

## Converting cash sums into monthly pay cheques: rational income investing in a post-QE environment.

### November 2022 update with 2021 income and capital records

- Equities have two sources of return: capital and income. Commonly these are conflated, which is an error because the capital volatility hides the income stability
- Sequence risk is largely irrelevant to a retiree deriving income from dividends paid out by a portfolio of investment trusts. This is because shares are never sold to generate income, so no loss is ever crystallised

**We define risk as the % likelihood that an investment will fail to do what an investor expects**

- Traditionally, the 0% equity portfolio would have been seen as the least risky and the 80% equity-heavy portfolio the riskiest, yet this is not borne out by historical results
- Stretching back to 1974, the major generalist investment trusts demonstrated a 100% track record in paying annual income and a 89% track record in continual annual dividend increases
- A Monte Carlo chart is of limited use in reassuring retirees they will be able to pay their gas bill

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## Executive Summary

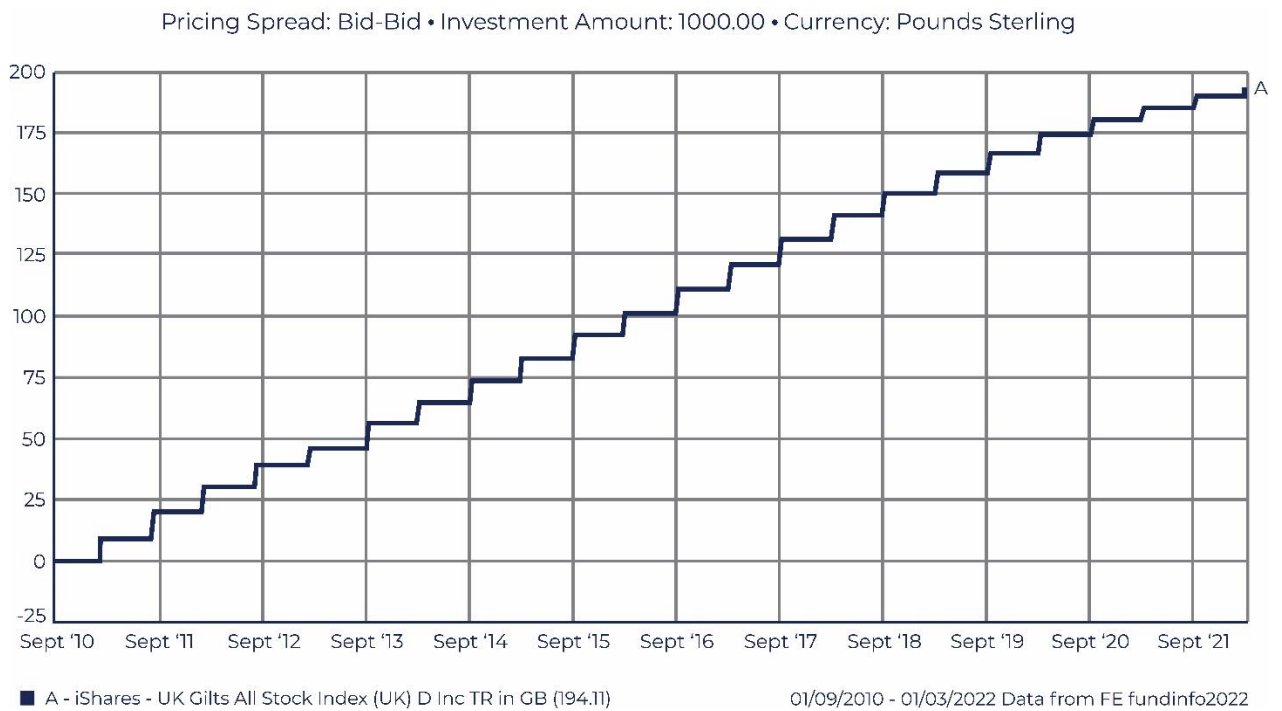
Investing with a primary objective of delivering income to pay for monthly living expenses, needs to match the confidence of monthly outgoings to confidence in monthly income.

Where there is no pension scheme taking on the responsibility to deliver that monthly income, an individual retiree must ensure that the investment itself is sufficiently reliable to meet this single, personal need.

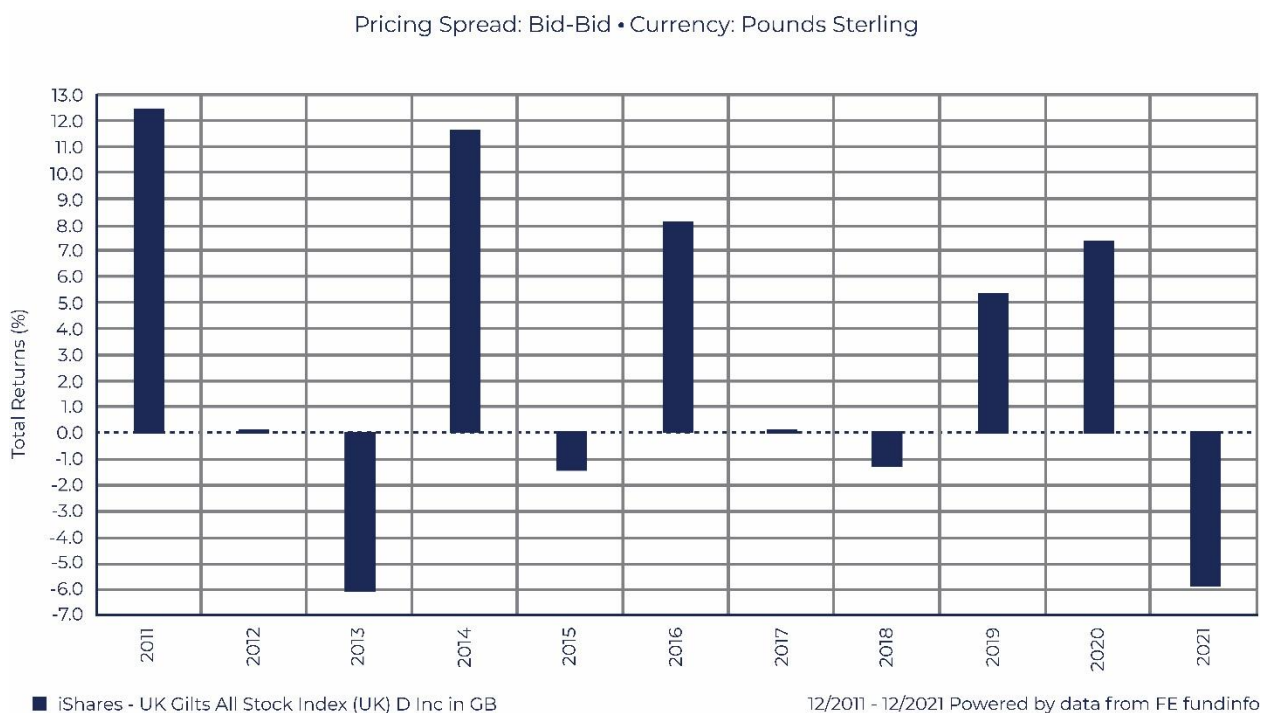
The largest single stumbling block appears to be the continued conflation of income and capital returns, and the continued promotion of a single badge for both risk of an asset and return on an asset.

This is simple to understand using gilts, comparing their income to their capital price, shown on the following charts.

## Income paid out from iShares UK gilt index



## Market price of iShares UK gilt index

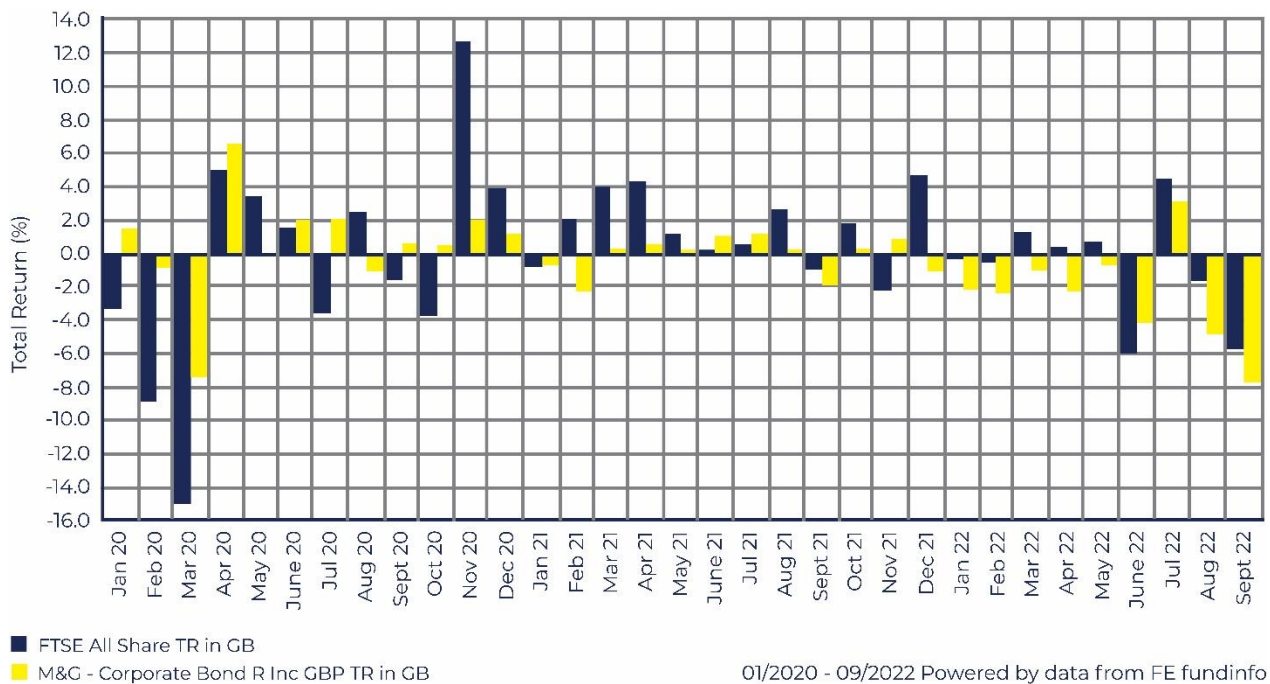


The lack of correlation between income and capital was demonstrated clearly by positive dividend returns throughout 2020's covid falls and continued throughout 2021.

- Of the major trusts tracked by Chancery Lane, the payment record remained at 100%, with only one making a reduction in 2020 – Temple Bar reduced its payout by 25%.
- Of the 33 months since January 2020, the FTSE All Share index has fallen 16 times, or 48% of the time, making passive index investing a stressful and unreliable method of creating income.
- The M&G Corporate Bond fund, as our bond market proxy, also fell in 16 of the 33 months

The performances above show that over this period of lively investment volatility, investment trust dividends were constant, and outperformed income via total return of both low cost passive trackers and the traditional 60/40 portfolio.

### Month by month values of FTSE All Share & M&G Corporate Bond – Jan 20 to Sept 22



## Introduction

Today's post-QE environment has been defined by interest rates at record lows, UK gilt yields below 1% and more than \$18 trillion of negative-yielding debt held in investment accounts around the world. Investing for income in retirement against that backdrop has never been more challenging and on top of that, 'pension freedoms' from 2015 have enabled retirees to pass on their pensions free of inheritance tax, as opposed to leaving their pension savings to a pension company. (And about time too.)

There is a solution to the need for reliable income.

Having analysed investment data spreadsheets supporting a number of popular retirement strategies back in 2019 (both backward and forward looking) we published our first findings then that compared the key alternative approaches to investing for income.

As an independent firm we do not run our own funds, and our research is both continuous and focused on running the maths behind the track records of the alternative strategies: passive, 60/40 and natural income.

Investment trusts have a rare ability to support dividend payments as balance sheet reserves can help to provide a stable income to those who have waved a fond farewell to their former stable income – their monthly salary. It may not be sexy, but it is definitely the more *'reliable boyfriend'*.

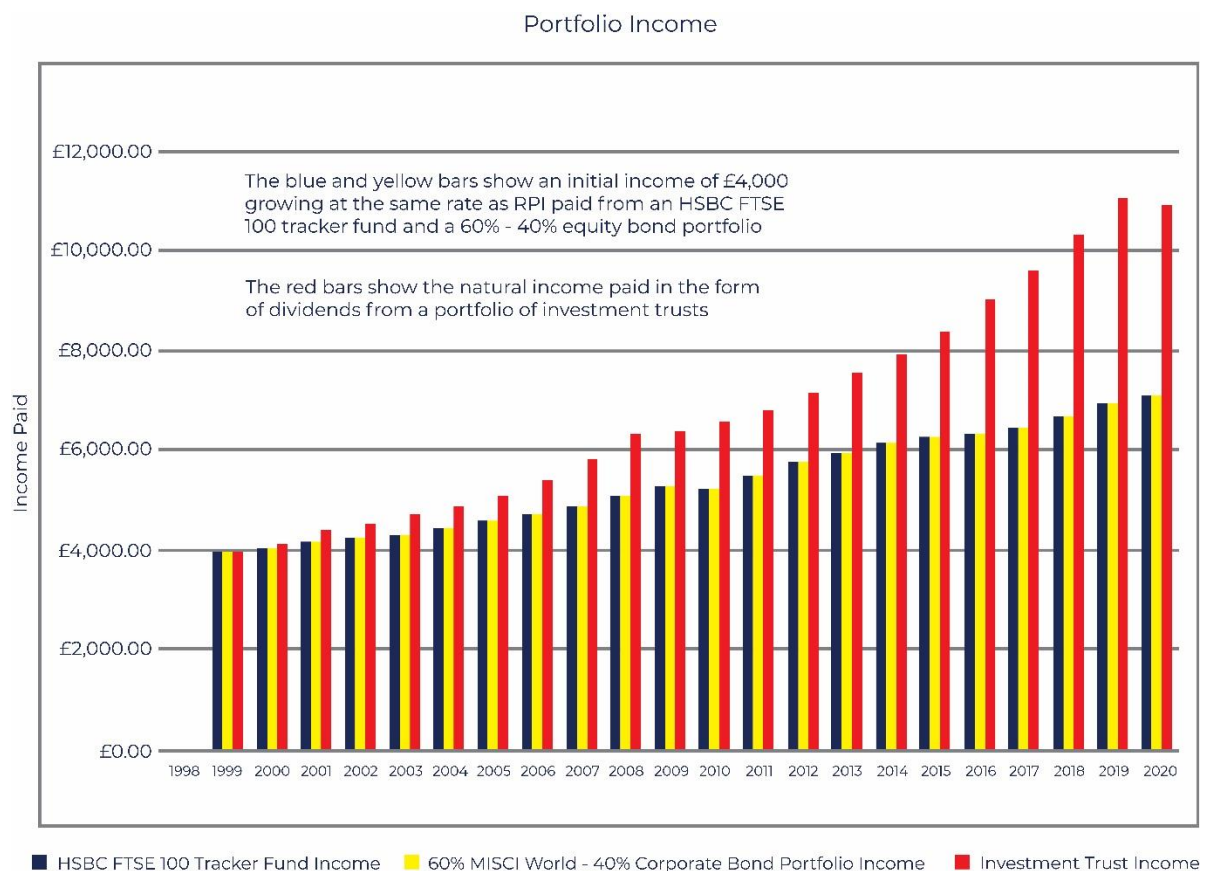
## Comparative evidence of drawdown investing strategies

### Income

- Does the American 'SafeMax 4% Rule' work in the UK?
- Do low-cost trackers give more income?
- Do traditional 60/40 portfolios still work?
- Will my money run out?

With a £100,000 portfolio and a starting income drawn of £4,000, the bars compare the income of three common retirement strategies from 1999 to 2020.

- The blue bar represents the HSBC FTSE 100 tracker as the oldest common passive UK tracker
- The yellow bar represents the 60% MSCI World-40% M&G Corporate Bond portfolio
- The red bar shows the natural dividend income from a general investment trust portfolio created to generate £4,000 from year one



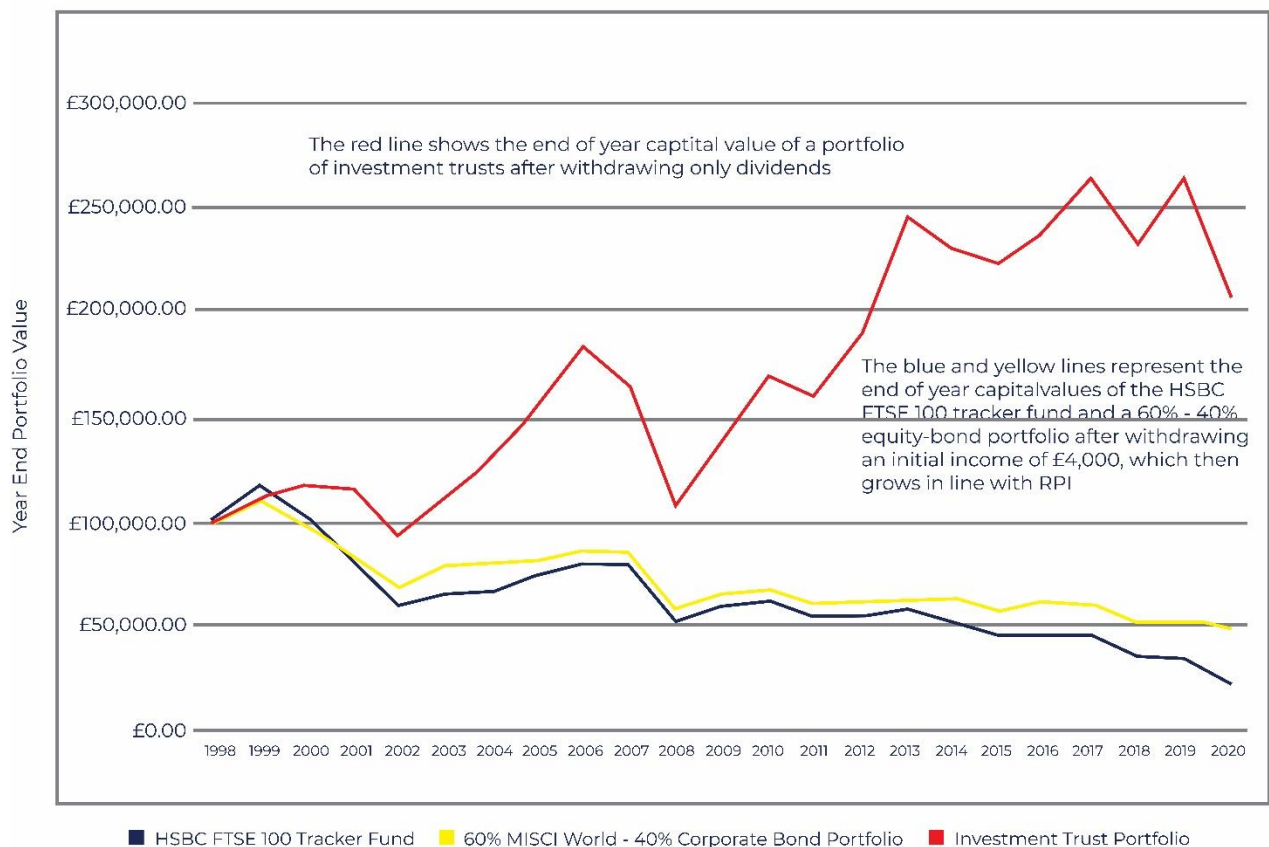
## Capital Growth

- Have equity/bond portfolios produced higher total returns?
- Do low-cost trackers produce more capital?
- Will my money run out?

With a starting investment of £100,000, the chart compares withdrawal rates of three typical retirement portfolios over the same 1999-2020 timeframe:

- The blue line represents the end of year capital values of the HSBC FTSE 100 tracker after withdrawing an initial income of £4,000, with that income then growing in line with RPI.
- The yellow line represents the end of year capital values of a 60%-40% equity-bond portfolio after withdrawing an initial income of £4,000, with that income then growing in line with RPI.
- The red line represents an investment trust portfolio made up of eight well-established investment trusts, purchased on 31st December 1998 at a total portfolio value of £100,000. This portfolio provides year one dividends equal to £4,000. The portfolio value is the value at the end of each calendar year after the withdrawal of any dividends paid.

Portfolio Capital Values



### Three key statistics

- **£1 trillion+** is currently held in money purchase pensions requiring Investment decisions to generate pension income <sup>1</sup>.
- **11 million investors aged 45+** in money purchase schemes require individual market sourced income, versus 7.1 million 'decision free' retirees In DB schemes <sup>2</sup>.
- **9 million people** will turn 60 over the next decade.

52% of all DC occupational scheme members are above the age of 45, yet little is being done to educate, guide and advise these 9.1 million pending retirees.

We propose the following investment assumptions need to be re-evaluated for today's low interest economy:

- If equity income is to act as a bond proxy, it should not be deemed as high risk and unsuitable for pensioners.
  - We believe volatility of Income and capital must be looked at separately
- Why is the US-modelled 4% rule still used so widely in the UK?
  - Historical rates of inflation and equity returns are very different, so the outputs of pension investing are not the same
- Why are models designed for institutional pension funds continually being recommended for individual investors?
  - Funds have regular cash inflows to offset pension payments and funds have multi-generational objectives. A crystallised private pension has one pensioner and no premium income so that pensioner's need for precise income is much more acute
- Investment income statistics are hidden by total return figures, thereby plastering capital volatility over the top of income stability.

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<sup>1</sup> ONS Pension Wealth background tables, Wealth and assets survey

<sup>2</sup> PPI Aggregate Model, PPF 2021



We invite you to consider the following questions:

***“Should I be thinking about capital growth, income generation or total return?”***

Equities have two sources of return, capital and income. Providers of investment solutions tend to present these together, calling it ‘total return’ – a technique adopted to simplify messaging for everyday investors.

We would argue that to do so is misleading because the capital volatility distracts from the stability of the income. The volatility of capital bears no relation to that of income.

***“Is a pension not a regular income in retirement?”***

A pensioner needs income, not capital: annuities and defined benefit (DB) schemes are seen by the Financial Conduct Authority (FCA) and Financial Ombudsman Service (FOS) as seen as the ultimate secure arrangements, yet both involve total loss of capital to the pensioner.

Put simply:

- Since 1990, the FTSE 100 and All-Share indices had individual annual capital gains in 66% and 70% of those 30 years, respectively
- Yet they had positive income returns in 100% of the same years
- i.e. while there may be no capital gain in a year, there has always been an income paid (although obviously that does not guarantee that there will always be an income paid in future years).

## In trusts we trust.

Sourcing income in a low % world leads us squarely to equity and property; investment trusts reign supreme as multi asset solutions for income reliability and predictability due to their accounting reserves.

Our research analysed 31 mainstream investment trusts over the period since 1974, one of the most volatile periods in the equity and bond markets since 1929, including 2000, 2008 and 2020.

In total, the research analysed 1,254 annual consecutive annual payments.

This analysis found:

- a dividend payment was never missed by any trust – we see this as reason for 100% confidence level
- the payment was the same or higher than the prior year in 97% of cases
- In 89% of cases, it was increased in every year.

The reasons for this consistency are not hard to find.

Dividends are set four times a year by the directors. Share prices, conversely, are moved every trading minute by unknown market traders and investors, so the share price volatility is always going to be completely different to that of the four dividends per year.

Like the underlying company holdings, the dividends from investment trusts are set and controlled by the publicly named directors and are based on actual cash receipts and liabilities. The directors have a legal responsibility to advise investors throughout the year how the profits and likely dividends are progressing via stock market announcements. Such accountability is another reason for our level of confidence.

Shares in the trusts tend to rise and fall in line with the value of the underlying holdings throughout the trading year, amplified by share trading in their own stock. This leads to little or no correlation with the stable dividends funded by the reserves.

- Investment trusts maintain revenue and capital reserves on their balance sheets and use these to support a smoothed dividend stream. As listed companies, the balance sheets are available to us for analysis and to monitor progression of items such as dividend /reserve cover.

These are examples of the value of dividend cover In two sample trusts, based on 2021 financial year, and 31/12/21 share price. Note, Scottish Investment Trust Is now merged with JGGI. Dividends per share are affected by share buybacks, splits and consolidations. Each trust Is Individual, with different quirks and strategies.

		2017	2018	2019	2020	2021	Ratio to divs
<b>British Empire (AVI Global) 0133508</b>	Y/e price	724.50	666.00	778.00	882.00	1082.00	
Dividend (p)		12.00	13.00	16.50	16.50	16.50	
Revenue/Income		£ 17,393,000	£ 22,638,000	£ 26,209,000	£ 15,157,000	£ 20,376,000	<b>1.41</b>
<b>Dividends Paid Out</b>		<b>£ 17,851,000</b>	<b>£ 13,817,000</b>	<b>£ 14,439,000</b>	<b>£ 14,439,000</b>	<b>£ 14,439,000</b>	
Revenue Reserve		£ 33,255,000	£ 36,371,000	£ 43,101,000	£ 30,941,000	£ 27,922,000	<b>1.93</b>
Capital Reserve		£ 781,555,000	£ 816,890,000	£ 807,421,000	£ 764,245,000	£ 1,016,811,000	<b>70.42</b>
<b>Scottish Investment (Now merged with JGGI)</b>	Y/e price	874.50	755.00	832.00	698.00	881.00	
Dividend (p)		25.00	25.20	30.25	23.20	24.40	
Revenue/Income		£ 25,898,000	£ 25,854,000	£ 28,859,000	£ 21,737,000	£ 21,761,000	<b>1.37</b>
<b>Dividends Paid Out</b>		<b>£ 21,095,000</b>	<b>£ 27,047,000</b>	<b>£ 19,800,000</b>	<b>£ 23,178,000</b>	<b>£ 15,908,000</b>	
Revenue Reserve		£ 56,104,000	£ 49,221,000	£ 52,080,000	£ 44,334,000	£ 43,759,000	<b>2.75</b>
Capital Reserve		£ 593,484,000	£ 555,308,000	£ 513,930,000	£ 423,402,000	£ 431,959,000	<b>27.15</b>

It Is the ratio of reserves and Income to dividends that allows Investment trusts to maintain and Increase dividend payments throughout market turmoil. ETFs, unit trusts, pension funds do not have this facility.

Income investors must always start investment analysis with their objective: generating income.

## Are investment solutions providers always using the right research models?

### Example 1

For decades, UK retail guidance on drawdown income risk tends to be based largely on data and models underpinned by US RPI and US equity performance. Many of these models use assumptions based on a so-called '4% rule' of income drawdown in retirement.

What is the 4% rule? US academic and ex-financial adviser Bill Bengen coined 'The SafeMax 4% Rule': a loose rule of thumb that suggests 4% of a total portfolio on day one of retirement is a safe withdrawal rate – that sum is then increased in line with inflation & the money never runs out.

Our biggest bugbear with UK financial services providers using models based on US data is simply that they are not comparing apples with apples. We understand why – it's because there is such a huge amount of Investment research carried out in the US, so it's far easier to come by.

But take these simple examples:

- On 31 May 2021 the yield on the FTSE 100 was 3% while the yield on the S&P 500 was less than half that, at just 1.37%.
- Over the past 60 years UK average RPI is 47% higher than in the US

US data is quite different from UK figures so the outputs of investment modelling in the two countries are not the same, and we believe it is dangerously misleading to suggest otherwise.

## Example 2

You may or may not be familiar with the term Modern Portfolio Theory, or MPT.

MPT was prescribed in the 1950s by leading US economist Harry Markowitz and – in very simplistic terms – defines the theory of portfolio diversification, or not putting all your investment eggs in one asset class basket.

Proponents of MPT ignore the fact that Markowitz pointed out this theory was relevant for open-ended mutual funds, and not for the individual retail investor. Indeed, he has been quite vocal about his decision to ignore it for his own personal pension planning.

MPT can be paraphrased in many ways including:

- risk = potential for gains = stocks and shares, and then,
- protection = potential to counter the risk = bonds.

Interestingly, this theory also assumes the bond portfolio will be the primary source of income.

We appreciate this theory may be useful when applied to an open-ended, professionally managed **collective investment fund** seeking to grow in value over the long term.

We would however argue against its relevance for an individual's retirement plan (as Markowitz himself did), not least because a person facing retirement will undoubtedly have a main objective of a reliable income stream (there's that monthly pay cheque again), not capital growth.

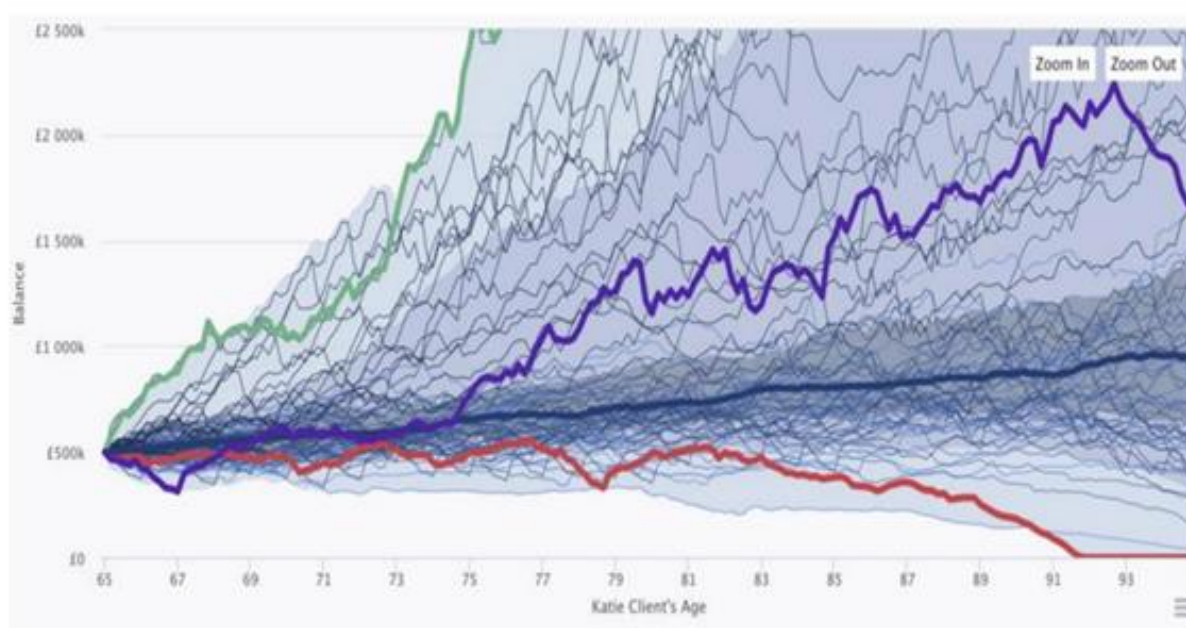
Their need is an income that securely matches the regular outgoings they face on daily, monthly and yearly. A traditional fund manager will work with different objectives and different structural cashflows.

### Example 3

The phrase 'Monte Carlo simulation' is yet another jargony term used across the investment profession and refers to a model used to demonstrate likely investment outcomes for individuals. These models simulate typically tens or hundreds of thousands of scenarios and potential outcomes, and sit behind many computing model-based investment tools.

The issue we propose is that a typical simulation will throw up a wide range of possibilities: in the example below, to the tune of £1 million leeway, yet we know our living expenses don't have the same broad range of possible outcomes.

The industry often talks about liability matching. We therefore believe a more stable and reliable income model is needed in retirement rather than an approach that, at best, delivers a distribution graph when retirees need a cashflow budget.



A typical Monte Carlo simulation, such as this, tells Katie that by the time she reaches 80 years old, she may have a retirement pot valued somewhere between £1.4m and £400,000 – a level of anxiety one would hope for ever, never mind age 80.

A range of plus or minus £1 million is not particularly useful for planning how to meet life expenses in old age.

## In summary

What we have outlined here are just a few examples of the shortcomings of models that, in our opinion, are all too common. What they all lead to, from various perspectives, is that risk of loss to a US-based, large financial provider is not the same as risk of loss of income to a UK-based pensioner.

We have questioned for some time the industry's accepted definition of investment risk. Typically, risk is defined as volatility, the amount by which an asset moves in relation to its own historical value or to other assets. We believe that is wrong, misinterpreted, and misleading.

- Why does the investment industry continue to hide annual income stability under capital volatility?

The FCA defines risk this way:

We consider risk to be the combination of impact (the potential harm that could be caused) and probability (the likelihood of the particular issue or event occurring).

- Note: F&C investment trust has never failed to make a dividend payment, in any year since it started in 1868.
- The UK government technically defaulted on War Loan and inter-allied debt in 1932.
  - ...suggesting the likelihood of F&C failing to pay a dividend is less than the likelihood of the UK government defaulting
  - ...leading us to think the FCA ought to be happy with F&C as a reliable source of income to pensioners, surely?

We challenge that definition to go further. If the regulator views risk as the percentage likelihood of an occurrence, and the potential harm that would cause:

- What is the percentage likelihood of income being cut or lost?

- Is the loss likely to be permanent or temporary?
- Will that loss have a material impact on the investor's lifestyle?
  - Is that loss likely to be permanent or temporary?
- Does a likely capital loss impact on the investor's income?
  - Is that loss likely to be permanent or temporary?

As advisers on regulated investments, we would define risk as the likelihood that an investment will fail to do what an investor expects, measured as a percentage.

The concept of known and unknown risks and factors are not new. Risk and uncertainty are not the same thing yet are often talked about as though they are.

If a risk is known, it can be planned for, worked around, and managed accordingly. Uncertainty makes that more difficult.

We emphasise the distinction between market volatility, which is predictable, and a permanent loss of capital, often lost through poor judgment.

We draw the following analogy...

- Tides rise and fall every day, with roughly six hours between each rise and fall. There is no risk that the tide will not come in, or when that will be: both are as certain as anything can be.
- An angler cut off by the tide, stranded on a sand bar, has made an error of judgment, not an error of fact. The risk was not that he would fail to predict that the tide would come in, but that he would fail to predict *when*.

The rise and fall of stock markets is as certain as the tides. The difference is that nobody has yet found a way of predicting when those rises and falls will occur. That the markets will rise and fall is a certainty, not a risk.

But, like the angler, an investor facing a loss has made an error of judgment, not of fact. The risk was in miscalculating the investment period, failing to diversify or trading at the wrong moment, not that the market would rise and fall – that was always guaranteed.



Like markets moving up and down, tides rising and falling are a certainty, not a risk.



## How not to run out of money

Apologies, but yet more jargon ... sequence, sequencing or sequence-of-returns risk can become particularly toxic when a retiree makes withdrawals from a fund's underlying investments to generate an income. This is why in the modelling we outlined earlier, our examples were comparing only the drawdown of dividends (or 4% of the portfolio) and not withdrawals from the base capital.

What we mean is that if a high proportion of negative returns occur in the beginning years of a retirement, there will be a lasting impact on the portfolio, reducing the amount of income generated over the lifetime of the retiree. This is the principal concern surrounding sequence risk – severe early losses of capital are rarely caught up later, leading to future income having to be cut to prevent capital from being exhausted.

Our philosophy is to seek to avoid sequence risk by looking for sources of income that have demonstrated minimal 'down volatility' for 30 years or more, a period that should be sufficient to cover the lifespan of the 'average' retiree.

Taking withdrawals locks in both losses and lower future profits, with the biggest losses hitting hardest when they occurred in the early years – a vital consideration for anyone taking withdrawals from an investment.

- With equities, a dividend is paid to each individual share; if you sell a share, you will never receive any more dividends from it.
- If sell some of your shares every year to generate cash to draw, you will always have less shares than you started with at the beginning of the year.
- To maintain the value of your portfolio over your decades of retirement, you need the remaining shares to grow enough to make up for all the shares you no longer have – and each year you compound the problem by selling more!
- When the share/fund/market price fall in value, you need the price to rise again to get back to where you started, PLUS you need extra growth to replace the value of the shares you sold.

- The FTSE falls in roughly 26% of the years; if your portfolio falls by 15% from £100 to £85, it then has to grow by 17.65% just to get back to where it started.
- If you draw £4 as income reducing your fund to £81 then you need 23.4% growth just to get back to where you started.
- Pensioners normally deal with this problem by cutting their pension income to protect their capital.

Natural income leaves the capital intact and must therefore be the least stressful, more predictable solution.

Capital and Income Summaries: 22 years to Dec 2021				
Source	Method of Withdrawal	Income Totals		Final Capital Values
HSBC FTSE 100	4% of Fund	£77,168		£84,047
	£4,000 Fixed	£88,000		£62,565
	£4,000 Increasing annually at RPI	£118,196		£22,914
MSCI World	4% of Fund	£91,437		£160,693
	£4,000 Fixed	£88,000		£146,250
	£4,000 Increasing annually at RPI	£118,196		£82,656
60/40 Split	4% of Fund	£82,931		£114,318
	£4,000 Fixed	£88,000		£98,022
	£4,000 Increasing annually at RPI	£118,196		£48,562
IT Portfolio	Natural Income	£151,133		£206,702
RPI annuity	Male, 65, No Spouse, no guarantee, RPI linked	£187,045		£0

In the table above perhaps the investment trusts have an unfair advantage due to the reserves and the directors' oversight, compared to the naked market returns that are simply determined by the market's daily traders and investors.

There is no guarantee that the future will repeat the past, but in the period examined our research shows that investors in such an IT portfolio would have ended up with substantially more income and capital at the end of the period examined.

- The period covered thirty five years which is longer than the expected retirement life span of twenty eight years.
- The period covered market falls of more than 10% in 1990, 2001, 2002 and 2008, and includes the three consecutive falls of 2000, 01 and 02.

- Average UK Interest rate Influencing the annuity rates was 5.4%.

The evidence displays that there is no correlation between the volatility of investment trust shares and the dividends they pay to investors. This is counter intuitive and not well recognised by investors. It is therefore wrong to assess the risk of the trusts to an income investor as that within the share prices, as that error may well exclude investors from perhaps the strongest investment solution available to them.

Modern Portfolio Theory is not applicable for individual income planning at retirement, other than to ensure diversification.

In conclusion, even light examination of the statistics reveals simple results:

1. Risk in income is not the same as risk in capital
2. It is illogical to apply fund management techniques to individual cashflow plans, at retirement
3. US investment data spawns arithmetic US drawdown conclusions that do not apply to the UK investor
4. Sequence risk is the most destructive risk when an investor is drawing income, and that risk is removed by using natural income

Having had institutional risk descriptors as the backbone of the definition of 'retail investor risk' for so long, it is not appropriate to miss out an interactive discussion about expectations, risk to income, risk to capital, emotional decisions and timescales, between adviser and investor.

**Traditional use of Institutional Investment strategies focuses on telling investors what their asset allocation is whereas retirees are more interested in knowing what their monthly income will be.**

The simplicity of the natural income approach is more predictable, more valuable and – ultimately – more reassuring for investors, particularly those retired. It meets what is required by most pension drawdown investors – an income for life, rising each year to counter inflation, with a good degree of certainty, whilst retaining some or all capital to be passed on as required. The outcomes meet investor expectations.



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