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ABOUT INVESTING

The challenges facing income investing

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It's been a challenging 18 months for income investors. Dividend payouts were hit hard by COVID-19 lockdowns and market uncertainty.

Traditional thinking on income investing is being tested and, as a result, asset managers are having to think differently about how to generate income for clients in future.

Dividends and the impact of the pandemic

On 31 March 2020, the Bank of England's Prudential Regulation Authority backed the decision by large UK banks to suspend dividends for the rest of the year and requested that any outstanding payments of 2019 dividends be cancelled.[1]

As companies felt the unprecedented impact of the pandemic, it wasn't just the banking sector that had to reduce or cancel dividends. The UK Dividend Monitor Q1 2021 report from the Link Group puts the total cost of lost dividends during the previous 12 months due to COVID-19 at £44.8bn, with two-thirds of UK companies reducing or cancelling dividends.[2]

By April 2021, the outlook on dividends seemed to be more promising and the Link Group's Q2 2021 UK Dividend Monitor report showed dividends jump by 51.2% in the period to 30 June 2021.[3]

In July and August, several banks resumed paying dividends, with one banking group pledging major dividend payouts and share buybacks over the coming years. Elsewhere, rising oil prices have seen some of the main energy groups raising dividends and announcing share buyback programmes.

The question fund managers are asking themselves now is whether this dividend recovery is sustainable. It may yet be interrupted by further impacts from COVID-19 itself or the unwinding of associated government stimulus packages as economies unlock at different rates and in different ways.

A challenging environment for bonds

A mix of shares and bonds has long been a go-to for advisers looking to generate retirement income for their clients. This is a tried and tested way to both dampen volatility and provide income.

But since the end of last year, this traditional approach to portfolio construction has become more challenging when it comes to meeting client needs. With low yields and low expected returns there is a view that many mainstream bonds will be less effective in their usual role of helping with overall performance, or acting as a way to balance the risk of equities.[4]

This market environment is creating challenges around investing in fixed income, with an unwanted combination of higher risk but limited reward. It is also raising questions around how to build diversified portfolios, and where to look for bond alternatives.[5]

For advisers, one of the challenges has been to manage client expectations around sustainable withdrawal rates.

There are also discussions happening between advisers and investment firms about the right approach for clients in retirement. The debate is between natural income (from dividends, interest or coupons) or a total return approach, where the focus is geared around generating returns from income or capital growth across the portfolio, with the client's retirement paid for via regular withdrawals.[6]

Thinking outside the income investment box

With the challenges around bonds and the prospect of uneven dividend payouts, fund managers are positioning their portfolios to take advantage of the opportunities for shares and bonds that can still be found in most market conditions.

European car makers are an example of big names that pay dividends, while also playing into the structural theme of sustainable investment through the development of electric vehicles.

Interest has also turned to the technology sector as a potential route for income investors. Typically seen as growth stocks, some asset managers are beginning to see technology firms as a more defensive play, with reliable income streams and good quality earnings over recent years.

Other managers point to the wider technology ecosystem as a way of going beyond the normal thinking on income.

Infrastructure has been widely tipped, too, as a way of encouraging a different approach to income investing. The UK Government has said it wants to see more institutional investors such as pension funds investing in 'long-term UK assets'. The hope is this will drive an economic recovery but also offer clients better returns.[7]

The sense among asset managers is there will be new 'winners' in this investment cycle, which will require more nuanced and creative ways of investing for income than has previously been the case.

Learn more

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[1] The Bank of England – PRA statement on deposit takers' approach to dividend payments, share buybacks and cash bonuses in response to Covid-19, 31/3/20

[2] Link Group – UK Dividend Monitor Q1 2021, 26/4/21

[3] Link Group – UK Dividend Monitor Q2 21

[4] Forbes – Time to rethink the classic 60/40 portfolio?, 13/3/21

[5] Forbes, The Key Fixed Income Challenge for 2021, 24/12/20

[6] Illuminate – The income vs total return debate in retirement, 21/1/21

[7] Gov.uk – Prime Minister and Chancellor challenge UK investors to create an 'Investment Big Bang' in Britain, 4/8/21

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