CION INVESTMENTS

A Changing Game: Income Funds Deserve a New Look

What are Income Funds?

Income funds are just what they sound like, an investment vehicle that focuses on assets that provide an income stream, either through dividend payments or coupon payments. In some cases, they can also be viewed as total return vehicles that provide some growth potential through capital appreciation along the way.

While that may sound pretty simple, income funds are deserving of a deeper look in this new world of investing where rates remain low, and markets are moving faster than ever before. The reasons to use them in a portfolio have changed, the investor pool has expanded, and the types of assets that they invest in have evolved.

From a Specific Audience to Mass Appeal

Retired investors have reached a life stage where they need a dependable source of income to provide money to fund expenses, and to preserve capital so that it may last out retirement. This group is the traditional investor base for income funds. As retirement gets closer investors were often advised to transition their portfolios into a 60/40 mix of equities and bonds, which was often an increase in the credit side of the portfolio from the 80/20 or 70/30 mix that younger investors may deploy.

While this overall approach may still be valid, the changing investing landscape and the availability of new types of investments in income funds have transformed them into an investing style that provides utility regardless of asset allocation goals, timeline, or income needs.

An Evolved Landscape: How Income Investing Has Changed

The biggest change has occurred in the credit space. Traditionally, investors accessed income assets through the public markets by buying Treasuries or corporate bonds. Over the last several decades, the amount of income these assets provide has declined precipitously as yields have trended lower and lower.

Warren Buffet sites an interesting statistic: In September 1981, the yield on the 10-year U.S. Treasury bond was 15.8%. At year end 2020, the yield was 0.93%.[1] While the 1980s were arguably an outlier for high interest rates, the reality is that today, over 80% of the world's overeign and corporate debt trades below a 2% yield.[2]

So where are investors seeking income? Investors are increasingly considering alternative assets. A recent study[3] of investment advisors found that they turn to alternatives to potentially reduce risk, enhance returns, and provide an uncorrelated asset to other portfolio holdings in order to increase diversification and lower volatility in client portfolios. While there are many different alternative strategies, such as private equity, hedge funds, and venture capital, which would generally be regarded as growth strategies, the same study found that a significant percentage of advisors responding (36%) are using alternatives on the income side of the portfolio as well.

And within income alternatives, the private markets are eating up a lot of the new inflows. Private debt generally refers to non-bank institutions, such as asset managers, making loans to private, middle market companies that because of their size, cannot access the public markets to raise capital. These loans may offer a yield premium over public market debt because they tend to be illiquid; they are not traded on exchanges and the manager may hold them until maturity.

The asset class began to gain scale in the aftermath of the global financial crisis beginning in 2008, as banks increasingly stepped back and institutions increased activity. Total global private debt assets under management (AUM) have risen 168% to $845bn in 2019, from $315bn in 2010, and the growth of private debt is expected to continue with a 73% increase in AUM to $1.46tn by 2025, according to Preqin.[4]

What Else are Investors Considering?

As the economy continues to recover and is projected to expand, volatility still remains high. And as concentration in equity markets has increased, it's even more important to seek sources of return that are not overly correlated to equities. A long-term asset that can both throw off income and provide relatively uncorrelated returns may help to maintain a preferred risk/return profile. Additionally, the availability of more diverse income-producing assets make these types of funds deserving of a new look.

Wrapping It Up

Whether you build a portfolio on your own, or you work with a financial professional, taking stock of your investments in light of the current environment is always a good idea. Income funds are a modern way to gain access to income without liquidating assets, and can also provide exposure to alternatives. There are of course risks involved, as there are with any investment, so be sure to understand them thoroughly, either by the reading the prospectus or the offering documents.

[1] Berkshire Hathaway Annual Shareholder Letter, 2021
[2] RIA Intel. How Health Is Today's Private Credit Market. January 4, 2021
[3] PPB Capital Partners. Wealth Advisor Survey 2020. February 4, 2021
[4] Preqin: Future of Alternatives 2025

RISKS

As with any asset class, there are certain risks associated with non-investment grade debt. Credit risk is the risk of nonpayment of scheduled interest or principal payments on a debt investment. The risk of default may be greater. Should a borrower fail to make a payment, or default, this may affect the overall return to the lender. Further, illiquid investments require longer investment time horizons than other investments. For these and other reasons, this asset class is considered speculative and may not be suitable for everyone.