Embracing alternative income assets

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Alongside the traditional income 'engines' of bonds and equities, the Aegon Diversified Monthly Income Fund has had a significant exposure to alternative investments. This category of assets includes property and what we call 'specialist income' which includes infrastructure and renewable energy. In turn, these assets have contributed to the Fund's successful delivery of income, with 100 monthly distributions since launch on 25 February 2014.

Declining bond yields since the Global Financial Crisis have supported 'bond-proxy' alternatives. Price action in fixed income markets has challenged that support in recent months although, collectively, these assets share key characteristics which remain attractive in today's environment of economic uncertainty and high inflation:

- They are typically bond-like investments, with an attractive initial yield and the opportunity for capital appreciation over time.
- Their dividends are often underpinned by contractually backed income streams, often with inflation-linkage.
- They offer material diversification benefits to the portfolio through their relatively low correlation with traditional asset classes.

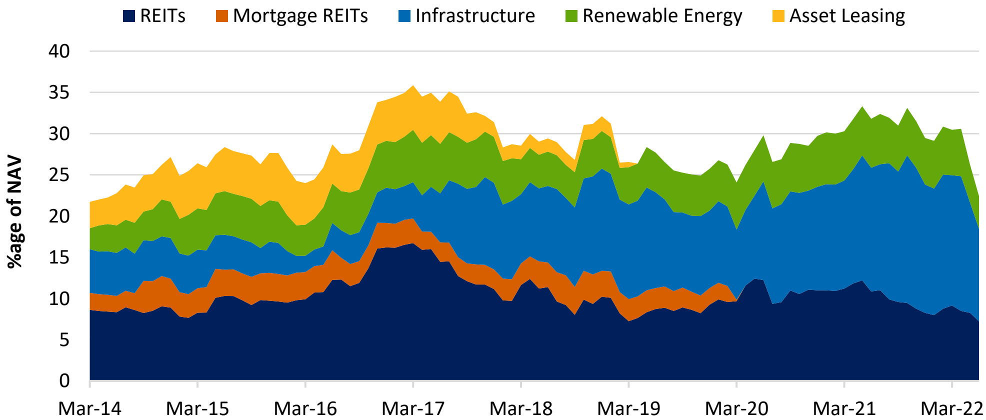
Our daily-dealt fund structure means we cannot directly hold individual assets such as properties, wind turbines or toll roads. Instead, we use listed vehicles to access the attractive risk/return profile of these assets, a route which offers valuable liquidity and pricing visibility.

Our search for 'natural income' means we do not take income from capital or use derivatives to manufacture yield artificially. This ensures we focus on operational assets, rather than those under construction, which also typically involves lower risk.

By 'specialist income' we mean, today, predominantly infrastructure and renewable energy. However, like traditional asset classes, themes and sectors come and go and, in the Fund's early years, we had a very successful allocation to asset leasing securities. In our portfolio that was largely aircraft, although asset leasing is a much broader universe.

While these alternatives share certain characteristics, they are also sufficiently different that our allocations evolve over time as we seek to anticipate or respond to the investment environment. Chart 1 shows how these allocations have evolved since the Fund's launch in 2014. In the rest of this paper, we explain the rationale behind today's allocations.

Chart 1: Evolving allocation to alternative income assets (%)



Source: Aegon Asset Management.

Renewables


Knockacummer wind farm, Ireland

Since inception, the Fund has invested in operational wind and solar assets for their attractive yields, low volatility, and growth potential.

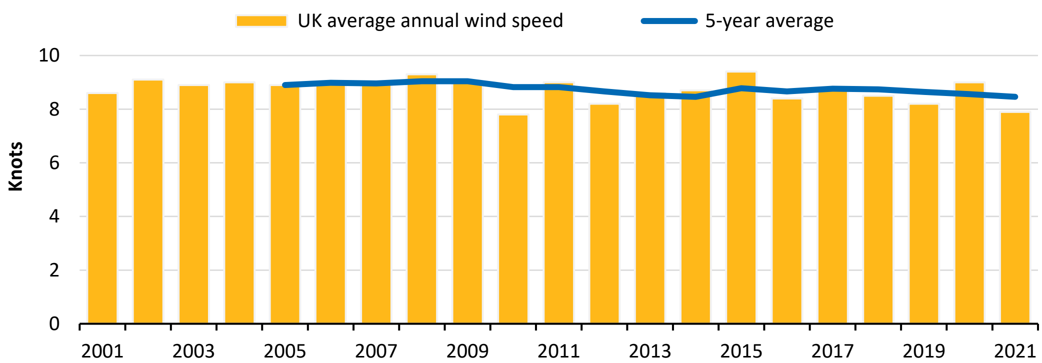
The undeniable shift in mainstream public, political and investment attitudes around the theme of sustainability, and particularly the impact of climate change, has highlighted the importance of these assets and supported their continued adoption.

Beyond the environmental angle there are further characteristics that are important in today's environment:

Predictability

Wind and solar levels may fluctuate from year-to-year, but they are relatively predictable over the medium term which allows for confidence in modelling long-term returns.

Chart 2: Wind power is highly predictable



Source: UK Government Department for Business Energy & Industrial Strategy, April 2022

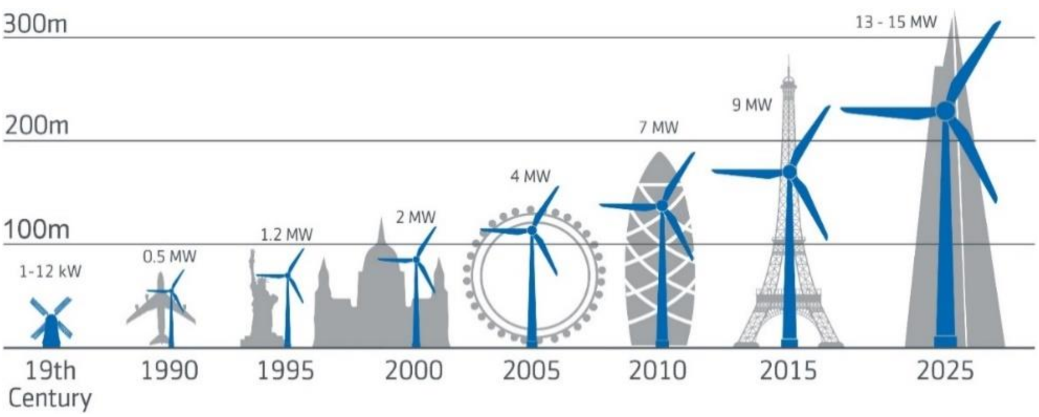
Input costs

These are essentially zero as wind and sunlight are free, a peculiar advantage when inflationary pressures mean sharply rising input costs across most other industries.

Technological progress

Limited technology risk around existing assets is helpful, and ongoing development in areas such as turbine scale, transmission enhancement and battery storage offers exciting potential to unlock greater returns.

Chart 3: The evolution of wind power



Source: Bloomberg New Energy Finance

Profitability

Income streams are often partly linked to government-backed, inflation-linked subsidies which reduce risk. The revenue split for these projects is typically around 50% regulated payments and 50% wholesale power prices. Whilst Russia's war in Ukraine has raised energy prices, meaning profit margins and cash flow generation are healthy, the longer-term investment case is equally about those subsidies. They are designed to underpin a sector which governments are determined should grow, helping to meet net zero commitments.

Property

We invest in property through listed companies, typically structured as real estate investment trusts (REITs). These are essentially investment vehicles that purchase real estate holdings and rent them out, providing indirect exposure to global property markets and with daily liquidity which allows us to adjust exposures in real time. Rising rates and the risk of recession are headwinds for a sector which is still recovering from Covid disruption. Our current allocation is small by historic standards and focused on defensive segments such as residential or on niche growth markets such as infrastructure, data centres or logistics.

Data Centre, Silicon Valley, US

Infrastructure

Inflation linkage is an attractive characteristic of many specialist income assets, including infrastructure. This has become a cornerstone of our multi-asset portfolio and includes assets across the risk spectrum.

At the lower end, we invest in 'availability-based' projects, often backed by the public sector, in areas such as hospitals and schools where the income stream is assured for as long as the asset is available for use.

We also invest in demand-based assets such as airports and toll roads, where returns are more sensitive to the economic environment, though today these investments are small by the fund's historic standards.

Reliance Rail, Australia

In the current environment we take comfort in a significant allocation to regulated utilities which have defensive qualities and can generate valuable income streams. Many of these businesses also offer access to the growth in renewable energy and we specifically select those that are strategically well-positioned, leading the transition to a low carbon economy.

An evolving landscape

We see strong prospects for certain segments of infrastructure and for renewable energy investments, and our current exposures reflect this view. Of course, in a multi-asset fund, all asset-class positions must compete for their place in the portfolio, and we are mindful of the effects of today's complex macroeconomic picture, with persistently high inflation and rising rates at its core.

The ability to adjust positions in real time as our expectations of risk and return evolve, to be unconstrained by any artificial benchmark or unrealistically fixed asset allocation framework, has been important to the Fund. That remains so and the Fund's investments will continue to evolve in pursuit of its income objective and achieving strong risk-adjusted returns.

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Fund Charges are taken from capital, increasing distributions but constraining capital growth.

Income is not guaranteed and 5% is a target yield, being the fund's target total distribution over the next 12 months as a percentage of the current mid-market share price. The target yield may be revised in future.

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