

## Talking Points

# Derivative Equity Income Funds: An Overview



Tom Whitelaw  
Research Manager

### Introduction

We recently completed assessments of three Australian share funds which have specific income bents. All three are classified in our recently-introduced Australian Equity Derivative Income category. Going forward, our analysts will cover these funds alongside their broad large-cap Australian share fund counterparts, which include more traditional dividend- and franking-focused income offerings, in our annual review of large-cap Australian share funds. This is scheduled for the second quarter of this year.

The three strategies assessed are **Colonial First State Equity Income** 16354, **Merlon Australian Share Income** 3683, and **Zurich Investments Equity Income** 14474. All three meet our comprehensive coverage criteria. There is currently strong demand from our clients for coverage, and the three investment strategies currently possess approximately A\$4.0 billion in assets. Most importantly, though, we believe that these funds have genuine investment merit, and that investors will benefit from the in-depth research we provide. After all, Australia's ageing demographic provides long-term support for such offerings. Share funds focused on providing income meet a defined need, while their capital return objectives should help maintain purchasing power. As we also discuss, we believe that these strategies can play a wider portfolio role as well.

### What is 'Enhanced' or 'Derivative' Income?

It's important to define exactly what 'derivative income' strategies are. We define them as vehicles which attempt to increase the income distribution from sharemarket investment by use of derivative instruments. The most common way of doing this is through the 'buy-write' approach. If a fund manager uses a 'buy-write' overlay strategy, for example, it means that the manager is capping some of

the upside potential of the stocks in the portfolio by the use of call options – in effect, selling some of tomorrow's possible upside growth on a stock for an income premium today. The actual day-to-day management is much more complex, and multiple derivatives contracts can exist on individual stocks or indices.

All three strategies employ buy-writing in some respect. Our individual fund reports detail the extent of the derivatives activities, and provide a fuller understanding of where the income and growth returns are being driven from. It's important to understand that this additional income doesn't come for free. It is paid out of potential future growth. The returns profiles of these strategies therefore differ from those of traditional long-only share funds. Derivative income approaches will lag the market in rapidly-rising market conditions, given the aforementioned upside cap, and will find themselves towards the bottom of our traditional categories. In negative, flat, or slowly-rising markets, however, derivative income strategies should outperform, because of the additional income premiums generated. Certain funds will also use put options to protect further on the downside, again altering their return dynamics.

Nevertheless, given that these strategies are often aimed at investors who require a relatively steady income stream, it's important to remember that they are still at the behest of sharemarkets. While an investor may be receiving eight percent in income, if the value of the capital is reducing, that eight percent is worth less in real money terms. It's also important to ensure that the investor is not sacrificing too much growth, or even receiving some income directly from the capital component of their investment. If this is the case, the day may come when the capital value of the investment has been eroded to such an extent that the income it produces is no longer sufficient to meet the investor's original needs.

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### Are All Derivative Income Strategies the Same?

All three strategies we assessed invest in shares, have income in their names, and use derivatives to supplement that income. However, they have different investment approaches. Rudi Minbatiwala and Jason Moodie, the portfolio managers for the Colonial First State offering, have a strong total return focus, the income component intended to complement the growth they achieve from underlying stock selection. Denning Pryce, the underlying investment manager for the Zurich strategy, is a more true-to-label income harvester. This firm pays much less attention to the fortunes of the underlying stocks in the portfolio, and focuses more on garnering income from shorter-term market movements. The third fund manager, Merlon, sits between these two approaches. Although like Colonial First State Merlon conducts underlying stock research and looks for outperformance, this manager tends to write some of its options very close to the money. This caps the upside, but does help increase the income. Merlon also uses put options, which helps provide further downside protection. How far investors wish to lean to one side or the other is up to them. We have allocated both the Colonial First State and Zurich offerings Morningstar Analyst Ratings™ of Bronze. We're less enamoured with Merlon, but it is investable.

### Experience Counts

When a new way of investing emerges, it often takes time to get established and accepted. This was certainly true for derivative income strategies, but once the market recognised their purpose and could see that the theory was backed up by strong returns over a number of years, flows to the sector increased. With these flows come copycat approaches looking for a share of the action. This was evident in the launch of a number of 'equity income' strategies at the end of 2012.

However, trading derivatives is a highly-specialised skillset, and requires a different mindset to traditional sharemarket investment. It's therefore important that the personnel responsible for the derivatives trading strategies are suitably-experienced. The key personnel for the three strategies we've covered have been running offerings with derivatives overlays for a significant number of years.

Time at the crease is especially important here, as any portfolio manager needs to be on top of a number of key issues. The first is a clearly proven ability to trade options, as this drives a proportion of the additional income. This needs to be undertaken with the bigger picture in mind, though. Investors are still buying a share portfolio, and on the

whole expect it to perform like the underlying benchmark. For instance, if a fund manager just has one call option written on **BHP Billiton** BHP at A\$40.00 when the stock is trading at A\$37.00, but the stock rises 10.0 percent to breach the A\$40.00 mark, the manager is effectively naked the largest name on the ASX. This often requires multiple positions to be written around individual names to avoid the portfolio getting unexpectedly called away, and thus looking markedly different from the index.

It's also better if portfolio managers have experience trading options and running money in Australia. Although these instruments trade in a similar fashion around the world, each individual market has its own quirks and nuances. For shops like Merlon which trade over-the-counter options, strong broker relationships are also important to ensure that the fund manager is consistently getting the best price for its dealings.

### Have They Achieved Their Aims?

Table 1 over summarises the performances of the three Australian derivative income strategies discussed above, comparing these to traditional income approaches which do not employ derivatives strategies. Given that many of these strategies are used to provide investors with income, the funds are ranked by three-year annualised income returns. This is the percentage amount of income investors would have received on average over each of the last three years. The table also includes the growth returns, which when combined with the income return comprises the total return figure. (Note that the effects of compounding mean that adding the growth and income figures does not quite equal the total return.)

What Table 1 shows clearly is that the three funds which employ derivatives strategies have provided much higher income than both the S&P/ASX200 Accumulation Index (as represented by **SPDR S&P/ASX 200 Fund** STW) and other income-focused offerings over the last three years. From a total return standpoint, though, returns have not been as strong. The negative returns in the five-year growth return column illustrate the point discussed earlier – although the use of derivatives provides extra income, it comes at the expense of capital growth. This has an even greater impact in rapidly-rising market conditions – during 2012, when the S&P/ASX200 Accumulation Index rose 19.66 percent, the derivative income strategies lagged significantly from a total return perspective, while traditional dividend and franking credit harvesters outperformed strongly. The income premium from writing options does however

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smooth returns, and although some of the upside is capped, this premium helps support returns in more difficult market conditions, as the much lower volatility over the past three years shows.

### Role in Portfolio

Derivative income strategies have their place, but given the differences in approach we discussed for just the three options we recently assessed, investors and advisers need to understand exactly what they are potentially getting into. Such approaches would clearly seem to favour retirees requiring a regular income stream but still wanting some growth assets exposure. Unlike traditional sources of income, however, distributions from these derivative income strategies are much more variable. Further, if the investor takes all

the income out of the fund, there's a danger that the capital value is being eroded – over the last three years, the capital value of the three derivative income strategies we have assessed fell by between 2.73 and 4.04 percent each year. This ultimately means that while the investor may be receiving a similar percentage level of income, the actual cash value will be lower.

An alternative use for such strategies could be as diversification tools. The use of derivatives changes the return profile. Therefore, if an investor was to reinvest their distributions, that income component helps diversify the source of return, reducing drawdowns for investors with less risk tolerance, while acting as a nice anchor for a portfolio in more turbulent times. ■■

**Table 1: Equity Income Funds – Returns and Volatility**

Name	Growth Return 6 Mth %	Income Return 6 Mth %	Total Return 6 Mth %	Growth Return 1 Yr %	Income Return 1 Yr %	Total Return 1 Yr %	Growth Return 3 Yr %	Income Return 3 Yr %	Total Return 3 Yr %	Growth Return 5 Yr %	Income Return 5 Yr %	Total Return 5 Yr %	Std Dev 3 Yr %
Colonial First State Wholesale Equity Income	8.50	3.72	12.53	7.09	8.20	15.94	-3.58	10.95	7.21	-	-	-	9.14
Zurich Investments Equity Income	8.06	4.37	12.72	6.31	8.47	15.26	-2.73	9.59	6.61	-5.12	10.16	4.56	9.36
Merlon Wholesale Australian Share Income	11.91	2.59	14.77	9.07	7.70	17.49	-4.04	9.05	4.89	-6.86	8.13	0.94	10.04
Perennial Value Shares for Income	16.26	3.24	20.02	21.45	5.03	27.54	3.19	4.92	8.31	-2.26	5.31	3.02	11.39
Vanguard High Yield Australian Share	12.97	3.22	16.60	20.69	4.95	26.63	5.52	4.84	10.63	-1.55	4.68	3.08	11.67
Tyndall Australian Share Income	14.91	1.72	16.86	18.23	3.72	22.61	1.18	4.82	6.12	-	-	-	10.65
SPDR S&P/ASX200 ETF	13.88	2.69	16.92	14.57	4.44	19.66	2.09	4.25	6.51	-3.50	4.86	1.36	12.20

Source: Morningstar Direct™. Performance data to 31 January 2013.