A very promising emerging market income fund | MoneyWeek

by: Cris Sholto Heaton

Emerging markets may not sound like a sensible place to go for dividends. But they can be a good source of income, says Cris Sholto Heaton. Here, he looks at one dividend growth fund that differs from many in the sector in some very promising ways.

Emerging markets may not sound like a sensible place to go for dividends. But as I discussed in a recent feature in MoneyWeek, they can be a good source of income.

You can read the whole thing here: Where to find income in emerging markets. But in brief, the benefits of focusing on dividends in emerging markets include the fact that income tends to grow faster; you have diversified foreign currency exposure; and you are that bit more likely to end up investing in better-managed, shareholder-friendly firms.

A couple of weeks ago, I had the chance for a detailed briefing with the manager of one of the funds I mentioned in the article: the Somerset Emerging Dividend Growth Fund.

It was a very interesting discussion and I think the fund could be of interest to many investors. So this week I'm going to profile it in more depth

A fund that certainly doesn't hug the index

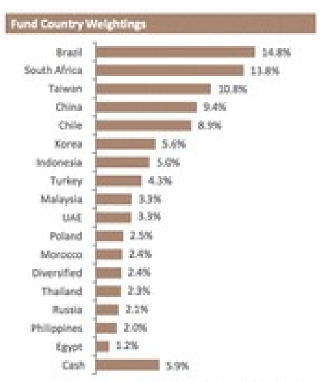
Somerset Capital Management is a London- and Singapore-based boutique, founded four years ago by a team from Lloyd George Management in Hong Kong. It focuses solely on emerging markets and runs three public funds.

There's a large cap fund with around US$500m in assets, a small cap fund with around US$200m, and a dividend growth fund. That's the one I want to look at.

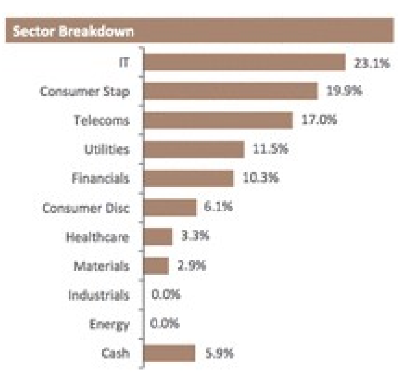
The dividend fund is a relatively new launch. It was founded in March 2010, and has around US$40m in assets at present. A track record like this is too short to give any useful information. So my views on it are based solely on speaking to the firm about the approach they're following.

The lead manager is Edward Lam. He follows a bottom-up, stock-screening approach to building the portfolio. But he will sometimes make decisions based on macroeconomic issues. For example, the fund recently sold Turkey's Akbank because of concerns that the country is overheating and running unsustainable deficits, which poses risks for the financial sector.

There are no constraints on geographical or sector allocation (so he can invest where he wants to). This is rather useful for investors, because it means the portfolio looks unlike many other emerging market funds. From the chart below, you can see that it has large weightings for a number of smaller markets and isn't dominated by positions in the Bric countries

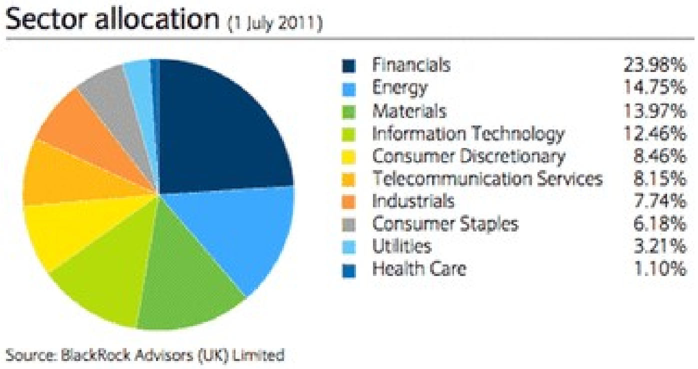


And on a sector view, it's drastically different. Financials and resources which tend to dominate most emerging market indices are a relatively small proportion.



Contrast this with the MSCI Emerging Markets benchmark in the chart below.

So a fund like this is potentially interesting for investors who want to avoid exposure to these sectors, or would like to hold it to balance out sector allocation in other funds.



Income from around the world

I prefer to see funds running relatively small portfolios, since that means the manager needs to have high conviction in his or her ideas, and can hope to perform very differently to the index.

Seeing a 100-stock portfolio tends to suggest that the manager is really running an index fund by another name. In this case, the fund limits the portfolio to 40 stocks, which is small enough that a good team can keep on top of all of them.

For most fund strategies, I also like to see a relatively low turnover rate, since this keeps costs down and suggests the manager is not just chasing what's hot. In this case, the target is a three-to-five year holding period (although obviously some will always be more and some will be less). The turnover rate is likely to be around 20% per year, which is consistent with the record so far.

Positions include a number of Taiwanese tech stocks. As I have previously written, over the last few years Taiwan has evolved into a relatively high-dividend market, with a number of firms that have good balance sheets, strong cashflows and decent payout ratios not what you automatically associate with the tech sector. Holdings include **Taiwan Semiconductor Manufacturing** (TT: 2230, US: TSM) and **HTC** (TT: 2498), both well-run and attractive firms - although the latter was bought considerably cheaper than it is today.

Mediatek (TT: 2454) is having a tougher time of it. As I've discussed before, the firm found a profitable niche making off-the-peg, system-on-a-chip solutions for cheap mobile phones in China. But it's under a lot of competitive pressure, squeezed from below by Spreadtrum and from above by Qualcomm.

However, Edward takes the view that the management team has beaten expectations over the years and he thinks there's a good chance they will innovate their way out of these problems.

Telecoms always tend to feature in a dividend fund. The portfolio contains several from around the world: **Philippine Long Distance Telephone** (PH: TEL, US: PHI) and African and Latin American operator **Millicom** (SS: MIC) among others. One out-of-favour position is **China Mobile** (HK: 941) for a long time an overpriced growth stock, this has now been dumped by many investors and now offers a yield of 4.2% and a play on a potentially improving regulatory environment.

Other interesting businesses that I don't know so well include Brazilian credit card processor **Cielo** (BR: CIEL3, US: CIOXY) and a number of South African consumer staples firms such as supermarket **Shoprite** (SJ: SHP) and food and household goods manufacturer **Tiger Brands** (SJ: TBS). All told, this is a diverse portfolio that taps into a number of promising themes.

Paying attention to corporate governance

I also like the fact that there seems to be a strong focus on owning good quality companies and understanding business risks. One example we discussed in the meeting was the mania for Chinese internet stocks (which I previously wrote about here: Why you should be wary of US-listed Chinese stocks) and in particular a risk that many investors don't understand. To quote from the latest fund commentary:

The issue in China is that ***foreigners cannot own media assets****. No sell-side analyst I know will tell you this up front, whether they know it or not. Foreign investors therefore need to do their own extra work to work out what they are buying and why they are buying it when they buy a US- or HK-listed Chinese internet stock.*

In my research of many different Chinese internet listings I have come across many different holding structures. What all of these have in common is the lack of true ownership by the listed holding company of the underlying operating assets

For foreigners to gain access and control of the underlying assets of the operating companies therefore it is necessary a) that the law changes favourably b) that the directors of the operating companies do not give away the existing assets in the meantime.

The latter, of course, is what seems to have happened with Alibaba.

Things like this may sound obvious, but I am always surprised at the number of managers who will buy stocks that have severe governance red flags without a second thought. Although I don't know every stock this fund holds, those I know are generally well-run in my view.

The portfolio is on an estimated yield for the coming year of about 4% (versus about 2.2% for the MSCI Emerging Markets benchmark). Both income and accumulation units are available.

There's no entry fee, the annual management charge is a low 1%, and the minimum investment for retail investors is £1,000. These are very attractive charges and it's good to see a firm making an effort to attract smaller investors to its new launches in this way.

The main caveat with charges is that small funds can have quite high total expense ratios, since fixed costs are high relative to the portfolio size. So this could turn out to be a drag on performance until assets under management grow. This is especially true early on when there are launch costs. However, the fund still slightly beat the MSCI EM benchmark over its first 15 months, which is encouraging.

Overall, this is a fund that looks well worth investigating if you're looking for EM income or EM funds that follow a non-standard strategy. More details are available from Somerset Capital Management at https://www.somersetcm.com or +44 20 7499 1815.