

# Financial **EXCHANGE**

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## Understanding Income Investing



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Unless you have unlimited resources or a very plush employer pension, some of your retirement income will eventually come from the investments you accumulate during your working life. During those 'working' years while you are busy making RRSP contributions and adding to your non registered portfolio when you can, the investments you make are for the purpose of growth. Your goal during this phase is to accumulate wealth as quickly as possible within your comfort zone for risk and according to your time horizon and objectives.

When the time comes to start reaping the rewards of your years of focused wealth building you will generally look at changes to your portfolio that will result in the production of income.

Income based portfolios can be tough to get used to at first. Over most of our investing life we tend to concentrate on the bottom line. The scoreboard. The media does an amazing job of reminding us how well or how poorly our investments are doing on a minute by minute basis. It was not always this way. The miracle of modern technology has made it possible (and almost mandatory) to know, to the second, how your investments are 'doing'. But is this really a good thing?

If you are a day trader then you need that up to the second data that determines whether you buy or sell. For the rest of us it may be information overload and can possibly contribute to some very unnecessary stress if things aren't going so well in the world.

Back in the early days of income investing people would buy shares in the so-called 'widows and orphans' companies such as Bell Telephone or other utilities and banks. They would buy these shares primarily for the dividends with little or no concern for the day to day variations in the share price.

Today's income investors should take heed from those early investors with respect to the share

price. Too much emphasis is put on the scoreboard when the real reason for the investment in the first place was strictly for income. That's not to say that you should disregard fluctuations in the market value of your investments. Far from it. The point is not to use this as your only method of assessment.

Think of income investments like you would owning a rental property. In most cases you would buy the rental property for the purpose of earning rental income. There may be long term gains in the back of your mind but the primary purpose of ownership is for the immediate rental income.

During the years of ownership the market value of the rental property will fluctuate depending on market conditions and the economy in general. These are exactly the same kind of conditions that will affect both the stock and the bond markets. Since your interest is in ensuring continued rental income your focus should be on the quality of the tenant and in maintaining the house in 'rent ready' condition. You will be monitoring the costs of ownership (taxes, upkeep etc) to ensure that the rent you are earning is more than adequate. Concern for long term market value appreciation is

there, but it's secondary.

Try to look at your income based investments in the same way. The main reason you bought them was to ensure that you have a continuous, uninterrupted, reliable income stream. In doing so you'll want to keep an eye on certain factors. Cost of ownership, tax efficiency, management etc. The very same types of things you would monitor as a property owner.

There is a tendency for virtually every investor to fixate on the bottom line. We all do it. It's the scoreboard. Evaluating an income based portfolio using this method exclusively can be both dangerous and misleading. The most important aspect to an income portfolio is income. Is it reliable, fixed, tax efficient, and cost effective to earn? If so, then it's doing exactly what you have asked of it.

One other interesting feature of an income portfolio that is often overlooked is dividend reinvestment. In many cases some of the income produced from an income portfolio is not immediately needed. The investor may be at the point where he or she wants to reduce risk from a growth portfolio by moving into income based investments but doesn't

need the income stream just yet.

In this situation the investor may choose to re-invest the dividends back into the original investment. This is an excellent way of accumulating investment units without writing a cheque as each dividend payment is used to buy additional units. It's especially effective during down market periods. If the unit price is lower due to market conditions then the fixed dividend is able to buy more units than if the unit price were higher. The net result in a down market is the ability to accumulate units faster because they are 'on sale'. And since you are paid dividends for every unit you own the objective is to accumulate as many units as possible. So in this case a down market can actually be beneficial!

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