First State Stewart

Martin Lau
Director, Greater China Equities

First State Dividend Advantage

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Reflections on managing First State Dividend Advantage over the last ten years

In November 2004 the First State Dividend Advantage fund was launched to provide investors with a combination of income and growth. The product was a response to the environment of low interest rates.

What we didn't anticipate when we established the fund was that ten years later interest rates would be close to zero in some markets. We did not foresee the global financial crisis with its aftermath of quantitative easing and loose monetary policy which would push rates down to historic lows.

Dividend Culture is Central

One of the key characteristics we look for in companies is a positive dividend culture and so the fund's strategy fitted well with the investment philosophy of the First State Stewart team.

Ten years later, I feel that our decision to launch the fund was justified given the fall in interest rates. However, back in 2004 it was easy to find good quality companies which provided dividend yields of 5-7%. Today it is difficult to find reasonable ones giving yields of 3-4% which is a significant challenge for the fund going forward.

It's worth stressing that dividend yield is not the sole factor on which we base our investment decision. The example of Australian REIT GPT shows how such a focus can be dangerous. The company was a favourite of investors looking for income because of its attractive dividend. However, it went bust during the global financial crisis because of its debt levels. A number of REITs in Singapore faced similar problems and had to raise cash from existing shareholders to survive.

The Chinese banks, with yields which are higher than Price-to-Earnings ratios (PEs), are a similar example from today. On this metric they may look attractive for income investors. However, given the high debt levels in the Chinese economy we believe they do not offer an attractive investment, as the downside is huge. I am reminded of the Royal Bank of Scotland which traded on a single digit PE ratio before going bust in 2008.

Free Cash Flow is King

We believe it's vital to focus on cash flow as well as dividend yield. One of our successes over the last decade has been our investment in Taiwanese technology company **Taiwan Semiconductor**. We were initially attracted by the company's Free Cash Flow yield of above 6%. The yield is now 3% as the share price has more than doubled since we bought it.

Over the years I have learned not to take a mechanical approach to yield, but rather a nuanced one. It's necessary to take account of differences between countries in the region. Large pay-out ratios are common in Hong Kong and Australia, while a dividend culture is less developed in other markets (India, Japan and South Korea). It is difficult to find an Indian company which would provide a 5% yield.

Our long-term focus on cash flow has underpinned the performance of the fund. We have also benefited from a low turnover in the portfolio, preferring to buy and hold companies over the long term. Some of the names we have held for most of the decade include **Taiwan Semiconductor (Taiwan), Cheung Kong Holdings (Hong Kong), Dabur (India)** and **ENN Energy (China)**. They have all performed strongly and we are happy to continue holding them.

Things we missed

We are always looking to learn from our mistakes. Our negative view on the Australian dollar and economy over the last decade meant that we did not hold any Australian banks, missing out on substantial upside in share prices. We focused too much on the risks of investing in South East Asia (Indonesia, the Philippines and Thailand), and as a result had little exposure there. These markets performed very strongly over the decade. We did not invest in internet companies such as Baidu, missing out on substantial upside. These decisions often stemmed from our conservative investment style. However, we believe our philosophy of focusing on preserving capital is a vital component in providing good returns for our investors over the long term.

A decade of change

The last decade has not been short of incidents in financial markets and managing the fund has been a challenge at times.

The fund was launched just after the SARS outbreak when valuations were low in the Asia Pacific region. This turned out to be fortunate timing as markets rallied strongly thereafter.

The global financial crisis was the key event of the last ten years. Thankfully, our cautious investment style and focus on preserving capital underpinned outperformance during this volatile period.

The continuing expansion of the Chinese and Indian economies was a significant development over these years. The rise of South East Asia as an economic powerhouse was also a feature.

Another aspect was the rise of property prices which supported consumption and economic growth across the region. We also witnessed surging indebtedness with Credit to GDP ratios expanding to a record high in the Asia Pacific markets. Mortgage debt to GDP is now at a higher level than at the time of the Asian crisis in 1997. Although there is less US$-denominated debt today and interest rates are much lower than the 1990s, we are concerned about the amount of debt.

The next ten years

Over the next decade we expect to see an expansion of the investment universe as other markets become more prominent. We anticipate that the portfolio may contain companies from Bangladesh, Burma, Cambodia, Sri Lanka or Vietnam over the next ten years.

A key issue for investors will be the timing of interest rate rises towards a more normal level. This will be a significant change as many companies and investors have become used to operating in an environment of very low rates. As a result it is an important part of our job to monitor the way company management respond to a low rate environment. Are they taking on too much risk for example?

Fund positioning

We remain focused on investing in high quality companies trading at attractive valuations which offer reasonable dividend yields. We are conservative in our approach and are likely to have little exposure to commodity companies, favouring stocks in the Consumer Staples, IT and defensive sectors.

Our bottom-up focus is generating plenty of ideas in the Indian market which is now a large part of our portfolio (c. 23%). It is much more difficult to find good ideas in China or South Korea, although the opening up of the A-share market to foreign investors should provide more choice in China and improve the quality of Chinese companies over the next decade.

It has been very enjoyable to watch the growth of the fund over the last ten years, especially as we have built up a good performance track record. I've also been pleased to see our team grow over the years. The First State Stewart team now has 36 investment professionals across the business with eight based in Hong Kong. It has been a great pleasure to look after client funds in the Dividend Advantage fund over the last decade and I look forward to the next ten years.