A Changing Game: Income Funds Deserve a New Look

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What Are Income Funds?

Income funds are just what they sound like, an investment vehicle that focuses on assets that provide an income stream, either through dividend payments or coupon payments. In some cases, they can also be viewed as total return vehicles that provide some growth potential through capital appreciation along the way.

While that may sound pretty simple, income funds are deserving of a deeper look in this new world of investing where rates remain low, and markets are moving faster than ever before. The reasons to use them in a portfolio have changed, the investor pool has expanded, and the types of assets that they invest in have evolved.

From a Specific Audience to Mass Appeal

Retired investors have reached a life stage where they need a dependable source of income to provide money to fund expenses, and to preserve capital so that it may last out retirement. Preserving capital, as opposed to growing capital, requires lower portfolio volatility. This group is the traditional investor base for income funds. As retirement gets closer, investors were often advised to transition their portfolios into a 60/40 mix of equities and bonds, which was often an increase in the credit side of the portfolio from the 80/20 or 70/30 mix that younger investors may deploy.

This approach has generally worked but has struggled in recent years as persistent low yields made finding income challenging. However, the environment for bonds over the past several years has created a difficulty on the performance side as well.

From a portfolio allocation standpoint, the changing investing landscape and the availability of new types of investments in income funds have transformed them into an investing style that provides utility regardless of asset allocation goals, timeline, or income needs.

A Historically Bad Environment for Bonds

The Federal Reserve is raising interest rates, but with yields at historical lows it may be much later in the cycle before increased yields become meaningful for income investors. In the meantime, the increases are decimating bond prices, which move inversely to yields.

With equity volatility increasing and bond performance struggling, the role of bonds in the 60/40 portfolio is coming into question.

While interest rate increases may ultimately help boost yields, the rate increases are being driven by a need to get inflation under control. Even as bond yields increase, they are not outpacing the highest inflationary environment of the last 40 years.

On the performance side, as bond yields have increased prices have fallen dramatically, as bond prices move inversely to their yields. With equity markets turning in negatives, bond yields still low and bond prices reflecting the worst performance in decades – the Bloomberg U.S. Aggregate had the worst four months in early 2022 since the index data began in 1976 – the 60/40 portfolio comprising equities and traditional bond investments is struggling.

And investors are taking note. Over the first quarter of 2022 investors pulled $87 billion out of bond mutual funds and ETFs, as reported by the Investment Company Institute. While the traditional method of constructing an income portfolio may not be working, there are options. Funds with innovative structures that allow for investment in alternative assets are experiencing demand.

An Evolved Landscape: How Income Investing Has Changed

The biggest change has occurred in the credit space. Traditionally, investors accessed income assets through the public markets by buying Treasuries or corporate bonds. Over the last several decades, the amount of income these assets provide has declined precipitously as yields have trended lower and lower.

So where are investors seeking income? Investors are increasingly considering alternative assets. A recent study[1] of investment advisors found that they turn to alternatives to potentially reduce risk, enhance returns, and provide an uncorrelated asset to other portfolio holdings in order to increase diversification and lower volatility in client portfolios. While there are many different alternative strategies, such as private equity, hedge funds, and venture capital, which would generally be regarded as growth strategies, the same study found that a significant percentage of advisors responding (36%) are using alternatives on the income side of the portfolio as well.

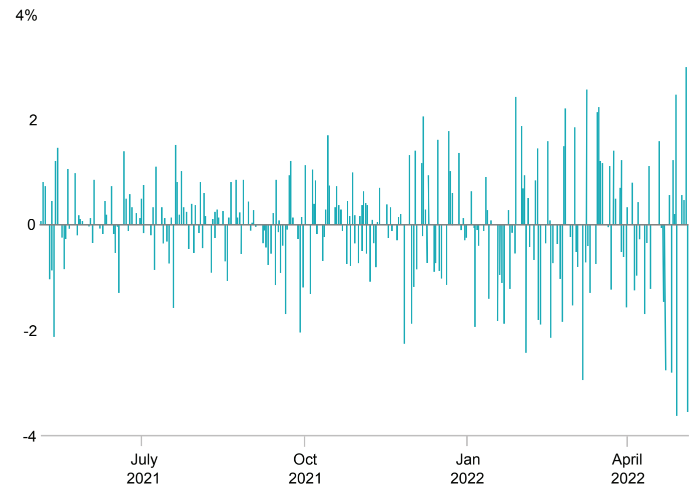
And within income alternatives, the private markets are eating up a lot of the new inflows. Private debt generally refers to non-bank institutions, such as asset managers, making loans to private, middle market companies that because of their size, cannot access the public markets to raise capital. These loans may offer a yield premium over public market debt because they tend to be illiquid; they are not traded on exchanges and the manager may hold them until maturity.

The Preqin Global Private Debt Report notes that after a decade of growth that averaged 13.5% annually, growth of private debt will accelerate to 17.4% between 2022 and 2023, propelling it to become the second-largest private asset class in 2023. In assets under management terms, annualized estimates from October 2021 put private debt assets under management (AUM) near $1.21tn for year end. Preqin forecasts that private debt AUM will reach $2.69tn by 2026.

What Else Are Investors Considering?

Equity market volatility is increasing, making it even more important to seek sources of return that are not overly correlated to equities. A long-term asset that can both throw off income and provide relatively uncorrelated returns may help to maintain a preferred risk/return profile. Additionally, the availability of more diverse income-producing assets makes these types of funds deserving of a new look.

S&P 500 Daily Percentage Change



Source: Baidi Wang/Axios using data from FactSet

Wrapping It Up

Whether you build a portfolio on your own, or you work with a financial professional, taking stock of your investments in light of the current environment is always a good idea. Income funds are a modern way to gain access to income without liquidating assets, and can also provide exposure to alternatives. There are of course risks involved, as there are with any investment, so be sure to understand them thoroughly, either by the reading the prospectus or the offering documents.

Footnote

1. PPB Capital Partners. Wealth Advisor Survey 2020. February 4, 2021

Risks

As with any asset class, there are certain risks associated with non-investment grade debt. Credit risk is the risk of nonpayment of scheduled interest or principal payments on a debt investment. The risk of default may be greater. Should a borrower fail to make a payment, or default, this may affect the overall return to the lender. Further, illiquid investments require longer investment time horizons than other investments. For these and other reasons, this asset class is considered speculative and may not be suitable for everyone.

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