Global equity income - it's timing not time in that counts

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We live in an uncharted world with cash and bond yields at or near historic lows and 40% of the world developed government bonds trading with negative yields. The returns and income expectations on long-term buy and hold strategies have never been lower. Generating meaningful income and return in this environment calls for innovative thinking and an active mindset. While not traditionally known for income, there are literally thousands of dividend income opportunities amongst global companies. This paper documents short-term income and return generating opportunities within global shares which can provide income levels similar to Australian shares.

LONG-TERM RETURNS TO BE LOWER

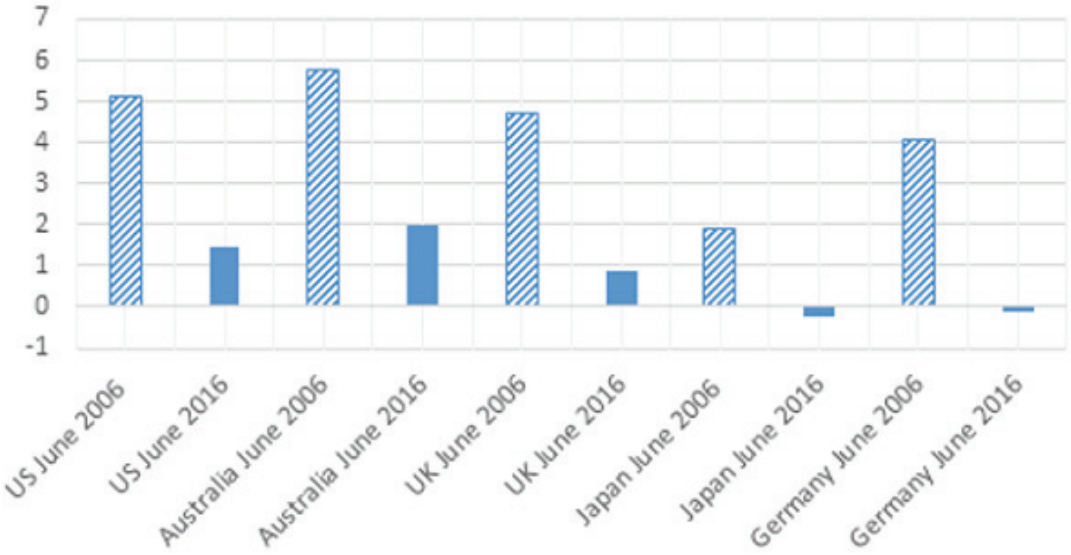
While many commentators have been warning that long-term returns are expected to be lower for some years (Mckinsey Global Institute, 2016), continuing falls in world developed market interest rates have helped deliver reasonable returns to investors. The short-term impact of falling interest rates is to bolster the returns on long-term bonds, and indeed any long-term assets which are valued using long-term interest rates. Equities have therefore also benefited from lower interest rates, particular the more bond-like equities such as infrastructure and REITs with fairly stable earnings.

Brightman (2012) notes that the starting yield-to-maturity that investors purchase bond investments at will determine the likely long-term return on those bonds. Joyce and Orr (2016) note that government bond yields in the developed world are currently trading at or near record lows, with an astonishing 41% trading with less than a zero yield-to-maturity and 80% of bonds trading with yields under 1%. Ten-year bond yields are currently trading on negative yields in Germany, Japan and Switzerland, with other major countries not far ahead of that mark (see Figure 1). The implication of this is that long-term buy-and-hold bond investors in Germany, Japan and Switzerland will likely earn negative nominal rates of return over the next 10 years, and a world bond portfolio will likely earn less than 1% given 80% of bond maturities are trading below that mark. The next decade will see seriously low bond returns.

Figure 1 also shows the comparable bond yields from 10 years ago, highlighting the expectation that future bond yield returns will be much lower than past bond returns.

Figure 1: 10-year Government bond yields in major markets

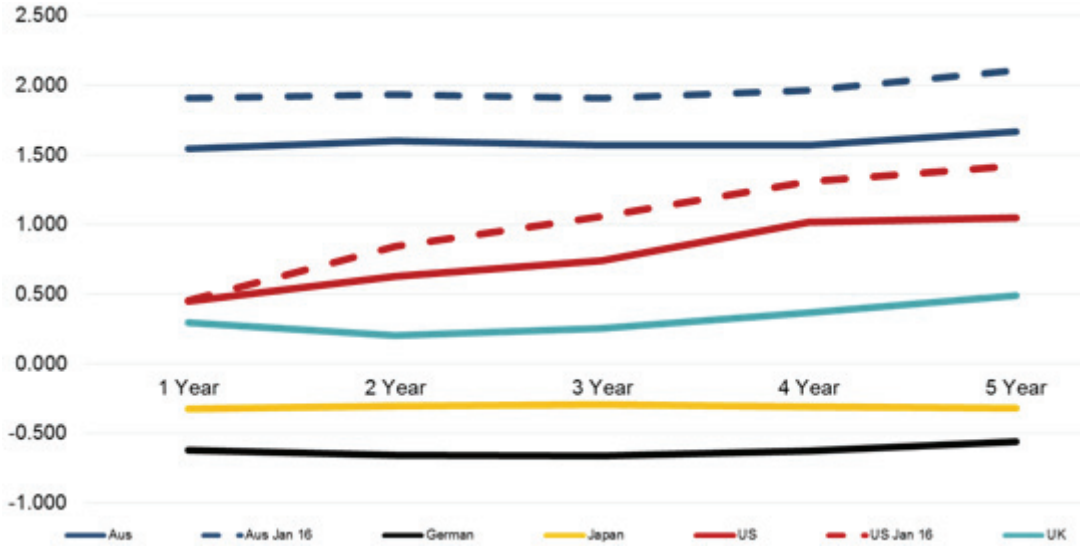
10-year treasury yields (%)



Sources: Factset

For Australians, the outlook is slightly better. Although bond yields are trading at record lows, the 10-year bond was nevertheless still yielding approximately 2% as at 30 June 2016. With Australian short-term rates higher and expected to remain higher (Figure 2) than rates on major developed markets, returns on a hedged global bond portfolio in $A are likely to provide around the same return level as our domestic bonds due to the hedging pick up on the short-term interest differential between Australia and foreign markets. Despite all this, the expected return on bonds and cash in the next decade is likely to be substantially lower than in previous decades. The current 2% 10 year bond yield in Australia is, however, substantially below the 6.7% realised Australia bond return recorded over the past decade (source Morningstar).

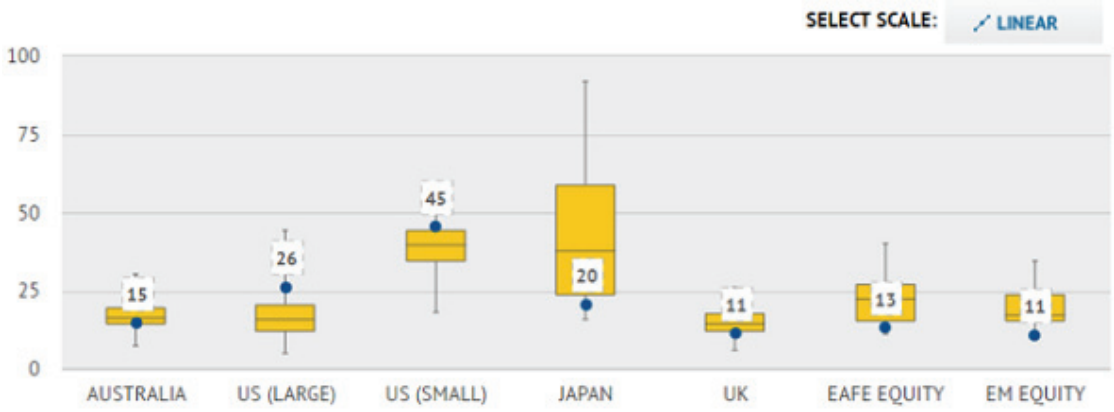
Figure 2: Short term interest rate expectations based on market yield curves as at 30/6/2016



Sources: Bloomberg, Plato.

Returns on equities are much harder to predict, but market valuation using the Shiller P/E can provide some guidance. Starting valuations are important for long-run returns. Figure 3 illustrates the Shiller P/Es for several markets compared to historical averages. US equities, which represent more than half of developed world equities (61.5% at 30 June 2016) are expensive, while some other major countries of the world such as Japan and the UK are trading at below average valuations. The outlook for individual equities markets is therefore mixed, but with the US market making up a substantial weight of the world market, the overall equity market is currently at a more expensive level compared to its long-run averages.

Figure 3: Shiller P/E for global markets
(30 June 2016)



Sources: Research Affiliates. These expected returns are calculated by Research Affiliates LLC using data provided by MSCI Inc. and Bloomberg. Data series have different start dates as indicated in each card above. This content is not investment or tax advice or an offer, sale or any solicitation of any offer to buy any security, derivative or any other financial instrument. Any use of the above content is subject to and conditioned upon the user's agreement with all important disclosures, disclaimers, and provisions found at www.researchaffiliates.com/Pages/Legal.aspx In the event the above content is provided or modified by a third-party, Research Affiliates LLC fully disclaims any responsibility or liability for such content. ©2016 Research Affiliates, LLC. All Rights reserved. This content is not investment or tax advice or an offer, sale or any solicitation of any offer to buy any security, derivative or any other financial instrument.

There is an old saying that it is time in the market that counts - meaning that the power of compound returns will deliver good cumulative returns over a long period of time. Given the low level of expected returns right now, especially in the cash and bond markets, time in the market at this particular juncture is unlikely to deliver good returns over the next decade. This is an incredibly challenging environment for traditional buy-and-hold approaches. Investors may be forced to rethink their investment strategies.

NEXT DECADE RETURNS MOST IMPORTANT FOR THOSE AT OR NEAR RETIREMENT

The analysis to date is only relevant for returns over the next decade or so. If passive returns are likely to disappoint over the next decade, this will have most impact on investors in or near retirement, for these will be most affected by a period of low returns. Hopefully for workers much further away from retirement, returns might normalise in subsequent decades. Such workers may also have the option of saving more or saving for longer to generate a decent retirement income, unpalatable though this may be. But for those already retired, a decade of low returns will crimp their retirement lifestyle.

Hamson (2014) highlights that the risk of earning lower returns is most acute in the retirement risk zone, the period either side of retirement date. This and most other analyses of sequencing risk assume retirees progressively draw down on their retirement balances to fund their retirement lifestyle. However, CSIRO research using ATO information has demonstrated that the average retiree tends not to draw down on their retirement savings, but rather they tend to continue to accumulate funds.

> "The implication of this finding is that today's retirees are unlikely to utilise the majority of their superannuation during their lifetime. (Dr Reeson) suggested at least two motives: one is the desire to leave a bequest, and the second is the psychological challenge of switching from saving throughout one's life to consuming in retirement. In addition, minimum drawdown rates may be acting as a "default" that retirees hold in mind as a benchmark for appropriate expenditure to mitigate against longevity risk."[1]

The findings are also consistent with the observation that retirees tend to fund their retirement lifestyle from the income of their investments and any pension entitlements, rather than drawing down on capital. The previous discussion regarding low rates of return also translates into relatively low rates of income generation, particularly for cash and bonds investments which traditionally make up a higher proportion of retiree portfolios. Given current interest rates, one would expect that low returns/income expectations will translate into a less bountiful retirement for those currently retired.

HOW CAN INVESTORS BEST BOOST RETURNS?

A simple way that investors, particularly retirees, could boost return expectations could be to take on more investment risk. Allocating more to equities would normally be expected to increase investment returns, but at the expense of increased investment risk. However, sequencing risk issues (refer Hamson (2014)) are likely to limit the ability for retirees to take on significantly higher total portfolio risk. Increasing returns by taking a more aggressive asset allocation stance may not be the answer.

If asset class returns are likely to be low in the coming decade, perhaps taking on more active risk might be a solution? That is, if we can pick up a few extra percent each year by using skill to pick the best assets within each asset class or by choosing the best asset class itself to invest in, then the outperformance that this can generate can significantly boost returns.

The fundamental law of active management provides a starting point for understanding the mechanism for boosting returns (Grinold and Kahn, 1999). This is neatly wrapped up in the equation:

IR = Skill x square root (Breadth)

Where:

IR = Information ratio, or Active Return/Active Risk
Skill = investment skill normally measured by IC, or "information coefficient", the correlation between return forecasts and subsequent actual returns
Breadth = (independent) investment decisions.

If we decompose the information ratio and re-arrange the equation we get:

Active Return = Skill x square root (Breadth) x Active Risk

Active returns can be increased by improving skill at forecasting returns, increasing investment breadth by increasing the investment universe or taking on more active risk. Increasing investment skill is hard. Increasing active risk is easy, but many investors, and particularly retiree investors, have limitations on how much risk they can take. Increasing investment breadth can be easier, at least in some asset classes. Simply pushing the odds in your favour such that you win just 51% of all bets is enough to produce a very large return if many bets are made. Casinos generate large profits by using the law of large numbers.

In the investment arena, this translates to finding a manager who not only demonstrates ongoing skill, but also finding an investment strategy where numerous asset selection or investment "bets" are being made. In this regard, currency managers and asset allocators have a much more limited set of investment opportunities when compared to Australian or global equity managers. An active currency manager may only have around 10 or so liquid currencies to take positions on, whereas the Australian equity market has around 200 to 300 liquid stocks in which a professional investor typically invests. The global developed equity market, however, has around 6000 stocks of equivalent size and liquidity to the 200 to 300 stocks in the Australian market, which means a significant increase in investment opportunities/breadth.

Of course, this enhanced breadth needs to be combined with a manager skilled in choosing amongst the many investment opportunities available, an area in which quantitative managers can have a distinct advantage as they are able to sift through enormous global datasets and forecast returns for thousands of stocks at a time - thereby well placed when it comes to analysing statistically the many price patterns and events that take place in global markets.

Figure 4 shows the impacting of increasing the "n" on breadth in the fundamental law of active management.

Figure 4: The effect of investment breadth

N	Square Root N
1	1
10	3.2
100	10
200	14.1
300	17.3
2000	44.7
6000	77.5

Source: Plato Investment Management

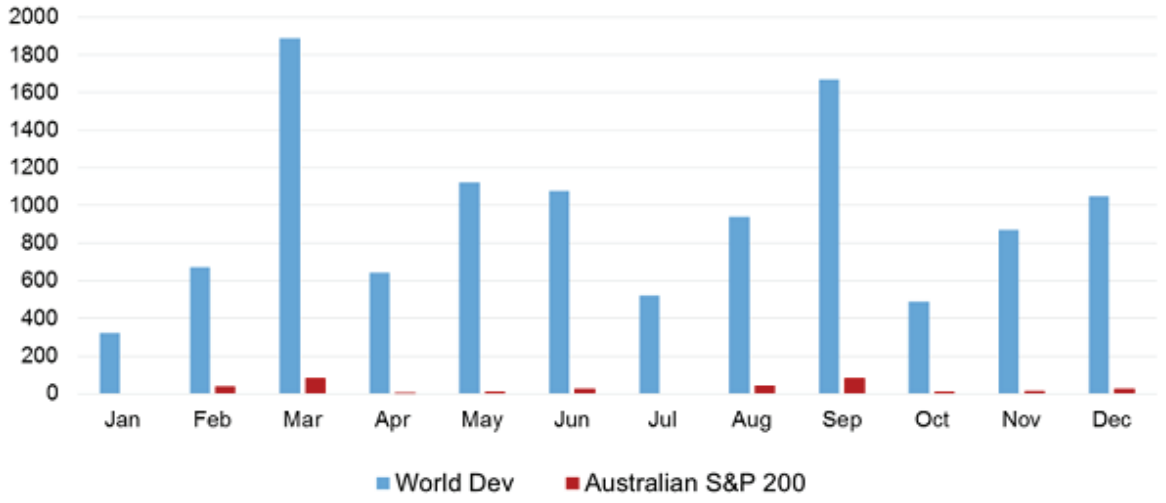
An event-based example

Within a global universe, there are literally thousands of dividends to choose from in a yield-enhancing portfolio.

Figure 5 shows the distribution of ex-dates in the global developed market universe in each calendar month of the year (blue), alongside those in the Australian market for comparison (red). The limitation of an Australian investor with a home bias is immediately obvious - not only is there a dramatic increase in the number of events when investing on a global scale, but there is also a much more uniform distribution from one month to the next. The month (January) with the fewest dividend events has 300 companies (compared to Australia which has around 0), while some months see close to 2000 dividend events. A by-product of the large number of ex-date events occurring every month of the calendar year is that the potential return/income stream from a global yield-based strategy can be a lot smoother, producing a monthly series of income that is desired by many retirees.

Figure 5: Distribution of global yields by calendar month

Number of ex-dates per month (2015)



Sources: Plato, Factset

The sheer number of global dividend paying stocks seems somewhat at odds with the average yield on global equity indices such as the MSCI World Ex-Australia Index, which averages just over 2% per annum. Many global companies pay quite low dividends, however, there are also a surprisingly large number of high dividend yield stocks in the global universe. As an example of the income investment opportunities available globally, by investing in Dutch Financial NN Group over the course of the past year, an investor would have achieved a yield of 6.3%, more than double the yield provided by the broader MSCI index. This stock is relatively unknown to domestic investors, but with a capitalisation of A$11.6 billion, it is larger than Qantas Airways. Another example is the German utility E.ON, yielding 5.3% and larger in market capitalisation than Australia's Macquarie Group.

But what about the skill aspect? How does skill play a part in the current example?

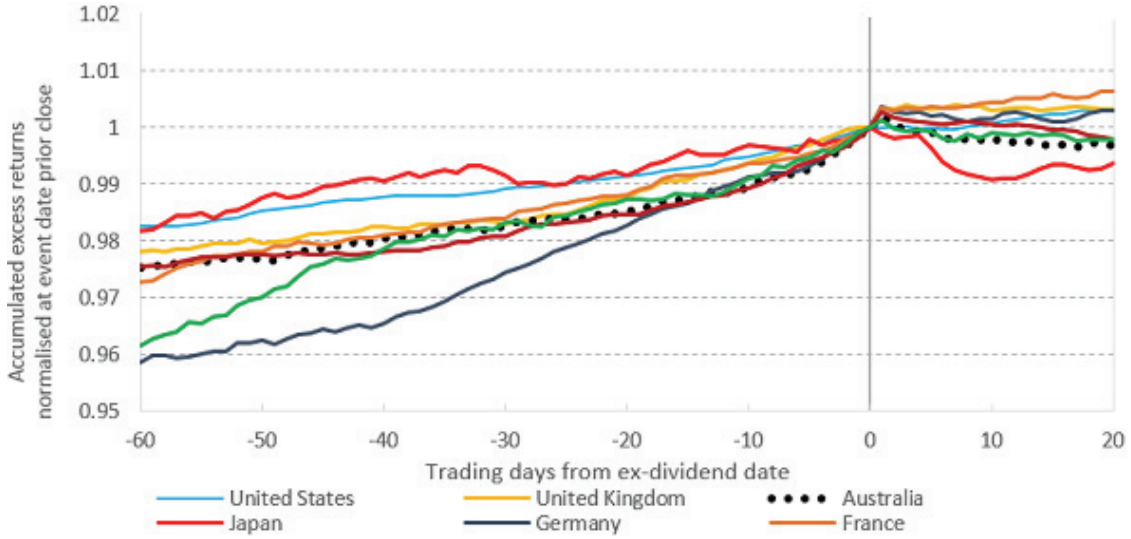
It is not difficult to buy a stock that is about to pay a dividend, as companies tend to pay dividends around the same time each year. However, the price of a stock usually drops around the same amount as the dividend being paid, and so for a simple identify-a-dividend-and-buy-it kind of a strategy, an investor will be essentially exchanging capital for income, a problem exacerbated by the transaction costs paid to brokers each time a stock is bought and sold. Further problems for such a strategy arise when companies are bought on the promise of a dividend, only for those same companies to later cut the level of the dividend (an action that is a negative signalling sign from management often accompanied by a further stock price fall), or even omit the dividend completely.

A skilled manager can avert such scenarios as those described above, and enhance returns above an index. Take the problem of eating into capital, for example. With the tools

available to the quantitative analyst, an analysis of every dividend event occurring in a global dataset over the last decade finds a statistical anomaly that occurs in the period immediately prior to the ex-dividend date of companies. This anomaly occurs in all developed countries, with Figure 5 displaying results for stocks in relatively large countries.

Figure 6 shows the extent to which stocks outperform the equity market in the lead-up to their ex-dividend dates (where returns are cumulative and normalised to 1.0 on the day before the ex-date in the chart). The extent of the ramp-up does differ across stocks and countries, but is significant. By increasing the level of skill by using investment insights gathered through exhaustive statistical testing, combined with a large breadth of event available in a global dataset, a skilled investor can expect to enhance investment returns and reduce risk, while producing a consistent dividend income stream along the way.

Figure 6: Run-up effect observed in a global dataset
Average performance in neighbourhood of event dates
(January 2000 through June 2015)



Sources: Plato, Factset

In summary, the elegance of a dividend-event based strategy is that not only can it increase total returns (without taking excessive portfolio risk), but it can also generate extra income over and above the normal level of income from a passive global equity benchmark. This can help boost retirement income for retirees who are loathe to sell down their assets, thus improving their lifestyle.

IN CONCLUSION

This paper has highlighted some challenges to investors, especially retirees, from the current unprecedented investment environment. This provides substantial challenges for traditional buy-and-hold strategies and requires investors to question the suitability of their investment strategies. There are multiple approaches to combating these challenges but as touched on, by incorporating active management and maximising the breadth of that active management, it is possible to improve return expectations, provided the investor has skill. Adopting a global investment focus increases the opportunity set and thus increases investment breadth, as well as providing diversification benefits. This can address the ultimate goal of superannuation, providing a desirable lifestyle in retirement.

REFERENCES

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ENDNOTES

1. http://australiancentre.com.au/publication/csiro-monash-superannuation-research-symposium/ - full paper yet to be published.