Equity income at a time of dividend destruction

The shock and uncertainties brought about by COVID-19 have resulted in many businesses around the world deciding to reduce the distributions they make to shareholders. As equity income investors, with clients who are attracted to the combination of regular cash windfalls and lucrative capital growth over time, this is particularly relevant.

We do not take lightly the fact that our clients are likely to receive lower income this year, especially since dividend sustainability is at the heart of our investment process. Dividend sustainability and growth come from long-term cash generation and balance sheet strength, and so it is natural that clients might wonder whether the reduction in income is an indication that we are failing to live up to our words.

Is the dividend cutting justified?

It is important to look at the context. The pandemic has resulted in a great deal of uncertainty for all businesses. Even those whose trading is currently unaffected still face potential issues relating to supply chains, distribution networks or employees.

It is therefore highly prudent that companies maximise their balance sheet strength, reducing leverage in the event of falling profits and boosting liquidity in case revenue streams dry up. They can do this by reducing capital expenditures to a bare minimum, by stopping acquisitions of other companies that may have been in the pipeline, and by cutting the regular distributions that they make to shareholders; be they ordinary dividends, special dividends or share buybacks.

In ordinary times, a dividend cut is a sign of failure. It implies a belief from management that the company will fail to generate enough cash to maintain its existing distribution to shareholders. In these exceptional circumstances, however, we consider dividend cutting to reflect sensible short-term capital allocation, designed to maximise long-term returns for shareholders.

In the majority of cases in which dividends are being postponed, reduced or eliminated entirely, it is eminently possible that dividends will return to 2019 levels within a couple of years. We are even seeing some businesses, which could readily pay dividends, being wary of the negative connotations of not being seen to share in the misery. Others are cautiously waiting to see how the pandemic develops over the coming months, intending to catch up with greater distributions later in the year.

Whether for these reasons, or simply because cashflows have been curtailed by the government restrictions to stem the spread of the disease, we are confident that the resumption of dividend payments will be swift once a solution, such as a vaccine, is found. The widespread financial support provided by governments to put economies on hold, preventing longer-lasting damage to companies and industries, should help businesses bounce back when social distancing measures are fully relaxed.

Sticking to our durable investment process

We are keen to emphasise that there will be no change to the way we run our income funds. We will continue to invest in a broad range of businesses from different industries and at differing stages of maturity. It might be tempting to rush to safety, seeking the companies with highly defensive cashflows, and consequently more defensive short-term dividends. Such areas of interest would include consumer staples, healthcare and technology stocks.

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Yet while fundamentally shifting our portfolios in this way might help us sleep soundly over the next few months, we believe it would seriously endanger our long-term returns. We own some very high quality defensive businesses in the aforementioned sectors, and they will remain key parts of our portfolios, providing steadily growing cashflows. But if the world returns to normal over the medium term, these businesses will have relatively little room for substantial valuation upgrades.

Meanwhile, the companies and sectors that investors are keen to avoid, such as consumer or industrial stocks, would not only experience sharp rebounds in the cashflows they generate, but also enjoy much higher multiples being placed on those cashflows; reversing the low multiples on distressed short-term cashflows that they currently struggle with.

What are we thinking about?

Our focus when analysing our holdings has been on whether any structural changes brought about by the coronavirus will reduce their cash generating potential, and furthermore, the extent to which that reduction is priced into markets.

A classic example is WH Smith, a business whose superior ability to manage space and introduce new product categories without charging more than competitors has led to it becoming the partner of choice for travel landlords, winning contracts globally from competitors and resultantly being able to consistently grow its cashflows in the pre-coronavirus world.

The key structural risk we must now evaluate is whether the 2019 air passenger numbers will be surpassed. While the short-term outlook undoubtedly looks terrible, with 2021 little better, we are confident that the desire to travel, for business and holiday purposes, is on a global upward trend. Considering the competitive advantages that WH Smith has, combined with strong cash management and a recently refinanced balance sheet, the 70% fall in the company's share price looks symptomatic of a market that is unwilling to look through short-term unpredictability. If normality returns, we believe that the share price could easily see a material recovery, with distributions to shareholders returning to previous levels.

Our recipe for success

This contrarian willingness to look through short-term uncertainties and focus on the long-term ability of business models to generate cashflows is the bedrock of our income process, whether you are looking at the UK Equity Income Fund, the UK Dividend Growth Fund or indeed the Global Equity Income Fund. By sticking to our proven investment process and philosophy, we are optimistic that our funds will not only return to their previous levels of income in due course, but will see attractive capital growth alongside it.

Contact us

For more information about our range of products and services, please contact us.

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