Is Dividend Investing Passe?

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Once upon a time investors in Asia equities may have given little thought to dividends. Instead, they most often sought growth strategies when allocating to the region. Post-2007, following the Global Financial Crisis, the ultra-low interest rate environment saw the appeal of dividend investing increase as income-generating strategies became more popular. Particularly for jittery investors, Asia's dividend strategies have been used as a means to help augment returns elsewhere in their global stock portfolios.

However, more recently as economic growth has picked up and the prospect for higher interest rates has increased, we believe stocks with more robust growth prospects have gained in popularity, raising the question: Is dividend investing now passé?

The short answer, we believe, is still: No. Dividend investing remains a compelling way to access Asia's long-term growth story. Some savvy investors use such strategies as a supplementary source of income, and a means to participate in the region through investment in quality companies as the strategies offer the potential for lower volatility than traditional growth strategies.

More discerning, yield-hungry investors have also differentiated between types of dividend strategies—those focused on high-yielding equities and those focused on total return through a combination of current income and dividend growth. To discuss the wisdom of dividend investing in Asia as well as the long-term opportunities, this month's Asia Insight features a conversation with Matthews Asia Portfolio Manager Yu Zhang, CFA.

Q: Was 2014 less favorable for income-focused strategies?

While the so-called "taper tantrum" created some uncertainties for dividend-focused income strategies, any real negative impact has been far less drastic than what we witnessed in 2013. Valuations for some traditionally high dividend-yielding stocks have been "reset," so to speak, and look less frothy today. Instead, during the course of the year, the bigger challenge was the shift in investor preference toward more growth-oriented strategies and holdings. The Internet sector, India equities and deeply cyclical stocks have performed well. Meanwhile, more conservative strategies—focused on cash earnings generation, balance sheet strength and the ability to pay sustainable dividends—have faced some headwinds. The dividend approach to investing, which tends to appeal to many during downturns, is less sought after when markets are bouncing back and going strong. But again, we believe you have to consider these markets with a long-term view, rather than focus on short-term cycles.

Q: How would you compare Asia's dividend environment in a global context?

In recent years, dividends paid by Asian companies have grown to about US$276 billion—almost comparable to those paid in developed Western markets. With this size, you also have the benefit of diversification, and this is important as we have witnessed a far greater sense of entrepreneurship throughout the region than in the past. More companies are being taken public and many have paid a dividend from the time of listing, so you have a wide range of opportunities, from start-ups to blue chips. The region's dividend payers are also well-diversified in terms of sectors and countries, reducing our strategy's reliance on any one country or sector. This is important from a portfolio construction perspective; it enables investors to collect dividends from more than a dozen different currencies and countries in various stages of economic development.

Q: Does Asia offer investors the potential to gain exposure to different investment strategies?

While traditionally viewed as fertile ground for investors looking for growth investment opportunities, Asia's capital markets are deeper today and continue to grow. Its more diversified equity universe also mean investors now can pursue a number of different strategies. Why does dividend investing make sense for investors looking at Asia? First, if we break down investors' long-term total return into current income and capital appreciation, dividends constitute a significant part of that total return. Asia is no exception in this regard. There is yield, and then growth in the underlying dividends. And it's the growth of underlying dividends that will facilitate capital appreciation over longer periods.

Second, when investors can anchor return expectations with current income (i.e. dividends), the expectations over forward-looking earnings growth that drives the capital appreciation element don't need to be quite as stretched. In other words, one doesn't need to overpay for the growth. Often overpaying for growth can be a pitfall for investors, especially in Asia, where we tend to see growth get priced in quickly. Not only do investors tend to overpay for growth, but management teams can as well.

Q: Does exposure to an Asian dividend-paying strategy mean giving up growth?

No, it doesn't. Actually, among the potential benefits of a dividend-investing strategy in Asia is maintaining the opportunity to invest in growth companies because in our view a large number of the region's dividend-paying companies are growth companies whose underlying businesses are growing at a decent rate.

This may sound counterintuitive for growth companies to pay dividends. However, one of the interesting features for listed Asian firms has been a relatively concentrated ownership structure. Many of these are family-owned businesses, in which the original founder or the founding family continues to retain a controlling stake. These listed businesses, often the so-called "crown-jewel" assets of the family business, are a significant source of income and cash flows to the founding family, and they often depend on these income streams. Similarly, in the case of listed state-owned enterprises (SOEs), the government is the main shareholder, and dividends paid by listed SOEs are often an important source of funding for government spending. So from the point-of-view of the majority shareholder, there is actually a reliance on the dividends. That's why we see a lot of so-called growth companies double as very good dividend growers, even on the back of strong earnings. In either case, dividends are meaningful because they assure that minority shareholders have as equal a claim to earnings as larger shareholders; and that they are also paid in accordance with their percentage of ownership.

Q: How has the market for dividends developed in Asia over the past few years?

The culture of paying dividends has improved quite a bit, and dividend payouts have been steady.
In recent years, I would say the governments of Japan and South Korea have been encouraging companies to better utilize excess cash sitting on balance sheets, and one way to do that is to pay dividends to shareholders. Japanese Prime Minister Shinzo Abe recently introduced reforms aimed at strengthening shareholder rights. For example, a special new Nikkei index includes only firms with strong corporate governance. And in South Korea, companies are expected to increase wages, dividends and capital spending to avoid a new tax on excess profits.

Of course, the final decision of whether or not to pay still rests with the individual companies so there is never any guarantee that a company will continue to increase or pay a dividend. But, on the margin, firms in Asia have generally been raising dividends. And perhaps more importantly, they realize that a track record of dividend payments can help improve their corporate governance profile and offer greater assurance regarding reported earnings. Companies in Asia generate plenty of cash, the question investors need to ask is, "Are they using that cash in a sensible manner?" One of the main objections to paying dividends is the notion that management teams can invest the cash at better returns than paying it back as dividends to shareholders. While that can hold true at times, few companies can successfully do so over longer periods.

Q: So how do you assess whether firms are using cash sensibly? And what is your approach to investing?

Dividends can be used as a lens through which we attempt to identify high-quality, financially healthy companies with prudent capital allocation policies. If an ongoing dividend is paid, the cash flow to support it must have been generated. Since cash is less prone to accounting manipulation, dividend growth can be a solid indicator of business performance. And this can be a better gauge than reported accounting earnings growth. By reducing cash on balance sheets, dividends can lead a firm's management to be more disciplined in its decisions around capital utilization.

We meet frequently with management teams, and have a strict yardstick for the way we measure each company that we consider for our portfolio. Our basic philosophy is that a firm needs to score well on its current dividend yield as well as on dividend growth over the next few years. Usually, if we get a high dividend yield today, we can be somewhat accepting of lower future growth in that dividend, and vice versa. When we meet with management face-to-face, we ask them about their willingness to pay dividends. Sometimes companies will generate plenty of cash flow, but will be unwilling to let it go. So the companies we seek need to have both the ability as well as the willingness to pay out dividends.

Q: Is the pace of dividend growth continuing?

On average, earnings growth throughout the region has moderated somewhat. But individually, for varying economies, there are obviously differing scenarios. For instance, we saw a meaningful pickup in dividend growth out of Japan in 2013 on the back of strong earnings growth, especially from export sectors. Chinese companies have also been drivers of dividend growth in the region; the total dividend pool as well as the number of dividend payers in China has expanded with the continuous development of its capital markets and the pace of initial public offerings.

Q: What are the potential tailwinds and headwinds for dividend strategies as we enter 2015?

Investors are increasingly thinking about the rising U.S. interest rate environment due to the exit of qualitative easing policies in the U.S. So the expectation is that dividend-paying stocks will look relatively less attractive in terms of yield pickup. The natural headwind for emerging markets then is the likely liquidity withdrawal due to the normalization of the U.S. Federal Reserve's interest rate policy. However, market expectations over the past two years should have already priced this in to some degree.

The key concern for us, as always, is picking the right companies, and asking: Will they continue to grow? Will they grow sustainably? And could that growth be translated into a sustainable, rising dividend stream paid to all shareholders? Compared to the U.S., Asia still offers opportunities for higher yields and the long-term growth outlook appears to remain more attractive compared to more mature Western markets.

We feel short-term volatility is more a reflection of market sentiment than it is of underlying corporate fundamentals, which is what we really care about. On the plus side, Asia's dividend stocks look attractively priced at the moment. Ongoing reforms in the region's shareholder return policies are encouraging, and top-down government policies are working their way through the system. We believe some firms are starting to show visible improvement in terms of raising dividend payments.

Furthermore, the opening-up of the Chinese A-share market to foreign investors is very exciting. Specifically for income investors, this brings a new set of dividend-paying Chinese companies into our universe, offering more unique business models for those with a long-term stance. It also has the benefit of further portfolio diversification.

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