Heartwood
Investment Management

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Investment Insight

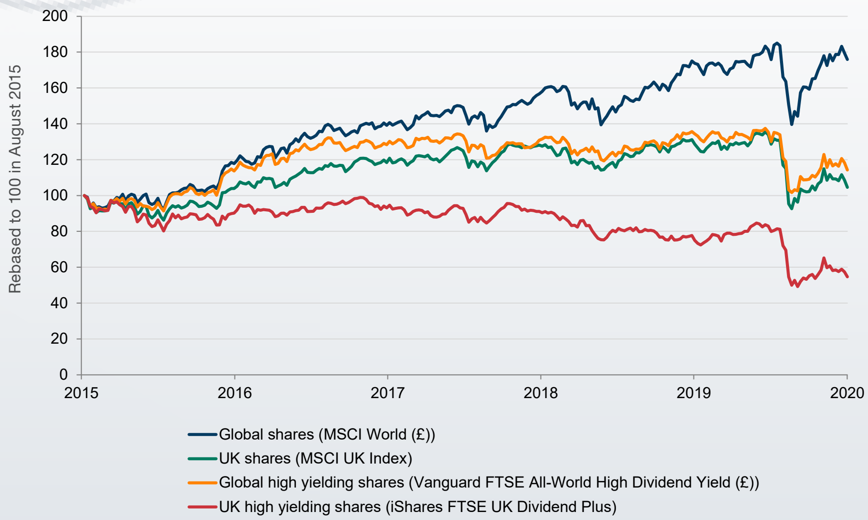
Surviving a crisis:
Five things income investors should learn from the global pandemic

It has been a challenging few years for investors looking to draw income from financial markets. Amid a multi-year trend of low yields in bond markets, and investor disinterest in dividend-paying shares in stock markets, 2020's economic crash led to the sharpest cuts to global dividends in history.

Following the worst of March's market falls, companies were placed under intense regulatory and political pressure to abort payouts to shareholders, meaning that even some shares which had already traded through their 'ex-dividend' dates (typically the point of no return for delivering on promised payouts) saw investor payments cancelled. The word 'unprecedented' has been used to excess in recent months, but the situation for income investors is genuinely unparalleled.

Not only have UK shares underperformed the global market, but UK dividend-paying shares have underperformed their (already weak) global counterparts

Representatives of UK and global stock markets, and UK and global high yielding stock markets



Source: Factset

Past performance is not a reliable indicator of future results.

Indeed, emerging unscathed from the global pandemic crisis is a sadly unlikely scenario for any income-oriented investment portfolio. Still, as highly active asset managers, and aware that many of our clients rely on the income they draw from their portfolios, we were at least able to mitigate some of the potential fall in income distributions. Five key moves helped us to weather the storm.

1. Be quick

When March's market crisis hit, income portfolios needed to be repositioned as soon as possible in order to protect income flows and client capital. We made a number of key adjustments at high speed. First, we reduced our lower risk and lower yielding stock market positions (such as Japanese shares, which pay only small dividends) in favour of positions in higher yielding, higher risk areas of global corporate debt markets which were boasting attractive valuations and yields at that point in time.

Clear Thinking

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>
> **Jaisal Pastakia**
> Investment Manager

Second, we also increased our allocation to selective investment trusts which were offering attractive yields, and whose share prices had been penalised (perhaps unfairly) in line with dramatic stock market falls. Third, positions in entirely non-dividend paying shares (held on the expectation of superior capital growth) were also swapped out of the portfolio in favour of income-producing shares and specialist 'overwriting' strategies designed to provide more attractive yields. These moves were begun within three weeks of March's financial market lows.

2. Be flexible

Moving quickly to reposition an investment portfolio is really only possible if that portfolio is already flexibly positioned, with a blend of holdings designed to be as liquid (easy to move in and out of) as feasible.

We need hardly name the spate of recent high profile cases of portfolio managers chasing sources of income down blind alleyways, only to find themselves irrevocably trapped in illiquid, out-of-favour assets. These cases predate the COVID-19 crisis, reminding us that while cancelled dividends on the scale witnessed in 2020 is brand new, the thirst for income in low-yielding mainstream financial markets is not.

In this environment, a truly multi asset approach (not focused solely on bonds or shares), aimed at delivering sustainable income and capital protection, is now more valid than ever. Happily, the range of products available to income managers is large and expanding, allowing us to use both traditional and alternative asset types as building blocks in well-diversified portfolios.

3. Search for the best

While all asset types were punished in the worst of March's market falls, the specific holdings within income portfolios still made a huge difference to performance and income flows.

Indeed, pockets of resilience in otherwise embattled sectors have proven once more that it is not enough for income investors to take a blanket approach to broad asset types – a focus on specific market opportunities and economic themes is key. Within our own portfolios, despite asset price volatility, cash flows continued to come through in specific areas like healthcare royalties and infrastructure project debt. The robust underlying fundamentals of these investments behaved relatively resiliently, even in a testing environment. Our social housing position – where rental streams are government-backed – also held up well versus the wider property sector.

Once again, a multi asset approach has the potential to help too. Within a company's structure of liabilities, paying coupons to debt holders is prioritised above paying out dividends to shareholders. Investors with positions in company debt (corporate bonds) can effectively expect to receive their bond coupon payments for as long as a company is solvent, even when payouts to shareholders are cancelled. Holding a blend of asset types (rather than only shares) therefore has obvious potential to limit the impact of broad-based dividend cancellations on a portfolio's income distributions.

4. Plan for the worst

For the most part, we have kept hold of the portfolio positions which served our clients well during the worst of the market falls. These positions do not necessarily provide income flows, but do serve to protect capital wherever possible. This includes a diverse range of holdings encompassing our position in gold (the best performing asset type in the first half of 2020) and some of our allocation to specialist strategies designed to protect against dramatic market falls.

Spreading the opportunity of reward and the possibility of loss is key to many investment styles, but arguably it is nowhere more important than in investing for income. With continued uncertainty around economic growth, the pandemic, geopolitics and more, we think it makes sense to ensure our portfolios include a number of different routes to financial returns, as well as capital protection under a diverse range of market and economic scenarios.

Contact

To find out more about the Heartwood strategies, visit our website or contact your local representative.

5. Think long term

In the coming period, market sentiment is likely to continue to favour growth-oriented sectors like technology, which are among the segments of the market least likely to pay out dividends. With bond yields currently held captive at very low levels (amid ultra-low interest rates), and investors still in need of income, they will ultimately need to find at least some of this in good quality, dividend-paying shares. Entering into the COVID-19 crisis, price valuations for dividend-paying shares were largely holding up fairly well, with corporate balance sheets looking rather healthy. Now, with dividend payments cancelled across a range of sectors, balance sheets for some businesses may actually be looking even better (more cash rich) than prior to the crisis.

What's more, many businesses have been taking advantage of low interest rates to issue new bonds, securing corporate funding very cheaply. There will be notable exceptions, of course, but the most robust businesses could actually exit the worst of the COVID-19 crisis with healthier-than-expected balance sheets. Once these businesses are able to restart paying dividends (potentially within a 6-12 month window) this should also help their share price performance. Truly active income fund managers should be aware of this, and have their portfolios positioned accordingly.

For financial markets as a whole, recovery in performance from the COVID-19 shock began almost at once. For dividend payouts, this recovery will take longer. Nevertheless, income investors should make sure they are ready for both crisis and improvement, including the right balance of assets in their portfolios.

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