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[INTRODUCTION]

Staci West (SW): Welcome back to the 'Investing on the go' podcast brought to you by FundCalibre. Today's guest tells us why the bond market is so attractive for income seekers and where the team has been focusing their resources to target a 5% yield.

Chris Salih (CS): I'm Chris Salih, and today we're joined by Vincent McEntegart, co-manager of the Elite Rated Aegon Diversified Monthly Income fund. Thank you for joining us today, Vincent.

Vincent McEntegart (VM):

Hi Chris.

[INTERVIEW]

CS: Let's start with the profile of the fund. I mean, it aims to produce an income of 5%, which in recent history would sound incredibly attractive, but, and I guess two things; how have you done that in the past and has that changed now, when perhaps the world has changed, and achieving 5% is perhaps not quite what it used to be?

VM: Well, indeed you know, it's always been my view that why aim for 4% when a 5% income means that you get 25% more income? You know, who doesn't want a 25% pay rise?! But you're right, for most of the last 10 years, getting to 5% has been something that clients have maybe thought was too high and perhaps we could achieve it, but we'd need to take on a lot of risk to do so. We've been able to deliver it, and the way that we've done that is by looking harder for and investing into securities that first of all have to meet our high standards of financial soundness, but they can have a yield that is anywhere between 2% on the low end, and 7 or 8% and the high end - we don't have to have securities that all yield 5%, it's the overall portfolio yield needs to be around five [percent]. And that's just been a continuous process, as markets change, as yields move up and down, we rotate the portfolio.

Today, what's interesting and different is that after last year, 2022, there's been a big change in bond markets, and so there's a lot more yield available in those markets than there has been for most of the last 10 years. To give you an example, investment grade bonds which have - only about 12 months or so ago -

had a yield that was less than 2%, today, you can get a portfolio of investment grade bonds with a yield of 5% or even 6%. So, that's a big, big change in a relatively short space of time.

So, to sum up the 5% target, it's achievable from here, and the mix of assets in the portfolio will be a little different from in the past; a bit more fixed income and a bit more in equities that probably have a lower yield, but better growth potential. So, that's the beauty of investing in multi-asset, the flexibility of it.

CS: So, I think it's best maybe just touch on that now. I mean, when it comes to bonds, maybe just talk about the structure of the fund at the moment. When it comes to bonds you've increased the allocation - what areas are you favouring and why have you increased those certain parts of the market?

VM: Well, mainly for … we had a low allocation to bonds because there was so little yield available until recent times. And so, what we've been favouring is bonds where we had less exposure to, such as investment grade that I just mentioned. And that's the area we've had the biggest proportionate increase in the portfolio. We also own some, what are called high yield bonds. They have a higher yield than investment grade. They also involve a bit more credit risk when you invest in them, because the companies that issue those bonds are not as safe and secure as the ones that issue investment grade bonds. So, we've got exposure there too.

And we've been a bit worried about inflation. As most people know, inflation - particularly in the UK - has been very high, persistently staying high; we're still worried about it – it is coming down - and so, we've been careful not to add, for example, longer-dated bonds including government bonds, because they are very sensitive to moves in inflation. I mean, all bonds are sensitive to moves in inflation, but particularly those ones. But when we do take credit risk, we do have to manage that carefully. You can lose money in investing in bonds, companies can go bust, so, you do need to do credit research, fundamental analysis of companies to see that they will - if you lend them money - that they will pay it back.

But that's what we've been doing in bonds, increasing it and focusing on quality with a lower exposure to interest rate risk.

CS: Okay. I'm going to come back to a couple of the other asset classes in a little bit, but in terms of themes, I just want to touch on obviously the multi-asset nature of the fund. I mean, I believe one of the things you've been doing recently is reducing banking exposure. Maybe that's an area of the market that's had a lot of negative sentiment for a number of years. Maybe just talk to us about that: has it been in equities and bonds? Or just one sort of specific asset class? Maybe just give us your view on what's been happening in the banking sector.

VM: Yeah, look, the banking sector, as you quite rightly say, is a challenging sector. For investors, it's this kind of ironic thing that banks are a really important part of the economy, they have a role in lending to consumers, to companies to help economies grow. But the banks' balance sheets often are complicated.

They're not necessarily very transparent, and controversy seems never very far away from banks. So, you know, it is a challenging sector. We're fortunate that we have some analysts, some experts, that look very closely at the balance sheets of banks, and that helps us, we think, to make some smart decisions when investing there. For a number of years, we've had quite a low exposure to the equity of banks, but we have had a meaningful exposure to bonds. And that's because we've felt that, in a low interest rate environment, it was quite difficult for banks to make a profit. And if you're investing in equities, you hope that the bank is going to make a good profit and return that to you in dividends and capital growth. But on the bond side, when you invest in bonds, really, you're just lending money. You expect to be paid interest while you lend that money to the bank, but you just want your money back. It's a different mindset. And so, we've been quite happy to have exposure to the bonds rather than equities.

Now, right up to date, you're quite right, the recent blow ups in the US where some regional banks - Silicon Valley Bank was one of them, but a number of regional banks in the US have got into trouble. Their business models weren't robust enough for this higher interest rate environment. There was then, in Europe - some people may have heard about Credit Suisse - it had to be a forced takeover by its Swiss competitor of UBS by the Swiss regulator. So, that's brought controversy and volatility [and] uncertainty again into the banking sector and has spooked investors. We reduced some of our small exposure to bank equity; we've held onto to our bank bonds, our bank credit - we're not adding to it at this stage, although, you know, you could argue that there are opportunities there, given that prices in both equity and bonds have fallen a bit. So yeah, an interesting sector, some people just stay away from it, but for a fund like ours, looking for a yield to get to that 5% target, bank credit continues to be an important component.

CS: Okay. I'm going to turn to equities now. Maybe let's just talk about [it in] two ways. Firstly, could you maybe just explain how the structure of your equities exposure works in terms of the global and the high dividend sort of sleeves you have within there? And then I believe you've been reducing your global equity income exposure. Is that in preference for any sort of regional or country specific income requirements? Maybe just give us a view on that as well, please.

VM: Sure. Yeah, you're quite right. So, what we try to do with everything in this fund is we try not to reinvent the wheel. We try to make use of all of the good ideas that come out of the different investment teams that we have at Aegon Asset Management: the equity side, the credit side, the alternatives side, and we feed them into this multi-asset portfolio.

So, from an equity point of view, we have a global equity program that investors can invest in themselves - there is a fund there - and that's the core of our equity exposure, but then we supplement that with some additional equities that is held in, for example, Japanese, European, UK equity programs that we run. We cherry pick some of the stocks out of there to help us to get to our 5% yield objectives. So, that's basically [it], it's two components, the main one being the global equity component.

Now, you're right to say that the headline allocation to equities in the fund has been reduced in recent months. That's really because, as the bond market - as I talked about earlier - as the bond market has changed, and as [there's] been much more yield available in the bond market, we've taken some of our exposure to equities and equity-like assets down and put that into the bond market, because the bond market assets are less volatile [and] less risky than the equity market assets. So, we've done that. And you know, the focus where we've adjusted down the most, is in the, what we call, the high dividend equity component. We've got about 20-29% currently in the two equity components, and the vast majority of that is in the global equity component, with only about 2 or 3% in the high dividend equity component.

CS: Ok. Let's also talk about alternatives. They have been integral to anyone wanting to achieve a reasonable yield, I think, in the past few years, but perhaps not as important now? I'm quite keen to get your take on it; I mean, infrastructure, real estate - there's nothing wrong with these asset classes, it just tends to be that perhaps some of the more traditional ones look far more attractive now. Is that the sort of notion that's being played out in your portfolio?

VM: Well, I think we've actually done more reduction in the infrastructure and real estate than we've done in the equity part of the portfolio, with all of those reductions going into the higher bond allocation. But you know, real estate has had a very tough time last year and it's continuing to struggle. Part of the reason for that, a large part of the reason for that, is that many of these businesses really have had a long period of time where being able to borrow money cheaply has allowed them to run quite a successful business, by just borrowing cheaply and then collecting rents on properties, whether they are warehouses, offices, residential even. And that gap between the rental yield and the cost of borrowing is essentially the business model of many of these property companies. But with the cost of borrowing going up a lot, and yes, rents have maybe gone up, but it's difficult for rents to go up too far, even though inflation is where it is. So, these business models have become much more … well, less profitable than they were for the last 10 years or so. So, that's a good fundamental reason to be reducing your exposure. There are still some good investments. Some of them have been marked down very significantly and look like quite attractive entry points, if you aren't currently invested there.

But then more broadly away from real estate, some of those comments I've just made about cheap funding and that being the business model, some of that applies in the infrastructure area as well. We had quite a lot of exposure to European utilities, for example. We still have exposure, but we brought that down in recent months and we've invested the proceeds into the bond market where we're getting similar yields to what we had in those infrastructure investments, but with a lot less uncertainty around those yields because they're bond yields rather than equity-type yields.

CS: In terms of a sort of way of evaluating alternatives, it's not as if it's a case of you only go into them when nothing else looks attractive. It's more a case of, you know, bonds do look very attractive at the moment rather than there's any issues with alternatives as an investment. Is that one of the reasons for the change in allocation?

VM: Yeah, that's right. I mean, I think if… there'll be people out there that have big allocations to alternatives, we are certainly not saying, you know, sell them and put it all into bonds. It's just in the balance of our portfolio, at the moment, this is what looks the right thing for us to do; a bit more in bonds, a bit less in alternatives, and, actually, we want the growth driver of the portfolio to remain equities rather than alternatives.

So, that's why we are getting, you know, … we're solving a big equation for our fund. Everyone who's got a different mandate with a different objective will solve that equation differently for their needs. But we'll still continue to own some of these infrastructure assets in the portfolio because we like diversification, we don't just want to own two assets: equities and bonds. And so we will own them, just less of them than we had in the past.

CS: Okay. Just in terms of your positioning at the moment and in terms of the outlook, obviously we've gone from an environment of where it's almost a dearth of income opportunities to one where sort of the sweet shop's almost open for business and there's almost too much choose from, to a certain degree.

Do you have to position your portfolio in that backdrop for any scenario? Because we don't know if it's going to be a recession or not, whether inflation's going to be sticky or not. How is that something that has to be factored in, when you build the portfolio in terms of that outlook at the moment, that we don't really have a direction in markets?

VM: Yeah, the top-down view of economies and markets at the moment is one that gives us reason to be cautious. You know, it is difficult to project whether there's going to be enough of an economic slowdown to lead to recession. You know, it is possible that the central banks engineer a soft landing, and we don't get recession. But it's fair to say that more than half the majority of people observing these things, talking with these things, think there will be some form of recession. How we deal with that in the portfolio is to just to be positioned more cautiously. We are not selling out of all of our equities, as I said already, we've got about 28 - 29% today in equities. We think those companies are really good companies that can survive a difficult environment. The share prices might move down a bit if the environment gets more difficult, but we are in there for the long term.

And then the bond part of the portfolio, which is around 50% of the assets now. I mean, there's some potential credit risk in there that could have a difficult time in a really bad recession, but we think that half of the portfolio is pretty solid, quite defensive, when it comes to a more difficult economic environment. So, that's how we try to deal with it. We try to stay invested because ultimately, we're still trying to get income to deliver to investors on a monthly basis. So, we stay invested, but adjust to a more cautious stance.

CS: And, just lastly, obviously the fund is active in nature, it's also active in terms of the sort of currency positions that it takes. Could you maybe just explain to listeners the importance of currency and give us an example of how you've taken advantage of currency?

VM: Yes, it is. I mean, most multi-asset funds - certainly our fund - we invest in global assets, we invest in bonds and equities that could be denominated in dollars, in Japanese yen, in euros, in Swiss francs, whatever, as well as some assets that are denominated in GBP, in sterling. So, when you have all of those, you know, you could have 70 or 80% of your portfolio where the underlying investment is denominated in the currency that is not pounds sterling. And we always manage that risk in this portfolio. Some multi-asset funds would just not manage the currency risk. We've always managed currency risk. And we can actually also use currency risk to enhance returns and to enhance income.

So, for example at the moment we have exposure to the Brazilian real and the Mexican peso in the portfolio. We like those currencies on a fundamental basis. We think those economies are in a good place relative to other economies, and they're doing quite well. And by investing in those currencies - the way listeners should think of it, a currency is like the share price of your economy. So, if your economy's doing well, your currency should do well, and vice versa. So, if we think Brazil as an economy is going to do quite well and we've got the risk appetite, the risk capacity, the risk budget to invest there, then we can invest in the Brazilian real and benefit from the Brazilian real doing relatively well against other currencies. And it happens to be a very high attractive level of interest while you're invested in that. It's like … think of it as cash in the bank, but it's notsSterling cash in the bank, it's Brazilian real cash in the bank, earning over a 10% interest rate, because that's what the short-term interest rate is in Brazil.

CS: Vincent, once again, thank you very much for your time today.

VM: No, thank you Chris.

SW: The Aegon Diversified Monthly Income fund is well diversified, geographically and across the asset classes — targeting a 5% yield per year for investors. As Vincent has demonstrated in this interview, the managers will decide how much to allocate to equities, fixed income, property and specialist income sectors in order to spread the risk and balance the sources of income. For more information on the Aegon Diversified Monthly Income fund, visit fundcalibre.com – and don't forget to subscribe to the 'Investing on the go' podcast, available wherever you get your podcasts.