SHORT BRIEFINGS ON LONG TERM THINKING – EPISODE 13

TOMORROW'S INCOME ARISTOCRATS

MB Malcolm Borthwick

JD James Dow

MB Hello and welcome to *Short Briefings on Long Term Thinking*. Thanks for joining us. I'm Malcolm Borthwick, managing editor of Intellectual Capital at Baillie Gifford.

Income investing has been shaken by the coronavirus pandemic, which has forced companies to cut back on dividends. That's the reoccurring payments that they make to shareholders. UK dividends are expected to fall this year by between 44 per cent and 61 per cent, or up to £55 billion.

So, is this a short-term set back, or will it have lasting repercussions? I'm joined by James Dow, who's joint manager of The Scottish American Investment Company, often referred to as SAINTS. James is also joint manager of the Global Income Growth Fund and the Responsible Global Equity Income Fund.

But before we start, some important information. Please remember that as with all investments, your capital is at risk and your income is not guaranteed. And this podcast is being recorded during lockdown, so James and I are both at home as opposed to the usual Edinburgh studio.

MB So, James, let me start with what I alluded to in the introduction there. Are we seeing a permanent reset in dividend payments as a result of the coronavirus pandemic?

JD Yes, in some parts of the market, Malcolm. I think that is exactly what we're going to see. And, what I'm hoping will come on the back of this is a surge in what I would call good dividend investing and those dividends, I think, will bounce back and be strong, versus bad dividend investing where I think you're going to see a permanent reset.

Let me explain that a little bit more. There is, what I would call, this good dividend investing where, as an income investor, you are essentially looking for genuine growing companies that have got a healthy balance between reinvesting in their own business and paying out dividends to shareholders. Where essentially, you, as investor or a saver, are taking, if you like, the excess cash that they don't need in their own business. And that's being used to support savers, folks in retirement, charities, the kind of folks who are our clients. That's good dividend investing. I'm optimistic about that.

What I think we are going to see is the decline, and I think this is a good thing if it happens, of bad dividend investing. That's where companies are, frankly, overdistributing. They're paying too much, they're not investing enough in their own business, they may even be borrowing to pay dividends.

Often, these companies are structurally in decline, or they're low growth companies. They're paying these dividends in a sort of desperate attempt to entice shareholders. I think these kinds of businesses are going to be forced into a permanent reset into lower dividend payments to shareholders, as they should be.

MB Give me an example of some of these sectors where we see good and bad dividend payers.

JD High street retail is a fairly obvious one. It's structurally challenged. There have been cases where companies are simply paying out too much. They're not investing in trying to make the transition to ecommerce, that kind of thing.

Some parts of the oil and gas markets, as well. I'm personally of the view that hydrocarbons, generally, are in the sunset period of their lives. The catch with something like a big oil company, or a bank, or a telecoms company – the usual suspects of income funds – is that they need to invest huge sums all the time just to keep their business level.

Whereas if you look at securities exchanges – like Deutsche Börse, the dominant exchange in Germany, a very capital-lite business model that throws off cash – that type of business can have growth, because they don't need a lot of capital, and a really stable and resilient dividend, because they naturally produce a lot of cash.

So, that's the type of business that we're looking for and the benefit has only been highlighted by the current crisis. If you've got a very capital-intense business model, you've really struggled. It's one of the reasons why UK dividends have been under such pressure, because there's a preponderance of those capital-heavy businesses in the UK.

MB What I find really interesting, James, is looking at the difference between UK dividend payers and global dividend payers. Helpfully, the Link Group's Dividend Monitor has provided us with some stats.

If we look at UK dividends, they're expected to fall this year by between 44 per cent and 61 per cent. That's up to £55 billion. Whereas global dividend payers are expected to fall by between 15 per cent and 35 per cent, which is much less, up to $933 billion. These stats are correct as of May. What does that tell us, James?

JD I think one thing it shows you is the benefit of having a globally diversified income portfolio. You are much more able to weather this storm if you've got that diversification outside of the UK market.

But, I think another thing that's really showing up is that the UK market has a preponderance of these structurally-challenged industries and often, unfortunately, companies that have been overdistributing dividends. That's really what you're seeing come through in these numbers. These businesses are being forced to face up the reality brought on by Covid-19.

I'm cautious of being too downbeat about the UK. My view is there are some great companies with sustainable dividends in the UK, but very large parts of the market are not in that category. If you're a long-term income investor, you're going to be much better off looking outside the UK, looking globally and finding some of these good dividend companies, like Microsoft or UPS. It's a long list of names that you can pick from globally.

MB We've talked about some of the oil and gas companies that don't have the prospect of paying large dividends in the future. In five- or ten-years' time, what do you think dividend payers will look like?

JD I think they'll be very much in the sort of 'going forwards' category. I'll give you three examples. Healthcare is an obvious place to start. I think that the value that we, as a society, ascribe to healthcare going forward, and our desire to see innovation and to pay for it, is only going to go up.

Within our portfolio we have companies like Sonic Healthcare, a lab testing company, and Roche, the genetics and testing company. That type of business, for sure, is going to be a strong source of earnings and dividends growth, in my view, years to come.

How about automation? That's an interesting area right now. As folks go back to work and we're thinking about how factory floors are laid out and how engineering processes can happen, it seems to me that there's going to be even more of demand for automation on the factory floor to help with distancing. That's another potential beneficiary of the way the world will be, going forward.

Anything digital. We've seen this, all of us, in our own lives in the past three months. Anything digital that enables us to either work remotely or to collaborate without having to travel, all of those kind of things. Those types of business, whether it be chip makers, software makers, whatever it might be, should be great beneficiaries.

It's tempting to look at the current environment and think, "it's doom and gloom" and, "everything's going backwards", but there are lots of businesses that are going to thrive in the years to come, that are going to be in more demand than ever. So, on a long-term view, I'd be very optimistic.

MB We've talked about tech and digital companies, but, if we take a five- or ten-year view, are you looking at different regions or countries that might offer attractive dividend-paying opportunities in the future?

JD Yes. I think the most exciting one, on the five to ten-year view, is China. I know there's quite a lot of angst at the moment about China's place in the world, and trade relations and so forth, but the thing with great companies is that they tend to thrive regardless of the geopolitical climate.

If a company has a great service that's really in demand, it will tend to do well, regardless of what the president of the US has tweeted recently, or whatever. and there are a lot of those companies growing up right now in China.

There's huge innovation going on. There are some great, often founder-run, businesses. Many of them – the Alibabas of the world – have grown to huge stature already. Our view is there are many more of those to come.

At the same time, as an investor, a great thing that's happening is that the China market is opening up to foreign investors. Our ability to invest in the local A-Share market has increased a lot over the past few years. It used to be very difficult to do. It's now become a lot easier.

So, my guess is that if we look out five or ten years, there are going to be a lot more of these great growth and dividend companies available to us for the portfolio, and we'll be able to access them through China's A-share market.

MB What's the difference in income payments between the investment trust and open-ended funds you manage? And are the current levels of dividend payment sustainable in this environment.

JD Yes, very much so. It starts with – and this is common to both the close-ended investment trust and the open-ended funds – that underlying portfolio income resilience. They have the same underlying portfolios, so the starting point they're both in is very strong.

The difference comes about because, by the rules of these things, in an open-ended structure you are legally required to pay out all of your income in any given period. What that means is if our open-ended income is down by, for example, 5 per cent this year, then the distribution will be down 5 per cent.

In the investment trust structure, you have the unusual advantage that you can tuck away income over the years in a sort of savings pot. You don't always have to pay out all the income you receive. We've done that for years and years within SAINTS, as the prudence of what's called the revenue reserve.

What that means is, although the portfolio income is down by whatever it might be, 5 to 8 per cent, because of the revenue reserve within the investment trust structure, we can draw on those saved reserves from previous years and top up the income stream.

In fact, the board of SAINTS has already announced distribution and actually increased the dividend by about 2.5 per cent year-on-year, because we are able to draw down a little bit of that money that we've saved and tucked away in years gone by.

So, that's really the difference. The underlying performance is essentially the same, but if you're looking for the absolute security of income backed up by a savings pot, if you like, that's what you get with the investment trust structure and that's why the distribution will actually be going up a little bit.

MB We're both sitting at home, maybe in an office, kitchen or living room. People are working in lots of different environments. How has this affected the way you work?

JD Well, I've got a lot more requests to fix BRIO train sets while working than I've ever had in the office. My five-year-old, being a BRIO engineer *par excellence*, likes to get me involved as often as possible. So, that's something I haven't dealt with before.

In practice, it's gone really smoothly, I'm delighted to say. I feel like technology, we've always invested in that heavily as a firm, has really paid off in spades in the past six months. I haven't had any issues there.

I guess, like all of us, I'm a little bored of looking at Zoom screens. I like talking to people face-to-face but, it's okay, that's not possible. We've coped fine. No real problems.

One thing that's really interesting is the working practices we've adopted, that we wouldn't have otherwise thought of. You realise afterwards, "oh, wow, that's a lot better than what we used to do when we could meet up in person".

I don't doubt that on the other side of this, our ability to keep on top of all the different things we're looking at will actually improve.

MB That's a good place to end it, James. Thanks very much for joining us on the podcast and I hope you'll join us again soon.

JD Thanks very much.

MB You can find our podcast *Short Briefings on Long Term Thinking* at bailliegifford.com/podcasts and subscribe at Apple Podcasts, Spotify and TuneIn. And, if you enjoy the podcast, please spread the word.

And, many thanks to Lord of the Isles for their music. The track we've used is called *Horizon Effect*, which was released on Permanent Vacation. And, if you're listening at home, stay well and we look forward to bringing you more insights in our next podcast.

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