M&G Investments

The M&G guide to

Income

Contents

Please refer to the glossary found on pages 15 and 16 for an explanation of the words highlighted in **bold** throughout this guide.

Understanding the income challenges facing investors today

A difficult environment for income investors

The legacy of the global financial crisis has made life difficult for savers. Across much of the developed world, policymakers, such as central bankers and politicians, have looked to revive economies with historically low interest rates. This means keeping cash in the bank has generally paid very little reward. As such, drawing an income from savings alone may no longer be sufficient for many people to maintain the lifestyle they expect.

It is particularly important to remember that if the income you receive on your savings does not keep pace with the rising cost of living (ie the inflation rate), your purchasing power will reduce over time. In other words, your money will buy you less of the same goods and services in the future than it can today.

Taking all this into account, individuals are recognising the need to put cash to work to generate a better level of income from alternative sources.

In this guide, we outline some of these options for generating income.

- Low interest rates and several longer-term factors make it hard to get income from cash
- If income doesn't keep pace with inflation, your purchasing power falls over the years
- You may need to explore other investment options to achieve the income you need

Risk and reward

What is risk and reward?

When it comes to investing for income, it is important to review your attitude to risk versus reward.

- **Risk** reflects the chance your investments could fall in value
- More risk normally means more potential for growth or income

If you choose a low-risk investment, the initial sum invested is not expected to grow very much. But if you choose a higher risk investment, your initial sum could grow or reduce considerably.

It is also important to keep a sufficient level of cash available for short-term needs and to fully understand the potential risks involved in investing. No financial **asset** is always either ‘risky’ or ‘safe’ and the risk/reward characteristics of different assets will change depending on the length of time over which you wish to invest.

Risk is the possibility of losing some, or all, of your capital (your original investment). Risk refers to uncertainty. All investments carry a level of risk.

Levels of risk

While there are varying levels of income available across the different **asset classes**, it is worth bearing in mind that investing in assets that pay higher levels of income can increase the risk of **capital** loss. This is because higher levels of income are often available as 'compensation' for taking on greater risk.

Before choosing a particular income strategy, it is essential that investors are comfortable with the level of risk involved.

low risk,
low reward

high risk,
high reward

Two ways to generate an income are by investing in **equities**, that is, company shares, or in **bonds** where you lend money to a government or company, usually for a fixed term. Both involve more risk than keeping your money in cash. If a company does well and is profitable, equity holders usually receive a share of the profits in the form of a **dividend**. If the company doesn't do well, shares may fall in value and the company may cancel the dividend.

Bond holders expect regular interest payments, and for the loan to be paid back to them at the end of the fixed term.

However, there is a risk a borrower might get into financial trouble and become unable to pay interest or repay its loan.

An income strategy

One way to make decisions about income investing is to ask yourself three simple questions:

- What level of income do I need?
- How often do I need to be paid?
- How much risk am I willing to take on to achieve the income I want?

Investing with an expert

Rather than managing your own investment portfolio, you may choose to invest in a fund.

A fund is an investment vehicle where the money of many investors is pooled to buy a portfolio of equities, bonds or other assets. The fund is managed by a professional fund manager, who seeks to achieve a particular investment objective. Some funds pay income to their investors in the form of **distributions**.

The value of your investments can go down as well as up so you might not get back the amount you put in.

Income from equities

Equities are issued by companies aiming to raise money by offering a share of ownership in the company to investors. The most common way of investing in equities is by buying shares of companies listed on a stock exchange.

For growth and for income

The value of shares will fluctuate depending on how much investors are willing to pay for them at different times. This is affected by a number of factors, such as the past fortunes of the company, perceived prospects for the business, broader economic trends or simply investor sentiment.

Investors make money in shares by selling them for more than they bought them for. In this way, equities can provide capital growth. It's also possible to generate income from equities in the form of dividends.

A share of the profits

Dividends are a share in the profits of the company paid to shareholders and will vary depending on the company's business strategy and how well it is doing. The directors of the company will decide how much profit – if any – is to be paid out in the form of a dividend to shareholders, and how much profit should be reinvested in the company to drive future growth.

The potential to rise over time

An attractive feature of financially stable companies' dividends is that they tend to grow over time. Firms often attach great importance to increasing their payout to shareholders. This is known as a progressive dividend policy. If a company is able to grow its dividend over time, there is potential for its shares to deliver a rising income stream, which may help offset the effects of inflation. Furthermore, dividend growth is often viewed as a measure of a company's long-term strength, which is also an important consideration for those seeking capital growth.

The risk of losing money

Making a call on the right companies to hold for capital growth and income can be complicated and risky. Share prices – and, therefore, the value of your investment – can go up or down and unexpected factors can affect a company's ability to pay dividends. One approach is to spread risk by investing in many different companies at once. For some people, the most efficient way of doing this is through investing in a fund.

Investing for dividends

If you hold company shares directly, any dividends will be paid to you as the shareholder, but if you've invested in equities through a fund, the dividends are paid to the fund. The fund may pass dividends on to investors in the form of distributions. Before investing, you should find out whether a fund makes distribution payments and if they do, how frequently they are paid.

The value of your investments can go down as well as up so you might not get back the amount you put in.

- When you buy a share, you become part owner of a business
- Some businesses share their profits with their owners in the form of dividends
- If a company does well, its dividends tend to grow over time, but there is never a guarantee dividends will be paid

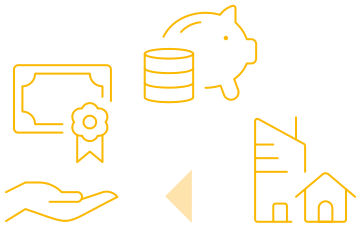
Income from bonds

Fixed income, or bond, investments are loans made by investors to governments (**government bonds**) or companies (**corporate bonds**) seeking to raise money by issuing debt securities.

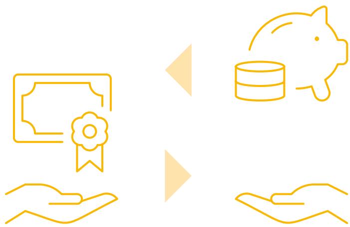
The borrower makes interest payments to the investors in the form of '**coupons**', and pays the original investment back at the end of the term of the loan ('**maturity**'), which can vary from a few months to many years.

What is a coupon?

Coupon payments mean that you could receive a stable, regular income. If the coupon is fixed, you'll generally know the exact amount of income you'll receive, and when it will be paid. This can make it easier to plan ahead. Fixed coupon investments offer little scope for income growth, however, and may not have the potential to keep pace with inflation. Some bonds are index-linked, which means the coupon will be adjusted over time to provide some protection for your income against inflation.



Income: coupons
You often know exactly how much you will receive, assuming the issuer doesn't miss payments.



Capital return
If you buy a bond from another investor for less than its original cost...

...you could make a profit by holding it to maturity.

Different levels of risk

It's important to remember that bonds are not 'risk-free'. There is always the risk that the government or company you have lent to will fail to keep up with payments. The higher the perceived potential for this to happen, the higher the income payment you will usually be offered.

The chance of a loss

While income payments are fixed, the price of the bond can go up or down as bonds are traded in the marketplace, although over the long term (10 years or more), prices tend not to fluctuate as much as company share prices. Therefore, it's possible to make a profit on a bond and achieve some capital growth. However, it's also possible to make a loss. Because bond prices can move, the value of your investment can also change as the return on the bond (also referred to as the **yield**) can vary.

- When you invest in bonds, you lend money to governments and companies
- They agree to pay you interest, plus the original amount back at the end of the loan
- This means there is potential for a stable income, but the borrower may fail to keep up with repayments

Understanding bond yields

Bond coupons and bond yields are two different things. Coupons are usually fixed, while yields vary. The yield is calculated by dividing the coupon by the price of the bond, and since prices can move, yields also change.

For example, if the UK government issues a bond at £100 with a 5% coupon, the coupon payment will always be £5. At issue price, or 'par value', the yield is also 5%. If the price of the bond falls to £90, the coupon is still £5, but the yield rises to 5.5%. On the other hand, if the price rises to £110, the coupon is still £5, but the yield falls to 4.5%. This is why, if you need a certain level of income, the price you pay for a bond is important as well as the coupon.

Government bonds

Government bonds are generally considered some of the safest types of investment. However, the risk and reward potential of government bonds varies across issuing countries according to the stability of their governments and economies. Investors should be able to identify those governments that present potentially greater **credit risk** by looking at the **credit ratings** given to different countries by independent **credit ratings agencies**.

Governments that are considered to have a low chance of **default** (inability to make interest payments or repay the initial loan) will generally offer lower levels of income from their bonds than those where the chance of default is believed to be higher.

However, even the supposedly 'safest' bonds can experience meaningful price movements as factors such as interest rates and inflation have a significant impact on prices.

Corporate bonds

Corporate bonds generally offer a higher income than government bonds as they are perceived to be riskier investments. However, there is, as with government bonds, also a hierarchy of risk/return potential within the corporate bond sector. Investors can identify those firms that present potentially greater credit risk by the credit ratings given to companies by independent ratings agencies.

Investment grade bonds are issued by firms that are believed to be in a comparatively stable financial position. These bonds are generally considered to be relatively safe investments with less credit risk, and therefore have a higher credit rating and usually offer a lower level of income.

High yield bonds are issued by firms that are perceived to have low credit quality. They are so-called because they offer particularly high levels of income due to the fact that they are believed to be less financially secure. Investors who are willing to lend money to these riskier companies may be offered very attractive real returns. The high yields are offered in part to compensate investors for the potentially greater risk that these issuers may not make their interest payments or repay their loans.

The value of your investments can go down as well as up so you might not get back the amount you put in.

Income from commercial property

Commercial property is a term for the buildings that are used for business, such as offices, warehouses and shops. Because of the required size of investment needed to buy commercial property, most people will only invest in this asset class by buying shares in companies that own and manage property or through investing in a property fund. A fund may own shares in property companies and/or invest directly in physical 'bricks and mortar' property.

Income focused

While it is possible to achieve capital growth through property investment (in other words, if the property were sold for more than the amount it cost to buy), property income tends to be the key driver of overall returns. Of course, capital loss is also a possibility if the value of the property falls.

Tenants and leases

Commercial property is generally rented out to a tenant who holds a lease on the property for a fixed period of time. The lease will have a pre-agreed end date and a rent to be paid on a regular basis, potentially providing a predictable, regular income for the term of the lease. Rents are generally reviewed every five years.

One risk to be particularly aware of is that property tends to be more difficult to sell quickly than shares or bonds. Therefore, you may not be able to sell out of a property fund as easily as other types of fund.

The value of your investments can go down as well as up so you might not get back the amount you put in.

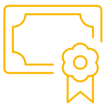
- Commercial property offers the scope for capital growth and an income from rental payments
- It is normally seen as less risky than shares, but more risky than bonds

Things to consider

While cash deposits may provide security of your money, or capital, as well as instant access, income from cash will fluctuate according to interest rates. In low interest rate environments, cash may provide very little income. This can be especially detrimental to purchasing power if the rate of inflation is higher than interest rates, as your capital will be growing more slowly than the price of the goods you wish to buy with it.

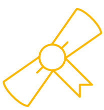
Higher levels of income may be available to those willing to invest in other financial assets. However, using cash to buy other assets that may potentially generate higher income will mean taking more risk.

Considering equities



Equities offer the potential for rising income over time through dividend growth. However, income is not guaranteed and equity prices can fluctuate considerably in the short term. This means that, although there is potential for significant capital gain, equity investors must think carefully about their time horizons and capacity for capital loss.

Considering bonds



Fixed income securities or bonds, typically offer less potential for income growth than equities, but more certainty and regularity in terms of knowing the amount of income you should receive. However, bonds are not risk-free. Capital loss can occur, particularly in a volatile interest rate environment. It is important to remember that there is a hierarchy or risk/return potential within the asset class, according to the perceived creditworthiness of the issuer – in other words, how likely it may be to default on the loan. Also, while the amount of income payable is fixed by the coupon, the value of the income (the yield) will fluctuate as bond prices go up and down in the marketplace.

Considering commercial property

Commercial property offers the potential for both income growth (through rent reviews) and long-term capital growth (through rising valuation of the property). However, there is also potential for capital loss, and although the income stream could be fairly stable due to regular, fixed rent payments, it is not guaranteed. The length of time that can be involved in buying and selling properties makes this a less flexible asset class than equities and bonds, in terms of access to your capital.

The value of diversification

One well-established way of trying to manage investment risk is **diversification**. This means investing in a blend of asset types that offer diverse characteristics and have the potential to behave differently in various economic or financial market environments. The essential principle of diversification is to avoid 'putting all your eggs in one basket'. This may provide the best chance of generating a sustainable income stream for the long term.

The risk/return trade-off

Achieving the right diversified blend for your needs will require careful consideration of the characteristics that different assets may offer, in the context of your individual circumstances. Investors need to think about whether they need a guaranteed income or if they are able to take some risk with their capital to aim for higher income. The typical trade-off between higher return and higher risk is a basic principle of investing and should always be borne in mind.

You should also think about what you need the income for, and over what time horizon. Different financial goals will require different types of income stream. You may want to aim for steady, regular income or it might be more appropriate to try and achieve income growth over time.

If you are unsure about the most appropriate way of generating income for your needs, please speak to a financial adviser.

A **diversified portfolio** could be more stable as the market rises and falls. Combining bonds, equities and property may reduce the impact of shocks.

Consider your individual needs

Achieving the right combination of investments will require careful consideration of the characteristics that different assets may offer, in the context of your individual circumstances. Investors need to think about whether they need a guaranteed income or if they are able to take some risk with their capital to aim for higher income.

Important information

We are unable to give financial advice. If you are unsure about the suitability of your investment, speak to your financial adviser. The views expressed in this document should not be taken as a recommendation, advice or forecast.

The value of your investments can go down as well as up so you might not get back the amount you put in. □

Glossary of investment terms

The following are explanations of some of the terms you would have come across in this guide.

Asset Anything having commercial or exchange value that is owned by a business, institution or individual.

Asset class Categories of assets, such as cash, company shares, fixed income securities and their sub-categories, as well as tangible assets such as property.

Bond A loan in the form of a security, usually issued by a government or company, which normally pays a fixed rate of interest over a given time period, at the end of which the initial amount borrowed is repaid.

Capital Refers to the financial assets, or resources, that a company has to fund its business operations.

Capital growth Occurs when the current value of an investment is greater than the initial amount invested.

Corporate bonds Fixed income securities issued by a company. They are also known as bonds and can offer higher interest payments than bonds issued by governments as they are often considered more risky.

Coupon The interest paid by the government or company that has raised a loan by selling bonds.

Credit rating An independent assessment of a borrower's ability to repay its debts. A high rating indicates that the credit rating agency considers the issuer to be at low risk of default; likewise, a low rating indicates high risk of default. Standard & Poor's, Fitch and Moody's are the three most prominent credit rating agencies. Default means that a company or government is unable to meet interest payments or repay the initial investment amount at the end of a security's life.

Credit rating agency A company that analyses the financial strength of issuers of fixed income securities and attaches a rating to their debt. Examples include Standard & Poor's and Moody's.

Credit risk Risk that a financial obligation will not be paid and a loss will result for the lender.

Defaulted/Default When a borrower does not maintain interest payments or repay the amount borrowed when due.

Distribution Distributions represent a share in the net income of the fund and are paid out to income shareholders or reinvested for accumulation shareholders at set times of the year (monthly, quarterly, half-yearly or annually). They may either be in the form of interest distributions or dividend distributions.

Diversification The practice of investing in a variety of assets. This is a risk management technique where, in a well-diversified portfolio, any loss from an individual holding should be offset by gains in other holdings, thereby lessening the impact on the overall portfolio.

Dividend Dividends represent a share in the profits of a company and are paid out to the company's shareholders at set times of the year.

Equities Shares of ownership in a company.

Fixed income security/securities A loan in the form of a security, usually issued by a government or company, which normally pays a fixed rate of interest over a given time period, at the end of which the initial amount borrowed is repaid. Also referred to as a bond.

Government bonds Fixed income securities issued by governments, that normally pay a fixed rate of interest over a given time period, at the end of which the initial investment is repaid.

High yield bonds Fixed income securities issued by companies with a low credit rating from a recognised credit rating agency. They are considered to be at higher risk of default than better quality, ie higher-rated fixed income securities but have the potential for higher rewards. Default means that a company or government is unable to meet interest payments or repay the initial investment amount at the end of a security's life.

Inflation The rate of increase in the cost of living. Inflation is usually quoted as an annual percentage, comparing the average price this month with the same month a year earlier.

Investment grade bonds Fixed income securities issued by a company with a medium or high credit rating from a recognised credit rating agency. They are considered to be at lower risk from default than those issued by companies with lower credit ratings. Default means that a company or government is unable to meet interest payments or repay the initial investment amount at the end of a security's life.

Maturity The length of time until the initial investment amount of a fixed income security is due to be repaid to the holder of the security.

Risk The chance that an investment's return will be different to what is expected. Risk includes the possibility of losing some or all of the original investment.

Yield (income) Refers to the income received from an investment and is usually expressed annually as a percentage based on the investment's cost, its current market value or face value.

The M&G guides

The M&G guides aim to give you the basics about investing, to help you make informed decisions about your financial goals and how to reach them.

We are unable to give financial advice. If you are unsure about the suitability of your investment, speak to a financial adviser. The views expressed in this document should not be taken as a recommendation, advice or forecast.

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