EQUITY INCOME

Inside the worst case scenario for dividend equity investors

With more and more companies suggesting the likelihood of a missed payment, what are fund managers doing?

by **CHRIS SLOLEY**
Posted 31 MARCH, 2020

With major companies moving to cut or withhold dividends at their next meetings in response to the Covid-19 outbreak, are managers who invest primarily in income-generating equities concerned?

The European Central Bank on 30 March, as an indicator, told eurozone banks to delay or avoid paying a dividend until October, which would allow them to ensure their own financial viability in the mid-term. According to *Reuters*, this could save eurozone financials around €30bn over this period.

'These are unprecedented times so one can never say never,' said Citywire A-rated Anu Narula, head of global equities at Mirabaud Asset Management. Narula, who runs the Mirabaud Global Equity High Income fund, is among those currently looking at how he would be adjusting to this challenging environment.

Matthew Jennings, an equity income investment director at Fidelity, believes dividend managers have faced these challenges before, albeit in different circumstance. 'During the financial crisis, dividends were cut by around 20%, albeit with variation by region and sector, and over a longer period of time.

‘Of course, the important difference today is that the recession is being caused by a policy response to a global pandemic, rather than years of financial excess and risk-taking in the banking sector.

‘This could mean that many companies will be able to resume dividend payments once the lockdown ends and economic activity resumes, though there is currently a great deal of uncertainty around when this will happen.’

However, Jennings said, a crucial part of a managers’ job at present will be to work out whether the dividend cut is due to the exogenous pressure on companies or due to some other fundamental weakness, which would mean it shouldn’t be invested in anyway.

What’s the worst case?

So, if the situation remains suppressed and no dividends get paid until October, what can investors actually do? ‘In a worst case scenario if the dividends were to be cut we have the option to add income through the use of covered calls,’ Narula (pictured) told *Citywire Selector*.

‘We can sell calls where we own the stock 5-10% out of the money which given volatility is high will bring additional income. This would be for select names and no more than 25% of the portfolio so around 10 names. This is something we have done successfully in the past.’

Narula has sought to focus on companies with both high free cash flow yields and strong balance sheets. His €78m fund has only two below investment grade positions, and many net of cash.

'There will always be a scale, some relatively weaker and others relatively strong within those sound balance sheets. We have been stress testing all the income holdings over the last 2 weeks for our worst case scenarios.

'There are also a number of key differences with the way we invest which should allow more protection. These companies all benefit from secular themes like the explosion of data and platform companies.'

For Jennings, he believes the market will be appreciative of the extreme situation seen globally. 'A dividend cut in normal circumstances can be a signal of a business which has been poorly managed or is in structural decline. However, this is not necessarily the case today.'

Meanwhile, Jason Pidcock, who runs Asian income strategies at Jupiter Asset Management, believed that cutting dividends in this environment made sense. 'There is no doubt there will be a widespread cut in dividends.

'I imagine most companies will cut but there will be a few who cancel altogether and a few who maintain dividends even in the face of lower earnings by paying from a strong balance sheet, probably where they are in a net cash position.

'We have seen a number of companies 'withdraw guidance' which is effectively an admission that dividends will be lower. However, we have to remember share prices have fallen by some way, and if dividends don't fall as much, then yields will still look very attractive, particularly in comparison to government bond yields.'

Pidcock said, ultimately, dividends have to be funded by earnings and earnings will be under pressure this year. 'At this stage we are hopeful that there will be an earnings recovery in 2021, which ought to be positive for dividends,' he added.

Where to buy?

Looking at the Covid-19 situation, Narula said many of the dividend-paying stocks will benefit from the stay-at-home economy. He has bought into Colgate, Starbucks, Home Depot and Procter & Gamble. He also named communications companies and internet service providers, as well as global data centre providers.

'We have also been conducting calls with our key names like CME the Chicago mercantile exchange yesterday - the CFO to get updates on current trading, outlooks for the business and dividends.

'We have made few changes to be honest. We are high conviction long term investors with around 40 holdings that use themes as a filter and are five globe rated on ESG by Morningstar. The only changes we made were selling two UK holdings - Compass Group who are in the eye of the storm as events have been shut down. As a leader in global catering the business model will not be as defensive as in the last cycle.'

Jennings said Fidelity International's equity income team has not been moved to do anything straightaway. 'We have no automatic 'knee-jerk' reaction to a dividend cut in the portfolio. In many cases a dividend cut today will be in the long interests of shareholders and aid a speedy recovery on the other side of the pandemic.'

'As such, we could own some companies which will not pay a dividend in the current year if we believe long-term franchise value is preserved and that dividends will be resumed once the pandemic has passed. We feel that at this time, taking a pragmatic view based on expectations for a long-term total return rather than chasing income growth in the current year is the right thing to do for our clients.'