

# Re-examining investors' options for income

**With interest rates at historic lows and equity valuations arguably stretched, advisers need to find new ways of generating income that don't necessarily expose investors to greater risk. Simon Hoyle reports.**

In May, when the Reserve Bank of Australia cut official interest rates to the historically low level of 2 per cent, most attention naturally focused on the impact the cut would have on the cost of repaying a mortgage.

Some, but considerably less, attention was paid to the impact on investors relying on income from interest-bearing investments. The impact on this group of people has been profound, and in some cases devastating.

Since August 2008, interest rates have fallen from 7.25 per cent. The chief investment officer

of ipac funds in AMP's multi-asset group, Jeff Rogers, notes that since November 2011, when the current cycle of easing began, rates have fallen by some 2.75 percentage points.

While that is great news for anyone struggling to pay off debt, Rogers also notes, the income from term deposits (TDs) is now less than the rate of inflation. In other words, even though their capital remains secure, investors in TDs are experiencing negative real returns.

A fall in interest rates often has the effect of encouraging investors to seek alternative sources of income. This is where careful guidance and advice can pay off spectacularly, if it helps these investors achieve their income needs without exposing themselves to unnecessary and unintended risk of capital losses.

But investors need to carefully – and on some suggestions, literally – consider their options when it comes to looking for new sources of income.

## CARE AND ATTENTION

In *Professional Planner* last month a senior investment analyst with Zenith Investment Partners, Dug Higgins, warned in the context of investing in listed investment companies (LICs) that chasing yield without paying due care and attention to valuations is an investment strategy not likely to end well.

While investors may achieve the kind of income they want or need, they also run the risk that if stretched valuations revert to the mean, they will suffer unexpected capital losses.

Justin Epstein, an executive director of One Investment Group – which provides responsible entity (RE), trustee, corporate trust, fund administration and custody services – says growing numbers of investors are “taking on additional credit risk, turning to higher-yielding equities and chasing shrinking returns from property assets”.

“Unfortunately, investors can be [blinded] by the expected returns,” Epstein says.

“For instance, property geared at 65 per cent might be yielding 10 per cent returns, but what happens when interest rates ultimately rise or the tenants default?”

“These investors are at risk of exposing their capital, and it is often questionable whether the sometimes marginal increase in return is justified.”

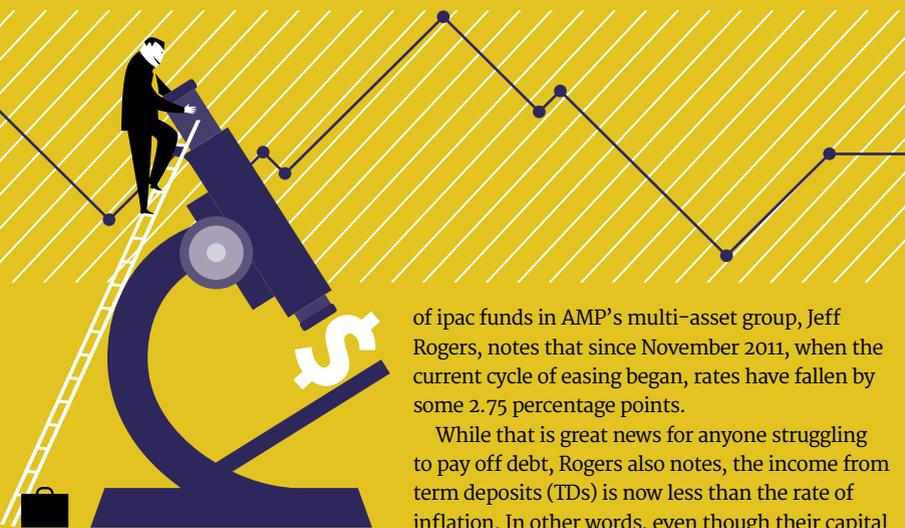
Rogers suggests that “a diversified portfolio of bonds, shares and real assets can be managed to meet the goal of a predictable and sustainable income stream that rises progressively over time, although it will exhibit capital volatility as the price of the securities goes up and down”.

“This stability of income can be achieved through the selection of investments with specific characteristics: high-quality corporate bonds with fixed coupons, shares of quality companies whose management is committed to delivering rising dividends to its owners, property assets with long-term rental agreements and infrastructure assets with inflation-linked contractual cash flows.

“The most important thing is for people to be clear on what they're trying to achieve and then identify an investment strategy best tuned to meet that goal. A financial adviser can help retirees identify and articulate their goals, recommend a strategy that is right for them and their circumstances, and help deal with the challenges and uncertainties on the journey.”

## TIME TO DOUBLE-CHECK

Patrick Noble, a senior investment specialist with Zurich Investments, says it's timely for investors and advisers to double-check that portfolios are not unwittingly exposed to too much risk. In some ways, they have been lulled into a false sense of security, even as their risk has ratcheted up.



## USING AN OPTION TO GENERATE INCOME

The Zurich Investments Equity Income Fund, managed by Denning Pryce, actively uses options strategies to seek additional income for investors. It invests primarily in a portfolio of shares drawn from the S&P/ASX Top 50.

Patrick Noble, a senior investment specialist with Zurich, illustrates how a strategy selling options can generate income for a portfolio.

“Back in March, AMP was enjoying quite a nice run leading into its dividend, and paid 13.5 cents a share on March 3,” Noble says.

“The fund sold a call option just after AMP went ex-dividend. While the fund gets the 13.5c dividend, it also found a good opportunity to sell a call option. We received 18c for selling a May \$6.75 AMP call option. AMP was trading around about \$6.50 at the time.

“Effectively, we’d be happy for someone to come and knock on our door between now and May and say, I’m going to buy your AMP shares from you for \$6.75. The fund has locked in some upside...but then got a further 18c from selling the option.

“So really we’ve generated 18c in income and the potential of up to 25c in capital growth, to \$6.75, over a two- to three-month period. And if we were to get exercised, the break-even is actually \$6.93 – the 18c plus the \$6.75.”

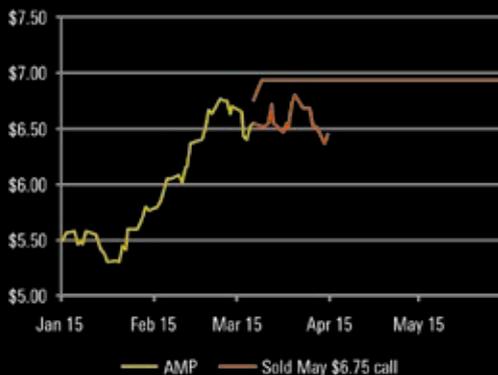
Noble stresses that the AMP trade is an example of one that has worked well for the fund. Not every options trade will pay off as well; but as with many things in funds management, the key is to get things right more often than not.

In this example, Noble says that “if nothing else happens, the fund generates an annualised income in excess of 10 per cent”.

“If we do get exercised the annualised return is closer to 30 per cent. We think that’s a pretty reasonable trade-off,” he says.

“It just so happens that AMP is trading at about \$6.60 and the option expires on May 28. While there’s a couple of weeks left, it’s trading well below the strike price providing a nice return from the income.”

### AMP OVERWRITE



Source: Bloomberg

“A lot of people have been observing some of the key drivers in the market: low interest rates, which we’ve seen be cut twice again this year, have made it harder for savers who have been seeking comfort in cash; but general monetary policy actions around the world have seen investors believe in a more suppressed volatility environment,” Noble says.

He says some investors have been “substituting some of their income requirements out into more risky assets, namely equities, and of course the higher-yielding end of that”.

“But I think that if you are in a suppressed volatility environment, some of those conditions are changing, potentially, with interest rates going up in the US sometime this year,” he says.

## OPTIONS ARE AN EXAMPLE OF INTRODUCING “A BIT OF RISK MANAGEMENT” INTO AN EQUITY PORTFOLIO, WHICH COULD BE “PRETTY HEALTHY FOR YOU, AND GIVE YOU SOME SLEEP AT NIGHT”

“We just don’t know if that changes that suppressed volatility nature.”

Noble says now is a good time for investors and their advisers to re-examine how investors want to generate income from their investments.

“You should think about whether or not you’ve moved outside of your risk profile,” Noble says.

“That’s where we think options strategies that can give you a more diversified income portfolio and a lower volatility exposure to the

equity market, we think can still make sense.

“But people need to recognise the opportunity costs. In what has been a pretty good bull market...you’re not going to get the highest of the market. It’s a much lower volatility, or less risky way...to still get some market growth, and a nice income stream as well.”

### RISK AWARENESS

Noble says some investors and financial planners may have the skills and the time to implement sound options strategies, but need to be aware of some of the potential risks.

“The client might need to be prepared to sell the shares that the options are sold over, and that could realise some capital gains that the client might not otherwise like,” he says.

“From our perspective, we think you can do it within a managed fund; you’re owning a portfolio of the Top 50 leaders and you’re using people who are solely focused on a daily basis to try and find the best option trades over those individual stocks – and they’re doing that to both give you a higher level of income or a regular level of income you can receive monthly, but also obviously managing that portfolio of options for you.”

Noble says options are an example of introducing “a bit of risk management” into an equity portfolio, which could be “pretty healthy for you, and give you some sleep at night”.

“This is a nice timely reminder,” he says.

“It sounds contradictory that there will be yield support in the market, but you just can’t ignore the fact that it still doesn’t remove the simple fact that not everything is bulletproof, and valuations are a little bit stretched.

“It’s just looking again at your portfolio and making sure again that the way it’s been put together... you might want to have a little bit of defence in some of the areas where you might have dialled up some of your exposure in more recent times.”

# THE SEARCH FOR THE BEST TAKES US EVERYWHERE.

Let innovative and  
specialist investment  
partners lead you to  
the top.

[www.zurich.com.au/  
investments](http://www.zurich.com.au/investments)

**ZURICH INVESTMENTS.**

  
**ZURICH®**