Four reasons well-constructed income fund can still offer better investor outcomes than Term Deposits

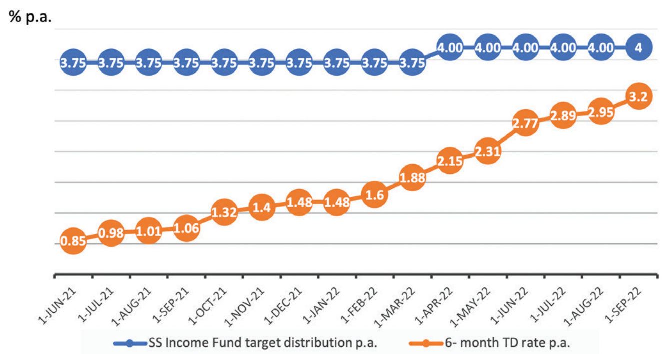
In an inflation-prone period, when rising central bank policy interest rates have finally pushed up the offered rates for term deposits, what are the advantages of investing in an income-oriented managed fund?

The well-diversified management of the **Salt Sustainable Income Fund** has allowed the fund to deliver a 4.0% gross distribution yield, paid quarterly, since May this year. At that time, the 6-month NZ bank average deposit rate was just 2.3% p.a. having risen from its all-time lows around 0.9% p.a. which had prevailed through 2021. Since then, the Reserve Bank has been in rate-hiking mode as inflation and capacity pressures raced higher. The result has been an additional 0.6% lift in the typical 6-month term deposit rate, which was 2.9% p.a. according to RBNZ July data at end-August, and which moved above 3% this month in anticipation of at least another 0.5% increase in the Official Cash Rate in October.

However, for longer maturities, the local banks have lifted TD rates up to the 4% "big figure," in anticipation of a persistently higher interest rate environment ahead. Given this development, what is the rationale for an investor tolerating the asset price volatility in a diversified income vehicle, rather than simply "parking cash" in a financial institution with sound credit ratings, like a High Street bank?

Advantage 1. Assurance of the fund's distribution yield target helps planning

As shown in the graphic below, since the inception of the Salt Sustainable Income Fund, there has been only a single adjustment to the target distribution yield: an increase of 0.25% in place since May 2022. Over the same period, the typical 6-month bank deposit rate has only remained constant month-to-month on one occasion: over the 2021 Christmas break period! So, investors will only now be contracting for the annualized deposit rate of 3% p.a. and have foregone the opportunity to receive the higher distributions available through the income fund (with surety of advance notice) throughout the period. Needless to say, when short-term bank deposit rates fall, this will also pass through more quickly, than adjustments to the target distributions made from a well-structured income fund would.



Source: Salt Funds Management, RBNZ data, updated to mid-Sep. 2022 with Interest.co.nz

Advantage 2. Liquidity can be better for Funds than for TDs

There is also the simple consideration of investor liquidity. While it is indeed possible to obtain comparable nominal distribution rates from an income fund, and interest rates from a term deposit, the income fund offers superior liquidity in terms of an unexpected need for the invested cash. By contrast, the early termination of a bank term deposit will incur a significant discount on the interest rate paid for the period invested. Furthermore, it is not actually legally required that the deposit-taking bank allows the customer to break the agreed deposit term early. In the words of the NZ Banking Ombudsman, "if the bank agrees to break your term deposit, it will probably reduce the interest rate on the funds you're withdrawing. It may also seek to recover interest that was paid at the higher rate while it had the money." These reductions are at the bank's discretion and timeframe.

Characteristic interest rate reduction for early withdrawal

Percentage of term elapsed	Interest reduction
0 to less than 20%	90%
20% to less than 40%	80%
40% to less than 60%	60%
60% to less than 80%	40%
80% to less than 100%	20%

This situation contrasts with the regime applying to units in the Income Fund, which may be redeemed, and their dollar value withdrawn (subject to certain minimum values) within ten business days of receipt of a valid withdrawal notification, once adjusted for the applicable sell spread.

Advantage 3. Interest rate and Dividend outlook changes during the investment horizon

We think it preferable to have an active funds manager at the helm of an income-oriented investment product, rather than for an investor to simply rely on a schedule of offered deposit rates at any given point in time. The Fixed Interest yield curve is in constant flux, and an interest rate that appeared attractive at the beginning of an investment horizon may well lose its lustre if subsequently, offered rates move upwards. Similarly, an active manager will be constantly "forward-looking," in seeking to obtain the best income yield for a given level of risk, and thus is in a position to anticipate dividend or yield payment changes on the securities *within* the income fund.

Multi-asset income focussed funds have an important role to play in a low-return and volatile investment environment, because of their ability to switch between assets. They can generate income from a combination of sources, which can be held directly or through funds, investing across equities, bonds, cash and property. At Salt Funds Management, we only invest in listed securities to ensure maximum liquidity and to allow for deep due diligence on the part of our portfolio managers. However, some Income Fund managers are prepared to hold direct assets such as commercial buildings, or even to act as lenders to developers or homebuyers.

So long as the additional risks are fully understood by investors, these strategies may well also be able to access superior yield streams. However, bear in mind a potential paradox in some enhanced-yield direct assets: the very factors allowing them to pay distributions above the norm for comparable-duration liquid instruments could make the underlying assets "unsaleable" during a true liquidity crisis (as many discovered during the GFC.)

In any case, all credible financial advice providers stress the need for extensive research, before adopting an Income-focussed strategy, as there are multiple pitfalls for the inexperienced. We believe that our own research combination of strong in-house Australasian Equity specialists and our external partners in Equity, Bonds and Real Assets provide an ideal skill base for a "sustainable" income offering; in which the income level is planned to prove reliable through a variety of economic cycles, both domestically and in global markets.

Advantage 4. Inflation consumes all returns, but Diversified Income offers some re-capture

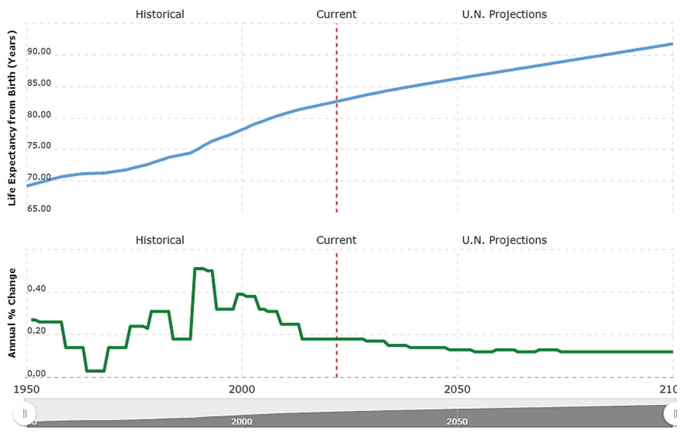
It is important to note that all investment assets can lose value during periods of negative event shock or economic adjustment. During such periods, it is tempting to retreat to the apparent stability of Cash and Term Deposits. However, when the probable inflation rate for some time ahead is in excess of the interest yield being paid to deposit holders, the after inflation return on them will by definition continue to be below zero. This means the real (inflation-adjusted) value of the deposit is being gradually eroded, and the interest rate paid is not defending purchasing power.

While this is also true of the dividend streams being harvested by Diversified Income funds, those dividends are reflecting the financial viability of the companies and enterprises distributing them. A well-selected set of underlying investments should contain firms which are utilizing inflation to raise their own corporate income levels. When the current inflation wave eventually recedes, those increases in corporate revenue (and, with good management, net income) will still be in place. At that point, the market value of the asset pools will most likely recover.

So, during the difficult investment periods such as the present, investors in well-constructed Income funds can take comfort that these vehicles are accruing a steady stream of dividends and coupons, many of which are being paid at a higher nominal cash value than before the CoVid shock unleashed inflation. Retirees' primary focus should be on "shortfall risk." That is, on ensuring that the income they earn is sufficient to meet their future spending requirements. Shortfall risk is also the possibility that an investor will outlive their savings. This could be due to living longer than expected, spending more, or the erosion of purchasing power of the investors "nest egg" due to inflation. Over the long-term, shortfall risk is reduced through a higher allocation to growth assets such as stocks. This is because the long-term growth rate in corporate earnings has outpaced inflation.

Dividend yields are also less volatile than stock prices. Dividends grow at a faster rate than inflation, on average, despite the current exceptional period. So, notwithstanding periodic bouts of negative asset returns (as presently) holding sustainable dividend-payers within a Diversified Income vehicle also reduces shortfall risk for those investors already in retirement – and this is the predominant group of people interested in Diversified Income funds, in New Zealand. Gains in longevity in recent decades mean that the typical retiree investor will see their total Diversified Income portfolio values record an annual dip of at least -5% around three times, within the fifteen years' of expected retirement duration between the ages of 67 and the current average NZ life expectancy of 82 years.

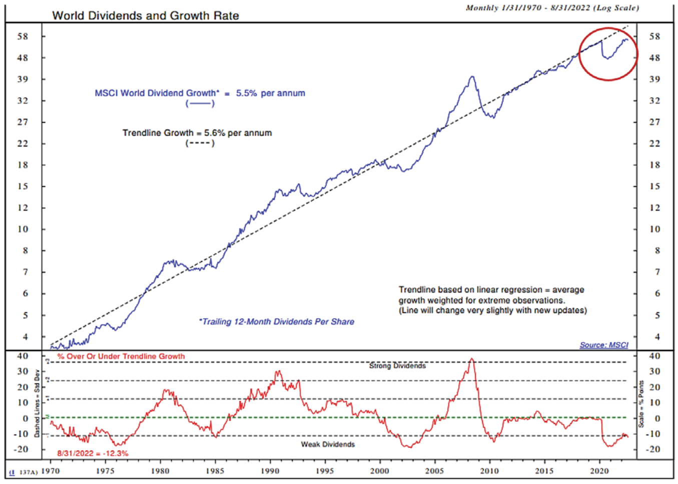
New Zealand's rising Life Expectancy



Source: United Nations World Population Prospects

However, even in those rarer years when a portfolio logs a negative full-year capital return, an Income portfolio will have offset this to some degree as the dividends and bond coupons will lift the total return. Promisingly for the future medium-term period, the CoVid shock of 2020 has ushered in an atypically low period of dividend growth globally. The rate of Dividend growth, which for the last 50 years has averaged 5.5% per annum (for MSCI World shares) dropped to a low only seen in two prior occasions in five decades (i.e. 1976 and 2002.) This growth rate is likely to revert upwards to more typical levels in the next year or two, enhancing this component of the Sustainable Income Fund and comparably diversified investment vehicles.

International Equity markets display cyclicality in dividend growth rates



Source: BCA / Ned Davis Research, data to 31 August 2022

In the words of MoneyWeb, "Dividend shares are quiet achievers. In New Zealand, they tend to be established retailers, power generators, infrastructure owners

and property investors." These are also companies represented in our own Income-focussed funds:

Source: SeekingAlpha.com

While it may appear at first sight that such sectors occupy an outsized allocation within the Sustainable Income Fund's current holdings, this is to be expected, given the premium on quality and earnings stability typically visible in these sectors, and on the richness in the NZ and Australian market of dividend-advantaged stocks for historical reasons. As market conditions and investment opportunities change, investors in our diversified fund would expect to see a lowering of this strong focus on Australasian shares and Property, in favour of higher allocations in selected International Fixed Interest and Infrastructure.

Conclusion

The broad asset market volatility seen this year is difficult to avoid within diversified portfolios. Inflation fears are hurting many asset prices, and even the Gold price – long thought of as an inflation hedge – has dropped by almost

10% this year. Gold, famously, has no yield, and it therefore fiendishly difficult to value. However, many quality asset do offer good and sustainable yields, and these can be used as the building blocks of a robust income-providing funds solution.

At times of capital price volatility, it is important to retain a focus on any fund's main objectives, and achieving defensible, stable income distributions combined with medium-term capital growth potential is the most realistic investor value proposition for Diversified Income. We consider capital price fluctuations inevitable, but over a well-chosen investment horizon, these will mainly provide periodic entry opportunities at good security price levels, on the "dollar cost averaging" principle.

The risk of locking investable monies away in bank deposits is less that one will receive an inferior interest rate or income yield, and much more, that those funds will not be available for rapid deployment into other market opportunities when the current inflation-driven volatility begins to subside. Therefore, given that the gross yield on our Sustainable Income Fund is in line with some of the best offered TD interest rates and Investment Grade single bond yields, we maintain that the diversification and active management elements give this fund type enduring advantages. Inflation is painfully high at present but holding too much Cash is not a solution – rather, it is a form of "money illusion" which can potentially lead to a more serious erosion of an investors' future purchasing power. Staying active and staying diversified is, in our view, the wiser course.

Salt's Rules for Diversified Income investment fund design

As we noted in mid-2021, and would re-emphasize today, when building an Income investment fund, it is crucial to take many variables into account, and to allow adaptivity to changing risk and reward conditions in global markets. Some of these principles are:

- Active management, as both agility and security selections are crucial.
- International asset reach, as individual economies like NZ are too concentrated, to be a reasonable basis for generating sustainable income on a multi-decade timeframe.
- Learning the lessons of the past, in terms of not promising return without risk. The claims made for Collateralized Debt Obligations (CDOs), Over-leveraged loan portfolios (CLOs), Consumer Finance Debentures, Subordinated or Unsecured Mortgages and a confetti-shower of marginal "receivables" in the world of commercial securitization need to be scrutinized thoroughly at inception, and consistently throughout the life of the investment product.
- Taxation is a constant, and tax efficiency should be part of product construction. However, products should not be built around a given tax regime, which may change.
- Currency and Foreign Exchange exposure management, for the international assets held is important, as the traditional "hedging premium" available to NZ investors is now minimal.
- Inflation-proofing the fund to some degree is possible by holding assets with performance that historically hedges inflation, and which have innate inflation- hedging characteristics.
- Do not over-complicate the fund with engineered risk-mitigation structures. These are quite expensive, and although they appear to provide security or "insurance" they often either drain the fund return over time due to in-built costs or worse, they fail to function when they are most needed, due to derivates market disruptions in panics.

Disclaimer: The information in this publication has been prepared from sources believed to be reliable and accurate at the time of preparation but Salt Funds Management Limited, its officers, directors, agents, and employees make no representation or warranty as to the accuracy, completeness, or currency of any of the information contained within, and disclaim any liability for loss which may be incurred by any person relying on this publication. All analysis, opinions and views reflect a judgment at the date of publication and are subject to change without notice. This publication is provided for general information purposes only. The information in this publication should not be regarded as personalised advice and does not take into account an individual investor's financial situation or goals. An individual investor should, before making any investment decisions, seek professional advice. Past performance is not a reliable indicator of future performance and no representation or warranty, express or implied, is made regarding future performance. More information is available at: www.saltfunds.co.nz. Salt Investment Funds Limited is wholly owned by Salt Funds Management Limited and is the issuer of units in the Salt Sustainable Income Fund and a Product Disclosure Statement can be found at www.saltfunds.co.nz