Atkins Bland

Investments • Pensions • Financial Planning

Guide to: Generating Investment Income From Natural Yield

What is, and what isn't, investment "income"?

For those wanting income from capital, it is important to consider where that income is coming from, and whether it is "income" at all. If it isn't, but is partly or wholly capital, the risk of it proving unsustainable inevitably increases.

Unfortunately, in the UK, this is a common problem. For decades the retail investment and pension industry was dominated by life insurance companies and, while that domination has been diminished steadily since the turn of this century, the UK remains awash with investment and pension products operated by life insurance companies where there are no investments available that distribute income.

Many are invested in areas where income is produced, but the income is retained, and added to the capital. An investor wanting to enjoy an "income" must therefore sell shares or "units" in the fund, often at a rate which has no particular reference to the amount of underlying income the fund is generating.

This usually means the investor is actually spending their capital rather than just the income it generates. In addition, it can often lead investors to invest in areas entirely unsuited to an income objective, thus increasing the risks even further.

Many people using plans like this do not realise the extra risk they are taking, as it is seldom explained or discussed, which is a core reason Atkins Bland chose to write this guide, dedicated to this one aspect of investment planning. After all, anything which adds to the risk of income proving unsustainable is usually best avoided, if it can be.

How income is generated from a portfolio

Most investments, including funds linked to the stock markets, bond markets, and commercial property, generate natural income, the level of which varies significantly from one fund to another. In some cases, it is zero whilst, in others, it is exceptionally high.

The income is usually from share dividends, loan interest or property rent.

Many funds offer two types of shares or “units” -

- “Accumulation” shares, which retain the income for re-investment
- “Income” shares, which distribute the income

Those wanting to receive income from their capital should, of course, choose the income shares, as the accumulation shares are not suited to their objectives.

To take an “income” from accumulation shares, you need to sell the shares, so you add risk.

Why does selling shares for “income” involve more risk than using distributed income?

Investment funds that don’t offer distribution of natural income retain any income in the fund. This adds to the price of the shares or units.

However, when income is needed shares are then sold. If market values steadily rose, this should not create any problems, but market values seldom do that. They go up and down and, even though the long-term trajectory has always been upwards, periods when values are down can last many months, or even years.

For someone selling shares or units in their investments every month to generate “income”, this can be a real problem. When markets are down, more shares or units must be sold to generate the target amount. This can cause the underlying asset base to erode and compromise its ability to support the withdrawals over the longer term.

In contrast, if only natural income is taken, then there is no need to sell any shares and the risks associated by market volatility in capital values are much less relevant.

What does Atkins Bland recommend?

This will vary, depending on a client's specific needs.

However, where income is needed, we nearly always recommend investments where natural income can be distributed, thereby avoiding the added risk of selling investments to fund withdrawals.

If someone wants regular withdrawals above the income available, so wishes to spend some capital each year as well, we will usually recommend a portfolio structured to generate a high natural income and then give ad hoc advice on periodic sales to make up the balance.

This enables sales to be targeted at areas where the timing seems good and avoids selling from areas where the timing looks bad.

While this structure does help mitigate the extra risks created by withdrawals above the level of underlying investment yield, it does not eliminate danger of the withdrawals proving unsustainable.

The extent of this risk, and the ability of someone to accept it, pivots on individual circumstance.

Where a client is engaging us for ongoing asset allocation advice we have robust processes in place to monitor the position with withdrawals above natural income and will routinely remind them of the situation.

Our *Guide to Sustainable Income and Capital Drawdown* looks at this topic in some detail and is available on request.

Key takeaways

- If you want or need income from invested capital, choose investments that generate and distribute income at a rate that meets your needs.

- If viable to your other objectives, avoid structures where "income" is produced by selling shares or "units", especially if you have limited capacity to tolerate the extra risk this creates.

- Unless your capital is only for discretionary spending and you are not concerned about its longevity, try to avoid spending the capital, as this erodes future income.

- If you feel you need more income than your capital can generate, so are forced to supplement the income by selling investments and spending capital, give careful thought to the longer-term implications of this, and review whether you really do need the extra or could manage without it. If the extra income is essential, you should consider buying an inflation linked annuity to provide a guaranteed income.

Important notes

Any opinions expressed on the merits or disadvantages of any options are intended as a general comment only and not as specific advice to the reader.

This document is intended as a supplement to full independent advice and not as a replacement for it and should be read in conjunction with any personalised recommendations provided by Atkins Bland Ltd and with any product brochures supplied.

The value of investments will fall as well as rise, as can any income produced.

Inflation can reduce the real value of capital and the income it generates.

Past investment performance is not a reliable guide to the future.

Any reference to taxation, regulation or legislation is based on our current understanding and details should be checked before any reliance is placed upon its accuracy.

The impact of taxation and tax planning depends on individual circumstances and may be subject to change, which can be retrospective.

Errors and omission excepted.

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The value of investments will fall as well as rise, as can any income generated. An investor may, therefore, get back less than invested.

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