FTSE 100 AND THE DIVIDEND *DILEMMA*

One of the UK's most popular investment strategies is under siege, assaulted by sweeping dividend cuts during the COVID-19 pandemic.

According to a recent Financial Times article, dividend distributions by UK companies were down 57%, from £38.1 billion to £22 billion, during the second quarter of this year when compared with the equivalent period in 2019. In fact, 176 companies within the UK cancelled pay-outs in Q2, with 30 more cutting them back – this represents significantly more than during the last global financial crisis, when two-fifths of companies cut or cancelled pay-outs at the worst point. These include many of the "blue chip" names upon which UK investors have traditionally relied to provide a reliable source of income that, against the backdrop of historically low bond yields have become increasingly important in recent years.

Among the constituents of the FTSE100 Index, Shell had been the biggest payer before it cut its pay-out – the first time the company had done so since 1945 – by 66%. Others to cut or stop pay-outs include telecommunication giant BT, property firms Persimmon and Taylor Wimpey, Imperial Tobacco, Royal Mail and well-known insurers such as the RSA Group. Included in this wave are the dividend darlings, the high street banks – HSBC, Barclays, Lloyds Banking Group and NatWest; where the Bank of England intervened and instructed them to cancel any ideas of dividend payments in 2020.

Since, in the main, dividends should be paid from a company's excess annual profits, companies that cannot comfortably afford their dividend might have to pay them out of capital or debt or slash their annual pay-out. A longer-than-expected economic downturn could therefore place further pressure on dividend payments as profits and cash flows are squeezed further – with second quarter earnings being announced, there are fears those companies that haven't yet cut will do so as the full extent of the economic shutdown is laid bare.

Still, the outlook isn't entirely bleak. Even after announced and anticipated cuts, London-listed stocks still offer a comparatively strong (estimated) dividend yield of 3.6% for the FTSE 100, which compares with 1.9% for the S&P 500, 2.8% for the MSCI Europe (ex-UK) and 2.4% for Japan's Topix. With interest rates forecast to stay close to zero for a long time, possibly boosting the appeal of all stocks, in general.

So where can you look to replace declining dividends and traditional sources of income?

Continued overleaf

Many UK-based investors have traditionally sought income by investing heavily in FTSE 100 companies that paid regular and significant dividends. Having said that, even prior to the COVID-19 crisis the strategy was becoming less sustainable as it involved more and more people investing in a steadily narrower range of companies and sectors. Importantly, with the ever-increasing need for income in a zero-interest-rate-policy environment there are other sources of income to be found elsewhere.

Infrastructure: This involves investing in the shares of companies around the world that provide critical infrastructure projects in sectors including transport, energy and utilities. Infrastructure assets tend to have long life spans and stable and predictable cash flows, earning income from consumers and businesses that need their services even during times of economic hardship.

High-yield and emerging market debt: Rather than buying shares, this form of investment involves buying the debt of a range of companies and countries. Although high yields tend to be associated with higher risk of default, provided that exposure to such assets is suitably diversified and well-managed, the additional returns from this form of investment will tend to outweigh the loss from individual defaults.

At MitonOptimal, we have never constructed income orientated portfolios with a bias to the UK market. Instead, we have and continue to prefer to construct income portfolios from a global perspective – this provides a much wider base (i.e. 1000's rather than 100's of stocks to choose from) across a more diversified geographic and sector perspective – this includes both fixed income and equities.

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