A guide to investing for income

Investing for income

A regular income is essential for most of us. For much of our lives, that income usually comes from working. But most of us will also need some form of income in retirement.

We may need income to last for several decades. And with all the regular outgoings we have – whether it's for bills, holidays, or the cost of care – the idea of some extra income can be very desirable. That's why income is a priority for so many investors in both work and retirement.

You can achieve an income in a number of ways, including income-focused investment, such as equities, bonds and property.

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The importance of income in retirement

Happily, most of us are living longer. And many people working today can look forward to a retirement that might last 30 or 40 years. That's good news of course. But it means that we'll need sources of income that last far longer than those needed by previous generations.

The UK government introduced pension freedoms in 2015. Many people over the age of 55 are now able to access their pension pot and can make their own decisions about what to do with it. Previously, most people used their pension pot to set up a guaranteed income for life (an annuity) at retirement. But now many people are instead choosing to keep their pension pot invested when they retire.

Of course, this doesn't apply to the more traditional defined benefit (or "final salary") schemes, which are being phased out. With this type of pension, the amount of the member's pension is based on years of service rather than the size of a pension pot.

Alternatives to pensions: income-focused investments

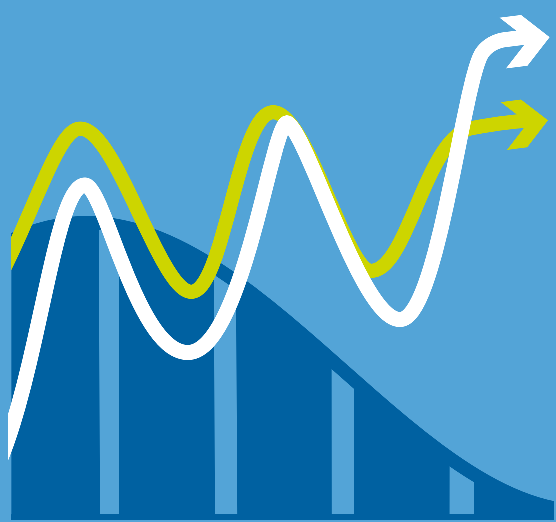
To achieve a retirement income that will last for many years, you might have to put your pension pot to work. You can do this by choosing an income-focused investment. These seek to achieve an income by investing in assets such as equities, bonds or property. However, it's important to make sure your money lasts as long as you need it to. Although the income you get from an annuity might be lower than what you could get from prudent investing, an annuity does at least guarantee a lifetime income.

But it's not just in retirement that income-focused investments can prove useful. Many of us face regularly recurring expenses that can put a strain on our salaries. These might include the fees for children's education or activities, the cost of holidays or paying for care for relatives. Generating income is therefore a consideration for most investors at some point in their lives.

Risk vs reward

All investments carry a degree of risk, and income-focused investments are no exception. The iron rule of investing is that the higher the potential reward, the more risk you have to take.

Investments can go down in value as well as up and, importantly, for many investments, the income they pay out isn't guaranteed. Unfavourable business outcomes or economic circumstances may mean that investments that previously offered an attractive income no longer do so.



Where to look for income

The main types of investments held by those seeking income are generally equities, bonds and property.

Let's look at these one by one.

Equities

Equities (or stocks and shares) are what most people think about when it comes to investing. Equities represent a proportion of the ownership of a company. So when you buy shares, you become a part owner of that company – a shareholder.

Equities have the potential to generate higher returns over the long term than most other types of investment. As a company becomes bigger, more profitable and therefore more valuable, its share price will tend to rise. As the stock market can rise and fall rapidly, equities can be much more volatile than other investments. Nonetheless, equities can play an important part in your investment portfolio.

For income investors, though, the most important consideration is whether the company pays a dividend. That dividend also has to be sustainable. Many companies (particularly those that are large and well established) pay out part of their profits to investors in the form of a dividend. The dividend is determined each year by the company's board of directors.

Not all companies pay dividends. Some prefer to reinvest all their profits to help the business grow (e.g. investing in new technology or machinery, or buying another company). For those that do, the size of the dividend can vary from year to year. It can also be cancelled altogether. That usually indicates problems within the company and can have a negative effect on the share price. So most businesses will be reluctant to cut their dividend. Nevertheless, setbacks or economic conditions may mean that they have no choice. For example, during the 2008 financial crisis many solid companies were forced to cut or cancel their dividends.

On the other hand, companies that do well will tend to increase their dividends over time. This allows them to reward their investors and make their shares more attractive. Most UK companies pay their dividends every six months, although some make quarterly or annual payments.

For income investors, these are the most important characteristics of equities:

- strong potential for growth and income
- more volatile (riskier) than many other investments
- income isn't guaranteed.

Bonds

A bond is effectively a loan to an institution – say, a government or a company that needs to raise money. When you buy a bond from an institution you're lending them your money for a predetermined period of time.

In return, you'll receive a promise of regular interest payments, known as coupons. The issuer also promises to give back the original amount you paid at the end of the agreed period. For example, a bond with 10 years to maturity offers to pay out interest for 10 years from the date it's issued. At the end of the 10 years (the redemption date), the bond issuer promises to repay the amount originally lent, and the interest payments will stop.

If you want, you can sell a bond before the end of the agreed period. But if you do that, the amount you get back depends on how much the bond is worth on the open market. Its value will go up and down depending on supply and demand, which is determined by factors like interest rates, inflation and the perceived ability of the issue to make the payments due under the bond.

Bonds are often referred to as 'fixed interest' or 'fixed income' investments. This is because the level of the regular interest payments are set and can't be changed or stopped at the discretion of the company as equity dividends can.

Government bonds

Bonds issued by the UK government are known as gilts. Those issued by the US government are known as US Treasury bonds, or Treasuries, while those issued by the German government are called bunds. Bonds issued by companies are known as corporate bonds.

For an income investor, the advantages of bonds include the steadiness of the income. When you buy a government bond, you know what you're getting. Government defaults (failing to meet bond payments) are extremely rare, especially in the developed world. The UK government has never defaulted on a payment to investors.

Corporate bonds

Corporate bond defaults are more likely but are relatively rare for so-called investment-grade bonds – these are a type of corporate bond considered low risk by credit rating agencies. High-yield bonds are a riskier type of corporate bond but offer higher rates of interest to compensate the investors who take on that risk.

For income investors, these are the most important characteristics of bonds:

- limited potential for growth but more dependable for income
- less volatile (less risky) than many other investments
- corporate bonds are riskier than government bonds, but also tend to offer higher interest payments.

Property

Investments in property can be either direct (buying a house or flat to rent out, for example) or indirect, through investing in property funds. These funds typically invest in commercial property, such as offices, warehouses or shopping centres. Investors benefit from the regular payment of rent by the properties' tenants. Fund managers can also make the properties in their portfolios more attractive by improving or developing them, allowing them to command higher rents or to be sold on at a profit.

Property income tends to be more reliable than that from equities, although it's less secure than that from government bonds or investment-grade corporate bonds. Properties can fall vacant if the occupying businesses shrink or fail, and it can take time to secure new leases for empty units. During an economic downturn, vacancies may become widespread. More positively, rents tend to rise over time, with regular rent reviews helping to make sure that property income isn't eroded by inflation.

For income investors, these are the most important characteristics of property investments:

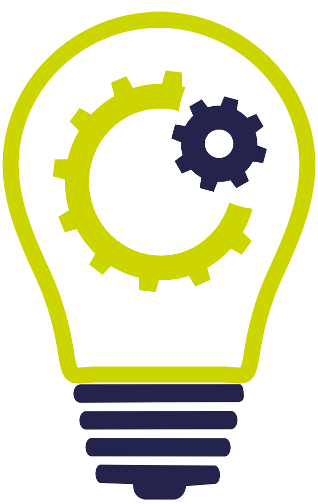
- potential for both growth and income
- less volatile (less risky) than equities but riskier than bonds
- rent reviews provide some protection from inflation.

How to invest

You could try to achieve an income stream by investing directly in various assets. But doing it effectively can be time-consuming and labour-intensive. That's particularly true of equities and property, because these types of investment need to be monitored to make sure that they're continuing to pay attractive levels of income.

That's why many people choose to invest in income-focused funds run by professional managers designed to offer a regular income. These funds pool investors' money together and then divide it between different investments. Many funds are designed to offer regular income. You benefit from the managers' experience and their knowledge of the risks associated with the different types of investment.

There are many different kinds of income-focused funds, each with its own level of risk. Whichever route you choose, we'd always recommend that you speak to a financial adviser before you make an investment decision. If you don't already have a financial adviser and would like to find one in your area, take a look at www.unbiased.co.uk.



Definitions

Equity

(n) shares in a company that can be bought and sold on a stock market

Bonds

(n) debenture, a security, issued by a government or a company when borrowing money

Property

(n) a building or buildings and the land belonging to it or them

Important Information

This information is to help you understand more about investing for income and the risks.

The value of investments, and the income from them, can go down as well as up and investors may get back less than the amount invested. Past performance is not a guide to future results.

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