

A Bird in the Hand:

Global equity income investing and our approach at Veritas

REAL RETURN INVESTING AT VERITAS

*“A Cow for her milk
A Hen for her eggs
And a stock, by heck
For her dividends.”*

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

A Bird in the Hand:

Global equity income investing and our approach at Veritas

INTRODUCTION

Over three years ago we concluded there was a strong rationale for global equity income investing and we believed we had a sound approach to it. 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 Income fund which now has a three 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.

As recently as February 6 of this year the Financial Times declared: *'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. When markets are choppy investors' minds are re-focused and the reliability and sustainability of dividend payments become the hot topic as opposed to 'momentum', 'liquidity' and an exciting stockbroker's story. 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.

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. Just ask BP. This is not exclusively a cyclical experience currently unfolding in Europe and the US. In Asia, managements are changing behaviour in response to maturing capital markets and payout ratios are rising. 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.

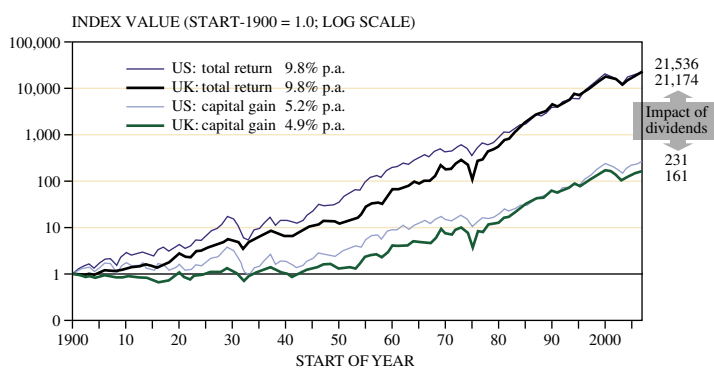
BACK TO BASICS

If you, like us, believe that investment brings together sound theory and practice as well as requiring experience and pragmatism, then skim this section. If you are most interested in our approach then skip the section. If the key underpinning to the investment thesis interests you then read on.

This is the section that could be dull and theoretical, be warned. It is like having to return to your classroom and revise the old classics. Even then some 'too clever by half' classmate says that all you say is tosh because of this or that academic article. It is usually citing someone with an axe to grind on early stage investing; the theory of dividends and their impact from Nobel Prize winners or the skills of their own stockbroker. However, for the sake of completeness and with no apologies for brevity:

- 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



- 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 Litzenger 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.

However, there is good reason to distrust our word for it despite our beliefs, our experience and our co-investment with our clients in our own global approach, putting our money where our mouths are. After all, we are in the *business* of investment management and do run a fund called global income. So, returning to the 'temple of wisdom' of investors, John Templeton was known for his twenty or so 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 has popped up around the world. 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 ensure we meet our income goals and deliver a real return to the capital and have done this since inception three years ago.

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

Our belief in increasing strain being put on natural resources around the world, combined with supply constraints in some areas led us to adopt the theme of 'Nature's Capital'. Within this we have sought investments where the supply response is limited or constrained (in the oil sector there is a chronic lack of investment in upstream supply infrastructure) and in those beneficiaries of the supply response itself. Allied with our work on individual company competitive advantage, strength of finances and sustainable yield we made a series of investments in Oil and Gas over the past couple of years such as Petrochina, ENI and StatoilHydro.

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 have been concerned about the fragility of the global macroeconomic environment and wrote this up on a number of occasions. We adopted a theme of 'Resilience' to seek investments with robust characteristics such as sustainable free cash flow; pricing power; oligopoly or monopoly; addressing the right consumer and addressing structurally growing markets. This led to some focused research work identifying good entry points based on yield and intrinsic value. These included Altria; Hopewell Highway Infrastructure and Telstra.

Concentrated portfolio: running concentrated global equity portfolios of circa 30 positions, backing our judgement with conviction but getting sufficient diversification.

Our portfolio has consistently held around thirty 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 three 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 year we have ranged from fully invested to 20% 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 three years to date. Consequently we have followed any sell disciplines if positions have reached our expected price and yields have declined sharply. Consequently, although low, turnover has been higher than we expect in the longer term.

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

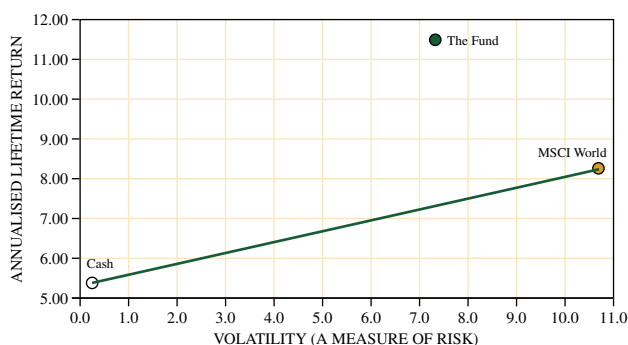
- We are not mechanistic buyers and sellers on yield criteria: too over-simplistic; too dogmatic and often a 'screen' to hide behind (pun intended).
- We do not adopt the 'Dogs of the Dow (or any other index)' theory of investment. Despite our contrarian nature we prefer to analyse intrinsic value and 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 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 paid two dividends in excess of 4% and have grown the dividend year on year. In addition we have grown the capital in real terms by over 20% since inception three years ago.
- Since inception the total return in sterling class terms has been 38.7% versus 26.3% for the MSCI World index in total return terms.
- We have delivered a total return of 11.5% annualised versus 8.1% for the MSCI World and with considerably less volatility since inception.

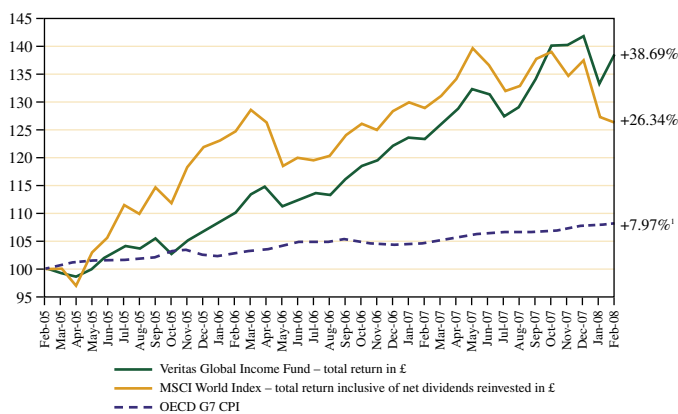
Veritas Global Income Fund

Higher returns and less volatility since inception



Source: Veritas Asset Management (UK) LTD, MSCI, Thomson Datastream

Performance since inception



¹ As at 31 January 2008

Source: Veritas Asset Management (UK) LTD, MSCI, OECD, Thomson Datastream

CONCLUSION

We have explored the market opportunity of dividend investing and explained our global income fund approach. There are subjects we have not directly addressed related to the area: taxation and its role; higher yielding industries versus lower (financials and 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 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. As we write, 10 year bond yields vary around the world with the UK gilt at 4.4%. The running yield of the Global Income fund portfolio which holds 31 positions is 4.6% net of all withholding tax. These are very demanding times for all asset classes and considerable uncertainties remain going forward. However, from global equities we can reasonably expect 6-7% real return over time. Add inflation using your measure of choice (maybe create your own basket!). The bird in the hand is the head start dividends give you to achieving those total real returns over time.



Charles Richardson

March 2008.

For more information please contact John Campbell – jcampbell@veritas-asset.com, +44(0)20 7961 1422

VERITAS ASSET MANAGEMENT

The above review has been issued by Veritas Asset Management (UK) Ltd., which is authorised and regulated by the Financial Services Authority. The opinions expressed above are solely those of Veritas Asset Management (UK) Ltd and do not constitute an offer or solicitation to invest.

The value of investments and the income from them may fluctuate and are not guaranteed, and investors may not get back the whole amount they have invested. Sources: Veritas Asset Management (UK) Ltd., Thomson Datastream.

Veritas Asset Management (UK) Ltd., Elizabeth House, 39 York Road, London SE1 7NQ

Phone: +44(0)20 7961 1600 Fax: +44(0)20 7961 1602

www.veritas-asset.com