

Emerging markets are the place to be, but should

David Hogarty, high dividend specialist at KBC Asset Management looks at the growth of emerging market investment

Investment in emerging regions has escalated over the past number of years with many investors committed to the idea of generating extra return through exposure to these markets. A combination of higher economic growth, higher risk (in the form of volatility), and more diversification are the reasons usually put forward for this conviction. More recently, a lack of indebtedness and better performance during the global financial crisis has made investors



revisit their interpretation of risk and further increase their enthusiasm.

Historically, lower debt levels reduce economic vulnerability (with particular links to taxes and inflation) and are followed by periods of higher growth.

We share this enthusiasm. So much so that we've just started to invest there ourselves. However, unless you want to get caught in the herd it's important to understand that investing in emerging markets is not just about accessing higher growth opportunities. A lot of other things are important too.

Investors are trained that high yields and high growth are opposites of each other and that quality is often sacrificed to achieve either. However, by comparing some characteristics of the global developed world to emerging markets in table 1, we can see that in addition to higher growth rates, higher yields and better quality can also be attained from investing in emerging markets. When measuring yields it's important to consider all the cash exchanges between shareholders and companies. Currently total payout yields are negative. This is very unusual and means companies are taking more money back from shareholders in the form of new equity issues than they are paying out in the form of dividends (usually total payout yield is higher than dividend yield as it adds the payout effect of share destruction).

How has it happened that emerging markets are now a richer picking ground for good quality income as well as growth? Well, it's the combination of a pretty aggressive improvement in payout commitments from companies in emerging regions over the last five years combined with a collapse in earnings (and many balance sheets) and subsequent dividend cuts in the developed world.

Asia already had its own financial crisis back in 1998, and the resultant regulatory changes forced banks to carry higher levels of liquidity. This has meant that banks across the region generally were in a much healthier position to survive the global financial crisis than their western world counterparts. And it's not just banks where cash reserves were healthier, it's true across all sectors of the economy – households, corporates and governments. Savings rates were higher and

debt levels were lower. This means that while the payout and capital appreciation potential of western equity markets will be hampered for some time by the millstones of unwinding too much debt, emerging market corporations can continue with their higher growth pattern for both.

The surge in dividend payers in emerging markets is a relatively recent phenomenon and is driven in part by the desire of ambitious firms to attract foreign investors. Because governance and regulatory standards are concerns to developed world investors, companies are under greater pressure to prove the strength of their covenant with shareholders. Dividend payments are the most tangible way to achieve this. The number and diversity of dividend payers available is also very encouraging. In fact as table 2 shows there are now more payers in emerging markets than any other region of the world.

We have been investing in global equities for over six years, employing an active dividend based approach within a regional and industry group neutral framework. Because of the dramatic rise in dividend payments in the region it is now possible for us to extend our method into emerging markets. As you can see in table 3 our approach further improves the overall payout, yield and quality characteristics versus the index. If our thesis is right and consistent with the results we get in the developed world, then this should also reduce risk and improve returns for investors.

While we can't backtest all the elements of what we do we can backtest the regional and industry group framework. This is simply a matter of dividing the index into the four main regions: Asia, Latin America, Eastern Europe and MEA (Middle East and Africa) and 24 industry groups. Then identify the higher than average dividend yielding stocks in each regional-industry group (96 in all), repeat the exercise every quarter and track performance. The results of this back test are extremely favourable as table four identifies.

Why does risk decrease while returns improve?

Quality of Information – By definition these markets are still developing

Table 1: Comparing market characteristics

	MSCI Emerging Markets Index	MSCI Global Index	
Dividend Yield	2.0%	2.5%	Better Total Return
Dividend Payout	39.9%	72.5%	
Dividend Growth	13.2%	7.6%	
Total Payout Yield	-0.8%	-4.0%	
Price/Earnings	16.5x	16.7x	Better Value Co's
Price/Book	2.2x	1.8x	
Price/Cashflow	9.1x	11.1x	
ROE (realised)	18.3%	17.9%	Better Quality Management & Balance Sheets
ROIC (realised)	13.2%	10.9%	
Total Debt/Com. Equity	101.3%	128.7%	

Source: KBCAM, Datastream, 31/12/09

Table 2: Dividend payers by regional industry group

	Dividend Payers in MSCI World & MSCI Emerging Markets				Total
	North America	Pan European	Pacific Basin	Emerging Markets	
Automobiles & Components	3	11	20	14	48
Banks	21	26	36	70	153
Capital Goods	46	49	54	76	225
Commercial & Professional Services	11	9	4	2	26
Consumer Durables & Apparel	14	10	20	11	55
Consumer Services	9	12	9	7	37
Diversified Financials	26	20	17	26	89
Energy	56	22	14	40	132
Food & Staples Retailing	14	11	9	10	44
Food Beverage & Tobacco	26	23	20	33	102
Health Care Equipment & Services	17	13	7	2	39
Household & Personal Products	7	5	3	7	22
Insurance	36	25	13	9	83
Materials	42	41	55	87	225
Media	18	18	9	7	52
Pharmaceuticals Biotechnology & Life Sciences	12	15	15	9	51
Real Estate	22	11	44	25	102
Retailing	21	8	19	16	64
Semiconductors & Semiconductor Equipment	11	2	6	20	39
Software & Services	12	5	12	9	38
Technology Hardware & Equipment	8	3	26	35	72
Telecommunication Services	11	20	9	46	86
Transportation	12	16	31	20	79
Utilities	39	30	20	38	127
	494	405	472	619	1990

Source: KBCAM, Datastream as at 03/09/2009 - MSCI World 1660 Stocks & MSCI EM 745 Stocks

you be looking for income or growth?



which means issues like market regulation, accounting standards, and disclosure policies can all have an impact on investment results. The inefficiency that they create contrives to further complicate an investor's judgement of fair value.

Dividends however are real and are physically received. They are a tangible guide to the financial health of a business and cannot be altered through accruals or accountancy practices. If the cash isn't there, the dividend can't be paid. For companies with a payout orientation increasing dividends is one of the clearest signals of improving cashflow and earnings projections, not just for the present but for the medium-term future. They reflect a company's confidence in their ability to generate sufficient earnings to pay the declared dividend on an annual basis going forward. So while almost every investor tries to establish earnings forecasts, dividends often give a clearer picture.

**Source: Elroy Dimson, Paul Marsh and Mike Staunton, Credit Suisse Global Investment Returns Yearbook 2010.*

Past performance is not a reliable guide to future performance and the value of investments may go down as well as up. KBC Asset Management Ltd. is authorised by the Irish Financial Regulator and subject to limited regulation by the Financial Services Authority in the UK. Details about the extent of our regulation by the Financial Services Authority are available from us on request. The views expressed are opinion only and should not be construed as investment advice.

Corporate Governance – The ultimate goal of corporate governance is to ensure that the suppliers of finance to corporations receive a return on their investment. While suppliers of equity can receive this return through capital gains or dividends, agency theory indicates that shareholders may prefer dividends particularly when they fear expropriation by insiders; have concerns over the motivations of management; or there is a weak regulatory environment. Firm level corporate governance, in addition to country level investor protection, is typically associated with higher dividend payouts. When shareholders are well protected either by governments or corporations themselves, then capital can be allocated more efficiently leading to better profitability. Better corporate governance is highly correlated with better operating performance, and market valuation. Firm level corporate governance provisions matter more in countries with weaker legal environments or political instability.

Attracting flows of capital from international investors is very important to any ambitious emerging market company. Given the governance concerns that prevail about the region generally these companies have a specific motivation to prove they are shareholder focused, and one of the most tangible ways to do that is to commit to regular dividend payments.

Capital Efficiency and Financial Discipline – Many investors make the mistake of focussing solely on earnings growth as the driver for share price appreciation, particularly in growth markets. However it's actually the ability to generate long term cashflow that drives value creation. In turn cashflow is generated in two ways: one is of course earnings growth, the other is returns on invested capital (ROIC). Typically companies with high returns on capital can generate more value for their shareholders from the earnings growth they generate than those with lower ROIC.

High dividend companies make a commitment to shareholders to pay them a fixed amount from earnings. This reduces the level of retained earnings kept within the business. A common mistake is to confuse retained earnings

with reinvested earnings. Just because a company isn't returning cash to their shareholders doesn't mean they are reinvesting it. Even if they are reinvesting it doesn't mean they are doing so profitably. Because high payout companies have an in built practice of rationing and allocating cash it is usually treated more carefully and used more effectively when compared to those companies that do not pay dividends.

Avoiding excessive volatility – *On average over the last decade emerging market volatility was 32.5% versus 23.5% for developed markets. Deviation around the average was also considerably higher and a careful analysis of the most extreme negative months is not for the faint hearted. Higher risk is part and parcel of investing in higher return areas like emerging markets. However, volatility can often exceed return and excessive volatility can seriously damage an investor's ability to build positive cumulative returns over time (it's known as risk drag). Remember that every negative number requires a larger positive number to erase it, so cushioning the downside is a lot more valuable when volatility is higher. Dividends fulfil this role very well as they are cash-in-hand payments, creating a consistent revenue stream. Maintaining regional and industry group neutrality throughout the process lessens the typical concentrations and style risks that can come with a yield and payout driven approach.

For investors building a diversified portfolio without an unlimited risk budget, this lower volatility means a higher exposure to emerging markets can be achieved, further improving the overall portfolio return.

Valuation – Buying shares that are delivering good yields means that the price you pay to take advantage of the higher emerging market growth rates is always good value. This helps investors avoid the classic growth trap of getting so optimistic about the promise of future growth that you forget to be critical about the price you pay for it. At a macro level this eventually leads to bubble risk. All great investments, as opposed to great opportunities, are determined by the price you pay. ■

Table 3: Comparing high dividend fund characteristics

	KBCAM Emerging Markets	KBCAM Global	
Dividend Yield	3.4%	4.1%	Better Total
Dividend Payout	68.9%	73.3%	Return
Dividend Growth	17.3%	11.9%	
Total Payout Yield	3.0%	2.7%	
Price/Earnings	18.1x	15.3x	Better Value Co's
Price/Book	2.7x	2.1x	
Price/Cashflow	9.1x	11.0x	
ROE (realised)	21.9%	19.6%	Better Quality
ROIC (realised)	15.5%	12.5%	Management &
Total Debt/Com. Equity	85.2%	137.5%	Balance Sheets

Source: KBCAM, Datastream, 31/12/09

Table 4: Performance & risk vs MSCI emerging markets index

PERFORMANCE	Backtest %	Index %	+/- %
One year.	78.13	73.45	+4.68
3 years pa	8.75	2.50	+6.25
5 years pa	16.95	14.64	+2.31
Six years pa	16.98	15.01	+1.97
RISK	Backtest %	Index%	Excess%
3 years pa	24.13	26.96	-2.83
5 years pa	21.46	24.09	-2.63
INFORMATION RATIO	Backtest %		
3 years pa	1.33		
5 years pa	0.52		

Source: KBCAM Datastream

All data to end December 09 and quoted in US\$ and Gross of fees