ClearBridge
A Franklin Templeton Company

Preparing Your Income Portfolio for Shifting Conditions

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Key Takeaways

- Income investors face very different risks than accumulation investors, and portfolios must be purpose-built for stable, growing income—rather than total return—to withstand shocks and protect spending needs in retirement.
- Danger ratings shift when viewed through an income lens: many ‘Goldilocks’ return assets offer poor income stability, while high-quality, dividend-sustainable Australian equities—with strong franking benefits—provide more resilient and inflation-aligned income.
- A customised, actively managed approach to Australian equities—focussed on sustainable dividends, quality, diversification, and franking—can significantly improve income preparedness and reduce the risk of capital or income impairment when conditions change.

Applying Bushfire Planning to Income Safety

Australians know all too well about the impact of natural disasters such as bushfires. Every summer, we prepare our properties and discuss bushfire survival plans with our loved ones ahead of a potential threat.

In the current market environment, we think the analogy of a bushfire survival plan and danger ratings assessment can also apply to various asset classes and your portfolios.

Just as during bushfire season, there are important risks that income-focussed investors such as retirees should consider planning for in their portfolios, well before ever changing market conditions could turn them into a potential disaster for your income stream.

Income Investments Need a Different Survival Plan to Accumulation

A bushfire survival plan should be customised to consider factors such as your location, the conditions and your desire to leave early or stay and defend. In a similar vein, we believe that your ‘portfolio survival plan’ should be customised differently for income and accumulation purposes.

- When an investor is in accumulation phase, their primary focus is typically on maximising the dollar value of their balance. There are normally no set income requirements, and no specific inflation concerns, just a certain level of risk tolerance.
- When it is time to turn into this into an income stream, such as at or leading into retirement, the objectives change and the focus needs to be on generating an income to support spending needs.

Firstly, this income needs to be as high as possible, stable for a certain risk tolerance, and take advantage of the tax advantages the Australian market offers through franking. This income also needs to grow so that when we do see inflation, like we have recently, that the income stream can maintain its purchasing power. The capital base must be sustained as long as possible to alleviate longevity risk and must be diversified to avoid a capital impairment in any one part to cause severe damage to the portfolio as a whole.

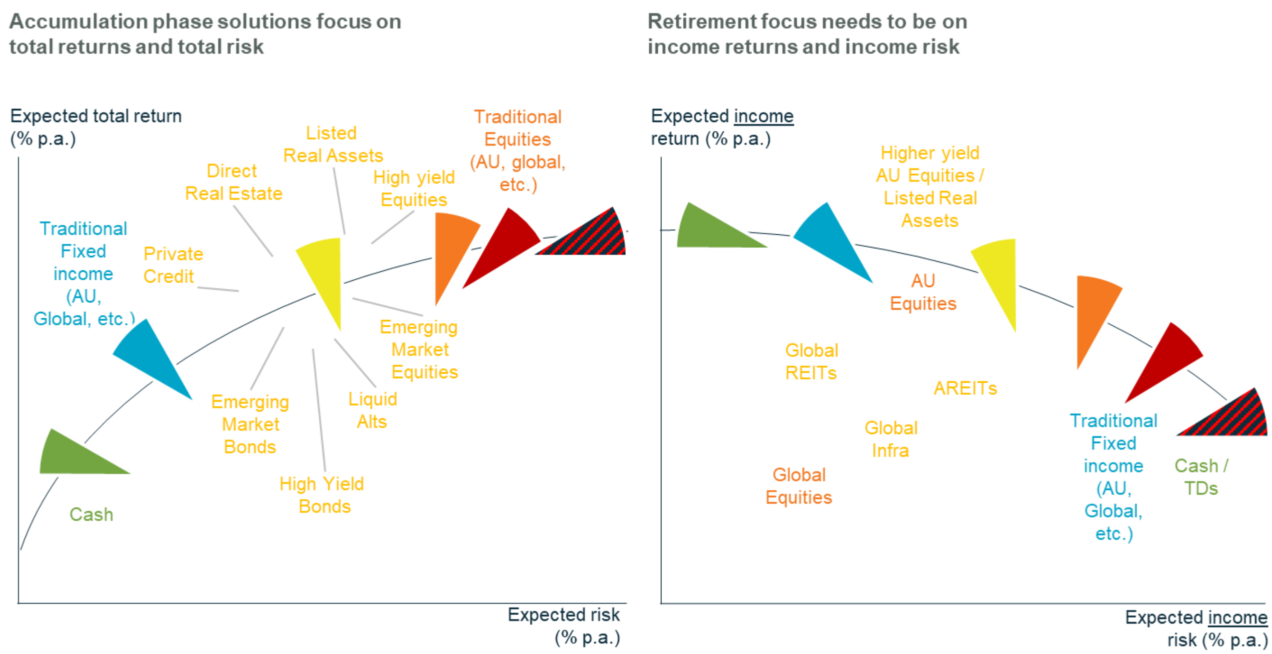
We like to call this objective a 'Sufficient Income for Life'. A portfolio built for this purpose can provide investors with the liquidity to leave early, and the quality and diversification to stay and defend.

Danger Ratings for Income Differ Across the Asset Classes

Bushfire danger ratings can also differ depending on location – there is often a much more extreme risk for the bush when the city is just high. We have thought about where different asset classes might sit on an equivalent "risk-adjusted return" danger rating scale, and to us, these risks are very different for accumulation and income investors.

- In the accumulation phase, the traditional scale is based on expected total return relative to expected risk. As you can see in the chart, there is relative safety, but relatively lower return in cash and fixed income, while a higher risk and higher expected return in equities. We also have so called 'Goldilocks' assets such as private credit, high yield bonds, emerging market bonds, direct real estate, listed real assets and higher yielding equities, in the middle.
- However, when you think about danger ratings from a 'Sufficient Income for Life' perspective, as we show in the second chart, total returns and total risk are not as useful metrics. We believe that investors need to be looking for assets with better income returns and income stability.

Exhibit 1: A Risk-Adjusted Return Danger Rating Acale



Past performance is not a guide to future returns. The investment vehicles shown may have different risk profiles and a direct comparison may not be appropriate.
Source: ClearBridge; for illustrative purposes only. Assumes zero percent tax rate and full franking benefits can be realised in tax return for Australian equities.

Generally speaking, on this scale, the so-called risky assets become safer as far as a stable income is concerned, and vice versa.

What is interesting is that many of the Goldilocks asset classes that were great for total returns do not perform as well across our key requirements for a ‘Sufficient Income for Life’ - such as higher income, capital growth or liquidity - and are hard to clearly place on an income risk spectrum.

From our perspective, Australian equities offer a better fit but do also suffer from some negative characteristics as a generic asset class.

Customised Income Process can Prepare your Portfolio and Provide Refuge

You cannot magically turn a passive Australian equity exposure into the ideal income investment, but active management can meaningfully improve outcomes. Through disciplined stock selection and thoughtful portfolio construction, an income-focussed Australian equities portfolio can be shifted toward a more attractive and resilient income profile.

A ‘Sufficient Income for Life’ approach relies on fundamental research to identify high-quality, higher yielding ASX-listed companies with the earnings strength to sustain and grow dividends, while maximising the benefits of franking for low or zero tax-rate investors.

More Sustainable and Resilient Dividends

Just because a company has a high dividend, it does not mean that it is a good candidate for a ‘Sufficient Income for Life’ focussed portfolio. If the company cuts its high dividend unexpectedly, it can create an income shock for the portfolio. And if then sold out, automatically as could be the case in many high yield ETFs when it becomes no longer ‘high yield’, it can also result in an impaired capital value.

Rather than focussing on spot yields, we look for companies with resilient, or more 'Sustainable Dividends'. To do this, we assess the likelihood of dividend payments all stages of the economic cycle. We base this on a 'bear case' scenario, rather than the 'worst case' dividend, because would simply be zero for every company. The advantage of this is it allows us to consider what level of dividend could still be paid in a crisis or at the bottom of the cycle. We have strong preference for stocks that can deliver on income growth even in a rising interest rate environment.

- When we assess the dividend paying ability of the banks, we have focussed on normalised loan loss charges, especially when they all are forecasting zero expected losses. This means our Sustainable Dividend is much more conservative than broker consensus yield forecasts.
- For many resource companies, we are cautious of the cyclicality and variability of commodity prices, focussing on those with cost structures that can better tolerate the fluctuations.

This approach reduces income volatility and provides greater certainty for investors, and by providing stable, predictable dividends, investors do not need to rely on the drawdown of capital to fund income needs.

For this reason, we also do not believe in investing in low/no dividend paying securities just to boost total returns. Technology startups, mining explorers, property development stocks and the like might be great for accumulation portfolios when you have a longer investment horizon, but they're not going to be able to provide a reliable level of dividend income and can be very volatile. An income portfolio needs more stable, or even "boring" companies where dividends are a larger component of total return.

- A stock like Qantas is an example of a stock that is not what we would call a Sustainable Dividend payer. Back in 2017 the company had repositioned themselves as a stable dividend payer with a progressive dividend payout ratio after many years of not paying any dividend. As a Covid loser, their dividend then went back to zero. But with a large cost in maintaining its fleet, the company has always been a low return on invested capital business where every dollar needs to go back into the business. To us, this kind of stock was never appropriate for an income focussed portfolio as we always had it rated as an unsustainable dividend.
- On the other hand, over the years JB Hi-Fi has been an example of how the profit stream on good companies can grow. It had a high starting dividend when we first identified it, and while it has re-rated significantly as a Covid beneficiary, it has continued to grow that dividend on a dollar income basis.

Higher Quality

Experience has shown us that fundamental research can also help identify higher quality companies. These have a competitive moat, strong balance sheets, competent management, sound governance structures, and a handle on their sustainability risks and opportunities. Companies like this offer a far greater probability of their earnings returning to normal following a shock or crisis, and thus will exhibit lower volatility than the broader market.

- A great example of this is Medibank Private, a rare example where we see a virtuous circle between what the company is doing on looking after customers by lowering the cost of the healthcare systems while producing better profits for shareholders.
- When the company went through the cyberattack in 2022, they were one of the stocks we rated as being the highest quality. We believe that the way management worked together, and their focus on customers was what saw them get through the situation and continue to grow.

Sustainable Dividends also go hand in hand with higher Quality. High-quality companies typically have strong pricing power and robust free cash flows, and dividends driven by earnings and nominal GDP growth. This allows them to generate more stable and resilient dividends.

We prefer stocks in sectors with strong pricing or regulatory levers, allowing them to increase prices without losing customers. This provides a reliable income stream that keeps pace with inflation.

Focus on Franking

While its often said there is no free lunch in finance, franking credits that apply to Australian equities could be considered as such. However, due to the predominance of accumulation investors, the market typically undervalues franking after-tax by not using the lower or zero tax rate for retirees.

- Defensive assets such as fixed income and term deposits pay no franking credits, and global equities often incur additional withholding taxes, and all miss out on the free lunch.

Franking provides a differentiated source of return, allowing more of the total return to come from a stable source. Our analysis suggests that franking can add around 1% to passive S&P/ASX 200 income yield, a non-insignificant level when the unfranked yield is around 3.1%[1].

Using an investment process that formally values franking credits, penalises unfranked dividends, and avoids trading that breaches the 45-day rule, our experience has shown that you can further maximise the benefits from franking credits for investors with low or zero marginal tax rates.

- Another good example of what we avoid for income is CSL. While its dividend has grown over the last few years, its started from such a low base that it is still low to better alternatives. Most of its total return comes from capital growth, and none from franking.
- Goodman Group is in the same camp. It has a poor yield as it reinvests most of its earnings into development, and has no franking. As cashflows are driven by its development skew over rent collection, they can be erratic.

Avoiding concentration risk

We also look at portfolio construction though an income lens, and we do not think it is appropriate to include any particular security in a portfolio just because it has a large weight in an arbitrary index, especially the indices used as a proxy for the Australian market.

The Australian equity market is notoriously concentrated, from a stock, sector and market cap perspective. However, the numbers are still startling[2]:

- The top 20 stocks by market cap make up almost 60% of the S&P/ASX 200 index weight.
- Two sectors, banks and metals & mining, make up more than 40%.
- And just seven stocks account for almost 50% of the index's total franked yield.

This concentration risk does not align with a 'Sufficient Income for Life'.

Furthermore, many of the larger stocks that dominate the index also have low, or no dividend pay-outs, high volatility or lower quality earnings, or valuations that make their dividend yield less attractive than other alternatives.

- The Commonwealth Bank is an example of a stock where its sky rocketing share price, due to index investing driven pressure, has now rendered its expected yield to be no better than the bond yield. We find that putting in 10% of a portfolio in one low yielding stock is hard to justify for an income investor[3].

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[1] Source: ClearBridge, FactSet; as of 30 September 2025. Data for the S&P/ASX 200 Index. Expected next 12 Months (NTM) data is calculated using the weighted average of broker consensus forecasts of each portfolio holding – because of this, the returns quoted are estimated figures and are therefore not guaranteed and may differ materially from the figures mentioned. The figures may also be affected by inaccurate assumptions or by known or unknown risks and uncertainties. In respect of the broker consensus data the number of brokers included for each individual stock will vary depending on active coverage of that stock by a broker at any point in time. A median of brokers is typically utilised. All estimates avoid stale forecasts which are removed after a certain number of days.

[2] Source: ClearBridge, FactSet; as of 30 September 2025. Data for the S&P/ASX 200 Index.

[3] Source: ClearBridge, FactSet; as of 30 September 2025.

We believe that diversification is the key to improving income risk characteristics. For example, in our income focussed portfolios, we limit individual stocks to no more than 6% of the total portfolio and 22-25% in any one economic sector, well below the weights of the largest stocks, and banking & resources sectors in the S&P/ASX 200 index.

While these limits mean that our portfolios are structurally underweight the Top 20 ASX stocks, this ensures that portfolio total yield is not dominated by any one security or impacted by an income shock in any one high index weight stock. The resultant lower beta portfolio helps to provide a more predictable income stream regardless of economic cycles or capital movements of a single stock.

Averting capital impairment

In implementing income portfolios, we also suggest avoiding the use of derivative strategies for income enhancement or the use of high turnover to harvest dividends.

- Strategies that use derivatives to provide income enhancements or capital protection are potentially detrimental to capital growth, and thus income growth, as the cost is borne from capital.
- Strategies that automatically sell stocks because of an income shock, such as rules based high yield ETFs, can result in an impaired capital value despite maintaining a steady headline yield.
- Furthermore, high turnover strategies also are more likely to impair capital due to excessive trading as they are turning capital to income by constantly moving to the next dividend paying stock.

Is your income-focussed portfolio ready to 'watch and act'?

Fires can threaten suddenly and without warning, so can changes in market conditions that impact income. These events can be scary and stressful, so understanding what to expect and having a plan can help.

We have provided the following checklist to help you asses if your existing income portfolio is appropriate for the objective of a 'Sufficient Income for Life', or if you need to consider improvements to your plan.

1. Is the portfolio specifically designed for income?
2. Is the portfolio paying a higher franked income yield than the S&P/ASX 200 today?
3. Does the portfolio provide a stable, more predictable income stream?
4. Is the portfolio maximising the benefit for franking credits available for zero-tax payers?
5. Does the portfolio invest in high quality stocks, lower volatility stocks?
6. Does the portfolio avoid following an arbitrary benchmark?
7. Is the portfolio designed to reduced income shock and have lower security and sector concentrations than the broader market?
8. Does the portfolio promote capital and income growth by avoiding high turnover, rules-based selling and derivative costs?
9. Does the portfolio have high liquidity to respond to unexpected events?

If the answer is NO to any of the above, we suggest that now is the time to act and to consider how to improve your income portfolio's preparedness.

And like at all stages of a bushfire, it is important to stay informed. Learn more about ClearBridge's Australian Equity Income strategies here: https://www.clearbridgeinvestments.com.au/investment-strategies/#sg-australian-equity-strategies

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