Factoring in Politics when Investing

Forecasts and predictions are tough in any business, but politics is possibly tougher than most to divine the outcome of future market events, even in this modern age. In the run-up to many elections—the recent British election, for example—there has been conflicting evidence to the clear consequences to come only after the final count is completed. Another challenge is that no one announces an upcoming coup or advertises planned political unrest, and it is never clear how long the status quo will persist. As an investment manager, I find that politics is important as it can materially impact investment returns. But outside of the shrieking headlines, is the long-term impact possibly less significant than one might suspect? In this issue of *Asia Insight*, we will explore some of the past challenges faced by investment decision-makers as well as the post-mortem outcomes to see if there are lessons to be gleaned.

Thailand 1932

Thailand is a fine starting point. Over the past century, Thai politics has been more colorful than most. The absolute monarchy was abolished in 1932 and since then the country has had 25 general elections. It has also had 19 coups d'état, of which 12 toppled the governing powers. In spite of this tumultuous political history, the country is one of only a few in the world to never have defaulted on its sovereign debt. Two of Thailand's more recent coups happened in the past 10 years. And rather surprisingly, over this time, the market has performed rather well. In fact, despite its history of repeat coups—more than any other Asian country—Thailand's stock market and investor returns have, in reality, seen virtually no impact over the medium term from such arguably "extreme" political activity. Including dividends, the Stock Exchange of Thailand Index has risen more than 300% in U.S. dollar terms over about the last decade. In this same period, the S&P 500 Index increased 120%.

Today, Thailand's military is in power once again. The investment community (ourselves included) appears relatively unconcerned by the situation. We might, however, be a bit more cautious than most in this regard; King Bhumibol Adulyadej is now 87 years old and struggling with poor health. He has served as Thailand's revered monarch for almost 70 years and the successional transition might be tougher than many expect. The transition from military to civilian rule too may not be as smooth as is widely expected.

Myanmar and Singapore in the 1960s

Now let's consider some issues an investor would have faced some five decades ago by comparing the two former British colonies of Myanmar (formerly Burma) and Singapore. At the start of the 1960s, Myanmar was one of the world's largest rice exporters, hence the nickname the "world's rice bowl." About the size of the state of Texas, it had a population at the time of nearly 25 million. By contrast, Singapore was a swampy little island off the southern tip of what is now Malaysia with no natural resources and a population of a mere 1.9 million. At that time, in terms of raw potential the investment decision was a "no brainer." Texas-sized Myanmar was a respected exporter of agricultural produce and with its relative land size and population advantages, the country had obvious potential. However, an investment decision would have been complicated at that time as both countries had political problems; in 1965, Singapore become the first country in modern history to unwillingly become independent when it was expelled from the Federation of Malaysia. Prime Minister Lee Kuan Yew tearfully shared the news via a televised press conference that Singapore was a sovereign, independent nation. Myanmar, on the other hand, was ensconced in military rule after the 1962 coup by General Ne Win, and its policies sought to reorient the economy to a socialist one. Foreign aid organizations were kicked out, companies nationalized and many freedoms greatly curtailed.

So, you can see that factoring in political backdrops can make any investment decisions much more complex. Today, Myanmar has nominal GDP per capita of US$1,221 while the equivalent for Singapore is more than 46 times higher at US$56,319. Interestingly, Ne Win ruled the

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> "There are innovative companies constantly finding solutions to new political barriers, finding solutions to meet the growing needs of the population."

country for 26 years while Lee Kuan Yew was at the helm for 31 years, and each man's political ideology and actions materially shaped the fortunes of both nations.

The development of these two states and the divergent outcomes for their populations—albeit extreme—drive home the importance for us, as investors in Asia's economies, of understanding political environments. Per capita income in Singapore is now higher than it was under its colonial rulers while in Myanmar most stakeholders have languished over this period. Clearly, this political reality unfolded over an extremely long time horizon, much longer than that of most portfolio investors. And this is one of only a few extreme cases in Asia, as on the whole, political impact is far more marginal.

But political changes can also be short and sharp, although frequently still be very difficult to predict. Recalling back more recently, elsewhere in the region, to the events of the 2014 elections in India, the consensus view was initially that reform-minded Narendra Modi would likely win, but with no majority. A cumbersome and unwieldy coalition was widely expected. When the results were finally tallied some months later, it became clear Modi had won a historic victory and investor sentiment toward the country turned extremely positive. Money flowed in strongly as the currency rebounded, delivering outsized returns over the following 12 months. The election outcome was tough to predict as was the extent of the investor exuberance over the Modi victory. As portfolio managers, we can typically make good assessments only after political events take place—keeping a long-term perspective and constantly weighing the realistic future expectations against the current valuations. The market's recent enthusiasm has made valuations less attractive, but the long-term prospects remain striking. I believe the potential for growth is significant in India, but so are the challenges faced by Modi's regime.

Opaqueness, duration and severity of political changes are a very real challenge for investors as we need to try to gauge what will unfold nationally over the long term and what impacts market sentiment will have over the shorter term. Consider the most recent election in Sri Lanka. The incumbent, Prime Minister Mahinda Rajapaksa, surprised the markets when he called for an early election—nearly *two years* before the end of his scheduled term. Rajapaksa had been in power for a decade, and along with his three brothers, controlled most facets of Sri Lanka's government as together they held the posts of minister of finance, minister of defense, minister of economic development and obviously also the position of prime minister. The early election result was expected to be close but seemed to be a foregone conclusion—except that Mr. Rajapaksa lost. Now everything has changed. The new party is off to a rather disappointing start, announcing a shareholder unfriendly 25% retroactive corporate tax within days of winning the election. We now expect less decisive decision-making and a period of economic stagnation while the new players establish their territories and we await a new round of parliamentary elections.

Another Asian country with political issues is Bangladesh, which too has long seen its share of troubles. Over the majority of the past 14 years, two female leaders, Khaleda Zia and Sheikh Hasina, have held the country's reins and been locked in a political power struggle. The last election was a farce and now Hasina is persecuting opposition leaders for alleged actions in the 1970 breakup with Pakistan. But the question to answer is what happens next? It's possible things may get worse politically before they improve.

Frontier Asia, in particular, is made of countries that have lagged in development for a variety of reasons, including war and civil strife, political instability, corruption and vestiges of colonialism. Of course, much can be said of Japan after World War II or Taiwan only some three decades ago. Therefore, many frontier Asian countries are traveling along a well-worn path, and we believe the positive changes we have seen across the Asian region in the past 25 years should probably continue. The pace of change may even be faster, driven by globalization, foreign direct investments, growing remittances, advances in technology and communications. As the economies and societies develop in these frontier countries, we can expect to see disposable incomes rising to support demand for staples, and especially discretionary consumer products and services.

Gauging Political Impact

With such low visibility, what can we do in our process to mitigate political risk? Our process is focused on gathering information from as many credible sources as possible. We meet various stakeholders, questioning them to build as clear a view as possible of a nation's political and corporate realities.

As an example, we visited Sri Lanka in December, just prior to elections, to understand the sentiment and expectations on the ground. Once the election was completed, and the outcome differed from the consensus view, we returned to the country in March to hold discussions over the changed situation. Sri Lanka is a tougher market to evaluate as the new leadership

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has been in power for less than 200 days. So far, the results are disappointing but any pullback in the stock market will probably offer an opportunity for long-term investors. History suggests political upheaval is most frequently an interesting buying opportunity for those with long-term horizons.

In Bangladesh, which does not have a market index history for useful analysis, some management teams have generated solid growth in revenue and profits, delivering respectable returns in U.S. dollars even in this septic environment. We can also look at export performance. Exports of mainly ready-made garments have also grown substantially in the past 10 years, from US$6.2 billion to US$24.6 billion last year, a growth rate of 14.7% per annum. Using these examples as a proxy, it is clear that local companies can adapt, improvise and overcome even severe political obstacles.

These examples show that political risk or noise in the media can possibly strike fear into the hearts and minds of investors, while in reality there may still be solid long-term returns to be had, even in a tumultuous environment. Investors should ask themselves: Over time, over the next five or 10 years, will we see the political environment improve? Will it become more robust? Will democratic institutions and system checks and balances continue to improve? How will companies fare under these regimes?

LANDS OF THE FREE

Asia Pacific claims 9 of the 35 highest-scoring countries on the 2015 Index of Economic Freedom, including the top 4 slots. Hong Kong and Singapore led the list as the world's most unfettered economies for the 21st consecutive year. Taiwan, Japan, South Korea and Malaysia have all improved their rankings since 2012.

		Overall Score	
2015 World Rank		*2015*	*2012*
1	Hong Kong	89.6	89.9
2	Singapore	89.4	87.5
3	New Zealand	82.1	82.1
4	Australia	81.4	83.1
12	United States	76.2	76.3
13	United Kingdom	75.8	74.1
14	Taiwan	75.1	71.9
20	Japan	73.3	71.6
29	South Korea	71.5	69.9
161	Myanmar (Burma)	46.9	38.7

The index ranks countries based on the extent to which governments allow people the freedom to work, produce, consume and invest with minimal interference. While Burma still ranks low among the survey's Asia-Pacific region countries, it has seen advancements in economic freedoms, and its world ranking has climbed higher over the past three years.

Source: The Heritage Foundation, Index of Economic Freedom

It is possible we are entering a period of reform in the region with the resulting payoff inevitably coming down the road. China, India, Japan and Indonesia all have relatively new prime ministers focused on reform. Myanmar has embraced change too and we expect to see a new stock exchange opening there later this year. On our upcoming trip there, we will be meeting with local officials, Stock Exchange representatives and companies planning to list on the new bourse. Our goal is to gain a better understanding of the regulatory facts, challenges and investment opportunities soon to be offered.

There is much we don't know about political change but there are also a few things we do know and must keep front of mind. Political change impacts sentiment and can create opportunities for long-term investors. We do know the Asian populations are industriously working and saving to build a better brighter future for themselves and their families. We also know there are innovative companies constantly finding solutions to new political barriers, finding solutions to meet the growing needs of the population.

In the future, there will almost certainly be political noise and setbacks but if we use history as our guide, we may conclude that if politics makes the investment road bumpy, keep your focus on the distant horizon as local businesses do not tend to just stop operating abruptly. As part of our investment process, we try to gauge the solid management teams that are nimble and resourceful enough to weather political and country risks to ultimately succeed over the long term.

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MATAI – May 2015

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