CASTING THE NET WIDER

WHY INCOME DIVERSIFICATION PAYS TIME AFTER TIME

Paul Roberts, Baillie Gifford Multi Asset Income

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Annual past performance to 30 June each year (%)

	2016	2017	2018	2019	2020
Multi Asset income Fund (B Inc)	n/a	n/a	n/a	n/a	0.2
Investment Association Flexible Investment Sector	n/a	n/a	n/a	n/a	0.3

Performance source: FE, total return in sterling. Returns reflect the annual charges but excludes any initial charge paid.

Please note as the funds launch date was 31 August 2018, full historic performance is not available.

The manager believes an appropriate performance comparison for this fund is the Investment Association Flexible Investment Sector.

Past performance is not a guide to future returns.

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CM13774 Multi Asset Income Fund _Income Diversification DC version_0720
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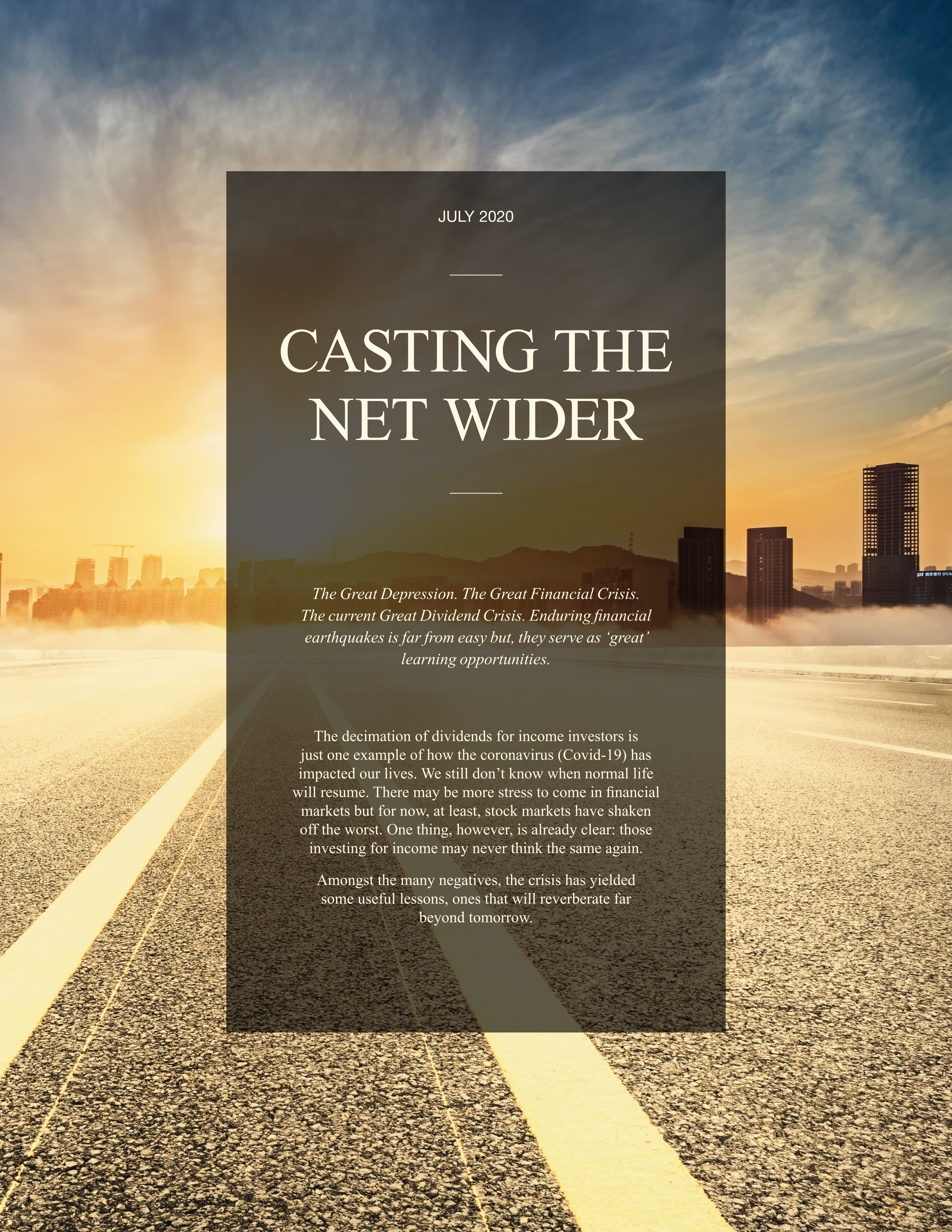


JULY 2020

CASTING THE NET WIDER

The Great Depression. The Great Financial Crisis. The current Great Dividend Crisis. Enduring financial earthquakes is far from easy but, they serve as 'great' learning opportunities.

The decimation of dividends for income investors is just one example of how the coronavirus (Covid-19) has impacted our lives. We still don't know when normal life will resume. There may be more stress to come in financial markets but for now, at least, stock markets have shaken off the worst. One thing, however, is already clear: those investing for income may never think the same again.

Amongst the many negatives, the crisis has yielded some useful lessons, ones that will reverberate far beyond tomorrow.

LESSON #1: THINK LONG-TERM INCOME, NOT SHORT-TERM YIELD

James Dow, joint-head of Baillie Gifford's equity income strategies, recently wrote on the unprecedented nature of the pandemic plight (*The Great Dividend Crisis*, April 2020). In short: although dividends have been decimated, the worst thing to do is try to 'plug the income gap'.

Faced with a big hole in current income the temptation for many income investors will be to pick up a bargain – one of those companies still expected to pay a generous dividend and trading with a temptingly high yield. But this is one reason we are where we are today. Many of the companies filling equity income portfolios, the darling dividend payers, already faced challenging futures before Covid-19 struck: High street retail was under pressure from ecommerce; oil companies were dealing with a low-carbon future; banks were enjoying an unusually long period of near-zero loan losses. Many of today's high-yielders face permanently impaired earnings. This will not only impact their dividend-paying ability for years to come but will also supress their capital values. Tomorrow's capital pays tomorrow's income and a permanent loss of capital is a real risk.

The answer is to accept a lower yield today but invest in resilient and growing companies. That way, the lower level of starting income will also grow, maximising long-term income.

LESSON #2: GO GLOBAL

UK equity income funds form a core part of many investors' portfolios due to historically attractive yields. But this market has been badly hit in this crisis. When Imperial Brands, the tobacco company held substantially in many income portfolios, announced a dividend cut in mid-May it took the total income lost this year from the UK stock market above £30bn. At time of writing around 40 per cent of companies in the FTSE 100 had cancelled or reduced this year's dividend pay-out.

Looking to a global opportunity set is not just about geographic diversification, although that certainly has merit. It is also about looking to the future. There are around 250 dividend-paying companies in the UK, and many operate in structurally challenged industries. Worldwide, about 4,500 companies form the dividend-paying universe. There are many great companies with strong business models that will remain relevant for many years. We have found going global to be incredibly liberating and rewarding. This is a time of real opportunity to invest in great companies and build income for the future.

LESSON #3: MAKE THE MOST OF DIVERSIFICATION

We believe equities have a valuable role in an income-generating portfolio. Most notably they have the ability to provide inflation-beating growth, in income and capital. For many investors however, equities will not be the whole solution. Combining equities with other assets can provide a higher level of income today, with less volatility. The most effective way to achieve attractive and resilient income is to widen the opportunity set and use a multi-asset approach.

There's nothing new about the notion that assets other than equities might provide a useful source of income. Bonds, after all, have traditionally been the starting point for an income-seeking portfolio. But with bond yields collapsing over the past few years, investors have been presented with the unappealing option of investing in securities providing 'return-free risk'. With low levels of income on offer, any return to more normal levels of yield would also result in capital losses.

So where should we be looking? Well, not all bonds are created equal. While developed market government bond yields have converged to zero – and even turned negative – emerging markets continue to provide attractive levels of yield: around 6 per cent in aggregate. Yes, they carry more risk, but for experienced managers who can sort the stronger developing economies from the basket-cases, they can form a valuable part of an income-focused portfolio.

The story is similar when considering corporate bonds. During the recent crisis, yields on higher risk bonds rose dramatically. Many investors are rightly worried about a rise in defaults, which would wipe out income and capital. However, as is often the case, some excellent companies with solid prospects saw their bond prices fall heavily. We see opportunities amid the chaos.

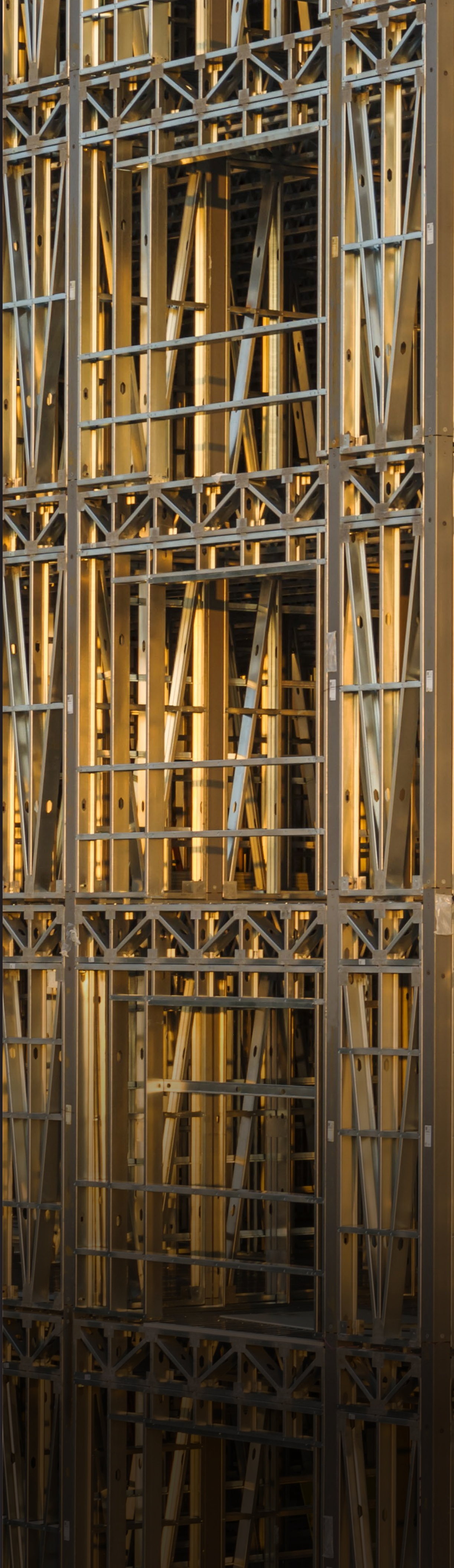
Looking still further afield, real assets such as infrastructure and property have fantastic qualities for income portfolios. Typically, they provide high levels of income that rise with inflation over time. However, they are not always a panacea for income resilience, so care is required. Parts of the property market face many challenges at present, notably retail. A number of property companies have already announced dividend cuts, faced with a rapidly rising number of tenants unable to pay rents. It's important to be able to select from a global diversified universe. Infrastructure, meanwhile, tends to provide excellent diversification benefits. Cash flows can be linked to long-term contracts underpinning schools and hospitals for example, assets not influenced by the economic cycle. Or regulated utilities where prices are tightly controlled, and companies are allowed to generate a steady return, typically distributed as income to their investors.

THE GREAT OPPORTUNITY

We see a great opportunity to invest for the future in Multi Asset Income: a strategy that delivers an attractive and resilient income stream, while preserving the real value of both income and capital over the long term.

Active management is vital to achieving those aims. It's important to look beyond indices and pick companies whose dividends or bond yields are more resilient. A wide opportunity set also allows freedom for active asset allocation. Active management fully earns its stripes when markets get choppy, as the key to providing a resilient long-term income stream is the careful and timely allocation of capital. We look ahead with optimism. 'Great' should be applied to the scale of the opportunity, not just to the crisis itself.

ACTUAL INVESTORS LOOK TO THE FUTURE. NOT THE PAST.



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