Using Funds to Get an Income

Funds are typically seen as a way to build up a lump sum of money over time, perhaps for retirement, but they can also be used to provide you with a regular income.

This factsheet:

- **Describes the main types of funds that can give you an income and compares their performance over ten years.**
- **Explains the four main forms of income, and the risks and rewards involved.**
- **Describes the positive effect of investing in an ISA (Individual Savings Account) on your income.**
- **Lists other important points to consider when you invest in income funds.**

The factsheet is for information purposes only. If you need help deciding your investment objectives and choosing a suitable fund, contact a qualified financial adviser. To search for one in your local area, visit IMA's Financial Adviser search tool: **www.investmentuk.org/investor-centre/ifa**

TYPES OF INCOME FUND

There are four main types of income fund:

Money Market Funds – pay interest and aim to protect the value of your money.

Bond (Fixed Income) Funds – pay a higher rate of interest than cash deposits, but there is some risk that the value of your original investment will fall.

Equity Income Funds – the income comes from dividends paid to shareholders. In return for some risk to your capital, you may get a more regular income than you would from cash, and that income, as well as your capital, may increase over time.

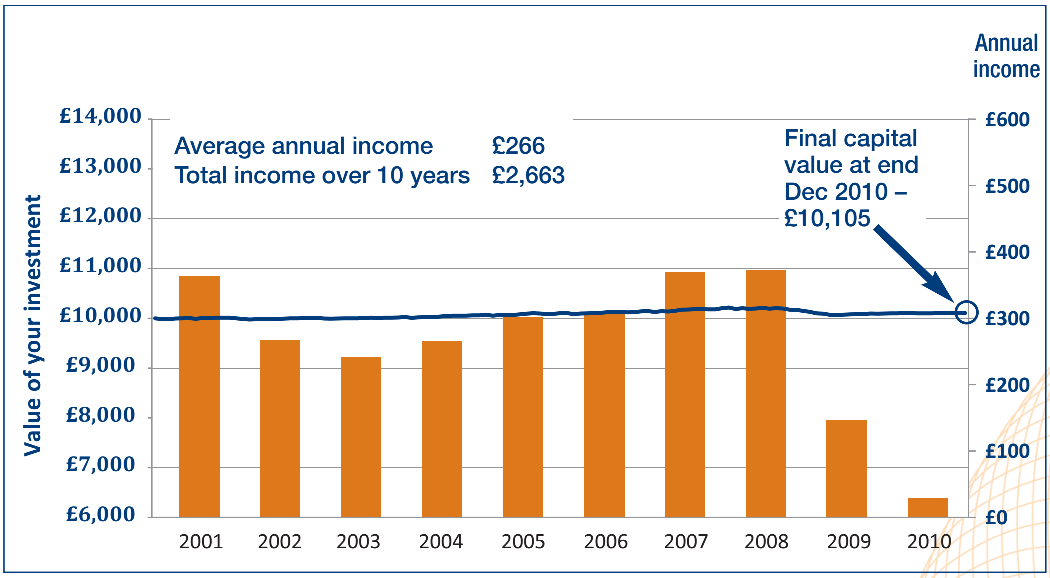
Property Funds – pay income from rents, but the value of your investment can fall as well as rise.

There are also mixed asset funds, which invest your money in both bonds and equities.

The four charts on the next two pages show (a) how much income investors in the main types of fund would have received over the past ten years and (b) the change in the capital value of their investment, assuming they had taken out their income every month. You will see that there are some big differences, which is why many investors select a mix of the fund types. The reasons for the differences are explained on page 4.

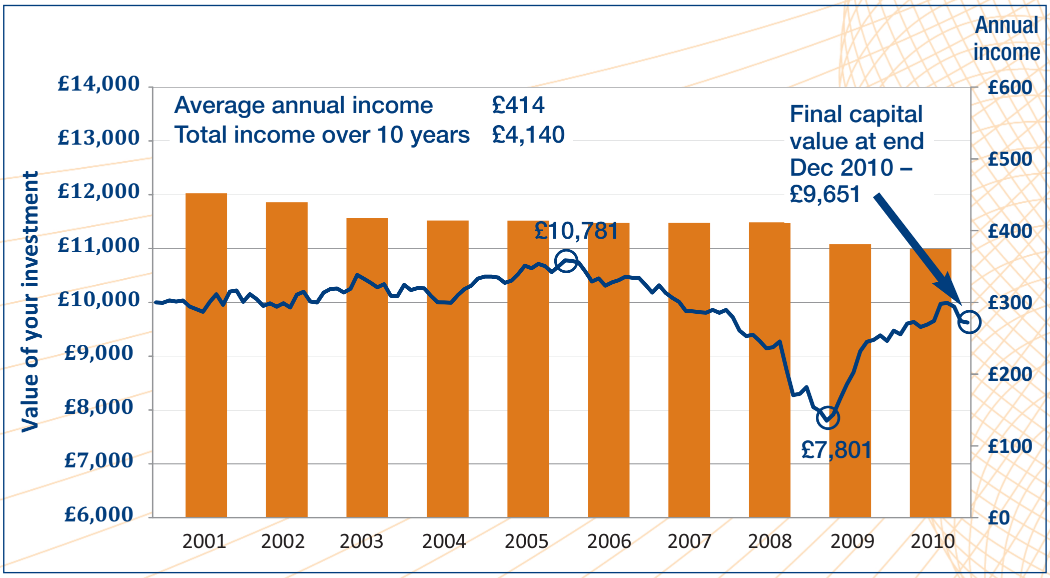
THE PERFORMANCE OF DIFFERENT TYPES OF INCOME FUNDS

Money market funds – variable income, capital value steady



- The income varied between £33 and £371 over the ten year period. It fell in the last two years in line with Bank of England interest rates.
- The capital value has not varied by more than a few percent over the ten year period.

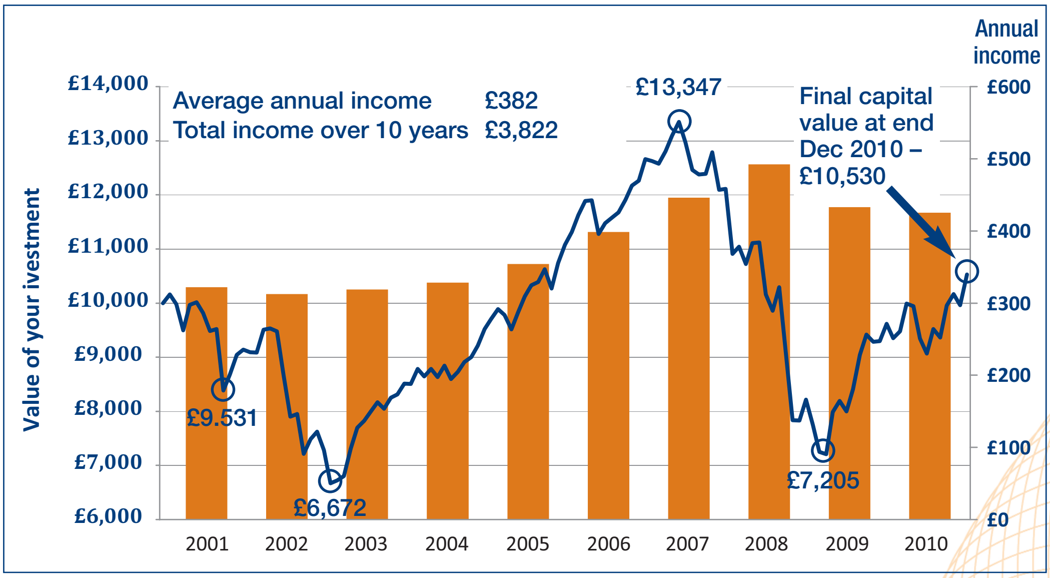
Corporate bond funds – steady income, capital value quite variable



- Income averaged over £400 a year.
- The capital value was quite steady until 2006, it fell below £8,000 in 2008, then rose again. Not a problem unless you needed the cash when the price was lower.

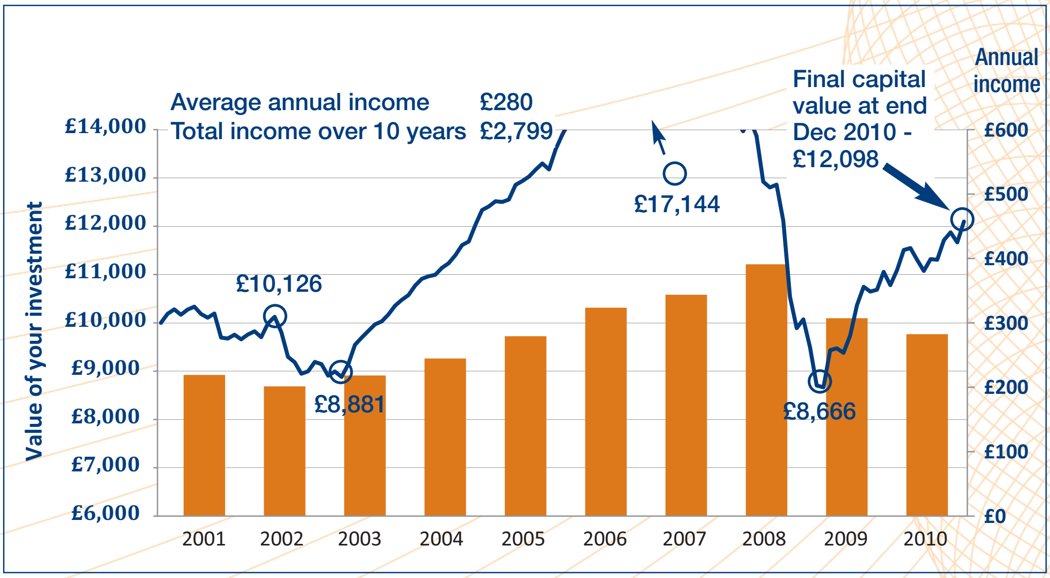
Sources: All the charts use figures from Lipper and the Investment Management Association. Figures based on average of funds currently residing in the IMA Money Market Sector and IMA Corporate Bond Sector and therefore include an element of survivorship bias. Capital returns are on a bid-to-bid basis and all figures are gross of tax. Annual income received is a sum of the monthly income paid out by each fund, and not re-invested. Figures reflect the experience of a £10,000 investment over a 10 year period from 1st January 2001 to 31st December 2010. Past performance is not a guide to future performance.

Equity income funds – rising income over time, capital value variable



- Income rose from £321 in 2001 to £491 in 2008. It fell to £432 in 2009 due to events such as the financial crisis. But it was still higher than income from money market funds.
- The capital value ranged from below £7,000 to over £13,000. *Not* a problem unless you needed the cash when the price was lower.

Property funds – income variable, capital value variable



- Income rose from over £218 in 2001 to nearly £390 in 2008 and then fell back to under £300 in 2010.
- The capital value was volatile ranging from below £9,000 to over £17,000. Not a problem unless you needed the cash when the price was lower.

Sources: All the charts use figures from Lipper and the Investment Management Association. Figures based on average of funds currently residing in the IMA UK Equity Income Sector and IMA Property Sector and therefore include an element of survivorship bias. Capital returns are on a bid-to-bid basis and all figures are gross of tax. Figures reflect the experience of a £10,000 investment over a 10 year period from 1st January 2001 to 31st December 2010. Past performance is not a guide to future performance.

THE FOUR FORMS OF INCOME – KEY FACTS

This section explains more about these different forms of income, where they come from and the potential benefits and risks.

1) Interest from cash or money market funds

The income varies in line with the interest rate set by the Bank of England. The fund's investment manager will aim to get the best rate available, helped by that fact that, with large sums to deposit, funds can often get better rates than individual investors. The capital amount you originally invested is unlikely to go down (subject to the limits for each deposit under the Financial Services Compensation Scheme). *I*f the interest rate is lower than the rate of inflation, however, the real spending value of your investment is likely to fall.

2) Fixed interest from bonds

Bonds are issued by governments (known as gilts in the UK) and companies (corporate bonds) to investors as a way to borrow money for a set period of time (perhaps 5 or 10 years). During that time, the borrower pays investors a fixed interest income (also known as a coupon) each year, and agrees to pay back the capital amount originally invested at an agreed future date (the redemption date). If you sell before that date, you will get the market price, which may be more or less than your original investment.

Many factors can affect the market price of bonds. The biggest fear is that the issuer/borrower will not be able to pay its lenders the interest and ultimately be unable to pay back the loan (see Credit ratings). A more general concern is inflation, which will erode the real value of the interest paid by bonds. Falling inflation, often associated with falling bank interest rates, is therefor typically good news for bond investors. Typically, bond prices rise if interest rates are expected to fall, and fall if interest rates go up.

If you invest in bonds via a fund, your income is likely to be steady, but it will not be fixed, as is the case in a single bond. This is because the mix of bonds held in the fund varies as bonds mature and new opportunities arise.

Credit Ratings

Every bond is given a credit rating. This gives investors an indication of how likely the borrower is to pay the interest and to repay the loan.

Typically, the lower the credit rating, the higher the income investors can expect to receive in return for the additional risk.

3) Dividends from shares and equity income funds

Many companies distribute part of their profits each year to their shareholders in the form of dividends. Companies usually seek to keep their dividend distributions at a similar level to the previous year, or increase them if profit levels are high enough to warrant it.

4) Rental income from property and property funds

Some people invest in "buy-to-let" properties in order to seek rental income and potential increase in property values. Property funds typically invest in commercial properties for the same reasons, but there are risks attached. For example, the underlying properties might be difficult to let and rental yields could fall. This could affect both the income you get and the capital value.

TAX – WHAT YOU PAY WHEN INVESTING IN INCOME FUNDS

Investing within an ISA can reduce the tax you pay

- The ISA manager can collect, on your behalf, interest and/or, in some cases, property income distributions, gross of tax. This means that basic rate, higher rate and additional rate taxpayers pay no tax at all on income earned.
- If you receive dividends, you won't have any further tax to pay. If you are a higher or additional rate taxpayer, you won't have to pay the extra 25% and 36.1% respectively that you would on income from a fund held outside an ISA.
- You will not have to include the income from investments within an ISA in your annual tax return.

Outside an ISA you may have to pay tax on income earned

If you are a taxpayer and unable to invest in an ISA, your tax position will depend on the type of income distribution you receive – interest, dividends, property income or a mixture of these.

When you receive income from a fund, the fund manager will also send you a tax voucher. The voucher will show both the amount of income you are receiving and, where applicable, the amount of tax that the fund manager has already paid on your behalf to HM Revenue & Customs (HMRC).

Interest distributions and property income distributions

Are paid net of 20% tax.

- If you are a non-taxpayer (or are eligible for the starting rate for savings), HMRC may repay some or all the tax that has already been paid.
- Basic rate taxpayers have no more tax to pay and do not need to include the income received on their annual tax return form.
- Higher and additional rate taxpayers will have further tax to pay on income received at rates of 20% and 30% respectively.

Dividend distributions

Any dividend income you receive will be net of 10% tax. This tax, paid to HMRC on your behalf, is called a dividend tax credit. How much tax you then personally owe depends on your tax position.

- Non-taxpayers have no more tax to pay, but cannot reclaim the tax credit.
- Basic rate taxpayers have no further tax to pay because the tax credit will meet their tax liability.
- Higher and additional rate taxpayers have further tax to pay at rates of 25% and 36.1% respectively.

Helpful Hint

If you are a higher or additional rate taxpayer, you will have to complete a self-assessment tax return form. For more information, you can download a copy of IMA's factsheet 'Investment Funds and Income Tax' at: **www.investmentuk.org/investor-centre/investor-factsheets/investment-funds**

For further information on how investments in funds are taxed, see our factsheet 'Investment funds and income tax', which can be found at: www.investmentuk.org/investor-centre/investor-factsheets

KEY POINTS TO CONSIDER WHEN SELECTING FUNDS

- **Balance your need for a regular income with the risks**

  The income from a fund may be higher and more stable than the interest you get from cash deposited in a bank or building society savings account, but it can still go up and down. There may be some risk to the capital value of your investment, but if a regular income is important to you and you do not need to cash-in your investment for now, you may be prepared to take this risk.

- **Income funds of the same type are grouped in "IMA sectors" to help you**

  The main IMA sectors for income investors are: Money Market; Fixed Income (including UK Gilts, UK index-linked Gilts, Corporate Bond, Strategic Bond, Global Bond and High Yield); Equity Income; Mixed Asset (ie.UK Equity and Bond) and Property. To find out more, go to IMA Sectors at: **www.investmentuk.org/fund-sectors**. You can also search for groups of funds, using a variety of criteria at: **www.investmentuk.org/investor-centre/fund-search**

- **Look at the fund yield**

  This figure allows you to assess how much income you may expect to get from a fund in one year. In the simplest form, it is the annual income as a percentage of the sum invested. Yields on bond funds can also be used to indicate the risks to your capital.

- **Note that expenses are normally charged to the fund's capital not its income**

  This is normal practice because income fund managers want to maximise the income for their investors. What the costs are and how they are charged is clearly stated in the information you receive from the fund manager.

- **Decide how frequently you wish to receive your income**

  All income funds must pay income at least annually, but some will pay income distributions twice a year, quarterly or monthly, so you can invest in a fund which has a distribution policy to suit your income needs.

- **Select income units/shares if you need cash regularly**

  The income generated in a fund is paid out in cash to investors who own income units. If you choose the alternative - accumulation units/shares - your share of the income will automatically be reinvested back into the fund.

FURTHER INFORMATION

This factsheet is produced by the Investment Management Association. We also publish other factsheets on investing and funds, which you can download free of charge from the IMA's investor website: **www.investmentuk.org/investor-centre**

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