FIERACAPITAL

Growth and Income Investing in Emerging Markets - the trend continues

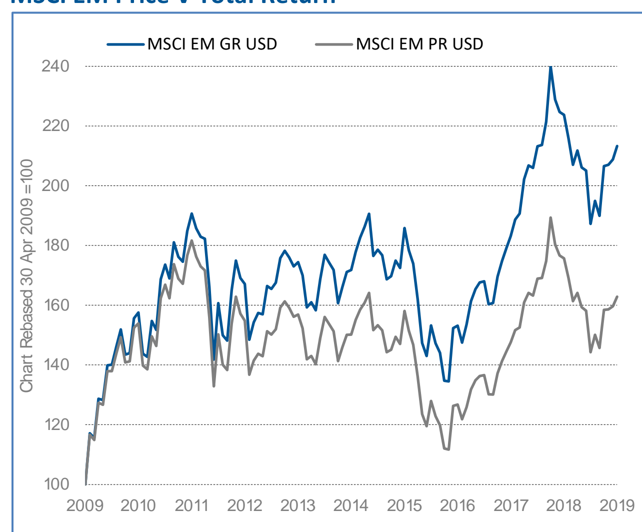
Since the start of the millennium, emerging market companies paying high and growing dividends have significantly outperformed the asset class. Over this time, almost half of the total return from Emerging Market equities (EM equities) has come from dividends. The MSCI EM price index has risen by around 60% in USD, while the total return index has risen by about 115%.

Dividend Yield and Growth by Quintile

	Annualised Return since 2000				
	Q*1	Q*2	Q*3	Q*4	Q*5
Dividend Yield	17.0%	12.0%	7.4%	3.8%	1.9%
DPS Growth	10.6%	12.6%	11.3%	8.1%	4.8%

USD returns with Q*1 = Quintile 1. Quintile 1 is the top 20% of the universe ranked by dividend yield or dividend growth. Q*2 is the next 20% and so on.
Source: Fiera Capital, Citi Group as at 29 Mar 2019

MSCI EM Price V Total Return



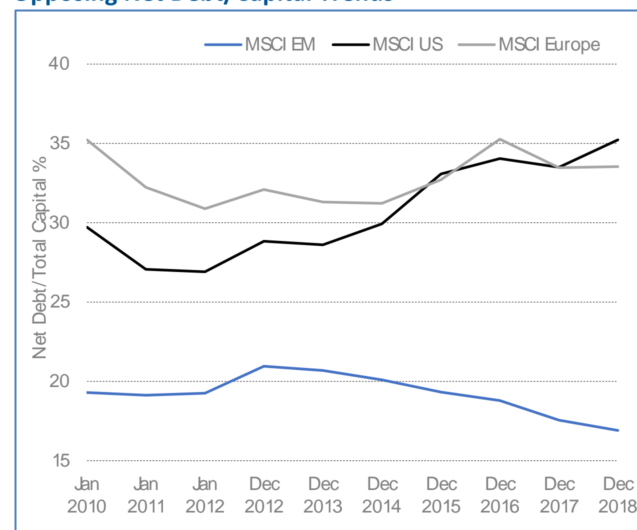
Data from 30 April 2009 to 30 April 2019
Source: Morningstar Direct, Fiera Capital

Investing in an Emerging Markets income and growth portfolio gives investors the opportunity to benefit from both the higher long-term growth in the underlying economies as well as a superior dividend. This may come as a surprise to some, who associate emerging markets with high growth but - rather than distribution of income - high investment spend, poor capital allocation and in some cases disregard for the interests of minority shareholders.

As bottom up investors in quality, growing companies, we have a natural bias in favour of companies run by managers that treat their shareholders well. We look for companies that generate sufficient cash flows both to invest in their future growth as well as to pay out what is not required for investments in the form of regular and growing dividends. Our portfolio has similar earnings growth than that of the market as a whole, with much higher return on equity and dividend yield. The portfolio is heavily weighted in parts of the economies which benefit from the long term growth in domestic demand. These include the consumer sectors as well as financials, especially non-bank financials such as insurance and stock exchanges. Our focus on long term growth contrasts with perceptions of an equity income portfolio as being made up of defensive, low-growth stocks (e.g. utilities and telecoms), and cyclicals such as commodities and real estate, where dividends may be high in a given year but are unlikely to be sustainable.

The average emerging markets company pays 35-40% of its earnings to shareholders. By comparison, the average for developed markets is around 50%. However, EM dividends are funded by genuine cash earnings, demonstrating organic growth, rather than being boosted by high debt and tax cuts. For companies in EM, a prudent response to earlier crises means that debt is low as a share of their capital base – indeed it has been falling – whilst for US and European companies, the opposite is the case. Additionally, for many companies in the US, dividends also compete with share buybacks.

Opposing Net Debt/Capital Trends



Data as at 31 December 2019
Source: FactSet Market Aggregrates, Fiera Capital

As we have shown, over the long term the case for equity income investing in emerging markets is compelling. Nevertheless, for the period 2015-17, this asset subclass fell out of favour, derating relative to the overall market. In the last year, the longer term trend has resumed. Having been very underweight China in 2016/17, our income and growth strategy took advantage of the 2018 selloff to buy into some stocks that fit into the overarching emerging middle-class theme that guides the growth strategy. For instance, the valuation of Wuliangye, a Chinese drinks company, de-rated from a PER of 30x to 15x, providing a great entry point: the shares have

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doubled so far in 2019. Another current example of overlap between income and growth investing is China's premium fashion retailer, JNBY, which now offers a dividend yield of 5% and by our analysis should grow earnings by more than 15% per annum in the coming years.

Across the world, developed and emerging, populations are aging. Birth rates are falling and, in emerging markets, life expectancy is rising rapidly. In China, for example, the average person is expected to live to the age of 76, only two years behind the US – and a rise of 17 years in the last half century. Therefore, it is becoming increasingly important that policymakers seek sources of income to fund this increasing pool of retirees. National pension schemes, such as Korea's NPS, are driving the improvement in payouts in that country. Its largest company, Samsung Electronics, now has a formal dividend policy linked to cashflow generation, and payout ratios in Korea have risen from 15% in 2011 to 23% in 2017. Furthermore, given that one third of emerging markets equities by capitalisation is state owned enterprises (SOEs), this means that government can put direct pressure on these SOEs to increase dividend payouts. One example is China, which is encouraging SOEs to provide income to shareholders but also to generate revenues for fiscal stimulus designed to prevent a sharp slowdown for the economy.

The trend towards better dividends has also been seen, perhaps surprisingly, in Russia. This market, sometime seen as a byword for poor governance, has seen an increase in the dividend yield from 1.5% to 6% over the last decade.

Russian Yields

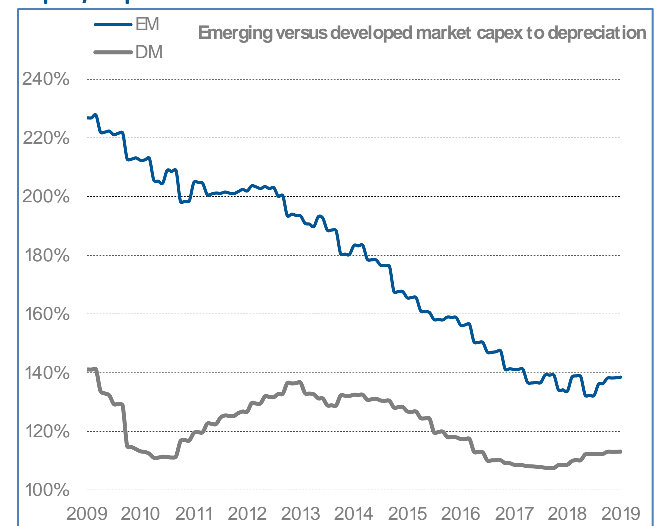
Data as at 31 January 2019
Source: Bloomberg, Fiera Capital

This trend comes from private businesses such as Lukoil, which has historically maintained a huge cash pile but is now enjoying a re-rating after setting out explicit policies on formal dividends linked to cash flow generation (as well as buy backs and the cancellation of Treasury shares). But it also comes from increased dividends from state related businesses such as Sberbank and Moscow Exchange.

A sensible dividend policy can often be a positive signalling mechanism, demonstrating the quality of corporate governance and management's commitment to generating cashflows, allocating capital and considering the interests of all shareholders, not only those who control the company. Comfort on governance forms a key part of the integration into our investment process of ESG analysis, which uses both proprietary work and external advice including from MSCI and ISS.

One cause of this focus on payouts to shareholders is a slower growth in capital spending. In the aftermath of the recession in 2008, EM companies initially assumed that economies would resume the 6-7% growth rates seen before the crisis, and this was reflected in their capex plans. However, by the time the 'growth recession' started in 2012, it became evident that this added capacity was not reflected in demand. Excess supply led to reduced pricing power and lower margins for corporates. Once they recognised that the world was in a new, lower-growth environment, they reduced their capex spending plans. Companies also paid greater attention to cost control. From 2015, these initiatives, together with the gradual economic recovery, resulted in a return in pricing power and a boom in free cash flow.

Capex/Depreciation



Data as at 31 March 2019
Source: Thomson Reuters, Credit Suisse research, Fiera Capital

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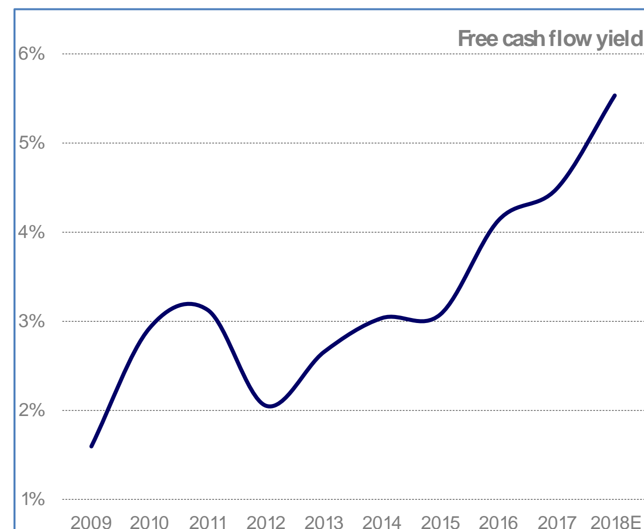
Free Cash Flow Yield



Data as at December 2018
Source: Thomson Reuters, Credit Suisse research, Fiera Capital

As stock pickers, our preference is for quality companies with high return on capital that can not only sustain the payment of superior dividends - but also retain sufficient earnings for reinvestment, in order to generate compounding growth in profits hand in hand with those dividends over a multi-year time frame. As longer-term investors with typical holding periods of two to five years, we are happy to get paid while awaiting growth. Dividends also can be more stable than earnings, which helps to absorb some of the market's volatility. Some companies have maintained dividends despite a downturn in earnings, while many are committed to increasing payout ratios.

Emerging markets have come a long way since the Asian Financial Crisis of the late 1990s and the Global Financial Crisis of a decade later. Both events were to some degree events of governance, at both the sovereign and the corporate level. Now, growth rates in emerging economies are mostly lower. At the same time, however, standards of corporate governance are much improved. We were at the forefront of income and growth investing in emerging markets, with the launch of the Magna Emerging Markets Dividend Fund back in 2010.

Almost a decade later, there have been a few adopters, but this part of the market remains curiously neglected, with only a handful of funds dedicated to dividend investing, in contrast to developed markets, where equity income is a large part of the market. Emerging Market Dividend investing can offer higher yield and higher growth than developed markets. Long term outperformance should ensure that this inconsistency will be addressed in the coming years. Companies are more willing to engage with their minority shareholders and, crucially, they see the merit in balancing investments for their future expansion with the creation of free cash flow and its distribution in the form of dividends. Over the long term, we expect companies such as these to produce sustainable stock price outperformance.

Julian Mayo and Ian Simmons
May 2019

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