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[Home](#)»[News](#)»Emerging markets ride is over: Somerset

   

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[Appointments](#)

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[Huntleys' market wrap](#)  
[Company profiles](#)  
[Stock of the week](#)

## Columns

## Events

## Education

## Emerging markets ride is over: Somerset

By Wouter Klijn  
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Emerging market stocks are unlikely to produce the double-digit returns experienced in the first half of the 2000s, as the market structure has fundamentally changed, according to London-based asset manager Somerset Capital.

"It is all over," Somerset Capital head of research and lead manager of dividend growth Edward Lam said.

"The thing with emerging markets is that we've had a pretty good ride over the last 10 years; we've had 20 per cent returns year-on-year, and from our perspective we are quite cynical about them.

"What we are trying to get our client base and potential client base to understand is that we are not going to have that in the next 10 years.

"Actually, I'm thinking more along the lines of 0 to 10 per cent."

An important driver behind the high returns between 2001 and 2007 was the under-allocation to emerging markets, Lam said.

This created a situation where the balance between the market capitalisation of emerging market companies and the gross domestic product (GDP) of these economies was well out of kilter.

"When you look at the markets in 2001, yes, you would have got the capital return, but you also got a boost from the lack of allocation to emerging markets," Lam said.

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"In 2001, there was a significant disconnect between the market cap of emerging markets and their share of GDP. You had 10 to 20 per cent market cap to GDP ratios.

"My view is that this effectively added a tailwind to emerging market returns in the order of potentially 10 per cent a year.

"So there is a capital appreciation story that once that has played out, it doesn't replicate itself."

As the gap between the emerging market capitalisation and GDP ratio has been reduced to a level similar to developed markets, future returns are expected to be much lower.

"Now, you wouldn't expect any extra performance from that factor because you have already caught up to what the rest of the world is at," Lam said.

Lam runs Somerset's emerging markets dividend growth strategy, a strategy that finds its origins at Lloyd George Management in 2000.

He argued the best way to achieve returns in emerging markets in the future was to focus on companies that paid reasonable dividends.

"If you invested in emerging markets in 2007 and you invested in stocks that didn't pay any dividends, you would be back to where you started in capital terms; we haven't moved fundamentally," he said.

"But that is the trick: we are now much more focused on fundamental growth and dividend growth.

"So if you invested in companies that paid dividends in 2007, you would get a dividend return and then that dividend would have grown over the last four years and you would also have got the extra return from the growth that you've had."

It is a mature-market investment style applied to still developing markets.

"We are not doing it because we think emerging markets are mature in the sense that developed markets are. There are still lots of issues with corporate governance and capital management - many of the companies even in our fund are not paying out dividends because of capital management, but for other reasons," Lam said.

State-owned enterprises often paid dividends to balance a budget deficit, while some emerging markets had listing regulations that forced companies to pay dividends, he said.

"In Chile and Israel it is a listing requirement that companies pay out 10 per cent and 20 per cent respectively of their profits as a listing requirement. Although in Israel they don't necessarily enforce that as strictly as they do in Chile," he said.

"Then there are many family-owned businesses in emerging markets that pay out dividends, where again it is not necessarily the case that they focus on shareholder value there; they are just focusing on their own income stream.

"The last category of stocks - and it is actually an increasing portion of companies, but it is still a very small one - pay out dividends because they want to increase shareholder value."

The strategy has attracted some interest from industry super funds in Australia, as well as from a separate managed account provider.

Somerset is currently exploring the possibility of opening an Australia-domiciled unit trust for the dividend growth strategy and has found one industry fund willing to provide seed money.

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