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Ninety One

Investing for a world of change

Why dividends tell us that earnings may be overbaked

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The fast view

- In a space of only a few weeks, we moved from a strong economic outlook to a place where one needs to consider the probability of a recession.
- The market still expects earnings to trend higher this year, reaching 50% higher than in 2019. Dividends, however, tell a different story.
- Payout ratios are expected to decline to 38% from 52% and are a far more intuitive metric of the sustainable cash generation of a business, in our view[1].
- We invest in companies with what we view as a combination of pricing power and stable revenues, which creates the potential for robust earnings growth, cash flow and finally dividend growth.
- The Global Quality Equity Income portfolio currently trades at a discount to the market; historically it has outperformed during periods of uncertainty.

1. As illustrated in Figure 2 on page 3.

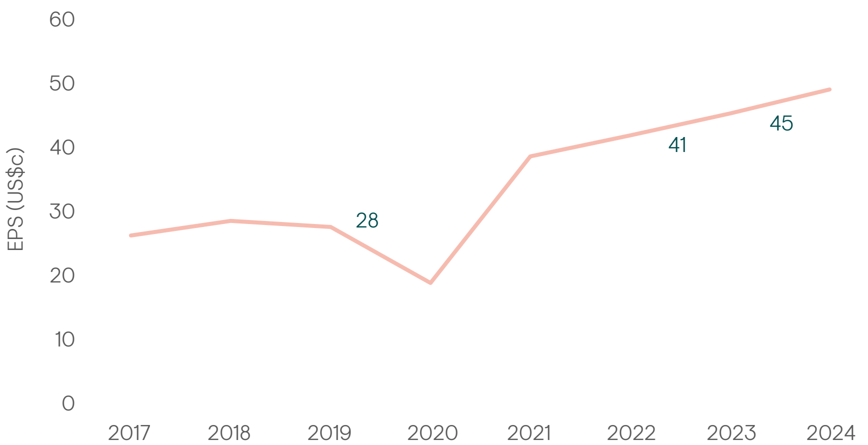
Most of us entered 2022 with an optimistic outlook; markets were at all-time highs and the consensus view was that while earnings growth will start to slow, it would probably be another year of decent growth despite financial conditions beginning to tighten. Most looked forward to finally dropping masks and putting the pandemic behind us as we moved on to a more normal environment.

War changes everything

Then came the war in Ukraine, triggering market turmoil and a material spike in commodity prices, which is likely to place further pressure on input cost and already disrupted supply chains. The scale of the increase in commodity prices and secondary impacts of sanctions were enough to impact the global growth outlook. For instance, the UN's trade and development body has downgraded its global economic growth projection for 2022 to 2.6% from 3.6%. In a space of only a few weeks, we moved from a strong economic outlook to a place where one needs to consider the probability of a recession.

From a fundamental perspective, the market devalued earnings during the quarter with the most overvalued companies showing the biggest declines. Yet despite this, market earnings expectations continue to be robust at 7% growth for 2022, according to Bloomberg estimates. We think this consensus is vulnerable and likely to disappoint the market in both 2022 and 2023. Comparing the MSCI ACWI earnings of 2019 — the year before COVID — to expectations for 2022 and 2023, gives us reason for caution. It is striking that the market is expecting 2022 earnings to be 50% higher and 2023 to be 60% higher than 2019 (Figure 1). Intuitively, it does not make sense that the average company has so much more earnings power, in our view.

Figure 1: The market expects earnings to continue rising through 2023, despite the headwinds

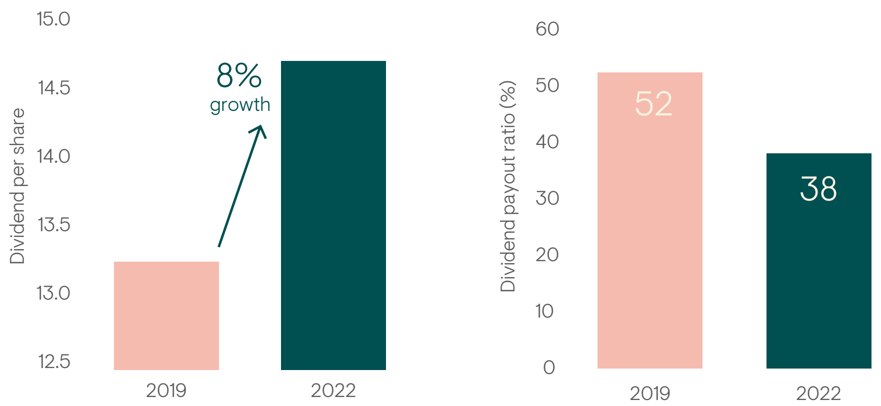


Source: Bloomberg, Ninety One, as of 31 March, 2022. Global equities are illustrated by the MSCI ACWI index. For further information on indices, please see the Important information section.

Why dividends are so insightful

As dividend growth investors, we tend to look at what management — as insiders to their business — tell us about the outlook. Dividends, that typically act as an insightful indicator of sustainable cash generation of a business, are expected to grow only 8% in 2022, compared to 2019. This might act as a strong signal that management is not expecting the same robust outlook as implied by the consensus earnings. Rolling lockdowns, supply chain constraints, the Ukraine/Russia conflict and secondary impacts of sanctions clearly still need to work their way through the system. We estimate, using the payout ratio of 2019 on 2022 expected dividends, that management view 'sustainable' earnings to be over 30% lower than what the market is currently using for PEs.

Figure 2: Dividend payout ratios suggest management doesn't share the market's robust outlook



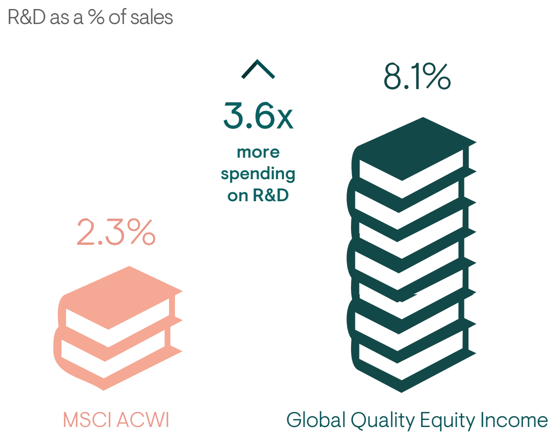
Source: Bloomberg, 31 March 2022. Based on the constituents of the MSCI ACWI index. For further information on indices, please see the Important information section.

Focus on the compounders

Our portfolio continues to focus on reasonably valued companies with the ability to compound dividends and earnings over time. We look for companies with strong competitive advantages that are sourced from intangible assets, such as brands and patents and not trucks or buildings. Our companies build sustainable businesses due to innovation that is not only creating barriers for competition but also creates pricing power, something we define as the ability to increase prices enough to drive real cash flow growth.

Examples of this in our portfolio could be businesses with new product launches like Siemens Healthineers[2] with the launch of its new MRI system. Although more expensive than previous versions, the product delivers increased value to customers.

Figure 3: The portfolio's companies future-proof themselves through significant R&D spending



Source: Ninety One, FactSet, based on constituents of MSCI ACWI, as at 31 December 2021. The portfolio may change significantly over a short space of time. For more information on indices and specific portfolio names, please see the Important information section.

Microsoft is another example of a company with considerable pricing power. For instance, its recent increase to the subscription price of Office 365 translates into pure profit for the company, as customers have limited ability to protest. High-quality companies are usually not economically sensitive as they sell daily-use products and services or have recurring revenue streams with structural growth. The combination of pricing power and stable revenue creates robust earnings growth, cash flow and finally dividend growth.

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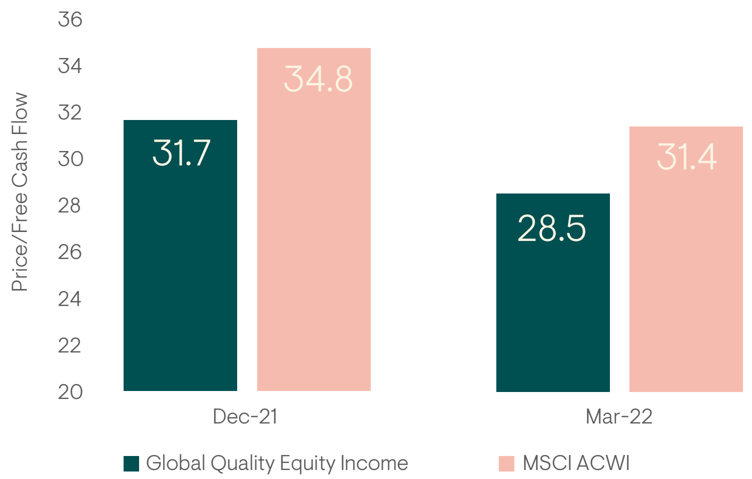
2. No representation is being made that any investment will or is likely to achieve profits or losses similar to those achieved in the past, or that significant losses will be avoided.

This is not a buy, sell or hold recommendation for any particular security. For more information on specific portfolio names, please see the Important information section.

Our objective is to deliver durable growth over time from at or above the market's starting dividend yield. As a result, we seek to avoid expensive growth names with business models that we don't believe are strong enough to generate excess cash and we also avoid the ex-growth companies that might have high dividend yields but can't deliver sustainable growth. After the widespread sell-off in the first-quarter, our portfolio valuation is lower today than at the start of the year and we also trade at a discount to the market.

Figure 4: The portfolio's valuation is lower than at the start of 2022, and at a discount to the market



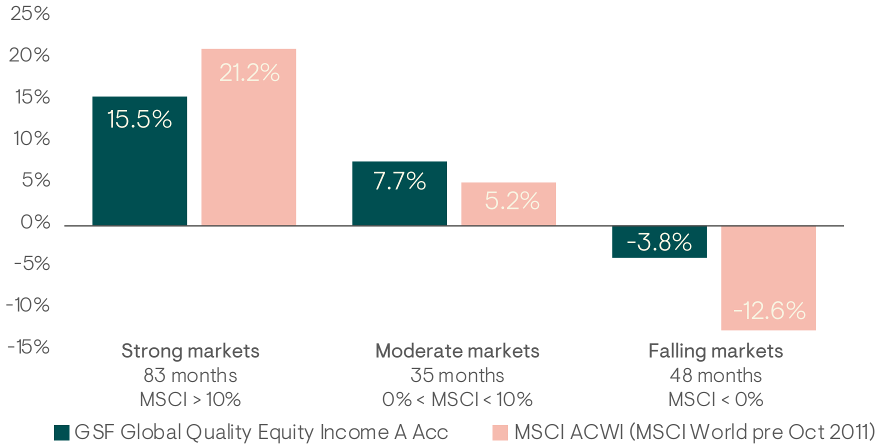
Source: Ninety One, FactSet, based on constituents of MSCI ACWI, as at 31 March 2022. The portfolio may change significantly over a short space of time. For more information on indices and specific portfolio names, please see the Important information section.

Seeking greater certainty

Valuations may be lower than the start of the year, but the outlook has also deteriorated. The persistent threat of restrictive COVID measures across many markets, supply chain challenges, high input cost, higher interest rates globally and the deeply uncertain geopolitical environment all make the earnings outlook incredibly hard to predict. That said, we think the market's expectation that 2022 will be 50% higher than 2019 is overly optimistic.

During periods of economic uncertainty, we believe it is prudent to invest in companies with durable earnings and dividend growth outlooks, supported by very strong balance sheets, with limited dependence on the economic cycle. This is particularly true when these companies trade at a discount to the market. Historically, as Figure 5 shows, companies within our portfolio have typically performed with resilience during times of economic uncertainty, a characteristic we embrace heading into the challenging period ahead.

Figure 5: The portfolio has historically outperformed during times of economic uncertainty



Past performance is not a reliable indicator of future results, losses may be made.
Source: Ninety One, 28 February 2022. Performance is net of fees (NAV based, including ongoing charges, excluding initial charges), gross income reinvested, in USD. Rolling 12 month periods since inception: 30 March 2007. For further information on indices, please see the Important information section.

General risks. The value of investments, and any income generated from them, can fall as well as rise. Where charges are taken from capital, this may constrain future growth. Ongoing costs and charges will impact returns. Past performance does not predict future returns, losses may be made. If any currency differs from the investor's home currency, returns may increase or decrease as a result of currency fluctuations. Investment objectives and performance targets are subject to change and may not necessarily be achieved, losses may be made. Environmental, social or governance related risk events or factors, if they occur, could cause a negative impact on the value of investments.

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