ASIA INSIGHT

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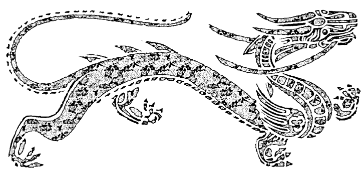

A Stock for its Dividends

"Even so spoke the old farmer to his son: 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)

Investors once valued shares primarily for their ability to pay consistent and growing dividends. With time however, the focus shifted towards earnings growth and capital gains, while dividends became more of an afterthought. Yet, as illustrated below, dividends have in the past accounted for a substantial portion of the total return for long-term investors, not just in the U.S. but in Asia as well. Many investors often turn to Asia to add growth potential to their portfolios. Thus it may be surprising to discover that companies in Asia Pacific ex-Japan currently have some of the highest payout ratios globally. Furthermore, the ability of companies in the region to distribute earnings to shareholders is at its highest level during the past decade. For instance, the absolute level of net debt carried by companies in the region is equal to that of 10 years ago, while operating income – and thus the ability to service the debt or alternatively pay dividends – has doubled during the same period.

For the long-term investor, dividends have been an essential driver of long-term return in Asia Pacific. Returns available from the region over the past two decades, as measured by the MSCI AC Asia Pacific Index, have not been particularly strong, weighed down in large part by Japan's economic stagnation. For example, $10,000 invested in the above MSCI Index at its inception in December 1987, would have grown to approximately $16,612 by the end of September 2006. Of that amount, $3,764, or 57% of the total return, would have been derived from dividends reinvested in the index[1] . If one were to exclude Japan from the same analysis, the absolute return would be much higher, yet still over half of the returns from that investment would be due to reinvested dividends. Given the importance that dividends have for long-term investment performance, an understanding of the dividends available to shareholders in the region is critical.

The shape of Asia Pacific's dividend landscape is quite diverse as seen from table 1, which illustrates the dollar amounts earned and paid out in dividends by

Current Yields: Lower in Japan, Higher Elsewhere

Country	Net Income	Dividends	Capitalization	Payout Ratio	Dividend Yield
	USD Billions				
Japan	$151	$31	$3,363	21%	0.9%
Australia	52	23	653	45%	3.6%
Hong Kong	36	13	492	36%	2.6%
Taiwan	22	13	309	59%	4.1%
China	41	12	562	29%	2.1%
Korea	40	8	435	20%	1.9%
Singapore	11	5	151	48%	3.4%
India	16	5	311	28%	1.4%
Malaysia	8	4	122	47%	3.0%
Thailand	8	3	76	42%	4.3%
Indonesia	4	2	71	44%	2.7%
New Zealand	1	1	18	66%	4.8%
Philippines	2	1	28	40%	2.9%
Total	**$391**	**$120**	**$6,590**	**31%**	**1.8%**

Sources: MSCI, Bloomberg, Thompson Financial and Matthews

The universe consists of companies in the MSCI All Country Asia Pacific Index as of 12/31/05 with average operating income greater than US$50 million during the past three fiscal years.

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companies in the MSCI AC Asia Pacific Index[2]. At the aggregate index level, about US$120 billion were returned to shareholders in the form of dividends during the last fiscal year, resulting in an average yield of about 1.8%. Japan, Asia's largest capital market, stands out, exhibiting both comparatively low yields and payout ratios. However, in terms of the absolute dividends distributed to shareholders, Japanese companies, due to their relative size, were the greatest contributors to Asia Pacific's total dividends, accounting for 26% of dividends paid.

Japan currently punches below its weight in terms of dividend payments, especially given the strong earnings growth enjoyed by Japanese companies during the past couple of years. However, structural changes, such as the unwinding of cross shareholdings as well as improved profitability have prompted a host of Japanese companies to revise their dividend policies. Given the scale of Japanese company earnings in the Asia Pacific context, these companies could become significant contributors to the region's aggregate dividends in the coming years, should they decide to pay out a higher proportion of their earnings.

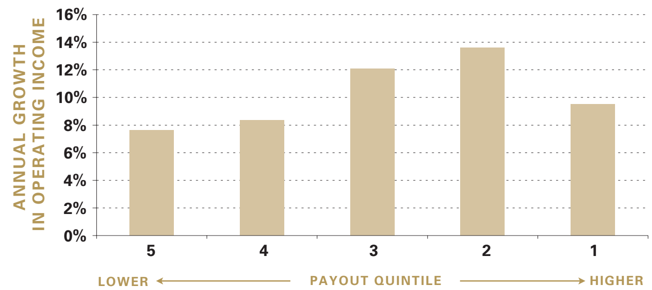
Japan's low payout ratio is in part the result of dividend policies traditionally focused on maintaining an absolute dividend payment per share, regardless of earnings. While dividends have been growing in Japan during the past couple of years, they have simply been outpaced by growth in earnings. While this has resulted in depressed payout ratios, it has also improved the ability of Japanese companies to pay dividends. Historically, Japanese companies have in the past been reluctant to reward shareholders through dividends, partly because of cross shareholding ownership structures. The rationale behind cross shareholdings was often not driven by financial returns, but instead by strategic business alliances centered around financial institutions. Companies were simply not pressured to return earnings via dividends and as a result dividend payments languished. With the unwinding of cross shareholdings, Japanese companies seem to have become more willing to reward shareholders with dividends. An increasing number of companies have shifted to dividend policies based on payout ratios, which is a significant change in paradigm. While payout ratios are still relatively low, the situation has improved at the margin.

Korea is the other noticeable laggard in the Asia Pacific dividend universe, with a payout ratio of just 20%. The low payout ratio may in part explain why Korean companies have tended to trade at a "Korean discount" relative to the rest of the region. While several other factors contribute to this discount, such as the risk of an armed conflict with North Korea, the resistance to return cash to minority shareholders has played an important role as well. Many Korean companies are controlled by their respective founding families, often through a web of interwoven cross shareholdings. Within this web, companies have at times engaged in non-transparent related-party transactions which have favored the interest of the founding family at the expense of minority shareholders.

Dividends align the interest of minority and majority shareholders, since they give minority shareholders a proportionate claim to a company's cash earnings. This sort of alignment is of particular consequence in Asia, where many companies remain majority-owned by families. Such ownership structures increase the risk that majority shareholders might siphon off cash for other family-related companies or personal perquisites. Paying dividends can also act as a form of capital diet. Having less cash in the bank encourages management to run the business more efficiently and further reduces the risk of ill-conceived acquisitions or low-return investments. In terms of injecting greater respect for minority shareholder rights, as well as instilling a capital diet, Korean companies and their shareholders may stand to benefit from greater dividend distributions.

Growth Companies in Asia Pacific Can Also Provide Strong Dividends

Annualized growth in operating income of Asia Pacific companies (2002–2005)



Sources: Matthews and Thomson Financial

The universe consists of companies in the MSCI All Country Asia Pacific Index with a minimum average operating income of US$50 million five and six years ago. Companies with cumulative earnings growth in excess of 300% were excluded. Annualized operating income growth is based on the average of operating income in the previous two years divided by the average operating income five and six years ago. Quintile 1 denotes the top 20% of companies by payout ratio, based on the level of dividends paid out of operating income.

Australia also constitutes an important part of the dividend landscape in Asia Pacific. The country generates 19% of the region's dividends. Australian companies, particularly within the financial sector, exhibit both high comparative payout ratios and yields. The Australian tax regime encourages the distribution of dividends, which in part may explain the higher propensity to pay out a greater proportion of earnings in dividends. Australia illustrates how a positive regulatory framework can impact how companies allocate earnings.

The greatest increase in absolute dividend payments has come from Chinese companies. It is worth noting that many of these companies and their associated dividends have only become available to investors during the past decade. Table 1 (on the previous page) masks the fact that a substantial portion of the dividends attributed to Hong Kong are in fact paid by Chinese companies listed in Hong Kong. It may come as a surprise to some that the company with the highest absolute dividend payment within the MSCI AC Asia Pacific Index is Chinese. While earnings growth was the main driver behind the expansion in dividends for this company, it was also the result of a higher payout ratio. This pattern of both high earnings growth and increasing payout ratios were replicated by other sizable Chinese dividend payers. Not only did these companies experience strong earnings growth, they also chose to distribute a larger portion of their earnings. Besides the sheer dollar value of these dividends, it is also important to acknowledge that these fast-growing companies are pursuing progressive dividend policies, especially when compared to Japanese or Korean companies.

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The Chinese example is of particular interest, because it does not seem to fit with the generally accepted notion that there is a trade-off between dividend payout ratios and earnings growth. Companies that distribute a significant portion of their earnings are often perceived as mature companies with lower growth prospects. Yet a growing body of empirical evidence from U.S. markets stands contrary to this generally accepted wisdom: in other words, market data suggests that high-dividend paying companies often grow faster than low-dividend paying companies. Unfortunately, insufficient historical data prevents a rigorous replication of these studies in Asia Pacific. One reason for this is the simple fact that a substantial portion of Asia's current market value is constituted by companies listed during the past decade. A study looking beyond ten years would therefore miss a large and very important segment of the current dividend universe.

Nonetheless, we find that at least the general pattern holds true in Asia Pacific too. Table 2 (see page 2) illustrates the relationship between payout ratios five years ago and the subsequent earnings growth over the next four years. The result indicates that companies with above average payout ratios do not as a group necessarily exhibit lower earnings growth. On the contrary, the slowest growing quintiles consisted largely of companies with below average payout ratios.

There are manifold reasons why dividend payments can act as a "signal" not of weakness, but of earnings growth. Dividend payments are one way for a company's management to "signal" its outlook for future earnings. If management feels confident about the company's earnings prospects it is more likely to raise the dividend payout, whereas a cut in the dividend is often a sign of financial distress. Dividends can also act as an indication of how efficiently the business is managed and as discussed above, to what degree minority shareholders are respected. On some level dividends also validate the quality of reported earnings growth whereas accounting earnings or "paper profits" can be restated downwards, thereby wiping out accounting earnings. Dividends on the other hand are "hard" cash payments, which cannot be retracted once received by the investor. Dividends therefore act as a helpful indicator of the soundness of earnings and financial reporting standards, particularly in countries with less regulatory oversight, since a company will indeed have to earn the cash before it can pay it out as dividends. An increase in the dividend or the maintenance of a high payout ratio can therefore be viewed as a sign of strength and not of weakness.

The dividend landscape in Asia Pacific continues to mature. Newly listed companies will continue to offer the prospect of previously unattainable dividends becoming accessible to investors, while a mix of more generous dividend policies and potential earnings growth offers another potential catalyst for dividend growth going forward. Asia's markets continue to grow and evolve – and so do its dividends.

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[1] Returns are pre-tax.
[2] The MSCI All Country Asia Pacific Index is a free float-adjusted.market capitalization-weighted index of stock markets of Australia, China, Hong Kong, India, Indonesia, Japan, Malaysia, New Zealand, Pakistan, Philppines, Singapore, South Korea, Taiwan and Thailand. It is not possible to invest directly in an index.

REGIONAL OVERVIEW

Entering the fourth quarter, Asian markets remained firm, with the MSCI All Country Asia Pacific Index adding another 3% to its gains in September, just shy of double-digit gains for the year to date. China and India continued to lead the advance, while the markets of North Asia were laggards. One of the challenges of reviewing performance on a monthly basis is that the short time scale can make trends within a country or sector appear illogical or contradictory. This is especially true when the economic outlook is uncertain. Looking across the region, autos, banks and financials, oils and resource companies did well, while tech was flat. It's hard to pin any general theme onto this behavior: the U.S. economy remains a key driver, but even here signals can be interpreted either positively or negatively, depending on whether your priority is consumption or interest rates. October witnessed no major shifts in outlook: crude oil appears to have found a floor around/just below $60 a barrel, and that floor, coupled with decent earnings, reinvigorated the sector. The market expects the Fed's next move will be to cut rates, but the timing is uncertain. If we had to pin the relative weakness of tech on one factor, it would be the uncertain outlook for consumer sales this year from the U.S. in the important holiday shopping period.

Valuations have risen in China and India as market liquidity continues to flow to these new darlings of Asia. However, fundamentals across the region generally remain supportive: earnings are robust, bank lending, especially to the corporate sector, is strong and overall valuations remain reasonable. While local factors appear sound, the market's short-term direction remains hostage to the ever shifting sentiment over the U.S. economic outlook for 2007.

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CHINA/HONG KONG

The Hong Kong equity market continued to rally in October, surpassing the six-year high registered during the previous month. Broad-based gains in Chinese equities were underpinned by more benign energy prices and positive sentiment regarding the domestic economy. The Hang Seng Index gained 4.71% while the MSCI China Index was up 6.90%. Hong Kong continued to serve as an important platform for Chinese enterprises to raise capital from global investors. The recent IPO of China's largest bank raised US$20 billion through dual domestic A-share and Hong Kong listings, making it the largest IPO in history. As of the end of October, China-related stocks accounted for almost 44% of total capitalization of the Hong Kong stock market, versus 37% in 2005.

Meanwhile, China released its third quarter economic data. China's economy expanded 10.4% year-on-year, compared to 11.3% growth in the previous quarter. The slower growth was in part attributable to a deceleration in investment in August and September amidst measures by the central government to cool the economy. Money and credit growth also showed signs of moderation for the same reason. Export growth remained buoyant: the third quarter trade surplus totaled US$48.7 billion.

INDIA

The Reserve Bank of India's (RBI) mid-term review of annual monetary policy turned out to be a non-event for the Indian equity markets, which continued to hit new all time highs during October. The central bank stopped short of raising the benchmark rate (unchanged at 6.0%), but raised the rates at which banks can borrow money from the central bank by 25 basis points to 7.25%. The outcome of the mid-term review highlights the dilemma facing the central bank. On the one hand, the RBI sees "indications of growing demand pressures and potential risks from rapid credit growth, strains on credit quality and elevated asset prices". On the other, the bank is evaluating the "the impact of lagged effects of earlier policy action". For perspective, the central bank has raised rates three times since the start of this year, and is apparently waiting to see if further consequences will result. What has perhaps gone unnoticed is additional relaxation in some capital controls by the RBI – for instance, resident individuals can remit higher amounts out of the country, and domestic mutual funds can invest up to $3 billion in overseas markets.

In recent months, the yield curve in India has flattened considerably as short-term rates have generally increased, while long-term rates have declined due to strong demand from institutions like pension funds.

The September quarter corporate earnings season revealed some mixed performances. Demand growth remains strong, and some industries like consumer staples actually experienced acceleration helped by good spending in rural India. This is particularly encouraging as it appears that even a less than robust monsoon season did not seem to have crimped spending patterns in rural India. On the flip side, there were clear signs of margin pressure from rising raw material costs across a broad swathe of India's economy. The pressures were especially evident in manufacturing industries like autos with companies unable to exert much pricing power even in the face of strong consumer demand.

JAPAN

Despite heightened geopolitical concerns regarding North Korea's nuclear test, the TOPIX reached 1,664 in late October, recovering to peak levels last touched in mid-May. This market

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movement came on the back of better-than-expected Tankan survey data, expectations of favorable corporate earnings and the upward trend of global stock markets. However, the index declined towards the end of the month, due partly to weaker-than-anticipated U.S. GDP numbers, and cautious earnings guidance on the part of corporates. The TOPIX and the MSCI Japan indices closed the month with a gain of 1.54% and 1.74%, respectively. The small-cap markets regained some ground, with JASDAQ and Hercules up 0.22% and 2.4%, respectively.

News that the Russian Central Bank's decision to purchase yen for its foreign exchange reserves and an announcement that the BoJ would monitor "yen-carry trades" appear to have supported a modest appreciation of the currency. Meanwhile, the 10-year JGB yield declined to 1.72% after reaching 1.86%, on the back of lower-than-expected September CPI data. Foreigners and investment trusts continued to be net equity buyers, while individuals were significant net sellers.

Declining energy prices and rising land and property prices supported the transport and real estate sectors' outperformance. On the other hand, the consumer finance industry was impacted negatively as the government debated the elimination of so-called "gray-zone" interest rates which pertain to high-risk borrowers. (The gray-zone is the gap between the 20% interest rate stipulated by the Interest Limitation Law and 29.2% set by the Investment Deposit and Interest Rate Law.) The government's intention is to ease the burden of people suffering from excessive consumer debt. Meanwhile, companies that announced half-year earnings on or before November 5 (except financials and companies listed on small-cap markets) saw recurring profits expand 16.1% from a year earlier. Earnings results for the remaining companies as well as the outlook for full-year results are likely to continue to be a focus of investors' attention.

KOREA

In October, the Korean market traded sideways as tensions with North Korea persisted and consumer sentiment remained lackluster. The KOSPI lost 0.05% during the period while the KOSDAQ declined 1.94%. The real estate market, however, continued its strength despite concerns over North Korea and poor consumer sentiment. Inflows into the equity market remained weak from both domestic and foreign funds.

The industrials and materials sectors broadly outperformed the KOSPI while the information technology sector generally underperformed. The financials sector was also weak as some of the major commercial banks released weaker-than-expected earnings during the month. The Internet sector recovered some lost ground as news related to an acquisition involving a major telecommunications service company was announced during the month. However, the overall KOSDAQ Index was weak as concerns over North Korea remained on the minds of many retail investors.

Consumer prices unexpectedly fell in October as the cost of fuel and fresh food dropped. The price of Dubai crude oil has declined around 19% since August, helping South Korea curb inflation. Export growth slowed to 11.5% year-on-year in October, after surging 21.5% in September, due in part to less working days during the month. Sales of electronics and automobiles to China and other Asian countries continued to increase. Shipments to China, which is South Korea's largest export market, increased 10% year-on-year in October.