

Investment Insights

Letting Your Money Work for You into Later Life

(Estimated Read Time: 4 Minutes)

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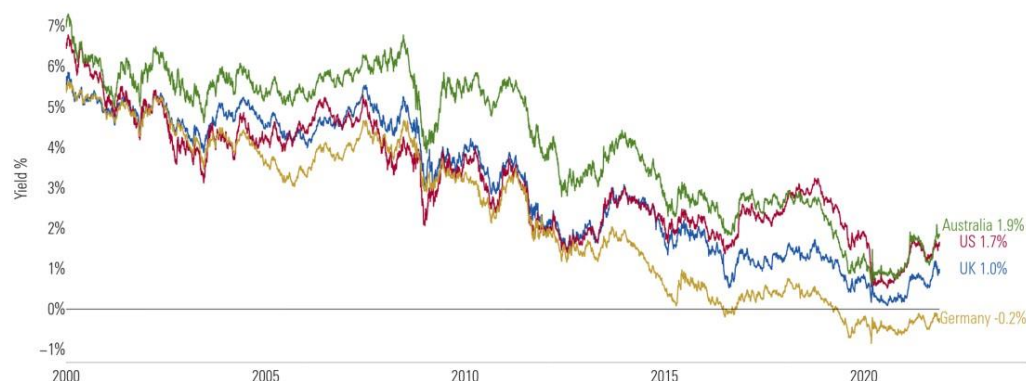
Morningstar Investment Management LLC
December 2021



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One of the primary motives of investing is to fund a comfortable retirement, with a 2020 Morningstar Behavioral Research survey showing that this remains the number-one goal among individuals. So, while retirement planning remains a foundational pillar of the financial advice industry, we'd broaden it out as making your money work for you. This is a timely and relevant topic, as it is no secret that income generation is getting harder, with several trade-offs and potential pathways to navigate.

Exhibit Interest Rates Remain Very Low Entering 2022, Posing a Continued Challenge for Retirees



Source: Cleantomics, Morningstar Investment Management, as of October 31, 2021. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index.

The Modern Dilemma for Retirees & Income Generators

The last decade has been a good one for investors of all types and sizes, with record-low volatility and record-high prices for most asset classes. For retirees, though, it has been a period of declining cash rates, declining bond yields, and declining dividend yields. This remains one of the great challenges for investors trying to live off their assets in 2022, as income is so much harder to attain.

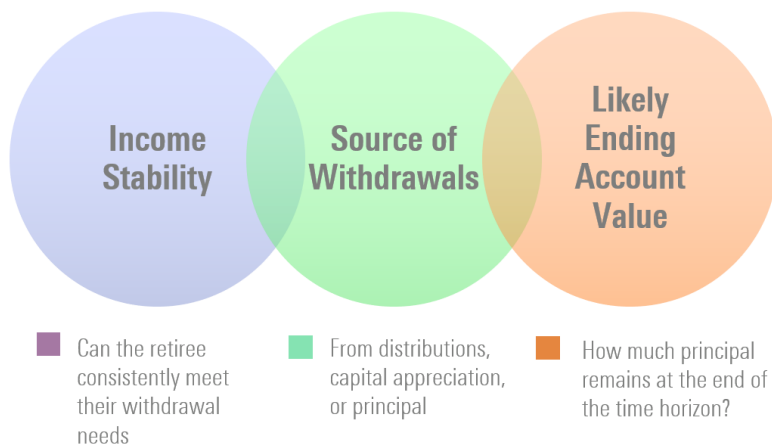
This might be about to change, with some expecting interest rates to rise. We note that we aren't in the business of predicting interest rates, although the general consensus is that the most likely direction for interest rates is up. Our expertise is to build portfolios that can handle different possibilities, which is really a matter of portfolio robustness. In this regard, higher interest rates would have obvious implications for asset prices, with retirees particularly sensitive given their typically higher weighting to bonds. This is a double-edged sword, however, as higher rates would cause bond price losses in the near term, but it could make income generation easier in a forward-looking context.

The harsh reality is that we are presented with a perfect storm against retirees—an environment that is low yielding and generally unattractive, with rising inflation reducing their purchasing power. This requires a selective approach to empower investor success and presents a modern dilemma to solve.

What Approach is Best for 2022?

Many timeless questions carry special weight in 2022. For instance, are retirees better positioned by focusing on a selective-income approach or a total-return approach in an environment of low current yields and higher risk? We did some interesting research on this in early 2021 and found that both approaches can still be effective, although both carry risks, too.¹ The same learnings are applicable in 2022, though starting yields are slightly lower again and risks slightly higher.

Exhibit Three Measures Retirees Should Understand



Source: Morningstar Investment Management, for illustrative purposes only.

- ▶ With a **total-return approach** in 2022, you would seek to accumulate further gains, then sell part of the portfolio periodically to meet the withdrawal needs. The obvious risk is that markets are expensive, so if you sell down assets that aren't rising (or worse, falling), you'll have a higher likelihood of running out of money. This is a risk many would like to avoid, especially those exposed to sequencing risk (the risk of a big decline early in your retirement wiping out a big part of your nest egg). Ordinarily, this would incline many towards an income approach, but the common mantra remains that "there is no alternative" (TINA).
- ▶ The **income approach** requires a selective approach in 2022, as a focus on cash-flow generation requires you to typically tilt portfolios toward asset classes with higher current income, such as high-dividend stocks and emerging-markets debt. However, some of the popular income assets can carry meaningful downside risk, and some exhibit no growth in income (a risk in the face of rising inflation). For example, we don't believe longer-dated bonds are an area that will serve income-hungry investors in 2022. We think yield chasing is a cardinal sin when it is taken to the extreme, moving up the risk curve without a thorough understanding of what you own and why you own it. Patience is key, as 4%+ yields are difficult, if not impossible, to obtain in 2022 without accepting meaningful risk.

Natural Sources of Cashflow in 2022

Some assets naturally lend themselves to stable income generation, and we see some attraction in these asset classes heading into 2022. The aim is for:

¹ Using U.S. data, we looked at 163 rolling periods, comparing the two approaches for a) income stability, b) the source of withdrawals, and c) the likely ending account value. We found that there is no best choice that works for everyone, with an income approach generally effective for (a) and (b), but less clear for (c). We also noted taxation and behavioral elements and highlighted the modern challenge of lower starting yields.

- ▶ Income growth,
- ▶ Some capital growth to keep up with inflation,
- ▶ Durability. Dividend cuts are an issue to avoid and technological obsolescence must be considered. ESG (environmental, social, governance) risks must also be assessed.

We look for these characteristics across our entire portfolio range, not just income-focused strategies, because natural income sources are a return driver with relatively reliable outcomes. For example, banks are a popular source for income and are an area we generally find attractive heading into 2022, represented in many portfolios. We note that banking income isn't always natural, with durability a nuanced issue — capital adequacy is important, with debt issues to consider and excess capital that can cause overdistributing — but it does offer relative value.

When it comes to robustness, defensive equity sectors such as consumer staples and healthcare are also areas that we believe offer natural income sources. The yields aren't high in absolute terms as we enter 2022, but they do help offset cyclical risk and provide durability. As you can see, selectivity is key for those wanting to live off their income in the current environment.

Key Takeaways for Living Off Your Assets

As was the case in recent years, 2022 is likely to be a difficult environment for passive-income generation, with low rates and expensive assets a common challenge. Arguably, this year's environment is even worse, with higher inflation eroding the purchasing power of your income.

This requires careful navigation. On one hand, your primary role is to maintain your purchasing power with an inflation-beating portfolio that is robust and can handle different environments. On another, it makes sense to capture natural income sources, helping you with the three measures of retirement success: 1) cashflow stability, 2) source of withdrawals, and 3) likely ending account value.

We seek to do all of the above in the portfolios we manage, including some that are specifically targeted with inflation-beating or income-targeted objectives.

Highlight of Our Convictions

Steering investors to our asset class convictions, our investment team monitors over 300+ markets across equities, fixed income, and currency. We highlight our conviction level across some core assets, including a micro-thesis on the key drivers.

| | Asset Class | Overall Conviction* | Key Long-Term Drivers |
|------------------------|----------------------------------|---------------------|--|
| EQUITIES | United States | Low to Medium | Valuations are not as compelling as international markets. Investor optimism was bordering on excessive, which remains a concern to us. |
| | Europe ex-U.K. | Medium | We find the opportunity set in Europe to be diverse. The recovery continues to take shape, with sector selection important. |
| | U.K. | Medium to High | Investor sentiment has improved, following a long period of negativity. The reward for risk continues to appeal. |
| | Japan | Medium | We still cite structural reform, providing upside to earnings drivers. The relative appeal is moderate. |
| | Emerging Markets | Medium | Recent weakness has improved the opportunity set in emerging markets, although the overall appeal is still moderate. Risks need to be managed. |
| | Germany | Medium to High | German stocks offer solid balance sheets and upside to earnings —without the eyewatering valuations in some other markets. |
| | South Africa | Medium | While sensitive to cyclical earnings and concentration risk, valuations reflect these concerns. Our view has moderated though. |
| FIXED INCOME | Government Bonds – U.S. | Low to Medium | Yields are still incredibly low and no longer cover inflation risks. The defensive attributes are appealing, but unlikely to contribute to returns. |
| | Government Bonds – U.K. & Europe | Low | Gilts, Bunds and other EU Treasuries have terribly low yields. Longer-dated bonds are particularly sensitive to inflation risk with poor return prospects. |
| | Investment-Grade Corporate Bonds | Low to Medium | Yields are unattractive in an absolute sense, with a narrow spread to government bonds. We are wary of valuation risks if the recovery stutters. |
| | High Yield Credit | Low to Medium | Yields no longer compensate for the risk taken. Defaults remain low, but credit risk should not be ignored. |
| | Emerging-Markets Debt (Local) | Medium to High | Emerging market debt in local currency (which we prefer over hard currency) continues to offer healthy relative yields, even accounting for risk. |
| LISTED PROPERTY | U.S. REITs | Low to Medium | U.S. listed property remains broadly unattractive on an absolute basis, carrying high debt and concentrated exposure. |
| | Non-U.S. REITs | Low to Medium | Continues to rank behind other opportunities on both an absolute and relative basis, although South African REITs continue to stand out. |

Source: Morningstar Investment Management, conviction levels confirmed at November 12th, 2021.

*Overall conviction is a long-term judgement built on a five-point scale from “Low” to “High”. Typically judged on a 10-year horizon, a “Low” means that reward-for-risk is likely to be subdued, whereas a “High” means reward-for-risk is appealing. This incorporates our four pillars of conviction including 1) absolute valuations, 2) relative valuations, 3) fundamental risk and 4) a contrarian scorecard.

Disclosures

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