A GUIDE TO

INVESTING FOR INCOME

Bright ideas to make more of your money by building a reliable strategy and casting a wider net to protect against inflation

A guide to Investing for Income

How do you generate a reliable income when interest rates are stuck at all-time lows and the Bank of England's quantitative easing policy of 'printing' money is squeezing yields on government bonds (gilts) and other investments?

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Tough challenges for investors

The legacy of the credit crisis is creating many tough challenges for investors, particularly those seeking a reliable income. Seven or eight years ago, generating income was straightforward: just buy bonds. A portfolio of safe government securities would pay out a decent yield every year, allowing investors to meet their expenses, fund charitable donations or supplement their income in retirement.

Today, the yields on the vast majority of bonds have shrunk to record low levels, driven down by central bank policies and investors seeking safe havens. As a result, investors don't receive the level of income they did in the past. What's worse, in this new world, there are no longer any truly safe investments that provide a steady and decent level of income: investors can have income or (the appearance of) safety, but not both.

Your ability to generate income

With more of us living longer in the UK, maintaining our standard of living in retirement and funding holidays and outings requires some careful planning. Have you considered how a longer lifespan and rising inflation could affect you and your ability to generate income?

Generating an income from your investments will be an important requirement, especially if you've retired or are approaching retirement, or if you need to supplement your salary or have a relatively short investment timeframe.

Fixed interest

The most popular forms of income investment have been bonds (which are also known as 'fixed interest' investments) and cash, both of which pay a regular rate of interest either annually, twice a year or four times a year. You can also obtain an income from shares in the form of dividends, and many equity funds are set up solely with the purpose of generating a stable income. Importantly, equity income funds often aim to achieve not only stability, but also an increasing income in the long term.

Low-risk income generation is becoming a thing of the past. Investors today can still meet their income needs, but they should look beyond cash and government bonds and be prepared to take on some more risk, whether that's from higher yielding bonds, equities, structured products or niche illiquid investments.

Rather than narrow in on the headline yield of a portfolio, investors should consider taking a broader view, focusing on overall total returns and using capital gains as well as coupons and dividends to generate the income they need.

Good cash flow

Income stocks are most usually found in solid industries with established companies that generate good cash flow. They have little need to reinvest their profits to help grow the business or fund research and new product development, and are therefore able to pay sizeable dividends back to their investors. Examples of traditional income-generating companies include utilities, such as oil and gas, telephone companies, banks and insurance companies.

You should remember that these investments do not include the same security of capital that is afforded by a deposit account.

The economic environment has been particularly unforgiving for investors who need to generate an income. The Bank of England reduced interest rates to a record low level as the financial crisis deepened – and savings rates followed. ■

WHICH INCOME-GENERATING INVESTMENTS ARE RIGHT FOR YOU?

In the current environment of abnormally low interest rates, cash savings accounts almost all pay negative rates of return after taking into account the effects of inflation and tax. To discuss your financial position or review which type of income-generating solutions are right for you, please contact us for more information.

Ten tips for investing for income

1. Sustainable long-term dividend growth – Investing in businesses when the growth potential is not reflected in the valuation of their shares not only reduces the risk of losing money, it increases the upside opportunity.

2. Inflation matters – Always bear in mind the detrimental effect of inflation. Corporate and government bonds offer higher yields than cash but returns can be eroded by inflation. Investment in property or equities provides a vehicle to help achieve an income that rises to keep pace with inflation.

3. Consider international diversification – A small number of UK companies account for approximately 40 per cent of UK dividend payouts. This compares with over 100 companies in the US, for example, that provide the opportunity to increase the longevity of dividend growth.

4. Patience is a virtue – Investing for income is all about the compounding of returns for the long term. As a general rule, those businesses best placed to offer this demonstrate consistent returns on invested capital and visible earnings streams.

5. Reliability is the key – Select sectors of the equity market that do not depend on strong economic growth to deliver attractive returns to investors.

6. High and growing free cash flow – Look for companies with money left over after all capital expenditure, as this is the stream out of which rising dividends are paid. The larger the free cash flow relative to the dividend payout the better.

7. Dividend growth – In the short term, share prices are buffeted by all sorts of influences, but over longer time periods fundamentals have the opportunity to shine through. Dividend growth is the key determinant of long-term share price movements - the rest is sentiment.

8. Cautious approach – Profits and dividends of utility companies are at the whim of the regulator. Be cautious of companies that pay a high dividend because they have gone ex-growth – such a position is not usually sustainable indefinitely.

9. Investment diversification – The first rule of investment is often said to be 'spread risk'. Diminishing risk is particularly important for income-seekers who cannot afford to lose capital.

10. Tax-efficiency – Increase your net income by using an ISA (Individual Savings Account). The proceeds from ISA income is free of taxation, thereby potentially improving the amount of income you actually receive. UK dividend income has been taxed at source at the rate of 10 per cent and this cannot be reclaimed by anyone. The proceeds from ISAs are also free from capital gains tax, allowing you to switch funds or cash in without a tax charge. ■

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Contact us today.

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