

The Search For Income

Historically low levels of interest rates on deposits have done little to stem the flow of cash which is seeking refuge from turbulent investment markets. But those who are dependent on savings income, particularly the elderly, are wondering whether there are better ways of generating returns on their savings. The short answer is "yes", but increased returns necessarily involve higher risk, so financial plans must be based on the all-important principle of diversification.

Deposits

Better rates are available from banks and building societies for larger sums – often £30,000 and over – and there is usually a requirement to tie up the money for at least two years. Instant access accounts are being penalised; and some offers are open only to savers aged 50 and over.

The recent experience of the Icelandic banks reminds us, however, that it is important to check that the institution offering the attractive rate is covered by the UK Financial Services Compensation Scheme.

ISAs

Some of the best rates are available on cash ISAs, not least because ISA savers tend to be less prone to switching. The fact that ISA returns are tax-free also helps. Only half the £7,200 annual ISA allowance may be invested in cash ISAs, but couples can invest £3,600 each. There is also the facility to switch from cash to stock market funds at a future date (though not the other way around).

Government bonds (gilts)

Gilts were one of the few investment sectors which out-performed in 2008, but some pundits have been warning that the effect of the massive Government funding programme aimed at stimulating the economy may make gilts a danger area for the future.

Corporate bonds

Corporate bonds have much greater appeal and some offer returns of a magnitude which many fund managers consider over-compensates for the risks involved.

This is prompting them to move out of gilts into corporate bonds. However, the disparity in performance of different managers in 2008 underlines the importance of looking under the bonnet and checking the quality of the underlying investments. Some funds have been found to have been harbouring tainted holdings.

Arguably, the most appropriate type of bond fund for the long-term investor is a 'strategic' bond fund, which is not confined to any particular sector of the bond market but permits the manager to exercise his judgment as to the appropriate weightings in the light of changing market conditions.

Global bond funds

One of the other sectors which prospered during 2008 was Global bonds – that is to say, funds which invest in the fixed interest securities of overseas companies. Not least among the reasons for their success was the decline in sterling, which boosted the overseas earnings, but the decline of the pound may now have reached its low point, so currency considerations would appear to militate against placing fresh funds in this sector.

UK Equity Income funds

The UK Equity Income fund sector, which had traditionally been regarded as a core investment holding, has been badly mauled by the economic crisis, largely because of its exposure to banks.

The banks themselves remain a speculative play. The Barclays share price increased by 25% on a single day in March, but the downside could be equally dramatic.

Nevertheless, the yields on other UK equities are temptingly attractive, with the FTSE All-Share index yielding around 5%; half of which derives from non-bank stocks such as pharmaceuticals, tobacco and oil.

This has prompted some commentators to suggest that the time may have come to re-enter the sector, though others point out that companies are slashing their dividends to cope with the recession, and suggest delaying investing for a further six months.

One alternative might be to consider phasing in investments over a six month period.



Structured products

The term 'structured product' refers to any form of packaged investment which is based on securities derivatives such as financial options. Most structured products have a fixed term and offer a guarantee which provides protection of the principal sum invested if the product is held to maturity.

The credit crunch has demonstrated that structured products require particular due diligence, because their guarantees are only as good as the institutions which stand behind them. Providers of these products will usually seek to reduce this risk by having it underwritten by a number of other institutions, but this gives rise to the question of 'counterparty risk', that is to say the risk that one of the parties to the agreement may default on their obligations. It is therefore important to ensure that structured products are covered by the Financial Services Compensation scheme.

National Savings

The interest rates available on National Savings Investment and Savings accounts are unexciting, but for the growing number of people who believe that Government policy is stoking up inflation, Index-Linked Savings Certificates could be attractive. These provide guaranteed index-linking plus 1%, tax-free, but they are not suitable for those requiring a regular income.

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The value of units and the income from them may fall, as well as rise. Investors may not get back the amount originally invested

CLAIRVILLE YORK LIMITED, THE BELLBOURNE, 103 HIGH STREET, ESHER, SURREY, KT10 9QE
TEL: 01372 470477 – Fax: 01372 469777 – E-MAIL cyfsl@cyfsl.co.uk
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