A guide to Income investing
Generating an income can help those who want to maximise money they’ve worked hard to save.
With interest rates at historic lows for many years now, savers have to look harder to find income that in the past had been provided by deposit accounts or bonds.

Income-starved savers wanting frequent payments to supplement pensions or other income are getting next to nothing from banks and building societies. Savings in these cash accounts have largely failed to hold their value in real terms.

Savers are becoming increasingly desperate to explore alternative sources of income to help plug the gap. A popular option is to place money in investments specifically designed to generate an income.

This is certainly becoming a more popular choice now that savers over the age of 55 can access their pension savings. Many are choosing to take control of how the money provides an income – rather than being forced to hand it over in exchange for an annuity – by placing it in these income-producing investments.

To achieve a better rate of return than you would typically get from a savings account, you need to accept more risk. That means getting comfortable with the fact that your investments can go down as well as up and the original capital is at risk.

In reality, even cash is not without risk. In choosing the supposedly safer option of cash as a long-term investment, it is almost certain your money will fall in value over time as it is slowly eroded by inflation. Historically speaking, stockmarket gains far outweigh cash. However, past performance may not necessarily be repeated in the future and shouldn’t be used as a guide.

£1,000 invested

<table>
<thead>
<tr>
<th>£5</th>
<th>The amount of interest earned in one year on a bank deposit</th>
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<tr>
<td>-£10</td>
<td>The value lost in one year, caused by inflation</td>
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Source for figures: Bank of England, ONS, as at December 2014. Bank of England base rate of 0.5% is representative interest rate. ONS Consumer Price Index (CPI) of 1.0% is representative of inflation.
By investing in **equities**, savers can back companies which have potential to pay out significant dividends – a share in the profits – to shareholders. There are many such companies which have historically provided not only reasonable dividends, but a track record of growing profits and consequently improving those dividend payments over time.

It is also possible to grow your original capital if the share price increases in value over the time you are invested, although it may go down as well as up along the way.

Investments in equities can be volatile. Their values may fluctuate quite dramatically in response to the results of individual companies, as well as general market conditions.

**Dividends** can be taken as income, or they can also be reinvested. This is a valuable long-term investment strategy because reinvested income is the biggest overall contributor to total returns because of **compound interest**. This is the term for earning ‘interest on interest’ or more specifically, generating income from previous income. It actually means you can save less for longer and be potentially better off than saving a lot in a short time.

Whether you take the income or reinvest it depends on what you are saving for and over what period of time.

**Bonds** offer a fixed income from money you ‘lend’ to the government or companies who need to raise cash. They come with the promise to give your money back at the end of a fixed period. You can buy directly or through a bond fund.

Investing in bonds do carry the risk that the issuer of the bond might not be able to repay either the interest or the original loan amount, meaning they default on the debt. They are also impacted by movements in interest rates, where their value may go down if interest rates rise and vice versa.
Property offers an income through direct investment in a buy-to-let house or flat but also through property funds. In both cases, rents can be raised in line with inflation.

The value of real property is generally a matter of a valuer’s opinion. If investing in a property-based fund, it can sometimes be difficult to deal in its units or sell them at a reasonable price. There is also the risk that the information about the properties invested in the fund is unreliable.

An annuity is an income-generating contract sold by an insurance company and usually bought with retirement savings. It guarantees an income for life.

However, the level of income provided by annuities depends on the interest rate on bonds issued by the government at the time you purchase the annuity.
Who is income investing suitable for?

There’s no hard and fast rule about who should use this kind of investment style.

Since income is produced by typically large, stable, and profitable companies, they could help form the bedrock of almost any portfolio for almost any investor.

Asset management companies offer managed funds – also known as ‘mutual funds’ – as an opportunity to invest in lots of different dividend paying stocks, or bonds, through a single investment.

Your money is pooled with that of other savers and invested by a fund manager who can choose established, cash generative companies that they think will satisfy the income goals of the fund. Spreading (or diversifying) the risk across a number of companies is less risky than investing directly in individual stocks.

These type of funds – known as equity income funds – could suit a lot of investors even if the income isn’t required. Instead it can be reinvested and the accumulation of the dividend should add significant value over time. It matches what many people want: income as well as some capital growth potential.

There are many different kinds of savers that might be interested in income investing. Here we explore some of the circumstances in which you might explore this option.
Those with a long-term view to build a secure financial future can choose to reinvest dividends which will provide the lion’s share of total returns over the long run.

Saving to put a deposit on a new home will help ease the pressure on monthly mortgage repayments. Using income investing you can aim to accumulate a decent sum to put towards your dream home.

When little ones come along and one half of a couple stops work, the drop in income could prove difficult. Being able to take an income from your investment can help plug the gap of a missing salary. If and when both of you are working again, you can switch back to reinvesting dividends.

Every parent wants to give their child a good start in life, which for many includes building a nest egg to help secure their financial future – whether this is a debt-free education or the deposit on a property of their own. As always, the earlier you start saving the better. Funding a private education can be a huge outlay for parents – and fees are on the rise. Starting to plan early for the expense of school fees will make a big difference to the school that you can afford.

Building savings for your future as well as the future of loved ones is important for many families. As well as helping children, more people are helping grandchildren to get a good start in life. With property prices high and mortgage companies demanding large deposits, a financial lifeline from family can make all the difference.

Having a robust fund for a safe and secure financial future is becoming increasingly important as we are having to wait longer to receive our state pensions—and we are all living much longer. Income investing is closely aligned with the needs of those in retirement as it uses existing savings to provide regular payment to replace a salary, so they can maintain their standard of living.

Why is income investing important now?

Savers have always been hungry for income, but since the Bank of England has been holding rates at ultra low levels, they are receiving derisory rates of return.

Meanwhile bond yields are also close to historic lows and, as interest rates rise, bond holders could suffer losses if their capital value falls. Many people are desperate to find somewhere to place their savings and use it to achieve inflation-beating returns.

Rising interest rate environment

While the base rate has been stuck at 0.5% for over five years, economists agree that there's only one way it can go from here. When the Bank of England finally starts increasing interest rates, any rise is expected to be gradual rather than sharp increases. Savers are unlikely to rush back to cash because it will take time for returns from cash to become attractive again.

Rule changes surrounding pensions

In April 2015 savers were granted full access to their pensions funds by allowing them to withdraw cash either to spend – or re-invest.

This means people are no longer forced to use their pension savings to buy an annuity (an insurance policy that promises to pay a set income for life). They now have more freedom to keep their pensions invested and draw an income from them, rather than having to lose the capital by locking in an annuity contract.

A key consideration for those at retirement should be the balance of accessing savings early versus the likelihood that they’ll live for a long time and will need a steady income.

While many still choose an annuity, others will want to retain control over their original fund and put it to work. This involves drawing an income directly from their pension pot, and is referred to as drawdown.

Many more are expected to use drawdown to regain control of their own money, choosing income generating funds to provide them with what they need to live on during retirement – or even beforehand for those who are scaling back on work as they get older and want to supplement their new lower salary.

* Source: HMRC, Chancellor George Osborne, Schroders, 2015
Managed income solutions

There are several ways to generate income. You can buy shares in some of the dividend-paying companies and hope you have picked the right ones at the right time. This route is riskier, however, than buying a managed fund instead. Managed funds are an ideal method for income investing, as a basket of carefully selected stocks helps spread risk. These stocks can be British companies or companies in other countries or regions, in many different industries and sectors.

The following sections outline some of the ways you can earn an income from investments. In each example your capital is at risk and the value of your investment can go down as well as up.

Equity income funds

Income-starved investors in particular should consider equity income funds, as they can generate returns above the rate of inflation, which is very hard to obtain elsewhere. They also offer the potential for capital growth. Such funds can be an effective way to diversify your income stream away from low-yielding cash and bonds, however they do come with higher risk (see page 4).

Whether you’re a cautious or adventurous investor, it’s important to diversify your dividend stream. Fund managers look for companies that offer fair value, a strong and sustainable dividend yield and are fundamentally good businesses with strong cash flow.

A fund makes regular payments of income, either quarterly or monthly. The level of income can vary, and so future income payments are not guaranteed.

All of these funds operate in different ways, so when selecting one you need to ensure it suits you. A financial adviser can help determine the level of risk appropriate for your circumstances.

UK equity income funds

These are often the first port of call for an income investor, forming a core holding of a typical investment portfolio.

They focus on holding companies listed on the London Stock Exchange that offer attractive prospects for income.

If you hold a few UK equity income funds, you should be looking to achieve diversification from each of the individual fund’s holdings. An overlap of holdings may make you more exposed to a dividend cut.

It’s worth noting that even those who think they’re investing solely in the UK are often tapping into international opportunities since many British companies have dealings abroad.

There is a growing case for adding extra global exposure to an equity income portfolio, as well as the fact it offers a good way of ensuring your income portfolio has a healthy level of diversification.
Global equity income funds

A global equity income fund offers diversified access to different companies and markets for income as well as capital growth.

Using these funds, investors can gain access to certain sectors which might otherwise be difficult to gain exposure to. Overseas companies are increasingly paying attractive dividends, and regions that have historically been off the dividend map are now some of the highest-yielding stocks.

Many investors are keen to tap into the established dividend culture that has emerged in the US and Asia, for example. Much of this can be explained by the economic changes as well as improved attitudes by companies overseas to please shareholders.

Investments in overseas markets can involve a higher degree of risk. Fluctuations in currency can impact the income earned on an investment. Investing in emerging markets can also carry greater risk as they are less well regulated than those in the UK.

Multi-asset income funds

Multi-asset funds arguably have a big role to play in a low-return and volatile investment environment because of their ability to switch between assets.

They can generate income from a combination of sources, which can be held directly or through funds, investing across equities, bonds, cash and property.

Some multi-asset funds run on a fund-of-funds basis where one manager runs a portfolio of funds on your behalf. Each fund has a different strategy with some delivering a high income and some a growing income.

Investment trusts

Investment trusts are another alternative for income seekers. These are structured companies that hold assets such as shares and are run by a fund manager, who is backed by an independent board, appointed to act in the best interests of shareholders.

Investment trusts can create steady returns by squirrelling away up to 15% of their dividends each year and using this money to boost dividends in difficult years. This means that some have very long records of raising dividend payments year in, year out.

In certain circumstances, investment company boards may elect to pay income out of capital – while this can erode the long-term capital returns generated by the funds, many investors are happy to prioritise short-term income payments.
Fixed income

Bond, or fixed income, funds offer an income and are popular with savers who like to be able to count on regular payments made for a fixed period.

Bonds are issued by governments and companies, which guarantee a fixed income over a set number of years, as well as your capital returned at the end of the term.

UK Government bonds, or ‘gilts’ are widely regarded as safer bond investments as they are backed by the UK Government. Corporate bonds are issued by companies, come in many guises. Those with strong balance sheets are known as investment-grade bonds. Companies with a higher level of risk associated with them are known as high yield or non-investment grade.

Market conditions have driven down returns from bonds in recent years and their value can be eroded by inflation. There are however ‘index-linked bonds’ available, that are designed to help protect against inflation.

Property

Investing in bricks and mortar is popular for income as it helps protect future purchasing power; property values and rents run largely parallel to inflation.

This asset class achieves ‘real income growth’ over the longer term because put simply, they are managed by landlords who increase rents, and the value increases.

Investing in a buy-to-let property is an obvious choice for many, but it does leave you heavily exposed to one asset class and is expensive to get started once you factor in stamp duty and other costs. It can also be difficult to get your hands on the original capital if the market doesn’t allow you to sell quickly, known as liquidity risk.

Property funds invest in real estate and can overcome some of the liquidity risks associated with direct investment in property.

Whether you choose direct investment or investment in property funds, there are tax implications. A financial adviser can help talk you through the options.

A word on growth funds

Income is not the only style of investing. Growth funds back firms that reinvest their dividends in their business rather than paying out profits to shareholders. They are popular among long-term savers who do not need to take an income from their investments. Growth fund managers will typically choose to invest in companies that they believe will be able to significantly grow their earnings over time.

These funds feature in most balanced portfolios because, after all, most savers are looking for investments that generate an income, protect their capital and have potential for capital growth.

Financial situations change with time, which means making the necessary adjustments to your portfolio. As your investment needs change you might need to switch your balance of growth funds and income funds.
The cost of investing

There are a number of charges to pay when investing because several parties are involved in helping manage your money. While these fees will eat into returns, remember that paying more for a fund with excellent returns is better than a cheap fund that offers poor returns.

So what are you paying for?

Your adviser will charge an amount for their advice; usually a fixed lump sum, or an hourly rate. This should be made clear and agreed at the outset of your sessions.

If you’re going it alone, an investment platform will charge an amount for their service; usually a portion of the amount you invest, or a set fee.

Whichever route you take, there are annual charges to pay to the fund provider. This is called the Ongoing Charge Figure (OCF) and covers administration, operating costs, investment management and independent oversight.

Know what you are buying

Dividend payments are attractive to income investors, but it’s important to remember these are never guaranteed, and there is always the risk they might be cut. Many of these funds hold the same big, blue chip names which mean that if a dividend cut does happen these funds may bear the brunt. Large companies can cut their dividends in times of distress, as was apparent to many dividend-dependent investors during the financial crisis. However, as part of a balanced portfolio they offer important and valuable opportunities.

The level of income achieved will vary from fund to fund. Some managers aim to produce a consistently high level of income with less scope for growth, while others look to grow dividends over the long term.

Remember, the dividend yield, a way of representing the income paid by a stock, has an inverse relationship to the share price — if share prices rise, yields fall.

The yield of a fund – usually expressed as a percentage — is used as an indicator about what the fund is returning to investors, yet it should not be the sole reason for choosing a particular fund. This is because it tells investors little about how the fund has performed or will perform as an income source. Yield is the dividend paid by a fund over the past 12 months divided by its current unit price and so can change frequently. It’s important to look under the bonnet of each fund you hold and familiarise yourself with the underlying companies in which it invests.

*Source: FE Analytics, as at December 2014. Based on the average OCF of the IMA UK Equity Income and IMA Global Equity Income sectors (1.6%)
Getting started

There are two routes for choosing and buying investments:

**Through your financial adviser**

A financial adviser can help match you with the right kind of investment by ascertaining your circumstances, goals and how you feel about taking risks with your money.

Advisers charge fees which can add up depending on the size of your investment. But, they can help take out some of the leg work for you by working to source the best types of funds for your situation.

If you don’t already have an adviser, you can find one at unbiased.co.uk, or by calling 0800 085 3250. You can also visit vouchedfor.co.uk, which allows consumers to rate and review advisers they have used. Financial advisers have to be authorised by the Financial Conduct Authority (FCA).

**Using a fund supermarket**

If you are confident in choosing your own funds, you can do so using a fund supermarket. Also known as platforms or discount fund brokers, they allow you to buy, sell and manage shares and funds from companies and many different providers.

There are plenty of online tools available to help with finding the funds to suit you. Many platforms offer access to performance figures, preferred funds as well as fund ratings.

It is sometimes possible to go straight to the asset management company which runs the fund you have chosen, however fees are generally lower via a fund supermarket. It also means you hold all your investments in one place which is far easier than keeping up with a long list of firms.

There are lots of fund supermarkets to choose from, so choose carefully. You should select according to how easy the site is to use, the funds available, how much it costs and the quality of customer service. You can compare providers at comparefundplatforms.com

Source: (number of advisers) FCA, 2013; (fund statistics) Investment Management Association, December 2014
Tax-free income investing

**Individual Savings Accounts (ISAs)**

Every year the Government gives everyone a tax-free ISA allowance. Filling up your annual ISA allowance is a must as far as savings goes, to ensure you maximise the tax-free opportunities.

For 2015/16 the allowance stands at £15,240, which means we can shelter a lump sum from capital gains and income tax.

However, it’s important to know that ISAs don’t offer complete tax-free status for all. Income from corporate bonds and gilts (and cash) is tax free. But income from equities can attract some tax charges, as income is taxed at source. Taxpayers can cross into higher tax brackets, so placing investments in a tax-free wrapper is a smart move. Investing in an ISA also means you don’t have to mention it on your tax return.

Not everyone can afford to save the full ISA allowance each year, but putting a little something away every month is better than doing nothing, especially if you start to build up your contribution over time.

**Self-Invested Personal Pension (SIPP)**

Your income-generating funds might also be placed in another very tax efficient wrapper for retirement – a personal pension or self-invested personal pension (SIPP).

The tax treatment when you start taking income from pension savings is slightly different because savers receive tax relief on the way in – it is on the way out where HM Revenue & Customs takes a slice.

You get a tax top-up when you contribute to your retirement pot, at the rate of 20%, 40% or 45%. So, every £800 paid in by a basic rate taxpayer, for example, will automatically turn into £1,000. Higher-rate taxpayers can claim back an additional £200 through a self-assessment form boosting their return even higher.

To access your fund you need to remove your money from its tax-free wrapper. From age 55, you can usually take up to 25% tax-free cash from your SIPP and a taxable income from the rest.

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Choosing a share class

Most open-ended funds are sold in individual units. Once you’ve selected a fund, you will be faced with the choice of two types of units – income or accumulation.

A financial adviser can help you if you have any questions around which share class is right for you, but here is a quick overview.

**Accumulation units**

Accumulation units are generally suited to those investors looking to grow the value of their original investment. Any income earned is wrapped up and reinvested back into the fund.

Accumulation units are attractive to a number of investors, for example those who are working and want to build their retirement nest egg.

**Income units**

For income units, any distributions from the fund are taken out and paid in cash.

Income units are attractive to those who want their distributions to be paid as income, for example those in retirement who would like to use the income earned for their living expenses.

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Source for tax rates: HMRC, 2015
### Jargon Buster

**Annuity**  
An insurance policy that guarantees a fixed income for the rest of your life.

**Bonds**  
Provide a way for governments and companies to raise money from investors for current spending requirements. In exchange for an upfront payment from investors, a bond will typically commit the issuer to make annual interest payments and to repay the initial investment amount on maturity at a specified date in the future.

**Blue chip**  
A term used to refer to leading companies on the stockmarket.

**Compound interest**  
The cumulative effect of earning interest on your savings and leaving your interest in the savings account — or in investment terms generating income from previous income.

**Dividend**  
A payment made to shareholders from a company. It is a distribution of a portion of a company’s earnings.

**Drawdown**  
Drawdown (or income drawdown) is a way of receiving income by receiving capital from pension savings while relying on capital growth to maintain or grow the fund. Drawdown is only available if a pension is (or is transferred into) a personal pension.

**Equities**  
A share in the ownership of a company.

**Equity income fund**  
A fund specifically invested in stocks which pay healthy dividends.

**Fixed income**  
Also known as bonds, fixed income securities work differently to equities or shares. Governments and companies issue bonds which promise a fixed income and your capital back at the end of the term.

**Growth fund**  
These funds back stocks that reinvest their dividends in their business rather than paying out profits to shareholders.

**Multi-asset fund**  
One fund which invests in a combination of assets either directly or through a fund.

**Ongoing Charge Figure (OCF)**  
The cost added to an investment to cover administration, operating costs, investment management and independent oversight.

**Pension freedoms**  
The government has allowed over 55s to access their pension pots for the first time. Savers are now able to withdraw some or all of their fund.

**Portfolio**  
A collection of investments that can include any or all asset types.

**Tax wrapper**  
A tax break that a saver can ‘wrap’ around their investment, so that it is sheltered from paying a proportion or any tax on it. The most common tax wrappers are Isas and pensions.

**Tax-free lump sum**  
The first 25% of a pension fund can be taken tax-free.

**Yield**  
The level of dividend income received from an investment, usually expressed annually as a percentage.

### About the Author

Holly Thomas is an award-winning financial journalist and former Deputy Personal Finance Editor at The Sunday Times. Holly writes across all areas of personal finance and consumer issues, specialising in investments, pensions and property. She has previously worked at the Daily Express and Sunday Express and Financial Times Business. Holly was voted Freelance Journalist of the Year at the Association of British Insurers Media awards, and won the title of Best Consumer Advice by the British Insurance Brokers Association. Her work can be seen in national press, including The Times and the Mail on Sunday.
A GUIDE TO INCOME INVESTING

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Source: Schroders, all data as at 30 June 2015