Atkins Bland

Investments • Pensions • Financial Planning

Guide to: Risks of Future Yield Compression

Introduction

Why we made this guide

The subject of generating income from invested capital is one of the most pivotal areas of financial planning.

It is also, therefore, one where Atkins Bland offers more than one guide, looking at different aspects.

This guide looks purely at the additional uncertainties associated with trying to estimate how much income might be available from capital not yet available but expected to be so in the future.

The sister guides to this are;

- ***Guide to Investing for Income***
  This looks at the general subject of what investment options are available and the core features of each
- ***Guide to Investment Income Yields***
  This looks at current income available from different types of investment
- ***Guide to Generating Income from Natural Yield***
  This discusses the benefits of using actual income rather than spending capital as income
- ***Guide to Sustainable Income and Capital Drawdown in retirement.***
  This looks at the subject of how much "income" may be sustainable throughout life from a capital sum, where someone is comfortable to take the risks of spending capital, rather than just the income it generates

These other guides look principally at the position for money already available for investing and, hence, are designed to assist those making current decisions on how to invest their money with an income priority.

In contrast, this guide looks at the uncertainties associated with trying to work out how much capital may be needed in the future to generate a given level of income.

How are income yields calculated?

An example to help explain

How are income yields calculated?

A simple example is to use a rental property.

If you can buy a property for £200,000 and rent it for £10,000 a year, the gross rental yield is 5%.

If, however, that property went up in value to £300,000 but the rental income has only gone up to £12,000, then the yield has fallen to 4% (4% of £300,000 is £12,000).

The person who bought the property for £200,000 at a 5% income yield is now getting a 6% income yield on their original capital (6% of £200,000 is £12,000) and has achieved a gain of £100,000 so should be feeling very smug with their decision.

The person who had planned what they can get from capital when income yields were 5% but, having accumulated the capital, finds that they can now only get 4%, may be feeling less so.

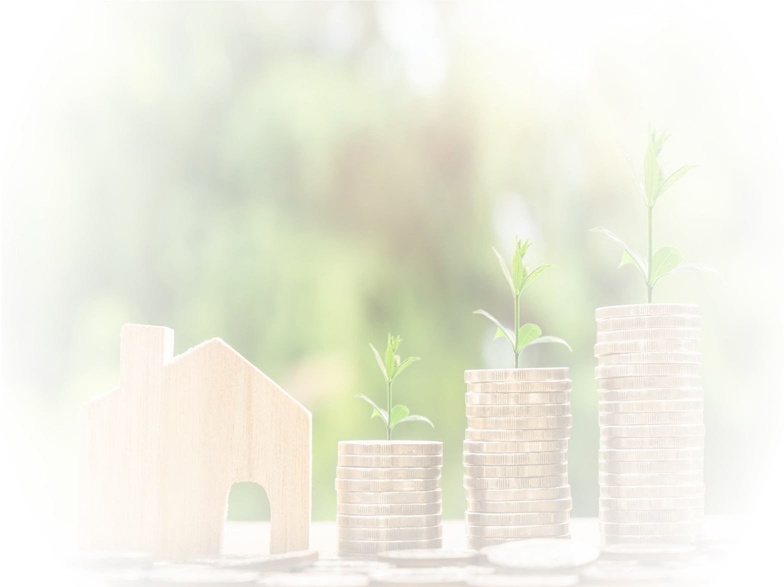
The same process applies with share dividends.

If the dividend yield on the stock market averages 4% then an investment of £100,000 would produce £4,000 of income.

If the market enjoys a substantial increase and shares double in price but dividends only rise 50%, then the person above would have a portfolio worth £200,000 and an income yield of £6,000.

That should make them very happy, but someone investing £100,000 at that point would only enjoy £3,000 of income, so, if they had planned things while dividends were 4%, they would have underachieved their ambitions by quite a significant margin.

These factors can work the other way round too, with falling values generally meaning income yields rise.



Past, present and future

An overview of income yields through time

Property has seen a substantial rise in capital values with a much more subdued rise in rental yields and, whilst 6% or 7% was readily available from buying a property to let a few decades ago, figures now are often underneath 4%.

With stock markets, there has been some fluctuation and a good deal of variance in different areas but, in the UK, the dividend yield from the market has merely wobbled about over recent decades, rather than trending in one direction or another.

This has occurred because, generally, rising share prices have approximately tracked the rising level of dividend payouts, which largely reflect rising corporate profits.

If the spikes and troughs caused by volatile stock market valuations and the impact of over enthusiasm and over pessimism at different times is averaged out, dividend yields from the UK stock market have trended around 3.5% to 4% pa over several decades.

Income from interest-paying investments, whether from deposit accounts or from fixed income securities (bonds) has experienced a rather unusual trend over recent times when compared with its longer-term history.

During the 18th century, UK interest rates were typically between 4% and 5% pa.

During the 19th century they fluctuated more, ranging typically between 4% and 10%.

In the first half of the 20th century this fluctuation continued, ranging between 5% and 10%, but in the second half of the 20th century we had some extreme volatility, especially from the late 70's through to the mid 90's.

Interest rates were 17% when Mrs. Thatcher took office in 1979 and got close to that point again in 1992, just before the UK crashed out of the European Exchange Rate Mechanism (ERM).

Following the ERM debacle, the Bank of England took over responsibility for setting interest rates and we have seen a lot more stability since then, with rates typically ranging between 4% and 6% between 1993 and late 2008.

We then had Quantitative Easing and a complete collapse in interest rates in response to the 2008 financial crisis. In the UK, bank base rates were stuck at 0.5% from March 2009 through to August 2016, then fluctuated between 0.25% and 0.75% for the next 3.5 years until Covid struck, and they fell to almost zero (0.1%) for nearly two years.

That ended abruptly when Russia invaded Ukraine in January 2022, causing prices to rise and central banks to respond to the increased inflation by raising interest rates.

In the following two years, the UK base rate soared upwards, peaking at 5.25% between August 2023 and July 2024, a rate last seen 15 years earlier, in March 2008.

At the time of last updating this guide, in October 2024, the UK base rate had notched down to 5%, with an expectation of more falls to come.

Where interest rates might be in a year, or 10 years, is anyone's guess, but the message from recent history is clear: interest rates are very erratic so it is impossible to judge what future income yields might be available from a deposit account.

A big difference between deposits & other options

With investments linked to the stock markets or property, income has trended upwards to combat inflation.

In contrast, the income from money invested in deposit-bearing options has fluctuated wildly, but achieved no inflation protection at all.

These past experiences may not be repeated, but the lack of inflation protection of income inherent in deposits or similar options is a feature of their structure, so unlikely to change.

Some interest-bearing investments can secure income yields for several years, such as Fixed Income Securities or fixed term deposits, but most have an expiry date, so continuation of the income yield achieved at outset on an indefinite basis is not normally an expectation.

This means that, when somebody is investing for income, which is normally during retirement, using an option such as an interest-bearing arrangement where rates are entirely or partly at the mercy of economic policy may not turn out to be a very successful strategy.

In most cases, investing for income involves allocating capital to an investment area where the availability of income is not determined by short term Bank of England policy but by, for instance, profit distributions from companies (dividends) or rental distributions from real estate investments.

The risks and our conclusion

What to take away from this guide

Yield compression is a phrase used to describe a situation where the income yield generated by capital, when expressed as a percentage of the value, reduces. This is normally due to the asset value of the investment rising more quickly than the income it generates.

Examples of this were given earlier.

Yield compression is a significant risk run by somebody accumulating capital for future investment rather than somebody who already has their money invested, where yield compression should reflect an increase in the value of their capital, so is a good thing, not a bad thing.

If the capital is not yet deployed and we see yield compression occur, the amount needed in future to generate the same amount of income which capital can produce now may be substantially higher.

The huge gap between interest rates and the investment yield from property and dividends during the period between the financial crisis and the Russian invasion of Ukraine in 2022 was always difficult to justify in terms of sustainability. That meant the gap needed to be bridged by either;

- Interest rates rising and staying higher
- Income yields from other assets falling, through the capital values rising

No one can predict which of these it will turn out to be in the longer term.

However, while interest rates have risen in response to the leap in inflation rates in 2022, the level of government and other debt, raises a significant doubt over the possibility of interest rates remaining high enough to justify current yields available from other investment areas.

This means there is a clear risk that, in future years, it may not be possible to invest in the stock markets or real estate markets at prices which generate a 4% dividend yield.

Much will depend on the future of interest rates, which is completely impossible to predict with any confidence.

However, yield compression seems a very real risk facing those accumulating capital in the future and needing that to generate their income in retirement.

Our conclusion

The purpose of this paper is not to try to predict the future but simply to flag that there is a risk, for those trying to assess how much capital they will need in future to generate a given level of income and doing so with reference to current available investment yields, that they will find they actually need substantially more due to the impact of yield compression.

The best way to combat this risk is to save as much as you can, and get it invested in a way which will benefit, rather than suffer, if asset values rise.

Important notes

Any opinions expressed on the merits or disadvantages of any options are intended as a general comment only and not as specific advice to the reader.

This document is intended as a supplement to full independent advice and not as a replacement for it and should be read in conjunction with any personalised recommendations provided by Atkins Bland Ltd and with any product brochures supplied.

The value of investments will fall as well as rise, as can any income produced or generated. An investor may, therefore, get back less than invested.

Inflation can reduce the real value of capital and the income it generates.

Past investment performance is not a reliable guide to the future.

Any reference to taxation, regulation or legislation is based on our current understanding and details should be checked before any reliance is placed upon its accuracy.

The impact of taxation and tax planning depends on individual circumstances and may be subject to change, which can be retrospective.

Errors and omission excepted.

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