

Multi-Asset Income: Sustainable Income Focused on Quality and GRIT

By the Multi-Asset Income Team
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KEY TAKEAWAYS

- Our investment process aims to create a sustainable and consistent income stream that can manage through volatile environments and potentially provide attractive total return.
- We focus on quality of income to drive returns and act as an embedded risk management measure.
- We use our cyclical framework, which incorporates GRIT, to help us gain critical understanding of how macroeconomic variables can influence income-oriented asset classes.
- Income can be a natural buffer in stressed environments. We tap diversified sources of income across low or negatively correlated asset classes to minimize risk and drawdown.

Our goal for multi-asset investing is straightforward: to maximize risk-adjusted returns. But achieving that goal is complicated. We follow three core principles to approach the challenge:

1. Understand the various global types of income and emphasize quality instead of merely reaching for yield.
2. Analyze how sensitive different asset classes are to the macro variables of growth, rates, inflation and turmoil (GRIT) in order to make tactical allocation changes.
3. Combine quality of income and awareness of GRIT to help diversify return streams. This emphasis is designed to help manage drawdown risk and protect capital in many economic environments.

Through this approach, our investment process aims to create a sustainable and consistent income stream that can manage through volatile environments and potentially provide attractive total return.

Why Quality of Income Matters

What's the best approach for building a portfolio with consistent income and total return upside? Our research shows that quality of income drives returns and acts as an embedded risk-management measure.

At a basic level, quality can be boiled down to a company's ability and willingness to pay investors. All income-producing assets—including equity dividends, MLPs, REITs and bond coupons—depend on these two conditions.

We assess quality in many ways. Is the company's balance sheet healthy? Is management committed to shareholder value, even during periods of drawdown? Balance sheet health, positive free cash flow, EBITDA growth and a sustainable dividend growth policy are critical factors for understanding potential return and managing drawdown risk. And with volatility



on the rise, honing in on reliable and sustainable sources of income is even more important. The following examples show the link between quality of income and performance potential.

- Dividend Equities:** Historically, companies with the ability to maintain or grow dividends tend to be better income-paying equity investments. Analyzing long-term performance of the S&P 500® Index by dividend category shows that companies with a stable or growing dividend policy have outperformed over time. It also shows that blindly reaching for yield can actually lead to negative total returns.

S&P 500 - AVERAGE TOTAL RETURN

	1991-2000	2001-2010	2011-2017	1991-2017
DIVIDEND CUTTER	12.51	8.92	13.30	11.58
DIVIDEND GROWER	23.06	10.43	16.61	16.70
DIVIDEND STABLE	21.57	11.03	15.57	16.06
HIGH DIVIDEND GROWER	5.72	-1.69	-14.83	-3.60
HIGH DIVIDEND	7.68	0.29	-0.55	2.47
NO DIVIDEND	18.02	9.06	12.29	13.12

Source: Bloomberg, as of 12/31/2017. Chart averages the total return from 1/1 to 12/31 in each period analyzed.

Past performance is no guarantee of future results.

- REITs:** Focusing on EBITDA growth, and avoiding low or no growth companies, is a strategy to help promote total returns and avoid larger drawdowns across income-producing assets. Similar to dividend equities, REITs with stable to growing dividend policies have historically outperformed other categories. In terms of downside risk, the weakest profit earners were the most susceptible to drawdowns.

REITs - AVERAGE TOTAL RETURN

	5-YEAR PERIOD ENDING DECEMBER 31, 2017
DIVIDEND CUTTER	7.86
DIVIDEND GROWER	17.37
DIVIDEND STABLE	12.67
HIGH DIVIDEND GROWER	8.44
HIGH DIVIDEND	6.93
NO DIVIDEND	-3.42
GRAND TOTAL	11.02

Source: Bloomberg, as of 12/31/2017.

Past performance is no guarantee of future results.



The chart below indicates how the first and second deciles of EBITDA growth are susceptible to higher drawdowns and below-average performance.

EBITDA GROWTH DECILE

	AVERAGE TOTAL RETURN 5-YEAR	LOWEST TOTAL RETURN 5-YEAR
FIRST DECILE	5.62	-34.24
SECOND DECILE	6.03	-18.26
THIRD DECILE	10.53	2.36
FOURTH DECILE	12.06	3.04
FIFTH DECILE	9.37	-2.01
SIXTH DECILE	12.89	7.84
SEVENTH DECILE	12.62	-3.19
EIGHTH DECILE	16.59	10.34
NINTH DECILE	16.91	-8.63
TENTH DECILE	9.45	-3.91
GRAND TOTAL	11.02	-34.24

Source: Bloomberg, as of 12/31/2017.

Past performance is no guarantee of future results.

Performance patterns related to quality persist in many other income-oriented asset classes such as global equities, MLPs and bonds. Higher-quality high yield companies that can maintain cash flows to meet debt obligations tend to be better fixed income investments. Lower-quality companies (CCC) or companies with volatile income and declining free cash flow are areas to avoid even though their yields may be enticing.

It's important to seek opportunities globally. Size and geography are factors that help identify a company's willingness and ability to consistently distribute income. Companies outside North America are typically larger and generally have a higher credit quality than their North American counterparts. On average, 81% of companies pay dividends globally, versus 57% of companies in North America. Dividends are the dominate source of returns outside of the US, historically accounting for 60% to 80% or more of total return across global developed and emerging markets.ⁱ



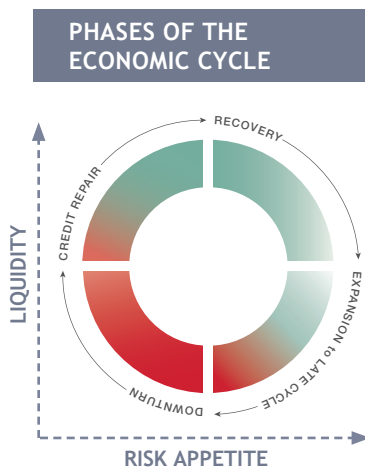
Maintaining Income in Any Market Environment

Quality of income is central to our investment philosophy; but to construct well-diversified, risk-aware portfolios, we also need to understand macroeconomic variables and how they can influence income-oriented asset classes. We approach this using a cyclical framework that establishes our strategic allocations and analysis of **GRIT (growth, rates, inflation and turmoil)**, which informs our tactical allocation changes. GRIT is our method for analyzing how asset classes tend to perform on their own and relative to one another during various growth, interest rate and inflation regimes, and also during stress scenarios. Economic cycles tend to persist for longer periods of time and thus are the basis for broad allocations. Changes in growth, inflation or rate dynamics can occur within any phase of the economic cycle and may cause us to shift positioning on a tactical basis.

The GRIT framework helps us form a top-down macro view, put today's investment opportunities in historical context, assess relative value and identify future considerations—all critical insights for evaluating portfolio diversification and managing drawdown risk. Analyzing the economic cycle and market volatility allows us to gain confidence in our allocation decisions and tactical changes as we strive to maintain consistent income and strong total return.

Growth, Rates & Inflation: Analyzing the Cycle

Our goal is to generate income and manage volatility throughout the cycle. We begin with a top-down macro assessment of where we are in the economic cycle. Cycle analysis tracks changing economic and credit conditions. We use our view of GDP strength, macroeconomic policy and price trends around the world to determine where individual countries, sectors and companies are in the cycle. Here is a snapshot of the major cycle phases:



- **Credit Repair:** Returns and volatility tend to be high during credit repair, when most investors might still shun risk.
- **Recovery:** Volatility tends to be moderate, but returns can potentially be strong.
- **Expansion to late cycle:** Valuations often become rich, and the market may be complacent; we tend to be more cautious. Identifying and investing in quality of income opportunities in credit and in equity companies with dividend stability and dividend growth is imperative.
- **Downturn:** Volatility spikes and returns are generally poor. We tend to be more conservative during this phase of the cycle in an effort to protect capital.

Cycle phases can last years and thus we need to analyze other fundamental inputs to inform our tactical shifts. This is where the **growth, rate and inflation** components of our GRIT framework become important. We may remain in the expansion phase of the economic cycle, yet observe changing growth outlooks, policy stances and inflation expectations. The changing aspects of growth, rates and inflation influence our tactical allocations. We believe tactical shifts based on prevailing economic conditions help generate consistent income and preserve total return. Investors have an opportunity to enhance income and manage risk when guided by a robust, research-driven cyclical view.



Cycle position determines the level of risk we are willing to take at any given time, and it is the foundation of our top-down asset allocation decisions. We may accept higher volatility to augment total return and increase yield, but strong cyclical views must inform these tactical shifts.

AVOIDING LOWER QUALITY IN LATE EXPANSION HEADING INTO DOWNTURN CAN HELP PROTECT CAPITAL

	DOWNTURN		EXPANSION		RECOVERY		CREDIT REPAIR		ENTIRE PERIOD	
	AVG RETURN	STD RETURN	AVG RETURN	STD RETURN	AVG RETURN	STD RETURN	AVG RETURN	STD RETURN	AVG RETURN	STD RETURN
BANK LOANS	-5.7%	10.9%	3.9%	2.55%	5.0%	2.83%	16.6%	7.04%	3.6%	5.90%
US CORPORATE HIGH YIELD	-10.0%	15.5%	4.4%	5.45%	7.7%	5.84%	24.8%	9.62%	4.6%	9.15%
BA US HIGH YIELD	-1.2%	12.5%	5.0%	4.47%	6.9%	5.17%	20.0%	6.65%	4.8%	7.18%
B US HIGH YIELD	-11.7%	16.0%	4.1%	5.66%	7.8%	5.58%	22.1%	8.93%	4.2%	9.17%
CAA US HIGH YIELD	-45.3%	22.4%	4.2%	9.34%	9.3%	8.57%	35.2%	15.7%	4.6%	14.4%
US CORPORATE INVESTMENT GRADE	3.5%	8.19%	4.3%	3.96%	3.4%	4.99%	14.3%	4.75%	4.0%	5.36%
AAA CORPORATE	6.0%	8.49%	4.6%	4.50%	2.5%	5.25%	8.3%	4.57%	3.7%	5.56%
AA CORPORATE	6.4%	7.05%	4.3%	3.55%	2.3%	4.37%	10.5%	3.97%	3.8%	4.62%
A CORPORATE	3.4%	9.31%	4.2%	3.92%	3.2%	4.93%	13.5%	4.67%	3.9%	5.60%
BAA CORPORATE	1.8%	8.86%	4.3%	4.32%	4.0%	5.31%	17.2%	5.50%	4.2%	5.91%
US TREASURY	8.8%	5.85%	4.3%	3.58%	1.9%	4.36%	4.2%	4.44%	3.5%	4.39%
US TIPS	7.5%	8.41%	3.7%	3.74%	3.2%	5.85%	9.2%	5.85%	3.8%	5.64%
US SECURITIZED: MBS, ABS, AND CMBS	7.3%	3.30%	4.3%	2.35%	2.5%	2.53%	6.1%	2.09%	3.6%	2.59%

Economic cycles defined using Loomis Sayles' proprietary models to assess historical data. Please see the endnotes for more details.ⁱⁱ

Tackling Turmoil: Position for Performance Through the Cycle

Volatility—or what we call **turmoil**—typically has very different characteristics in each cycle phase. But markets don't follow a script; every phase of the cycle is vulnerable to idiosyncratic disruptions and periods of market stress, when volatility dominates. Because we pursue risk-adjusted income throughout the cycle, we need to diligently monitor and dynamically adjust to changes in volatility. Many of the strategies we use to promote upside and total return—including managing top-down risk exposures based on a cycle view and tapping multiple sources of income across low or negatively correlated asset classes—inherently support efforts to minimize risk and drawdown.

We build on these foundational elements of our process by stress testing the portfolio against extreme volatility events. Risk tools such as correlation analysis, beta and volatility measurement and scenario analysis help us identify where risks may be materializing, providing an opportunity to adjust the portfolio to ensure we are allocating capital effectively. Scenario analysis, for example, simulates hypothetical portfolio impacts based on a variety of positive and negative historical environments. We use this information to optimize positioning for what we believe will be the next major macro environment.



Below we highlight a few historical stress scenarios to show how different asset classes have performed. A few key conclusions:

- Quality of income matters. Higher-quality high yield historically is the best-performing portion of the sector when markets are volatile. CCCs significantly underperformed in most crisis markets. Higher-quality investment grade also has done better than lower quality.
- Income can be a natural buffer in stressed environments. Dividend equities have generally outperformed the broader equity market in times of stress and when rates have moved higher.
- Alternative sources of income such as MLPs and REITs can provide diversification in a range of market environments because they often have different sensitivities to macro drivers compared to traditional income assets.

	US TREASURY	IG A	IG BBB	BANK LOANS	HY BB	HY B	HY CCC	DIVIDEND EQUITY	S&P 500	INTL DEV. EQUITY (EX US)	EM EQUITY	MLPS	REITS
BLACK SWAN (9/08-11/08)	5.8%	-11.2%	-13.2%	-25.5%	-22.6%	-30.0%	-40.8%	-17.9%	-29.7%	-33.6%	-44.9%	-31.4%	-47.5%
WORLDCOM (4/02 - 7/02)	7.0%	3.8%	-0.9%	-0.6%	-10.4%	-9.2%	-15.0%	-11.5%	-20.2%	-17.2%	-16.2%	-7.0%	-0.5%
EQUITY SELLOFF (11/07-2/08)	7.0%	2.0%	0.4%	-6.7%	-2.0%	-4.1%	-9.4%	-9.8%	-13.5%	-13.5%	-12.7%	-4.5%	-17.6%
ENERGY SELLOFF (6/14 - 2/16)	6.1%	4.7%	-0.6%	-2.3%	-0.3%	-8.2%	-21.0%	12.3%	4.2%	-9.8%	-28.0%	-43.1%	10.0%
SEPT 11 (9/01)	1.6%	-0.1%	-1.1%	1.5%	-5.0%	-6.8%	-10.4%	-4.7%	-8.1%	-8.9%	-15.7%	-2.9%	-4.2%
FED TAPER TALK (5/13 - 6/13)	-2.8%	-4.9%	-5.3%	-0.4%	-3.6%	-3.2%	-2.4%	-0.1%	1.0%	-2.9%	-9.5%	1.0%	-8.0%
'04 FED HIKE (6/04 - 12/04)	4.2%	5.8%	6.9%	3.0%	9.5%	10.5%	15.6%	10.1%	9.3%	12.2%	25.7%	24.5%	28.4%

Scenario analysis has inherent limitations and should not be viewed as predictive of future events. It relies on opinions, assumptions and mathematical models, which can turn out to be incomplete or inaccurate. Actual results will be different. Views and opinions expressed reflect the current opinions of the investment team, and views are subject to change at any time without notice. Other industry analysts and investment personnel may have different views and opinions.

Past market experience is no guarantee of future results.

It's also important to think about return per unit of risk. However, current market volatility may not be indicative of where we expect volatility to trend based on our cyclical work and analysis of GRIT. To address this, we use volatility data from relevant historical time periods and efficient frontiers to optimize today's portfolio. For example, if we want to prepare the portfolio to withstand rising rates, we may isolate historical volatility and average returns in similar markets from the past, such as the 2013 Fed taper talk shown in the chart above. Using this context, we then optimize positioning according to that subset of data. Scenario analysis and stress testing are some of the ways that risk management can help us build a portfolio that focuses on optimizing income, managing drawdown risk and creating strong total return potential.

Once we've established a top-down asset allocation strategy and have considered the most prominent risks, we populate the portfolio with our best ideas. Security selection decisions are informed by our knowledge that quality of income drives total return and plays a key role in combating volatility and drawdown risk.



Generally, we are comfortable when our highest-conviction names are large contributors to portfolio volatility because we believe we will be compensated for the additional risk. We develop and actively review forward-looking yield and total return expectations at the asset class, sector and security level using Loomis Sayles' fundamental credit and equity research. Analysts also give relative value recommendations within each sector. From there, we fine tune positions based on analysis of the macro landscape, valuations and technicals—factors that help us determine whether to close, maintain or add to a name.

Why Consider Loomis Sayles Multi-Asset Income?

Generating consistent, risk-adjusted income is a tall order. It is not a goal that can be achieved by blindly reaching for yield or shunning risk altogether. We strive to earn income by intelligently taking risk when we believe we will be compensated for doing so. We use a global economic cycle framework to inform top-down asset allocation decisions and incorporate our GRIT framework to enable tactical allocation changes. In our view, a focus on quality is crucial for promoting return potential and managing drawdown. We populate the portfolio with high-conviction names based on fundamental research. This economic analysis, awareness of GRIT and quality of income focus help us in our effort to provide consistent income with attractive total return potential in any macro environment.



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Endnotes

ⁱ *Data source: Bloomberg, MSCI. Europe data is from 12/31/1998 through 7/31/2017. Associated indices used for each region: S&P 500, MSCI World ex USA, EM, Europe, Pacific ex Japan, Japan*

ⁱⁱ *Regime periods as shown on page five are determined by the investment team based on a variety of subjective and objective factors, including past economic and asset performance metrics. Views and opinions expressed reflect the current opinions of the investment team, and views are subject to change at any time without notice. Other industry analysts and investment personnel may have different views and opinions.*

Downturn periods include 9/1/2000 to 10/31/2002 and 1/1/2008 to 3/31/2009.

Expansion periods include 1/1/1997 to 8/31/2000, 3/1/2006 to 12/31/2007 and 1/1/2014 to 12/31/2017.

Recovery periods include 6/1/2003 to 2/28/2006 and 6/1/2011 to 12/31/2013.

Credit repair periods include 11/1/2002 to 5/31/2003 and 4/1/2009 to 5/31/2011.

About Risk

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