Matthews Asia

Matthews Asia Perspective
Q&A: Taizo Ishida, Lead Manager, Matthews Asia Growth Fund

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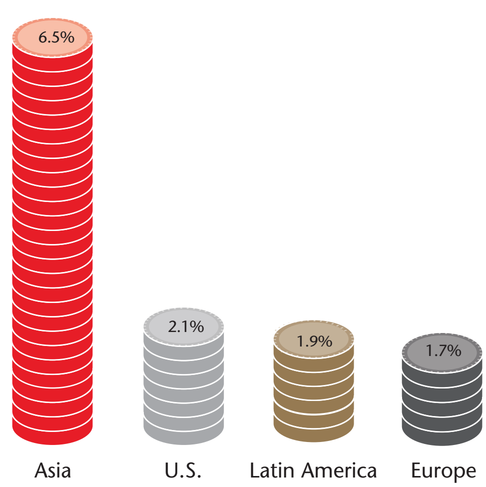
Why should growth investors consider Asia equities?

Across Asia today, many economies are growing much faster than the rest of the world. Asia's economic growth for 2018 is expected to be larger than that of the United States, Latin America and Europe combined, according to International Monetary Fund projections. In addition, while Asia currently accounts for roughly a third of global GDP, it represents more than half of global GDP growth. Investors without a dedicated allocation to Asia equities, therefore, may be missing out on more than half of the world's economic growth.[1] The pace of growth in Asia creates a prime opportunity for global investors to gain exposure to attractive companies. Investors with long-term goals—such as saving for retirement or funding a child's education—may benefit by building a regionally diversified growth portfolio, which can include Asia equities.

How large is the investment universe for the Matthews Asia Growth Fund?

The strategy covers the broadest universe of Asian markets, encompassing more than 28,000 individual stocks from which to choose. We have the flexibility to invest in developed markets, including Japan and Singapore, as well as emerging markets such as China and frontier markets such as Vietnam. As a bottom-up investment manager, we start with evaluating individual securities across all these markets. We seek out the most attractive long-term growth opportunities wherever they may be within our available universe. Country exposures within the Fund are typically the result of bottom-up security selection, rather than top-down country views. Our benchmark is the MSCI All Country Asia Pacific Index, which contains about 1,042 companies, typically large cap in size. The Fund, however, takes an all-cap approach, which also greatly expands the its universe beyond the benchmark.

Figure 1. Projected GDP Growth in 2018



Source: World Economic Outlook, July 2017 estimates

Figure 2.

Developed	Emerging	Frontier
Australia	China	Bangladesh
Hong Kong	India	Cambodia
Japan	Indonesia	Laos
New Zealand	Malaysia	Mongolia
Singapore	South Korea	Myanmar
	Pakistan	Papua New Guinea
	Philippines	Sri Lanka
	Taiwan	Vietnam
	Thailand	

Source: Matthews Asia

1 Source: International Monetary Fund; World Economic Outlook Database, April 2017

For growth investors, what are the benefits of investing in a strategy with such a large universe?

Markets in various stages of economic development will have different growth drivers. Japan, for example, is a leader in factory automation and robotics, excelling in the type of sophisticated manufacturing we aren't seeing yet in emerging markets. China, for example, isn't yet skilled or competitive in producing robotics, so it relies on robotics imported from Japan. Many Chinese manufacturing companies are increasingly buying Japanese robotic systems to help automate warehouses because rising wages are driving up production costs. Growth companies in frontier markets, meanwhile, may be leaders in things such as groceries and consumer staples, including dairy products. In the frontier market of Vietnam, dairy is an industry with high margins, high growth and relatively low competition. In nearby China, an emerging markets country, dairy is a very different story. The dairy industry in China has intense competition, resulting in low margins and low growth. By choosing from a large universe of companies, we believe we can capture growth across a broad range of industries and sectors. As a country progresses from frontier to emerging and then developed, it will offer different growth opportunities along the way.

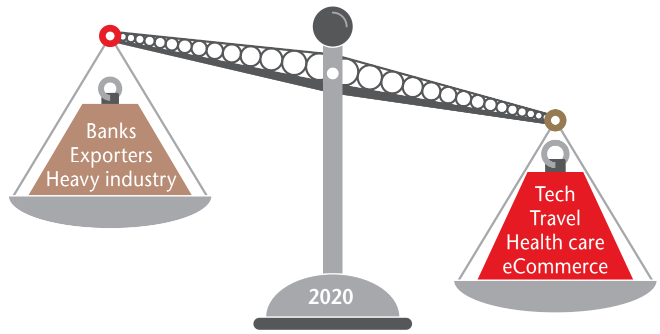
What defines an attractive growth company?

We have strict guidelines for what qualifies as a growth company. Less than 1% of the 28,000 companies in our investable universe meet our basic criteria. As a starting point we want to identify companies with strong profits and strong growth. We are generally looking for companies that with above-average profitability—those with at least 20% return on equity. In addition, we are looking for companies that are consistently growing their businesses by seeking out those with at least 20% profit growth. For the bulk of our holdings in the Fund, we are looking for companies that can remain industry growth leaders for the next five years or longer. Roughly 90% of holdings fall into this category. We also have the flexibility to make occasional tactical investments in the portfolio, with a shorter time horizon of one to three years for holding those investments. Roughly 10% of holdings fall into this category.

Do you see health care as growth industry?

Yes. Demand for health care services is growing across frontier, emerging and developed markets in Asia. In frontier markets, health care spending is typically very low, so governments and health care providers will need to find novel ways to better serve the needs of growing populations. And the business community

Figure 3. Consumer Sectors Drive Growth



Source: Matthews Asia

will be part of crafting those solutions. Meanwhile, in emerging and developed markets, managing health care data more effectively through software and big data solutions is a tremendous need. We're already seeing businesses develop innovative models around managing health care data in very profitable ways.

How is consumer spending driving growth in other areas?

Asia's regions have many different growth drivers, but a common thread is consumer spending. In China, for example, as the middle class gets larger and wealthier, consumer patterns are changing. We're seeing more spending in areas such as luxury travel and high-end electronics. Accordingly, we pay close attention to the behavior of consumers in all Asia markets. In our view, investing on the basis of growth in consumer demand is a much better way to capture the growth of Asia because consumers are loyal to certain brands. Buying patterns based on brand loyalty and recognition are more predictable and reliable. While Asia indices tend to be heavily weighted toward older parts of the economy, an active approach to portfolio construction can help investors capture the newer, more consumer-driven growth sectors in Asia.

What are some of the risks associated with investing in growth companies in Asia? How do you manage those risks?

During periods of market volatility, growth stocks can experience larger price swings than value stocks or dividend stocks. Investors should bear in mind general stock market risks when considering any growth strategy. In addition, corporate governance structures can vary widely across some of the markets where we invest, so our research teams closely examines criteria such as company management, board composition and a company's treatment of minority shareholders. And finally, all Asia equities are subject to general macroeconomic risks of the region, which can include currency and political risks.

As Asia investment specialists, we consider these risks very carefully. Employing a bottom-up, fundamental approach to security selection, we believe our research process can help reduce exposure to at least some of these risks. For example, we typically exclude companies with poor or declining corporate governance from consideration for our portfolios. Security selection can also help protect against risks associated with the strength or weakness of an individual company's balance sheets and the competitive position of a company within its industry.

Because we employ an active approach to security selection, our Asia Growth strategy diverges from the benchmark in ways that we believe are meaningful and beneficial for long-term investors. We exclude companies that we believe have poor management and we set a very high bar for profitability and growth. Launched in 2003, the Fund has a well-established track record that investors can review and evaluate how the Fund has performed during different market conditions. We remain committed to helping our clients capture Asia's attractive long-term growth potential through a disciplined, active approach to investing.

What are the advantages of using a team-based approach for managing a growth strategy?

Using a team-based approach means we can draw upon multiple perspectives when making investment decisions. The team for the Matthews Asia Growth Fund includes co-manager Sharat Shroff, as well as highly experienced research analysts. We also occasionally leverage ideas concerning growth stocks with other investment professionals at Matthews Asia, who represent a broad range of Asia-only investment strategies. Each year, we have roughly 2,500 touchpoints throughout the region in the form of company, supplier, customer, regulator and other stakeholder meetings. With a large team that has a strong background in Asia, we are fluent in the region's languages and familiar with its cultures. For the Matthews Asia Growth Fund, we draw upon these insights to identify companies that we believe have healthy and sustainable growth prospects.

Index definitions

The MSCI All Country Asia Pacific Index is a free float-adjusted market capitalization-weighted index of the stock markets of Australia, China, Hong Kong, India, Indonesia, Japan, Malaysia, New Zealand, Philippines, Singapore, South Korea, Taiwan and Thailand.

General definitions

Return on Equity (ROE) is the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested, and is calculated as net income divided by shareholder's equity.

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