Why income investing is for everyone

Members of AGF's investment management team recently sat down for a special roundtable to discuss the importance of income investing in a time marked by rising debt loads, low interest rates and stagnant wages. These are not small challenges, but our team believes a diversified approach to seeking yield is crucial in the current environment and can leave investors of all ages in a better position to achieve their long-term goals.

Questions and answers that follow have been edited for clarity and length.

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> **– Jean Charbonneau**

Why is it important in today's economy for investors to generate income in an investment portfolio?

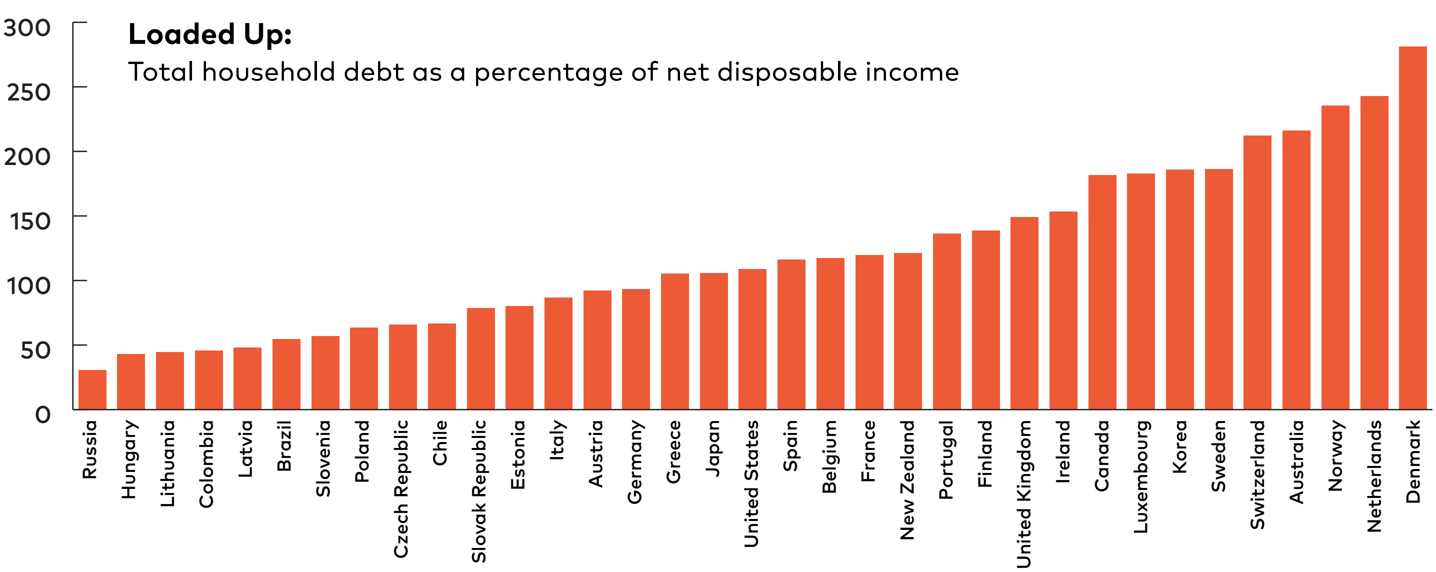
Jean Charbonneau (JC): What we have seen since the Great Recession is that wages haven't gone up at all, while debt loads have. This is true globally, but if you look at the typical Canadian household, for example, its indebtedness relative to disposable income is at a record high. For every dollar of assets it owns, it has about a $1.80 in debt so income is needed to help fill in the gap that has widened in the past ten years.

Andy Kochar (AK): The high debt environment has resulted in mandatory expenses going up and a much lower level of discretionary income that leaves people with less to spend. At the same time, the current environment of low interest rates has made it very difficult to earn a reasonable return from an investment that is also relatively safe.

Stephen Duench (SD): It's like the old saying, "one bird in the hand is better than two in the bush." A lot of investors just feel better about generating income from their portfolio than maybe taking a bigger risk on something that does not. But there's also more to being an income investor than just that. I think the selloff at the end of 2018 reiterated some of the other advantages – including downside protection – that are associated with these types of assets.

Is the current environment helping redefine the identity of an income investor?

AK: I think the identity of an income investor runs the gamut. It could be an investor who is conservative by nature and likes the certainty that income provides. Or it could be a retiree who depends on additional cash flows, or someone who just wants to supplement their working



Source: Organization of Economic Co-operation and Development (OECD) as of March 25, 2019. Based on 2017 data or latest available.

day salary. It's a matter of circumstances, but all are very valid reasons to be an income investor.

JC: An aging demographic is definitely at play but so too is the need for working people to supplement their salaries because of their growing debt loads, which have been fueled by easier access to credit.

SD: Everyone sees an income investor as an older, more conservative investor, but I think that's being turned on its head. Take millennials. This is a generation that really appreciates the assurance that an income investment can provide. Older millennials entered the workforce and started investing right when the credit crisis happened and younger millennials have had to deal with delayed household formation and delayed wage inflation. So, all of this points to risk-averse investors being much younger than was the case in prior generations.

JC: The shift away from defined benefit to defined contribution pension plans is another factor that people overlook. This is a major shift that is forcing younger investors to think about income investing at a much earlier stage in their careers.

SD: It's basically bookended, right? You have the baby boomers that are retiring that need fixed income and probably become more allocated to income investments than previously. And then you have the younger generation that could be more income-focused than before.

Let's talk more about interest rates. They've risen over the past couple of years, but can they go much higher?

AK: It's going to be very hard for rates to rise significantly until we have a solution to our debt problem. There will be cyclical upswings and downturns, but we're in a period of secular stagnation and low interest rates for a while.

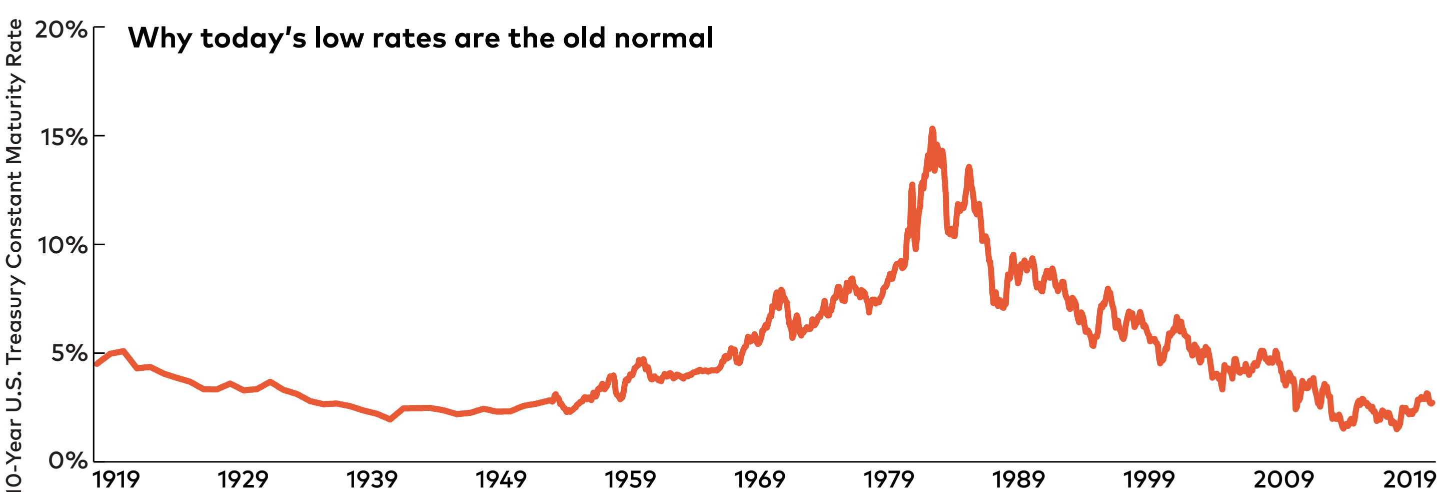
SD: I agree. With so many investors seeking yield at a time when yield is scarce, it's tough to see rates getting that much higher.

JC: In the U.S., in particular, a lot of the defined benefit plans have moved away from riskier assets as rates have moved up and are doing more matching of liabilities to assets. That provides more constant demand for fixed income and keeps a lid on yields.

AK: A lot of investors recall the double-digit interest rates of the 1970s and 1980s, but if you look back at the past 100 years, this period was an anomaly. In other words, the level of rates today is much closer to the historical norm and investors shouldn't expect them to rise significantly from here.

So, low for longer, but investors have far more choice than ever before. How has the hunt for yield changed since you first started investing?

JC: If you look back at the 1980s, fixed income was typically confined to an investor's domestic market and was mostly government bonds with a bit of corporate debt. So, there wasn't very much breadth, but today the



Source: Robert J. Schiller as of March 25, 2019 http://www.econ.yale.edu/~shiller/data.htm.

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opportunities have exploded and can be found globally.

SD: It's also become much more global on the equity side as other equity markets play catch up to North America in terms of offering more sustainable dividend-paying options. You're finding yield opportunities everywhere and it seems like every company is growing their dividend. Even companies with high growth profiles often have attractive yields nowadays, which, in downturns, makes them that much more attractive.

AK: Today you can generate income from a wide variety of instruments in the market on both the fixed income and equity side of the equation. And whether that be investment grade bonds, high-yield bonds, convertible debentures, preferred shares, real estate funds, or even REITs, that's really helpful for portfolio construction. As an investor, you don't really care much about where your income is coming from as long as it maintains your risk and return objectives.

SD: And don't forget exchange-traded funds. You can go out there and buy an ETF of any sort of very niche pocket of the market and often be able to get a pretty healthy yield.

Does this greater choice also breed new challenges?

SD: It can be difficult. In part, because the term "yield" gets thrown around pretty loosely these days. A stock with a dividend yield just slightly above zero might now be considered a significant part of the dividend landscape. As a buyer, you need to know what you're getting into. Is that dividend truly sustainable? Is that fund really a yield fund? Not all are created equally, so you need to get under the hood and understand what's at stake.

AK: One of the trends I worry about is the pursuit of income in extremely illiquid asset classes, like private equity, private debt and or infrastructure. There's nothing wrong with these categories, but investors need to make sure they understand the tradeoff between potentially higher yields and far less liquidity.

JC: This is a very good point. In a recent household spending survey by the Federal Reserve Bank of New York, those polled were asked what they would do with an additional boost to their income. The large majority said they would pay down their debt and only a very small percentage said they would spend it. But if you can't access your income, you can't pay down your debt. That tells me how important it is to maintain liquidity in assets that are generating yield and providing supplemental income.

What are the characteristics of a good income-generating asset?

SD: From the equity side – and also as a quantitative investor – there's nothing better than a stock with a strong multi-factor profile that also has a sustainable yield which is growing. So, a company that is increasing its dividend, has good growth, is good quality, and which potentially might be on sale as well? That's like a perfect storm.

AK: As a fixed income manager, there are two things that are extremely important to me: The first is principal protection because return of capital is just as important as return on capital; the second is the stream of income. If it's too volatile, I have to ask myself, "How much risk am I exposing my client to."

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– Andy Kochar

JC: For me, it's first and foremost about the predictability of cash flow streams. It's so important that an asset generate income on a predictable basis. It's something that is underappreciated at the moment. Because rates are so low, too many investors are taking too much risk and owning less predictable cash flows in order to generate yield.

Why is it important to have both fixed income and equity income in a portfolio?

AK: Bonds mature, but stocks don't and that gives you certainty at the expense of capital appreciation. So, a diversified income portfolio of bonds and stocks can give you the combination of a reliable source of yield with smaller upside on one hand, while on the other, a stream of income that can provide more potential for capital appreciation.

JC: To pick up on an earlier point, people are taking way more risk to generate yield than they did before the Great Recession. So, a portfolio approach that considers the risk-adjusted streams of income that are generated from both bonds and stocks makes sense.

SD: That's a good way to look at it. Last year's equity rout might have woken people up to that a little bit more. Dividend equities didn't do so well relative to their fixed income counterparts. And, you know, a bear market in stocks is far worse than a bear market in fixed income. It's not even close.

AK: Whether it's a bond or a stock, an income investor is not expecting a lot of volatility. That's why diversification is so important. It never makes sense to put all your eggs in one basket.

What are some of the opportunities you're considering these days?

JC: Broadly speaking, the best way to seek opportunities is to take a global approach. Some countries like Canada are very low-yielding on the fixed income side, but you can find some really nice yield in emerging markets without sacrificing on quality and liquidity. In particular, there are some very attractive, short-term "Supranational" bonds that are rated AAA and have double-digit yields. There's currency risk attached to them, but very little duration risk and they provide very high cash flow.

SD: There's been a constant rotation of opportunities being created on the equity side. Most recently, we've seen some good options in our quantitative factor models in both growth and value pockets of the market. As well, we've done some recent work on North American Financials and found some fundamentally strong companies that have underperformed quite substantially, but continue to pay sustainable and growing yields. Something a bit more defensive is U.S. Consumer Staples, which have also drastically underperformed. But in all of these cases, you have to pay attention to just how quick things are moving nowadays.

AK: There's no shortage of opportunities on the fixed income side. The key is to have conviction in your category and security selection through a cycle. Macro conditions can often take over and investors are extremely negative right now in that regard. But that can be an opportunity and not something to be afraid of.

Jean Charbonneau, MBA

Senior Vice-President and Portfolio Manager[1]

Jean Charbonneau is responsible for the overall management of the AGF Fixed Income team and is committed to a strong, collaborative team culture driving all aspects of portfolio management. Jean and his team employ a global approach that derives value from multiple factors, including category allocation, country allocation, security selection, credit, currency and duration management.

A veteran fixed-income portfolio manager with more than three decades of experience managing a wide array of fixed-income mandates for retail and institutional clients, Jean is a leader across all facets of the team's analysis.

Jean is also the co-chair of the AGF Asset Allocation Committee (AAC), which is comprised of senior portfolio managers who are responsible for various regions and asset classes. The AAC meets regularly to discuss, analyze and assess the macro-economic environment and capital markets in order to determine optimal asset allocation recommendations.

Jean graduated with a Bachelor of Commerce (Finance) degree from the University of Ottawa and an MBA from the University of Sherbrooke.

Stephen Duench, CFA

Vice-President and Portfolio Manager[2]

Stephen Duench has been an integral member of the Canadian equity portfolio management team at AGF Investments subsidiary Highstreet Asset Management Inc. (Highstreet) since 2007. He contributes to both quantitative and fundamental research initiatives.

Stephen is central to the creation and support of Highstreet's proprietary portfolio management tools, analysis and applications across both Canadian and global mandates. He has a keen interest in research on factor characteristics and their subsequent performance.

Stephen earned an Honours degree in Financial Mathematics from Wilfred Laurier University and is a CFA® charterholder.

Andy Kochar, CFA

Portfolio Manager and Head of Credit[1]

Andy Kochar is a principal member of AGF's Fixed Income Team and serves as the firm's head of global credit. Using a cross-asset framework, Andy is responsible for the research and allocation of credit risk across all of AGF's fixed income portfolios.

He previously served as Associate Portfolio Manager for AGF's credit-oriented portfolios from 2013 to 2018. Prior to that, for more than five years, Andy served as Investment Analyst, Credit Research at Acuity Investment Management, which was subsequently acquired by AGF in 2011.

Andy earned a B.A. in Economics (Cum Laude) from York University. He is a CFA® charterholder and member of CFA Society Toronto.

[1] AGF Investments Inc.
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