The best of both worlds

Why Asia offers investors both income and capital growth...

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Benjamin Graham, often lauded as the 'father of value investing', is quoted as saying: "The stockholder wants both income and appreciation, but in general the more he gets of one, the less he realises of the other."

Time has moved on but investors may still face somewhat of a binary choice: invest in high-growth US technology companies (and sacrifice an income stream) or opt for the higher dividend-paying (but lower-growth) UK companies. But what if there was the option to potentially combine both capital appreciation and dividend income?

The solution to this perennial trade-off for investors may well lie in the Asia Pacific region. It's jam-packed with global behemoths such as Taiwanese semiconductor manufacturer TSMC, Korean-headquartered Samsung and Australian mining company BHP. It also benefits from strong secular growth drivers, including above-average economic growth, a burgeoning market of middle-class consumers and exposure to mega-trends such as AI and green energy.

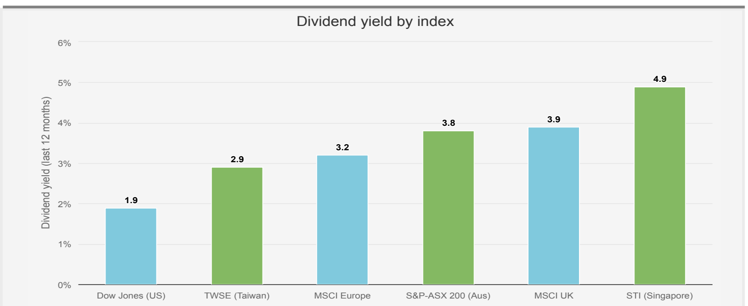
That said, Asia Pacific has often been overlooked for its income credentials, despite the region eclipsing many of the traditional markets for income-seekers. This also provides an opportunity for investors to diversify their portfolio, both by sector and geography.

A stream of income

There has been a sustained effort to cultivate a supportive environment for dividend payouts in Asia over the last decade, including corporate governance reforms in China, Korea and Japan.

This approach has proved successful, with the chart below showing that STI (the leading index in Singapore) tops the group with a dividend yield of almost 5%.

Fig.1: Asian Equities Offer Attractive Dividends



Source: Bloomberg (as at 24/04/2024)

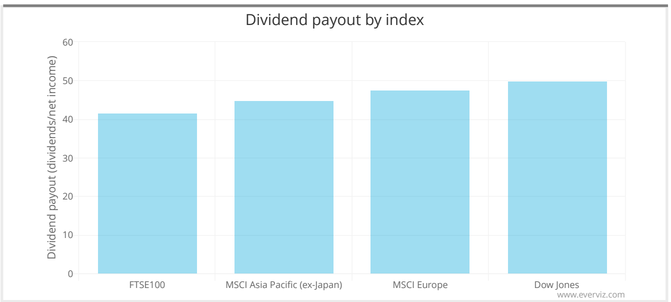
This is comfortably above the c. 4% yield in the MSCI UK, one of the more popular equity income markets. In a similar vein, the ASX 200 (the 200 largest companies on the Australian stock exchange) currently exceeds the yield on offer from both the MSCI Europe and Dow Jones.

But it's not just about the headline dividend yield: Asian equities offer several advantages beyond their high-yielding UK counterparts. There is a noticeable concentration risk in the UK equity income sector, with the top 10 FTSE 100 companies accounting for 55% of overall dividends, rising to 74% for the top 20, according to AJ Bell.

This is not the case in Asia Pacific, with Schroders reporting that almost 40 companies account for half of the dividend income from the MSCI AC Pacific Ex Japan Index, which provides a broader foundation of income-paying companies.

Another key consideration is the resilience of dividends. The chart below shows that the MSCI AC Pacific (ex-Japan) has one of the lowest pay-out ratios (the proportion of earnings paid as dividends) amongst its peers, which provides a useful buffer if earnings fall.

Fig.2: Attractive Dividend Payout Ratio



Source:Bloomberg (as at 24/04/2024)

Asian companies also tend to hold a higher level of cash than their US and European counterparts, which helped to protect dividend payments during the pandemic (when dividends were slashed in the UK).

The AIC's dividend hero awards are a good point of reference for income-seeking investors, highlighting the investment trusts with the most consistent track records of rising dividend payments.

Schroder Oriental Income (SOI) is the highest-ranked Asia Pacific investment trust in this list, qualifying in the 'next generation of dividend heroes' thanks to 17 consecutive years of dividend growth. This is testament to the quality of dividend-paying companies offered in the region and puts the trust ahead of many of its UK equity income peers.

The growth engine

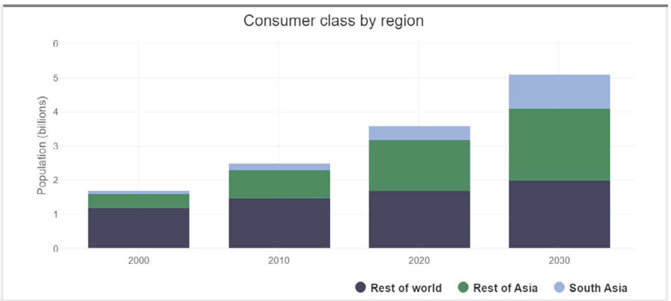
The Asia Pacific region also boasts strong secular growth drivers. Three of the top five countries with the highest forecast GDP for 2024 are found in Asia, with forecast annual growth of 4-6%, compared to 0.7% and 1.5% for the UK and US respectively, according to the OECD. In addition, some Asian countries have yet to experience the ageing demographic issues of their western counterparts, with a large working population helping to support economic growth.

As a result, strong economic and demographic growth has created a burgeoning middle class in Asia, providing an ever-expanding domestic consumer market.

The chart below shows that Asia will account for most of the global consumer class by 2030 (defined as people spending more than $12 a day) and the World Data Lab forecasts that 80% of new consumers in 2024 will come from the Asia region.

Whilst economic strength doesn't necessarily drive stock market performance, it provides a solid foundation for earnings growth in Asian companies. Asia is also home to global leaders in the semiconductor, consumer products and clean energy sectors, amongst others.

Fig.3: Asia Leads The Way In Consumer Class Growth



Source: World Data Lab, 2030 forecast numbers

Richard Sennitt, manager of SOI, sees the Asia Pacific region as a fertile hunting-ground for companies well-positioned to ride the tailwinds of structural growth. As a result, the trust is currently significantly overweight financials, information technology and real estate stocks due to the attractive growth opportunities on offer.

The trust's largest position is currently TSMC, a pure-play semiconductor manufacturer with a prestigious client list that includes NVIDIA, Apple and AMD. Semiconductors are a key component for mega-trends such as AI, the rise in remote working and increased demand for electric vehicles, with McKinsey forecasting that the global semiconductor market will hit $1 trillion by 2030.

Another mega-trend is the exponential forecast rise in demand for commodities over the next decade. BHP, one of SOI's portfolio companies, is a leading miner of copper, iron ore and nickel, which are critical inputs for the clean energy transition. Electric cars are estimated to use six times more minerals than their petrol equivalents, and S&P Global forecasts that the demand for copper is set to double by 2035 due to the wide-scale upgrade in electrical infrastructure needed to support the shift to renewable energy.

Why stock-picking matters

We should say at the outset that Asia Pacific is a large and diverse region, encompassing economies at varying stages of development, as well as differing political regimes. While corporate reforms are underway, investors may not have access to the quality and depth of information provided by UK companies, which can make it difficult for investors to find the stars of tomorrow.

This is where active fund managers come into their own: Richard, together with his colleague Abbas Barkhordar, has extensive experience in Asian equities and carries out regular meetings with companies. They also draw on the comprehensive resources of the Schroders Asia Pacific team, with 40 analysts across six regional offices, which provides a significant advantage in an under-researched market.

Asian markets are typically higher risk (and reward) than the US and Europe and the managers seek to mitigate this risk by investing in quality companies with strong earnings growth and sound balance sheets. The trust also has a material underweight to China and is overweight developed markets such as Singapore, with Australia and Taiwan also being significant weightings.

This approach has protected against downside risk, with SOI achieving positive net asset returns in each of the last five calendar years, which is particularly impressive given the geopolitical and macroeconomic volatility during this period.

Overall, the trust has delivered a net asset total return of 30% over the last five years, significantly above the 17% return of the MSCI AC Asia Pacific ex Japan Index and is currently trading on a dividend yield of 4.6% (as at 23/04/2024). As a result, the trust has been awarded a **Kepler Income and Growth Rating**.

Looking ahead, Asia looks set to play a starring role among global equity markets over the coming years, although investors should be cognisant of the higher volatility that Asian equity markets can be subject to. With that in mind, Asian exposure could offer investors a winning combination of capital growth and an attractive income stream, which might just disprove the words of Benjamin Graham after all.

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