

## INVESTMENT UPDATE

### The Outlook for Income from Externally Managed Pooled Funds for Arlingclose Clients Only

In a relatively short period since the onset of the COVID-19 pandemic, the global economic fallout has been sharp and large. We have yet to reach the peak in infections in the UK and many countries around the world. Market reaction has been extreme with the large falls in equities, corporate bond markets and, to some extent, real estate echoing lockdown-induced paralysis and the uncharted challenges for governments, businesses and individuals.

#### *The outlook for income for 2020 and 2021*

Local authority investors should be prepared for **lower** income from bond, equity income, multi-asset and property funds. Bond and property funds, and therefore to an extent multi-asset funds, will receive coupon/contractual income. For equity funds, the generation of income will be very dependent on individual securities held in the fund and the degree of portfolio concentration. UK and Eurozone banks, a big source of dividends, are under regulatory direction to suspend or freeze dividends in 2020, deferring them to a later date.

Arlingclose has asked all managers of funds in our Strategic Fund Suite to provide dividend estimates for 2020 and 2021 and their outlook for the main drivers of income and capital returns. We expect their responses to be generic or heavily caveated as the corporate world is still adjusting to the economic shock, with probably more to come, and it is still too early to tell which companies will withstand the economic damage in the short- to medium-term or which will choose to conserve cash in very difficult economic conditions simply to survive.

**We do not believe income will be zero.** Even though the circumstances of the COVID-19 related crisis are different to those which led to the global financial crisis, we illustrate later on pages 4 and 5 of this update, the dividend declaration by funds whose history extends to the period of extreme market distress in 2008/09 and its immediate aftermath.

If your budget for income from your bond/equity/property/multi-asset funds has been based on income received in previous years, then it would be prudent to recognise that income in 2020/21 will be under pressure and advise that you consider making downward adjustments:

- Bond funds and property funds: **20%** lower
- Multi-asset income funds: **25%** lower
- Equity income funds: **50%** lower

This is Arlingclose's subjective assessment. Dividends and income paid will ultimately depend on many factors including but not limited to the duration of COVID-19 and the extent of its economic impact, the fund's sectoral asset allocation, securities held/bought/sold and, in the case of equities, the enforced or voluntary dividend cuts or deferral.

#### *March 2020 valuations*

The wild gyrations and volatility, measured by the VIX index, are almost as high as they were during the global financial crisis of 2008/9 and evidenced in plummeting equity prices and the widening of corporate bond spreads, now very close to rivalling those twelve years ago. Gilt yields have fallen but credit spreads

have widened markedly reflecting the sharp deterioration in economic and credit conditions associated with a sudden stagnation in economies, so corporate bonds yields (comprised of the gilt yield plus the credit spread) have risen and prices have therefore fallen.

Clients invested in bond, equity and multi-asset funds will have seen some swingeing falls in capital value reflected in 31<sup>st</sup> March valuations. Almost every fund in the Arlingclose Strategic Funds Suite has negative capital returns over 12 months to March. Several March-end dividend details are awaited, but early calculations suggest that, despite decent income returns in 2019-20, most funds will post negative total return over the one-year period due to the capital component of total returns.

The unrealised capital losses (the 'drawdown' referred to by fund managers) in equity income funds are especially severe, ranging from -5% to -33%. Short-, long-dated and absolute return bond funds have not been immune either with falls ranging between -2.5% to -11%.

These unrealised capital losses will not have an impact on the General Fund if clients have elected to present changes in the funds' fair values in other comprehensive income (FVOCI). Clients in England and Wales using the alternative fair value through profit and loss (FVPL) accounting must defer the fair value losses to the Pooled Investment Fund Adjustment Account until 2023/24.

Market volatility and sentiment-driven selling will calm once real economic data emerges and a more objective assessment and response replaces speculation-driven sentiment we are seeing right now. However, it does not necessarily mean that financial markets will rebound in tandem and rise to pre-pandemic levels just as rapidly as they fell. It is way too early to say if, following an economic recession, the recovery is V-shaped and similar to the growth path following the 2008/9 financial crisis, or a lot more protracted.

## Income Outlook

**Bond funds:** Bonds have contractual income which, in the absence of default, will be received by funds. The massive government response and support initiatives will limit some of the damage to corporate earnings but, as not all firms are at the front of the queue for government assistance to adjust for the economic shock, it is too early to tell how many or which companies will default.

**Resilience:** Highly rated government bond and supranationals in portfolios will underpin capital values and income, at least in the short-term. Income from secured and collateralised bonds can also be relied upon.

**Under pressure:** Corporate bonds in sectors directly affected by COVID-19 such as travel and leisure, auto, retail and the energy sector have come and will remain under increasing pressure and are at risk of default. Portfolios invested in high quality and senior bonds and healthcare, supermarkets and telecoms will likely be more resilient.

Financials (banks, insurers, fund management companies) are better placed than in the 2008-09 financial crisis and, from a creditworthiness aspect, there is much higher confidence in their ability to honour debt obligations. However, Royal London has shared some useful insight: *"Banking and insurance issuers have come under regulatory pressure to suspend equity dividend payments and may come under pressure to defer bond coupon payments. .... but the likely deferral (as opposed to suspension) nature of any changes to income would mean that income would still be expected."*

**Equity income funds:** The longer that COVID-19 intensifies and government-enforced lockdowns and the economic fallout persist, the bigger damage it will inflict on revenues and profits. Financial leverage and adequacy of liquidity will also play their part in determining which companies survive.

**Arlingclose believes that dividends in 2020 will be lower than that received in the last 2-3 years.** Companies that have sought COVID-19 related government financial assistance will very likely have moratoriums on (though not necessarily cancellation of) the payment of dividends.

A case in point are banks, many of which are regular dividend payers and which feature in many equity income portfolios. The Bank of England has already asked large UK banks to defer dividend payments until at least the end of 2020. Eurozone banks are also under regulatory orders to freeze dividend payments and share buybacks this year in order to conserve capital to cope with the economic fallout. Several banks in Nordic countries have indicated plans to reconsider their dividends.

Even profitable companies which are unfettered by government assistance but facing tough trading conditions may consider preserving cash, deferring or cutting dividends if only to ensure resilience in what could be a prolonged period of economic stress and uncertainty.

Fighting for survival, let alone profitability, are retailers reliant on footfall, supermarkets excepting, and the travel and hospitality industries which have also been hit hard. Cyclical (e.g. construction, capital goods, non-essential consumer products) have also come under stress and the general view is that some may cut or cancel dividends this year or defer them to 2021.

Oil prices had been falling even before the full impact of COVID-19. With the price of oil around \$35 a barrel, the share price of oil companies has also slumped; however, some oil companies have strong balance sheets and may nonetheless pay dividends.

**For clients with funds which also employ an income enhancement strategy using options** (Schroder Income Maximiser, Fidelity Global Enhanced Income and UBS Global Income), it will be prudent to assume that income could be much lower than in normal market conditions. Managers may prefer to be very cautious in applying the option strategy in extremely stressed markets and reduce the proportion of the fund overwritten by options.

Fidelity states: *“We have no automatic ‘knee-jerk’ reaction to a dividend cut in the portfolio. In many cases a dividend cut today will be in the long interests of shareholders and aid a speedy recovery on the other side of the pandemic. As such, we could own some companies which will not pay a dividend in the current year if we believe long-term franchise value is preserved and that dividends will be resumed once the pandemic has passed.”*

It is a view shared by other managers including M&G and Schroders.

**Property** as an asset class tends to have low correlation with other risk assets but is not immune to the effects of economic downturns and recessions. Contractual income from long leases to creditworthy tenants are, however, the mainstay of returns even in periods of prolonged uncertainty and volatility when capital values can be susceptible to large downward adjustments and transaction volumes dry up.

Exposure to sub-sectors and geographies as well as the credit strength of tenants, lease terms and covenants will be key to income reliability during an economic downturn or recession.

Contractual income derived from long-term leases allows property funds to distribute to investors not only income received but also that which is accrued. However, where the prospectus allows, in an economic downturn funds may choose to limit distributions to only that income that has actually been received.

**Defensive sectors** include public sector backed real estate including those of local authorities, housing associations and universities which will continue to provide relatively better income protection through periods of economic and political instability. Assets linked to student accommodation could however be

under pressure if social distancing and disruption to academic terms continue longer than currently anticipated.

**Under pressure** in the current economic crisis are tenancies relating to retail, hotel and leisure, food and beverage, automotive (car dealerships) which will struggle in the near term from the fallout of COVID-19, increasing the risk of arrears, default or CVAs which force landlords to accept revised lease terms and lower rents or risk the tenant’s default and subsequent vacancies.

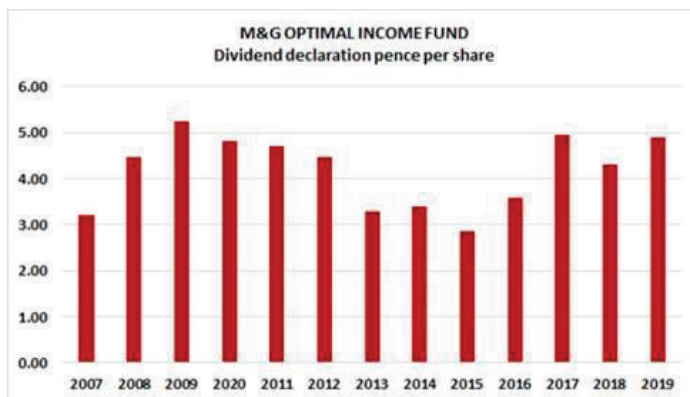
CCLA’s comment on the Local Authorities’ Property Fund: *“At the moment there are clear uncertainties over the payment and so the Board have decided that we will pay each quarter income received + accrued income where we have a high confidence of the payment. .... We have little exposure to traditional retail (3.5% of rents) with another 12% from retail warehouses. Tenant quality too is high, so we should be relatively well sheltered, also there will be an element of income delayed rather than lost. Given all this we haven’t yet felt able to make a forecast for the year but realistically there must be a good chance it is lower by more than our early year estimate.”*

**Multi-asset income funds:** These funds use a combination of bonds, equity, property (often using REITs) and alternatives (e.g. aircraft leasing). The income generated will largely depend on the asset allocation to securities with more reliable contractual income in current market conditions (bonds, property).

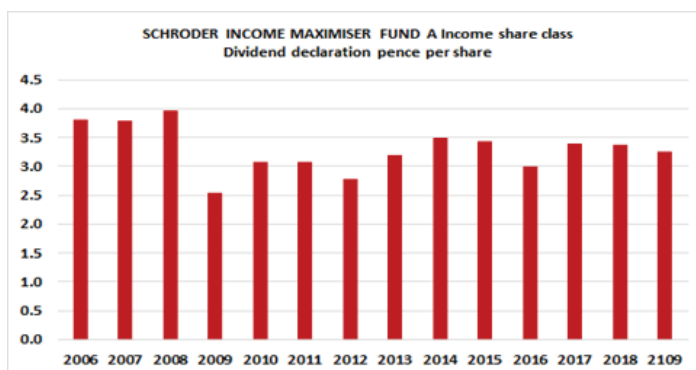
**Dividend declarations (calendar years) by funds with history from 2008/09 or earlier.**

Share classes may differ to those in which clients are invested.

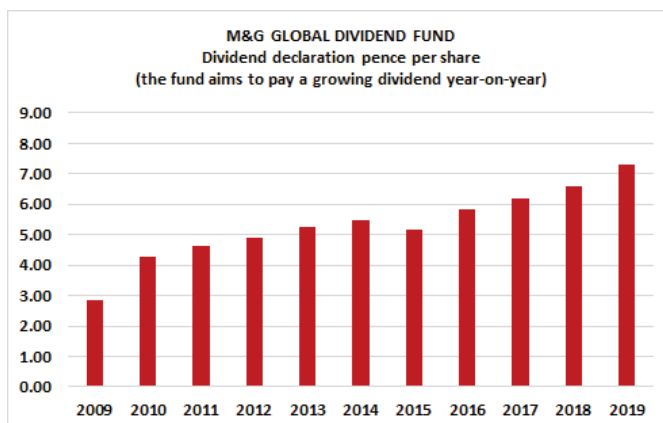
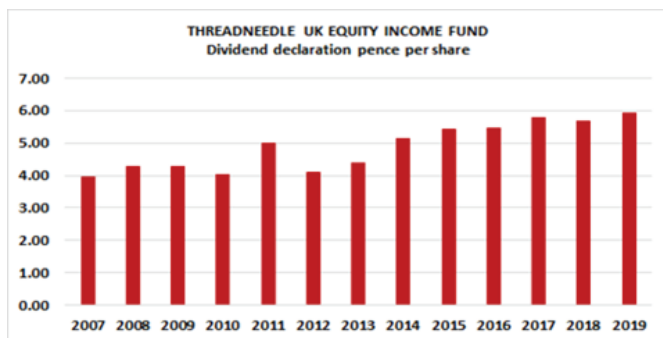
Bonds



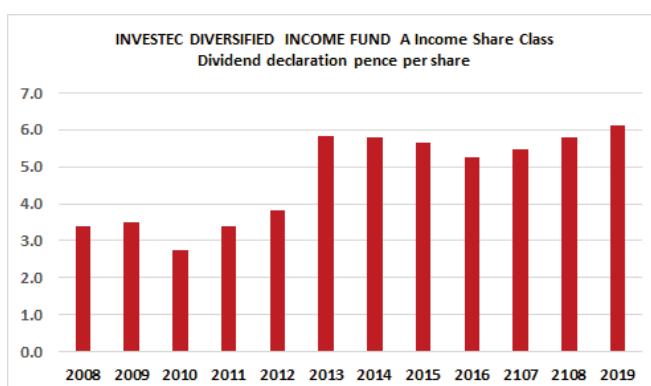
Equity income



Dividend data for the Z Income share class extends only as far back as June 2011



Multi-asset



Dividend data for the I Income 2 share extends only as far back as July 2012

Property

