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'Income' funds – a good idea for conservative investors?

Among the biggest beneficiaries of new investment flows over the past year or two have been 'income' funds which mainly invest in interest bearing or rental generating assets such as cash, bonds and property and deliver much of their total return in the form of income (as opposed to capital growth). 'Income' is not a fixed definition but our broad definition includes funds categorised in the 'Income Funds' and 'Fixed Interest–Varied Specialist' unit trust sectors and these have attracted nearly R25 billion in net inflows from the beginning of 2004 to September 2005, fully 28% of all inflows. These flows have been driven by positive investor experience with excellent nominal and real returns being enjoyed, and have encouraged the launch of a number of funds to satisfy this investor demand.

The average investor places a high emotional premium on drawing from income, rather than capital, to fund expenditure and conservative investors place a very high value on minimising or removing the risk of capital loss. These psychological factors in investors have also contributed to the success of income funds, which are positioned to provide what investors want.

One needs to examine whether these returns are sustainable or likely to be repeated, and whether investor preferences are sensible and, if not, consider the alternatives.

- The returns on income funds have been fuelled by interest rates falling from their highest levels ever (with prime at 25.5% late 1998) to the lowest levels in 25 years with prime currently at 10.5% (you would remember that as yields fall the capital value of bonds and property rises). This has driven massive growth in the prices of these assets to the benefit of investors in 'income' funds. These circumstances are extremely unusual and the returns delivered by bonds and property have been well above their long-term averages – in fact multiples of long-term real returns. In addition, because yields have now fallen substantially, further falls of similar size are unlikely.
- The desire for income is largely emotional and can in fact impede rational investor behaviour. Drawing income (from a combination of capital and income or even capital alone) from a fund achieving a higher total rate of return for a given risk profile is logically better than looking to the level of income yield alone. This is even more so given that for most South African investors, capital gains are taxed at a lower rate than interest or rental.
- Investors wishing to maximise returns for a given level of risk (or conversely minimise risk to achieve a desired return) are well advised to do so by diversifying their portfolios, which in practical terms means investing in a combination of assets whose return characteristics are uncorrelated with one another. The problem with a typical 'income' fund is that the assets it invests in – bonds and property as well as cash – are in fact highly correlated with one another.

So what is the alternative for an investor seeking an investment that will maximise total return to fund his or her income needs at very low risk of capital loss? We would suggest that they should look to a fund that has the flexibility to invest in other asset classes, specifically equities that are less or inversely correlated with cash, bonds and property – and a manager that can do so with demonstrable skill. In fact it is this sort of investor for which the Allan Gray Stable Fund is most suited – despite the fact that it is categorised a Prudential – Low Equity fund. The table below illustrates the point.

The 'Max. drawdown' figures represent a simple and intuitive measure of risk (although not the only such measure) and calculates the historical risk of capital loss as measured by the maximum cumulative drop from a peak in fund performance to the following trough, using monthly prices. This is important because investors cannot always time their withdrawals and wait for losses experienced to be recovered over time.

Period to 6 January	**5 years**		**3 years**	
	Cumulative return %	**Max. drawdown %**	**Cumulative return %**	**Max. drawdown %**
Allan Gray Stable Fund	**115.6**	**2.0**	**57.0**	**1.9**
Fixed Interest-Income simple average	67.0	3.3	32.9	2.1
Fixed Interest-Varied Specialist simple average	66.8	4.1	34.4	4.5
Sectors combined simple average	66.9	3.7	34.6	3.5
Allan Gray Stable Fund rank out of selected funds	1 of 17	4 of 17	2 of 30	18 of 30

Source: Profile Data

The only fund in these categories that outperformed the Stable Fund over either period is a fund that also invests partially in equities (achieved the return at a higher level of volatility and a maximum drawdown of 4.9%). The results show that, with the appropriate skill in stock selection and asset allocation, the addition of equities to the traditional income fund can enhance returns and even at the same time reduce risk of capital loss meaning that higher levels of income withdrawals can be sustained for a longer period of time without diminishing or depleting capital.

Commentary by Greg Fury, Chief Operating Officer, Allan Gray Limited

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