Colonial First State
Global Asset Management

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Equities | Capability Document

# EQUITY INCOME

## Invest in a low volatility Australian share strategy that addresses the short term need for income without compromising long term total return objectives.

Many investors who have a long-term investment horizon seek conservative exposures for their equity portfolios that balance the need for higher income, volatility management and attractive total returns.

There is a common misconception that simply investing in stocks with high dividend yields will generate a higher income return with lower volatility. While dividend yield is a measure of short-term income generation, it does not provide any insight into the long-term income and total return an investor will receive. Investing in this segment of the market alone to increase near-term income can come at the expense of the growth needed to extend a portfolios' ability to generate income over the long term.

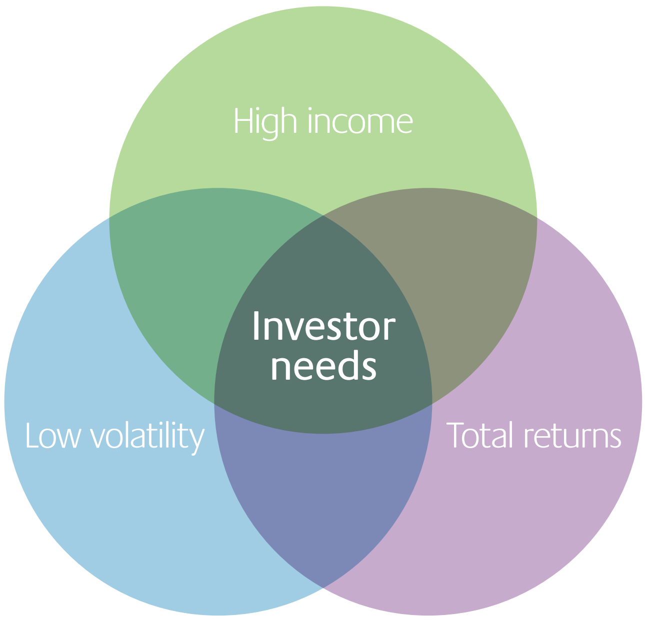
We invest in the best opportunities on the ASX, regardless of each stock's dividend yield. We also use an active options strategy to construct a portfolio that aims to generate a higher income stream than the broader share market over the long term with lower volatility. Our fundamentally different approach provides exposure to attractive stock ideas that are often overlooked by more conservative, income-seeking equity investors.

# Battling conflicting objectives

The reasons for considering an equity income strategy in a portfolio are varied, but can be summarised into three broad needs;

1. **High income** – generating cash flow from the investment.
2. **Low volatility** – reducing short-term fluctuations so an investment grows more smoothly over time.
3. **Total return** – generating an attractive return over time to grow the investment.

While riskier assets can offer the higher rate of return needed to address longevity risk or target earnings requirements, these assets increase capital volatility, and can lead to a diminished level of income. When an investor is relying on their portfolio for income, they cannot afford to suffer large drawdowns.




## A solution for a range of investors

Our equity income strategy is designed for investors who want an approach that addresses all three of these often competing investment objectives. We offer a true long term approach to maximising income from equities that can complement most typical direct share holdings and suit low tax rate investors. Most importantly, our strategy has cushioned investors from falls in the share market, providing protection when it's needed most.

| Client type | Potential use |
|---|---|
| Retirement | Maintain exposure to growth assets while delivering higher income and reduced volatility than a traditional equity investment |
| Liability matched | Reduce volatility to increase likelihood of achieving target objectives |
| Accumulation | Under a risk budgeting framework, reduce volatility of core component to allow more aggressive satellite exposures |
| Charities | Benefit from the 'no tax differential' between income and capital gains |
| Lifecycle | Provides a transition between the late accumulation phase and pension drawdown phase |

"Our equity income strategy provides an added layer of risk management beyond what can be delivered through traditional asset allocation alone."

**Rudi Minbatiwala**
Head of Equity Income

# Our approach

## Our long-term approach to equity income is defined by three, research-backed findings:

1. High dividend yield stocks do not ensure the generation of high income on a dollar basis over the long term.
2. Concentration risk from a lack of stock-specific and sector diversification can result in a risk outcome that has larger negative drawdown tail risk.
3. The types of investors using these kinds of strategies are seeking long term solutions to address their mix of objectives rather than a short-term tactical alpha allocation to a particular market factor/style.

We believe that by maintaining a focus on total returns from a broad set of shares beyond high yield stocks alone, and extending our fundamental insights with an active options strategy, we can achieve a better outcome for clients seeking more consistent returns and a higher income stream over the long term.

## Our team of experienced specialists have managed equity income funds together for over a decade with distinctive points of difference:

### Fundamentally different approach

Using an active options strategy, we can increase the proportion of returns delivered as income, provide a smoother return profile while maintaining a long-term mindset to stock selection.

### Broader universe delivers the most sustainable solution

We use fundamental stock analysis to search the entire investible universe for stocks likely to outperform the broader share market. No screening or tilting towards yield is carried out as we believe this type of investment process can adversely impact the investor's total return over the long term.

### A 'solution', not merely a 'style' for goals-based investing

We believe that by extending the analyst's research to selectively implement option positions on the underlying stocks, the long-term requirements for goals-based investors can be achieved regardless of cycles, themes, style headwinds or yield volatility.

# How we invest

## Step 1: Actively selecting stocks and building the portfolio

**Stock assessment**
Industry and company analysis – The bottom-up, fundamental research process addresses management quality, industry position, financial strength, valuation and sustainability.

**Stock modelling**
Financials and valuation assessment is undertaken in order to determine an appropriate value for the stock and identify key growth drivers.

**Stock intelligence**
Company engagement and in-depth industry cross-check – Excellent access to company management teams provides an information advantage when undertaking analysis of both industries and individual stocks.

**Stock research output**
Investment view and recommendation – Expressed through five calls (strong buy through to strong sell) based on expected 'total shareholder return' for each stock in the investment universe.

**Stock implementation decision**
Portfolio managers make the decision on which stocks to include in the portfolio based on expectations of total return, confidence and volatility.

# How we invest

## Step 2: Active option positioning overlay

### Implementing an option position on a particular stock typically has three impacts:

**Once the portfolio has been constructed, each stock position is analysed for the potential inclusion of option strategies (primarily written call options). Options are used to more actively reflect the investment view and insights the team has on each stock in the portfolio.**

**1. Generating income**
Sold options generate cash flow for the portfolio. This adds to the income that is received from dividends and franking credits.

**2. Lowering volatility**
The income received from sold options will partly offset any decline in the share price. The income generated from options can provide a meaningful cushioning of losses during adverse market conditions.

**3. Limiting capital gain**
The opportunity cost of using options to generate income is that the potential upside beyond a certain share price is limited. Our key focus is managing the upside that is retained to ensure that the portfolio still delivers sufficient growth over the long term.

# Our team

The Equity Income team, led by Rudi Minbatiwala, has been managing equity income funds together for over a decade and offers a range of equity income, low volatility, cash-plus multi-strategy income, tax aware and non-vanilla benchmarked outcomes-based equity strategies.

The team comprises three dedicated portfolio managers who each have specialised derivatives expertise – and undertake derivatives related research in the equities market – as part of their portfolio management responsibilities. The portfolio managers are supported by a large group of equity analysts with a proven track record of fundamental bottom-up stock research.

**Rudi Minbatiwala**
Head of Equity Income (18)*

**Jason Moodie**
Senior Portfolio Manager (19)*

**Marlon Chan**
Portfolio Manager (11)*

*Years of industry experience as at 2018.

**Important Information**

This document is directed at persons of a professional, sophisticated, institutional or wholesale nature and not the retail market.

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