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Quilter

Generating income – then and now

May 2020

Investors were well-rewarded in 2019, with the majority of asset classes recording a positive result for the year led by US shares. Income investors were equally successful, although some may be surprised by the sources of some of their yields. We look at three of the best income generating asset classes over 2019 and examine where they are now.

1. UK shares

Then: Many investors have avoided the UK stock market since the EU referendum in June 2016. Brexit uncertainty has weighed on UK growth and investor attitudes towards the country, and 2019 was no exception.

From an income point of view, however, the UK market is a significant dividend payer, with the FTSE All-Share index yielding around 4.75% at the end of 2019. This made it attractive compared to other stock markets and asset classes as an income generator. Over the course of 2019 roughly three-quarters of UK companies paid out a higher income than you would have received from lending to the UK government in the form of 10-year government bonds (gilts).

Perhaps surprisingly, the UK market performed better than some might have expected in 2019. And even more surprisingly was how well the medium and smaller sized companies in the FTSE 250 index did, despite a difficult first half of the year.

During the Brexit chaos last year, investors were less positive on the outlook attached to many smaller companies, which as a result traded on historically low valuations while also offering attractive and growing dividends. The additional clarity on the Brexit outlook from the Conservative UK election victory in December, combined with a boost to sterling, all helped these stocks to rally – which would have rewarded income investors prepared to look through the short-term market noise and focus on the underlying quality and value of these companies.

Now: The unexpected coronavirus global pandemic and the resulting social distancing and lockdown measures have put pressure on economies and businesses around the world, including the UK.

For UK income investors, the biggest blow so far has come from the banking sector, with Lloyds, Barclays, HSBC, Standard Chartered and Santander among those who have cancelled their dividends following pressure from their regulator the UK Prudential Regulation Authority (PRA).

Many of these banks are perfectly healthy though, having shored up their balance sheets since the last crisis. Were it not for the dividend ban they would be in a good position to pay out, even considering expected losses from bad loans. This makes the dividend cancellations particularly hard to stomach for equity investors, but from a policy perspective it is understandable that after loosening the constraints on banks' ability to lend, the regulator is keen to ensure all this benefit goes directly towards supporting the economy rather than remunerating shareholders.

Other sectors have also been affected. The oil and gas industry, for example, has been severely affected by the fall in demand for oil as people stopped travelling, and despite an eventual agreement between oil producing nations to cut supply, the reduction has been inadequate to alleviate the oversupply that pushed the oil price lower. With Royal Dutch Shell among those cutting their dividends, there are questions over the sustainability of some oil producers' dividends, although most look to set to maintain them for now.

Businesses that provide the regular products that we all need are having a better time of it, however. Consumer staples companies are maintaining their dividends, with their sales largely unaffected by or even benefiting from the coronavirus pandemic – supermarkets are reporting strong increases in sales as everyone is forced to cook for themselves at home. While certain sectors might be less attractive for income investors in the short term, dividend pay-outs should resume once the pandemic passes.

2. Emerging market debt

Then: 2019 was a good year for hard currency emerging market bonds. This is debt issued by less developed nations, for example India or Brazil, which is denominated in a foreign currency (usually US dollars) rather than their own domestic currency such as the rupee or real. Falling US interest rates inherently pull the price of bonds like this higher, and by taking on the additional credit risk of lending to an emerging market issuer – essentially a higher chance that they might not pay back their debts – investors receive a higher interest rate than if they just lend to the US government.

Investors also benefit from an increase in bond prices when a stronger economic backdrop reduces the risk of an emerging market borrower defaulting. This happened over 2019, when optimism that trade tensions would ease and signs of a pick-up in global manufacturing helped emerging market debt to post healthy returns.

Now: The environment for emerging market debt looks more challenging going forward. Any government spending to counter the effects of the coronavirus will see budget deficits and debt to GDP ratios (a measure of a government's ability to pay back its debts) increase, leading to inevitable questions about debt sustainability.

The oil price crash, driven by the huge fall in global demand and the recent price war between Saudi Arabia and Russia, comes at a particularly bad time for oil exporters, a group that includes many emerging markets. The additional yield on hard currency emerging market debt compared with US Treasuries, as measured by the EMBI Global Spread index, increased by 3% from mid-February to the end of March. Investors are certainly being compensated for the additional risk, but is it enough? The sort of market turmoil witnessed in March often presents opportunities to pick up bonds from high quality issuers at attractive prices; this could prove to be one of those times.

3. Asian and emerging market equities

Then: As the largest emerging market economy, it is not surprising that emerging market equity indices have a large weighting in China, with Chinese companies often accounting for roughly a third of an index. Some investors were therefore understandably cautious about the outlook for emerging markets in the midst of the US-China trade war. After a positive start to 2019, the share prices of Chinese listed companies experienced a large fall in April before slowly moving back up towards their earlier highs, albeit with some volatility as the trade war to-ing and fro-ing continued.

Traditionally emerging market stocks would be thought of more as growth assets – carrying higher risk but with the potential for higher returns over the long term – rather than as stable income generating ones, but they should not be overlooked by income investors.

As emerging market companies have matured, their dividends have also grown. The MSCI Emerging Market (EM) index recorded annual growth for its 12-month aggregate dividends per share of almost 25% in 2018. This helped the index start 2019 by yielding a healthy 3%, and while that was some way off what was on offer in the UK, there was perhaps a better chance of those dividends growing over time.

Now: Asian shares, which constitute the bulk of emerging market equities, could become some of the best performers over the next few years after a decade of dominance from the US. The coronavirus hit Asian countries first, but following aggressive lockdowns previously deemed unthinkable in the developed West, indications are that these economies are starting their return to normality. From an income perspective too, Asian companies pay out a lower percentage of their profits than elsewhere and tend to have less debt. Both factors should help to make their dividends more sustainable in a world where dividend cuts are becoming more and more common.

Taking stock

The events of the past year have clearly shown the benefits of diversification for all investors – including those investing for income. In the uncertain world created by the coronavirus, the UK will most likely continue to be an attractive market for income seekers, but it seems likely that dividend growth will be lower than profit growth in the coming years as companies look to make their pay-outs more sustainable. And with even financially sound companies such as banks suspending their dividend pay-outs for regulatory reasons, income investors should be aware of the risks of concentrating investments in too few areas.

Equally it is crucial not to simply pick companies that pay the highest dividends at time of purchase.

If you are looking for a sustainable income stream that grows over time, then the ability of companies who pay out a lower portion of their profits as dividends to grow these payments, something you see in many emerging market companies, is equally important.

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