Investing Capital for Income

Background

Over recent times investors and particularly retired people have seen the headline yields available from all savings reduce dramatically. Luckily this has gone hand in hand with an even greater reduction in inflation, meaning that the real return on savings (the difference between available interest yields and price inflation) has actually improved. However, inflation, however low, still leads to erosion of value in the long run.

So how does an investor, often a person reaching retirement with a lump sum to invest, obtain a decent, sustainable and hopefully growing income from their capital?

Interest, Dividends, Yields and Rent

There are only four types of asset that actually produce a cash return and of these only two can really be said to have some prospect of capital growth. These asset classes, their income types, suggested duration and the current (September 2002 - RPI at 1.3%) typical approximate gross yields are as follows:-

Asset	**Income Type**	**Duration**	**Yield**
Stocks and Shares	Dividends	10 plus years	3.5% (FTSE 100)
Bonds (Gov't & Corporate)	Yield or 'Coupon'	5 plus years	4.5 – 13%
Commercial Property	Rent	7 plus years	7 – 8%
Cash	Interest	2 years	4%

In respect of the bonds the higher the yield the higher the risk.

In order to ensure that one's income rises year by year to compensate for inflation, it is necessary to grow the capital of the fund. Of the four asset classes, only stocks and shares and property have any real prospect of capital gain and in reality only stocks and shares deliver such appreciation sustainably. All property eventually needs refurbishment or becomes obsolete and therefore of reduced value. This redundancy can be masked by the increase in land prices, as land is scarce and of finite supply. If held directly, in let domestic property say, it is very difficult for the average small investor to achieve enough diversification to reduce risk.

It is also obvious that not only is the yield from shares low but that the capital value can be very volatile in the short term which is not helpful to those living on income from their capital. The solution to this volatility is to mix up all four asset classes in the appropriate proportions. In this way the stable capital values of bonds, property and cash as well, as their high yields, compensate for the volatile capital values of shares and their low yields. Whilst the capital appreciation (over time) of shares compensates for the erosion by inflation of the capital value of the other asset classes.

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So How Best to do this

Well, you could do it yourself by buying suitable stocks, bonds and properties and building your own fund. More realistically you hand over your capital to a manager who runs a specific fund designed to satisfy your requirement for income with growth. These funds are run by Investment and Insurance companies, Banks and other similar institutions. Of course they charge you for this service but with careful selection these charges need be not onerous.

The 'T' Word

Taxation. Properly organised such funds can be very tax efficient indeed. A good adviser will be able to work with you to ensure that as far as possible, your income and growth is delivered in the most tax efficient way.

So What Income Can I Expect

Our rule of thumb and target for our clients is about 4% - 5% per annum in their hand. On top of this we try to ensure that they enjoy about 1.0% – 3% capital appreciation each year. Of course it is possible to obtain higher yields but this will almost certainly be at the expense of capital. Capital growth cannot be guaranteed as all investments can go up or down in value. Recent (Over the period 2000 to 2007) stockmarket performance is clear evidence of this.

Flexibility and Access

This is your capital. No adviser worth his salt would ever recommend an investment that did not allow you access. However, investing is a long-term business and you should always make sure that you retain sufficient liquid capital to deal with the vicissitudes of life.

Costs

There are three elements of expense incurred in investing money. Firstly there are the fees you pay the adviser, hopefully us, for the strategic advice, research and implementation and ongoing supervision of the investment. We will give you an estimate of the cost before proceeding.

Then there are two main expenses directly involved with the investment. These are the initial charges and annual management charges. It is part of our job to see that these are minimised. It is not possible to quote figures here are the amounts vary from time to time and with the amount you wish to invest. Please note that the ongoing annual charges have a much greater affect on overall return than initial charges.

In general the prices charged are fair for what is done. At the time of the last edition of this note (January 2007) we have noticed apparently conflicting moves in prices. Over the past year many active managers have been increasing their fees – probably thinking that it is easy to do this on a rising market. At the same time we have been moving clients out of these expensive (not to say wildly overpriced) funds and buying into institutional (wholesale) priced passive funds. These passive funds usually have no initial charge and a much lower annual management charge.

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Conclusion

The income seeking investor is well served by a plethora of funds and products all designed to satisfy the demand for income. Many of them are unsuitable, some are excellent, others will do you a job. However as long as you remember a few golden rules you should be able to invest confidently and enjoy a rising income over time.
The golden rules are

1. **If something looks to good to be true it probably is.**
2. **Be realistic in your income ambitions.**
3. **Be tax efficient.**
4. **Ensure good diversification.**
5. **Keep it simple**
6. **Keep enough cash in reserve.**
7. **Get time on your side and don't panic.**
8. **Be disciplined.**
9. **…and lastly, he who has the gold - sets the rules.**

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