Steve Dodge writes on Income and Risk

I was recently asked to build a portfolio for a couple that really wanted to understand what they had to do with their money but were both a bit nervous about the market and risk etc.

"I have two friends who both have £30,000 in a Bank account" said the wife "they take the interest of about £1,800 each year and spend it, why can't we just do that" she asked.
"Because such a plan will leave them very poor very quickly", I replied.

There are a few simple facts they need to consider.

If they spend the interest then next year their capital although still £30,000 has actually fallen in value thanks to inflation. At 5% inflation the real value of £30,000 would only be £28,500, and that's only after one year! Over seven years £30,000 would only be worth £21,320!

So leaving money in a bank account and spending the interest each year simply guarantees that their capital will fall in value, but that's only part of the problem, what about the interest?

Unless interest rates increase by inflation every year the income is also effectively falling in value each year.

Interest rates simply cannot go up every year; no one could afford their mortgage repayments. The Bank of England has reduced interest rates to help get us out of recession, so the income from their £30,000 is also going to reduce in real money terms as well as in value.

The third problem with such a plan is the rising cost of the items the interest is spent on i.e. rates, food fuel etc, which rise each year with inflation.

At 5% inflation £1,800 of bills today will be £2,412 in seven years time and yet the interest on £30,000 might only be 4% or £1,200.

Where is the difference to come from, the £30,000 capital perhaps? But if they spend any of their capital their interest falls, which means they must draw more capital to make up the shortfall and so on and so on…

So, why can't they simply leave all their money in cash? Their capital will reduce in value, the income will reduce in value and they will be forced to spend their capital meeting their bills, leaving them very poor indeed, very quickly.

There is simply no substitute for a properly constructed, spread and balanced portfolio, which will aim to create capital growth and provide a rising income in future and minimise your tax liabilities.

IFA's (Independent Financial Advisers) build these all the time, go and speak to one today. If you want more information about investing for income visit our website on www.impartialadviser.com/ then click on investing for income.