

INVESTMENT

5 MINUTE MONEY GUIDE

INVESTING FOR INCOME





Independent Financial Advisers - Financial Life Planners



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CONTENTS

Investing for Income	4
Income from Shares	5
Risk	6
Income from Fixed Interest	7
Income from Property	8
A Balanced Approach	9
About Us	10
Compliance Statement	12
Contact Us	12

Investing for Income

The important element when considering income from an investment portfolio is to understand how different the various income generators are from each other.

There are three core income generation investment areas to focus on:

1. Income (dividends) from shares
2. Income from fixed interest areas
(e.g. Government Bonds and Corporate Bonds)
3. Income from rental income derived from property

These are the 'asset classes'.

Just about any other income source is likely either to be a variation on one of the three core areas above or to be outside the mainstream and to represent something too risky for most investors to consider.

A typical example of a variation might be Preference Shares, which are a form of shareholding in a company which is more akin to a fixed interest Bond.

Investors need to determine how they wish to use these various asset classes in combination with each other to deliver their income requirement.

Income from Shares

History shows that the most successful long term strategy is to invest into shares which provide regular and rising dividend payments.

Study after study shows that this is the most likely source of a good investment return and a sustainable and regular income.

There is an inherent logic to this and whilst the future holds no guarantees of repeating past trends, there is every reason to think that using the asset class of shares as a bedrock for a successful income portfolio, remains steadfast.

The logic is around basic economics and the law of supply and demand. Companies need to make profits to survive and to grow, if they fail to make profits they will, in all likelihood, fail and cease business.

Companies that are listed on a main share (stock) exchange and therefore the ones most likely to attract investors have to demonstrate that they have a good case to benefit from the investor's money and the best way to do this is to show that they can and will make healthy, sustainable profits which they can then share out with those same investors.

Companies will set their prices and margins at levels attuned to the current prices in the market and therefore one would expect there to be a strong

element of inflation protection in the income levels because prices of the companies goods/services will make up the inflation figure and provided profitability percentages remain solid then the profits should increase in line with inflation.

This in turn allows the companies to share their increasing profits with their shareholders, the investors who have invested for income.

Sounds too simplistic? Maybe, but the clear picture that has emerged from years of income investing shows that over time (taking out the peaks and troughs, smoothing the bumps in the road etc.) this analysis is borne out by the evidence of the returns.

Most investors will seek income (dividends) from shares either through a portfolio of holdings (i.e. they will hold a number of shares in a number of different companies) or through funds (where the fund manager invests into the individual companies and the fund provides the portfolio spread).

Typical examples of funds could be Insurance funds, Pension funds, Unit Trusts/OEICs or Investment Trusts, even though technically some of these may not be funds as dictated by their legal structure; all however have the key feature of a fund approach i.e. that they pool investors' money and invest into the shares through a diversified approach.

USING THE ASSET CLASS OF
SHARES AS A
BEDROCK FOR A
SUCCESSFUL INCOME...
REMAINS STEADFAST



Risk

The problem most investors have with using income from a share portfolio is risk. The investor might want the sustainable and growing income that shares potentially offer but they will be shy of the risk of the shareholding.

The risk being that the price of the share may fall (including to zero!) and/or that the income will fall (or disappear).

Risk is an important factor and any portfolio should have a well-diversified spread of holdings to reduce the risk and keep the risk controlled. Income investors should work hard to ensure that the

income sought does not come from a source that is paying a high income to attract investment – but has no underlying strength to support to this.

Risk cannot be removed, so the important point is that investors should aim to quantify, control and contain the risk taken within their own risk profile tolerance level.

Income from Fixed Interest

Fixed Interest areas predominately cover Bonds. Bonds are normally issued by governments 'government bonds' (otherwise known as gilts in the UK, treasuries in the US) or by companies 'corporate bonds'.

They are generally seen as IOUs. The issuer provides the bond to the investor on terms as dictated by the offer documentation and then meets the income and capital repayments accordingly.

As long as they are as good as their word then the investor knows what they will get and when.

If they fail to meet their payments then this is known as default and investors do not get the money as promised.

Terms on the bonds issued normally come down to two factors: the interest being offered and the term (length of time). For example, a 5 year bond may be issued with a 5% interest attached. If the investor takes out the bond on day one (i.e. the day it is issued) and invests £10,000 they will receive £500 per year each year until the fifth anniversary when they will get their £10,000 returned.

Simple? Yes, but with some minor complicating factors to think about.

Companies (corporate bonds) tend to pay higher income than governments (government bonds) simply because companies are seen as more likely to default therefore their rate needs to be higher to compensate investors for the greater risk. This is generally a truism: the higher the interest rate offered, the greater the risk.

Another factor which confuses investors is that bonds are traded throughout their period of existence. This means the price can vary.

Take the example of a 5 year bond with a 5% fixed interest as described above. If two years after issue general market interest rates have doubled, investors may well be able to invest, at that point, in a similar risk vehicle and get 10% interest.

This means investors would want to dump the 5% interest in favour of the better rate. However to exit their existing fixed interest holding they would need to offer someone a tempting price so they would need to 'sell' their 5% coupon for close to 50p in the £ to make this stack up. So the bond's price could fall by 50% in the 'market'.

As with shares, bonds come with risk. This risk is often a lot higher than investors realise.

As with shares, investors can reduce/control this risk by taking a diversified approach and using a portfolio of different bonds, probably using an expert fund manager or series of fund managers to manage the bond holdings for them.

THE HIGHER
THE INTEREST RATE...
THE GREATER THE RISK

Income from Property

Investors can seek out an income from property, good old 'bricks and mortar'. There are two types of property which can generate an income: commercial property and residential property.

As with shares there are strong economic arguments for expecting income from property to be sustainable and growing.

The income an investor will derive is from rental income from a tenant or tenants.

The level of income will be determined by a number of factors to do with the location, the quality of the property, its usage (e.g. rental rates on factories are different to office blocks) and other market forces.

Property rentals (i.e. the income percentage) tend to be higher at any given point in time than bond income levels and share dividend levels. This is for a number of factors:

1. Property income can sometimes be expensive to collect and with some property investments the income has to cover various maintenance costs and other running expenses.
2. There is a pay off against the risk of default, which is deemed higher than in other investment areas. A non-paying tenant can cause mayhem, not just in the absence of their rental payments, but in causing damage to a property or being difficult to remove.
3. Property itself is deemed to be an illiquid asset, it is not easily tradeable (most bonds and shares can be bought and sold at the press of a button) and therefore investors really need to stick with their property investment, the trade-off for this longer term, less flexible option is a higher yield.

Property investing has risks against the income (i.e. rental levels falling in the market, non-paying or difficult tenants) and also with the capital value falling. UK property prices have tended to do well in the past decades but this is by no means a sure thing and many property investors over the years have suffered serious losses along the way.

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A Balanced Approach

All things being equal any investor wanting to invest for income is likely to be best served investing in a balance of investments covering each of these areas as described.

The mix and the exact assets used and the spread of the assets will need to be factored in against the investor's risk position, their income level targeted, the length of time this is required and what other income they have (e.g. is the income required from investments the only income?) and their tax position and requirements.

To get a really strong, well-controlled (from a risk point of view) portfolio, investors should seek out help from the best advisory sources.

In this respect to achieve the best income investment portfolio outcome an investor's job is about picking the best helpers not picking the best investments.

History, Structure, and Expertise

Interface Financial Planning started providing independent financial advice in 1992. From the beginning it had the aim of providing professional advice and quality service to people with modest income and wealth.

Its key value was putting people before profit, and contribution before reward. This mission statement has been our torch to light the path ahead and has been the reason that we have endured for over 24 years.

Alan has lead the company with his personal values of: Integrity, Compassion, Respect, & Loyalty, and he is proud that over the years he has worked with clients who share similar values. Like him they want to help others and make the world a little better.

Client care and service is important and he is proud that his first two clients from January 1990 remain his clients today.

We believe that every client should have access to highly qualified advice and expertise.

Technology is used to the full to maximise efficiency and engage expertise from throughout the UK. The business has been paperless for 10 years and for over 5 years has been 'cloud' based. This structure reduces costs and allows support staff to operate anywhere - from Colchester to Honiton to Leicester and elsewhere.

Clients are encouraged to access their online account where they can exchange messages and documents securely. They can view their investments and reports, and they have immediate access to their paper file. Clients love the transparency and openness of being able to view and print paperwork going back for years and many clients use it as a source of reference.



ALAN MORAN
Owner, Director
Interface Financial Planning

Alan Moran is one of the most highly qualified advisers in the UK. He became a Certified Financial Planner in 1995 and he was one of the first Chartered Financial Planners in 2005.

He is a Chartered FCSI, a holder of the IMC certificate and member of CFA UK. His expertise has been called upon by The CII, The IFP, The Kinder Institute, and others, where he has trained and examined other financial advisers.

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The information contained in this guide is based on legislation as of the date of preparation and this may be subject to change.

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(<https://register.fca.org.uk>) Financial Services Register No: 424729
Registered Address: 122 Hamstead Hall Road, Handsworth Wood, Birmingham, B20 1JB Registered in UK, No. 2644317

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Content supplied by: Independent Check Ltd
www.independentcheck.co.uk 2018

Design by: Rae Shirley Photography & Design
Ref: FMMGIFI V1 APRIL 2018

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