

The importance of income

Income plays a variety of important roles in portfolio management. The broad range of ETFs now available offers exposure to income-oriented market segments across various asset classes, expanding the number and types of strategies available for investors. This piece reviews the importance of income in portfolio total returns and defines the opportunity with income ETFs.



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The total return of a portfolio can be broken down into two components:

- Price – the portfolio’s price change over a given time period.
- Income – cash flows distributed to investors over a given time period. These periodic income payments can either be withdrawn by the client to cover short-term expenditure requirements or reinvested to capture additional price movements.

The chart “Income plays a substantial role in total return” on the following page illustrates the substantial role income can play in total return by comparing the price only and total return of the DJ Euro Stoxx 50 Index over a period of 16 years. For the period shown, in absolute terms, the income component represents approximately 38% of the total index return and 22% of the total index return on an annualized basis.

Thinking beyond fixed income

During times of increased market volatility, income investing can serve as a defensive strategy and positively

contribute to a portfolio’s total return. Income ETFs can provide investors with a cost-efficient and flexible way to use income. Specifically, income ETFs can provide a regular income stream that mirrors those of a specific index or a group of securities while enhancing overall portfolio risk-adjusted return. For example, by increasing the proportion of income in the total return, investors can enhance risk-adjusted return, lower the portfolio’s volatility with periodic income cash flows and provide some downside price protection.

Fixed income instruments have traditionally formed the core of income strategies. Bonds generate higher yields required by income investors, but they also produce lower risk-adjusted returns than equities.

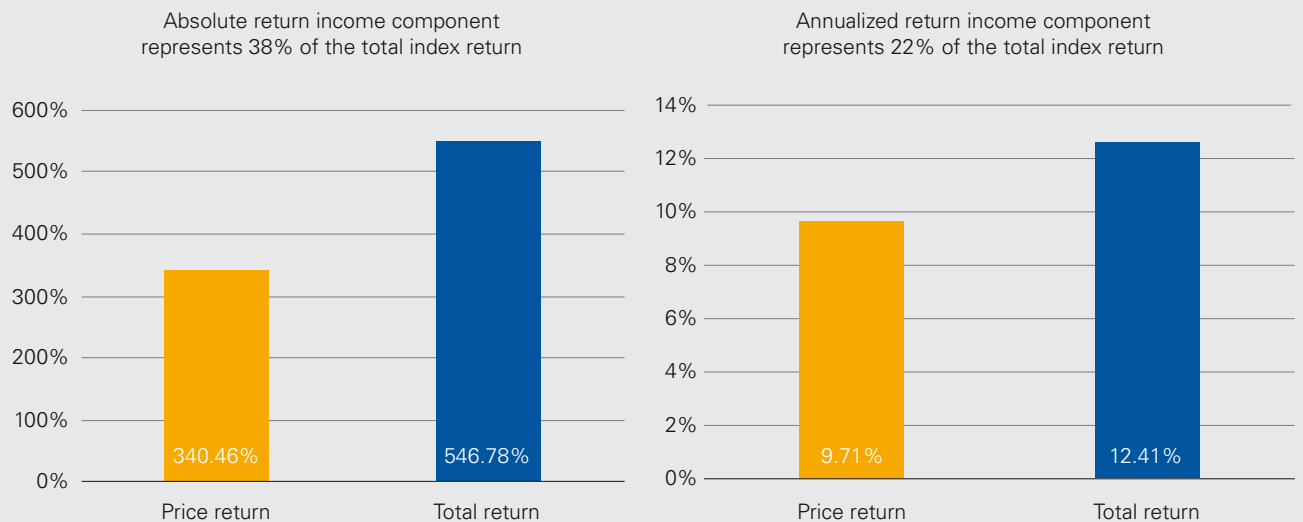
A wide range of ETFs allows the implementation of income-enhancement strategies across equity and fixed income segments. For example:

- Select dividend ETFs provide a combination of current dividend income and capital appreciation.
- Property, sector and style ETFs track companies that historically have paid high levels of income due to the nature of their business.
- Fixed income ETFs provide an income stream that mirrors the weighted average coupon payments of a particular bond index.

ETFs can offer a good balance by providing investors not only with strong

Income plays a substantial role in total return

DJ Euro Stoxx 50 Index – Price and total returns



Source: Bloomberg. Time period: 31.12.1991 – 31.12.2007

risk-adjusted returns associated with equity investment, but can also distribute substantial dividends, thus supplying the income levels approaching those associated with investments in bonds. Therefore, although it is possible to increase portfolio yield and risk-adjusted return within a single asset-class portfolio, combining equity- and fixed-income instruments also improves diversification, thus further lowering portfolio volatility.

Strategic and tactical application of income ETFs

Portfolio optimization can enhance risk-adjusted returns without exposing the portfolio to higher volatility. In an optimal portfolio, assets can be com-

bined to achieve the best risk-return trade-off using income ETFs.

Taking it a step further, it is important to consider how investments in different asset classes can complement each other to produce the balance between risk-adjusted return and enhanced yield when constructing an income portfolio. The aim is to create an optimal blend of assets using ETFs that can generate risk-adjusted returns and yields appropriate for a given portfolio.

In addition to this, ETFs can also be used to implement tactical investment decisions. As an example, ETFs could be used to enhance portfolio return during the European equity dividend season. The second quarter of the year

(April to June) is the busiest time of the year for European dividend payouts – known as the European dividend season. During this time, some investors aim to capture additional cash flows.

Conclusions

As the number of ETFs increases, the opportunity to implement an enhancement-income strategy across equity and fixed income segments using ETFs becomes simpler and easier. However, before implementing this type of strategy it is recommended that investors seek professional advice first to examine all possibilities.

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