INVESTMENT COMMENTARY

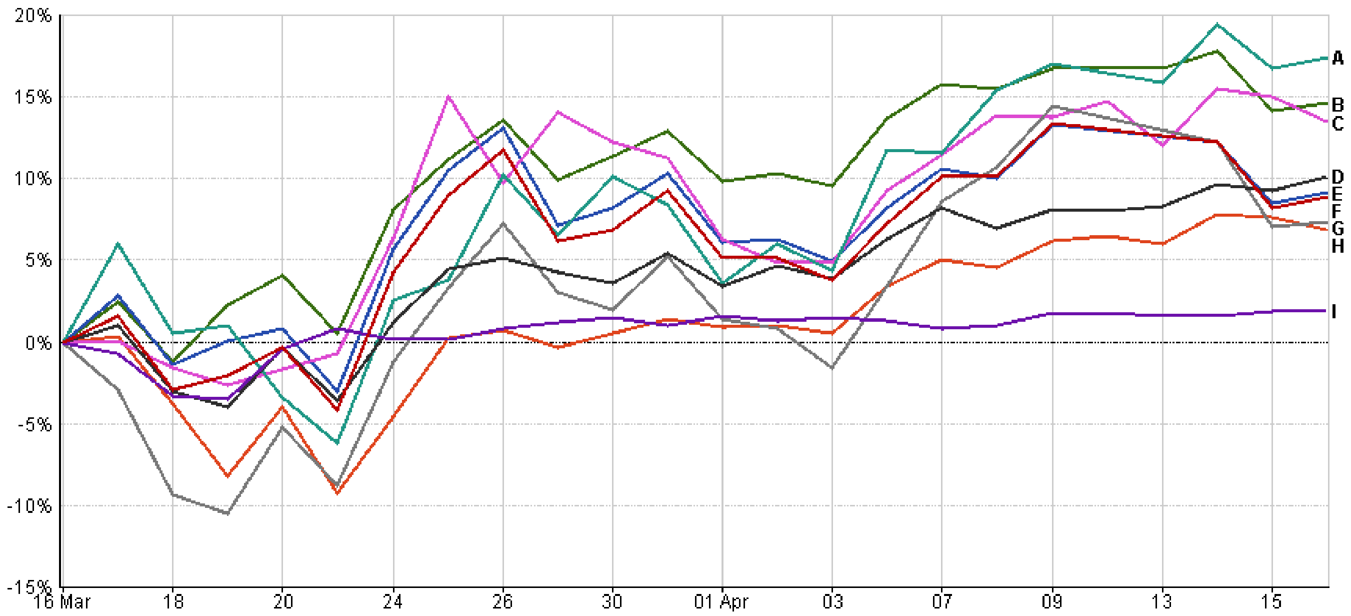
16 April 2020

CARTLIDGE MORLAND

In last week's commentary (9 April 2020), we pointed to the fact that equity markets had started to recover from March lows, but we expected that there would be further volatility around poor economic data releases. This has been the case this week, with sharp declines seen in US retail sales and industrial production in March, coupled with a fall in the oil price, even after OPEC and Russia reached an agreement on cutting supply. We are also seeing the earnings figures for the first quarter being announced. In the US, major banks reported steep falls in income and that they had set aside billions of dollars to reserve for losses on loans. Investor sentiment turned more negative as a result. The International Monetary Fund (IMF) has predicted that global growth will contract by 3% in 2020. Significant increases in US unemployment to 20m, combined with highly various relief programmes amongst the individual states, are now concentrating minds in the Administration.

The daily number of reported COVID-19 cases continues to fall globally, although very sadly the death rate has increased as this lags the former. Against this background of containment of the virus, a few countries have started to announce some relaxation of economic restrictions with a partial return to work to be allowed in Germany, Spain, Italy and Denmark. These gradual moves towards emergence from lockdowns are positive for society, economies and investor sentiment. However, speculation about the time it will take to fully reopen economies will continue to dominate investor sentiment.

Investment Market Returns in Local Currencies Over One Month



- A - S&P 500 TR in US [17.46%]
- B - FTSE World Europe ex UK GTR [14.64%]
- C - Nikkei 225 in JP [13.46%]
- D - MSCI China TR [10.14%]
- E - FTSE 100 TR in GB [9.16%]
- F - FTSE All Share TR in GB [8.83%]
- G - FTSE 250 TR in GB [7.31%]
- H - FTSE World Asia Pacific ex Japan GTR [6.85%]
- I - FTSE Actuaries UK Conventional Gilts 10-15 Years TR in GB [1.87%]

16/03/2020 - 16/04/2020 Data from FE fundinfo2020

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UK EQUITY INCOME FUNDS—CURRENT AND FUTURE PROSPECTS

UK equity income funds have been core holdings for many years in portfolios, as they have offered attractive, growing income streams and the potential for capital growth in the longer term. Funds in the UK equity income sector are targeted to achieve a historic yield in excess of 100% of the FTSE All Share yield on a three year rolling basis and 90% on an annual basis. These funds tend to invest mainly in larger UK companies which are financially secure and have the potential to maintain and/or grow their dividends. Usually these companies keep dividends steady through difficult economic conditions and increase them during good times. Cuts are usually the last resort. Banks, pharmaceutical/healthcare companies, food and drinks companies, tobacco companies, mining companies, oil companies and utility companies are some of the key dividend payers in the UK. Share prices have been hard hit in the recent equity market turmoil and dividends now look under severe pressure. Around 45% of UK companies had already scrapped dividends by 5 April 2020 worth about £23.8bn. Banks have been 'advised' by the government to cancel dividends for the next year which amounts to around £13.5bn. Defensive dividends are more likely to be retained – those paid out by food retailers, drinks, tobacco and healthcare companies. More cuts or postponements of dividends are likely in the coming weeks as companies seek to retain cash to see them through the lockdown period and beyond. This is the right thing to do and in some cases, share prices have risen as investors have rewarded this prudent approach. The full impact on dividends depends on the length of the lockdown and the severity of the economic downturn on profits.

Our recommended UK equity income funds are run by experienced managers who maintain diversified portfolios. They have exposure to a range of dividend producing companies which may include banks, oil and mining companies which have seen or are likely to see dividends scrapped or cut this year. However, they also have holdings in the defensive dividend sectors mentioned above which should insulate the income paid out by the funds to some extent. The managers are focussed on ensuring that they are invested in companies that survive - those remaining solvent and preparing now for worst case scenarios. Ultimately, these survivors may benefit if weaker competitors do not make it through these challenging times. Where liquidity permits, some managers are taking the opportunity to invest in shares of companies with strong balance sheets but which have fallen steeply in value. In the longer term, they believe that these well-run companies will recover significantly and dividends will be reinstated. Nevertheless, income levels from the funds will reduce as a result of the dividend cuts and postponements. The extent of falls in income levels from the funds is as yet unknown but estimates for the whole market range from around 30% to 50%. Once coronavirus is contained and the economy is restarted, dividend levels are likely to start from a much lower base than prior to the COVID-19 crisis and dividend policies reset to reflect the more prudent mood. Dividends will return as they did in the aftermath of the Great Financial Crisis in 2008 but it is now imperative that good managers continue to analyse balance sheets and liquidity remains paramount.

CARTLIDGE MORLAND UK EQUITY INCOME RETURNS

The performance of equity income funds has been severely impacted by the recent correction in the UK market due to the types of sectors in which the managers seek dividend paying companies. Over the longer term, as illustrated in the graph, equity income funds (represented by the Cartlidge Morland UK Equity Income Portfolio and the Investment Association (IA) UK Equity Income Sector Average) have produced steady returns for investors either with the compounding effect of reinvested dividends or an attractive regular income stream paid to bank accounts.

We expect to see share prices and dividends recover over the next couple of years as they did in the wake of the Great Financial Crisis.

UK Equity Income and FTSE All Share Index

Total Returns over 10 Years

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