Extracting reasonable, sustainable levels of income in a low yield environment

Economic growth challenges in a low-rate setting are a natural source of worry for income seeking investors who also want to keep risk levels low. The demand for income generating products in Asia Pacific is emanating both from its senior citizens and workers looking for additional income. The urgency has stepped up in a rapidly aging society – the share of Asia-Pacific's population aged 80 years and over, is expected to treble by mid-century, according to figures from the Organisation for Economic Cooperation and Development (OECD).

While preservation of principal is key to the retirement income solution of such income seekers, there is also common wisdom around what is considered a reasonable income level in retirement planning. A research study popularized the 4% handle as a good starting point for retirement income withdrawal. (Source: Cooley, Philip L.; Hubbard, Carl M.; Walz, Daniel T. "Retirement Savings: Choosing a Withdrawal Rate That Is Sustainable." AAIJ Journal, February 1998.)

Income generation, comprising of natural yield and capital growth, has become challenging ever since the global financial crisis crushed safe-haven yields. Natural yield is no longer able to deliver a 4-5% annual payout that prevailed before the global financial crisis with US Treasuries currently yielding a third lower than the past decade's average. And the coronavirus pandemic has impacted central bank policies, with interest rates expected to remain low for an extended period.

What is a Reasonable Income Level Today?

As central banks across the world pursue "lower for longer" monetary policies, traditional fixed income products are unable to deliver the same level of interest income as in the past, even after putting on additional duration. In equities the dividend yield landscape is varied, but none of the sub-asset classes are able to deliver a yield level as high as 5%. As a result, investors are currently forced to choose between taking on additional risk by exposing themselves to greater default probability or increased volatility in the pursuit of higher returns.

Historical Yield versus Volatility

Asset Class	Latest Yield[1] (p.a.)	10-Year Volatility[2] (p.a.)
Emerging Market Bonds	4.8%	8.4%
Global High Yield Credit	4.7%	8.2%
Global High Dividend Equities	3.6%	12.8%
Global Infrastructure	3.4%	14.2%
Global REITs	3.2%	15.7%
Global Value Equities	2.7%	14.4%
European Equities	2.5%	16.5%
Japanese Equities	2.0%	16.7%
Global Investment Grade Credit	1.6%	5.5%
US Equities	1.4%	13.6%
Global Growth Equities	0.8%	14.3%
Global Government Bonds	0.8%	5.2%

Past performance is not a reliable indicator of future performance.

[1] Benchmark yield represented. Please see the table on the next page for each asset class' representative benchmark. As of 30 June 2021.

[2] Annualized volatility using monthly total returns data over the last 10-years ended 30 June 2021.

Sources: Bloomberg Barclays, J.P. Morgan Chase & Co., MSCI. See Additional Disclosures for more information.

Source for Bloomberg Barclays index data: Bloomberg Index Services Limited.

The Rise of Fixed Maturity Products and Multi-Asset Income Products

This conundrum has led to the emergence of Fixed Maturity Products (FMPs) and multi-asset income products (MIPs) as yield-enhancing products designed for retail and high-net-worth investors.

FMPs, buy-and-hold basket of bonds whose maturity dates match those of the products, aim to provide regular income as well as the return of capital at the expiration date. Risk is lowered by investing into an effectively diversified basket of bond holdings. Market data shows that FMPs launched in recent years with global exposure have targeted annualized yields of 4-5% while those heavily invested in higher yielding Asian bonds and bearing a greater credit risk profile may deliver yields of 5-6%.

> *"[The] conundrum [of taking on default risks or volatility for higher returns] has led to the emergence of Fixed Maturity Products (FMPs) and multi-asset income products (MIPs) as yield-enhancing products..."*

It is to be borne in mind that many of these FMPs have an average rating of BBB-, which is borderline investment grade. This implies there is a risk default probability could rise sharply in the event of a downgrade, as this would push the average rating to junk category. And were these FMPs to target similar yield levels in the current market environment, they would need to go further down the rating spectrum.

On the other hand, attractive payout supported by a total return approach has boosted the popularity of MIPs. The increased significance of capital growth in a low yield environment has compelled fund managers to position their portfolios differently. As yields continued to plunge to new depths, there was a growing recognition that without capital growth, a reasonable and sustainable payout is hard to achieve.

However, extracting higher returns remains a challenge – our global multi-asset income funds performance study shows that a 30-50% equity allocation during the 2013-2020 period could only support a return of less than 4% annually^. This meant a higher payout of 5-6% annually could only be achieved by taking on greater risk either through increased equity exposure, by going down the credit spectrum or via principal erosion. In their pursuit of higher income in the current low rate environment, investors may be forgoing capital appreciation opportunities.

Is a Higher Yield Always Better?

Chasing high yielding products in a low rate environment comes with its share of risks – investors could be missing out on capital appreciation opportunities if they focus too much on income. This could also involve shrinkage of principal which in turn hurts future income opportunities.

We conducted a simulation study on a 40% equity, 60% fixed income portfolio and modelled the investment returns of the portfolio under 10,000 scenarios. The results indicated that in order to achieve a 6% annual payout over 10 years, it would involve an 82.7% probability of capital erosion while for a 4% annual payout that probability would fall to 32.3%. A further decline in the erosion probability could be achieved by active management. Based on the study, we therefore believe 4% or slightly higher annual payout level as a reasonable and sustainable target for a multi-asset income product*.

> *"We believe a proper balance between sustainable payouts and capital protection can be achieved by considering multi-asset income products which are expected to provide the necessary diversification and upside potential."*

In the current environment it would be judicious to set a reasonable payout target and then establish a strategy bearing in mind the risk-taking ability. An indiscriminate hunt for yield could set off an income trap which fails to sustain payouts in subsequent years. We believe a proper balance between sustainable payouts and capital protection can be achieved by considering multi-asset income products which are expected to provide the necessary diversification and upside potential.

Asset Class Benchmark Representations

Asset Class	Asset Class Representative Benchmark
Emerging Market Bonds	J.P. Morgan EMBI Global Core Index
Global High Yield Credit	Bloomberg Barclays Global High Yield Total Return Index Value Unhedged USD
Global High Dividend Equities	MSCI ACWI High Dividend Yield Index
Global Infrastructure	S&P 500 Global Infrastructure Index
Global REITs	FTSE EPRA/NAREIT Developed Index Net TRI USD
Global Value Equities	MSCI World Value Net Total Return USD Index
European Equities	MSCI Europe Net Total Return USD Index
Japanese Equities	Tokyo Stock Price Index
Global Investment Grade Credit	Bloomberg Barclays Global Aggregate Corporate Total Return Index Value Unhedged USD
US Equities	S&P 500 Total Return Index
Global Growth Equities	MSCI World Growth Net Total Return USD Index
Global Government Bonds	Bloomberg Barclays Global Aggregate Treasuries Total Return Index Value Unhedged USD

^ Source: Bloomberg Finance, L.P. Data analysis by T. Rowe Price. All analysis begins on 30 July 2013, the longest track record available for the selected funds.

* **Hypothetical Results:** The information is shown for illustrative, informational purposes only. This does not constitute investment advice or recommendations. The results shown above are hypothetical, do not reflect actual investment results, and are not a guarantee of future results. Hypothetical results were developed with the benefit of hindsight and have inherent limitations. Hypothetical results do not reflect actual trading or the effect of material economic and market factors on the decision-making process. These results are derived from a Monte Carlo simulation tool based on T. Rowe Price's latest capital markets assumptions. Results do not include management fees, advisory fees, trading costs, and other related fees. Results have been adjusted to reflect the reinvestment of dividend, rebalancing frequency, and capital gains. Actual returns may differ significantly from the results shown above. Further details of the methodology, modeling assumptions and material limitations are available upon request.

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Additional Disclosures

OECD/2020, Health at a Glance: Asia/Pacific 2020 – Measuring Progress Towards Universal Health Coverage, https://www.oecd-ilibrary.org/sites/1ad1c42a-en/index.html?itemId=/content/component/1ad1c42a-en.

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[1] Firmwide AUM includes assets managed by T. Rowe Price Associates, Inc. and its investment advisory affiliates.

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