TOMORROW'S INCOME ARISTOCRATS

INTERVIEW WITH JAMES DOW

MB Malcolm Borthwick

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MB Hello and thanks for joining us. I'm Malcolm Borthwick, managing editor of Intellectual Capital at Baillie Gifford.

Income investing has been shaken by the coronavirus pandemic, which has forced companies to cut back on dividends. That's the reoccurring payments that they make to shareholders. Global dividends are expected to fall this year by between 15 per cent and 35 per cent, or up to $933 billion.

So, is this a short-term set back, or will it have lasting repercussions? I'm joined by James Dow, co-head of Baillie Gifford's Equity Income Team.

But before we start, some important information. Please remember that as with all investments, your capital is at risk and your income is not guaranteed. And this podcast is being recorded during lockdown, so James and I are both at home as opposed to the usual Edinburgh studio.

MB So, James, let me start with what I alluded to in the introduction there. Are we seeing a permanent reset in dividend payments as a result of the coronavirus pandemic?

JD Yes, in some parts of the market, Malcolm. I think that is exactly what we're going to see. And, what I'm hoping will come on the back of this is a surge in what I would call good dividend investing and those dividends, I think, will bounce back and be strong, versus bad dividend investing where I think you're going to see a permanent reset.

Let me explain that a little bit more. There is, what I would call, this good dividend investing where, as an income investor, you are essentially looking for genuine growing companies that have got a healthy balance between reinvesting in their own business and paying out dividends to shareholders. Where essentially, you, as investor or a saver, are taking, if you like, the excess cash that they don't need in their own business. And that's being used to support savers, folks in retirement, charities, the kind of folks who are our clients. That's good dividend investing. I'm optimistic about that.

What I think we are going to see is the decline, and I think this is a good thing if it happens, of bad dividend investing. That's where companies are, frankly, overdistributing. They're paying too much, they're not investing enough in their own business, they may even be borrowing to pay dividends.

Often, these companies are structurally in decline, or they're low growth companies. They're paying these dividends in a sort of desperate attempt to entice shareholders. I think these kinds of businesses are going to be forced into a permanent reset into lower dividend payments to shareholders, as they should be. The good dividend investing, I think, will go on stronger than ever.

MB Give me an example of some of these sectors where we see good and bad dividend payers.

JD High street retail is a fairly obvious one. It's structurally challenged. There have been cases where companies are simply paying out too much. They're not investing in trying to make the transition to ecommerce, that kind of thing.

Some parts of the oil and gas markets, as well. I'm personally of the view that hydrocarbons, generally, are in the sunset period of their lives. The catch with something like a big oil company, or a bank, or a telecoms company – the usual suspects of income funds – is that they need to invest huge sums all the time just to keep their business level.

Whereas if you look at securities exchanges – like Deutsche Börse, the dominant exchange in Germany, a very capital-lite business model that throws off cash – that type of business can have growth, because they don't need a lot of capital, and a really stable and resilient dividend, because they naturally produce a lot of cash.

So, that's the type of business that we're looking for and the benefit has only been highlighted by the current crisis. If you've got a very capital-intense business model, you've really struggled. It's one of the reasons why UK dividends have been under such pressure, because there's a preponderance of those capital-heavy businesses in the UK.

MB We've talked about some of the oil and gas companies that don't have the prospect of paying large dividends in the future. In five- or ten-years' time, what do you think dividend payers will look like?

JD I think they'll be very much in the sort of 'going forwards' category. I'll give you three examples. Healthcare is an obvious place to start. I think that the value that we, as a society, ascribe to healthcare going forward, and our desire to see innovation and to pay for it, is only going to go up.

Within our portfolio we have companies like Sonic Healthcare, a lab testing company, and Roche, the genetics and testing company. That type of business, for sure, is going to be a strong source of earnings and dividends growth, in my view, years to come.

How about automation? That's an interesting area right now. As folks go back to work and we're thinking about how factory floors are laid out and how engineering processes can happen, it seems to me that there's going to be even more of demand for automation on the factory floor to help with distancing. That's another potential beneficiary of the way the world will be, going forward.

Anything digital. We've seen this, all of us, in our own lives in the past three months. Anything digital that enables us to either work remotely or to collaborate without having to travel, all of those kind of things. Those types of business, whether it be chip makers, software makers, whatever it might be, should be great beneficiaries.

It's tempting to look at the current environment and think, "it's doom and gloom" and, "everything's going backwards", but there are lots of businesses that are going to thrive in the years to come, that are going to be in more demand than ever. So, on a long-term view, I'd be very optimistic.

MB We've talked about tech and digital companies, but, if we take a five- or ten-year view, are you looking at different regions or countries that might offer attractive dividend-paying opportunities in the future?

JD Yes. I think the most exciting one, on the five to ten-year view, is China. I know there's quite a lot of angst at the moment about China's place in the world, and trade relations and so forth, but the thing with great companies is that they tend to thrive regardless of the geopolitical climate.

If a company has a great service that's really in demand, it will tend to do well, regardless of what the president of the US has tweeted recently, or whatever. And there are a lot of those companies growing up right now in China.

There's huge innovation going on. There are some great, often founder-run, businesses. Many of them – the Alibabas of the world – have grown to huge stature already. Our view is there are many more of those to come.

At the same time, as an investor, a great thing that's happening is that the China market is opening up to foreign investors. Our ability to invest in the local A-share market has increased a lot over the past few years. It used to be very difficult to do. It's now become a lot easier.

So, my guess is that if we look out five or ten years, there are going to be a lot more of these great growth and dividend companies available to us for the portfolio, and we'll be able to access them through China's A-share market.

MB And, what has the crisis changed your mind about, James?

JD The thing that, I guess, might be different in future, and exciting as an investor, is that typically when you have a period of crisis, you get a wave of innovation of some kind after it.

If we think back to some of the other crisis periods, very different crisis periods, thinking back to the Cold War and the Space Race in the 60s and 70s. That prompted NASA to put a man on the moon and to space, and they invented all kinds of things in the process. In the 80s, the birth of the GPS satellite navigation system which, today, is massively important for so many different functions, came about because of that.

If you think about the Global Financial Crisis of 2008, a lot of today's financial tech start-ups had their origins in the shakeup that happened in the big banks around that time.

One way that I can see the future, and we're discussing this internally a lot, being very different and potentially exciting as an investment opportunity is seeing how companies react to the current crisis, and how they can innovate to drive growth in the future. Because, typically, you do get a huge wave of innovation after a crisis.

We've seen that already within our own portfolio in various different ways. I guess there are some more trivial examples, like what you can see happening in terms of online communication. Companies like Microsoft are, right now, innovating better ways of doing things during the Covid crisis.

But, then, there are other less obvious examples. Within the networking and telecom infrastructure that companies like Cisco play into, there's quite an exciting wave of innovation likely to come that will basically raise the speed of the internet - because, as we're all sitting at home, we're hitting bandwidth capacity limits. There's a lot of innovation that's going to happen on the back of that, it's already started to happen, to speed up the internet and increase bandwidth.

So, those types of innovations, for sure, are going to come flooding through in the next five to ten years. It's going to be really exciting to see how individual companies respond and seize that opportunity to grow and pay out higher dividends in future.

MB What type of conversations are you having with companies at the moment?

JD We've been extremely keen to reach out to every holding within the portfolio, that's about 60 different names, and have a Zoom face-to-face or a phone call with them. First of all, just to offer our support as long-term shareholders, because for many companies right now these are very challenging times.

Maybe they want to talk through different decisions, or they want to sound us out on some particular topic that they're wrestling with, and we encourage them to make the right decisions for the long term. If that means spending more money and seeing their margins go down in the short term, because it's going to set them up better for the long term, then absolutely go ahead and do that. So, it's those types of conversations that we've been having with pretty much all 60 names that we invest in to offer our support and talk about the long term.

MB We're both sitting at home, maybe in an office, kitchen or living room. People are working in lots of different environments. How has this affected the way you work?

JD Well, I've got a lot more requests to fix BRIO train sets while working than I've ever had in the office. My five-year-old, being a BRIO engineer *par excellence*, likes to get me involved as often as possible. So, that's something I haven't dealt with before.

In practice, it's gone really smoothly, I'm delighted to say. I feel like technology, we've always invested in that heavily as a firm, has really paid off in spades in the past six months. I haven't had any issues there.

I guess, like all of us, I'm a little bored of looking at Zoom screens. I like talking to people face-to-face but, it's okay, that's not possible. We've coped fine. No real problems.

One thing that's really interesting is the working practices we've adopted, that we wouldn't have otherwise thought of. You realise afterwards, "oh, wow, that's a lot better than what we used to do when we could meet up in person".

I don't doubt that on the other side of this, our ability to keep on top of all the different things we're looking at will actually improve.

MB That's a good place to end it, James. Thanks very much for joining us on the podcast and I hope you'll join us again soon.

JD Thanks very much.

MB If you'd like to learn more about how the income generators of the future, which could include Alibaba and Alphabet, will replace the dividend payers of the past such as Shell and Standard Chartered, check out James' recent paper *The Great Dividend Crisis.* You can find that on the insights page of our website at balliegifford.com/insights.

And, many thanks to Lord of the Isles for their music. The track we've used is called *Horizon Effect*, which was released on Permanent Vacation. And, if you're listening at home, stay well and we look forward to bringing you more insights in our next podcast.

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