

Why A Focus On Dividends Rewards Long Term Investors

Investing for Growth

Since launching in 2010, Dundas has pursued a single, clear investment strategy – to invest in global companies that offer the best opportunities for long-term capital and dividend growth.

Our philosophy centres on the principle that the best prospects for superior returns lie in companies that are able to grow their dividends faster than the market during the good times, whilst not cutting dividends during times of stress. We take the view that as dividends are delivered, the market will reward those companies with higher share prices.

The Case for Dividends

In 2010, MSCI produced an in-depth analysis of the drivers of real equity returns from 1975-2009.

The study demonstrated that global equities returned 11.1% per annum over the 40-year period. Adjusted for inflation, this translates into a real return of 7.1% p.a.

Delving deeper, the dominant components of long term returns were dividend income and book value growth, providing returns of 2.9% and 2.1% respectively – over 70% of the total real return. Importantly, the study also showed that these are, by a long way, the least volatile components of return.

	MSCI World returns % p.a.		Volatility
	1975 - 2014	2015	
Total gross return	11.1	-1.8	14.9
less Inflation	3.9	1.0	1.3
Total real return	7.1	-2.8	
Valuation change	1.7	-3.0	14.0
Growth	2.1	-2.0	5.6
Dividend income	2.9	2.5	0.4

*Sources: MSCI Barra Research Bulletin – 'What Drives Long-Term Equity Returns?' January 2010, data from 2009 onwards calculated by Dundas using MSCI published data. Dundas has used the MSCI methodology to bring this up to 2014 and also 2015. Please note residual interactions account for 0.4% per annum.

Dividend Disciplines

The global market provides a sizable universe of companies that can be divided into two broad categories according to their dividend profiles –

Mature, slow-growing companies

Typically well-established companies that have little need to invest in their own growth. They typically pay out a high proportion of profits – around 75% - in the form of dividends and offer a yield that is significantly higher than the market. For example, GlaxoSmithKline yielded 5.7% at the end of 2015 – considerably higher than most global companies.

Investments in these types of businesses, however, come with a catch. In difficult economic times, their high payout ratios leave little margin before a decline in profits removes their capacity to sustain or increase the dividend. Reserves may compensate temporarily for this shortfall but when profits do recover, the priority will be to rebuild those reserves, detracting from their ability to pay a dividend. Either way, long-term growth prospects will be lower and the likelihood of a dividend cut is higher.

Fast-growing companies

An alternative is to seek companies in faster-growing markets, which typically retain most of their profits to fund their expansion. These companies typically pay out lower dividends. For example, Microsoft had a yield of 2.0% at the end of 2015.

On the face of it, the gap between a yield of almost 6% and 2% appears quite daunting. It narrows surprisingly quickly however for two reasons. Firstly, the dividends on fast-growing companies increase much faster in the good times - our research suggests a dividend growth rate of around 10-12% per annum compared with only 5% for the slower growing businesses. Dividends will therefore double in six to seven years compared to 14 years for the less buoyant companies. Secondly, as faster growing companies only pay out around one third of profits, they have far greater scope for maintaining and growing dividends even in difficult times.

Returning to our examples, Microsoft's compound returns per annum have been; share price +16.6%, dividends +23.3%. For GlaxoSmithKline, returns were +2.3% and 4.5% respectively.

The Dundas Approach

At Dundas, our collective experience tells us that the companies in the best of health exhibit three common characteristics –

- Strong, sustainable business models and consistent growth in revenues, earnings and cash flows;
- A pattern of sufficient profit retention to fund future growth
- A commitment to provide a meaningful dividend to shareholders that grows over time. Paying dividends is an essential capital discipline for these businesses.

These companies provide shareholders with an ever-increasing incentive to invest – not only are they developing their business to earn higher profits, they are providing the opportunity to pay sustainable and growing dividends.

The Dundas Scorecard

Dundas commenced managing the Australian Apostle Dundas Global Equity Fund (ADGEF) in August 2012. The following is a snapshot of the Fund as at end March 2016 –

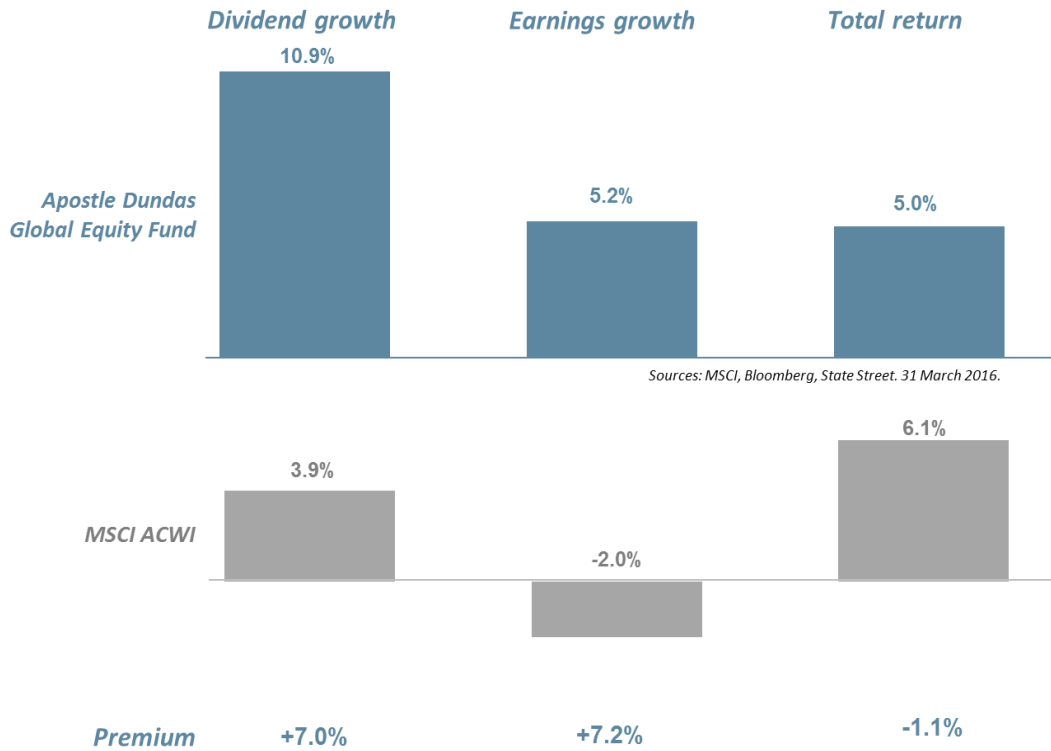
	ADGEF	MSCI ACWI
<i>Dividend Yield</i>	2.04%	2.60%
<i>Future Dividend Growth Rate</i>	10%	5%
<i>Price/Earnings</i>	17.9x	15.5x
<i>Return on Equity - past 12 months</i>	15.64%	9.54%
<i>Payout Ratio</i>	40%	54%
<i>Net Margins</i>	10.78%	6.65%
<i>Leverage</i>	1.93x	2.31x

In summary;

- Quality companies with sustainable growth
- Some current yield foregone to fund future growth
- Higher Return on Equity
- More retained earnings
- Higher margins with less debt

Dividend and Earnings Growth

The following chart shows Dividend/Earnings Growth since inception, together with Performance (all expressed in USD to dampen any currency effects);



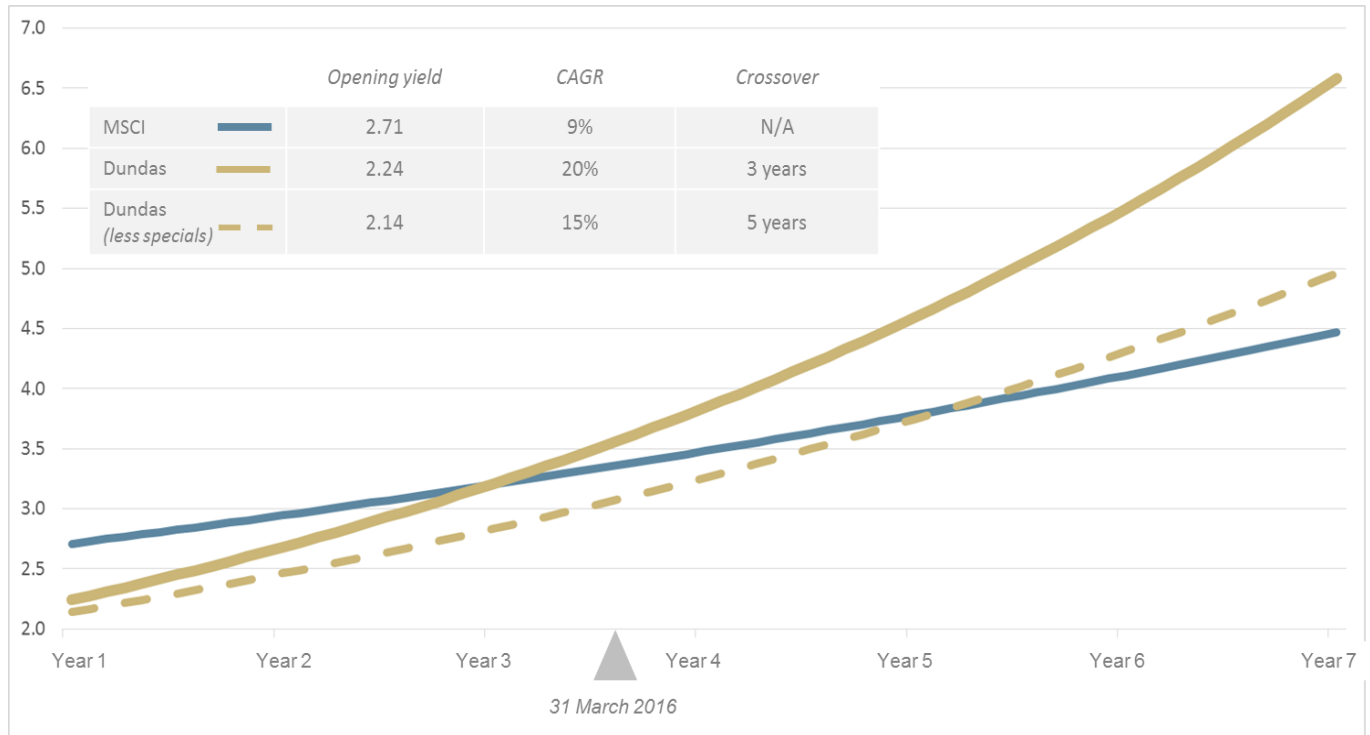
*Annualised Returns in USD - Sources: MSCI, Bloomberg, StateStreet as at 31 March 2016.

- Historical Dividend Growth at a 7% premium to the market
- Historical Earnings Growth at a 7% premium to the market
- Total Return trailing the market. Dundas have not held many of the valuation-driven high performers, particularly in the US, which have inflated equity markets over the past three years. Instead, Dundas have held a quality portfolio based upon underlying fundamentals.

Income

As mentioned, Dundas are prepared to give up some current income for the prospect of higher growth in a company’s profits, and consequently higher future dividends.

The following chart depicts how that manifests itself in higher income to an investor over time:



Fund

The gold line reflects the dividends in the ADGEF portfolio since inception in Australian Dollars on an XD basis. Each monthly figure is divided by the number of units in the portfolio and shown on a rolling one year indexed basis. Please note special dividends are included.

Index

The line represents the trailing dividends received divided by opening published index price on 31st August 2013. This reflects monthly changes in both dividends and the currency impact to Australian Dollars.

The gold line reflects the dividends in the ADGEF portfolio since inception in AUD, whilst the blue line shows the dividends in MSCI ACWI.

With the portfolio having a much higher dividend growth rate than the market, income foregone in year one is quickly made up, and by year three the income received by the portfolio had exceeded that of the market.

Summary

The Dundas approach is to invest in quality companies who we believe have both the capacity (based upon strong fundamentals) and the intention to grow their dividends to shareholders. This, we believe, will lead to capital appreciation, regular and growing income, and will provide protection in down markets.



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