

Bees for their honey; not their buzz: Global equity income investing and our approach at Veritas

REAL RETURN INVESTING AT VERITAS

*“An orchard for fruit
Bees for their honey
And stocks, besides,
For their dividends”*

“The old farmer knew where honey came from,
but he would make no such mistake as to tell his son to buy bees for their buzz”

John Burr Williams: ‘The Theory of Investment Value’ 1938

Bees for their honey; not their buzz:

Global equity income investing and our approach at Veritas

INTRODUCTION

Over five years ago we concluded there was a strong rationale for global equity income investing and we believed we had a sound approach to this investment philosophy. To our knowledge there were no other offerings such as this but there were numerous funds with a smaller opportunity set and less diversification, usually UK based. We self-seeded (we like to invest alongside our clients and pay the same fees) and launched the Veritas Global Equity Income Fund which now has a five year track record. We thought it worthwhile to recap on why we launched; how we have gone about it and what the results have been.

There are many investors who made a name for themselves in the twentieth century who expounded the value in dividend based investment. John Burr Williams is not as well known as a Ben Graham but in the early twentieth century he was a founder and developer of fundamental analysis and ideas of 'value'. His poetry was awful, as you can see from the front cover, but his investment thinking was leading edge. In dividend based investment of numerous kinds there is nothing new and it suits all kinds of clients. Those wanting income can take it and remain invested in a real asset. Successful companies grow and they reward their shareholders with growing and higher dividends; companies and governments do not tend to reward their bondholders by raising the interest rate on the bond! Those not requiring the income can enjoy the compounding returns of reinvested income if they elect to. This is such a powerful contributor to long term real total returns that it suits all forms of clients from private clients to charities to institutions.

London's Financial Times Lex column coined the phrase: 'Dividends are reassuringly honest'. Honest, that is, if they are payable and sustainable. Honest also in that they cannot be massaged like earnings: this is why they are used by managements to signal strength. We like companies that sensibly manage their free cash flow. When markets are choppy, investors' minds are re-focused and the reliability and sustainability of dividend payments (the "honey") become the hot topic as opposed to 'momentum', 'liquidity' and an exciting stockbroker's story (the "buzz"). In uncertain times the cash flows of a company come into focus as a driver of returns rather than short term capital appreciation of the share price in the capital markets.

This was especially apparent in the turbulent period 2008/9 when dividends were cut or withdrawn altogether to add insult to the injury of capital depreciation.

Alongside this healthy quest for cash flow and yield (which should be maintained in all market conditions) there comes attitudinal changes. Managements understand the need for confidence building and 'signalling'. Boards raise 'capital discipline' up the agenda and think hard about returns on reinvested earnings. They begin to doubt the value of ill judged and badly timed buy-backs and shift thinking to that foundation stone they don't ever wish to cut back on: the dividend. It is especially notable in Asia ex Japan that during the decade following the 1998/9 Asia crisis, managements have been changing behavior in response to maturing capital markets and payout ratios have been rising and are more dependable. Contrast this with the US that eroded the dividend focus during the same decade. We believe the coming decade could reverse this trend in the US but there are contextual issues such as tax to consider. Investor behaviour changes too, in tougher shorter term conditions conversations are more based on 'security of earnings' and ability to pay the dividend as fund managers bunker in to their desks. More longer term, demographics and savings profiles are developing the demand for yield from asset managers who are responding with their own corresponding demands on managements.

In investment, we are the first to admit that there are many ways of skinning a cat. So long as you have a coherent philosophy and methodology; it suits your skills, experience, temperament and resources, then sticking to this and becoming better and better at it is a good approach. There are arguments for investment approaches that ignore yield and place attention elsewhere. There are managements that have high return reinvestment opportunities and their stage in the corporate lifecycle may not argue for dividends. Fair enough. However, empirical evidence, academic research and our 'roll your sleeves up' investment experience which spans well over twenty years has led us to consistently argue there is a place for soundly based and differentiated yield investing. Soundly based, as we do not believe in mechanistic, dogmatic purchases of high yield equities. Differentiated, first because we accept that it is hard to produce exceptional performance unless you do something different from the majority and second, because the approach we adopt is based on our own thinking and experience.

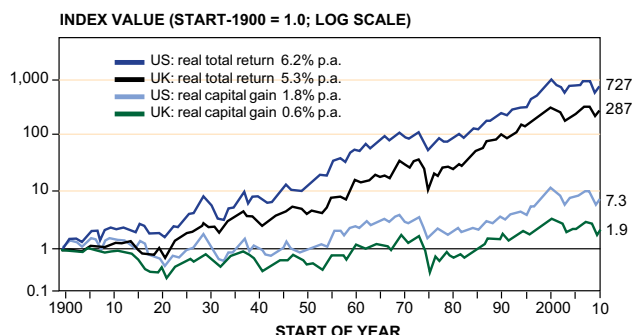
In this paper we aim to remind readers of the underpinning of the approach generically, explain why a global approach makes sense and highlight the key tenets of our differentiated approach.

BACK TO BASICS

If you, like us, believe that successful investment brings together sound theory and technical skills with extensive experience and pragmatism then it is worth rehearsing the theoretical underpinning for global equity income investing. This 'back to basics' section of our paper is designed to serve only as a reminder of the importance of dividends, over time, to total real returns.

- Dividends matter: **'Dividends are a critical element of long-run gains in wealth'**. Dimson, Marsh and Staunton. Triumph of the Optimists 101 years of global investment returns: the bible of long term returns in equities, bonds and cash revised each year.

Dividends Matter-1900-2009



Source: Dimson, Marsh and Staunton (Credit Suisse) and Triumph of the Optimists, Princeton University Press.

- **Dividends are the main source of real return we expect from equities, much more important than valuation expansion or dividend growth over the medium to long term:**

Dividends and the Three Dwarfs. Arnott, 2003 Financial Analysts Journal.

- **There is a marked historical returns premium from stocks with above average yield:**

'The longer the time horizon the more important is dividend income'. Dimson, Marsh and Staunton. Triumph of the Optimists. Also see Litzenberger and Ramaswamy, 1979, The effect of personal taxes and dividends on capital asset prices. See also the writings of some of the 'fathers' of value investing such as Ben Graham.

- **High payout ratio does not mean low subsequent growth and in many cases is related with good capital discipline and high subsequent growth:**

Surprise! Higher Dividends=Higher Earnings Growth: Arnott and Asness in Financial Analysts Journal 2003.

International Evidence on Payout Ratio, Returns, Earnings and Dividends: Gwilyn, Seaton, Suddason and Thomas. University of Southampton 2004.

- **Sustainable dividends are a source of support, reduced volatility and return:**

Do dividends matter more in declining markets? Fuller and Goldstein, 2005, University of Mississippi and Babson College.

Overall, the dividend investing approach has some real substance and offers a market opportunity in the hands of an experienced and focused investor.

THE GLOBAL OPPORTUNITY

Our own experience and the evidence arising from it over a number of decades is that embracing global investment thinking and analysis creates value. There is now a received wisdom regarding this which was absent in the early nineties because economies have become inter-connected, international trade and communications have exploded, industries have addressed globalisation in a number of ways, academics have rushed to debate whether the world is flat or round and capital markets have developed in tune with this. Markets are global. There is a changing dynamic of global growth towards developing economies such as China and Brazil.

In addition, the consolidation and development of single country equity indices has demonstrated a narrowing of opportunity set in companies and sectors. This constraint is not useful for investment notably if the country has a mature economy and a limited number of sectors with access to growth.

Returning to the 'temple of wisdom' of investors, John Templeton in the early twentieth century was known for his twenty maxims of investment. Amongst them: 'if you search worldwide, you will find more bargains and better bargains than by studying one nation. Also, you get the safety of diversification'.

We agree, and this succinctly summarises two of the key advantages to the global approach:

- Capturing the growing opportunity set of investment opportunities on a global basis. As markets mature and investors develop internationally there is a growing dividend paying and dividend growing universe globally.

- Diversification benefits: we tend to run concentrated portfolios which express high conviction. We gain sufficient diversification both regionally and across sectors globally. Diversification is a logical and proven way to protect the portfolio alongside a sound understanding of your investments.

Finally, there is a third benefit: that of focused global research. Given that we have a global research team working within our framework, we can gain a broad perspective and cross-fertilise ideas around the world. Trends and themes around the world shape how companies invest, behave and compete. It is not indices or base of listing that drives them and their success. Similarly with the macro context, there are key global trends that don't recognise arbitrary boundaries, just look at where US sub-prime popped up around the world in 2008/9. We have always invested within our assessment of key themes as tailwinds or headwinds. For example, the global telecommunications sector which exhibits some strong growth themes of connectivity and the networked world, it may be worth compromising on the highest yielding share in one region for another that combines a high yield with some stronger growth characteristics. The same applies in banking. We can be selective and do not need to concern ourselves with what we don't own. Our global approach is not to hire armies of analysts and cover the waterfront. It is not to try and be knowledgeable on everything because we cannot be. However, being able to carefully select across regional boundaries those equities that combine yield with our own thinking is vital.

Let's turn to the key tenets of our approach at Veritas and what our results have been.

THE VERITAS APPROACH

Having covered the generic underpinning of our investment philosophy by way of dividend investing and a global perspective, what about the specifics of our approach?

Any Investment House differentiates by its people, its culture and its performance. However, in addition what is it that distinguishes our global income approach?

What we are and what distinguishes us:

Combining income and real return: Pursuing an objective of income and real return to the capital over time. Both are addressed and the former is key.

We target to meet our income goals and deliver a real return to the capital and have done this since inception five years ago.

High conviction themes: Using high conviction themes to reduce our global opportunity set to those companies with good fundamental drivers or tailwinds.

Our belief is that a well defined and implemented global thematic framework can generate outstanding performance. At Veritas, we understand the limitations of themes and we have extensive experience of the use of themes in our investment. Often a good theme is over-valued or not investable with sufficient quality of position.

Proprietary research: Using proprietary screening to identify sustainable yield ideas.

Maximising the benefits of a focused global research team in identifying and valuing stock ideas within the context of the themes and the screening undertaken. We are not concerned about waterfront coverage and knowing everything, we ignore indices and their structures. We aim to assess intrinsic value believing prices in the market often bear little relationship to ultimate values.

We concentrate our research on our own proprietary universe of companies. Our analysts work hand-in-glove with the fund managers. We exclusively manage two global strategies at Veritas ensuring no over-stretch or dilution of research effort: Income and Focus.

Concentrated portfolio: running concentrated global equity portfolios of circa 35 positions, backing our judgement with conviction but getting sufficient diversification.

Our portfolio has consistently held around thirty-five holdings, each being well understood and contributing to performance. The top ten holdings have often approached fifty percent of the portfolio. Whilst this exhibits high conviction we have always considered diversification and regard risk in its broadest form, not simply volatility.

Lower volatility over time: lower volatility than broad global equity indices over the long term is an expected outcome from our approach.

We have delivered total returns well in excess of relevant world market indices over five years but with considerably less volatility.

Elements of protecting capital: Incorporating elements of protection such as allowing cash to rise if there is a better time to enter opportunities and the use of derivatives if appropriate.

We have allowed cash to rise as a residual when we cannot find investments that meet our criteria. We only aim to make investments when the risk/return profile is judged in absolute terms to be better than that of risk-free investments. We would not have cash greater than 25% of

the portfolio and over the past five years we have ranged from fully invested to 21% cash. We will conduct currency hedging if we regard it as worthwhile but it will be more strategic than tactical (ie no currency short term trading). More recently we have had minimal exposure to sterling. We use listed index put options as the preferred derivative to hedge out market risk if we regard the exercise as worthwhile.

Low Turnover and long holding periods: We aim to hold our positions for an average of 3 to 5 years.

We have experienced sharp movements in share prices, both collective (indices) and individual (our holdings) during the five years to date. Consequently we have followed any sell disciplines if positions have reached our expected price and yields have declined sharply.

It is also worth succinctly pointing to **what we are not which also distinguishes us:**

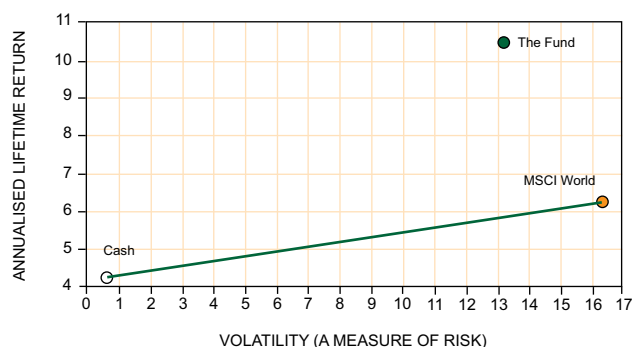
- We are not mechanistic buyers and sellers on yield criteria: too over-simplistic; too dogmatic and often a 'screen' to hide behind (pun intended).
- We do not adopt the 'Dogs of the Dow (or any other index)' theory of investment. Despite our contrarian nature we prefer to analyse intrinsic value and sustainable dividend not speculate. The highest yielders are often not the best investments, for obvious reasons.
- We are not concerned about competitors, peer groups or indices. We do not chase 'relative to' returns or as Keynes said in his General Theory: 'devote our intelligences to what average opinion expects average opinion to be'.
- We are not momentum based, greater fool investors. We avoid the "buzz".
- We are not running large portfolios of sixty stocks and over that tend to over-diversify and lack conviction or sufficient knowledge of their investments.
- We are not using high trading strategies to shift capital in and out of stocks according to ex-dividend dates (no high turnover dividend stripping and no dividend swaps).

WHAT HAVE THE RESULTS BEEN?

- We have exceeded our annual dividend targets and have grown the dividend year on year. In addition we have grown the capital in real terms by 22% since inception five years ago.
- Since inception (28th February 2005) the total return in sterling class terms has been 63.3% versus 34.7% for the MSCI World index in total return terms.
- We have delivered a total return of 10.3% annualised versus 6.1% for the MSCI World and with considerably less volatility since inception.

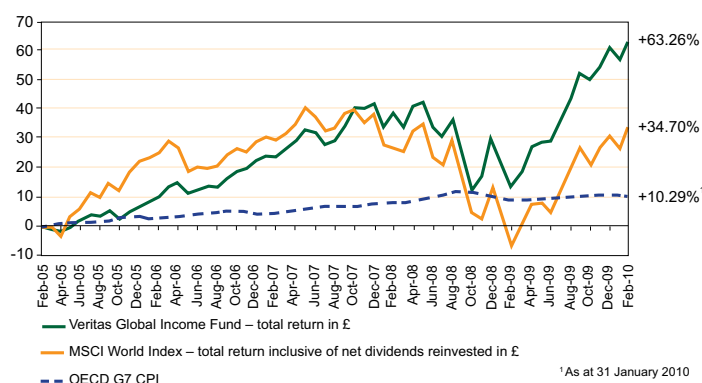
Veritas Global Income Fund

Higher returns and less volatility since inception



Source: Veritas Asset Management (UK) Ltd, MSCI, FactSet

Five years of performance



Source: Veritas Asset Management (UK) Ltd, MSCI, OECD, FactSet

Past performance should not be seen as an indication of future performance. The value of investments can go down as well as up.

CONCLUSION

We have explored the market opportunity of global dividend investing and explained our global equity income fund approach. There are subjects we have not directly addressed related to the area: taxation and its role; higher yielding industries versus lower (telecommunications versus oil exploration and biotech for example); higher yielding regions (Australia/ New Zealand; Taiwan; Hong Kong; UK for example); shifts in payout ratios over time and attitudes to special dividends/buy backs. However, we hope to have got across the opportunity in global income investing and how we approach getting real returns from it. These are very demanding times to successfully navigate all asset classes and considerable uncertainties remain going forward. However, from global equities we can reasonably expect 6-7% p.a. real return over the long term. Concentrating on ensuring a solid foundation of dividend yield is a key element of this real return. Do not keep bees for the buzz, you need to ensure there is honey.



Charles Richardson



Andy Headley

April 2010

VERITAS ASSET MANAGEMENT

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Sources: Veritas Asset Management (UK) Ltd., FactSet.

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