Retirees need funds to show good incomes

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IT'S a painful fact that a lot of retirees are using the wrong type of investment vehicle to earn inflation-linked income.

First, unitised managed funds won't give you the income you need because of the way they're structured and, second, unitised super funds are also inappropriate from an income-paying perspective because they make no income distributions.

My final warning in last week's article was that investors "should deal with advisers who have appropriate income earning experience with their own investments over the medium to long-term."

Taken on their own, these comments might seem unfair. Today I'll explain why I made these remarks. Let's talk about unitised managed funds.

The two main advantages of these products are that they allow inexperienced investors to benefit from the skill and knowledge of professional investors. They also potentially allow a small investor to have an interest in much larger assets that they ordinarily would never own.

However, the fundamental objective of a retiree has to be to live off the income from their investments.

A structural problem with some managed funds is that it's difficult to see how much income the underlying assets have actually earned. For example, an investor in an Australian equity managed fund will receive several distributions every year. Some of these distributions will represent income earned as well as any net capital gains.

The sad, and well-known, reality is that some fund managers regularly turn their investment portfolios over. Their primary objective is to hunt capital gains rather than earning investment income.

This means that when markets are performing well, the managed fund distributions will be high. Conversely, the distributions will be lower when overall market performance struggles.

From a practical perspective, the net result is that the more measured progress of investment income - and dividend income from Australian companies, in particular - is hidden. We can also add to this another problem that involves the way most funds report investment income.

Often the income earned from investments will be shown on tax statements net of asset-based fees. It's only logical to falsely conclude from these numbers that dividends are as volatile as share prices because the net income shown on these reports has been made volatile by the deducted asset fees.

Retirees wanting to use managed funds need to find funds that can show good income distributions over the medium to long term. Look at the actual income paid, not the yield, which is the income divided by the current market value.

My second target, unitised super funds, make no income distributions.

The actual income earned in these funds is invisible and you see only the volatile movement in unit prices caused by asset price fluctuations.

Unfortunately, the information reported by the Australian Prudential Regulation Authority in its regular publications about superannuation doesn't detail the actual investment income paid from the different super industry sectors.

The income earned is lumped together with asset price movements and remains hidden.

This brings us to the need for investors to deal only with advisers who are suitably experienced in earning income from their own investments over the medium to longer term.

Most professional member associations demand that before providing advice, their members need to have appropriate skills, knowledge and experience.

For example, the Financial Planning Association's practice standards say an FPA member should consider "his or her skills, knowledge and experience in providing the services requested or likely to be required by the client".

Is it reasonable to believe that someone has suitable experience earning income from investments if their practical knowledge has come solely from investing in managed funds, unitised super funds or share trading based on the movement of asset prices?

Over the years, I have seen many reports by fund managers and financial advisers to clients that report investment portfolio performance as well as the movement in relevant financial markets.

Also noted is the over- or under-performance of a client's portfolio relative to the market. This might look like important information but it isn't.