

Dividend Cuts and Equity Income Funds

As a result of the economic crisis and the stock market falls over the past 12 months, many of the UK blue chip companies that have long been the stalwarts of the equity income sector have begun to slash their dividend distributions. This has been particularly evident in the banking sector which had provided a high concentration of the dividend income stream within the UK stock market in recent years. The dramatic falls in the market values of the banks has resulted in inevitable dividend cuts, as they attempt to repay borrowing and rebuild the balance sheets. This has had a knock-on effect on the equity income funds that invest in such companies, which in turn presents a problem for clients who are dependent on a steady or growing level of income, in order to maintain their standard of living.

In defensive sectors of the market (i.e. the oil giants and pharmaceuticals) companies have so far maintained dividends and therefore, the equity income funds which have positioned their portfolios in these areas of the market remain positive about maintaining and even growing their dividend over the course of this year. However, it should be noted that these are also the funds that are now lagging the market in relation to capital returns following the recent market rally in cyclical stocks. Funds which have invested in the cyclical areas of the market have captured the market rally, but these are the stocks that are now making such dramatic cuts in dividend yields.

Therefore, there does seem to be an emerging dichotomy between defensively placed equity income funds, which have suffered on capital returns but maintain income and the cyclical focused funds, which have seen significant capital recovery in recent months, but now are cutting income by 20-25% in some cases. This is closely related to the economic forecasts of the individual fund manager or investment house. Those that maintain that the recent rally in the market is unsustainable and that the defensive areas of the market will lead the UK recovery will be well placed to maintain income. This view is typified by Invesco's Neil Woodford. Those that believe that the rally signals the beginning of a slow recovery are seemingly sacrificing some of the income for the capital appreciation that they believe is possible over the next couple of years. This has been most markedly demonstrated in the Schroder Income fund managed by Ian Lance and Nick Purves.

The remedy to this problem might be in a diversification of income sources. This could mean maintaining exposure to a blend of funds that can in some cases achieve capital growth while sacrificing a proportion of income and in counterbalance investing in some funds that will be able to grow the dividend while lagging behind in the short term on a capital recovery. In addition, an exposure to international equity income funds may provide some protection from the income concentration within the UK market. The key focus will be ensuring that the blend of funds in a client's portfolio continues to meet their income requirements in these turbulent times.

The view from the fund managers

Fund	Dividend expectation of fund manager
Artemis Income	To cut by 25% this year.
AXA Framlington Equity Income	Estimate cut in yield by 15-20% this year, but then growing the dividend again quite quickly.
AXA Framlington Monthly Income	Estimate cut in yield by 15-20% this year, but then growing the dividend again quite quickly.
BlackRock UK Income	May increase slightly.
Credit Suisse Income	Would anticipate a reduction in the income distributions payable to unitholders. We should fare better in income generation than the market as a whole.
Credit Suisse Monthly Income	Would anticipate a reduction in the income distributions payable to unitholders. We should fare better in income generation than the market as a whole.
Fidelity Growth & Income	May cut dividend.
Fidelity Income Plus	Should maintain dividends.
Invesco Perpetual High Income	Grow dividend by 5-10% this year.
Invesco Perpetual Income	Grow dividend by 5-10% this year.
Invesco Perpetual Income & Growth	May experience small cut to dividend.
Jupiter High Income	No plans to cut dividend - may grow into 2010.
Jupiter Income	No plans to cut dividend - may grow into 2010.
New Star Higher Income	Will be cut this year. Would not indicate by how much, but should be substantial due to heavy weighting in banks.
Newton Asian Income	Income yield will fall by about 10% from last year's yield.
Newton Global Higher Income	Believe they will maintain current dividend levels.
Newton Higher Income	Do not foresee cuts. Likely to grow dividend.
Psigma Income	Believe that they can maintain dividend levels in year ending March 2010. If it were to be cut, they would imagine this to be by 2-3% at most.
Schroder Income	To cut by 20-25%
Scottish Widows UK Equity Income	Could not confirm whether or not there would be dividend cuts.