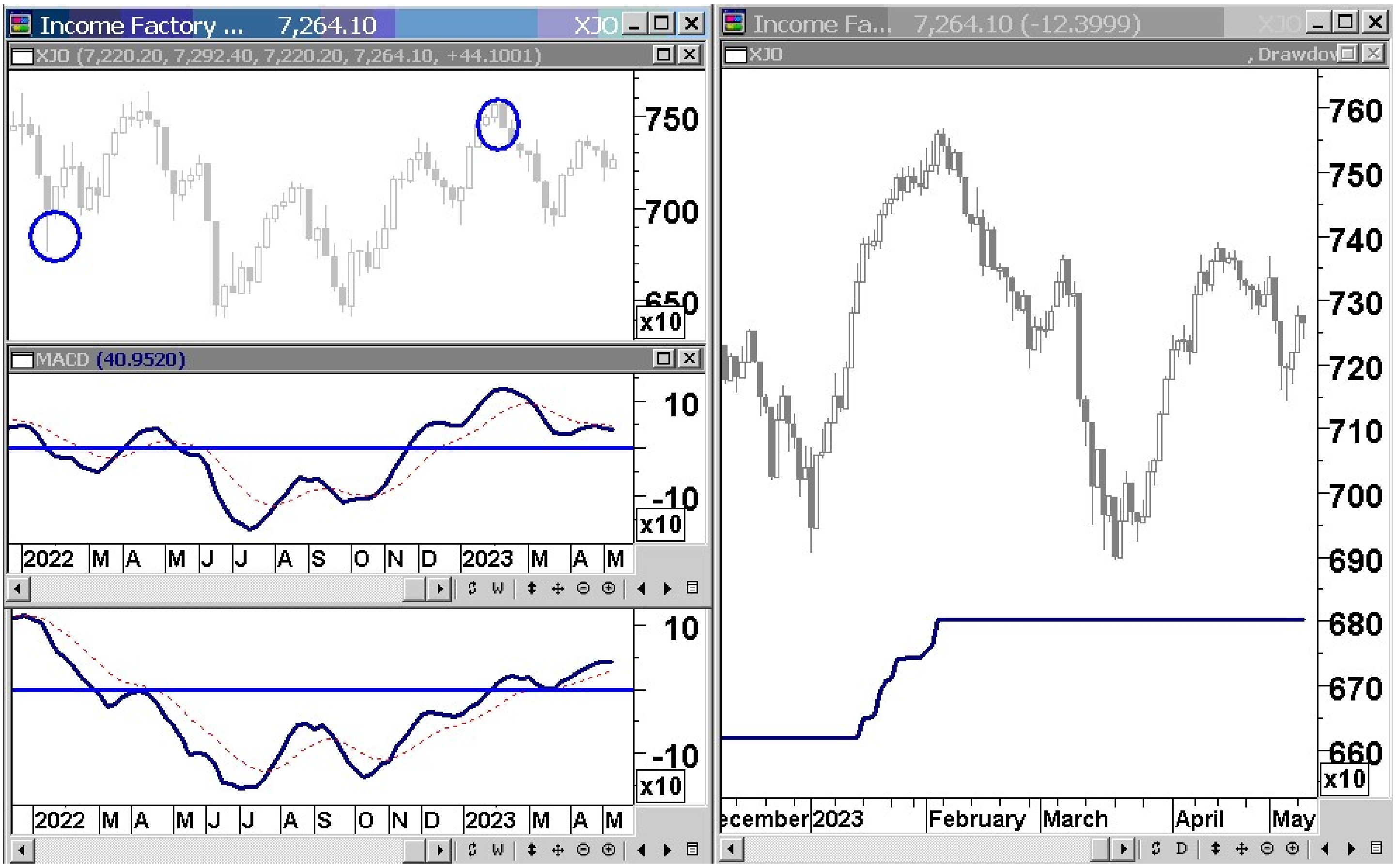
My Income Factory portfolio appears every week in the Blue Chip Report

While there are good sound stocks and ETFs providing attractive dividends, there is the ever present concern that a Stockmarket crash or bear market will cause a capital loss which will reverse out any dividend yield…and then some.

So the answer is to have an income portfolio that is actively hedged and therefore has capital protection against a market crash or prolonged bear market. It also means – and this is important – that when a crash or bear market is over, you will have free capital (being the profit from the hedge) to spend on the now cheaper income stocks that now have higher yields.

The catch is that a hedge is a safety net and doesn't ensure a portfolio against making any losses. In fact a hedge is usually activated by a market fall and so a loss has to be incurred in order for a hedge to be activated. But once activated, a hedge will limit a portfolio's downside. Investors should always consider hedging to be a form of insurance which limits the downside.

The Income Factory's hedge is activated when the ASX200 falls by 10% and the exit trigger is when the ASX200 & SP-500 weekly MACD indicators cross up. This approach bridges any falling periods in the market like the Covid crash or volatile periods like 2022.The following charts show the ASX200 index in the right hand window with a 10% drawdown line and the windows on the left hand side are the ASX200 with the weekly MACD indicators underneath.



And you can't see it in the above charts but the hedge has only been activated on 8 occasions during the last 23 years. And all of these occasions are times when applying a hedge was fully justified…which is not surprising given that the activation trigger for it is a 10% correction...

Hedge On	**Hedge Off**	
09/2001	06/2003	Mini-Bear market of 2002
08/2007	10/2007	Correction prior to the GFC
01/2008	06/2009	The global financial crisis
07/2011	04/2012	Mini-Bear market of 2011
08/2015	05/2016	Mini-Bear market of 2015
10/2018	03/2019	Correction of late 2018
03/2020	08/2020	The Covid-19 crash in 2020
01/2022	01/2023	Double correction of 2022

When the hedge is activated, the five worst performing stocks (in terms of dividend yield) are sold and BBOZ is bought using 40% of the value of the portfolio, after the five shares have been sold. This hedge condition makes the Income Portfolio 100% hedged, albeit an indirect hedge via BBOZ. And the portfolio is still generating a dividend yield as the portfolio continues to hold 14 of the best yielding stocks available. This is an actively managed hedging strategy.

When the market recovers and the hedge is closed, the portfolio is reset and any surplus capital (which comes from the sale of the inverse ETF, BBOZ) is used to buy more income stocks. You will suffer some capital loss in a crash or bear market but it will be largely mitigated if you have an actively managed hedge. And markets do inevitably go up over the longer term.

What's more…this strategy is about income and so a capital loss over the shorter term can be tolerated. And unlike cash, stocks are inflation proof as their prices will go up with inflation. So this strategy addresses the risk of a crash or a bear market and the risk of inflation, these being the biggest concerns for most investors. And getting a decent return on their savings, of course.

The inverse ETF is BBOZ which is issued by BetaShares and it has proven reliability, based on how it performed in the Covid correction. BBOZ is based on the ASX200 index and has gearing of between 2 & 2.75 to 1. Below are the guidelines for controlling the hedge strategy…

- The hedge is triggered if the ASX200 index breaches a 10% drawdown on the daily chart
- When the hedge is activated the IF portfolio is reduced from 19 stocks to 14 stocks and BBOZ is purchased using 40% of the value of the IF share portfolio, after it is reduced to 14 stocks
- The 5 worst performing stocks in terms of their dividend yield are sold to reduce the IF portfolio
- The hedge should be periodically checked & adjusted to keep it at 40% of the IF portfolio
- The hedge is closed when both the weekly ASX200 and SP-500 MACD indicators cross up
- If a MACD line is below the zero line when the hedge is activated then the MACD line must cross up through the zero line
- If a MACD line is above the zero line when the hedge is activated and doesn't travel below it while the hedge is active, then the MACD line must cross up through the reference line
- When the hedge is closed, BBOZ is immediately sold and 5 stocks are purchased, using 5% of total capital in each case, to take the IF portfolio back up to a total of 19 stocks
- The 5 stocks chosen should be the best stocks available in terms of their dividend yield

Keeping the portfolio drawdown in the ballpark of 10 to 15% is the objective because recovering a loss of 13% will take 1 to 2 years whereas a drawdown of 30% would take 4 to 5 years. This is the cruelty of mathematics where a 13% loss can be recovered by an 15% gain whereas a 30% loss would take nearly a 45% gain. This is what you want to avoid!

And remember that most of the time the hedge isn't activated and so the capital performance of the portfolio is primarily dependent on the stocks being held and these are 19 diversified, fundamentally sound and high yielding Australian Blue Chip companies. And therefore they can be expected to track the performance of the broader market, which inevitably goes up over time. The objective is to maximize the gross yield while preserving capital over the long term.

So let's move on to the actual stocks and ETFs being used, and their selection criteria. The portfolio is initially made up of 19 positions, each bought using 5% of total capital. And I am using StockDoctor and Martin Roth's perennial book, Top Stocks to do the heavy lifting for the stock selection. I also exclude mining stocks because of their price and dividend volatility…

- Turnover of at least $20M per week
- Must be a StockDoctor StarStock or a Martin Roth Top Stock (or ETFs)
- Can be from the Materials sector but not a mining stock
- A maximum of two stocks per industry group (excluding ETFs)

But there's a special selection criteria, called linearity. What if we have a stock that is in an accelerating downtrend? It is fundamentally sound and has a rising dividend yield as its share price is falling. In fact this very situation actually happened with a company called Adairs…

This stock was a StockDoctor Star Income Stock and was rising up the Income Factory's portfolio list because the lower the price went, the more its dividend yield increased. Thus the concept of buying high yielding StockDoctor Star Stocks isn't foolproof. And being an income portfolio we can't apply a stop loss as that is counter-intuitive when we're investing for income.

But there is a quality about Adairs that does make it undesirable for an income portfolio. It is being driven by sentiment rather than by fundamentals. This is evident by its non-linear price behaviour. In other words, you can't explain or capture its price behaviour by using trendlines.

Compare Adairs to Waypoint REIT (WPR) which also qualified to be in the income portfolio. Waypoint's price goes up & down but it's different to Adairs that looks more exponential than linear…which indicates being sentiment driven. WPR is linear and fundamentally driven...

There is an argument that says a higher yield will offset a falling price but with its latest dividend it would have taken Adairs 4 years to repay the capital loss. Picking income stocks is about buying into underlying fundamentals and sharing in the profitability of the company. But Adairs dividend yield was more a function of its price trend than its underlying fundamentals.

There are positive & negative sentiment driven stocks…stocks that trend up & stocks that trend down. But assuming rising stocks will offset falling stocks in a portfolio simply doesn't work in real time. Rising stocks are eliminated by a falling dividend yield because they are replaced with higher yielding stocks, as we are frequently optimizing for yield. And the counterbalance for falling stocks is to have a preference for medium to long term linear price behaviour. So the fourth selection criteria for choosing stocks or ETFs is…

- The medium to long term price behaviour should be of a linear nature

It is part of the Income Factory's selection criteria and also the ongoing management criteria. Below is the complete management criteria for the Income Factory's share portfolio…..

- Stocks must be a StockDoctor StarStock or a Martin Roth Top Stock (or an ETF)
- Stocks must initially have a liquidity of at least $20M per week
- Stock/ETF price behaviour should be linear in the medium/long term
- The portfolio can have a maximum of two stocks per industry group
- Sector risk doesn't apply to ETFs given their inherent diversification
- Stocks/ETFs are selected/optimized according to their gross yield
  (where stocks/ETFs will only be replaced with a higher yield of at least 1%)
- Yield is optimized on a yearly basis & linearity is checked monthly
- The StarStock status is checked on a monthly basis
- The liquidity is checked yearly

The yearly optimization is performed after the final reporting period which occur in August every year. Hence the IF optimization occurs in September. And to maximise the stability of the IF portfolio, stocks are only replaced if the net result to the average yield of the portfolio is an increase of at least 1%. Otherwise it remains unchanged.

The other task that has to be performed on at least a yearly basis is the rebalancing of the portfolio. This is to prevent any individual positions getting too small or too large compared to the portfolio as a whole. The benchmark I use here is 20%, which means that no individual position should be 20% more or less than the nominal position size of 5%.

Let's do this with an example using a hypothetical $100,000 portfolio (stocks + cash), where a 5% position is $5,000. So if any position is greater than $6,000 (20% larger than $5,000) then it should be sold back down to the nominal value of $5,000. Then any position less than $4,000 (20% smaller than $5,000) should be bought up to the nominal value of $5,000.

So the Income Factory portfolio is an actively managed income portfolio where the mandate is to actively maximize the yield of a portfolio of fundamentally sound blue chip stocks while preserving capital over the longer term. The longer term being defined as 3 to 5 years.

Below is a sample portfolio, showing the 19 stocks that make up the Income Factory portfolio appearing in alphabetical order and in black type. The three stocks in blue type at the end of the list are alternate stocks for investors who may have ethical reasons for excluding one or more of the original 19 stocks. This portfolio is from September 2023, after an optimization/rebalance…

Code	Name	Industry Group/Sector	Gross DY (%)
ANZ	ANZ Group Holdings Limited	Banks	8.98
APA	APA Group	Utilities	7.05
ASX	ASX Limited	Financial Services	5.79
CGF	Challenger Limited	Insurance	5.58
CLW	Charter Hall Long Wale REIT	Real Estate Inv. Trust	8.28
COL	Coles Group Limited	Consumer Staples	6.08
CSR	CSR Limited	Materials	9.38
HVST	BetaShare's Dividend Harvester	Australian shares	9.06
IPL	Incitec Pivot Limited	Materials	12.03
JBH	JB Hi-Fi Limited	Consumer Discretionary	9.86
MFG	Magellan Financial Group	Financial Services	12.91
MTS	Metcash Limited	Consumer Staples	8.75
NEC	Nine Entertainment Co	Media & Entertainment	7.70
SUL	Super Retail Group Limited	Consumer Discretionary	9.49
SUN	Suncorp Group Limited	Insurance	6.10
TLS	Telstra Group Limited	Telecommunications	6.33
WBC	Westpac Banking Corporation	Banks	9.17
WDS	Woodside Energy Group Ltd	Energy	13.59
YMAX	BetaShare's ASX Yield Maximiser	ASX Top 20 shares	11.14
NHF	NIB Holdings Limited	Insurance	5.36
WES	Wesfarmers Limited	Consumer Discretionary	5.16
MQG	Macquarie Group Limited	Financial Services	5.20

Gross dividend yield includes tax credits, which are also known as franking or imputation credits. And where they exceed a recipient's tax liabilities, they are converted to a cash refund. This is typically the case in a Superannuation fund, especially in pension mode at 0% tax rate.

And given that you would be applying 95% of your total capital to these 19 positions, the gross yield as a proportion of your total capital (based on the above portfolio taken from September 2023) would be 8.3% per annum. And yield is the key benchmark for an income portfolio.

Some of these positions are trending up and some are trending down. But on balance the capital value is rising over the long term, inline with the broad market. So should we screen for just stocks and ETFs that are trending up as this would give us capital growth, as well as yield?

This would be good and bad because we would improve short term capital growth at the expense of missing out on higher yields. Remember that yields rise when prices fall...and vice versa. What's more, with 19 positions across 10 plus sectors we're dealing with a diversified portfolio that will track the broader market over the longer term, which inevitably goes up.

So we can't use stop losses to manage an income portfolio, which would be the conventional way of eliminating falling stocks. But this is where the test for linearity comes in because it will eliminate any stocks that are falling aggressively, in both our initial selection criteria and as part of our ongoing management criteria. It also eliminates aggressively rising stocks as well, but this is a good thing as these stocks also add unwanted volatility to an income portfolio.

To summarize…the mandate for this portfolio is to actively optimize yield where it is balanced against capital protection, which is provided by an actively managed indirect index hedge.

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General Information