The Key To Quality In International Investment

An international equity analyst explains how to find quality in the global market by using the rising-dividends investment philosophy.

By Jean-Baptiste Nadal

The investment community has done an admirable job in recent years of educating investors on the importance of diversification. Today, investors are eager to diversify, and increasingly they look to international investment as the means. Too often, however, in the interest of diversity they plunge into stocks of international companies that do not belong in a high-quality, conservative portfolio.

There is an undeniable trend toward greater capital inflows by American investors into international equity markets. For example, in April 1996 American assets in international equity mutual funds reached a record level of $148 billion, compared to less than $30 billion just four years ago. It appears the desire to diversify their assets has finally overcome the reluctance of Americans to invest in foreign companies.

Although the risk associated with international investing has decreased significantly over the last few years, it is not a completely safe recommendation for many financial advisers. At the end of the day, the main risks may no longer be the traditional political or currency exposures, but rather the risk of investing in a mediocre business. There are thousands of international stocks available, and uncovering top-quality companies suitable for a conservative portfolio is a considerable challenge. Global diversification is the primary reason for exploring international equities, but it should not come at the cost of lower quality and diminished investment results. ➢

The Rising-Dividends Investment Philosophy

One way to find outstanding companies is to use a strategy that has proved successful in ferreting out quality American companies. The rising-dividends investment philosophy has helped many investors identify companies that are "good for all seasons." It consists of choosing stocks of companies with a record of consistent dividend increases that spans economic cycles. The emphasis is on dividend-increase consistency, as opposed to just the size of the dividend. The dividend is a tool that helps identify consistent companies, but it is not the exclusive focus.

The stocks of typical rising-dividend companies maintain a relatively low dividend payout ratio, and a large part of the earnings of these companies are reinvested in the business. This contributes to rising earnings, rising book value and a company's underlying value. Moreover, these companies usually present very strong balance sheets.

The rising-dividends philosophy was formulated after an analysis of the market decline of 1973–74 determined which stocks best resisted the decline and, similarly, which stocks outperformed the 1975 recovery. The best-performing stocks were found to be those earmarked by rising dividends, reinvested earnings, low debt and strong business franchises. Separate research disclosed that stock prices of companies with rising dividends tended to keep pace with rising markets and resisted better when markets declined.

The philosophy is grounded in the belief that the risk of investing in stocks can be significantly reduced and the overall quality of the portfolio enhanced by selecting companies able to generate a steadily growing cash flow for dividend payment from an underleveraged balance sheet. When a company raises its dividend, management sends a clear signal to the market that it anticipates improved future earnings. By definition, stocks with rising dividends represent strong, successful companies with a history of consistently rewarding investors with handsome returns.

Consistency is no longer an exclusive attribute of American corporations. Over the past decade, many companies outside the United States have adopted a more progressive dividend policy. Managers of overseas companies, like their American counterparts, recognize that a clear dividend policy is one of the most efficient tools to communicate confidence in the prospects of their organization to shareholders. More and more, this rising-dividends disposition is being found in companies in Europe, Japan—even Malaysia and South Africa.

Greater Emphasis On Shareholder Value

The movement among international companies toward greater emphasis on shareholder value is evident in the increasing number of firms that link management bonuses to share price and tie management performance more closely to increased return on equity. In addition, the ownership structure of many international companies has been simplified, with state ownership declining. Many of these companies are emerging with new management who are not necessarily part of the country's establishment. Corporate governance has become more of an issue as the more Anglo-Saxon view of running a business, with a clear focus on shareholder value, is emerging around the world.

The end of the Cold War spawned more intense competition for capital. Many countries, such as China, are trying to build their infrastructure and achieve a more advanced society, which requires a great deal of capital. Despite savings rates as high as 25% or 30% of the gross national product in some of these countries, it is not enough. They still need to attract capital, and they realize the pension funds in the United States are the main source of that capital. In order to appeal to American pension fund managers, companies in countries around the world have steered toward greater focus on shareholder value.

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All of these factors are contributing to the growth in the number of international companies that now closely resemble the best-managed American corporations. Searching for a history of consistent dividend increases is a good start in identifying outstanding international companies, but it is only the first step. There are some critical screens that must be applied to pare down the list of companies that, at first glance, might appear to be candidates for a high-quality international portfolio. The initial screens for an international rising-dividends stock are:

- increased dividends in at least three of the last five years with no cut or, preferably, in seven of the last 10 years;
- dividends raised at a rate that would double them in 10 years;
- at least 35% of earnings reinvested back into the business;
- long-term debt less than 35% of total capital.

Only about 250 international companies with a market capitalization of more than $1 billion pass these screens. Additional qualitative criteria, such as management strength and a preference for businesses with a global franchise versus local firms, reduces the number to about 130. Some of those companies are Swiss food manufacturer Nestle, British financial information company Reuters, Dutch legal and tax publisher Wolters Kluwer, French retailer Carrefour, Japanese consumer products company Kao and utility company Hong Kong & China Gas. Many stocks of rising-dividends companies trade as an American Depository Receipt and are thus easily available to U.S. investors.

Detailed Analysis

Of course, no serious investment strategy should rely exclusively on a set of a few quantitative criteria. Strong investment convictions arise only after detailed research is conducted on the companies identified, and the depth of research is contingent upon access to information and the ability to interpret that data.

In utilizing the rising-dividends philosophy, our firm systematically tears a company apart and develops spreadsheet analyses of its financials for at least the previous five years. Each company's anticipated growth in dividends, earnings, cash flow and book value is projected two to five years into the future. The objective is not to predict earnings with precision, but rather to understand thoroughly the driving forces underlying future growth and build conviction in the company's long-term expected growth rate. Our ongoing contacts with the company's management strengthen this process.

As rising-dividends companies are generally consistent growers, we rely with confidence on their stocks' historical valuation, determined by the stock's five-to-10-year high and low price earnings multiples or other appropriate valuation tools, such as price-to-cash flow ratio or dividend yield. Alternately, when history does not provide a reasonable basis to value a stock—because of a fundamental change in the company's growth rate—we determine a value range by relying on the results of discounted cash flow analysis.

These numbers are then used in conjunction with the estimates for coming years for the firm to arrive at an expected market price range—or value range—for the stock. When we compare the price of a stock today with the price we think it could sell for in five years (if we assume the stock trades in the middle of its value range), we are able to compute an expected average annual return.

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This long-term expected return drives our decision to invest in a company that already matches the characteristics we require for a sound investment. We will buy the stock of such a company only when the expected return for the investor is at least 13% per annum. This approach has the advantage of putting the focus on a company's long-term prospects and of buying a stock only when it is trading on the low side of its value range.

Domestic Vs. International Criteria

There are some fundamental differences in applying the rising-dividends philosophy to international as opposed to domestic equities. One has to do with inflation. In countries with historically above-average inflation, such as Italy, Spain and Hong Kong, the dividends growth could be misleading and not comparable with the growth of dividends in countries with lower inflation, such as Japan. As a rule of thumb, a company that increases its dividend at a rate equivalent to 1.5 to 2 times the inflation rate is usually doing a good job.

Another difference is that in evaluating ratios, such as long-term debt/total capital, differences in accounting principles may distort the picture. For example, in the United Kingdom, the accounting rule regarding goodwill amortization can cause the capital portion of the equation to be misleadingly low, so other measures of financial strength, such as interest coverage, must be considered.

Interestingly, most international companies that pass the rising-dividends screens are global companies operating in a variety of geographic areas. One reason is that global companies are better able to withstand the impact of a negative economic cycle in one of their operating areas. Thus, the typical international rising-dividends portfolio is made up of large, multinational companies that operate globally.

The screens, in conjunction with our proprietary research, tend to identify companies that operate independently, as opposed to companies with a large country or state ownership. A critical objective is to ensure management is acting rationally and not basing decisions purely on political considerations. Also, many global companies generate a significant portion of their revenues and profits in emerging markets, where the growth prospects are higher than in mature economies.

Investing in non-U.S. global companies is a way to participate indirectly in the growth of the emerging world without the risks associated with direct investment in those countries. Additionally, global companies tend to communicate better with the American financial community by providing reports in English and having a more active investor relations programs.

The rising-dividends philosophy seeks to identify a small number of outstanding international companies with which to remain long-term partners. These are companies that have displayed consistency in producing above-average returns for shareholders primarily because they are very well managed, are operating good businesses, have a strong and sustainable competitive advantage and are financially solid.

Two global rising-dividends companies that exemplify the characteristics discussed are Ericsson of Sweden and Kao Corp. of Japan, both current holdings in Kayne Anderson's International Rising Dividends Portfolio. While both are high-quality companies with a history of consistent dividend increases, Ericsson is a fast-growing company while Kao is a slow but consistently growing firm.

Two Excellent Examples

Ericsson: Ericsson is a multinational company that supplies infrastructure equipment to the telecommunication industry. It is the world's leading manufacturer of cellular analog equipment, with a 42% market share, ahead of Motorola (19%) and AT&T (16%), and claims a 50% market share in digital equipment.

Roughly 84% of sales are outside Sweden. Ericsson has cellular systems in place in 71 countries, and its public switching system (AXE) in 111 countries. The firm has also soared into third position in digital handsets for the booming mobile cellular phone market, right behind Motorola and Nokia. Europe represents 31% of its sales; the United States, 12%; and China, 6%. Ericsson also has strong positions in Asia and South America.

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An analysis of Ericsson's record for the past five years shows that its dividends grew at a compounded rate of 14.9% and its earnings by 11.4%. This growth has accelerated dramatically (above 20%) in the last three years. With long-term debt below 10% of total capital, Ericsson presents a very strong financial position.

The company's prospects are excellent, because most of the people in the world still do not own their own phones. Building mobile telephone networks is the easiest and least expensive way to provide telecommunications facilities to emerging countries. In 1995, mobile phone systems served 85 million subscribers worldwide. By the year 2000, they will serve 350 million. As a result, the company predicts the market for cellular phones should grow by 30% a year.

Ericsson's fast growth and success reflects visionary management, including an impressive research and development budget representing more than 15% of total sales. The firm has the ability to adapt itself rapidly to technologic evolution. Ericsson is better placed than its competitors to tap the benefits of the digital technology trend. Today, 20% of the 85 million worldwide subscribers are connected to a digital network; by 2000, 80% of the projected 350 million subscribers are expected to be connected to a digital network. Ericsson has a stronger presence in emerging markets than its competitors. It is the most global of all the telecommunications equipment suppliers.

The focus of Ericsson is more on infrastructure (base stations) than on telephone handsets or terminals. The handset business is more competitive than infrastructure. Here, too, Ericsson is better placed than Motorola or Nokia, which have greater focus on handsets.

The major risks in holding the stock are that technology is changing fast and prices are declining sharply (15% to 20% annually). Motorola's CDMA digital technology may prove to be more successful than expected, while Ericsson is primarily relying on TDMA digital technology. But TDMA is a proven technology, while CDMA has yet to establish its superiority.

Kao: Kao is Japan's largest manufacturer of household products, which include cosmetics, detergents and personal products. Although 80% of its sales are in Japan, it operates in 25 other countries and is focusing increasingly on the fast-growing markets in Southeast Asia.

Despite its slow growth rate, Kao is a model of consistency. In 1995, the company posted its 16th consecutive year of growth in sales, earnings and dividends. Over the past 10 years, Kao's dividend grew at a 9.5% annual rate in a very low inflation environment. As the company is reducing its debt, which already stands at a comfortable 30% of total capital, Kao's dividend should keep on growing steadily.

The firm utilizes information technology to cut costs, and its cost-control efficiency is unmatched by rivals Shiseido, Mandom or Proctor & Gamble. Kao is able to launch new products successfully, attempting to expand its share of mature markets with inexpensive, off-the-shelf products distributed through mass merchandisers.

With a price-to-earnings ratio of around 30, the stock may look expensive, but on a price-to-cash flow basis, the stock is trading at a more reasonable level—according to Western standards—of seven to eight times cash flow. Also, a discounted free cash flow analysis indicates that the stock is somewhat undervalued.

Kao still has to prove itself in the global arena and that competition has intensified. But this is counterbalanced by the steadiness of the business.

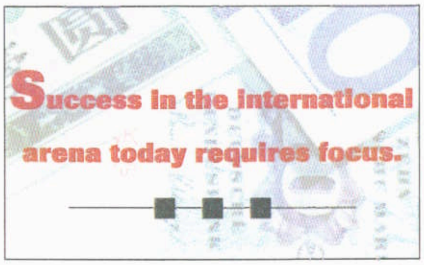
Sell Signals

Typically, an international rising-dividends portfolio has three sell mechanisms. The first is based on price. When a stock appreciates to near the high point of its value range, it becomes a candidate for selling. However, since the value range is dynamic and should constantly be adjusted, just because a stock is near the upper end of the value range does not mean it should be liquidated.

If it is rising steadily, for example, and growing at 15% to 20% annually, it can be held. If it looks as though by waiting a quarter or two a stock's trading range will rise, moving the price lower within the range, it should be held.

If, on the other hand, an issue is near the top of its anticipated trading range and is growing only 10%, or if it rises because of some specific news that comes out, it should probably be sold and replaced in the portfolio with one that is at the lower end of its value range and, consequently, more attractively priced. If a company declines 15% from its purchase price, it triggers an automatic review.

The second sell mechanism is based on industry shifts or geographic factors, such as when research indicates a certain sector or country is headed for structural change or instability, or when economic, social or political events portend a downturn.



The third sell mechanism can be prompted by changes within the company itself. If monitoring indicates a stock no longer passes one or more of the rising-dividends screens—a more leveraged balance sheet, for example—it becomes a candidate to be sold. Other events within the company, such as an acquisition, management change, product introduction, strategic marketing shift or similar event—although it may not necessarily have an immediate impact on the screens—may make the stock a liquidation candidate.

To paraphrase investment guru John Templeton, the best time to sell a stock is when you have found something of the same quality that's cheaper.

Many investment managers have a short-term view that dictates buy and sell decisions. The rising-dividends philosophy encompasses a longer-term view than most other investment disciplines. It is rooted in the fundamentals of selected companies; their strengths, the businesses they are in, management, capacity to generate profits and likelihood of continued prosperity. A rising-dividends approach does not exclude economic factors, but neither does it rely solely on economic cycles and other short-term elements when viewing the life of a stock. As a result, we are often buying companies that meet rising-dividends criteria when others are selling. Frequently, we can unearth undervalued global equities in such a scenario.

A Conservative Approach

It is illogical to assume any investment strategy will generate superior results in both good and bad markets internationally. An investment adviser would have to have meticulous timing in switching back and forth between aggressive and defensive strategies globally. Barring divine intervention, rarely can any investor or asset manager attain such a performance. As a result, investors are relegated to finding a single, well-conceived approach that can be executed with consistency.

The rising-dividends approach provides a sound investment strategy for identifying the highest-quality international companies. While the highest returns in international markets may typically go to those willing to take the most risk or invest most heavily in developing countries, big losses are what cripple the compounding of money over the long term. Rising-dividends investors can insulate themselves from such emotionally and financially adverse experiences—ones that might tempt them to sell out at times of weakness rather than sense opportunity. Such a miscalculation can turn price fluctuation into permanent loss.

Success in the international arena today requires focus. Financial advisers rely on the soundness of the strategies of the investment managers they recommend to their investor clients. One method of diversifying a client's portfolio conservatively is to advocate international equities identified by the rising-dividends investment screens. The strategy focuses on following a limited number of high-quality international companies that meet strict investment criteria in order to provide the desired diversification while safeguarding the integrity of the client's portfolio. Just as important, the financial adviser can take credit for introducing the investor to a long-term strategy that produces consistent investment returns while addressing the need for diversification. FP

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Reprinted from *Financial Planning*, September, 1996.
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