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Investing to generate an income

At one point or another in your investment journey you may want to draw an income from the capital you're accumulating. Ideally, this will be part of your financial plan and might include things like taking a break from work or paying for a child's tertiary education. Or you may be getting closer to retirement, and investing to ensure that once you retire, you have extra income over and above what your pension or provident fund will be paying you.

To achieve these goals, your investment portfolio should include unit trust funds that are aimed at income generation, not solely at building up capital. This is because you want to avoid withdrawing funds from your capital growth vehicles in order to benefit fully from the positive impact of compounding returns over time.

What type of funds should you be considering that will help you generate an income that's higher than a simple bank deposit over time?

Considering enhanced income funds

Enhanced income funds can be a smart solution. These funds aim to deliver a high level of regular income that will beat a cash or money market return over two to three years. How do they do this? By investing in a combination of assets that give investors both:

- a steady income stream, and
- some capital growth over time.

These assets include cash and bonds for income, and can also hold smaller amounts of growth assets like listed property and even some equity. As such, enhanced income funds are classified as multi-asset funds, and are riskier than pure cash or money market funds.

Looking at market returns for 2022, both local bonds and cash outperformed equities. This made the [M&G Investments Enhanced Income Fund](#) well-positioned for the year, since it held no equity. It did, however, hold a small percentage of listed property in addition to a selection of bonds and other fixed-income instruments. The benefit of investing with an active manager like M&G Investments is that the investment team adjusts the weighting of different assets in their funds on an ongoing basis according to their mandate (return and risk parameters), so investors don't have to.

Partly because of their high bond holdings, returns from enhanced income funds reflect the interest rate cycle. They tend to outperform money market and cash returns over periods of two to three years and longer, but there are shorter-term periods (one year or less) in which they are expected to underperform, and do so. This is generally during rising interest rate cycles. Longer-term investors are rewarded for taking this risk.

This is why we believe it's important for enhanced income investors to have an investment horizon of between one and three years. We view this timeframe as essential in achieving the additional returns over cash and money market instruments.

The risk of switching

The M&G Investments Enhanced Income Fund generated a healthy return of 6.2% (net of fees) for 2022, meaningfully outperforming cash investments -- the STeFI Composite Index, a common measure of cash performance, returned 5.2%. However, there have been periods of temporary fund underperformance. Unfortunately, as interest rates have risen in the past year, we have seen investors make the mistake of switching away from their enhanced income fund in favour of money market funds or a one- or two-year bank deposit offering slightly higher future returns.

There are two risks with this strategy: first, investors lock in the short-term underperformance. Second, when the bank deposit reaches maturity after one or two years, the interest rate cycle will have turned so that interest

rates will be falling – the investor will have missed out on potential gains from the enhanced income fund and will be forced to move out of the bank deposit and reinvest at lower rates. This “reinvestment risk” needs to be taken into consideration.

Consequently, even though it may be tempting to switch, income investors should try to weather any short-term relative underperformance and stick with enhanced income funds. In the end, steady investors should be rewarded with a higher return than that from a bank or cash deposit, helping them achieve their investment goal.

For more information or if you have any questions, please contact your financial adviser, or feel free to get in touch with our Client Services Team on 0860 105 775 or info@mandg.co.za

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