Whitechurch
Financial Consultants
A Division of Whitechurch Securities Ltd

Defending Your Income
- A Useful Guide

Tax Year ending 5th April 2019

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Introduction

The growing need for income

Due to medical advancements and improving healthcare we are all living longer. Naturally, this is a good thing, but it also means that many of us will be in retirement for much longer. For example:

- A man retiring in 2021 at 65 is expected to live to 87
- A woman retiring in 2021 at 67 is expected to live to 89

(Source: Artemis Investment Managers, using ONS data, February 2017)

As such, your retirement savings need to go further than you expected.

Interest rates – the income dictator

Over recent years the greatest demand from investors has been the need to boost their income.

It has been eight years since the Bank of England systematically reduced the base interest rate to emergency levels. At its lowest point reaching 0.25%. Although there has been some recovery in this time. The UK base rate is still low at 0.75% and this sustained low rate has had a significant knock-on effect for income seeking investors.

There has been much speculation over when UK interest rates will rise. However, the Bank of England has indicated that significant rises may not be for some time.

This publication explores the income producing investment options currently available, so that you can maximise your income within the current low interest rate and relatively low inflation environment.

Inflation – the income nemesis

Inflation measures the price rise of goods and services within the economy over a period of time – i.e. the cost of living.

The inflation rate in the UK averaged 2.6% from 1989 until 2017, reaching an all-time high of 8.5% in April 1991, and a record low of -0.1% in April 2015.

(Trading Economics, February 2017)*

The primary objective of income investing is to generate a return in excess of inflation. If you can achieve this then you will be receiving a 'real return' on your income.

UK inflation has been at historically low levels but we have recently seen inflation ticking upwards with the headline consumer price index rising to 2.0%* (and the retail price index rising to 2.8%*). This has been driven by two key factors: rising oil and commodity prices; the weakness in the pound since the vote to leave the EU driving up import costs.

(Source: Office for National Statistics (ONS), December 2018)

Whether inflation remains at these levels, continues to rise or falls back again it is not known. However, to produce inflation beating income returns is much more difficult in the current environment.

If your income returns don't beat inflation, your income would lose its 'purchasing power'. In other words, the price of goods and services are rising faster than the income you receive making them more expensive and less affordable over time.

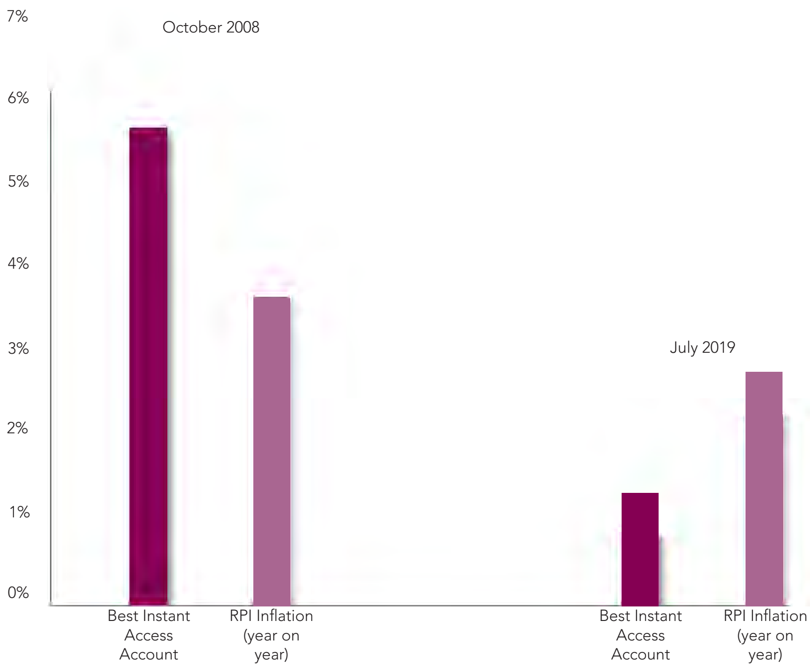
Cash

To most people cash means bank or building society deposit accounts, paying interest.

The Bank of England base rate was at 4.5% in October 2008 (before they systematically cut rates down eventually leading to the current level of 0.25%). Back then you could have found a deposit account paying 6.5%.

The best deposit account rate you can currently find is 1.4%, significantly lower historically and not even providing an inflation beating return.

Then and now...



Sources: The Telegraph Best Instant Access Account, October 2008; moneysupermarket.com Best Instant Access Account, July 2019; ONS RPI Inflation figures, July 2019.

It pays to shop around and get the best rate on your money. The internet is a good place to start, and a number of comparison sites can help you find the most competitive rates.

Instant Access vs Fixed Term

When looking for the best rates it is important to take flexibility into account.

Fixed term (or Notice) accounts usually pay higher interest rates than Instant Access accounts as they limit you as to when you can make withdrawals.

For example, a fixed term account may offer an elevated interest rate over the first 12 months as long as no withdrawals are made over the first 12 months.

Cash ISAs

It is vital that you make sure you are receiving the maximum tax breaks on your savings. Through Individual Savings Accounts (ISAs), individual investors can invest up to £20,000 for the 2019/20 tax year into a Cash ISA which will earn interest tax-free.

However, at the moment rates are uninspiring with the best Cash ISA deal currently available offering a miserly headline rate of just 2.0%

(Moneysupermarket.com, July 2019)

Whilst deposit accounts and Cash ISAs are good homes for "rainy day" money, they are not ideal homes for longer-term money whilst interest rates are at historically low levels and with inflation at current higher levels.

If you are going to hold a significant amount in cash accounts, then it makes sense to spread your money around UK banks and building societies. This will ensure that you are within the limit that the Government will guarantee in the event that the bank / building society defaults. The protection provided for deposits is 100% of the first £85,000 per authorised institution.

Fixed Income

The term fixed income is applied to investments where the amount of income paid does not vary with each instalment.

Most fixed income investments occupy the middle ground within the investment world, whereby the risk/reward profile lies between cash and high risk equities.

The most common example of fixed income investments are Government bonds and Corporate bonds.

Yields

The yield is a direct result of the relationship between a bond's income payment and its capital price.

Income payment / bond price = yield

The income amount is fixed. So if the bond price goes up the yield goes down.

If the bond price goes down the yield goes up.

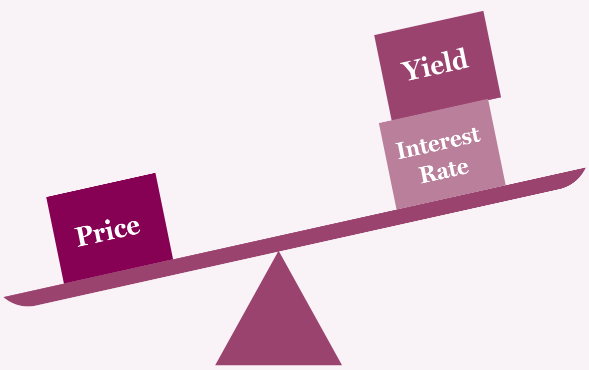
Interest Rates

Bond prices are also affected by movements in interest rates.

If interest rates are lowered, the bond price goes up.

If interest rates are increased, the bond price goes down and this increases its yield.

The bond yield has to increase so that the bond remains attractive to new investors.



Government Bonds

These are issued by sovereign states, whereby they 'borrow' money (and so create a bond) from investors.

In return, the Government agrees to pay a fixed income return over the bond's life and repay investors their original capital on the bond maturity date.

UK Government bonds, also known as gilts, can be used in a variety of ways. Gilts vary in the rate of interest they pay and the period to maturity.

Gilts are seen as a traditional, safe haven for investors. They have been in high demand due to low interest rates and when investment risk is high. This has caused gilt prices to rise dramatically and yields to fall. For instance, the long- term historic yield on a UK 10 year gilt is between 4% and 5%. Currently it yields 0.5%.

(Trading Economics, August 2019)

So whilst gilts are typically seen as a low-risk asset, you can still end up with capital losses. Particular when interest rates start to rise.

Government Index Linked Bonds

In the UK these are the same as gilts except they are linked to UK inflation and offer an interest rate return over their life above the prevailing inflation rate.

Therefore, when there are rising inflation expectations, index linked gilts become very popular as a way to hedge returns against higher inflation.

Global Government Bonds

Just as in the UK, Governments across the globe issue bonds (both conventional and index linked as per UK gilts) and the returns available will be dependent upon the risks associated with the underlying economy.

Exchange rate fluctuations between currencies may also cause the value of overseas investments into Government bonds to fall as well as rise.

Corporate Bonds

These provide an alternative to Government bonds, though in terms of the mechanics they are principally the same.

Corporate bonds are issued by companies and generally offer a higher yield than those available from Government bonds. The trade-off for this higher return is increased risk, as you are lending your money to companies and not to the Government.

Fixed Income

Fixed Income Funds

Most investors choose to get exposure to fixed income from collective investment funds (e.g. Unit Trusts). This is a sensible approach as it allows you to spread the risk across a diversified portfolio of bond issuers.

However, the fixed income universe is broad and can be complex. Employing an expert fund manager to assess the value in either Government or Corporate bonds can prove invaluable.

Issues to consider when investing in Fixed Income

Default risk - If a bond issuer (Government or company) stops paying the fixed income or does not return your capital at the bond maturity date it has 'defaulted'.

High Yield risk - Typically the higher the yield on fixed income bonds, the higher the risk.

Some companies offer higher yielding bonds to attract investors. However, there is a greater chance of default as companies issuing these types of bond are generally not as financially secure.

Interest Rate risk - The inverse relationship between bond prices and interest rates is noted in the panel on page 2.

Generally, when interest rates rise, bond prices go down and when interest rates go down, bond prices go up.

Depending on the scenario at the time, this can lead to capital gains or losses for bond investors.

Inflation risk - Inflation is a key concern for fixed income investors. Rising inflation means that both the fixed income being received as well as the initial capital return at the bond's maturity are losing purchasing power as prices rise due to inflation.

Inflation really is the enemy of bond markets. With bonds that have a long date to maturity, investors will demand some protection from inflation risk. The only way for a bond to provide this is for its yield to increase. As with rising interest rates (see previous page) when a bond's yield increases, its capital price falls.

National Savings & Investments (NS&I)

National Savings & Investments (NS&I) are a popular and secure haven for savers and investors as it is a state owned savings bank.

Most of the headline interest rates from NS&I are generally on par with the best instant access deposit accounts. However, many savers will feel comforted by having their savings backed by the Government.

Direct ISA

NS&I offer a Direct ISA account which currently offers 0.9%. The ISA can be opened for as little as £1. This is a No notice and No penalty account so withdrawals can be made at any time.

(NS&I website, August 2019)

Income Bonds

These are No notice, Instant Access accounts which pay a monthly income and can be accessed for as little as £500.

The current interest rate on these bonds is 1.5% and is paid gross and so subject to tax at your marginal rate.

All NS&I products can be bought via the Post Office, telephone, by post or over the internet at www.nsandi.com

(NS&I website, August 2019)

Commercial Property

Bricks and mortar commercial property is a traditional income paying asset class.

The easiest way to gain exposure to commercial property is by investing in a collective investment fund such as an Unit Trust or a Property Authorised Investment Fund (PAIF).

Commercial property funds are currently offering yields around 3-4% for investors, which is attractive in the current environment.

For investors with balanced portfolios, UK commercial property acts as a good diversifier from equities and bonds, with little correlation between those asset classes.

The key benefit to commercial property investments is its income generation which accounts for the majority of the long-term returns on this asset class.

However, commercial property is an illiquid asset class. Commercial property funds invest in tangible, physical buildings which are not readily realizable. This was certainly bought home immediately after the vote to Brexit when several high profile open-ended property funds suspended trading.

This was due to large redemptions from the asset class which forced property managers to close the funds whilst they sold down physical properties. The high profile funds are all now open again but this highlights one of the risks of investing in property funds.

Permanent Interest Bearing Shares

Also known as PIBS, these are shares issued by building societies.

They provide a fixed coupon, paid twice yearly, and are traded on the London Stock Exchange.

PIBS tend not to have an expiry date, so you have to sell them in the market if you want access to your capital.

You need to be confident of the financial strength of the issuer if you are going to purchase these shares.

6% to 7% yields appear to be the median mark for PIBS.

Whilst this is tempting it is important to remember you are effectively investing in the shares of a single building society.

Because of the company specific risk it pays to be selective when looking at PIBS.

Equity Income Investing

For investors prepared to accept the risks of stockmarket investing then an equity income approach could be appropriate.

Equity income investing involves buying shares of companies who pay out dividends to shareholders.

Investing in dividend producing shares allows investors to receive an attractive, growing income and potential for long-term capital growth

This potential for dividend growth makes equity income ideal for producing inflation beating income returns without losing capital.

Dividend Growth

The key difference between dividend producing shares (i.e. Equity income) and most other income producing investments (including cash) is that your income has the potential to grow over time.

How a 3% dividend can grow year on year			
Years	5% growth per annum	10% growth per annum	15% growth per annum
1	3.2%	3.3%	3.5%
2	3.3%	3.6%	4.0%
3	3.5%	4.0%	4.6%
4	3.6%	4.4%	5.2%
5	3.8%	4.8%	6.0%

Equity Income Funds

A popular way of investing in equity income is to use collective investment funds such as Unit Trusts and Open Ended Investment Companies (OEICs).

These are managed with the prime objective of providing growing dividends for investors from a portfolio of company shares.

At present many such funds provide an income of 3% or higher — well in excess of deposit account rates and in excess of inflation currently.

Risk & Reward

Equity income funds are invested in stockmarkets and so are high risk and you can lose capital. If the stockmarket falls the value of your investment will likely fall but, on the other hand, if it rises, so too should your capital.

Historically, over the longer term, equities have tended to rise and have generally made better returns than cash or fixed income investments.

However, past performance is not necessarily a guide to future returns and so equity out-performance, going forwards, cannot be guaranteed.

With people living longer in retirement, equity income investing is becoming more and more important.

The stockmarket should be a consideration for investors looking at least five years down the line and looking for income, whether immediately or in the not too distant future.

Opportunities at Home & Abroad

The UK stockmarket has traditionally had a reputation as a leading source of dividend income and has attracted investors from around the world.

However, such is the global demand for income, investors can actually source equity income from dividend paying companies across the globe.

Dividend income can be obtained from the stockmarkets of Europe, Japan and North America or the developing markets of Asia and the Emerging Market regions.

There are a growing number of funds tapping into the income story either globally or regionally.

There have been some very high profile new fund launches over recent years for funds looking for yielding equities in Europe, the US and Emerging Markets.

However, it is important to remember that in addition to the risks of investing in equities, investing in overseas listed shares means currency fluctuation is an added risk to consider.

Multi-Asset Solutions

The Whitechurch Way

The most prudent way to produce a healthy and diverse level of income is to select opportunities within each of the asset classes mentioned.

Such a balanced mix of assets can provide a sustainable level of income, whilst providing diversification to combat any swings in market values in the short term.

How much you need to save to produce income of £25,000 in a year?

The illustration below shows potential returns from a selection of investment options.

Cash ISA, 0.9%
£2,777,777

UK Gilt 10yr, 0.5%
£5,000,000

UK Equity, 4.52%
£553,097

Whitechurch Income Portfolio (Risk 5/10), 3.99%
£626,566

Sources as at August 2019:
Cash ISA, NSandI.com;UK Gilt and UK Equity yields, Trading Economics and FT.com; Multi-asset portfolio yield, Whitechurch Securities.

Important Notes

This publication is intended as a brief overview of the most popular income producing investments. It does not cover the investments in detail so there are some warnings you should be aware of:

- The description of each investment may not include all the warnings of risk to your capital.
- This publication is not intended as a personal recommendation and it is unlikely that all of the investments will be suitable for your personal or financial circumstances.
- Any reference to taxation is based on our current understanding of taxation. You should remember that the rates and bases of, and reliefs from, taxation could change or terminate in the future.
- Past performance is not necessarily a guide to future performance. Investment returns cannot be guaranteed and you may not get back the full amount you invested.
- If you are unsure about any of the investments we urge you to seek professional financial advice from Whitechurch Financial Consultants before making any investment decisions.

You should not forget about your existing investments when investing for income. You should ensure that your overall portfolio is suited to your current financial needs.

For example, your financial circumstances and risk profile may well have altered from the time when you initially took out your investments.

Whilst growth may have been the sole objective in the past, income may be now much more of a priority.

In addition, the range of investment opportunities has grown considerably over the past few years and it may be worth speaking to one of our consultants to see if there are better options available.

If after reading this publication you feel that you need to seek expert, financial advice then we recommend that you contact us and ask to speak to one of our qualified financial consultants.

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