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Income investing in a challenging environment

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The environment

The current macroeconomic and financial market environment remains supportive of income focused strategies. The deleveraging process that began in Western economies in 2008 has forced developed market central banks to provide support for economic growth. They have cut interest rates and printed money as consumers and businesses reduce expenditure and repair their finances. This has led to near zero interest rates in many developed nations and resulted in investors struggling to meet their income requirements. Although progressing well, we believe the current deleveraging that is currently taking place still has some way to go. In the United States, aggregate debt peaked at 385% of GDP in early 2009 and has since declined steadily to 355% of GDP. In the 1930s, however, debt to GDP ratios fell to levels considerably below where they peaked leading us to believe that we are only part way through the current deleveraging process.

Figure 1: US Debt as a % of GDP

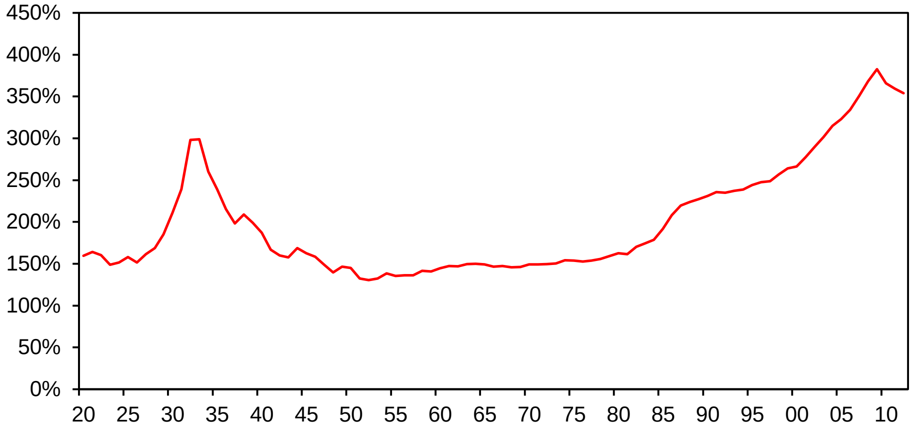
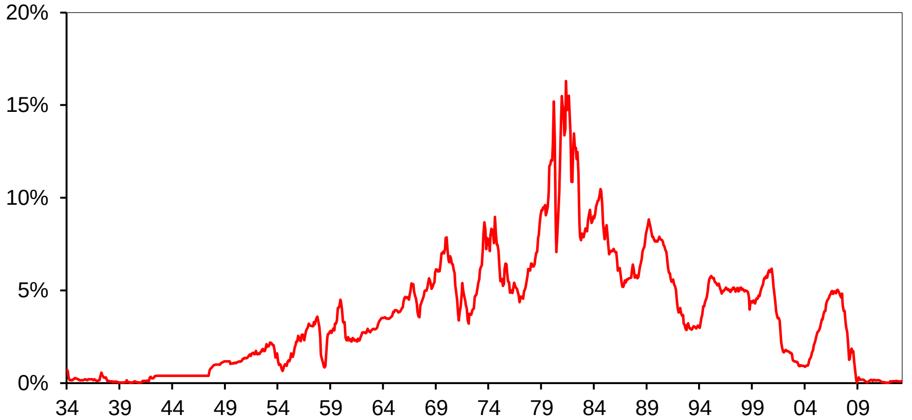


Figure 2: US Short Term Interest rates



Source: Federal Reserve Bank of St Louis, 31 December 2012

Against this backdrop, where continued deleveraging is acting as a headwind to economic growth in the developed world, central banks are likely to have to maintain highly accommodative monetary policy measures to encourage growth. This was the case in the 1930s, where interest rates were moved to near-zero in the early 1930s and remained there until the early 1940s. The requirement for policy makers to provide this support at present should, in our view, lead to a continuation of near zero interest rates until the current deleveraging process has further progressed.

In this environment, where it remains challenging for investors to meet their income requirements, income-focused strategies should remain well supported by continued demand for higher yielding assets. However, given that the current environment is characterised by tepid growth and plentiful liquidity, we believe that investors who are searching for income should tread carefully when exposing themselves to asset classes that are more volatile than they are used to. Below we set out our principals for income investing, which we hope will help guide investors through the challenges of the current environment.

Our six principles for income investing

1. **Be careful when investing in passive income products.** Investing in generic income products like ETFs can result in unnecessary exposure to avoidable risks. For example, income-focused equity ETFs can be highly concentrated in a small number of sectors, such as utilities, leaving investors exposed to, for example, regulatory risk. We believe investors should pursue more bespoke strategies that are designed to minimise such risks.

2. **Pursue a diversified approach.** Investing in single asset classes for income can leave investors exposed to the specific risks inherent within those assets classes. Whether it is market risk in equities, liquidity risk in high yield debt or the political risk inherent in emerging market debt, these risks can lead to meaningful underperformance by particular asset classes. We believe that by investing across a spectrum of asset classes, investors can diversify these risks and produce superior risk-adjusted returns.

3. **Focus on higher quality assets with sustainable income.** One of the biggest risks in investing is the risk of permanent capital loss. Investing in higher yielding securities without paying attention to the security issuer's future ability to pay dividends or meet coupon and principal payments, risks permanent capital loss. We believe it is imperative to focus on investing in high quality securities that are able to sustain and,
   *Schroder International Selection Fund is referred to as Schroder ISF
   ** Source: Federal Reserve Bank of St. Louis, 31 December 2012

   for equities, to grow their income streams in order to minimise the risk of capital loss.

4. **Take advantage of opportunities globally.** Investors who are geographically restricted, for example by focusing too narrowly on their home market, have a reduced opportunity set compared to those investors who invest globally. Assets in certain regions can be expensive at points in time, while assets in other regions can simultaneously be cheap. By investing globally you can take advantage of opportunities in different regions whenever they present themselves.

5. **Be flexible and unconstrained.** Different asset classes offer value relative to other asset classes at different points in the economic cycle. We believe that a flexible and unconstrained approach should be taken when managing exposure to different income sources. This allows you to take advantage of relative value opportunities in different asset classes, styles and market cap size over time.

6. **Analyse risk and manage it carefully.** By following the first five principles listed above, concentration risk and the risk specific to individual asset classes and securities should be minimised. However, it is also important to take into account liquidity risk to ensure that assets can be bought and sold with ease. It is also important to understand the amount of risk being taken and to examine how your portfolio will perform in different market environments. We believe an active approach to risk management, in order to understand the sources and portfolio implications of different types of risk, can assist in protecting a portfolio during turbulent markets.