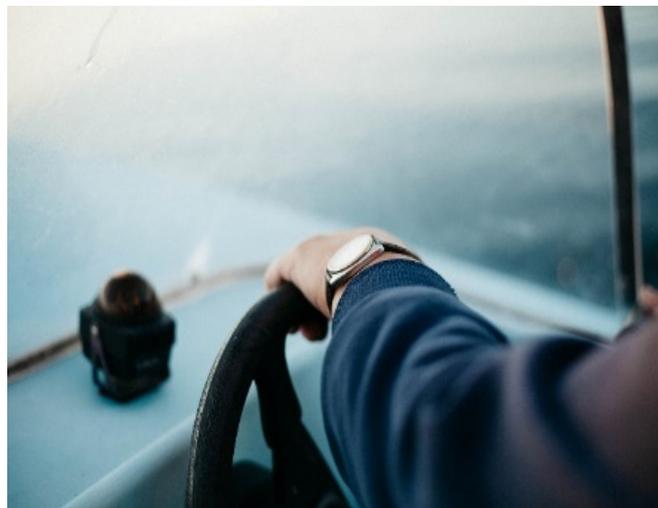


NAVIGATING COVID-19

AN ACTIVE MOMENT FOR INCOME INVESTING

COVID-19 has created one of the biggest drawdowns in Australian Equity earnings in history, even bigger than during the Global Great Financial Crisis. Income investors are thus understandably concerned about the impact the shutdowns and ongoing social distancing will have on the ability of Australian equities to pay dividends.

In this article we discuss our forecast of the near-term dividend outlook and examine how active managers can help investors navigate this unique moment with the objective of creating a sustainable income stream.



Our Australian Dividend Outlook

It must be acknowledged that the near-term outlook for dividends remains challenging. At the time of writing, based on broker consensus estimated for next 12 months dividends, the dollar dividend stream for the Equity Income strategy will be down ~24% from the February (pre- COVID-19) peak. For the broader market (i.e. S&P/ASX 200), it is down more than 32%¹.

We expect the income stream to come down further as dividend forecasts published by stockbroking analysts have yet to fully account for the effect that the reduced company earnings will have on dividends.

Our 2020 COVID-19 Dividend Profile work, and our proprietary Profit Pulse Indicator suggests that the full extent of downgrades to the income stream for the broader Australian market will be in the order of approximately 40% down on February estimates.

A Crisis and An Opportunity

We recognise that the fall in income is a critical issue for investors such as retirees who rely on that income for their living expenses. However, without minimising the seriousness of that issue, we would also point out that we believe this crisis is an opportunity for active managers like ourselves to build a diversified portfolio of businesses with the ability to generate sustainable dividends at once-in-a-lifetime valuations.

Why Active Management for Income Today

Active managers stand in a unique position to help our clients through this unprecedented situation both in the near-term and long-term. This is because, for an income-oriented strategy, successfully navigating these market conditions requires a balancing act that entails a nuanced approach satisfying both of the following two conditions:

1. Ensure that the long-term of income potential of the portfolio remains robust, i.e. the need to focus on the long-term business outlook and dividend potential of the portfolio companies.

¹ Source: Martin Currie as of 29/05/2020, Next 12 Months (NTM) Income yield is calculated using the weighted average of broker consensus forecasts of each portfolio holding –because of this, the returns quoted are estimated figures and are therefore not guaranteed. Assumes zero percent tax rate and full franking benefits realised in tax return for Martin Currie Equity Income.

2. Deliver the best possible income stream over course of the near-term business disruptions caused by the COVID-19 pandemic, i.e. ensure that there is a reasonable level of income in the coming 12 to 24 months to support our clients income requirements.

The need to optimise across these two parameters illustrates an important benefit of active management over passive or 'smart beta' strategies at this critical juncture.

For example, a passive manager who indiscriminately sells stocks where the dividend is cut to \$0 will likely be selling uniquely profitable and monopolistic businesses at historically low valuations; in effect, throwing the proverbial baby out with the bathwater. Similarly, buying stocks in sectors where dividends haven't been reduced to chase higher short-term income will entail paying a significant valuation premium and must be done with a discriminating eye towards long-term dividend sustainability. The combined effect of such a robotic approach to income investing is likely to result in a significant impairment of the long-term income potential for investors in these passive, yield chasing strategies.

What's called for at this moment of market dislocation is a case by case assessment of each company's prospects by a seasoned team of sector specialists to parse the likely winners from losers. At Martin Currie, we use a dual track analytical framework that examines both the short and long-term income potential of each portfolio company.

Deep Fundamental Analysis of Short-Term Impact

Since the start of the COVID-19 crisis, our team of investment analyst has been conducting specific analysis of each and every stock in our portfolios and investible universe to create a "2020 COVID-19 Dividend Profile" to accompany their Sustainable Dividend analysis. The objective of this analysis is to more precisely calibrate each securities downside income risk, and understand which stocks should see dividends recover relatively quickly versus those that are likely permanently impaired.

Our recent focus has been on the following market segments:

- Companies that "make money while you sleep" rather those that have a more "transactional" nature;
- Exiting positions that we were most vulnerable to the adverse outcomes from social restrictions; and
- Purchased undervalued companies that have not acted as defensive as they genuinely are

Quantifying Dividend Sustainability & Long-Term Income Potential

All our income strategy portfolios are constructed from stocks based on their ability to pay what we call a forward looking "Sustainable Dividend" rather than a current or consensus dividend.

To determine this, our team of fundamental analysts judge each company's dividend paying power by assessing their free cash flow generation through different stages of the economic cycle. The analysts then explicitly model a two-year bear-case scenario, i.e. can a dividend be paid in 8 out of the next 10 years? The advantage of our 8/10 approach is it allows us to consider a significant downside scenario for each company and what level of dividend they can pay post a crisis.

The unprecedented impacts from COVID-19 mean that for a number of companies, short-term expectations for dividends have fallen below our Sustainable Dividend forecast. Critically, though, where our analysis indicates the long-term sustainable dividend potential remains robust, we continue to hold them so that we can capture that long-term income potential when they recover.

The Result: A Portfolio with A Stronger Income Outlook

"We continue to think that it is usually foolish to part with an interest in a business that is both understandable and durably wonderful. Business interests of that kind are simply too hard to replace." - Warren Buffett

Using this dual track analytical framework has helped us craft a portfolio that achieves an intelligent balance between long-term dividend potentials and short-term income protection. Using this analysis, we have carefully

re-positioned our income strategies since the start of the crisis and believe we are well positioned to provide investors with portfolios built on a foundation sustainable dividends for the long-term.

Will Baylis is a Portfolio Manager for the Legg Mason Martin Currie Equity Income Fund.

IMPORTANT INFORMATION

Past performance is not a reliable indicator of future results. Please note this information is not intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such.

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