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Quilter Investors

Income in the year ahead

Portfolio managers Helen Bradshaw and CJ Cowan give their forecast for income in the coming fiscal year and drill down into the outlook for key holdings in both Quilter Investors income portfolios.

May 2022

CJ Cowan
Portfolio Manager

What are your income forecasts for the fiscal year to 30 April 2023?

"As we look into the next fiscal year, we are forecasting a small increase in the projected range for both portfolios compared to our previous estimates for the fiscal year to 30 April 2022.

"We forecast paying income in the range of 3.1p to 3.5p[1] per share for the Quilter Investors Monthly Income Portfolio and 3p to 3.4p per share for the Quilter Investors Monthly Income and Growth Portfolio.

"It's worth noting that the top of the new range is marginally lower than the income delivered in the last financial year. This is because much of the income outperformance generated in the fiscal year to 30 April 2022 was the result of adjustments made to the portfolios during the year, the fortuitous timing of these changes plus the boost provided by the weakness of sterling.

"While similar opportunities and effects may present themselves in the year ahead, we are reluctant to bake these into our forecasts by assuming these will be repeated.

"As ever, we remain alert to the risks of 'chasing yield'. It's also important that the portfolios retain enough flexibility to tactically tilt towards asset classes and sectors where we see the best total-return opportunities, as well as the best income opportunities."

Helen Bradshaw
Portfolio Manager

What's your outlook for income investors in the coming year?

"Looking ahead, we expect to see continued dividend growth in most regions.

"Drilling down into our forecasts, we once again expect a decent chunk of next year's income to come from UK equities, not least because of the portfolios' appreciable exposure here, but also because the broader economic backdrop remains very supportive to sectors such as energy, materials, commodities and banks, which are major constituents of the UK market.

"Whereas last year materials and mining stocks were the big UK dividend payers, energy companies are expected to show the strongest dividend growth in the coming year as power prices have surged.

"However, in recent days we have seen the announcement of a temporary windfall tax on oil and gas companies as the UK's Chancellor seeks to fund the cost of living household support package. This clearly has the potential to be a big headwind.

"Opponents to windfall taxes worry that they act as a deterrent to investors, further harming the prospects of UK companies that have struggled to attract foreign capital ever since the Brexit vote in 2016. Nevertheless, the popularity of this policy among voters, as well as the pressure to intervene, means concerns as to the longer-term detriments have been cast aside.

[1] **Please note:** All income figures quoted in pence per share, based on the U Income share class of the Quilters Investors Monthly Income and the Quilters Investors Monthly Income and Growth portfolios.

"There are, of course, a few risks to the outlook for equity dividends. Firstly, companies will need to effectively manage inflationary pressures in order to avoid corporate profits and margins coming under pressure.

"We're also mindful of the threat posed by renewed coronavirus outbreaks in China, which could further clog up global supply chains, adding to inflationary pressures at a time when input and materials costs are already elevated. This could lead to further challenges for some companies and sectors.

"There's also the looming shadow of a potential recession – especially in Europe. The risk remains that, in battling inflation that's cresting at 40-year highs, the central banks raise interest rates too far and too fast, which could impact corporate earnings and, ultimately, the dividends that companies pay.

"That said, an environment of elevated inflation and rising interest rates should continue to favour dividend-paying stocks as they're inherently less vulnerable to rising interest rates than their 'growth' stock counterparts. Consequently, we continue to believe that the portfolios are well-placed to weather the coming conditions.

CJ Cowan
Portfolio Manager

What's the dividend outlook for some of the core equity holdings?

"In the UK, the iShares FTSE 100 and iShares UK Dividend ETFs are where we expect to see some notable dividend per share growth, but for different reasons.

"While the FTSE 100 fund will see a notable decrease in dividends as a result of the previously dual-listed BHP leaving the London Stock Exchange, Glencore PLC is expected to cushion some of this shortfall. In addition, the UK index weightings to energy and healthcare stocks have grown over the last year following strong price performance, leading to an increased contribution from these sectors.

"While GlaxoSmithKline is set to reduce its dividend after spinning out its consumer healthcare business, the outlook for the rest of the sector looks more robust. Elsewhere, energy dividends are expected to grow due to higher energy prices.

"By contrast, the iShares UK Dividend ETF will see an increased weighting in consumer discretionary stocks, primarily housebuilders. The sector suffered weak price performance over the past year meaning it now offers more attractive forward-looking dividend yields.

"The financials exposure is also expected to contribute to the fund's increased distributions, both through a larger weighting and expected increased dividends from some of the UK's asset managers.

"Further down the market cap spectrum, the Montanaro UK Income Fund saw a rapid bounce back in dividends last year after suffering an equally significant decline in income in 2020. While the manager is still expecting dividends to grow in the coming year, the impact of the special dividend it received last year from Pennon Group PLC means a small decline in the fund's overall distribution is expected.

"In the US, we expect dividends from the financials sector to improve as banks are set to capitalise on higher interest rates while their loan books appear to be well insulated from the upcoming growth slowdown. Meanwhile, the consumer discretionary sector is also expected to deliver double-digit dividend growth, boosted by the recovering auto industry. Ford has now reinstated its dividend after halting pay-outs in 2020. General Motors, despite record profitability, is yet to resume payments but may do soon.

"Europe is an interesting case too, as it is one of the few regions where government spending in 2022 will be greater than in 2021 due to disbursements from the EU recovery fund. Consequently, many strategists had a positive view for European equities coming into 2022 but Russia's invasion of Ukraine brought the region's reliance on Russian gas to the forefront of investors' minds.

"Hence, the more positive fiscal picture must be balanced against the cloudier domestic position, as well as weaker global growth given European companies tend to be major exporters.

"At the moment, analysts still expect to see the best dividend growth in the developed world in Europe, driven especially by the autos industry as it continues to clear production backlogs. Among our holdings here, the SPDR Euro Dividend Aristocrats Fund is the standout from a dividend growth perspective, largely down to compositional changes to the fund as the underlying index re-balances towards more reliable dividend payers.

"Greater exposure to insurers should also provide attractive income while solid dividend growth from industrial stocks is also predicted.

"In emerging markets, our managers remain reasonably upbeat about the outlook for dividends. It's worth noting that the composition of the benchmark has changed this year, with Russia, a high dividend-yielding market, being eliminated earlier in the year. At the same time, prolonged lockdowns in China and the economic impact of its 'zero-covid' policy could also create headwinds."

Helen Bradshaw
Portfolio Manager

Fixed income markets have suffered so far in 2022, what's your outlook for such holdings in the coming year?

"At first glance you might expect a big increase in income from our fixed-income exposure given the surge higher in bond yields over the past year. But, due to the lag between higher bond-market yields and higher bond-fund distributions, we're not forecasting growth in distributions from our passive fixed-income holdings for the coming year.

"However, those active managers who trade their portfolios more regularly are more likely to see the increase in bond yields feed through into their income distributions in the coming year.

"This particularly applies to funds holding shorter-maturity bonds such as the Janus Henderson Absolute Return Fixed Income Fund and the Allspring US Short Term High Yield Bond Fund. In the case of the former, income distributions should also be boosted by the floating-rate assets (meaning the income they pay rises in line with interest rates) that make up around 20% of the portfolio.

"We also expect alternative income trusts to be well-placed to maintain their distributions in the coming year, even if loan default rates pick up a little."

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