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Making Financial Sense

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FACTSHEET

Investment risk

Reducing the overall level of exposure

The volatility experienced in global markets over the past six years has tested the nerves of even the most experienced investors, making it a difficult time for individuals who rely on income from investments for some or all of their needs.

To avoid concentrating risk, it is important not to 'put all your eggs in one basket' by investing in just one share or in one asset class. If appropriate to your particular situation, spreading capital across different shares and different asset classes can reduce the overall level of risk.

Funds are typically seen as a way to build up a lump sum of money over time, perhaps for retirement, but they can also be used to provide you with a regular income.

TYPE OF INCOME FUNDS

There are four main types of income fund:

Money Market Funds – pay interest and aim to protect the value of your money.
Bond (Fixed Income) Funds – pay a higher rate of interest than cash deposits, but there is some risk that the value of your original investment will fall.
Equity Income Funds – the income comes from dividends paid to shareholders. In return for some risk to your capital, you may get a more regular income than you would from cash, and that income, as well as your capital, may increase over time.
Property Funds – pay income from rents, but the value of your investment can fall as well as rise. There are also mixed asset funds, which invest your money in both bonds and equities.

GENERATING INCOME

INTEREST FROM CASH OR MONEY MARKET FUNDS

The income varies in line with the interest rate set by the Bank of England. The fund's investment manager will aim to get the best rate available, helped by that fact that, with large sums to deposit, funds can often get better rates than individual investors. The capital amount you originally invested is unlikely to go down (subject to the limits for each deposit under the Financial Services Compensation Scheme). If the interest rate is lower than the rate of inflation, however, the real spending value of your investment is likely to fall.

FIXED INTEREST FROM BONDS

Bonds are issued by governments (known as 'gilts' in the UK) and companies ('corporate bonds') to investors as a way to

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borrow money for a set period of time (perhaps five or ten years). During that time, the borrower pays investors a fixed interest income (also known as a 'coupon') each year, and agrees to pay back the capital amount originally invested at an agreed future date (the 'redemption date'). If you sell before that date, you will get the market price, which may be more or less than your original investment.

Many factors can affect the market price of bonds. The biggest fear is that the issuer/borrower will not be able to pay its lenders the interest and ultimately be unable to pay back the loan. Every bond is given a credit rating. This gives investors an indication of how likely the borrower is to pay the interest and to repay the loan. Typically, the lower the credit rating, the higher the income investors can expect to receive in return for the additional risk.

A more general concern is inflation, which will erode the real value of the interest paid by bonds. Falling inflation, often associated with falling bank interest rates, is therefore typically good news for bond investors. Typically, bond prices rise if interest rates are expected to fall, and fall if interest rates go up.

If you invest in bonds via a fund, your income is likely to be steady, but it will not be fixed, as is the case in a single bond. This is because the mix of bonds held in the fund varies as bonds mature and new opportunities arise.

DIVIDENDS FROM SHARES AND EQUITY INCOME FUNDS

Many companies distribute part of their profits each year to their shareholders in the form of dividends. Companies usually seek to keep their dividend distributions at a similar level to the previous year, or increase them if profit levels are high enough to warrant it.

RENTAL INCOME FROM PROPERTY AND PROPERTY FUNDS

Some people invest in 'buy-to-let' properties in order to seek rental income and potential increase in property values. Property funds typically invest in commercial properties for the same reasons, but there are risks attached. For example, the underlying properties might be difficult to let and rental yields could fall. This could affect both the income you get and the capital value.

BALANCE YOUR NEED FOR A REGULAR INCOME WITH THE RISKS

The income from a fund may be higher and more stable than the interest you get from cash deposited in a bank or building society savings account, but it can still go up and down. There may be some risk to the capital value of your investment, but if a regular income is important to you and you do not need to cash in your investment for now, you may be prepared to take this risk.

INCOME FUNDS OF THE SAME TYPE ARE GROUPED IN SECTORS

The main sectors for income investors are: Money Market, Fixed Income (including UK Gilts, UK index-linked Gilts, Corporate Bond, Strategic Bond, Global Bond and High Yield), Equity Income, Mixed Asset (i.e. UK Equity and Bond), and Property.

LOOK AT THE FUND YIELD

The fund yield allows you to assess how much income you may expect to get from a fund in one year. In the simplest form, it is the annual income as a percentage of the sum invested. Yields on bond funds can also be used to indicate the risks to your capital.

DECIDE HOW FREQUENTLY YOU WISH TO RECEIVE YOUR INCOME

All income funds must pay income at least annually, but some will pay income distributions twice a year, quarterly or monthly, so you can invest in a fund which has a distribution policy to suit your income needs.

SELECT INCOME UNITS/SHARES IF YOU NEED CASH REGULARLY

The income generated in a fund is paid out in cash to investors who own income units. If you choose the alternative – accumulation units/shares – your share of the income will automatically be reinvested back into the fund.

TIME TO REVIEW YOUR CURRENT INVESTMENT STRATEGY?

If you would like to review your current investment strategy, please contact us – we look forward to hearing from you.

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