BROADENING YOUR HORIZONS, INCOME DIVERSIFICATION MATTERS

Sticking to the well-worn path of term deposits and annuities may not provide for the comfortable lifestyle that income investors seek. When taking inflation and longevity risk into account, it is clear that income investors should diversify.

Now is the time for income investors to ‘rethink’ their approach to investing. This mean turning some of the traditional portfolio construction approaches on their head.

In this white paper, we discuss how investors need to ‘rethink’ their approach to investing, turning some of the traditional portfolio construction approaches on their head.
What you need to know

Redefining the ‘risk/return’ question.

A traditional portfolio management approach looks at the potential total return (capital plus income) versus the expected risk of each asset class and then aims to combine them into the most ‘efficient’ portfolio to produce the best possible level of expected return for a given level of risk.

Income investing involves a different risk. The sustainability of income is the challenge. In this context low risk means sustainable income. As the chart below shows, equity income, illustrated with reference to the Legg Mason Martin Currie income funds has a different risk and return characteristic to equity markets overall and to other income producing assets.

Dispelling the Myths

The standard approach to equity investing is not aligned with meeting the needs of the income investor for a number of reasons:

- It is 'benchmark aware' rather than income focused, with greater attention paid to capital growth
- It uses benchmarks that are market capitalisation-based indices
- It misdirects the investor’s attention to capital volatility and it ignores the investor’s tax rate

Though growth assets have an important role to play, particularly in today’s low income world, a new approach is required.

Past performance is not a guide to future performance. Source: Martin Currie Australia, as of 31 December 2016. Data shown for illustrative purposes only.
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Myth 1: Can a home country bias be a benefit?

The Myth: A key concept of traditional asset allocation is to avoid a ‘home country bias’. This concept is based on the idea that investors’ exposure to domestic assets is too high, at the expense of exposure to global assets.

The Reality: If our cost of living is tied to inflation in Australia, doesn’t it make sense to match our assets to our liabilities? If the objective is sustainable income, investors should not be discouraged from having a higher allocation to Australian assets.

In reality, investing overseas adds a new risk dimension - currency movements - that can add unnecessary volatility to the regular income received.

Myth 2: Australia – a diversified economy

The Myth: Many commentators still, incorrectly, view Australia as a resources dominated market.

The Reality: The accompanying chart shows the breakdown of the Australian economy by industry contribution to GDP, demonstrating a significant shift towards the service economy.

Since matching our assets with our liabilities is paramount, it makes sense to invest in those industries that contribute to Australian economic growth – which surprisingly to many is not mining. This is also the most constructive and efficient way to incorporate inflation protection into our equity income strategy.

Changing the asset mix to deliver income

For income investors, conventional wisdom has been us that a typical ‘conservative’ balanced fund is a suitable investment strategy, particularly for retirees. However, it is important to remember that we may spend a long time in retirement and the cost of living is not going down.

We believe that the asset mix of the Legg Mason Martin Currie Diversified Income Trust is a much more robust and effective solution that can meet and exceed investors’ income objectives over time. It’s not a ‘set and forget’ approach. Our dynamic asset allocation approach is designed to capture the best income-producing returns and also grow the capital base over time.

The chart above shows the current asset allocation of the Legg Masson Martin Currie Diversified Income Trust, while the chart below shows how we use a dynamic approach to asset allocation. We recognise that a lot of clients do not have the time to spend on managing their investments and this fund is designed for those investors looking for an actively managed ‘one-stop’ solution.

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Source: Martin Currie Australia, as of 31 December 2016. Based on the representative Martin Currie accounts. Data shown for illustrative purposes only.
Managing the income shock – beware of sequencing risk

Investors searching for income solutions can be at any stage of life. It is not just when entering retirement that our focus turns to enhancing our income stream.

One risk that investors need to be wary of is sequencing risk (also referred to as transition risk), which is the risk of locking in losses as a result of transitioning to a different investment strategy.

This risk can be managed by continuing to invest in growth assets. The chart below shows what would have happened to investors who switched from a standard balanced fund to a pure fixed income strategy at various points in the investment cycle, and what would have happened to their income streams. Investors do not necessarily have to make dramatic moves in their asset allocation to meet their future needs.

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Source: Martin Currie Australia, as of 31 December 2016.
Data shown for illustrative purposes only.
How Legg Mason can help

At Legg Mason we have purposefully developed our range of income solutions to meet the needs of Australian investors seeking sustainable income. This suite provides investors with a high level of flexibility, whether is be playing a specific role within a client’s broader investment strategy or providing an all-encompassing ‘one-stop’ income solution. Since 2010, Legg Mason has been a pioneer of income investing, having recognised that future interest rate falls would cause stress across client portfolios.

The picture above illustrates our Diversified Income Strategy, which is designed to be a one-stop income solution investing across four underlying asset classes with the objective of delivering a growing and sustainable income stream. Each of the underlying building blocks – Australian equity, Australian real assets, Australian fixed income and cash are managed by experienced and dedicated teams with proven track records.

The Legg Mason Diversified Income Solution

Leverage Legg Mason’s multi-affiliate income spectrum

Diversified Income Strategy

Legg Mason Income Building Blocks

- Designed with income as the objective not just an outcome
- Pioneers and innovators of Income Solutions
- Avoid complexity, deliver transparency
- Align with a client’s real world income objectives

DESIGNED TO DELIVER A SUSTAINABLE AND GROWING INCOME STREAM

- Capital growth potential
- Focus on quality
- Inflation protection
- Liquidity
- Tax optimisation
- Minimise longevity risk
- Lower volatility

Cash
Equity
Real
Fixed

Income
Income
Income
Income

Legg Mason Diversified Income Solution

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