THE GREAT DIVIDEND CRISIS

WHAT CAN INCOME INVESTORS DO?

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Annual Past Performance % to 30 September Each Year

	2016	2017	2018	2019	2020
Global Income Growth	10.9	16.7	6.8	5.5	14.1
FTSE All World	12.6	19.3	10.2	1.9	10.9

Source: Baillie Gifford & Co, US Dollars, net of fees.
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THE GREAT DIVIDEND CRISIS

BY JAMES DOW

The old order of dividend-paying companies has been overthrown by the coronavirus pandemic. The task now, writes the co-head of Baillie Gifford's equity income strategies, is to take a long hard look at the potential winners of the future.

Unprecedented. That is the only word to describe the ongoing collapse of corporate dividends. At the time of writing, FTSE 100 dividend futures are pricing a 62 per cent reduction in dividends this year. This compares to a peak drop of 20 per cent globally in the Great Financial Crisis just over a decade ago.

Behind the collapse, we have witnessed British banks, which constitute 13 per cent of dividends in the UK market, cancel their payments indefinitely. Rightly they have been instructed to conserve cash in order to survive the economic fallout from the coronavirus (Covid-19) pandemic. Meanwhile BP and Shell, which together constitute 19 per cent of the UK market's income, seem likely to cut their dividends unless oil prices recover sharply.

We saw dividends slashed by banks and oil producers during the Great Financial Crisis, but we did not simultaneously witness dramatic cuts across other sectors. In this crisis we have already seen several retailers cancel their dividends – again understandable given that many currently have no revenues. Likewise restaurants, hotels, airlines, travel companies, manufacturers: the list is as wide as it is deep. Even Real Estate Investment Trusts (REITs), which exist primarily to provide an income stream to investors, are suspending their dividends in the face of drastic reductions in the rents they are managing to collect.

Equally shocking is the speed of the reversal: often dividend payments proposed only weeks ago are being withdrawn from Annual General Meeting schedules in April and May. Again, unprecedented.

What on earth can be done by dividend investors in the face of this crisis? Whether they are individuals investing on their own account, or income fund managers serving the charities, universities, and savers of all descriptions who rely on dividends to finance their expenses, our recommendations are the same.

Let's start with what we think they should *not* do. There will be a great temptation in the weeks and months ahead for dividend investors to trade into high-yielding stocks to 'plug the income gap'. Wherever a company has withdrawn its dividend and there is a hole in the investor's income stream, there will be an impulse to sell that company and reinvest the capital into another high-yielder, whether that be an oil company, a retailer, a tobacco company or a REIT, most of which now trade on high dividend yields.

In our view, this is a mug's game. Many of these seemingly high-yield dividends will prove to be a mirage. In the current environment there is unprecedented uncertainty about which companies will pay their dividends and which will not. Selling a dividend-cutter to buy a company which subsequently reduces its dividend will simply incur trading costs. To take an example that has already played out, selling Hammerson and buying British Land in its place would not have 'plugged the gap', as British Land too has now postponed its dividend.

There is also a high risk that trying to plug the income gap will end up destroying capital value. Why? Because earnings and dividends ultimately determine capital value, and many high-yielding companies suffering large drops in earnings and dividends will simply not, in our view, see a bounce-back to the levels they enjoyed before the coronavirus struck. For many such companies we anticipate a permanent impairment of their dividend paying ability.

It is important for dividend investors to remember that before Covid-19, high street shops and retail REITs were already under intense pressure from ecommerce. Oil companies were already fighting a losing battle against the long-term decline in hydrocarbon consumption. Banks were riding an unusually long wave of near-zero loan losses. Carmakers and airlines, viciously competitive industries for decades,

were in most cases making no economic profit. In other sectors, many companies were simply over-distributing capital, whether in buybacks or excessively high dividends.

Once the world defeats Covid-19, these companies are highly unlikely to see their earnings and dividends resume at pre-crisis levels. Established trends are simply being accelerated by the current crisis. There will be no ‘reversion to the mean’. Many companies are facing a dividend reset, not a V-shaped bounce.

Purchasing these troubled companies in the hope they will pay high dividends that plug the gap is therefore a doubly dangerous game. Not only is the dividend uncertain in the near-term, but as investors digest the reality of these companies’ permanently impaired earning power and dividend-paying ability, their capital value post-crisis is unlikely to rebound. This is true risk – the permanent impairment of capital value.

What about the less cyclical high-yielding sectors that income investors have traditionally turned to, such as utilities, tobacco, and telecoms companies? Unfortunately these are mature sectors, fraught with regulatory risk, and with weak long-term growth prospects. They may offer some near-term security of income. But the investor who piles into these sectors to plug this year’s income hole will face the near-certainty of very dull long-term profit growth. It is not a coincidence that many companies in these ‘low-risk’ sectors, from Vodafone to Centrica, have failed to deliver profit growth over long periods – and in many cases have had to rebase their dividends.

Now for the good news. Happily, there is also a huge opportunity in the current environment. It does, however, require the right mindset.

The beauty of equity markets is that, as an active investor, you can avoid the companies and business models of yesterday and invest instead in the shares of the future. That may limit your dividend income in 2020, as these companies have a lower yield than others which are ex-growth. But in the long-term, if you find these companies, it is likely to pay off in far higher levels of income, together with strong capital appreciation.

For every company facing a prolonged period of troubled times, there is another for which Covid-19 will ultimately prove transitory. Great companies with relevant business models will undoubtedly see earnings and dividends bounce back.

Well-run insurance companies, for instance, will continue to play a vital role in protecting policyholders against disasters – and the value of that insurance may well be higher in a post-pandemic world. Innovative manufacturing companies, with products that genuinely enhance the efficiency of their customers, will see their earnings bounce back too.

Delivery companies will find their services in ever-greater demand. Restaurants which are happy to deliver as well as host diners will surely thrive. Even in the property sector dividend investors can anticipate that well-invested residential assets, in a post-virus world of Zooming and flexible home-working, will generate solid rental income.

The challenge is to make sure that you, as an investor, or else your dividend fund manager, exercise the discipline to invest in these businesses of the future, rather than clinging to the

high-yielders of the past. Even if doing so means moderating dividend income in the short term.

The question for dividend investors to ask therefore is not "What companies can I buy to plug this year's income gap?" It is rather: "What companies do I believe have a strong future once this crisis has passed?"

Our mantra as income managers at Baillie Gifford is "long-term income, not short-term yield". The yields on the funds we manage are by no means the highest in the income universe, because we have been longstanding advocates of sacrificing short-term yield in the pursuit of better long-term income and capital growth. We have shunned many of the sectors and companies that are now struggling profoundly. This approach has delivered stronger total returns than most short-term yield-focused funds, as well as providing an income which has risen over time.

Be demanding of the businesses you invest in. If you're investing for long-term income, set a high bar that only accepts genuine growth businesses. In our experience companies that can grow their earnings to support higher dividends in five or ten years' time are far more rewarding investments than short-term 'yield plays'. That is why we largely avoid the mature, ex-growth companies that have propped up the market's yield.

In assessing dividend resilience, we aim to avoid companies that are capital-intensive, or highly cyclical, or are simply distributing cash in a way that is not in the long-term interests of their business. We use a checklist for dividend dependability which penalises companies for these and other weaknesses. Discipline in observing these risks, focusing instead on companies with stable, cash generative business models, will greatly enhance your long-term income and capital prospects.

Despite our best efforts we still make mistakes. An example is Bankinter, the Spanish retail bank. As the highest quality bank in Spain we had foreseen it taking market share from its weaker local competitors. But we now expect that government support for the entire banking sector will put pressure on balance sheets and dividends for a long period of time. We mis-calibrated the regulatory risk here, and we do not anticipate that Bankinter's recently-suspended dividend will 'bounce back' any time soon.

We therefore sold our holdings and, in re-investing the proceeds of our sale, we asked ourselves the question posed above: which companies have a strong future once this crisis has passed? We invested into companies where we have great confidence in their long-term prospects, even if they don't have the same high yield that Bankinter had before recent events. We added to our holdings in Deutsche Böerse, Nestlé and Roche, for example.

Do be careful about the UK market. A UK-only approach to dividend income is extremely narrow. There are roughly 250 dividend-paying companies in the UK, not a huge number for an active stock picker, and the market is dominated by companies in structurally challenged industries. Many are paying out too much in dividends rather than re-investing for the future.

Worldwide, there are about 4,500 dividend paying shares that you, or your dividend fund manager, can choose from. Many of these are great companies with strong business models that will remain relevant for years to come.

Again, you have an opportunity to take the long-term view. Going global, as we did for our own funds in 2011, will allow you the chance to escape from the risks of the UK oil companies, the banks, the high street retailers, and the other troubled companies that make up so much of the UK dividend sector. Instead you will become free to choose the well-run insurers, the value-add manufacturers, the delivery companies and so on that will thrive in the future. Your portfolio will be far more likely to bounce back from this crisis. Our own experience has been that going global is incredibly liberating and rewarding.

CONCLUSION

Dividend investors can survive this unprecedented setback. They can do so by exercising the discipline of a long-term approach and actively picking the winning companies of the future. With a global portfolio of these names, there is a terrific opportunity for your income and capital to bounce back stronger than ever.

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James was appointed co-head of the Global Income Growth Team and co-manager of The Scottish American Investment Company P.L.C. (SAINTS) in 2017. He joined Baillie Gifford in 2004 on the Graduate Scheme and became an investment manager in our US Equities Team. Previously, James spent three years working at The Scotsman newspaper, where he was the Economics Editor. He is a CFA Charterholder, graduated MA (Hons) in Economics-Philosophy from the University of St Andrews in 2000 and MSc in Development Studies from the London School of Economics in 2001.

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