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Taking an active approach to investment

With record low cash and bond rates both in Australia, and in many developed nations around the world, most retiree investors now recognise that they need healthy allocation to equity income strategies.

However, recognising the need for dividend income is just the first step. An investment in the equity market comes with a higher degree of risk than one in fixed income, so having the right investment manager who can maximise the income whilst avoiding the companies where dividends are most under threat, is crucial to meeting investment goals over the long-term.

Income focus

The Nikko AM-Tyndall Australian Share Income Fund's goal is to provide a tax effective income stream that is 2% greater than the dividend yield of the broader Australian equity market over rolling five-year periods before fees and tax. The strategy also aims, as a secondary objective, to position for potential capital growth over the long term.

Malcolm Whitten, a portfolio manager and senior analyst behind the fund who has been with the business since 1994, explains the importance of such an approach.

"In this environment, we believe that earning a sustainable income from Australian equities and avoiding income traps requires an active approach with thorough, forward-looking research that seeks out diversity in income sources, rather than blindly following the herd," says Whitten.

High dividend yields

Central bank policies across the globe have pushed interest rates down and led a five-year charge into traditionally defensive businesses with stable cash flows and high dividend yields. They've been especially popular with investors buying them via passive or index-tracking funds. These so-called 'bond proxies' however, have been heavily bought by investors in recent years and Nikko believes careful active management is needed to avoid being caught in the expensive end of the market, particularly in stocks where challenges to earnings could result in dividends being cut, or worse, withdrawn altogether.

"Relative value has been distorted and in our view, the blind pursuit of income could be dangerous in a world subject to change," says Whitten, who manages the portfolio alongside 18-year industry veteran, Michael Maughan.

"The performance of 'yield' assets over the past few years has been outstanding," he adds.

"However, this also means that the risk to capital has increased should there be a reversal in yield. The atypical cycle has led to an expectation of ongoing and entrenched low rates of economic growth and commensurate low rates of investment return."

"While it is undeniable that persistent, long-term forces are unlikely to change, we believe that many investors underestimate the possibility of a reversal," he says

Dividend yield at the right price

The strategy steers clear of the riskiest dividend payers by having a keen eye on company valuations through what it calls CVA, or comparative value analysis.

"The philosophy at Nikko Australia Equities is that markets are inefficient. Linking back to that, we need some sort of cardinal marker. In a maritime metaphor, you need a guiding mark for where the safe water is and any potential hazards. Our belief is that you can establish value and determine what's expensive and what's cheap, what's dangerous and what's safe. Our research process is our means of establishing that Cartesian map," explains Whitten.

On traditional measures such as the price-to-earnings ratio, professional investors are reaching a consensus that the Australian market looks a little bit expensive at the moment and this is precisely why, according to Whitten, an active approach is the most sensible route to take right now.

"Just passively investing in equities could be dangerous so invest your time and your fee in the comfort of an active portfolio service," he says.

"We generate active return through our fundamental research process. It's not passive. It's not dependent on a quantitative model that's historical; it's forward-looking and focuses on expected and sustainable yield.

Opportunity is in equities

He adds that though some commentary is espousing doom and gloom about the equity market, paltry yields in fixed income, combined with likely future drawdowns in the asset class means that on balance, stocks are still the place to be.



The quote

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"The last five years have seen the forward price-earnings ratio rise from 12 times to 17 times so it appears quite stretched but it's wrong to think of the market as a whole because there are various segments. What we find right now is that the defensive, bond-like stocks are super expensive and there are other segments of the market that are cheap," he says.

"In a world in which incomes have been crunched down very, very low, the opportunity is in equities at this stage. The fund has very attractive characteristics which includes that superior income."

The areas of the market where Whitten and his team on the Nikko AM-Tyndall Australian Share Income Fund see the most opportunity right now are those that have been shunned, which is to say anything with a cyclical earnings pattern. In the current distorted market this unusually includes the banks.

"Historically they've been high yield, but a world of negative interest rates is bad for banks. Concerns regarding heightened capital requirements, bad and doubtful debts as well as the property market are all embodied in market prices right now, so we think the banking sector is quite cheap."

Ultimately, picking income winners in this market centres as ever, on focusing on the fundamentals of investing.

"Our qualitative assessment is to meet the management and figure out that they are capable, that they are trustworthy and that they're willing to share the gains of their hard work with us," finished Whitten. **FS**

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