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In this two-part discussion piece, QuantQual's Matthew Dewsnap considers income portfolios and the changing environment for CRPs and income funds.

Why Now is The Time for Advisers to Urgently Revisit Natural Income and their Income Portfolios: Part One

Part 1: Out of Vogue

- Why advisers urgently need to revisit their views on income portfolios and understand how properly managed income portfolios operate
- Why MPS providers and IFAs may not be able to construct income portfolios in a way in which income can be managed properly, and why bucketing is not always the answer
- Why pound cost ravaging is back, and why a lack of understanding in this area could lead to complaints and mis-selling

Just like the fashion industry, our investment markets are constantly in flux. However, while the editors of *Vogue* look to colours, silhouettes, and materials, investment markets use words like BRICS, FAANGS, and Dot Com to point out changing market trends. In the last cycle, discussing natural income just wasn't 'in vogue'. Despite the fact that it does work, it was avoided because it was easier for advisers to use growth to fund income by selling units. In addition, growth was strong and easy to access - and it worked!

However, as many advisers are now discovering, the issue with selling growth is that you actually **need** growth. Inflation and rising rates are back with a vengeance, and growth is becoming harder to find on a consistent basis. Lower growth availability brings volatility and a risk in compounding losses with sales of units. Advisers are now realising that markets have well and truly changed - and so the big question is whether advisers have now fully realised that their approach and attitude to natural income has to change with it?

Using Income for Income Clients

It sounds simple, but why have advisers insisted on using growth for income, and not income for income?

Under Mifid2, advisers are deemed as 'distributors', while the portfolio providers are deemed as 'manufacturers'. As distributors, advisers are responsible for aligning manufactured solutions to their intended 'target market'. Therefore, these portfolio manufacturers are required to define their target market, and thus consider for whom these solutions are designed.

By using a growth fund for income - effectively ignoring the target market and objective of the portfolio - advisers could run the risk of future complaints. It's akin to saying, "*I know I'm supposed to use this screwdriver to turn the screw, but hitting it with a hammer has always worked*". The problem is that this approach may work – until it doesn't. Unfortunately, **that time is now**.

***"When the facts change, I change, what do you do, Sir?"* (John Maynard Keynes)**

There is no denying that the market has changed, and potentially for the long term. Long gone are the days of QE, high liquidity, low inflation, low volatility, and easy-to-access growth. Inflation and volatility are back and, as many investors are currently experiencing, using growth for income without the growth is hurting their capital.

What does a properly managed income fund looks like?

Many advisers don't like income funds because they simply don't understand them. However, we are all products of our environment, and our environment has been obsessed with growth metrics and quartile rankings for the last ten years - not to mention risk metrics and risk profilers that focus on capital, rather than income risk. A good, natural income fund is like an annuity but with access to capital, exchanged for less certainty over the income. However, this uncertainty is where the skill of the manager comes in and why advisers need to understand the difference between good income portfolios and bad income portfolios.

When assessing robust income funds, the first thing to remember is to **ignore the yield**. Yield is a function of capital and only relevant for new investors. For example, Ninety One have been a global quality dividend growth investor since inception in 2007. Until the end of 2021, the realised yield/income from their securities have compounded at a far greater rate (6.9% Compound Annual Growth Rate (CAGR)) than the broader market (3.1% CAGR), growth indices (3.1% CAGR) and even value indices (1.1% CAGR)), which has been managed by John Stopford and Jason Borbora-Sheen. Their investors traditionally search for income, and as a consequence the realised income yield over time is significantly higher (4.6%) than other styles of investing. In addition, this approach has led to a better risk return profile and greater excess returns relative to value and growth. Ultimately, you can get both real income **and** capital growth by focusing on the right type of quality. The most important outcome for a client in decumulation is that the income has grown consistently - despite whether the current yield of the portfolio has remained level or steady (for budgeting purposes), and even if underlying capital hasn't escaped some of the market downside.

I was recently approached by an adviser who wanted to understand why his DFM had increased their yield. This was simply because their capital had underperformed, thanks to falling bonds and equities. Furthermore, I explained that this was not an increase in yield at all; this was for an existing investor, and so yield was irrelevant. DFMs, MPSs, and passives have a lot of room for improvement when it comes to managing income. To be able to manage the income, you actually need to be able to manage the income!

Advisers tell me that natural income is difficult to manage and often does not pay enough. This suggests that they are looking in the wrong place, which can be seen by looking back to markets during the Covid-19 pandemic. This was one of the most stressed periods for dividends, with the All-Share seeing some 40% wiped off the dividend register. We heard stories from advisers of DFMs calling clients to turn off their income in the face of 25% - 30% falls to avoid eating into capital. One of our favourite income managers, Premier Miton's David Jane, saw only a 1.8% drop in his income. Even more impressively, his income was starting from a far, far higher base than the DFMs and MPSs in the first place.

Another example of good income distribution management is from Stephen Friel & Matthew Bance of UBS. Their portfolio is constructed around the primary objective of income generation, with an explicit income target of 4.5%. This is distributed as a fixed Pence Per Unit (PPU) amount, providing a monthly smoothed income of 3.8% per annum. Any income the fund achieves in excess of the PPU amount is distributed at the end of its accounting year. Since launch, the fund has consistently hit its income target. Within the investment process, assets are carefully selected on the basis of income contribution, while also ensuring that the fund is broadly diversified in terms of income sources. This allows the fund to generate smooth, consistent income, providing clients with the needed level of certainty.

Pence Per Share and Managing the Income is Key

So, how is it possible for someone like David Jane to manage the income so well, while the DFMs and MPSs do not? As discussed, the first criteria is actually the ability to actively manage the income account. However, this is not a given, as not all income managers are specialised income managers. The important thing to be aware of is the second account: the income account. This is where and how managers govern income, and it illustrates how and why MPSs are not so good at it; they simply do not have an overarching income account.

A proper income manager will run two accounts: a capital account, with a focus on capital return and capital volatility; and an income account, with a focus on income return and income volatility. Each has their own distinct characteristic and calculation to understand their value, as seen below.

1st	**Total Number of Income Shares**	**X**	**Dividend per Share**	**=**	**Income**
		+			
2nd	**Total Number of Income Shares**	**X**	**Share Price**	**=**	**Capital Value**

The key to assessing income is not yield; as discussed, this is simply a function of capital. Therefore if capital falls, the income naturally increases as a percentage of the capital. This makes yield an important consideration for new investors, because falling markets enable clients to lock in more income by buying more units for less. However, this is not always the case if the manager is not committed to the pence per share.

What is Pence Per Share (PPS)?

PPS is as basic as it sounds. It is the amount of income you receive for holding each share, expressed in pence. Therefore, the more shares you hold, the more income your clients receive. The more consistent the dividend from the share, the more consistent the income. It is this consistency that is key, thanks to prioritisation and focus. In short, a good income manager will have a greater focus on the income account and will therefore place priority on ensuring a client's pence per share doesn't fall - thus equalling higher and more consistent income. While many advisers overcomplicate and struggle with natural income, frustratingly the end client gets it. Pence per share, natural income, and yield is no different than using the capital to purchase a buy-to-let - or even the pension - as an asset to generate income to spend.

Pence per share is simply the rent received.

Yield is the income expressed as a percentage of the house price. Again, only relevant at the time of purchase, but recalculate if you like.

Share Price is the value of the house, which you only really care about when you sell it.

PPS Should Not Fluctuate

A big frustration is when advisers try to argue that natural income is not consistent. The issue isn't the income - it's the adviser's understanding – often because they are looking at the wrong thing. They should ignore the yield figure, which fluctuates, and instead focus on PPS using the 'buy-to-let' analogy. Just like a 'buy-to-let' client, your client's main concern is having a tenant that pays the full rent. If the property price falls temporarily, it does not concern the landlord if the tenant still pays the rent. It is precisely the same for funds (apart from the fact managers have to publish the yields monthly), and existing clients need to ignore this as it's only relevant at the outset. A good income manager, therefore, is like a good property manager: ensuring that you buy in a good area, with the house or capital rising over time, with a good tenant who reliably pays the rent on time.

Return and Return Distraction

When it comes to performance, bucketing is not the answer. Put simply, income is income and growth is growth. If a client needs income, then they need income, and so your job is to maximise it. This often means prioritising the income account over the capital account if this is the client's primary need.

By placing more money in an income fund, you get more income - and placing less creates less income.

By placing cash into a 'safe bucket', you are effectively still selling units and not providing the client with income, which some may argue is delayed pound cost ravaging. You can potentially top this up with growth from the growth bucket, but this is reliant on growth even existing. We are not saying that natural income is a one-size-fits-all panacea for clients. Bucketing can play a part, but we do feel that if a client needs income, then you need to give them income - not (fingers crossed) growth.

Summary Points

- Some portfolios pay more income more consistently than others. Therefore, look for portfolios paying the most growth and do not tar every income portfolio with the same brush as the MPS providers.

- If a client needs £20,000 income per year and you can only generate £15,000, it's potentially better to give them £15,000 and sell £5,000 than give them £0 and rely on growth.

⇒ Your fact find will say that the client needs income. However, in your role as a distributor, you have ignored the manufacturer's advice and placed them in a growth product. If a client retired late last year and their adviser put them in an MPS or Vanguard-esque strategy with an arrangement for the frequent selling of units to fund income, they would not be happy if they later realise that there was an alternative solution designed for income that was naturally generating between 3% & 5% - and has done for 20+ years.

- Part two will consider the outlook for markets. Different commentators can create different arguments and counter-arguments on any market outlook, which includes income vs growth. While we can never be sure in which direction the markets will head, we can be sure that income clients require income, while growth clients require growth. Although it is tempting to use income for growth and growth for income, it is far simpler to select the best solutions for each outcome and use these accordingly.

QuantQual

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for Independent Financial Advisors

Part 2:
Why the market environment has changed and what this means for income portfolios.