Building income portfolios with ETFs

In a world where rates on cash deposits and government bonds are at or near historic lows, financial advisers can use exchange traded funds (ETFs) to help their clients meet individual income requirements.

Back in 2007, Australian corporate bonds were yielding eight per cent p.a. while 10-year government bonds were delivering a solid six per cent p.a. These rates enabled financial advisers to recommend fixed income portfolios that generated adequate and consistent income for their clients.

Fast forward to 2015 and the yields on both have more than halved. Over the past eight years, a very disconcerting market environment has emerged where interest rates are lower than inflation and various asset classes are delivering their lowest yield levels in recent history.

One of the largest investment managers in the world, BlackRock, has come up with a solution to combat this investor dilemma: a suite of exchange traded funds that can be used to build tailored income portfolios. In this article, BlackRock explains its four-step process and the key benefits of using both fixed income and equity ETFs.

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As yields from cash and government bonds remain at near historic lows, the search for income is a top priority for many investors. We believe that diversification across asset classes is vital and this can be achieved using ETFs.

ETFs are increasingly being used by advisors to tailor existing portfolios and to build individual income portfolios to meet their clients' objectives and requirements. Our four step process and ETF toolset are designed to help.

Building an income portfolio in four steps ...

The fundamental objective of an income portfolio is to provide a steady stream of cash flows, while also allowing for capital growth, in a risk controlled framework. To build an income portfolio we use a four step iterative process:

STEP 1 – Establish portfolio goals
Define an income target, risk budget and any constraints.

STEP 2 – Define an investment universe
Domicile and exposure differences need to be considered.

STEP 3 – Define allocations
Establish minimum and/or maximum allocations.

STEP 4 – Monitor and reallocate
Decide on the review and rebalance frequency, having established the time horizon of the portfolio.

... and using ETFs provides benefits

1. Building block approach
- This allows for the building of custom exposures and bespoke portfolios, optimised to specific objectives and subject to defined constraints.
- ETFs offer access to many different fixed income and equity segments.

2. Diversification
- ETFs can be combined to create portfolios tailored to a desired level of diversification across asset classes.
- ETFs track benchmark indices which usually have a minimum level of diversification, so returns are less likely to be influenced by a single security.

3. Transparency
- ETFs are transparent in their investment objective, i.e. to track the performance of their benchmark index.
- The methodology of the underlying benchmark indices is publically available and transparent.

4. Liquidity
- Continuous trading on regulated exchanges means that ETFs benefit from transparent secondary market liquidity.
- This liquidity allows investors to trade in-and-out quickly and cost-effectively.

5. Cost efficiency
- ETFs offer cost effective exposure to many markets which would otherwise be expensive to access, e.g. emerging market equity and high yield debt.
- This is due to difficulty in accessing some markets, additional costs and, in some cases, limited liquidity of the underlying securities.

What is my toolset?

ETFs have evolved as effective building blocks in creating income portfolios that incorporate fixed income and equities. A multi-asset approach to income investing through ETFs will incorporate fixed income and equities to ensure diversified exposure across the income-generating universe. The actual exposures may differ depending on a number of different considerations including domicile and exposure differences (multiple indices with varying construction methodologies and risk and return profiles).

There is now a wide range of ETFs available to Australian investors to help build income portfolios. Broadly, these fall into the two main asset class families: fixed income and equity.

Benefits of fixed income ETFs
Fixed income ETFs provide income investors means to deploy capital quickly and efficiently in investment grade and high yield markets, such as corporate bonds. They can help investors find new ways to manage duration within portfolios.

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Benefits of equity ETFs
Equities are increasingly popular with investors seeking income because of lower government bond yields. They also provide diversification. ETF equity dividend index strategies have evolved to offer exposures ranging from major developed equity markets to emerging markets.

With ETFs you can build an income portfolio that delivers diversification across income generating equities as well as across the fixed income universe. These include sectors and/or exposures that may respond differently to changes in interest rates, and is vital in order to produce a stable, reliable and diversified income solution. FS

Table 1. iShares income options on the ASX

Investing for Income on the ASX: The iShares Toolset*		
Ticker	**Name**	**Exposure**
IHCB	iShares Global Corporate Bond (AUD Hedged) ETF	Global Investment Grade Corporate Bonds
IHHY	iShares Global High Yield Bond (AUD Hedged) ETF	Global High Yield
IHEB	iShares J.P. Morgan USD Emerging Markets Bond (AUD Hedged) ETF	Global Emerging Market Debt
IHD	iShares S&P/ASX Dividend Opportunities ETF	Australian High Dividend
IAF	iShares Composite Bond ETF	Australian Composite Bonds
IGB	iShares Treasury ETF	Australian Composite Bonds
ILB	iShares Government Inflation ETF International	Australian Composite Bonds

** At the date of publication, iShares Global Corporate Bond (AUD Hedged) ETF, iShares Global High Yield Bond (AUD Hedged) ETF and iShares J.P. Morgan USD Emerging Markets Bond (AUD Hedged) ETF are not currently available for trading in Australia and have not yet been admitted for quotation on the Australian Securities Exchange (ASX). Admission to quotation is subject to ASX approval and is not guaranteed.*