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Alternative Income Episode IV - A New Hope

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The preamble…

If you cast your minds back to the Global Financial Crash, which occurred 16 years ago, you may remember that in order to stimulate a recovery and avoid a Depression akin to the 1930s, Central Banks began Quantitative Easing. QE for short, is when a Central Bank purchases securities in the open market to reduce interest rates and drive more lending to consumers and businesses. This policy triggered a decade of low growth and low inflation.

Income hungry investors during that time had to take on more risk to eke out a return, by venturing into the stock market or owning riskier bonds. When government bonds were offering a miserly 0.5% return, higher yield or junk bonds became an attractive option, underpinned by loose monetary policy.

Risk of permanent capital deprivation turned out to be low as Quantitative Easing ensured such low –quality companies rarely defaulted.

To satisfy income needs markets will supply where there is demand. The financial community introduced a panoply of income generating investment funds, backed by real assets such as property or infrastructure and listed these companies on the stock market.

Sectors included Care Homes, Warehouses, Primary Care Facilities, Renewable assets (solar, wind farms) Economic Infrastructure (schools, hospitals, roads) to name a few. The yields on offer were a healthy 4-6% which compared favorably to bank savings rates and Gilts offering paltry returns.

For a decade all was well until late 2021 when post covid inflation took hold and the financial world was turned on its head. Inflation rocketed from almost zero to 11% and interest rates followed, albeit Central Banks were slow to react. We were told there was nothing to fear, this inflationary move would be transitory.

"The Committee's central expectation is that current elevated global and domestic cost pressures will prove transitory," the Bank of England said in August 2021. How wrong they were.

From November 2021 the BOE increased Interest Rates on 14 successive occasions.

The value of UK Government bonds, that investors held for low risk, fell by over 30% in the two years that followed. The impact on Alternative Income funds was even more severe as investors realized they could now achieve attractive returns of 5% from Government bonds. The investment case to hold alternative assets was diminished.

In addition, having traded on modest premiums to their asset value, consistent selling placed Alternative Income companies on wide discounts to their net assets, a double whammy of falling valuations compounded by increasingly greater share price declines.

Fast forward to today and across the West all Central Banks - ECB, UK and US - have begun the process of easing, i.e. rate reductions. Quantitative Tightening has replaced Quantitative Easing and Inflation is at or around Central Bank targets. Interest rates are expected to continue to move lower this year and into 2025.

In the UK, current projections are rate cuts this year and next, bringing interest rates down to 3.5-4% by the end of 2025.

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A New Hope

So, is now the time to take a fresh look at the sector? (apologies for the Star Wars reference)

We would say yes.

We surmise that declines in interest rates will usher in a tightening of the discounts across various alternative income funds whilst also enabling investors to lock in higher yields for longer. Investments are, to some degree, priced off the Risk-Free rate i.e. cash. As cash returns fall with lower interest rates there will be fresh impetus to allocate capital to real assets once again- property and infrastructure as well as fixed income. These funds have the ability to lock in higher yields for longer too.

So, let's look at certain subsectors for opportunities.

The listed infrastructure funds have suffered materially and are very sensitive to interest rates. Peel Hunt estimate that for interest rates to fall by 0.5%, there would be a 7.9% change in the share price of **Greencoat UK Wind** and an 8.3% change for **HICL Infrastructure**.

Today, **HICL** offers a yield of 6.3% and **Greencoat** yields 7.5%. **Greencoat** has an inflation linked dividend policy, trading on a 12% discount whilst buying back its own shares too. HICL trades on a wider 16.5% discount, having traded consistently at a premium for many years. It has a core allocation to UK infrastructure assets. It too is buying back its own shares.

The property sector also offers attractive returns. **Assura** is a landlord and developer in the healthcare sector, leasing properties to GP practices in the UK and Ireland. Rental income is primarily underwritten directly or indirectly by the UK and Irish Governments. The company recently acquired a Private Hospital portfolio of 14 assets to diversify its exposure. How does the market price such quality? The shares trade on a 13% discount to Net Asset Value and yield 8.5%. Shares are priced today at 42 pence

For context, this time 5 years ago the shares peaked at 80 pence and yielded 3.9%.

For a more diversified exposure to property we need to look at **TR Property Investment Trust**, highlighted in last month's factsheet. As a fund of property companies, you can arguably achieve a double discount. The shares trade on a 7% discount but the constituent funds held are trading cheaper than their net asset value. The shares pay a more modest 4.5% dividend yield, yet the shares can re-rate very quickly.

We have only touched upon the many opportunities available in the alternative investment sector. Our clients have historically benefited from these funds to help diversify their asset and income exposure. The past three years have been a challenging time to hold these assets but we may now be on the cusp of a rerating for share prices and income yields too.

You too may wish to take advantage before interest rates fall any further.

Discrete Annualised Performance (%)	Aug 24	Aug 23	Aug 22	Aug 21	Aug 20
Assura	-2.3	-25.7	-14.2	1.0	21.4
HICL Infrastructure	0.7	-17.9	4.8	8.1	5.1
Greencoat UK Wind	8.0	-9.3	33.4	-4.4	7.7
TR Property	23.3	-16.7	-24.2	41.9	-12.5
FTSE UK Gilts All Stocks	6.8	-9.5	-19.7	-1.8	2.4
FTSE All Share	6.1	-14.4	-30.9	35.3	11.8

Source: FE Analytics