Where do you find yield?

While lower interest rates are good news for borrowers, it's bad news for those investors needing income, writes **Albert Botha**, investment analyst at Glacier

For a large part of society, the capital gain on their investments is an incidental thing. Income is much more important to them. When they look at their investments, both the stability and the amount of income are key considerations in their investment decisions. While we may look at the lower interest rate environment and heave a sigh of relief, for them the lower yield they will now receive on their interest-bearing funds is distressing.

For these people (who are often older and retired, have paid off their homes and have a large proportion of their investments in money market accounts) the search for yield is reaching fever pitch; unfortunately it may prove to be more arduous than they expect.

The three main ways of improving or maintaining your standard of living require you to take on slightly more risk. Fortunately, if managed correctly, this should not be without its reward.

Corporate bonds

The first way is to swap into higher yielding fixed-interest assets, the most common being non-government bonds, otherwise known as corporate bonds. However, most investors do not have access to these types of bonds, nor do they have the expertise to properly manage them. The solution lies in selecting a fund manager with the stated goal of selecting bonds that fit in this category. There is, however, a downside.

While these bonds do currently offer a higher yield, they also carry a higher risk. The capital value of the bonds may be more volatile, but if the investor is interested mostly in income this should not be a problem. Another issue is that the institution issuing these bonds may default. While this is a distinct possibility, especially given the recent economic problems, in South Africa we have not ever had a listed bond default and our financial and banking systems are in significantly better shape than those of the United States and Europe.

Listed property

Property is another asset class that could be considered. While the yields on properties are currently lower than those of bonds, the possibility for that income to grow is not an attribute of traditional fixed interest investments. Property is a bit of a schizophrenic asset class. At times its behaviour mirrors that of bonds and at other times it behaves more in line with financial shares. It is important to remember that in a property investment both the capital and the income could be subject to variation. Yet, regardless of this fact, it is often included in retirement portfolios.

Dividends

A last option is equities. Equities (or shares) are not traditionally seen by investors as an income-providing asset class, yet many of the world's richest people derive their income solely from them.

The reason traditional investors avoid equities for income is because the yield on equities is traditionally a lot lower than that seen from other asset classes. Furthermore, both the income and the capital are often subject to a lot of variation. People who are very wealthy can live with both these problems.

The upside of using equities for income provision is that the income stream should be able to keep pace with inflation over the long term. Additionally, the income (dividends) from equities is currently not taxed in South Africa. This is expected to change next year and dividends will be taxed, but at a relatively low rate of 10%.

Given the current market levels, it may be possible for many investors to include equities as an income generating asset class. Other investors may simply use them to make a medium term capital gain. This will allow investors to retain their standard of living, even if yields remain low for a while.

For many investors, however, this all seems like too much hassle. For those who feel that they should leave these decisions in the hands of fund managers, there exists an entire category of funds with the express purpose of shifting your capital between different income generating assets. Funds in the “Fixed Interest Varied Specialist” category can be invested in anything from cash to bonds and property and everything in between.

While the search for yield may be daunting, you do not have to walk alone. A trusted financial adviser and a good fund manager will help you along the path.

A reader asks:

I am retired and finding that my income has fallen. Where should I be investing to increase my income?

Albert Botha replies:

Retirees use a variety of vehicles to provide income. For many of them, however, the income from their investments is of vital importance. So when interest rates fall and the income from money market funds decline, these investors need to find alternatives. Ideally one should have started the move away from money markets last year before the yields on bonds started falling. The benefit of doing so would have been that the investor would have benefited from the gain in the capital value of the bonds as interest rates fell (remember that the value of bonds increase as the interest rates decrease). Investors who did not manage that will have to consider alternative options. Unfortunately the alternatives all introduce an extra amount of risk — the degree of which varies depending on the option chosen. All three of the options mentioned in the accompanying article are feasible, yet the implementation and the effects will vary.

For many investors in this space, higher-yielding corporate bonds are the answer. Selecting a fund that utilises these types of bonds should increase the yield on the investment — as long as the investor is aware of the accompanying risks. This option should increase the income, but at the added risk of volatility and defaulting. The other two options involve completely or partially rotating out of fixed-income investments (at least for the short to medium term) to make a possible capital gain. Both property and equities offer this opportunity. If capital gain is realised on these investments, it can be used to supplement the income going forward. The downside of this is that the income from these investments is low and uncertain. As such it may force a retiree to deplete capital in other segments in the investment to provide income while waiting for capital gain. Furthermore, the risk in these investments is that the capital gain may not occur in time or it may not happen at all. The ideal solution for most investors, however, will be a combination of changes in behaviour with a change in investment strategy. Most households have some limited ability to reduce their spending. It is vastly preferable to bite the bullet now regarding unnecessary spending, rather than being in the unfortunate position of having a change in behaviour forced on you involuntarily down the line.