FactFile

Income funds:

what you need to know

This fact file is designed to help you understand how income funds work, and the effect of interest rates and credit markets on this type of investment.

What is an income fund?

'Income fund' is a term that encompasses a variety of investment vehicles that pool the resources of a group of investors to invest in income-earning assets such as bonds and even mortgages. There are many different types of income funds, but for simplicity we will focus on those that invest in government and corporate bonds.

Investors purchase units in income funds just as they would for any kind of managed fund. As the name suggests, traditional income funds are designed to provide investors with regular income (in the form of interest payments) while keeping the capital value relatively stable. Generally, capital growth is not a priority.

How are term deposits different to income funds?

In contrast to income funds, term deposits are effectively a loan made by an individual to a bank or other financial institution. The bank gets the principal to invest, and the individual receives interest payments, which are calculated as a fixed percentage of the principal. At the end of the loan term, the principal is repaid as a lump sum plus the interest earned.

Term deposits are locked in for a set period of time and at a set interest rate. This means the return will remain stable for the fixed term, no matter what happens to interest rates. In contrast, the returns received by investors in income funds vary as interest rates fluctuate and the capital values of the investments held by the fund change.

When investing in term deposits, the main risk is that you could miss out if a higher yielding opportunity arises during the time your money is tied up in the term deposit. However, the potential for capital loss when investing in term deposits is very small, and would only occur in the rare event that the financial institution holding the term deposit failed and could not repay the loan.

It is also worth noting that term deposits of $1 million or less are usually subject to the Australian Government guarantee on deposits.

What influences income fund returns?

Three main factors influence the returns delivered by income funds. The first is the 'yield' (interest rate) of the bonds or assets held in the fund's portfolio. The second is the capital value of those bonds or assets. These factors are discussed in more detail in the following section. The final factor is defaults. Just as there is a risk (however small) that you could lose money invested in a term deposit if the borrower (bank or financial institution) closed, you could also lose money in an income fund if the borrower (bond issuer) had financial difficulties and defaulted on the bond interest payments. This helps explain why diversification is important when investing in income funds. Income funds generally hold bonds from a large number of companies, which helps to minimise the risk of defaults.

Of course, these are general concepts only. Each income fund has a different management style, structure and investment strategy.

Understanding bonds

It is important to understand the link between the bonds an income fund invests in and investment returns. This is because the unit price of an income fund is determined by the values of the bonds it holds.

Bonds are loans to a government or company (including banks). In return for lending the money, the lender receives an agreed rate of interest, known as the 'coupon payment', for a specific period of time such as three, five or 10 years. Coupon payments are calculated as a fixed percentage of the amount lent. At the end of the term, the principal lent is repaid as a lump sum. In this way, bonds work in a similar manner to term deposits, however unlike term deposits, bonds may be bought and sold throughout the term.

What is a yield?

The yield of a bond is the annual return (interest paid) on the investment expressed as a percentage of its purchase price or current market value. For example, if you purchased a $100,000 bond that was paying a coupon of $5,000 per year for 10 years, the annual yield would be $5,000 ÷ $100,000 = 5%.

If you wanted to calculate the current yield of a bond, you would divide the coupon payment by the current market value of the bond. If we use the example above, but assume the bond's value has risen to $150,000 because the yield it pays is greater than that offered by new bonds on the market, the current yield would be $5,000 ÷ $150,000 = 3.3%.

Bond yields change constantly, influenced by factors such as the risk of investing in the bond and the bond's term to maturity.

What is a running yield?

At any time, an income fund can hold a number of different bonds bought from different borrowers for different terms and with different yields. The average interest rate across all the bonds in a fund's portfolio is expressed as a percentage, and is known as the 'running yield'.

What factors affect bond yields?

Two major factors influence bond yields: interest rates and credit spread.

Interest rates

When the Reserve Bank of Australia (RBA) changes the official cash rate, there is a flow-on effect to income funds. This is because the price of bonds rises and falls in line with interest rates. As the bonds an income fund holds reach maturity and are paid out, the fund will need to purchase new bonds. These new bonds will be purchased at the prevailing rates, which could be higher or lower depending on the economic environment at the time.

For example, when the RBA cuts the official cash rate, the yields offered on new bonds will generally fall. This will have the effect of lowering the income fund's returns as the new bonds purchased will be paying lower yields than the existing bonds held by the fund.

Conversely, if the RBA increases the cash rate, the income fund's returns will usually increase, as the new bonds purchased by the fund will pay higher yields.

Credit spread (risk margin)

When purchasing a bond, lenders take into account the risk of an individual borrower defaulting. The level of credit (default) risk determines the interest rate a company must pay to borrow money. The higher a company's credit risk, the higher the interest it must pay to its lenders.

Governments are usually considered the lowest risk borrowers. So when lending to borrowers that are considered riskier than governments, lenders expect a bigger reward and demand a margin, known as a 'spread', over what government borrowers are charged. The 'credit spread' is the difference in interest rates between what's known as the 'risk free rate' (the interest rate on government bonds) and non-government bonds.

The credit market turmoil that emerged in mid-2007 and remains in 2009 has resulted in lenders demanding more credit margin from borrowers, even those traditionally considered lower risk, such as banks. This situation is known as a 'widening credit spread'. Widening credit spreads are bad news for borrowers – as they have to pay more to secure loans – but good news for investors who can purchase new bonds with higher yields. While the tightness in credit markets did improve slightly during late 2008 and early 2009, investors are still demanding wider spreads than historical levels.

What factors affect the capital value of bonds?

In this context, the capital value of a bond refers to its market value at a particular time. That is, if the bond was sold today, what price would it be sold for? This price could be higher or lower than the fund originally paid. As already discussed, factors such as interest rates and credit spreads influence the capital value of bonds.

In a climate where interest rates are falling, the capital value of existing bonds rises. This is because the new bonds available are offering lower yields, and therefore lower investment returns. This increases the price the existing bond could be sold for, and hence its capital value.

Conversely, if interest rates are rising, the capital value of existing bonds falls. This is because investors can purchase new bonds with higher yields, thus reducing the price the existing bond could be sold for.

When the capital value of the bonds held by an income fund decreases, the unit price of that fund will also fall and returns will be lower. The reverse is also true. If the capital value of the bonds a fund is holding rises, the fund's unit price will increase and returns should improve.

The market volatility seen since 2007 has created a climate of fear in investment markets. Lenders' uncertainty about borrowers' credit risk has been reflected in unstable credit spreads. Widening credit spreads have the same effect on the capital value of existing bonds as rising interest rates, decreasing their capital value, while narrowing credit spreads have the same effect as falling interest rates – increasing the capital value of existing bonds.

Interest rates increase and/or credit spreads widen	New bond yields ↑
	Capital value of existing bonds ↓
Interest rates decrease and/or credit spreads narrow	New bond yields ↓
	Capital value of existing bonds ↑

How do you compare term deposits rates with income fund returns?

Comparing current term deposit rates with income fund returns does not provide a valid comparison. This is because term deposit rates are forward looking (advertised at current interest rates), whereas the returns stated for income funds are historical. To provide a more accurate comparison, you should

compare the rate for a one-year term deposit with the income fund's running yield. This will provide a useful comparative measure of the performance of both investments.

What opportunities are emerging for investors?

Due to the current credit market issues and many lenders' aversion to risk, companies are still being forced to offer relatively high credit spreads (interest rates) compared to official cash rates to attract investors.

This situation is creating significant opportunities for investors and fund managers. As the bonds held by a fund reach maturity and the principal is repaid, the fund can reinvest the interest and principal in new bonds from sound and reputable companies that deliver higher income. As these higher yielding bonds enter income funds' portfolios, running yields (and hence returns to investors) will increase. Given we are now more than 12 months into tighter markets, running yields have shown an improvement.

Important facts to remember

A decrease in the capital value of the bonds held by an income fund is an on-paper loss only. A loss will only be realised if a bond defaults or is sold before maturity. Assuming there are no defaults, a portfolio of bonds will continue earning the same coupon payments and, at maturity, the principal of each bond will be repaid in full.

By withdrawing your investment, you would make this loss a reality. You could also miss out on any higher returns the fund may generate in the future as older bonds mature and the money is reinvested in new bonds.

If you are worried about the effects of credit market volatility and changes in interest rates on your income fund investment, you should speak to your Financial Wisdom adviser. It is important to seek professional advice before making any changes to your investment portfolio.

A guide to income fund terminology	
Bond	A loan to a government or company
Capital value	The value of an asset
Coupon payment	The periodic payment of interest on a bond
Credit spread	The difference in interest rates between government and non-government bonds
Income fund	An investment vehicle that invests in income-earning assets such as corporate and government bonds or mortgages
Maturity	The date at which a bond becomes due for repayment
Principal	Original amount of money invested or borrowed, on which interest is paid
Risk margin	See 'credit spread' above
Running yield	The average interest rate across all assets in a fund's portfolio
Term deposit	Money invested for a set period of time at a fixed rate of interest with a bank
Unit	A single share in a trust or investment vehicle
Yield	The annual return (interest paid) on an investment expressed as a percentage of its purchase price

Call us for more information

If you would like to know more about income funds, contact our office and talk to your financial adviser. We can give you more detailed information on the best approach for your situation.

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