HKRSA 香港退休計劃協會
The Hong Kong Retirement Schemes Association

PREMIER SPONSOR ARTICLE SERIES

APR 2022

## Rising Rates and Implications for Investors

FRANKLIN TEMPLETON
富蘭克林鄧普頓

The pandemic has been difficult to navigate; unfortunately, there does not appear to be light at the end of the tunnel for investors just yet.

To support individuals and businesses throughout the pandemic, global governments collectively announced nearly USD 10 trillion in relief through the first half of 2020, significantly overshadowing the financial relief provided during the global financial crisis in 2008.

To add to that, persistent disruption to global labour and productivity capacity means more demand chasing fewer goods and services. This has contributed to the highest inflation levels in over 40 years.

Russia's invasion of Ukraine further stoked the flames of inflation; sanctions on Russian exports have caused commodity prices to surge, exacerbating the pain already felt by businesses, and threatening to erode the purchasing power of retirement savings.

With accelerating inflation and the spectre of higher interest rates to combat it, companies may face rising input costs in the form of higher costs of capital, material and labour, putting profit margins at risk if price increases cannot successfully be passed along to consumers. Consequently, shares may be likely to be repriced lower to reflect moderating profitability.

Over time, sustained volatility may hinder investors' returns, as illustrated in Exhibit 1:

**Exhibit 1: Higher volatility does not necessarily equate to higher returns**

Source: Templeton Global Equity Group; for illustrative purposes only. [1] Exhibit shows the impact of a hypothetical $100 investment in 2015, which experienced gains and losses of 2% for the low volatility strategy, and 15% for the high volatility strategy in alternating years.

### How can one potentially reduce volatility in the portfolio?

From an investment style perspective, it is important to note that rising inflation rates may impact 'growth' and 'value' type equities disproportionately. Growth names (typically paying fewer dividends, exhibiting less profit, and being more interest rate sensitive) may be impacted more adversely.

In contrast, a 'value' style of investing typically involves purchasing businesses that tend to already be profitable, and where the price of shares relative to earnings (P/E ratio) tend to be lower, avoiding companies whose prices may have appreciated more quickly than the corresponding increase in earnings.

An additional solution to consider: including dividend paying companies. This can be attractive for two reasons: a recurring income component, and the ability to potentially temper portfolio volatility.

While a concern during inflationary periods is that rising prices diminish the value of fixed payments, companies with a record of consistently paying attractive dividend yields, *as well as the ability to grow dividends over time*, may provide investors with a growing income stream, helping to offset the impact of inflation. If reinvested, the impact can be substantial. For example, examination of the MSCI Asia Pacific Index over a twenty year period since 2000 suggests that the total returns of the index including dividends, would have exceeded price returns by approximately 29%; total returns with dividends *reinvested* would have exceeded price returns by nearly 65% over the same period: a feat which Einstein has called 'the eighth wonder of the world' (compounding).

Other studies[1] have drawn similar conclusions regarding dividends and volatility: a portfolio comprised of both equities with the potential for meaningful appreciation as well as income, may offer comparable returns to a portfolio comprised of non-dividend paying equities, but with less volatility.

[1] C. Mitchell Conover, Gerald R. Jensen & Marc W. Simpson (2016) What Difference Do Dividends Make?, Financial Analysts Journal, 72:6, 28-40

Exhibit 2 illustrates this with two hypothetical portfolios:

- Portfolio 1 represents a portfolio where no dividends are paid; all corporate profits are re-invested into the business to achieve higher growth (higher expected return)
- Portfolio 2 represents a portfolio where some companies pay dividends (lower expected return)

Moving from portfolio 1 to portfolio 2 reduces the expected return of the portfolio by ~6% but volatility by ~43%.

**Exhibit 2: Adding dividend paying stocks to a portfolio may help to materially lower volatility**

Source: Templeton Global Equity Group; for illustrative purposes only. Exhibit shows a frontier of hypothetical portfolios which vary both in terms of expected return and volatility

## Why Might Asia Pacific (APAC) Equities Be Attractive in this Context?

Following sanctions, illiquidity, and declines in Russian markets, Morgan Stanley Capital International (MSCI) and FTSE Russell have eliminated Russian companies from their emerging market indices. Proforma estimates suggest that APAC equity markets may be a well poised recipient of these flows.

Additionally, our research indicates that the APAC region is a fertile source of investment opportunities, in part owing to the following regionally attractive factors:

1) Strong economic prospects and accommodative financial conditions: Economic growth rates in the APAC region tends to be generally higher than the rest of the world. Furthermore, while many global central banks seek to raise their policy rates, evidence exists to suggest that some central banks in the APAC region may aim to maintain relatively accommodative financial conditions to achieve growth/inflation targets.

2) Unique businesses/exposures: The entire APAC region (including Japan) is home to several unique businesses lacking true competitive peers. Multiple companies in the robotics, semiconductor, and materials sectors stand to benefit from broad global trends such as the electrification of vehicles, 5G wireless technology, and automation.

3) Strong balance sheets/liquidity: For several countries in the region, the percentage of companies who are in a positive net cash position exceeds the global average. While some investors may frown on cash balances, in uncertain times, it provides flexibility to service debt, pay dividends, or make strategic acquisitions. In fact, we have found that the region offers opportunities to earn above average yielding dividends supported by ample liquidity.

4) Attractive valuations: Despite boasting favourable GDP growth rates, APAC equities appear cheaper relative to global equities now than they were during the global financial crisis; this extreme may be suggestive of an inflection point.

## A Bridge Across Troubled Waters

For investors, navigating an environment characterized by inflation and geopolitical uncertainty can be challenging – industries can be disproportionately impacted as costs rise, profit margins decline and competitive positions shift. It is uncertain how long the current inflationary environment or conflict may persist (or worsen!), and as such, it may be beneficial to adopt a position which attempts to mitigate portfolio volatility, but still permits the ability to benefit from when the world returns to more 'normal' conditions.

In this context, we believe that the ability to combine two powerful factors across the APAC region: a consistent stream of sustainable/attractive dividends (which can help to provide current income / reduce portfolio volatility) and the generation of excess market returns from the purchase of undervalued companies by adopting a value style of investing, can help to potentially generate market returns in excess of inflation levels while helping to reduce the spasmodic volatility that so often accompanies regime changes.

## Important information

Franklin Templeton Investments (Asia) Limited and Legg Mason Asset Management Hong Kong Limited are the issuers of this document. The comments, opinions, and estimates contained herein are based on or derived from publicly available information from sources that Franklin Templeton believes to be reliable. Franklin Templeton does not guarantee their accuracy. This document is for informational purposes only. Any views expressed are the views of respective portfolio management team of Franklin Templeton as of the date published and may differ from other portfolio management team/ investment affiliates or of the firm as a whole. The security provided (if any) is for illustration purpose only and is not necessary indicative of a portfolio's holding at any one time. It is not a recommendation to purchase, sell or hold any particular security. This document is not intended to provide investment advice. **Investment involves risks. Where past performance is quoted, such figures are not indicative of future performance.**

The underlying assumptions and these views are subject to change without notice. There is no guarantee that any forecasts expressed will be realized. Neither Franklin Templeton, its affiliates nor any officer or employee of Franklin Templeton accepts any liability whatsoever for any direct or indirect consequential loss arising from use of this document or any information, opinion or estimate herein. This document has not been reviewed by the Securities and Futures Commission of Hong Kong.

The information in this document is confidential and proprietary and may not be used other than by the intended user. This document may not be reproduced, distributed or published without prior written permission from Franklin Templeton.

**Legg Mason Asset Management Hong Kong Limited is an indirect wholly owned subsidiary of Franklin Resources, Inc.**

### About HKRSA

The Hong Kong Retirement Schemes Association (HKRSA) was established in 1996 to promote the interests and best practices of retirement schemes in Hong Kong including provident and pooled retirement funds. The HKRSA is a not-for-profit, non-political association, which represents retirement schemes and their members, providing a forum for discussion of issues of current and topical interest.

### About Franklin Templeton

Franklin Resources, Inc. [NYSE:BEN] Franklin Templeton's mission is to help clients achieve better outcomes through investment management expertise, wealth management and technology solutions. Through its specialist investment managers, the Company brings extensive capabilities in equity, fixed income, alternatives and custom multi-asset solutions. With employees in over 30 countries, including 1,300 investment professionals, the California-based Company has more than 70 years of investment experience and more than US$1.5 trillion in assets under management as of January 31, 2022.

### Disclaimer

This document is intended to be for information purposes only and it is not intended as promotional material in any respect. It does not constitute any solicitation and offering of investment products. The views and opinions contained herein are those of the author(s), and do not represent views of the Hong Kong Retirement Schemes Association (the "HKRSA"). The material is not intended to provide, and should not be relied on for, investment advice or recommendation. Information contained herein is believed to be reliable, but the HKRSA makes no guarantee, representation or warranty and accepts no responsibility for the accuracy and/or completeness of the information and/or opinions contained in this document, including any third party information obtained from sources it believes to be reliable but which has not been independently verified. In no event will the HKRSA be liable for any damages, losses or liabilities including without limitation, direct or indirect, special, incidental, consequential damages, losses or liabilities, in connection with your use of this document or your reliance on or use or inability to use the information contained in this document. This document has not been reviewed by the SFC. Any link to other third party websites does not constitute an endorsement by the HKRSA of such websites or the information, product, advertising or other materials available on those websites and the HKRSA accepts no responsibility for the accuracy or availability of any information provided by linked websites.