TCM investment funds
Your connection to new markets

Tactical advantage in emerging markets

A company that makes a profit has two options to use the profit. The profit can be reinvested in the company or the profit can be distributed to the shareholders as dividends. On the assumption that it does not matter to an investor whether the return is achieved through price appreciation or dividend payments, it seems better for the company to invest in new projects so that ultimately this will result in a higher earnings growth. This view was scientifically confirmed when Miller and Modigliani (1961) published their Dividend Irrelevance Theorem.

In 1984 another important scientific publication on this subject appeared: Myers Pecking Order Theory. This theory notes that companies are indifferent to sources of funding for new projects in the pursuit of profit growth and therefore always choose the one with the lowest cost of capital and that is retained earnings.

Both publications indicate that the relationship between the pay-out ratio (the percentage of the profit that is paid out as dividend) and future profit growth is negative. For years this was the generally accepted theory. However, these theories rely heavily on a series of assumptions, such as the lack of taxes, symmetrical information about the capital markets and that all business investment actually contributes to future profits.

So when Arnott and Asness (2003) first examined the US stock market over a 130-year period based on real-world data, the opposite trend was suddenly found. Their publication was therefore given the catchy title: Surprise! Higher dividends = Higher earnings growth. These findings have shaken the financial literature and sparked a wave of further research in the field, leading multiple scientists to investigate the validity of the statement in the "real world." And yes, it was soon followed by one publication after another that confirmed Arnott and Asness's thesis that profits grow faster at companies that have higher dividend pay-out ratios.

These studies focused exclusively on developed markets and little to no research has been conducted on this issue in the context of Emerging & Frontier markets so far. That is why Trustus Capital Management was the first in this research field to initiate a study into the relationship between dividend payments and future profit growth within Emerging & Frontier markets. This was carried out by Idan Isvoranu as a graduation project at the University of Groningen under the supervision of Dr. Auke Plantinga.

Unlike developed markets, emerging markets are characterized by rapid economic growth, smaller market capitalization, lower liquidity and reduced market accessibility for international investors. The higher volatility and other preferences for financing and tax treatment in these markets also raise the question of whether the positive correlation found by Arnott and Asness (2003) also applies to these markets.

That turned out to be the case. Over the period 1999-2019 and with data from 15,996 Emerging and Frontier companies, the existence of a strong statistically significant correlation between dividend pay-outs and future earnings growth over a 1.3 and 5-year observation horizon was demonstrated. To check that the profit growth is really related to the pay-out ratio and not caused by other factors, a multivariate regression analysis was used. These are factors such as the size of the company, the return on capital and the ratio between debt and equity. In total, 6 control factors were used.

Another very interesting angle was to see if the positive relationship between dividend payments and future earnings growth was caused by mean reversing. This phenomenon of “return to the average” means that if a company is temporarily in dire straits, profits often recover in subsequent years when the difficult period is over. Meanwhile, management often leaves the dividend intact, as a dividend cut is usually received negatively by investors. Dividend is “sticky downwards” and is not easily adjusted downwards. This would give the situation that with a temporarily lower profit the pay-out ratio is relatively high, after which the profit grows again in the years that follow. This could be the explanation of the positive relationship that has been demonstrated in the study. But it turned out that this is not the case! This mean reversing is also one of the control factors included in the analysis.

The proposition that higher earnings growth is actually positively related to the pay-out ratio cannot be rejected with the multivariate regression. There are several explanations for this remarkable phenomenon. With too much cash on hand, corporate managers would tend to make sub-optimal investment decisions in an empire-building desire. Bonus arrangements and the tax treatment of dividends can also play a role. However, no significant evidence has been found for this (by testing the Free Cash Flow Hypothesis).

Another explanation is that a high pay-out ratio sends a signal from the company to investors that the management has confidence in the realization of profit growth. This has also been investigated in the study, but this (Signalling Hypothesis) also did not provide sufficient explanatory power for the outcome that a higher dividend payment leads to higher future earnings growth.

Anyway; the relationship higher dividend payment = higher future earnings growth has been demonstrated and this conclusion has important implications for investment decisions, especially for those investors involved in such investment styles as value and growth. TCM Investment Funds' dividend strategy is often regarded as a value strategy. However, the findings from this study show that companies that distribute a large part of the profits are precisely the companies that show above-average future profit growth. Since TCM Investment Funds specifically selects stocks for (among other things) high dividend, it is good to know that based on the research conducted, this offers a tactical advantage in Emerging & Frontier markets.

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