Learning outcomes: 1. How a natural income approach compares to a fixed rate of income withdrawal 2. The difference between yield and income 3. The main asset classes for generating long-term income growth MIKE HAMMOND: I think the factors that are driving the demand for income have actually been around for a while now. So we've seen significant change in demographics, the world is becoming older, and therefore people are reaching retirement and there are a large number of clients in that sector of the marketplace. And then obviously they're living a lot longer now, so we're seeing people live much longer than they were previously. I heard a story the other day that the oldest person in the world was about 114, 115, and they were predicting that when my son who's 17 gets to my age the oldest person in the world will be somewhere around 150, which is clearly a frightening thought. So people living longer, and then on top of that you've got a very low interest rate environment, and people are looking for alternatives to cash and other alternative assets for income. And then more recently in the last two years we've had the introduction of pensions freedoms, which again has helped the demand for income. So as far as we're concerned it seems to be a trend that's growing and one that we see being there for some considerable time. PRESENTER: But what do you say to those people who think that there's a safe withdrawal rate of income that you can take, even if it means you have to cash in a bit of your capital? MIKE HAMMOND: That's an interesting debate, Mark, which has been kicking around the market for some considerable time now, and there's lots of articles that are written about it in terms of what is a safe withdrawal rate and what isn't? I think our view is that natural income is the right way to go in terms of delivering income, particularly if you're looking for income over the longer term. And what we've got on the screen is some slides here which show the different types of issues that you need to consider when you're either thinking about natural income or whether you're talking about unit encashment. So in the first scenario here we're talking about somebody who's investing £100,000 and the options are to go into an average fund in the mixed 20-60 sector, and then taking a withdrawal, and then looking at investing in the Premier Multi-Asset Distribution Fund, and taking a natural income, i.e. the natural income that that fund delivers. Now, we have used a start date here of 1st of April 2009, and simply the reason we're using that date is that's the beginning of effectively the bull market. And as you can see we've withdraw capital from the mixed 2060 sector, and we've taken natural income. And broadly those two figures are very similar. The only consideration from a financial advisory point of view is obviously if you're unit encashing then that's subject to capital gains tax; whereas when you're taking your natural income if it's outside of a tax wrapper, then potentially that's subject to income tax. What you can see is the capital values are very different in both scenarios over the period that we're talking about. But the key thing is that in taking a natural income from the multi-asset distribution fund the number of shares that you've got, i.e. the number of shares that you bought at outset, remain intact. So you haven't actually reduced any of your shareholding. Whereas if you're taking unit encashment you can see that you've actually reduced the number of shares that you've got by just over 36%. And if you look on the next slide, we look at a slightly different scenario here. It's exactly the same but the only difference is that we've taken a slightly different start date of the 1st of April 2000 when we're going into a falling market. And in that scenario you've got either the cash withdrawal or the income being very similar levels, but the big difference now is that you've had to encash a lot more shares to actually generate that cash withdrawal. So you've actually reduced your shares by just over half, i.e. 58%, and your capital values are very different. If you're thinking about looking at the long-term income solution, that can potentially create a problem for you, as you can see from the slide here, because what you've got now is you've got a situation where the actual graph is showing you pictorially what this looks like, so the blue line is investing in the multi-asset distribution fund. Because you've got your shares intact, what that actually means is that when you get to the bottom of the market you can see that your fund can still recover; whereas within the 20 to 60 sector the average fund there, you've got a situation where because you've got to the bottom of the bull market unfortunately it can't recover because of the issues around the fact that you've reduced your share base. PRESENTER: Well, Simon, if natural income is so important to investors, what does a good natural income fund look like? SIMON EVAN-COOK: Well we're in the position of being both the managers of income funds, and we're also a buyer of income funds, so we've got quite a lot of experience at looking for good income funds, good income fund managers. Really the important thing to think about is is the fund manager actually an income manager, as opposed to being a total return manager? Is that what they're actually trying to achieve? Because quite often you have different types of managers. They might have the name "dividend" in the fund title, might have the name "income" in the fund title, but really what they're after is total returns. Whereas what you really want to understand is your fund manager actually, if you want them to produce an income are they focusing on producing that income? Now, the best way of judging that is to quiz them about, not about the yield of the fund but about the pence per share, the dividends that their fund is actually producing. Now, we've got a chart here that shows that quite nicely. This is in respect of one of our funds, one of the funds that the team I belong to runs the multi-asset distribution fund. And what the blue bars show there are the pence per share. So that's the amount an investor is actually getting in their bank account, obviously multiplied by the number of shares they have, and really if you're an income investor that's what matters to you. You want to be able to pay your bills or go on holiday or whatever it might be when you get your income payment in. And obviously if an income payment doesn't appear then you're going to be very upset about that. So that's really the crucial thing is to understand that firstly that's what they're trying to do. So the counter example is if they're only focused on the capital return or the total return, then as a manager you might be tempted to go into a low yielding or a nil yielding asset. So you might be tempted to go and buy gold, which is something we've never done in this fund. It doesn't yield so it's got no place being in our income fund. We want assets in there that are going to help our investors to earn. And another thing that people don't really understand with this type of investor is what yield actually is, and what it means and what affects yield. So yes the amount of income you produce affects the yield figure, but the other input into that yield calculation is price. And so if the price of any investment has risen quite a lot, then the yield has dropped. But that doesn't mean the income payments actually drop. So you've got to be aware of that. And that's why sometimes just chasing a high yield can lead you to difficulties, because you're actually, particularly if you're late on in a market, if you're buying something with a high yield, then what's left are really riskier investments. So it's important to understand that high yield has risks with it. So all these factors you need to understand. This chart shows that quite well. You go back to, let's take 2009 there with this fund. Our fund at that time was yielding 6.7%. You can see there's not a massive difference between that and a couple of years before when it was yielding 3.5% in terms of what you're actually getting in your bank account. But because the price, given the fact that that was the financial crisis, had dropped, then the yield appears higher. And now I'll fast forward to today, we're yielding around about 4.3%, in the mid 4s percentage-wise. But the income has actually risen over that time. So the yield has dropped but you're actually getting more pence per share than you were when the yield was up over 6%. So it's important to understand the difference between yield and income. That's crucial to understand. So we have to understand all these things and make sure that an income investor is actually focusing on doing that job for their clients. PRESENTER: Now when there's a stock market crash the value of shares goes down, typically what happens to the value of those dividend payments, those pennies that you were talking about earlier? SIMON EVAN-COOK: If you get it right, and you are in the right assets that protect their income, then what happens is you get a level of protection on the capital side from that. Yes, in a stock market say if you're buying a dividend paying equity, the equity price probably will drop. But it might drop less than those equities which aren't paying a dividend. And then if it continues paying that dividend, and particularly if it continues growing it, then eventually what will happen is that price will rebound to reflect that because people always want to pay for a good income stream. So there is a total return argument for holding an income fund. So it's not to say that an income fund can't be a good total return vehicle. But if your focus is on income I'd say first and foremost make sure that your income manager is at least aware of what is happening with the dividend payments that you'll be receiving in your bank account. PRESENTER: And Mike, do you think most investors understand this concept of natural income? MIKE HAMMOND: As a generalisation I think the average man in the street doesn't understand natural income, for all the reasons that Simon just alluded to. It's this complication around yield and dividend pence per share. So if you look at any data you typically see the yield, but you don't see the pence per share. And I've had numerous conversations with various members of my family and various friends, and it's clear that most members of the general public seem to think like a building society investor. So what that effectively means, if they've got more cash they get more income, if they've got less cash they get less income, and clearly investing in this type of environment that's not necessarily the case. And what we've done is we've created a schematic which tries to clearly show what happens in different scenarios. So, on the left-hand side, we're talking about a market rise. So client's investing £100,000, we're assuming that the share price of the fund or the company is £1, so their capital value is £100,000. Let's assume that that pays 5p dividend per share. You've effectively got a yield of 5%, and your income is £5,000. So what happens to that income, what happens to the yield when capital values go up? So in this scenario market or the share has gone up to £1.20, which is obviously a nice healthy 20% increase; the number of shares that you've still got remains intact, i.e. 100,000, but now your capital value of those shares is £120,000. But if that company or that fund is still paying a 5p dividend, effectively it means that your income stream is still the same, i.e. you will still receive £5,000 worth of income. But more importantly to a new investor they've now got to give you £120,000 to buy that 5p dividend, and therefore as a result of it to the new investor the yield has dropped to 4.2%. Conversely, if you go into a market full scenario, you've got exactly the same in terms of the share price has gone from £1 to 80p. The number of shares is still intact, so you've still got your 100,000 shares, but your capital value has now dropped from £100,000 to £80,000. However if that company still pays you the 5p per share, then that means you still get your £5,000 income even though your capital value has fallen. Conversely, if you're a new investor, you're actually only having to pay £80,000 to buy that 5p income stream, so your yield has increased to just over 6%. So there is a clear differential between pence per share and dividend. And therefore from an adviser's point of view the key thing that the advisor needs to be looking at and reviewing and monitoring is not as Simon said the yield, but more importantly the actual pence per share that the fund managers are paying from those funds. PRESENTER: And Simon, talk us through in a bit more detail the multi-asset team's approach to managing income funds. SIMON EVAN-COOK: There's only really two things you need to know from the highest level about what we do. There are two principles that underpin every single decision we make on the income funds, and all the other funds we run as well. The first of those is that we're outcome based investors. So for each of the funds that we run it has a very specific and well defined outcome, which should match up with the outcome that the end investor is actually looking for. So in the case of our income funds we have one that's looking for a high income today and we're hoping to keep that stable. And in the case of the multi-asset distribution fund we're looking for a reasonably high income but that will grow over time, so it'll give you a little bit of protection over your standard of living with the income. So when we're making investment decisions we as managers are well aware of that consideration. And so we're looking at making sure we hit those outcomes for each of those funds. So that's at the heart of each investment decision. Now, the other thing to consider, the other principle that is at the heart of everything we do is valuation. So when we're looking at assets, when we're looking at markets, when we're making investment decisions, what we're judging is the valuation of the asset that we're holding. We're looking at the quality, the fundamental value of what we're holding, and that's what's really key. So what is, that means we're not doing is trying to forecast what's going to happen to interest rates or to macroeconomics or politics or anything like that at all; it's really understanding what we're buying, and making sure we're getting good value for money. Now why that's important is because it means that what we're doing first of all with the funds is making sure as I say that each asset we buy is going to help with that outcome on the first case. So it's going to help the growing income fund to grow its income, so we're looking at the individual asset. Making sure that it is an asset that pays a decent level of income, and that that income is going to grow over time. The quality of it is there as well. But the other side of that, this is where the value part comes in, is making sure that you're not overpaying for that. So you're not having a threat to either your capital from that valuation dropping back down to a reasonable level again. Also you're not overpaying in terms of the yield is too low for what you're getting. And conversely we're judging the quality as well, so we're making sure we're not buying weak quality assets where the income may be high today, but it's going to come under serious threat in future, and therefore threaten that income stream. And it all comes back effectively to making sure that that pence per share that our clients get hits what they're expecting from it. PRESENTER: Given that primary focus on pence per share, does that mean you're a bit more relaxed about capital volatility, at least in the short term? SIMON EVAN-COOK: In some sense we are, in others we're not. We're well aware that it's very important to clients to have their capital be relatively stable. But at the same time this is a high yielding fund, it is in assets whose prices will fluctuate on a day-to-day basis, so there is a level of acceptance that that will happen. But at the same time really what underpins it is if we get the income right, which is to say if we buy assets whose income remains stable or it remains growing and it doesn't get cut or it doesn't default, then while the price may move around that level ultimately it will come back and reflect the fact that if you buy that asset you're going to get that decent level of income. So there will be capital fluctuations but we think it's quite a stable way if you focus on the income and get that right, the capital will tend to follow you. PRESENTER: And what's your preferred asset class to produce long-term income? SIMON EVAN-COOK: Well this chart here shows where we're currently investing. You can see there the majority of that, half the fund is in equities currently. And particularly this is relevant where we're trying to grow the income. Because if you're looking to achieve a decent income today, and you're looking to grow that, which is obviously important if you're retiring today, you're 65 and you may have 30-35 years left of retirement. It's important to still have the same standard of living in terms of what you can afford to buy in 35 years as you can today, so growing income is important. Equities are a very good way of doing that at the best of times. At the current time, particularly with bonds where they are, equities look like a very good way of doing that, in the sense that good dividends from decent companies tend to grow over time, certainly match pace with inflation of not slightly outpace inflation. So providing you're not overpaying for equities at any given time, then as a long-term income producing asset then equities are a very good vehicle. And at the current time we don't think they're the bargain of the century, but we do think they look reasonably good value for money. PRESENTER: And you've got a big exposure within equities to UK equities, why that big domestic bias? SIMON EVAN-COOK: The big domestic bias there is partly because we are a UK fund manager, and we only sell our funds to UK investors. So when we're talking about an outcome, we're in the privileged position of being able to say that this is an outcome based on sterling-based investors. So what we want to do is make sure that the income stream we produce is relevant for people in the UK. So it makes sense for us to have a decent slug of UK equities there. And then again at the current time there are plenty of companies across the market cap spectrum which are producing good dividends, and the valuations that you're currently being asked to pay for them, particularly compared to some markets, most notably the US, are actually pretty reasonable, and post-Brexit have become even more reasonable given that there has been a little bit of pressure on their prices. PRESENTER: One thing that does make a change over timeless returns is fees. Why not simply go passive in this space? SIMON EVAN-COOK: If you look at what you're buying in passive it's going to be market weighted generally. And you look at what the UK market, and we use the example of the UK market, is buying you tend to be very loaded into a few number of shares, maybe just four, five, six UK companies. Now you think back to what's happened to the likes of Tesco, to the likes of BP, they've all been very big constituents in those income producing assets in the past. But the dividend can come under threat. So you're taking big business risk. Whereas what we tend to do is try and diversify that as much as possible. So we're looking for active managers who are looking further away from those areas, who are looking at mid caps, maybe in some cases in small caps, to make sure that income stream is as diversified as possible. Now the rub of that is you have to pay a little bit more for those active managers to do that, and to also assess the quality of the assets that you're buying to hopefully avoid those hiccups. But as our performance has shown over time, which is all after fees, that's worth doing to help you avoid those areas of hiccups and to get you into the best income producing areas. PRESENTER: Well, Mike, you're out talking to advisers the whole time, I mean obviously you're promoting this active approach. But what time period should advisors judge whether that's successful or not compared to passive? MIKE HAMMOND: Well, ultimately, Mark, the objective of these funds is to deliver an income over the longer term, and people should be investing in these funds for the long term. So the key driver is whether we're delivering the types of outcomes that the clients are looking for over the long term. So in our view the measurement should always be over the longer term, not the shorter term. PRESENTER: Now bonds have traditionally been seen as a low risk asset class, would you categorise them as that today Simon? SIMON EVAN-COOK: That's a very good question, and it's probably the $64 million question at the current time, given what's happened to bonds, particularly over the last decade but even longer than that. You've seen yields come down and prices rise. We're very wary of bonds at the current time. As an asset class, particularly for income investors it's very useful given the income it pays and the quality of the assets that are paying those incomes. But at the same time you got to a situation where they've been so popular and there's been such a big demand for particularly the highest quality bonds, so I'm thinking gilts in this case, that yields have been driven down to very low levels to the point in many cases where they're actually lower than inflation is currently. Now that to us creates a problem. In some cases you're almost guaranteeing yourself a capital loss by holding them if you hold them to maturity. And as value investors that makes us inherently uncomfortable. So we're avoiding some of the most obvious areas. Gilts is a very good example where you're just not being compensated in terms of the income you're receiving for the risks that you're taking on. Now that's not a default risk, we don't think the UK government is about to default. Really the big risk is inflation. Is inflation about to rise? It doesn't take much a rise, and for interest rates to rise, for that to take quite a lump out of the fixed income that you're getting. So we're very wary about that. So when we do own bonds, and we do own bonds, we're looking off the beaten path to a certain extent, and we're being very conscious of that interest rate risk, and making sure that the assets that we own are going to do that job for us, are going to give us a level of protection. So when I say off the beaten path, the type of thing we're looking at can be corporate loans, it might be asset backed securities. You can take corporate loans as an example here. We own a fund there. When people are issuing or when companies are issuing corporate loans, they tend to be linked to Libor in the sense that they are, if Libor rises in response to inflation, then the coupons these corporate loans pay will rise with it, which to us gives us that level of protection particularly for the income holders that we're interested in achieving. The other issue with bonds currently is that you're seeing volatility of gilts pick up quite a lot. They're getting to the point where they're actually becoming quite a volatile asset class as people worry about inflation, and then stop worrying about inflation and start thinking about deflation. The moves have been quite severe. So it being that kind of classical low risk investment, that seems to have gone out the window a little bit. Now, we've got some of our bond holdings. Here on this chart are various different types of holding we have here. But the key line really to look at there is the light blue line. Now that very clearly looks like the most volatile line on that chart, and that is gilts. The other lines represent different holdings that we own, so the green line there is a corporate loan fund. The other lines are asset backed security funds, which have tended actually, despite the fact they're being perceived as maybe being slightly higher risk, have actually turned out to be less volatile over time. So that's the kind of areas we're looking in. We want to make sure that the assets are secure, the income is secure, but at the same time we want to make sure that we're not overpaying for that, and therefore at risk of either a correction of prices or particularly driven by inflation. PRESENTER: And what's your outlook for property? I mean it went through some rather interesting times at the back of the Brexit vote. SIMON EVAN-COOK: Yes very interesting times, and coming up to the Brexit vote as well. So we were, we tend to be quite glacial in terms of our asset allocation changes. We don't make big whopping great shifts on a sixpence; we tend to move quite slowly. But one area that's been a slight exception for us has been property recently. So you go back to 2013, we had some closed-ended property but we had no open-ended commercial property. But at that time we'd seen equities do particularly well, so they'd risen quite a lot. And you'd see commercial property funds and prices be a bit of a forgotten asset class. But actually that meant that valuations looked good, particularly related to equities. So at that point we went from holding none of those assets through to holding quite a lot in both of the funds. Because we thought actually the capital risk was quite low, the yields were pretty reasonable compared to other areas, so for us that's exactly how we operate. We're always looking to seek value and strong income streams, which we did in some volume. But then you fast forward to the end of 2015, so again we're still before Brexit, it was still a twinkle in David Cameron's eye at that point. And we're now getting to a point where actually yields have come down because the prices have corrected quite a bit. A lot of investors coming into that asset class before, and for us the risks particularly from liquidity started to outweigh the benefits. So at that point we started to move out of open-ended commercial property funds. Leaving some returns on the table, but better safe than sorry. That had nothing to do with Brexit at the time, that was purely to do with valuations, and we were largely out of those before Brexit. And then sure enough Brexit came around and you had all the issues around liquidity and fair value pricing, which didn't affect us. And again you see it come under pressure. So, last year 2016 was quite a tough period for open-ended property funds. It was something that affected us because we were mostly out of it by that stage. And we'd moved back to being interested in closed-ended property funds again. Now the reason we like closed-ended is firstly because you don't have to run large cash pots within those funds to cover people coming in and coming out, because it's a fixed pot of assets. And so the yields tend to be higher. So we have a chart here for property, which shows the yields that are available on what we own, which is closed-ended, versus what we don't, which is open-ended in the grey there. And you can see there we're getting decent incomes, decent yields from these investments now on very good quality assets. So we're quite happy to own closed-ended but we think open-ended, given how far yields have dropped, and given how much cash they have to hold, and give the liquidity concerns, it's not an area we're interested in holding currently. Now, in terms of Brexit, the reason we quite like commercial property is from a UK investor's perspective it seemed a bit of a blow to commercial property. But then you consider it from a, if you're an American or a European investor looking at commercial property, overnight on Brexit all these properties were available at a 20% discount to what they were available the day before because sterling dropped so much. So that's what people sometimes forget is that for an overseas investor commercial property in the UK suddenly looks a lot more interesting, even if you consider Brexit to be something of a negative for the UK market. So we're quite happy to hold some exposure, and where we do again we're very conscious about what we're holding. We do hold some more interesting areas there as well. So we hold the likes of Target Healthcare and Medic Suite we've held in the past as well. These are both trusts which focus on a specific niche area, being primary healthcare trusts, properties, which has an element of government backing given that the NHS is linked to that, but also tends to give it some resilience through a recession because you're never going to stop needing to go to doctors. PRESENTER: But if the UK's so attractive for those reasons, why look overseas? SIMON EVAN-COOK: Well it's changed quite a bit, the equity paying world, particularly over the last 10-12 years or so. It used to be the case that the UK was famed for being almost the only place to go and get dividends. But now the rest of the world to a certain extent is moving in that direction. So Europe, you take Japan, particularly Japan where there's a bit of a shareholder revolution going on, more and more companies are understanding about the power of paying dividends. More and more investors are putting pressure on companies to pay dividend. So more companies are paying dividends, and are more committed to paying dividends. So that opens up the world for us. And why we'd do that is because it again gives us the ability to diversify the income stream a little bit more, so we're not just relying on UK companies for that now, but also more opportunities. So at certain points it may be that Japanese dividends are cheaper than UK dividends are, or European equities may be cheaper. So again it gives us more ways to be able to increase the income we're paying and not overpay for getting that. So the more we can do that I think the better for our investors. PRESENTER: Well we're almost out of time. So Mike, if I can come to you first for a final thought, what is the outlook for income? MIKE HAMMOND: In terms of the demand for income Mark, I don't see that changing. In actual fact if anything I would see it increasing. We're still getting older, and with pensions freedoms the demand for income solutions is going to be increasing all the time. Anecdotally we're out seeing financial advisors on a regular basis, and one of the constant themes that is coming up is them looking for some kind of income solution. So I think the demand for income is going to increase. I just don't see that changing at all. PRESENTER: And Simon, from an investment point of view, isn't that worrying? If everybody wants income doesn't that tell you as a contrarian you say I should be buying growth? SIMON EVAN-COOK: It would do, but those demographic trends are very well set. There's plenty of things in investing that can change very quickly, demographics doesn't tend to be one of those. So in terms of how we view the investing world, that being a very long term pressure helps us to form a view on what we should be paying, and what is interesting to us. But really from our perspective, from an investment point of view, I think what we've got to keep doing, and what we do permanently is just concentrate on the income we're paying, and again the outlook differs depending on what you're looking at. If you're looking at it from an income perspective, so let's say you are a holder of our fund, then what we're confident we can keep doing is just keep that pence per share ratcheting up, or if it's in the case where we're trying to defend it we can defend it at a high level. So we can keep doing that. That's not an issue. But we can't guarantee is obviously that markets won't fall or rise in the meantime, so the capital side of it is much harder to predict, which is why we don't try and predict it. But I'm confident that even if we were to see a correction at any point over the next five to 10 years that as long as we get the income bit right then that correction will be temporary in nature, and you'll see the capital eventually come back to reflect the solid income producing elements. So again for us it's focusing on produce that income, and I think the rest will look after itself if we get that right. PRESENTER: We have to leave it there. Simon Evan-Cook, Mike Hammond, thank you both very much. MIKE HAMMOND: Thank you. SIMON EVAN-COOK: Thank you.