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Best ways to beat inflation – without too much risk

Savers are being forced to look at increasingly specialised funds to reap decent returns, writes **James Charles**

INFLATION jumped again last month, forcing savers to work even harder to secure a real return on their cash.

The consumer prices index hit 4.4%, up from 4.2% in June, fuelled by higher transport costs and rising utility bills. The Bank of England has warned that it is likely to hit 5% by the end of the year.

There are no deposit accounts that beat inflation for higher-rate taxpayers, according to Moneyfacts, the data firm. Basic-rate taxpayers can choose from eight fixed-rate cash Isas that beat inflation but savers have to tie up their cash for five years to do so. Birmingham Midshires pays 4.65% on at least £500 for five years.

Investors have therefore turned to the equity markets, where the FTSE All-Share has an average dividend yield of 3.65% and some blue-chip stocks, such as Aviva and Glaxo Smith Kline, are paying more than 5%. However, the recent stockmarket turmoil has demonstrated the risks of that strategy and left investors looking for alternatives.

Martin Bamford of Informed Choice, the financial adviser, said: "Investors are having to work harder to seek out good yields that remain lower risk but still beat inflation in the current environment."

INFRASTRUCTURE

Infrastructure funds generally invest in ventures where private companies have a contract to run a project on behalf of the government. The contracts can be for up to 20 years, providing consistent returns over the long term.

Simon James at Gore Browne Investment Management said: "Infrastructure funds provide good yields and stable returns. There is also an inflation hedge as contracts with the government will typically include an inflation link."

Four of the most popular funds are 3i Infrastructure, International Public Partnerships, HICL Infrastructure (formerly HSBC Infrastructure) and John Laing Infrastructure, which listed on the London Stock Exchange at the end of last year.

The 3i fund owns Anglia Water and has a holding in Eversholt, the train leasing company, as well as a 10% stake in 3i's India Infrastructure fund. It has a current yield of 5% and is trading at a 2% premium to its net asset value.

The John Laing fund has a diverse range of holdings in the UK, Canada and Finland, including part of the M40, a hospital in British Columbia and the Ministry of Defence headquarters in Whitehall. It promises a yield of 5.8% and is trading at a 6% premium to the value of its assets. Unlike 3i, it has no exposure to incomplete projects, which reduces risk but also prospects for growth.

COMMERCIAL PROPERTY

Commercial property funds, which invest in shops, offices and industrial space, have held up relatively well in the downturn, with the average fall only 4.3% over the past six months compared with an 11.5% drop in the average UK equity fund.

Bamford said: "We continue to favour commercial property because it does not always perform in line with equities."

Moreover, the funds are yielding between 3% and 6% net, making them attractive to income seekers.

Darius McDermott of Chelsea Financial Services, the adviser, likes the F&C Commercial Property Trust, which is focused on central London. It offers a yield of 5.9% and is down 0.9% in the year to date. The fund is based in Guernsey so is not covered by the Financial Services Compensation Scheme, which protects investors if a firm collapses.

"The fund has big holdings in West End property, which is more likely to be sheltered from weaker demand," McDermott said.

Other funds may have more hold-

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ings in the retail sector, which has suffered in the wake of the collapse of a number of high street chains over the summer.

The Ignis UK Property fund holds 28% in retail units and 38% in offices, with the rest in industrial premises such as warehousing.

OVERSEAS GOVERNMENT BONDS

The yield on UK government bonds (gilts) has fallen to historically low levels, closing at 2.39% last week.

Nick Gartside of the JP Morgan Strategic Bond fund advocates looking farther afield at foreign government debt. He favours Australian 10-year government bonds, which have a yield of 4.49%. "The economy there is in a good position and there is little chance the government will default," he said.

Gartside also has small holding in Mexican 10-year bonds paying 6% and South African five-year bonds paying 6.8%.

However, currency fluctuations increase the risks. Sterling fell to a 26-year low against the Australian dollar in July, trading at A$1.48 to the pound compared with A$2.66 in 2008. On Friday it was A$1.58.

Hannah Edwards of BRI Asset Management said: "Buying sovereign debt can provide investors with an attractive yield in times when they are seeking income but also looking to provide some diversification into their portfolio. However, what comes with this is currency risk and the ultimate risk of default."

She suggests using a fund such as Investec Emerging Markets Local Currency Debt, which holds government debt from South Africa, Malaysia and Turkey. The yield is 6.22% and it is up 4.7% this year.

GROUND RENT

Pramerica Real Estate Investors, the fund manager, announced last week that it had raised more than £100m for its UK ground lease fund from institutional investors and ultra-high net worth individuals. It has invested in a 128-year lease on Vintners' Place, a City office block, and a 999-year lease for the Great Northern hotel in King's Cross.

Ground lease or rent funds acquire leaseholds to residential and commercial buildings that typically run for more than a hundred years, providing stable returns. However, the sector is largely unregulated, without protection from the Financial Services Compensation Scheme.

Ben Yearsley of Hargreaves Lansdown, the adviser, said: "Ground rent funds have historically provided a relatively stable but modest return, and in the current low interest rate environment it doesn't take much for even a modest return to look interesting."

PIBS AND ZEROS

Permanent interest bearing shares (Pibs) are issued by building societies to raise capital. They come with a yield, or coupon, but unlike traditional bonds, they do not have a maturity date. Instead there are call dates when the mutual has the option to redeem or extend shares.

Pibs are traded on the stock market and can be priced below or above par, depending on the market's view of the financial health of the provider.

In June, Principality building society said it was cutting the interest rate paid to investors, and during the financial crisis a number of building societies had to change the terms of their Pibs.

Danny Cox of Hargreaves Lansdown said: "The lack of liquidity in the market for Pibs makes investing problematic to buy and sell."

Nationwide has a Pibs with an initial coupon of 7.25% on an option to call in 2021. It is trading at 89.5p, giving a yield of 8.1%.

Zero-dividend preference shares, known as zeros, are issued by split capital investment trusts and backed by the assets that are held. They aim to return a target sum to shareholders on a set date. Returns are subject to capital gains tax rather than income tax.

Mick Gilligan at Killik & Co, the broker, tips the Jupiter Second Split Trust, which offers a gross redemption yield of 5.4% and is covered by assets 1.3 times.

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JUSTIN GRIFFITHS-WILLIAMS

Martin Alcock, 58, and wife Susan, 56, of Lavendon, Buckinghamshire, have invested in the First State Global Listed Infrastructure fund through adviser Hargreaves Lansdown

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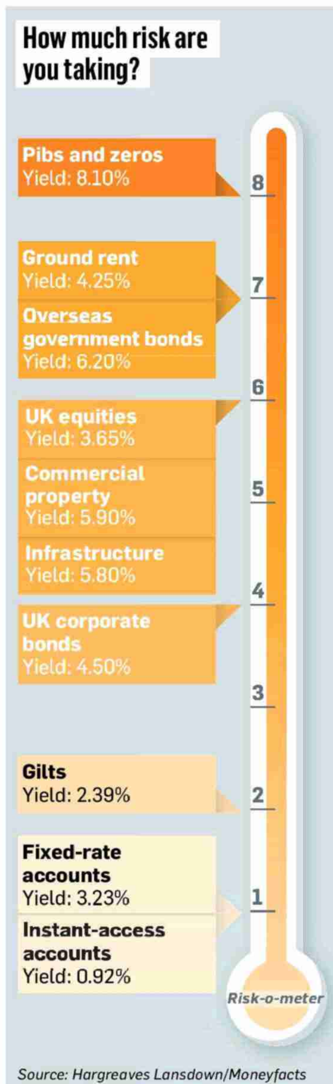

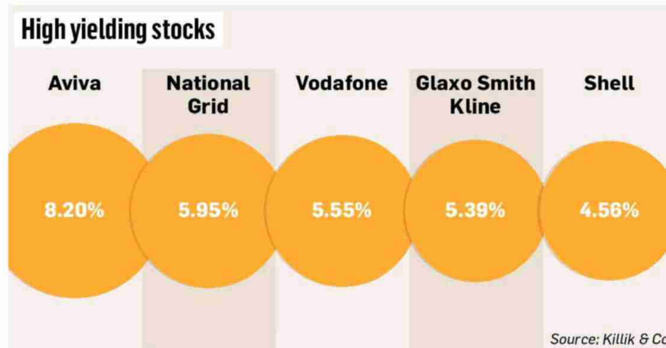

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