November 2020
Income portfolios addendum

In April this year, we issued an addendum to the regular monthly portfolio review, which focused in particular on the income portfolio, as well as looking at the dividend outlook for UK companies. Just over 6 months later, it is worth revisiting what has and has not come to pass and what the outlook holds for this specific sector.

2020 has certainly been a difficult time for income investors. Many dividends have been cut and interest rates on cash savings have also fallen. In April we commented that many businesses in the most affected sectors such as tourism, hospitality, aviation and retail, would have to cut or suspend dividend payments entirely for a period to preserve their cash resources and the viability of their businesses. Companies that receive government assistance to stay afloat, will find it particularly difficult to justify maintaining their dividend payments to shareholders. Even those companies that are benefitting somewhat (food, logistics, pharma for example) and have ample financial capacity to keep paying dividends are likely to adopt a cautious approach, given the high level of uncertainty.

At the time, FTSE 100 dividend futures were pricing a 62% reduction in dividends for the year compared to a peak drop of 20% globally in the Great Financial Crisis just over a decade ago. Behind the collapse we have witnessed British banks, which constitute 13% of dividends in the UK market, cancel their payments, having been instructed to conserve cash in order to survive the economic fallout from the coronavirus (COVID-19) pandemic by the Prudential Regulation Authority (PRA). Meanwhile BP and Shell, which together constitute 19% of the UK market's income, were likely to cut their dividends unless oil prices recover sharply. They therefore had to cut.

So where are we now? If we look at AJ Bell's latest Dividend Dashboard report for Q3, dividend payments for FTSE 100 companies are forecast to fall 24% - or £18 billion. Not great but a long way above the predicted 62% fall anticipated earlier in the year. This means the FTSE 100 is expected to yield 3.5% for 2020, rising to 4.2% in 2021. But as the forecast states, on a positive note, dividend forecasts for 2021 suggest many big payers will return to regular pay-outs next year.

If we look in a bit more detail, 35 members of the index have cut, deferred or cancelled payments for 2020 due to the Covid-19 viral outbreak and subsequent recession, while 28 have maintained or increased one for fiscal 2020. Following cuts or cancellations from Shell, HSBC and BP earlier this year, British American Tobacco (BAT) is now forecast to be the biggest dividend payer in the FTSE 100 in 2020, paying out £4.9 billion. Elsewhere, even after cutting dividends in 2020 and 2018, BP and Vodafone still offer yields of more than 8%, while Imperial Brands and Aviva are both forecast to provide a yield of more than 10%. BP CEO Bernard Looney recently laid out a new fixed dividend policy, payable at 5.25 cents each quarter for the foreseeable future. Surplus cash over and above this amount will be used to fund share buybacks, not dividend growth. This policy makes sense given that Looney has also committed to cutting oil and gas production by 40% over the next 10 years but makes the proposed yield realistic.

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At the start of April, the UK's banking regulator ruled that none of the big banks would be allowed to pay a dividend this year. However, Lloyds' third-quarter results suggested that bad debts haven't risen as quickly as expected so far this year. Lloyds returned to profit during the quarter with a pre-tax profit of £1bn and a return on tangible equity of 7.4%. The bank's regulatory CET1 ratio (which measures surplus capital) also looks strong, at 15.2% and well above the 11% minimum specified by the regulator. Therefore, unless losses worsen as we head into 2021, the bank should have enough spare capital to resume dividend payments. City analysts seem to agree. Their dividend forecasts suggest a pay-out of 1.54p per share in 2021, which would give the stock a yield of 5.5%.

What does this mean for an income focused portfolio?

At the time of writing, since the start of March the portfolio is back to about 8% below its March value having fallen about 27%, compared with about 36% for the FTSE UK Equity Income Index and 33% for the FTSE (see below). The portfolio is more UK equity focused than other portfolios due to the history of UK companies paying and growing dividends and the lack of currency interplay to a UK investor. Whilst the FTSE 100 accounts for a large percentage of dividend pay-outs by monetary value, the portfolio remains highly diversified among medium and smaller companies also, ensuring the income stream is never too reliant on any one company. To this end, whilst initially it fell further, the FTSE All share has now also recovered reflecting the bounce in these medium and smaller companies.

As we reinforced in April, we think this is the time for long-termism, and there are many market watchers and fund managers who believe the UK is oversold and undervalued, as is reflected in the weakness of Sterling. Fund managers in the portfolio have confirmed they are doing some underlying restructuring of holdings as some stocks are just too cheap to ignore. And, as long as the yield is supported, the capital growth will follow albeit often at a lag. To use the metaphor of 'buy to let', if the income is coming in, it matters less how the property value is fluctuating. And to continue the metaphor, it also does not stop you making improvements such as changing the windows. To this end there are changes we will be making to the portfolio in the new year, but the timing and macro-economic events mean they are better left for another month or so.

We have already seen the positive fillip that the Biden election has added. With Trump policy responsible for a number of deteriorating global trade relationships, not least China, there is optimism the future US rhetoric will be less aggressive. One reason to wait for January. The Covid Vaccine/ Biden 'bounce' is also a possible early indicator of a rotation from Growth to Value stocks. Growth stocks have unarguably held the whip hand over value in the decade since the global financial crisis – and, up to now, the pandemic-induced events of this year have only exacerbated that trend. But it is worth pointing out that, in value investing, there is a direct relationship between historic and future returns – indeed, the worse the short-term returns, the better the subsequent five years has proved. And currently it could be argued that many investors are already paying too much for perceived 'safety' and 'certainty' of growth, dislocations are still extreme and the market's eventual snap-back to its typical function as an arbiter of value will come at some point. As the income portfolio is slightly more value biased than growth it is worth persisting to see if this rotation gathers momentum in the next few months.

The Covid vaccine results from various manufacturers has already helped the markets to move upwards and some of these moves can be sudden (over 5% in a day over the last few weeks) and being out of the market at such a time will mean losing out on growth that should be re-priced in as ‘normal’ returns.

And finally, Brexit. Again the UK based nature of the portfolio makes any move planning before the end of the year (and hence a clear outcome on any trade deal with the EU), a risky strategy. Brexit talks continue but time is running out with EU negotiators now expecting to brief member states on progress on 18th November. The Irish foreign minister said that both sides had entered ‘move week’ in which the big issues had to be resolved in principle this week. Hence, we are strapping in and along for the ride until the outcome is known.

Despite all these headwinds (and we feel some will be moving to tailwinds as discussed), all holdings in the portfolio except two, continue to pay a yield above the FTSE 100 yield of 3.5%. We continue to monitor and manage against dividend growth and dividend cover but seeing out 2020 will give a clearer indication of the future direction and we will indeed see if the built in value in UK stocks does indeed pay dividends, if you’ll excuse the pun!

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Performance Line Chart

FE Analytics

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Pricing Spread: Bid-Bid • **Data Frequency:** Daily • **Currency:** Pounds Sterling