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Investing For Income – Where To Now?

One of the often forgotten aspects of the Global Financial Crisis (GFC) is that the hardest hit investment group were investors wishing to generate income, as opposed to capital growth. This group of investors are usually retired, conservative in their outlook, and least able to recover from the shocks of capital loss. Today's income investors have been hit with a combination of record low interest rates, global meltdown of mortgage and credit markets, and loss of confidence in advisers and the finance industry.

What are the issues for the income investor?

Investment advisers who specialise in building cost effective and diversified income biased portfolios realise that New Zealand's limited investment market simply does not have enough suitable retail products to select. Income portfolios require a wide range of income producing assets if they are to meet the minimum requirements of diversification, liquidity, security and interest rate yield. These assets include:

- secured term deposits
- secured bonds and secured debentures
- listed bonds, senior bonds and subordinated bonds
- capital notes and subordinated capital notes
- redeemable preference shares and perpetual preference shares
- dividend paying ordinary shares
- residential and commercial property

The challenge facing advisers is accessing suitable investment products (at appropriate risk levels) available in the right quantities at the right time. The other challenge advisers have is convincing investors that some consumption of capital is acceptable during low interest periods of the cycle, and that some volatility in price is acceptable if the trade-off is extra liquidity and security. Tax is also a major issue facing investors and advisers. RWT rates have changed, PIR rates offer considerable advantages to some investors, and FIF rules have changed how overseas income is taxed in New Zealand.

As advisers, we have agonized over the correct approach to these issues. We have felt the consequences of the demise of the non-bank lending sector and all investors have seen the impact first hand of the GFC on mortgage funds, finance company debentures, property values and interest rates.

What are the options for the income investor today?

1. <u>Fixed Yield Securities</u>

   These include bank term deposits, non-bank deposits providing they have been accepted into the Government Deposit Guarantee Scheme (GDGS) (extended through to 31 December 2011) and secured Government and semi-Government stocks held to maturity.

2. <u>Tradeable, High Quality Debt Securities</u>

   These include corporate bonds and high quality capital notes. Our preferred method to hold these is in a pooled, managed Portfolio Investment Entity (PIE). PIEs allow the investor to access a pool of 20-30 of these assets, therefore diversifying the risk over many different institutions. As many of the better quality bonds on offer are only available to wholesale clients, PIEs are the only way a smaller retail investor can access them.

3. <u>Growth Assets That Offer Income In Addition To Growth</u>

   These include property where a rental yield is received in addition to long term capital growth, high dividend yielding shares and other corporate debt such a convertible notes. Our preferred means of holdings these depends on the asset. Property, for a passive investor, is probably best held via a property company that manages and administers a number of properties and/or tenants. Shares are best held via a PIE which specialises in high dividend yielding and tax effective companies.

How do Portfolio Investment Entities (PIEs) help the income investor?

PIEs were introduced by the last Government in order to ensure KiwiSaver investors were not disadvantaged when compared to direct investors. Although pooled, or managed, investment products are not new; they were mostly directed toward the growth investor who required a greater diversification of assets.

The benefits of income PIEs are:

- Investors can access a pool of very high quality, and very low risk income assets therefore spreading the risk of a failure in any one of the pool of assets.

- Fees for income PIEs are considerably cheaper than for a pool of growth assets. Management fees (MERs) for growth portfolios are typically 3.00% while the MERs for income PIES are often less than 1.00%, and as low as 0.50%.

- A good manager is able to access many investment opportunities on the wholesale market that are not available for retail clients. This ability to purchase income assets at cheaper prices often saves the investor more than the MER fee paid. The manager can add new investments when they come available and sell poor performing investments before they can harm the investors' return.

- Because all assets held in a PIE are tradeable, investor funds are effectively available for 'ready access'. Clients can add funds, or withdraw funds, as the need arises. This is ideal when investors' funds are coming available at different times or from different sources.

Many investors will have funds coming available from maturing deposits or the early payback of South Canterbury Finance debentures and bonds. By using a selection of Government Deposit Guaranteed deposits, income PIEs and selected investment-grade bonds you can compile a diversified, secure portfolio with very competitive rates. Capital growth, with income, is available through property syndicates managed by HFK and by using selected income PIEs.

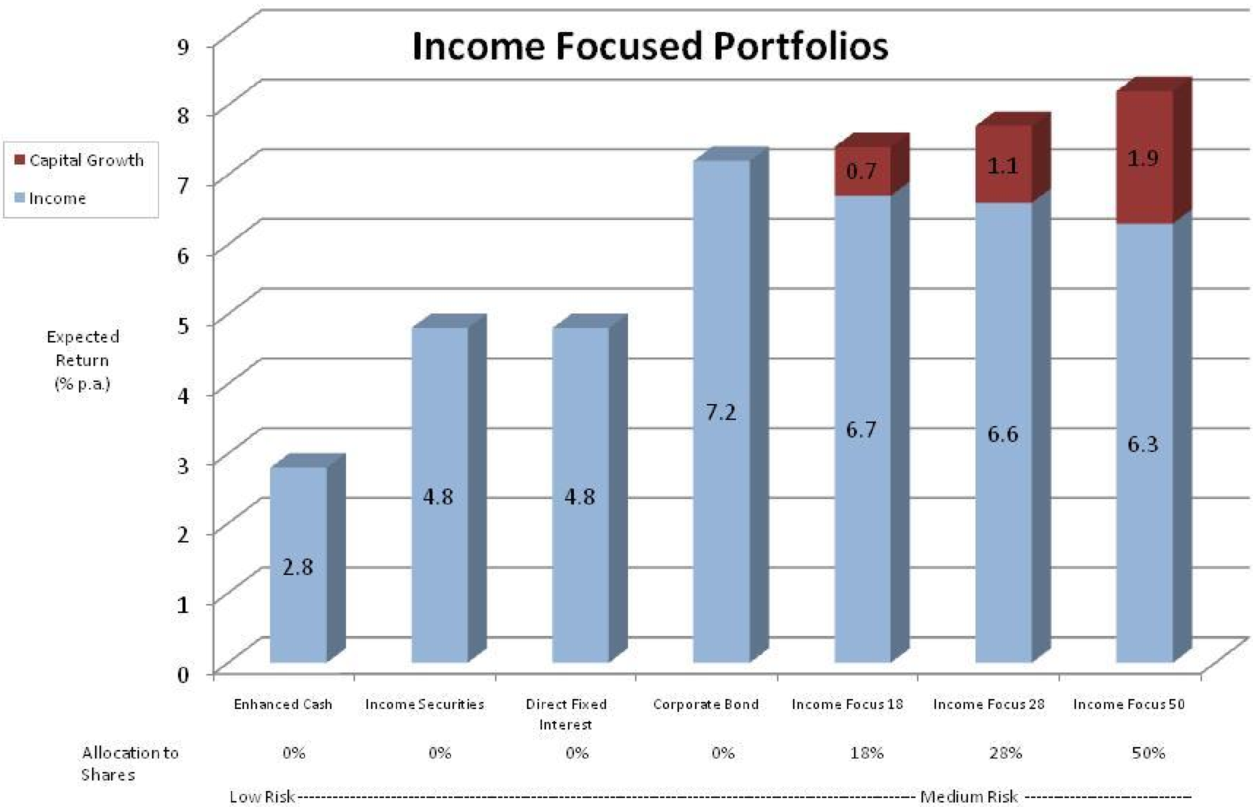
Please call Steve on (03) 964 4209 or Michael on (03) 964 4222 today.

Income Portfolio Investment Entities (PIEs)

Our preferred provider of income PIEs is Grosvenor Financial Services Group. David Beattie and his investment team have constructed a range of income portfolios to meet the demand for regular income streams. The seven portfolios all meet strict criteria of diversification, liquidity, security and interest rate yield.

Investment Option	Securities Held	Investment Return *
Enhanced Cash Portfolio (ECP)	• Portfolio of high quality, short term money market securities e.g. cash, bank bills & short term corporate securities	2.00% - 5.00%
Income Securities Portfolio (ISP)	• Portfolio of high quality, short term bonds, GDGS deposits & investment grade mortgages	4.50% - 6.50%
Direct NZ Fixed Interest	• Portfolio of Government & semi-Government stocks and high quality bonds	4.50% - 6.50%
Corporate Bond Portfolio (CB)	• Portfolio of high quality, medium term corporate bonds issued by leading banks & infrastructure companies with a minimum investment grade rating	6.00% - 8.00%
Income Focus Portfolios (IF18, IF28 & IF50)	• Three portfolios made from a combination of Corporate Bonds (CB) & high quality NZ dividend yielding shares	6.00% - 8.00%

** Expected range of investment returns for the next two years*



Case Study:

Mary is 65 years of age and has recently retired. She is receiving the Single, Living Alone New Zealand Superannuation of $16,536 per annum. She has $300,000 cash available from her company superannuation fund and her own growth portfolio. She requires extra income of $200.00 net per week to meet expenses, access to capital to fund holidays and house improvements, and she is wary of the impact of inflation on her spending power.

Solution

- provide $50,000 of 'on call' ready access investment to meet capital draw downs
- provide CPI inflation indexing of income equal to her weekly shortfall
- provide combination of fixed rate and floating rate quality investments to protect against interest rate risk and credit risk

Recommended Model Portfolio (taxed at 17.50% rate)

Income Investment	**Sum Invested**	**Interest Rate**	**Term**	**Capital Growth**	**Net Income**
Income Securities Portfolio	$ 50,000.00	5.00%	On Call	-	$ 2,062
Income Focus 28 Portfolio	$ 160,000.00	6.00%	On Call	1.50%	$ 7,920
Equitable Mortgages Deposit*	$ 20,000.00	6.50%	12 months	-	$ 1,072
Marac Secured Deposit*	$ 20,000.00	6.00%	12 months	-	$ 990
Property Syndicate	$ 50,000.00	7.00%	Fixed Term	5.00%	$ 2,814
Total	$ 300,000.00				$ 14,858

*GDGS applies

In addition to the $14,858 net income there is the long term capital growth provided by the shares portion of the Income Focus 28 Portfolio (28% allocation to shares) and by the growth of property value in the property syndicate. This is expected to average $4,900 p.a. If we assume Mary will draw down on her Income Securities Portfolio investment to fund her holidays and house improvements, then the core portfolio of $250,000 must meet her requirements. The net income produced from the core $250,000 is $12,796 ($246 per week), and the capital growth of $4,900 per annum is 1.96% of the core portfolio.

Result

Mary has been able to achieve all her objectives:

- she has ready access to $50,000 through the Income Securities Portfolio
- her core portfolio of $250,000 produces $246.00 net per week
- her core portfolio provides CPI capital growth of approximately 2.00% per annum
- the majority of her funds are readily accessible
- the portfolio is very well diversified amongst many of New Zealand's best institutions

A Disclosure Statement under the Securities Markets Act 1988 relating to Stephen Benton, Michael Shears & Roger Lewis is available on request and free of charge.