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Has Goldilocks left the room?

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Some of our readers will remember the era of the private client stockbroker whose obsession was with dividends – the yield on a share, the dividend cover and the history of the company growing its dividend. This was also an era in which most investors strictly compartmentalised capital and income. Preserving capital, or at least not losing it through ill-considered speculation was important, but much more important was the income and the growth in the income year-by-year. Panic would set in if a company passed on its dividend, or worse, cut it. Clients were very unforgiving if that happened, but they could live with volatility of the headline capital value as economic cycles moved markets up and down.

Roll on to the 1990's and a new concept of efficient investment management took a grip. It emerged from the business schools of the most prestigious US universities, Harvard, Yale, Chicago, and Wharton being prominent among them. The approach adopted by their endowments looked at returns above the market average for each unit of risk taken. This optimisation of investment opportunities was indifferent to whether it came from distributed dividends or growth in the share price. At around the same time and again under the influence of the business schools, senior executives of public companies secured performance packages related to share price performance. Investor appetite for capital over income grew and a generation of successful income managers quickly became obsolete.

We can look back on that period from 1990 to 2010 and see that the capital appreciation in public equity markets owed at least as much and often much more to a combination of monetary factors – the rise in the influence of central banks and the 30-year managed decline in bond yields, the growth in share buy-backs (which often triggered the performance thresholds for the executive remuneration packages), and an investor appetite to harvest capital gains for spending and not to live within the means of an income stream than underlying company performance.

The world has turned and some or all of these conditions have changed. We believe it is once more appropriate to focus on the skills of the experienced income investment manager. The cycle probably turned with the credit crisis in 2007 and the subsequent invention of Quantitative Easing; the Covid pandemic added greatly to the changing global conditions, not least by disrupting supply lines and laying the basis for inflation; now we have significant geopolitical turbulence in which energy prices are a material weapon. It seems to us that Goldilocks' porridge has turned slightly cold.

But that is not the end of this potted history of wealth management over the last few decades. What goes around, comes around and we have been telling our readers that we expect some years of lower GDP expansion rates, higher inflation and modest equity market headline growth. However, a corollary of this is that yields, both from equity dividends and company debt are now significantly higher than they have been for at least a couple of decades. Dividends tend to provide a natural hedge to inflation as companies pass on higher input costs in higher output prices whilst higher company credit spreads provide a cushion against potential defaults. We have been steadily repositioning our strategies to benefit from that over the past years and will continue this process over the coming months as opportunities present themselves.

You may not be ready to live off natural investment income alone, but you should expect dividends and income to comprise a significant part of your total return as it did before the turn of the century.

The party isn't over, it's just the tune that has changed.

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