GROW YOUR INCOME

A NEW ERA FOR INCOME STRATEGIES

Income investing has moved into a new dimension. In the past, income-generating strategies were largely restricted to cash and fixed income so that, to a large extent, investors had to accept the need to sacrifice the opportunity for capital growth in order to obtain a higher yield.

Times have changed and an income strategy does not necessarily mean you have to accept a hit to your portfolio's value - especially if you are in a position to take on a bit more risk with your capital. There are plenty of choices available to income-seeking investors of all persuasions and this guide sets out a number of the available options.

FLEXIBILITY AND VERSATILITY

For many investors, an income-generating strategy forms the core of their approach. Some want a portfolio that will provide a regular income stream for them to spend. For others, an income-based approach is a consequence of their attitude to risk, rather than an instigator of their strategy, and these investors might choose to reinvest their income to boost their portfolio's total return over the long term. Still others might have a core investment strategy that focuses on capital growth, complemented and diversified by an income-generating segment.

Every investor will have their own unique needs – for instance, they might choose to draw the income or to reinvest it for the long term. However, an income strategy can easily be adapted to meet each investor's changing circumstances as time moves on.

A WORLD OF CHOICE

Whatever your risk profile, there are a wide range of asset classes and sub-asset classes from which to formulate a diversified income strategy – from government and corporate bonds, through UK and global equities, to property and real estate investment trusts.

FIXED INCOME (BONDS)

Fixed income investments provide a stable and predictable level of income many investors find reassuring. They pay a set rate of interest that does not change, regardless of the prevailing economic environment, and also have a fixed repayment date. Bond prices are influenced by fluctuations in interest rates and the rate of inflation. In addition, corporate bond prices are also affected by individual company or industry newsflow.

CASH: NOT NECESSARILY KING

A cash deposit account might be the first port of call for many investors who want to generate an income. In an environment of low interest rates, however, it is difficult for savers to generate a meaningful return from their cash deposits. Furthermore, the impact of inflation will erode the purchasing power of their capital over the longer term.

Changes to UK base rates, which are set by the Bank of England's Monetary Policy Committee, will affect the level of interest paid on cash in a bank deposit account but base rates will not affect the level of income paid on a bond. In an environment of rising interest rates, bonds become less attractive, because investors can more easily achieve a competitive rate of interest from their cash deposits. Similarly, low interest rates increase the appeal of bonds, as it becomes harder for savers to generate an attractive level of income from their cash deposits.

When bond prices fall, their yields rise and, when bond prices rise, their yields fall. However, the amount the investor receives – the coupon – is unaffected, so the investor receives the same amount of income, regardless of the movement of interest rates. Because fixed-income securities tend not to offer any real opportunity for capital growth, bond investors risk seeing the erosion of their investment's real capital value in a climate of high or rising inflation.

GOVERNMENT BONDS

As the name suggests, government bonds are issued and underwritten by a government. UK government bonds – also known as 'gilts' – are regarded as very low-risk investments as, to date, the UK has never defaulted on its debts.

However, because they are a low-risk investment, the level of return available on gilts tends to be relatively low and they offer little protection against inflation. Index-linked bonds are the only exception – they pay a rate of income that is partly influenced by the rate of inflation. If the rate of inflation rises, the level of income they offer is adjusted upwards while, in an environment of falling inflation, the level of income paid will fall.

CORPORATE BONDS

Corporate bonds are issued by individual companies as a way of raising capital for their businesses. As with gilts, a corporate bond is redeemed at a predetermined date for a fixed sum and, during the life of the bond, the investor receives a fixed amount of interest.

Corporate bonds carry a higher level of risk than UK government bonds but that level will

BONDS

ADVANTAGES

- Stable, predictable income stream; capital is returned at the end of the bond's life
- Volatility of capital values tends to be lower than equity markets
- Even in default, bond investors are usually 'preferred' creditors and so may still get some money back

- A fixed rate of interest means the value of that income can be eroded in an inflationary environment
- Some areas of the bond market can be illiquid, particularly lower-rated bonds and some overseas issues
- Sub-investment-grade bonds are not generally suitable for more cautious investors

DISADVANTAGES

vary from one company to the next. High-quality companies are regarded as relatively low-risk, whereas lower-quality companies are believed to have a higher risk of defaulting on their obligations to bondholders.

The level of income paid to bondholders tends to reflect the level of risk involved. Investors who take on a riskier investment are compensated for that risk with a higher level of income. If a company should go bust, bondholders rank higher than shareholders as the company has to meet all its obligation to its creditors – including bondholders – before it considers its shareholders.

It is important to understand the risks of investing in corporate bonds. There can be a substantial difference in quality between one corporate bond and the next. Many of the large fund management houses undertake research to evaluate the potential risk of each bond, but they also often rely on research produced by credit-rating agencies such as Standard & Poor's, Moody's and Fitch. These companies assign a rating to companies that offer bonds. A high credit rating indicates the company is believed to have a low risk of default while a lower credit rating suggests the company presents a higher risk of default.

Bonds may be divided into two classes – 'investment-grade' for the highest credit ratings and 'sub-investment-grade' (also known as 'high yield' or sometimes 'junk') for the lower grades. A lower credit rating means a higher level of income paid, in order to compensate for the extra risk involved. Generally, investment-grade bonds are seen as a relatively lower-risk asset class, while higher-yielding sub-investment-grade bonds are regarded as higher risk.

COLLECTIVE BOND FUNDS

Collective funds that focus on government and/or corporate bonds will invest in a managed portfolio that can help you to reduce your risk by diversifying across a range of investments, rather than owning just one or two. Some funds will focus on a specific area of the market while 'strategic' bond funds are 'go-anywhere' portfolios, whose managers take a view on the bond market and focus on the areas they believe offer most value. If you are interested in adding an element of additional risk to your overall portfolio, therefore, strategic bond funds can offer an introduction to the sub-investment-grade arena or to overseas opportunities.

EQUITY INCOME (SHARES)

Over the long term, equities offer the potential for superior returns compared with many other major asset classes. An equity income strategy focuses on shares in companies that pay consistently high and rising dividends and typically aims to generate a consistent, above-average income stream, accompanied by the potential for capital growth over the long term.

Dividends are paid – usually in cash – by companies to investors and are taxable. By law, dividend payments must be paid out of the company's profits or from profits generated in previous years. Companies are not obliged to pay a dividend, but a high dividend payout can provide an incentive for investors to take a stake in the company.

A company does not have to pay a dividend, and many – particularly small- and medium -sized ones – prefer to reinvest surplus cash into the business. The profits of a relatively young company, for example, will be unpredictable as it seeks to establish itself – and any profit it does make will probably be used either to repay start-up costs or as a reinvestment to help growth. Even as a company grows older, its management might decide to retain profits to finance debt, expansion or product development.

Longer-established companies tend to pay higher dividends – hence an equity income strategy tends to focus on large, high-quality companies, rather than smaller, younger firms. Nevertheless, a small but rising proportion of

OVERSEAS OPPORTUNITIES

While there is a longstanding culture of dividend payments among UK companies, a growing number of companies in overseas markets are returning value to their shareholders in the form of dividend payouts. The US has, for example, traditionally been home to a core of large companies that pay high dividends. More recently, Asian companies have sought to attract and meet the needs of international investors by focusing on dividend payouts, with countries such as Hong Kong and Taiwan establishing solid dividend regimes.

A global equity income approach has become increasingly achievable, and many investment houses have launched funds to tap into this trend. UK-based equity income investors now have much greater scope to diversify across a broadening range of countries and to gain exposure to industry sectors that might be less well-represented in the UK stockmarket.

dividend payouts are coming from medium-sized and smaller companies.

Even large, well-established companies can fall on hard times, however, and the management might decide to shore up their firm's finances by reducing its dividend payout or cancelling it completely. Furthermore, a diminished or cancelled dividend will undermine confidence in the company and its share price is likely to be negatively affected, cutting the value of your capital investment.

COLLECTIVE EQUITY INCOME FUNDS

An equity income fund invests in the shares of companies that pay consistent and attractive dividends and then combines the dividend payouts in order to pay a regular income to investors. Diversification across a broad range of companies reduces the danger a single company's decision to cut or cancel its dividend might drag down the overall yield of the portfolio.

PROPERTY

As an asset class, property can polarise opinion. It is often viewed as a relatively illiquid asset in that it can be time-consuming and expensive to trade. Some experts also believe investors are already overexposed to the property sector if they own their own home or a buy-to-let property, or if they are invested in commercial property through their business. However, property can play a part in an income portfolio for those investors who are not overexposed or who are attracted to its potential benefits.

RESIDENTIAL PROPERTY

'Buy-to-let' is a popular means by which investors gain exposure to residential property. Traditionally, buy-to-let has enabled investors to generate income through rents negotiated on short-term tenancy agreements. More recently, many buy-to-let investors have chosen to use their rental income to finance their own mortgage payments and to wait for the bigger profit in the form of a capital gain when the property is sold. Of course, as some investors have found to their cost, there is no guarantee a property's market value will rise over the long term.

COMMERCIAL PROPERTY

In contrast, commercial property investment focuses principally on the generation of a high and consistent income that is generated through rents. Whereas residential leases typically operate on a series of short-term agreements, however, commercial leases tend to be much longer – perhaps 10 or 20 years.

Income from commercial property can derive from a variety of different sectors – ranging from City real estate, through shopping centres, to industrial parks and warehouses. Each sector commands a different level of rental yield and will react differently to the prevailing economic climate.

COLLECTIVE PROPERTY FUNDS

Direct investment in commercial property is very expensive but smaller private investors can access the asset class through diversified collective funds. Diversification helps to reduce the extent to which the loss of a tenant from one particular property might negatively affect the overall performance of the fund.

REAL ESTATE INVESTMENT TRUSTS

A real estate investment trust or 'REIT' is a company that manages a property portfolio on behalf of its shareholders. A REIT can contain residential and commercial property. Its profits are exempt from corporation tax, but it must pay out at least 90% of its taxable income to shareholders.

EQUITIES

ADVANTAGES

- Often highly liquid and transparent
- Dividend income offers the potential for some protection against inflation
- Dividend payments should increase over the long term, whereas coupons on bonds are fixed
- Dividends can act as a valuation discipline – if a share's price rises too far, its yield will drop, making the stock less attractive

DISADVANTAGES

- Equities are volatile – share prices can go down as well as up and you may not get back the amount you invest
- Company dividends are not guaranteed – company profits, and thus your income, can also go down as well as up.

PROPERTY

ADVANTAGES

- Low level of correlation to equity and bond markets
- Rental income tends to be more stable than equity dividends
- Commercial rents might be contractually protected against inflation

DISADVANTAGES

- Illiquidity – it may be difficult to get your capital investment back quickly
- The value of properties and the rental income from them can go down as well as up
- Direct investment in individual commercial properties can involve a significant outlay

KEY FACTORS TO CONSIDER BEFORE YOU INVEST

Before deciding on the right blend of assets to generate an income stream, you should consider the following factors, which might affect the decisions you make:

INFLATION

The rate of inflation measures how the price of a basket of goods has changed over time. So, for example, if the cost of running your home increases by 5% in a year, you will need to earn 5% a year more to pay for the same level of comfort.

If you are aiming to maximise the income from your investments in order to pay for everyday expenses, you should consider the impact of inflation and – particularly over the longer term – whether you require a specific form of protection against inflation.

However, if you decide to invest in a fixed-rate investment – for example, a gilt or a corporate bond – be aware inflation will definitely have an impact. As an example, a fixed rate of 4% is attractive when the rate of inflation is 2%. However, if inflation rises to 5%, that return of 4% becomes less appealing.

RISK

Risk is a very personal thing as it can mean different things to different people. Some investors are not prepared to tolerate financial loss in any form while, at the other end of the spectrum, some investors most fear missing out on an opportunity. For still other investors, risk means not being able to meet future financial commitments.

Before formulating an investment strategy, every investor needs to be clear about their investment goals and their tolerance for risk. No investment is risk-free – the lowest-risk investments might guarantee the preservation of capital and/or regular income payments, but they cannot necessarily protect your money against the erosive effects of inflation.

Ultimately, in order to enjoy an absence or reduction of risk, a cautious investor has to accept the prospect of lower returns. Equally, an investor who is willing to pursue higher returns will also have to accept the possibility of increased potential for risk to their capital.

DIVERSIFICATION

Since every source of income carries some form of risk, it pays to diversify your portfolio across a range of different asset classes. Diversification helps to reduce the possibility especially weak (or even strong) returns from a particular investment or asset class might have a disproportionate effect on the overall performance of the portfolio.

There is a world of choice out there for income investors. Whether you are a more cautious person or someone willing to take on significant levels of risk in the hope of achieving ultimately higher returns, please do get in touch so we can help you find a solution that meets your individual needs.

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