With dividends hit by the pandemic, where should investors turn?

BY STEPHEN LITTLE

Dividend-paying UK shares have always been popular with investors, but Covid-19 has led to many firms cutting their payments to stay afloat or rein in costs.

FTSE 100 companies have regularly paid substantial dividends, but companies have already made cuts of £30 billion this year to shore up their balance sheets.

Some banks, including HSBC, Barclays and Lloyds, have announced they are scrapping dividend payments.

Meanwhile, Royal Dutch Shell has cut its shareholder dividend for the first time since the Second World War.

For investors looking for returns from dividends the future looks bleak.

Fund manager Janus Henderson is predicting global dividends from investments could fall by more than a third this year.

It says investors in sectors including banks and specific industrials such as aerospace are likely to be the worst hit.

Europe and the UK could end up being heavily affected this year as regulators have forced banks and insurers to suspend dividend payments if they have accepted state support.

North America and Asia will likely be impacted less as issuers tend to focus more on share buybacks – where companies buy up their own shares to return money to shareholders – and pay less out of their profits as dividends.

This gives companies more flexibility to maintain dividends when earnings are weaker.

A higher share of technology firms in the US, which are less likely to be impacted by the pandemic, also means dividends should not do as badly.

Pensioners may face huge losses

With the pandemic showing no sign of abating, investors are unlikely to get a decent return from dividends any time soon, even when a vaccine is found.

Pensioners who rely on dividend payments and are approaching retirement will likely face heavy losses.

Consultants Lane Clark & Peacock (LCP) estimates that £260 billion of private pension assets will enter decumulation – the process of converting pension savings to retirement income – over the next 10 to 15 years.

Data from financial regulator the Financial Conduct Authority shows people retiring usually expect to withdraw around 8% of their fund, which would hit decumulation cash in the short term.

What are your options?

Clearly investors need to look elsewhere to get a steady income from their holdings or else reconsider their spending in the medium term.

In a recent report, LCP suggests investors could consider replacing some lost income by investing in infrastructure, high-yield and emerging market debt, and private credit.

Infrastructure projects tend to have long lifespans and stable cash flows, earning income from consumers and businesses that need their services even during times of recession.

They often require a large upfront investment to develop, which is recouped through a long-term stream of fairly reliable income.

Investing in companies listed on the Stock Exchange, such as the National Grid, also makes it easier for investors to sell their shares.

Corporate bonds are looking more attractive now

Another possible option is to invest in debt, a strategy that institutional investors like pension funds have employed.

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 the portfolio is suitably diversified and well-managed, additional returns from this investment will tend to outweigh the loss from individual defaults.

Asset managers are increasingly lending money to smaller companies that are struggling to raise capital, which has led to a growth in private credit investing in recent years.

These loans generate an income in the form of interest but as the private credit investments are illiquid, they cannot easily be sold on to another investor.

So a big downside for investors in this asset class is that it can take years to recoup the interest and maturity payments. Because of this inconvenience, this type of investment will typically offer a higher rate of return compared to a listed corporate bond.

Darius McDermott, managing director of FundCalibre, suggests investors looking to shore up their reserves should consider investment trusts or corporate bonds.

He says: "Investment trusts are able to hold back up to 15% of their income in good years for precisely times such as these. When dividends are scarcer, they can dip into this 'revenue reserve' to maintain dividend payments.

"Corporate bonds are also looking more attractive now and have yields of about 3%. As they are contractual, not discretionary like dividends, you are more likely to receive a payment."

However, investors may also want to consider taking a lower income at this time if possible, until markets recover.

Changing portfolios can also mean changing the level of risk involved, and investors need to be sure they are happy with this. mw