



The search for sustainable income

The Bank of England's Monetary Policy Committee left interest rates unchanged at 0.5% in May. Despite inflation continuing to breach the MPC's targets, a recent poll of Reuters economists suggested that the Bank will continue to leave rates at these low levels until October 2011 (source: Reuters, Tuesday 9 November 2010).

While this is good news for homeowners, it presents a bleak prospect to investors in search of regular income. When UK interest rates last peaked at 5.75% in 2007 many banks were offering an attractive level of interest. Today, income-seeking investors must look beyond cash deposit accounts to find an investment that meets their needs.

Investors within this bracket include those seeking income in retirement. Annuity rates, dominated as they are by long-term interest rates, are likely to be lower when income from savings accounts is low. Low interest rates are forcing pensioners to take higher degrees of risk to obtain an acceptable retirement income.

For investors looking for income but unwilling to take on the additional risk associated with equity investment, fixed income products may be a viable solution. While many equity income funds today are generating a healthy yield, the volatility of returns can be off-putting for the more risk-averse. Fixed income products tend to be less volatile than equities plus, should a company face problems, bondholders rank above shareholders in the order of creditors. The sustainability of the income paid is also a key factor; while covenants exist to help protect the payment of fixed income coupons, the payment of equity dividends is at the discretion of the company. Bonds, then, offer the potential for a more reliable stream of income and a lower level of risk.

Maximising income

One way for investors to maximise their income stream is to invest in a fixed income mutual fund. Fixed income funds are categorised according to the type of bonds in the portfolio – you'll find funds offering access to investment

grade bonds, high-yield bonds and gilts, amongst others. The yield generated, or income available from these funds, is generally determined by their inherent level of risk. Gilts are generally considered less risky than corporate bonds, and therefore offer a more modest, stable yield. With corporate bonds, credit ratings agencies evaluate the debt and assign ratings based on their assessment of the companies' ability to repay it. High-yield debt, issued by companies perceived as carrying a higher degree of credit risk, offers a higher yield to compensate investors for the extra risk they are undertaking.

Companies issue bonds to raise capital, perhaps when they have reached their bank borrowing limit or are unable or unwilling to issue shares. Several European companies issued high-yield debt for the first time in 2010, compelled by the need to find alternative sources of funding as banks' lending criteria remained tough. These new issues brought further diversity to the high-yield universe, opening up new opportunities for high-yield investors.

At the peak of the recent credit crisis, rating agency Moody's predicted a default rate of up to 20% from European high-yield debt. The reality was much less severe for investors, with defaults peaking at around 11%. At the time of writing, Moody's expects high-yield defaults to decline still further.

For clients seeking to maximise income while mitigating default risk, one option is to invest in a high-yield mutual fund. As opposed to buying individual bonds, a mutual fund offers the additional benefit of diversification. It invests in numerous bonds from many companies, thereby spreading risk. That way, if one company defaults, the effect on an investor's portfolio is less painful.

Focus on quality

For investors seeking a sustainable income, quality is an important consideration. Although many funds offer an impressive headline yield, it's necessary to examine both the level of income actually distributed and the quality of

In this article we look at one option for generating income in the current investment climate.

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the underlying bonds. A rigorous approach to stock selection is where a good fund manager earns their fees – by focusing on companies with strong underlying fundamentals, when rigorous research has revealed that the market consensus is wide of the mark. This is particularly pertinent when investing in high-yield bonds, which are influenced far more by company-specific drivers than macro-economic drivers such as inflation and interest rates.

Conclusion

Although inflation is becoming more of a concern for policymakers, growth concerns have kept interest rates low, a trend which may continue. Against this backdrop, we believe that the search for income will continue to be a key focus for many investors in the months ahead.

We would like to thank Standard Life for providing this article.

The attractions of a resilient market



My attention was recently drawn to how resilient the UK market has been since the beginning of this year.

Over the last few months the problems and challenges have been considerable, ranging from continued

concern over European Sovereign debt – especially for the periphery so called “PIGS” – to the terrible tragedy in Japan, continued unrest in North Africa and the Middle East and although now most probably delayed by the most recent GDP figures, the inevitability of higher interest rates at some point especially following the tightening that has been started in Europe.

The simple fact is that the UK market does not want to go down. Events since the beginning of the year have given every excuse for a major correction, but no matter what is thrown at the market almost everyone wants to treat a pull back in equities as a buying opportunity.

Now investors are invariably taught that the consensus is wrong and that you can’t swim against the tide but I just feel that the UK market has tremendous potential from here even though we are faced with the

old adage of “Sell in May and go away, return again St Ledger’s day.”

On the 14th December I wrote an article on forecasts for 2011 and said that “...UK equities have the potential to rally significantly. This is based in no small part on the fact that thanks to the restructuring that companies engaged in during the early stages of the recession corporate profits are up around 50% in 2010 and in my view this has not been fully reflected in share valuations, especially those paying good dividends.” I still fully stand by that statement and indeed I would add to this that in my view the M&A cycle has hardly started yet which will be a further driver for the UK market in 2011.

From here (6,000 for the FTSE 100) I am going to put my neck on the line and say that the upturn for UK equities has only just started and that the FTSE100 will finish at or above 6,800 at the end of this year.

If you think I am right however don’t just jump in with both feet – speak to a good IFA about your risk profile/aims and objectives and putting an appropriate balance of investments together (the UK market is only one of many investment opportunities that will make up a good portfolio) and also ask about the advantages of pound cost averaging.

Andy Gadd,
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Research at
Lighthouse
Group, gives his
thoughts on the
UK market and
the benefits of
talking to a
good IFA.

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