.4%	-2.3%
Continental Europe	EUR	0.3%	0.3%	6.3%	-7.0%
Japan	JPY	-0.1%	-0.2%	4.7%	-14.5%
Asia Pacific (ex Japan)	USD	1.3%	0.0%	7.3%	-12.9%
Australia	AUD	-0.7%	0.0%	3.8%	0.5%
Global	USD	1.4%	0.1%	7.8%	-6.5%
Emerging markets equities					
Emerging Europe	USD	1.5%	-0.2%	11.5%	-11.4%
Emerging Asia	USD	1.7%	0.2%	7.5%	-15.2%
Emerging Latin America	USD	2.5%	0.1%	15.1%	-5.9%
BRICs	USD	2.4%	0.4%	10.3%	-13.6%
MENA countries	USD	1.0%	0.0%	6.4%	7.2%
South Africa	USD	1.1%	-1.4%	10.6%	-18.7%
India	USD	0.3%	-0.1%	-2.1%	-10.2%
Global emerging markets	USD	1.7%	0.0%	8.8%	-13.8%
Bonds					
US Treasuries	USD	0.4%	-0.3%	0.2%	2.8%
US Treasuries (inflation protected)	USD	1.0%	-0.2%	1.2%	1.0%
US Corporate (investment grade)	USD	0.9%	-0.1%	2.2%	0.9%
US High Yield	USD	0.8%	0.1%	4.7%	2.0%
UK Gilts	GBP	0.5%	-0.2%	0.9%	3.8%
UK Corporate (investment grade)	GBP	0.9%	-0.1%	1.8%	0.6%
Euro Government Bonds	EUR	0.0%	-0.3%	0.8%	2.0%
Euro Corporate (investment grade)	EUR	0.5%	0.0%	1.1%	0.1%
Euro High Yield	EUR	0.5%	0.0%	2.2%	-2.0%
Japanese Government	JPY	0.4%	0.3%	0.9%	2.3%
Australian Government	AUD	0.0%	0.2%	1.0%	6.7%
Global Government Bonds	USD	0.5%	-0.3%	1.0%	-0.8%
Global Bonds	USD	0.6%	-0.2%	1.2%	-1.1%
Global Convertible Bonds	USD	1.0%	0.2%	4.3%	-4.2%
Emerging Market Bonds	USD	1.0%	0.1%	5.2%	0.2%

Source: Bloomberg. **Past performance is not indicative of future returns.**

Currency returns					
Asset class/region	Currency	Week ending 01 February	Month to date	YTD 2019	12 months
Property					
US Property Securities	USD	3.0%	-0.7%	10.9%	11.5%
Australian Property Securities	AUD	-0.8%	-0.4%	5.8%	6.8%
Asia Property Securities	USD	1.7%	-0.7%	8.7%	-4.0%
Global Property Securities	USD	2.4%	-0.6%	9.9%	2.2%
Currencies					
Euro	USD	0.6%	0.2%	0.1%	-8.1%
UK Pound Sterling	USD	-0.7%	-0.3%	2.7%	-8.1%
Japanese Yen	USD	0.2%	-0.7%	0.1%	0.0%
Australian Dollar	USD	1.2%	-0.1%	3.1%	-9.5%
South African Rand	USD	2.2%	0.1%	8.1%	-10.8%
Swiss Franc	USD	-0.1%	-0.1%	-1.2%	-6.6%
Chinese Yuan	USD	0.1%	-0.7%	2.0%	-6.6%
Commodities & Alternatives					
Commodities	USD	0.5%	0.9%	7.5%	-5.5%
Agricultural Commodities	USD	0.0%	0.1%	2.3%	-5.7%
Oil	USD	1.8%	1.4%	16.6%	-9.9%
Gold	USD	1.5%	-0.3%	2.8%	-1.8%
Hedge funds	USD	0.4%	0.0%	2.1%	-7.1%

Source: Bloomberg. Past performance is not indicative of future returns.

For more information, please contact:
Anastasiya Volodina
Distribution Services
E: distributionservices@momentum.co.uk
T: +44 (0)207 618 1806