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TRANSCRIPT: EPISODE 91
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[INTRODUCTION]
Ryan Lightfoot-Brown (RLB): Hello and welcome to the Investing on the go podcast brought to you by FundCalibre. I'm Ryan Lightfoot-Brown and today we have the pleasure of hosting Ian Simmons, the manager of the Magna Emerging Markets Dividend fund, which is on FundCalibre's Elite Radar. Ian thank you very much for your time today.

Ian Simmons (IS): Thank you for having me.

[INTERVIEW]
[0:18]

RLB: Investors have been shunning emerging market equities in recent times. I think you said that foreign investor flows have actually been negative every single week of 2020. Why is the asset class so unpopular?

IS: Yeah, you're right. It certainly feels like the US equity markets and especially the tech-heavy NASDAQ are the only game in town at the moment - they are attracting all of the attention and perhaps fears about the impact of US/China trade tensions on emerging markets are not helping, but really this year, I think we can explain that flow data by, unsurprisingly, by the Coronavirus and the ability of emerging markets to respond to that.

It's a mix of things. It's how strong their finances were before the virus, and therefore how they were able to respond. And then of course, how they actually did respond. There's been a big mix of approaches across the emerging market universe to this Coronavirus outbreak. They came into it with weaker healthcare systems than developed markets and emerging markets of course, are negatively impacted by a slowdown in global trade, and many of them by falling commodity prices. That's unhelpful. But really on the fiscal side of things, it's their ability, or inability, to provide the same level of stimulus and support that Western governments have. If you think about the percentage of GDP, which has been spent by countries like the UK and the US in supporting their economies, if emerging markets did that, then it would have a huge impact on their debt to GDP ratios and therefore provide a, quite a large hangover on future growth potential, and even worry some of the rating agencies.

But you know, flows don't necessarily tell the whole story and actually emerging markets as an asset class are flattish year to date. So, they've actually outperformed many developed markets. And within that, you still have some quite attractive pockets of performance. So, China is one of the better performing equity markets around the world, and there's other Asian markets which have also done well. So, it's clear that parts of the emerging market universe are doing a decent job in this challenging environment. And we've actually just seen for the first time, two weeks of inflows after all of those outflows. So perhaps investors are starting to realise that the growth outlook in parts of the emerging market universe is actually still quite appealing.

RLB: So it sounds that things are starting to turn a corner, really?

IS: Yeah, we hope so. I think as with anywhere, a lot of this depends on how the virus progresses. If we see a second wave, a traumatic second wave, in any of these markets or a more extreme, significant lockdown again, then that would set us back a few steps. But from what we can tell so far, case counts are certainly dropping and we're well on the way to getting back to normal and in big parts of the universe.

[3:25]

RLB: And you've indicated that some domestic investors are getting more active in emerging markets, are these sort of professional or institutional investors or is it the public getting more involved in the stock market too?

IS: Yeah, definitely, we're seeing local emerging market investors coming into the equity markets. And perhaps that helps explain why performance has been reasonable given the challenges. It's a function of lower interest rates essentially. So, where savers in emerging markets used to get fairly guaranteed returns by investing in their own government bonds, with falling interest rates they have been forced to move into riskier asset classes. And, of course, the equity market is the primary option for most people. So it's a mix of institutional, pension funds, insurance funds who have long term liabilities to meet, but also we've definitely seen a new wave of retail investors opening up accounts, and that's happening in multiple countries: Brazil, Korea, Russia, Turkey, and of course China, to some extent. So, it is a phenomenon which I think emerging market investors like myself have been hoping for, for many years. So, it's good to see at last. And of course, if you're a retiree, then companies with decent dividend yields should be the first port of call for you.

[4:50]

RLB: And perhaps moving onto sort of how you run your fund in the space. Any investment that you make has to have a dividend yield of at least 2.5%. How are dividends holding up in emerging markets, because obviously the story in the UK here is how much they've been decimated. Are they doing better in the emerging markets?

IS: Yeah, compared to the UK, definitely holding up much better. So, consensus currently has emerging market dividends dropping close to 20% for this year, for 2020, and that's primarily led by the cyclicals. So, both domestic cyclicals like banks and retailers, travel companies that simply shut down for several months. But also of course, the commodity companies who are suffering from lower prices, but it's very much a temporary hit to dividends, we believe.

Now, we of course have a dividend focus, and we therefore hope to do considerably better than that minus 20% for our portfolios. We look for companies with strong balance sheets, so companies which have much lower leverage than the broader universe. And so even where we have seen cuts in dividends, we're very confident that they will catch up later in the year or early next year. And the cuts we've seen have come for two main reasons I would say. The first is where they've simply been imposed by a regulator. So, this has happened, especially in the banking sector where, regardless of the size and capital position of different banks, the regulator has simply said, no dividends can be paid for an extended period. And the other reason is companies which would typically be reporting their results in February, March, April of this year, and making decisions on their dividends, that was right in the middle of the worst of the Coronavirus so understandably they have taken a more cautious approach and decided to defer dividends for now. But the clear message, as I say, has been that once there's more clarity on how the virus is panning out, those dividends will be topped up, and we will still receive what we were expecting.

I think it's worth pointing out that in emerging markets, one reason why we think that they are a good compliment to traditional sources of income actually, is the dividends we receive tend to be a function of genuine organic earnings growth. They're not unsustainably boosted by cheap debt. And that's a trend that we've certainly noticed in some developed markets over the last few years. So, what you get in emerging markets is ongoing genuine growth and cash generation comes alongside that, with companies willing to pay that back to minority investors in the form of dividends.

RLB: Which is probably why you've seen a much lower level of cuts because those dividends are more sustainable to these shocks.

IS: Exactly. Yeah, the payout ratio, which is the proportion of earnings which companies pay out as dividends is close to 40% in emerging markets. So, it's only slightly above long term averages. It's not an excessive number. It's a level that we feel companies can sustain both an attractive mix of growth, continued reinvestment in growth, and a dividend payout at the same time.

[8:19]

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RLB: And you touched on China earlier on - around two thirds of your portfolio is invested in Asian companies in particular China, why is this?

IS: Yeah, well, first of all, worth saying that our approach is driven by stock selection, it's a very bottom up approach. So, it's the individual companies and the ideas that we can find, which really drive that overall country and sector allocation. But of course, Asia has some well-known attractions. It's a much larger opportunity set. There are literally thousands of companies to choose from relative to other parts of the EM [emerging markets] universe. There's a greater degree of predictable and macro stability. There's still some strong demographic tailwinds in some of those countries. And actually, with the focus on China, some of these large liquid markets, like the Philippines, Indonesia, India, and more recently, Vietnam has come to the stage. They're becoming more and more over-looked, so they are opportunities there for bottom up stock pickers.

But the other thing about Asia of course, is it's still largely domestically-driven and that suits our style and what we're looking for, we prefer to invest in companies which are plays on long term structural growth, hiring calm with the middle class in emerging markets, rather than the more cyclical areas or commodities, for example. And we've seen it in, in the last few months, in response to this virus, Asia and especially in North Asia, so China, Korea, Taiwan, have actually handled the crisis extremely well. They have emerged from the worst of it before most other markets in the world. And those strengths, I just mentioned actually gave us confidence to continue adding to our exposure in Asia over the course of a year. It really is just a case of growth being temporarily interrupted, I think.

[10:17]

RLB: And before you came onto this fund, you were running Latin American equities, I see you've got a couple of holdings in like Brazil and Mexico, which you touched on before, are you tempted to hold any more?

IS: Yeah, I did. I ran a Latin America fund, but I think the one thing everybody always has to try and do in this job is remove any biases. So, there's no obligation to continue having large positions in Latin America just because of my history, but there's certainly plenty of yield on offer. And these markets are still well off their highs for the year, unlike some Asian markets which are reaching new ground. There's record low interest rates in Brazil, which has driven a lot of enthusiasm for the market amongst local investors. And of course, Brazil has a minimum dividend payout, which provides plenty of choice for dividend investors. But, at the same time, they are struggling with the virus more than most. Both Brazil and Mexico have what I would say are unorthodox leaders. So, they have their issues. Brazil's currently seeing conflict in government over how much they can spend through this crisis in supporting the economy. It has implications, as I said earlier, for long term growth and potentially the rating agencies' view of the market.

But you know, definitely as we get a bit more clarity on the emergence from the crisis and virus getting under control, then there's definitely scope to add more to these markets. But in the meantime, I think we'll be more likely to add to existing holdings, which we believe can be resilient in either scenario. So, for example, the stock exchanges of both Brazil and Mexico, we own a position in, and they benefit from the volatility, the trading activity, where the markets are going up or down, and therefore they work well in this environment where there's still some uncertainties.

[12:20]

RLB: And perhaps our last area, on our little global tour, you've got about 10% of the fund in Russian companies. It's a country that's never far from the headlines. So, what sorts of opportunities have you found there?

IS: Yeah, we've actually been adding to Russia consistently over the last couple of years. It's a great example of what we're starting to see across the board, but they were quite early to it. And there's been rewards to both the managers of these companies, but also to shareholders and investors in them. And it's been a quite a dramatic mindset change. So, for years, Russian companies had a reputation for sitting on cash, investing in low or zero-return projects at the behest of the government. But what we're seeing now is much more of a focus on profits, returns and, with better capital allocation, has come a willingness to return that excess cash to shareholders in the form of dividends. So, despite that actually strong performance from Russia, as it has been rewarded for this changing mindset, it's still one of the higher-yielding markets in the emerging market universe. And we still continue to find plenty of attractive ideas there.

We have positions in the financial sector. So, we own Sberbank, which is the dominant bank in the market, very, very profitable bank. And we have a position in the Moscow exchange, which is the stock exchange of Russia. We also own X5, a supermarket operator, which is still in a growth phase, but doing so with very high cash generation, and so still yields about 5%. And we have some of our quite minimal commodity exposure in Russia. We have a couple of positions there in companies which operate in the lowest parts of the cost curve. They still have some growth projects to invest in, but they are generating stellar returns - much higher than other commodity companies around the emerging market space - and paying dividends in the high single digits.

RLB: Well Ian that's been really interesting. Thank you very much for your time.

IS: Thank you, Ryan.

RLB: And if you'd like to learn more about the Magna Emerging Markets Dividend fund, please visit our website FundCalibre.com and for more from our Investing on the go podcast, please don't forget to subscribe.