Income-only or total return investing?

What you need to know about the choice facing charity trustees.

Rathbones
Look forward

When did you last review your investment mandate – is it fit for purpose in today's financial markets?

Are you taking unappreciated risks in following an income-only approach?

Have you considered the merits of switching to a total return approach?

Understanding the best available investment option is important for your charity. This booklet contains the main highlights from our full research paper on the factors that trustees should consider when deciding which investment approach to adopt.

Charity trustees are increasingly asking their investment managers whether they should take an 'income-only' or a 'total return' approach. But why has interest in this subject increased?

Two major changes have been seen in recent years:

1. The investment choices available have increased greatly over the last two decades. While much of this 'modern' investment technology offers lower income yields than traditional instruments, it can offer greater capital appreciation and better diversification and risk management.

2. Interest rates and bond yields have collapsed in the last few years, making it increasingly difficult to generate reasonable levels of income. To fulfil traditional income-only mandates, investment managers may be consciously or otherwise placing the capital at greater risk and with it the charity's future activities.

These issues can be confusing, particularly if your investment manager appears to be delivering on your mandate – how can you assess the level of risk being taken to achieve a particular return?

Have a question for us?

Call our charity team on 020 7965 7103 or email james.brennan@rathbones.com and we'll be happy to provide a solution.

Income-only

Advantages

- Ease of identification
- Reliability of income
- Income is a good measure of 'value'

Disadvantages

- Current income levels are low
- An income-only approach may reduce your investment opportunity set
- Income is only part of the return

Advantages of an income-only approach

1. Ease of identification. Any income arising from an investment portfolio is easily identifiable compared to capital appreciation, so it is easy to ensure that only income is spent and to assess whether you are achieving your income objective.

2. Reliability of income. A suitably diversified income-only strategy tends to produce a fairly stable level of income. Even in a recession, equity dividends tend not to decline as much as corporate earnings as directors try to maintain dividends to uphold shareholder confidence.

3. Income is a good measure of 'value'. Income represents one of the more reliable measures of 'value'. If there is no income (e.g. as with a commodity such as gold), it is more difficult to value an investment.

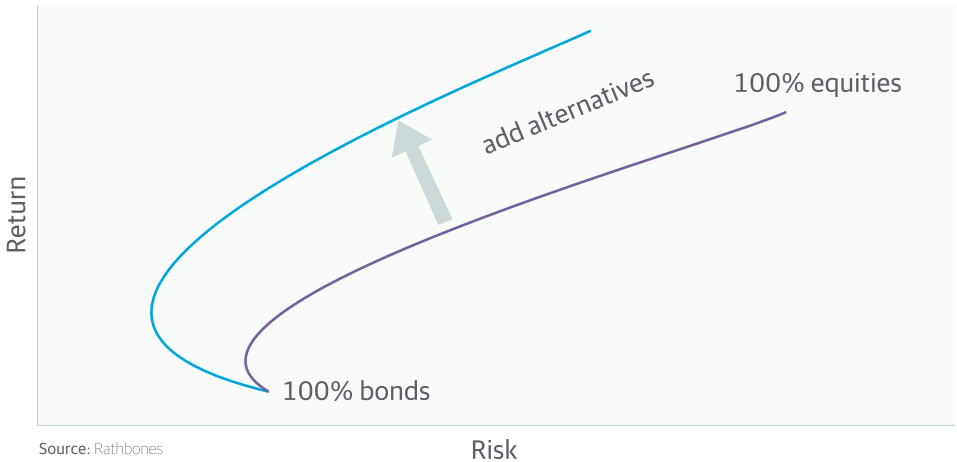
Disadvantages of an income-only approach

1. Current income levels are low. Today's environment makes it harder than ever to achieve decent levels of income. One only has to look at the Bank of England's base rate, which at the time of writing is 0.5%, to appreciate the scale of the problem.

2. An income-only approach may reduce your investment opportunity set. Investing for income-only introduces a bias against stocks or asset classes that pay little or no income. But does it make sense to ignore smaller, fast-growing companies that need to reinvest all of their profits to fund their growth?

Similarly, certain alternative investments such as private equity, absolute return funds, structured products and commodities can also be attractive. Should one exclude them and have a less well diversified portfolio, just because those asset classes don't produce dividends in the traditional sense?

Illustration of how the risk/return trade-off of a portfolio can be improved by introducing alternative investments



Source: Rathbones

3. Income is only part of the return. An income-only approach doesn't utilise any capital gains that might arise and, perhaps more importantly, ignores capital losses. If you strip out dividends, equities normally produce real capital returns over long periods of time, so why ignore this element? Equally, spending the income from a portfolio of conventional bonds is a sure way to end up with no portfolio over the long term.

Today's real value of £100 invested at the end of 1899 without reinvesting income

Equities	**£203.71**
Gilts	**£0.73**

Source: Barclays Equity Gilt Study 2018 (data as at 31 December 2017)

Total return

Advantages

- It doesn't matter that income levels are low
- Maximises your investment choices
- Higher withdrawals?

Disadvantages

- Reduced ease of identification

Advantages of a total return approach

Given the greater flexibility offered by total return, such an approach can incorporate almost everything that an income-only strategy can, but without the disadvantages.

1. It doesn't matter that income levels are low. The fact that current income levels are low isn't such a big issue for a total return investor.

2. A total return approach maximises your investment choices. A total return investor has the broadest universe of investments and asset classes to choose from. This offers benefits from both a risk and a return perspective.

3. Higher withdrawals? A total return strategy may enable you to make a slightly higher withdrawal than if you pursue an income-only strategy because equities normally produce real capital returns over the long term.

Disadvantages of a total return approach

1. Reduced ease of identification. A total return approach is slightly more complicated than an income-only approach, in so far as 'identification' of the return goes. This disadvantage is, however, relatively easy to overcome.

So which approach should your charity choose: the reliability of income-only or the ability to better diversify risk with total return?

Our team would be delighted to explain the pros and cons of an income-only approach, and introduce the alternative of total return investing.

Our charities team has considerable experience in helping charities to better understand complex choices like these. Call us today and let's discuss your charity's future.

020 7965 7103

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Have a question for us?
Make a note of it here.

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Look forward

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The value of investments and income arising from them may fall as well as rise and you might get back less than you originally invested.