Investing for Income: Meeting the Challenges of a Low Yield Environment

For many investors, generating a high and sustainable income stream is challenging in the current secular landscape, which PIMCO calls The New Neutral. Over the next three to five years, we expect to see global economies converging to modest trend growth rates as central banks are constrained to set policy rates at levels well below those that prevailed before the financial crisis.

Lower overall yields in The New Neutral mean that traditional sources of high quality income, such as bank deposits or government bonds, may no longer be sufficient to maintain real spending needs. At the same time, a singular focus on picking the highest-yielding securities may leave investors vulnerable to significant downside risks or market shocks.

Key principles for income portfolios in The New Neutral

Across all of our income strategies, PIMCO expects three fundamental principles to guide portfolio construction over the secular horizon: diversification, flexibility and inflation hedging.

Diversification. Diversification across asset classes and underlying risk factors can potentially deliver better income and return outcomes; it may also help protect the portfolio during downturns or changing interest rate environments, and smooth overall volatility. Diversification is equally crucial within asset classes: In fixed income, for example, some income-oriented investors focus only on the highest-yielding sectors (such as high yield or emerging market debt), but this may leave portfolios vulnerable to concentration risk. Diversifying into more defensive sectors (such as developed market sovereigns) may provide some downside protection in periods of stress. In equities, relying too heavily on yield or domestic market stocks may leave portfolios vulnerable to an overly narrow set of risk factors.

Flexibility. Instead of managing a portfolio with a goal of outperforming a particular benchmark, an income strategy should focus on achieving its objective – consistent yield, income growth, capital appreciation, or a combination of these – within its risk parameters. The global opportunity set evolves rapidly. A flexible approach can adjust asset class or sector concentrations along with risk measures, targeting attractive opportunities and avoiding areas that no longer offer value.
**Inflation hedging.** Because inflation erodes purchasing power over time, it poses a significant risk to retirees and other income-oriented investors. We foresee global inflation increasing gradually toward central bank targets over the secular horizon, meaning long-term income portfolios should consider exposure to a broad range of asset classes that provide some degree of inflation hedging.

**Balancing income objectives**

Many kinds of investors seek reliable, consistent income. Demographics suggest this investor base will only grow as more baby boomers retire and as more retirees rely on defined contribution (rather than defined benefit) plans. Many endowments and foundations also see income generation as a key investment objective as they seek to maintain a consistent spending rate. Yet income investing is not one-size-fits-all. Income-oriented investors should be mindful of their specific objectives, their risk appetite and how their needs evolve over time. Depending on their individual needs, some investors may value the stability of income, while for others, growing their income may be more important.

Broadly, we believe there are three key “dimensions of income” that provide a framework for investors to think about their objectives and assess their tolerance for risk. Income portfolios can focus on any one of these three objectives, or they can be designed to balance among them.

**Consistent income yield.** Investors with regular spending needs, bills or other commitments may seek a steady and consistent distribution of income as their primary objective. For these investors, an emphasis on fixed income may provide a source of consistent yield.

**Growing income.** A growing yield is attractive to investors who need to maintain real purchasing power to combat rising inflation. An allocation to equities with growing dividends and to inflation-related assets is a potential solution.

**Capital appreciation.** Investments that grow in value can provide an important source of future income. Investors setting aside retirement savings many years or even decades in advance may want to focus on this objective, recognizing that targeting a higher level of return can entail additional risk.

Over time, as investor needs or risk tolerances evolve, the emphasis on each of these goals should be adjusted accordingly. For example, investors closer to retirement are likely to need a portfolio with a fairly stable income and modest level of volatility, as they may be less able to tolerate drawdowns in their portfolio.

**Designing income portfolios that consider specific objectives and risk parameters**

Customizing mixed-asset portfolios of fixed income, equities and other income-generating securities may allow investors to achieve a specific level of sustainable income in changing market environments while tailoring for their specific tolerance of investment risks or volatility. These bespoke mixed-asset portfolios should be designed with the underlying risk parameters of each asset class or sector in mind.

Here we illustrate three hypothetical portfolios where a combination of strategies is designed to achieve an income target for a specified risk budget. (Please note the specific allocations shown are for illustrative purposes only. They are not representative of any PIMCO products or strategies and do not take into account a particular investor’s specific investment objectives and risk tolerance.) The categories in these examples include core bonds (typically investment grade securities issued by governments, agencies and corporations), income-focused securities (bonds or equities that typically offer a higher level of income versus core bonds, with higher risk), inflation hedging investments (bonds with values linked to inflation rates) and diversified credit (a combination of global investment grade, high yield and emerging market bonds that typically targets a higher yield versus core bonds, with higher risk).

A more cautious or lower-risk strategy (shown in Figure 1) would focus on a consistent, sustainable stream of income and capital preservation. A lower allocation to risk assets such as equities and relatively higher allocation to core bonds and inflation-linked securities would aim to achieve a lower level of volatility.

![FIGURE 1: SAMPLE STRATEGY: CAUTIOUS](image)

**Focus on income and capital preservation**

Hypothetical example for illustrative purposes only. Not intended to be a recommendation for an investor’s particular needs. Source: PIMCO
A more moderate or strategic approach (shown in Figure 2) could aim to balance income with growth by employing a diversified allocation of risk assets and high quality fixed income. A smaller allocation to (less risky) core bonds and inflation-linked securities and a greater allocation to income-focused securities targets higher income and growth potential. The overall volatility is designed to be moderate, allowing for higher return potential but with increased risk.

An active investment process matters
Mixed-asset solutions can be challenging for investors to implement on their own. Analyzing value across and within asset classes and being able to change allocations as the opportunity set shifts require significant resources and expertise.

PIMCO actively manages income strategies across a range of income and risk targets. We rely on PIMCO’s time-tested investment management process to navigate changing market conditions in the search for income.

Portfolio strategy begins with PIMCO’s top-down forum process. At our annual Secular Forum, PIMCO investment professionals from around the world discuss the critical macroeconomic themes of the next three to five years. This is complemented by the quarterly Cyclical Forum, where the contours of the global business cycle are debated over the coming six to 12 months. Following each forum, PIMCO’s Investment Committee distills our outlook into tangible investment themes and risk factor targets.

Within this top-down framework, portfolio management teams scour the investment universe for what they believe are the best risk-adjusted sources of income across asset classes and securities, up and down the capital structure and around the world. Research teams assess a range of metrics – business models, balance sheets, transparency, cash flow generators, management skill, to name a few – to seek the best bottom-up income ideas.

Relative valuation is also key to the active investment process. We screen for attractively priced sub-segments of the fixed income and equity markets, looking to take advantage of mispricing while avoiding areas where we believe value is already reflected in the price.

We also stress test portfolios through a range of probability-weighted economic scenarios as a risk control mechanism and as part of routine evaluation of investments for potential outperformance.

Employing this rigorous investment process, PIMCO develops income portfolios that incorporate our best ideas, diversified across asset sub-segments as well as global risk factors. We then actively manage the portfolio to take advantage of market shifts, to hedge volatility appropriately and to help ensure consistency with clients’ investment objectives and risk preferences. Ultimately, we aim to create strategies that may enable income-oriented investors to achieve their distribution goals while providing capital growth and appreciation.
Key takeaways

Many investors will find it challenging to generate a high and sustainable income stream from traditional sources such as government bonds over The New Neutral secular investment environment. As income investors widen their search for income, they may be well-served to take a diversified, flexible approach that focuses on high-conviction opportunities while avoiding benchmark-driven constraints and incorporating some long-term inflation hedges.

Past performance is not a guarantee or a reliable indicator of future results. Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies is impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and the current low interest rate environment increases this risk. Current reductions in bond counterpart capacity may contribute to decreased market liquidity and increased price volatility. Bond Investments may be worth more or less than the original cost when redeemed. Equities may decline in value due to both real and perceived general market, economic and industry conditions. Investing in foreign-denominated and/or -domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Inflation-linked bonds (ILBs) issued by a government are fixed income securities whose principal value is periodically adjusted according to the rate of inflation; ILBs decline in value when real interest rates rise. High yield, lower-rated securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. Diversification does not ensure against loss. Statements concerning financial market trends or portfolio strategies are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest for the long term, especially during periods of downturn in the market. Asset allocation is the process of distributing investments among various classes of investments (e.g., stocks and bonds). It does not guarantee future results, ensure a profit or protect against loss. Investors should consult their investment professional prior to making an investment decision.

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