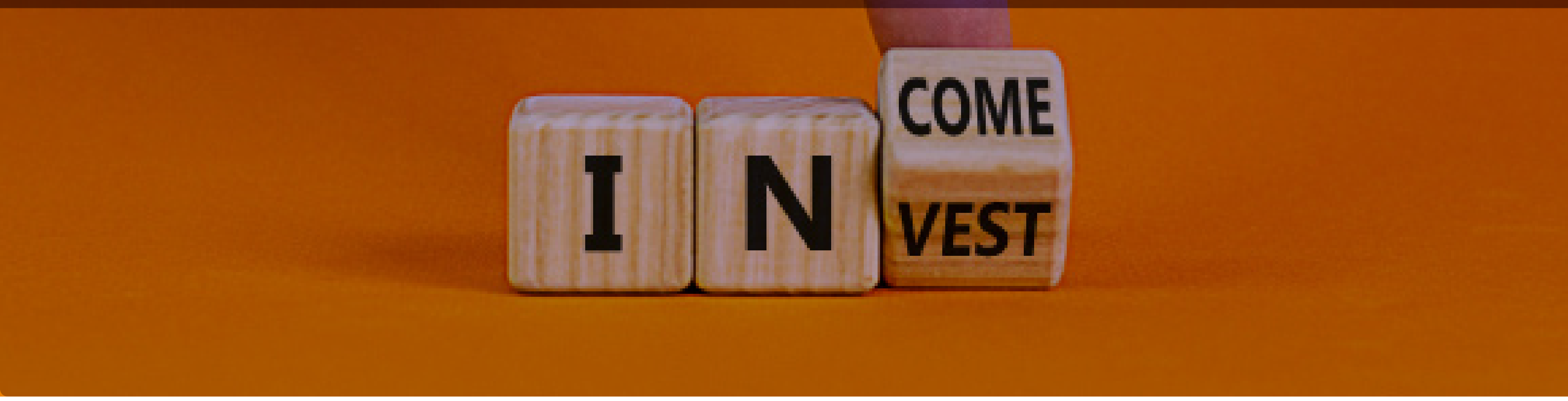
The Case for a Total Return Approach for Income-Seeking Investors

Blog Post, May 2023



Written by Jonathan Griffiths
Investment Product Manager

Introduction

In seeking to generate income from a portfolio, there are two broad approaches to consider: a traditional income-focused approach and a total return approach. This blog makes the case for a total return approach for income-seeking investors, looking at the key considerations through the lens of pros and cons.

How does a total return approach differ to a traditional income-focused approach?

Considering a traditional income-focused approach to begin with; this is an investment approach that prioritises income generation from a portfolio, seeking to produce income through dividends, interest, or coupons, and distributing this income to fund portfolio goals (typically retirement spending).

On the other hand, a total return approach uses a combination of both income and capital gains to provide for a portfolio's distribution requirements, rather than relying purely on income alone.

What are the advantages of a total return approach?

There are a range of advantages for income-seeking investors from utilising a total return approach rather than a traditional income-focused approach.

The first point to consider is **diversification**. Portfolios built using a total return approach have the flexibility to invest in a diversified manner across asset classes, rather than being obligated to focus on high income-generating areas and having to rule out lower-income assets.

This leads to benefits in terms of portfolio performance; as higher-yielding assets may not represent the best potential investment opportunities at a given point in time, the flexibility of the total return approach means that a portfolio can be built to deliver the highest expected performance in line with the relevant capacity for risk. This is particularly relevant over the long term, with total return portfolios typically in superior position to preserve real value, as opposed to traditional income portfolios, which focus on higher yielding sectors which might deliver less in terms of capital growth.

It also leads to potential **risk-reduction** benefits; as total return portfolios are more diversified, by their nature they are less concentrated in a small number of assets or sectors, in which the assets themselves might be riskier in nature. For example, traditional income-focused investors have historically been overexposed to higher income equity sectors such as energy and financials, and higher yielding bond types such as junk bonds. The more concentrated nature of traditional income portfolios can lead to greater volatility and reduced resilience to market shocks, as well as potentially greater inherent risk from the underlying assets (such as higher risk junk bonds, or high-yielding stocks paying an unsustainable yield and therefore exposed to potential price revaluations). Additionally, portfolios reliant on fixed-income investments such as bonds can find them exposed to the risk of inflation outpacing the return received on the underlying assets, compared to a total return approach which typically has greater exposure to assets that are likely to generate a return in excess of inflation.

Alongside this, a traditional income-focused approach can lead to issues in terms of income consistency. Income from dividends can be volatile and isn't guaranteed – for example while UK dividends rose 8% over the 2022 calendar year, they had previously fallen 42% over the 12 months to 31 March 2021 as two thirds of UK companies reduced or eliminated their dividends in response to the Covid-19 pandemic. An income-focused investor relying heavily on dividends is highly exposed to the developments and gyrations in corporate dividend markets globally.

What are the disadvantages of a total return approach?

As we all know, free lunches are quite rare in life, there are some potential tradeoffs or disadvantages to income-seeking investors adopting a total return approach.

The first to mention is of course the risk of being forced to sell investments that have fallen in value, in order to provide the required level of income. However, by investing across a broad globally diversified basket of assets, overall returns from the portfolio should be enhanced, with lower expected volatility. Alongside this there is the risk of distributing a larger amount of income than the portfolio is able to support, and therefore stricter discipline is required in terms of making distributions from the portfolio. One approach to guarding against this and preserving the real value of the portfolio is to limit distributions to the portfolio's excess return generated above inflation, and to put a strong framework in place to maintain portfolio distribution discipline.

Finally, there is the question of how to provide **distributions in years of negative returns**. One approach to guard against this is to build a capital buffer, to help fund distribution needs during down-years. Building a reserve of unspent capital in this manner can help fund income needs during leaner times.

Conclusion

While there are pros and cons to income-seeking investors adopting a total return approach over a traditional income-focused approach, and while each individual situation is unique with its own challenges and complexities, we believe the broad advantages of total return approach outweigh the disadvantages.

Investors utilising a globally diversified total return orientated portfolio in order to achieve strong risk-adjusted returns over the long term are well positioned for capital growth and income-generation, and through prudent management, the income generating capacity of such a portfolio can be maintained over the long run.

Alongside accumulation share classes, ebi provides access to our portfolio range through income share classes, for those investors who wish to generate income from their portfolios while maintaining a total return approach.

Disclaimer

We do not accept any liability for any loss or damage which is incurred from you acting or not acting as a result of reading any of our publications. You acknowledge that you use the information we provide at your own risk.

Our publications do not offer investment advice and nothing in them should be construed as investment advice. Our publications provide information and education for financial advisers who have the relevant expertise to make investment decisions without advice and is not intended for individual investors.

The information we publish has been obtained from or is based on sources that we believe to be accurate and complete. Where the information consists of pricing or performance data, the data contained therein has been obtained from company reports, financial reporting services, periodicals, and other sources believed reliable. Although reasonable care has been taken, we cannot guarantee the accuracy or completeness of any information we publish. Any opinions that we publish may be wrong and may change at any time. You should always carry out your own independent verification of facts and data before making any investment decisions.

The price of shares and investments and the income derived from them can go down as well as up, and investors may not get back the amount they invested. Past performance is not necessarily a guide to future performance.

Suite 7, Beecham Business Park, Northgate, Aldridge, WS9 8TZ 01922 472 226 ebi.co.uk enquiries@ebi.co.uk

ebi Portfolios Ltd is authorised and regulated by the Financial Conduct Authority (581079). Registered in England, Number 07473221