

INVESTMENT

HOW TO

INVEST FOR INCOME IN A LOW INTEREST RATE ENVIRONMENT





Independent Financial Advisers - Financial Life Planners



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Introduction

This is a guide aiming to help investors who are primarily looking for income from their investments and savings, as opposed to capital growth.

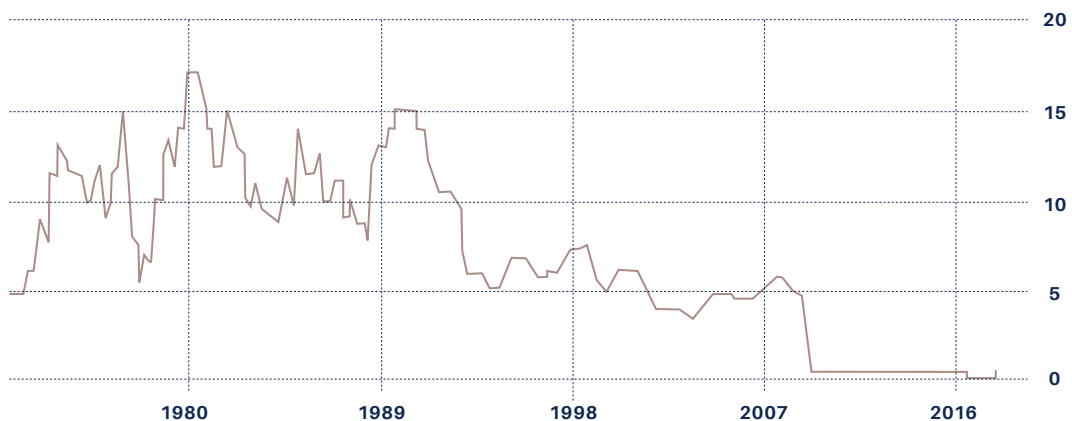
In this respect financial planning and investing is largely about finding effective ways of providing income from any capital employed.

Income may mean different things in different people's hands so we need to be careful about employing broad brush statements to this quest, however across the board any means we can find to improve income prospects should be pursued.

Our objective is to help you find the best income solutions in the current low interest rate environment, regardless of your position relating to the risk you are looking (or able) to take with your capital, your wider objectives or your tax position. We aim to cover each possible position you may be in at the current time within these pages and show you how you can get a decent income generated even though interest rates are at such a low level.

A

UK INTEREST RATE



DATA SOURCE: TRADINGECONOMICS.COM | BANK OF ENGLAND

The History Of Interest Rates

It is commonly accepted and understood that today's interest rate (late 2016), measured by the Bank Base Rate of 0.25%, is a historical all-time low. But just how unusual is this current position and how does it look against a longer term history of interest rates in the UK?

Below **Graph A** shows interest rate movements over the past 40 years:

This clearly shows how low interest rates are in comparison to the longer term trend and how unusual, indeed unprecedented, this level is. Rates are actually at their lowest for 300 years.

To help with a further view we can now show on **Graph B** how inflation has moved over recent years.

Since 2008 nearly all of the period since has entailed negative returns for savers, savers are losing money in real terms. This is one of the longest periods of real negative returns since records began. There is no obvious sign this trend is set to reverse any time soon.

The implication for savers is clear: savings accounts are in a poor position and no longer represent a viable home for savings which are required to produce an income.

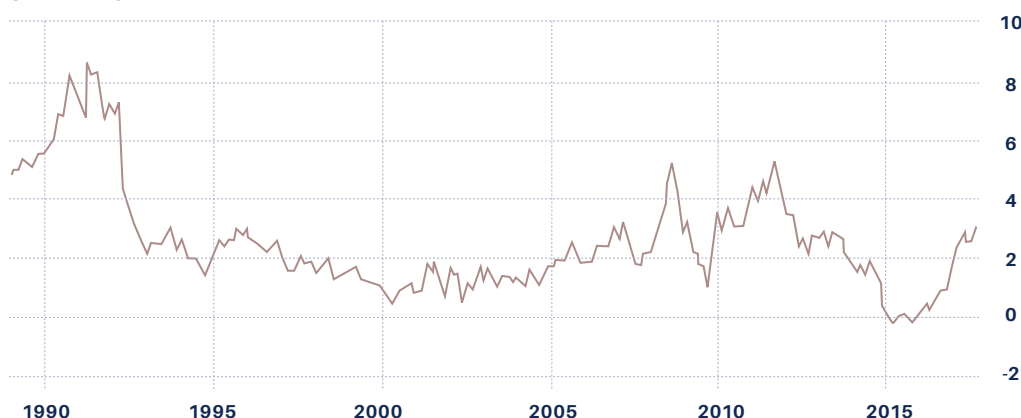
Compare this with 1990 for example, when savings accounts would produce interest rates of around 10%. At that point savings accounts were able to generate the income most savers needed and required.

The interest rate level is expected to return towards its average at some point and when this occurs savings accounts may once again become a part of the income producing landscape.

However there is no indication that any increase is likely in the near future or short term: savers cannot wait indefinitely and income portfolios need to be constructed based on the known facts of today's rates and levels.

B

UK INFLATION RATE



DATA SOURCE: TRADINGECONOMICS.COM | BANK OF ENGLAND

The Income Generating Investments Available To You

There are many different investments that generate income and the good news for income investors is that many of these are capable of providing much higher income levels than a savings account. Furthermore, some of these are either unaffected by the general base rate or may even benefit from them.

Unfortunately these alternatives do not necessarily have the same level of risk on the capital invested.

This means investors have to pay careful regard to the risk/return position on any investment used to produce an income.

There are four main 'income generating' investment options from four major asset classes:

- Savings Accounts (normally described as 'Cash')
- Fixed Interest Investments
- Shares
- Property

We will examine each in turn.

Savings Accounts:

These are bank accounts, building society accounts and other cash accounts, for example, National Savings. As an asset class they are known as 'Cash' and their characteristics are that they offer a risk free home for the capital placed into them, in return for an interest rate payable. The level of interest payable will be closely linked to the general base rate.

Although described as risk free they do have some risk in the sense that (a) when interest rates are lower than inflation the saver will be losing capital value in terms of the purchasing power of their money: the inflation rate will be eroding the saver's capital (b) there is always the risk that the bank or building society will default/fail and capital could be lost as a result – however in the UK there are substantial guarantees in place to protect against this.

In all other respects it is accurate to consider Cash accounts as risk free.

WHEN INTEREST
RATES ARE LOWER
THAN INFLATION
THE SAVER WILL BE
LOSING CAPITAL VALUE

Fixed Interest Investments:

There are many types of investment that will fit into this category, we will consider just a few within this document to highlight the main features and factors that exist.

The most popular example of a fixed interest investment would be government bonds. In the UK government bonds are known as 'Gilt' in the US as 'Treasuries'.

They are simple to explain: the government issues a bond and investors purchase them, handing their money to the government. In return the government 'promise' to pay the money back at a fixed point in time, in the meantime they pay an annual rate of interest. For example, a 10 year gilt may be issued offering an interest rate of 4.5% per year. This means that an investor subscribing to such an issue would subscribe a sum (say £10,000) and would receive 4.5% per year in interest (£450) knowing they would get their capital back (£10,000) 10 years later.

Government bonds tend to offer slightly better rates than cash, mainly to incentivise investors to take the additional risk that they pose.

Bonds of this type are considered riskier than cash because they are a promise and if the government fails to meet their promise, capital could be lost. This can and does happen as has been evidenced by many governments worldwide over time (such events are known as 'defaults'). The general trend is that the 'safer' the government, the lower the rate of interest they will have to offer. This is why there has been such a focus on credit ratings – because it is perceived that the credit rating indicates a sign of the strength of the issuing body. A good rating indicates they should be good for their promise, a low rating makes it less likely.

The other big fixed interest 'instrument' is a corporate bond. A corporate bond is virtually identical in structure to a government bond except they are issued by companies (hence, the name). They will typically pay a higher rate of interest than a government bond, simply because they are another notch up the risk scale. Companies are more likely to default than a government, as a general rule of thumb.

Bonds can be traded – they do not have to be bought on issue or held to maturity. They can be bought and sold throughout their period of time between these two points. However the price of a bond can fluctuate throughout the period and this can mean that bonds have a risk to the investor's capital

There are many other fixed interest investments, an example would be Permanent Interest Bearing Shares (PIBS) issued by Building Societies. As their name implies strictly speaking these are shares however their structural nature is more akin to a bond.

PIBS pay a fixed rate of interest (an income) to investors and this income is generally fixed but unlike bonds they have no redemption date, although there is normally a cancellation date which allows the Building Society to cancel them. PIBs can be bought and sold on the stock market.

They are not covered by UK compensation schemes. Although they can look attractive in terms of the fixed income payable and are often considered low risk, these other factors mentioned above need to be taken into account and balanced against the possible benefits.

Shares:

Shares in companies will normally offer investors the chance to receive dividends. Dividends are paid out of the profits made by a company.

Dividend payments are most often paid to investors twice per year and will be dependent on how well the company performs. Buying shares in a company is a risky venture because the share price can fluctuate and the dividend payment may also go up and down and possibly disappear altogether. A company could go out of business – making the investment a high risk.

The upside however is that dividend payment levels are generally disconnected from the base rate and tend to have a higher (sometimes much higher) percentage level than cash alternatives. There is also the prospect of a decent growth in the amount of dividend payable year on year, offering the possibility that the income level can keep rising.

The company share price could also rise – which could provide a ‘win, win’: a higher income plus a profit on the capital amount invested.

Property:

Property can generally be classed into two separate categories: residential property and commercial property. A residential property can be bought to let out with the rental income acting as the basis for an income payment to the investor.

Likewise a commercial property (an office, factory, warehouse etc.) can be bought and owned in the same way, with the rental being paid by the tenant (the business that rents/leases the property) being collected as an income.

Rental income is unlikely to be tied to interest rates, the level is probably going to be much higher in the current environment.

As with shares there is an issue around the capital value of the property owned, which could go up or down – similarly the rental income could be unreliable or fall. Therefore property investments have the same hallmarks as shares: offering the potential for much higher income than cash, the potential for growth in the capital value of the asset, but inherently much riskier overall.

Property has another risk factor: it is deemed ‘illiquid’. This means it can be difficult to sell a property quickly (and in very bad markets, possibly at all), leaving investors stuck if markets turn and they wish to exit their investment.

Summary:

These are the main asset areas and the characteristics of each: the areas offer different income prospects, different positions with the risk attached and variable prospects on the potential capital return.

The core understanding of each investment and their structural nature is a crucial start point, however there needs to be some serious application towards the details, because it will be the details which provide the solutions to anyone seeking to improve their income and to get a good income, almost regardless of the prevailing environment.

There are many different individual possible investment types that investors may use in creating an income portfolio. However the greatest challenge for investors is not the choice of these individual types but the construction of the right asset allocation mix to meet their needs.

THE GREATEST
CHALLENGE FOR
INVESTORS IS
[DECIDING ON] ...

How To Invest For Income

The asset areas described above are considered the main income producers for anyone looking to generate an income from their available capital.

There are other possibilities but these are generally esoteric in nature; this does not mean they should be discounted but it is probable, in the main, it will be one or a combination of these mainstream assets which are utilised.

If this is the case then there are several questions which need to be answered before any structure can be applied, some of the key questions are:

- What income level is required or desired?
- What risk can be tolerated?
- How important is capital growth?
- What is the tax position?
- How is the income required and how often?

This is the fact-find element: the part of the process which creates the overview of the investor's requirement positioned against their current and future situations.

This is going to be the most important factor; determining the levels and parameters from which the income portfolio can be constructed.

Different combinations of different types of investment will be appropriate depending on the individual's requirement, overall financial and tax position.

Assessing Risk

Amongst the fact-finding there has to be a careful appraisal of risk. For example, investing in shares has proven to be one of the most dynamic ways of generating income. The current position (end 2016) has dividend levels from UK shares averaging 3.9% per year (based on the FTSE 100). This is compared to cash returns which struggle to get above 1.5% per year. Shares are producing around 2-2.5 times the level of income. Indeed with careful selection of high yielding shares the percentage could probably be lifted to close to 5%.

UK shares offer investors two further tempting possible advantages: dividend (income) growth and growth on the capital invested. A cash account has no capital growth possibility.

Without a risk factor the use of shares is clearly a better prospect. However as stated earlier, shares do carry a risk and the trade-off is between the prospect of extra return and the added risk.

The risk is – to a significant extent – measurable, through a number of methods. Although it can be measured and assessed this still only helps to a limited degree, because the risk can only be positioned as a factor of a number of future possible outcomes. Using a simplistic example: If there is a 10% chance that the shares used to generate income may fall by 35%, the investor still cannot know what is going to happen. Is the 90% possibility going to occur or the 10% possibility?

THE RIGHT ASSET
ALLOCATION MIX TO
MEET THEIR NEEDS

Assuming the risk can be assessed accurately then the issue becomes one of risk tolerance. This is a very important word, because for decades everyone used to focus on risk attitude. The reality is that the investor's attitude to risk is not especially important (from a financial planning viewpoint).

Their tolerance to risk is the important factor. If the investor cannot tolerate a 35% drop in value (if they choose to invest in shares and this is the correct level of loss that may be sustained) - because it would create havoc with their finances - then the investment is not suitable.

All of the income areas need to be assessed in this way and a healthy regard for mixing and matching the risk of each investment/asset area considered against the investor's own risk position (as dictated by their ability to tolerate losses) needs to be taken.

The steps in creating an income structure need to start with a fact-find and then a full assessment of the risk as described needs to be undertaken. Once this has happened then an income portfolio can be structured.

Creating An Income Portfolio Structure

The asset areas outlined above: cash, bonds, shares and property are quite easy to widen simply by splitting bonds into government and corporate bonds; shares into UK and overseas shares and property into residential and commercial property. It is possible to go even further and look at smaller company shares and larger company shares. Although the asset areas may at first look narrow, they do have breadth beneath their headline titles.

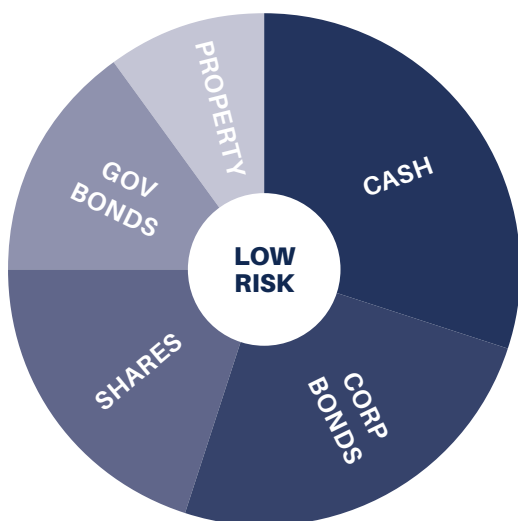
The critical aspect of creating a portfolio is to take the two steps mentioned in the section above (the fact-find and risk assessment steps) and then to start marrying these against the income structures, of which there will be many variations that could exist.

The structure used should be the nearest match to the income required & risk tolerance.

The structures will mix the asset classes to balance the risk and reward in line with the investor's requirement/position. This is known as "asset allocation" - balancing out the different asset classes in different proportions to match the required position. For example a low risk income investor may have an asset allocation portfolio as shown in **example A:**

ASSET AREAS MAY
LOOK NARROW [BUT]
THEY DO HAVE BREADTH...

EXAMPLE A: LOW RISK INCOME INVESTOR ASSET ALLOCATION PORTFOLIO

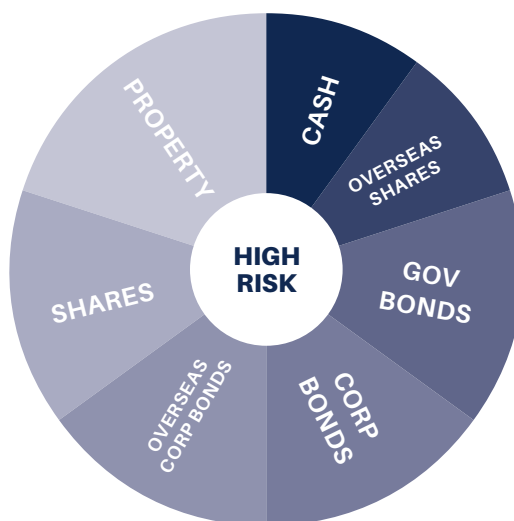


10% UK Property
15% UK Corporate Bonds
20% UK Shares
25% UK Government Bonds
30% Cash

This could produce an income of around 3.5% depending on the exact holdings within each asset area, but the risk is definitely on the low side. A high risk income investor may have a different allocation, see **example B**.

This could produce an income of around 4.5% per year and this portfolio has a greater prospect of future income growth and future capital growth than the low risk version above. However it is much riskier.

EXAMPLE B: HIGH RISK INCOME INVESTOR ASSET ALLOCATION PORTFOLIO



20% UK Property
15% UK Shares
15% Overseas Corporate Bonds
15% UK Corporate Bonds
15% UK Government Bonds
10% Overseas Shares
10% Cash

Important Note: The asset allocation splits above are merely illustrative and are provided as general examples to highlight the point. They are not indicative or suggestions. Any asset allocation breakdown must only be considered on an individual basis and after appropriate steps have been taken to analyse individual circumstances and requirements.

There are other factors that have not yet been covered which need to be brought into the 'equation'.

Correlation

Any asset allocation split has to be considered with a high regard for 'correlation'. This means that an ideal portfolio will mix the assets in an attempt to ensure that returns are as loosely correlated as possible, so that if one area used is performing below expectation another area will hopefully be doing better. Historically different asset classes have performed differently at different times. It is important to avoid correlating assets too closely together otherwise they may move in the same direction causing unwanted losses or difficulty. Through careful correlation the overall risk of any portfolio can be reduced.

Tax

The assets classes which make up the asset allocation which in turn will determine the portfolio structure, could be influenced by tax. Different asset classes have different tax treatments. The growth on shares and property is classed as a Capital Gain and in the right circumstances investors can use these gains within their annual allowance against Capital Gains Tax to generate a tax free return. Also the rate of Capital Gains Tax maybe lower than the Income Tax rate for a particular investor (or it may be higher). Tax factors can influence the mix of assets used.

Vehicles/Funds

Most investors do not invest into the asset classes in a direct fashion, preferring instead to use investment vehicles (such as an ISA or Investment Trust) as the means to gain exposure to that asset class. The use of such vehicles and funds is an important consideration, once again providing an element of risk reduction.

For example if you were inclined to invest into Government Bonds it may be more prudent to invest into a fund, which in turn invests into a range of Government Bonds. Not only is this generally more convenient it also allows investors to diversify their holdings across many individual Bond types.

There are practical reasons as well: many investors who want to invest in property simply do not have the available money to buy an individual property or the expertise (or time?) to manage their own property, however a property fund allows an easier and lower entry point allowing the investor to access the asset class without having to buy the asset direct.

The choice of which vehicles to use and which funds, fund managers and type of funds is an important and influential part of the process.

Summary

If you are looking to invest for income, then there is no reason to allow the current low interest rate environment to depress you! Income can be generated from many different asset classes and the level of income from some of these remains very competitive in relation to the current inflation level. The higher risk attached with these better income producers can be managed, if you follow the steps and processes outlined in this guide; we are here to help you do this.

DIFFERENT ASSET
CLASSES HAVE
DIFFERENT TAX
TREATMENTS

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.

Alan Moran B.Sc. M.Soc.Sc. Cert.Ed. FPFS FSWW IMC CFP^{CM} RLP[®]

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