February 2016 | £3.95
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Income investors in a quandary

The oil price plunge has put the hitherto reliable dividends of some FTSE firms in doubt. Our experts consider where investors should look for their payouts

COMMITTEE CHAIRMAN

Laura Suter
Editor,
Fund Strategy

Last year began a period of uncertainty for UK dividends, with falling profits making investors unsure which companies could maintain their payouts. Tesco cut its dividend, which many saw as the signal for similar action by other solid dividend payers.

The oil and gas industry and mining companies are particularly under the spotlight, with falling commodity prices expected to have a knock-on effect on these normally solid dividend payers.

More supermarkets are likely to be under fire as the price war militates against profits, while there are also rumours of dividend cuts among pharmaceutical giants such as GlaxoSmithKline and AstraZeneca.

Research by AJ Bell into the dividend cover of FTSE 100 companies does not make pretty reading. In an ideal world, earnings would cover the dividend twice over, but resources firm BHP Billiton has cover of just 0.4 times, BP has 0.9 times and oil giant Shell 1 times.

Sir Philip Hampton, chairman of GlaxoSmithKline, which has 1 times cover, was reported as saying he sees the company's 6 per cent dividend yield as a "financial straightjacket on the business". After such comments it would not be a surprise if the GSK dividend was reduced. So where can the UK equity income investors who crowd into many of these companies go to get their payouts?

Some experts suggest a move down the market cap scale, from FTSE 100 stocks into the FTSE 250 and FTSE 350, where stocks are better able to increase their dividends, albeit sometimes from a smaller base.

Jonathan Davis

I've been bearish on equities for a long while now, and I continue to be so. The macro picture is dire, with slowing global growth, falling global debt levels, falling manufacturing and China exporting deflation, to name a few. In this environment, both small and large international companies simply can't make the profits they once enjoyed.

On top of this, we are seeing slowing UK growth. Indeed, 2016/17 could well be recessionary.

If dividends stay high it will be about the first time in history they have done so in a profits and economic recession.

Investors for income should expect reduced dividend income generally. If, for example, the FTSE falls further and dividends stay the index could be paying over 6 per cent. This is unlikely to be sustained, or even occur, in a zero interest rate environment.

We foresee further falls in global equity indices and further sizeable rises in quality government bond prices. That rate of circa 3 per cent on long-dated US Treasuries is looking increasingly lip-smackingly attractive.

James Calder
Investment manager
Equilibrium Asset Mgmt

In my view, the outlook for UK dividend stocks has deteriorated and will continue to do so throughout 2016. This view emerged towards the end of last year and led to some changes in our asset allocation.

While our overall weight to the UK did not change, the structure did. UK Equity income was reduced in favour of UK long-short funds. The question we have to ask is: why is there all the negativity on UK dividends? We did some simple research and realised that the percentage of the market that provides the overall yield is very concentrated; the top 10 stocks contribute 43 per cent of the market yield, and commodity stocks play an important role.

Despite their recent falls, commodity-related stocks still account for a large proportion of the index. Moreover, a deteriorating outlook is putting a number of income or dividend stalwart stocks under severe pressure for dividend cover.

As a consequence, our view towards this group of stocks has dimmed. We have reduced our exposure to UK equity income and will likely continue to do so over the coming months.

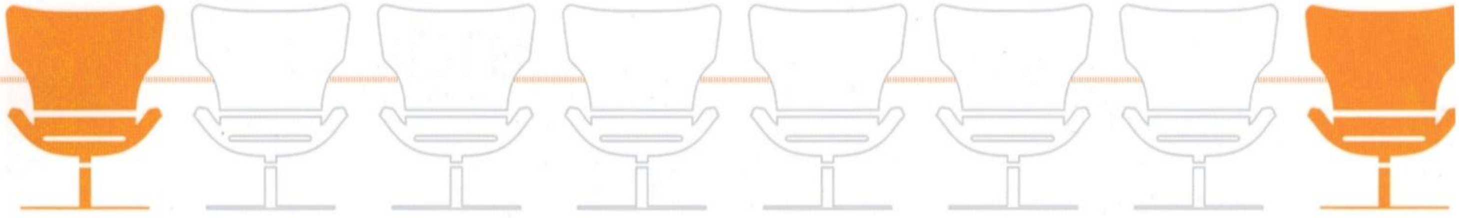
Peter Lowman
Chief investment officer
Investment Quorum

We have seen the FTSE 100 fall by about 20 per cent from its record 7,104 last April, and with this fall have come forecasts that many leading companies will soon be cutting their dividends, if they haven't already.

This has affected many oil groups, miners and retailers, which have struggled amid lower oil and commodity prices and tougher high street competition. If global growth is slowing, then balance sheet weakness is the likely outcome. Hence the possibility of dividend cuts.

And there could be further implications for the UK market, and more importantly for UK income funds. While we might see dividend cuts from stocks vulnerable to current conditions, many companies, such as some UK banks, consumer stocks and housebuilders, might increase payouts as they benefit from the weaker pound and a strong demand from the property market.

It will be important to identify those UK income fund managers who are building their portfolios around the strengths of the current investment and economic cycle.



Mike Deverell
Investment manager
Equilibrium Asset Mgmt

Dividend cover is a big focus for us when reviewing funds right now. We calculate that the total earnings of the companies in the UK market are about 1.7 times the market's dividends. Five years ago, dividend cover was almost three times.

If we look at the top 100 stocks, the cover drops to just over one time, meaning the profits of FTSE 100 companies are barely more than the dividends they pay.

The picture gets worse when we look at some of the largest companies. Of the top 10 stocks, four have dividend cover of less than one, meaning dividends are not fully covered by profits.

This includes the oil giants but also, surprisingly, stocks such as Vodafone and GlaxoSmithKline. While in the short term dividends can be paid from reserves, unless profits grow strongly these dividends could be cut.

This is one reason we are holding a lot less in index-tracking funds in the UK than we do normally. We much prefer actively managed funds that can avoid some of these potential pitfalls. In particular, we like funds that can go down the market cap scale and find potential bargains.

Tim Cockerill
Investment director
Rowan Dartington

The concentration of the major part of the FTSE All Share dividend in the hands of a small number of companies has long been a concern. It's true that if you invest without straying far from the benchmark, dividend cuts by the big payers are a problem, and with oil at $30 a barrel, oil companies big and small will struggle to maintain payouts. Indeed some have cut their dividends to zero.

With Shell recently stating that profits will be half what they were previously, this puts huge pressure on the management team. Many shareholders want them to maintain the dividend, but if the profits aren't there it might simply not be possible.

Big UK equity income funds tend to have a bias towards large cap payers and it is these funds that seem most likely to be affected by dividend cuts – although tobacco stocks look robust and these are a favourite with large income funds.

I anticipate quite a lot of dividend cuts this year, but I expect some income funds to escape relatively undamaged because they have a focus on mid and small caps and aren't themselves too large.

John Husselbee
Head of multi-asset
Liontrust Asset Management

Finding investment income is not getting any easier. The Monetary Policy Committee decided again at its January meeting to leave interest rates unchanged, which means they have been at 0.5 per cent since March 2009, and there is no relief in UK gilt yields any time soon.

Meanwhile, many investors continue to look to dividend-paying stocks for both current income and future growth. According to Investment Association data, UK Equity Income was the best-selling sector seven out of the past 12 months. But there are now concerns on dividend cover and reports that dividends are forecast to fall in the UK for the first time since 2010. The collapse in the oil price is dragging down payouts, although a weaker sterling has boosted the income pot.

The dividend story is far from over, although fund buyers are reviewing the concentration and polarisation within the fund sector. They are seeking diversification, while many managers continue to seek alternative sources of income, namely in fixed interest, global equity, real estate and in mid and smaller cap companies.

INDEPENDENT VIEW

Will Meadon
Fund manager
JPMorgan Claverhouse Investment Trust

UK dividends are on average going to be lower in aggregate in 2016. This presents a problem for investors who rely on the UK market for a regular and growing income.

On the surface, this fear might appear unfounded. For example, both the oil and mining sectors would appear to offer attractive dividend yields: BP offers a prospective yield of 7.7 per cent, Shell 8 per cent, while BHP Billiton's yield of over 11 per cent is surely irresistible.

Regrettably, the market is not so inefficient as to offer investors such mouth-watering yields without a huge health warning. Such high yields pose substantial investment risk.

For example, the balance sheets of all three companies mentioned above have suffered in 2015 from plummeting commodity prices. Even if they pay their dividends in 2016, each will have to borrow the money to do so, as they are not generating sufficient cash.

Investors should instead focus on stocks with lower yields but which have a greater certainty of dividends being paid or – better still – increasing.

Sectors with strongly supported dividends include housebuilders. Many quoted housebuilders have such strong order books and balance sheets that they have committed to minimum cash returns for the next few years. Barratt and Berkeley Group both yield over 4.5 per cent if they stick to their commitments for cash returns.

Other attractive dividend sources include British American Tobacco and Imperial Tobacco, both of which yield over 4 per cent on a 12-month view.