# Q&A from Matthews Asia Funds

April 2017

## Matthews Asia Focus Fund

Q **What is the objective of the Fund?**

A The Matthews Asia Focus Fund seeks long-term capital appreciation by investing in companies capable of sustainable growth based on fundamental characteristics. Although the Fund is unconstrained by sector, geographic area or market capitalization, it primarily invests in medium or large-capitalization companies and hold stocks of between 25 to 35 companies.

Q **Why was the Matthews Asia Focus Fund launched?**

A At Matthews Asia, we look to provide investors with strategies across the risk/reward spectrum when we believe there are compelling opportunities in the region.

The extraordinary pace of change, modernization and economic growth within Asia now presents investors with a large pool of established companies that operate across a broad range of sectors and industries. Many of these seasoned businesses have management teams that have delivered sustainable returns on capital to shareholders through varying economic cycles, making them particularly attractive to long-term investors. At Matthews Asia, we believe these quality companies operating in Asia meet the high standards required for inclusion within a high conviction portfolio. We believe that the potential for a high conviction investment approach—commonplace within developed markets—highlights how far the region has developed.

Q **What is driving Asia's growth?**

A There are many drivers to Asia's growth today including, the world's most rapidly growing middle class, technological innovation, increased entrepreneurship and financial and political reform.

We believe the region's prospects for additional economic growth are now more promising than that of the West. China and India, in particular, have emerged in recent decades to become driving forces behind global growth. A lot of this economic growth has been driven not only by increases in factors of production, but also through improving productivity. To gauge an economy's productivity growth and use of its resources, we look at total factor productivity, or TFP. In countries like China and South Korea the average annual growth rate of TFP of 4.2% and 2.3%, respectively, has outpaced that of the U.S. growth of 0.9% over the past decade.

In addition to productivity gains, Asia's middle class is expected to rise markedly. In 2009, Asia marked 28% of the world's total middle class population, and is projected to increase to 54% by 2020 with more than 1.5 billion middle class citizens. By comparison, the anticipated middle class population for both the U.S. and Europe combined is expected to be 32% by 2020. This profound economic transformation in Asia is producing an emerging consumer group that has already become a pillar of global consumption. Rising wages and personal wealth alongside increasing urbanization are continuing to drive consumption of not only physical goods, such as automobiles and property, but also the build-out of social infrastructure like health care and insurance.

Q **What makes a focused approach attractive for investors?**

A The benefits of a concentrated approach have long been advocated by many well-respected investors, including John Maynard Keynes and Warren Buffett. The appeal behind this investment approach is the logic of putting more money to work toward a shorter list of high conviction ideas. These are holdings that have undergone in-depth analysis. Some active management styles may add needless "risk diversifiers" to a portfolio that can result in a long tail of holdings that have had little analysis performed and are therefore of low conviction.

Matthews Asia

We fundamentally believe that a concentrated portfolio can provide strong risk-adjusted returns, and we view our shorter list of holdings as a competitive advantage for our increased ability to understand each company's business, management team and history in greater depth. This may also provide a portfolio considered to have a high "active share," or deviation from a benchmark index, that has been shown to potentially deliver excess returns.[1]

**Q** **What is your approach? What do you look for in a company?**

**A** A bottom-up fundamental investment process is used to manage a portfolio of high conviction ideas. There are approximately 21,000 companies within the broader investment universe. However, this investment universe is reduced considerably to about 750 companies upon screening. Our process begins by first screening companies with at least 10% return on capital, seeking out those that have medium- to long-term operating histories, strong cash flow generation, healthy balance sheets and attractive valuations. We also look for companies with:

- Seasoned high quality management teams with prior track records in creating value for minority shareholders
- Appropriate capital allocation, striking the right balance between reinvestment within the business, dividends, share buybacks, balance sheet strengthening and acquisitions
- Appropriate capital structure, with close attention paid to "real" leverage in the business, including working capital—maintain preference for not combining financial leverage with operating leverage
- Demonstrated strong corporate governance standards, including incentivization and board structures
- Sustainable return on capital through varying economic cycles, identifying competitive advantages that may include brand, distribution, intellectual capital and technology
- Sustainable and attractive medium to long-term growth prospects

Company visits and meetings with management are essential to our process. These meetings help to provide better insight into a company's business model and growth prospects as well as management's thoughts about capital allocation. We place great importance on management's balance between capital return through dividends and buybacks, and reinvestment within their business.

In constructing our portfolio of 25 to 35 holdings, we also consider other inputs including diversification, absolute risk and valuations.

**Q** **Will the Fund invest only in large-cap holdings?**

**A** The Matthews Asia Focus Fund holds a natural bias toward more established firms with seasoned management teams and businesses that, by virtue of these standards, tend to be medium and large-sized companies. But that does not mean that we exclude holdings of other sizes. We may still invest in smaller-sized companies where appropriate if they fit with our investment objective. We focus on only the highest conviction ideas and therefore maintain a high hurdle rate for the initiation of any new position. We seek firms that we believe possess high quality management teams, strong governance standards, sustainable growth and returns, and a history of good capital allocation as well as an appealing valuation relative to intrinsic value.

We are keen to evaluate all of these aspects over time and through various economic cycles, and this may tend to lead us toward those companies with which we have the ability to analyze longer-term operating histories. Naturally, we anticipate that the majority of companies with these longer corporate histories tend to be established players within their own industries and are, therefore, generally larger in size.

**Q** **Do you believe larger, established companies can still deliver attractive returns?**

**A** At Matthews Asia, we believe there is a misconception that only very fast-growing companies can deliver attractive returns. We see a large number of established companies with high quality management teams that can also generate attractive returns. The key is to identify those companies. Given the size of the investment universe, we believe that we can spend more time conducting in depth due diligence on each individual holding and have even greater oversight of the management teams. It also allows more modeling and understanding of corporate structure and governance. We believe this deeper level of research into each company has the potential to deliver information advantage and allow us to identify those companies that are undervalued and over the long-term may deliver strong risk-adjusted returns.

**Q** **What is the rationale for including U.S.-listed and European-listed stocks?**

**A** We intend to invest in those U.S.-listed and European-listed stocks that are expected to generate at least 50% of their revenues, operating profit or earnings from Asia and/or have at least 50% of their assets based in the region. We don't necessarily categorize companies as being from the country in which they are listed, but rather, from the country or countries in which they derive the majority of their economic value. These companies may be U.S.-listed but generate a majority of their earnings stream through Asia and in our view, are providing access to what we set out to find—the long-term domestic growth opportunities which the region provides. As our portfolio is very concentrated we have no obligation or target to hold these companies if they are not suitably attractive relative to other investable opportunities.

**Q** **How do you decide to sell a stock?**

**A** The Matthews Asia Focus Fund intends to be a long-term investor in all positions that are initiated within the portfolio. We typically look to exit existing positions if one or more of the following occurs:

- **Fundamental changes:** A fundamental change in the investment case may arise from a negative change in the operations of a company or through corporate governance issues

1 How Active is Your Fund Manager? A New Measure That Predicts Performance by Martijn Cremers and Antti Petajisto, March 31, 2009

- **Valuations:** The valuation of an existing holding becomes unattractive in relation to its growth prospects and intrinsic value
- **Superior ideas:** As a high conviction portfolio, we generally refrain from reducing position sizes to accommodate new ideas

### Q How do you define risk?

A The Matthews Asia Focus Fund takes an unconstrained, benchmark agnostic approach to portfolio construction, leading to a high "active share" component for the Fund. This means that we focus on risk in absolute terms rather than relative to any benchmark and do not manage to metrics, such as tracking error or information ratios.

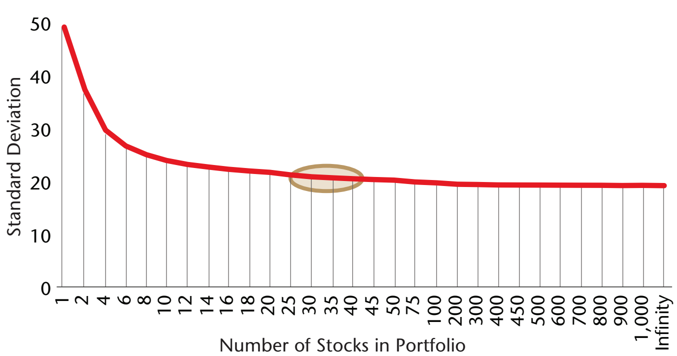
Our primary concern is the risk of loss of capital in securities within which we invest, and the portfolio at large. We believe that by investing in high quality companies with strong and sustainable cash flow generation, tested business models and management teams alongside their alignment with minority shareholders, we lower the business risk for the portfolio. Our high hurdle rates around valuation discipline further aim to minimize the overall value at risk for the portfolio.

### Q Can you expand on your focus on quality and valuation?

A Quality companies in Asia can often be overlooked by investors focused on identifying the latest fast-growing company. This can lead to more established businesses being undervalued despite delivering sustainable returns to shareholders over many years. By conducting in-depth fundamental research, we believe that we can select the most attractive investment opportunities and build a more concentrated portfolio that has the potential to deliver attractive risk-adjusted returns.

The Fund represents the purest expression of Matthews Asia's investment process—deep fundamental company analysis backed by high conviction stock selection and valuation discipline.

**EXPECTED STANDARD DEVIATION OF ANNUAL PORTFOLIO RETURNS**




Sources: Elton and Gruber, *The Journal of Business*, Vol. 50, Issue 4 (Oct. 1977), 415–437; M. Statman, *Journal of Financial and Quantitative Analysis*, Vol. 22, No. 3, (Sept. 1987) ; Stocks in Portfolio from New York and American Stock Exchanges

### Q Do fewer portfolio holdings increase risk?

A Liquidity and volatility are potential risks due to the Fund's concentrated nature, and the Fund may invest a larger portion of its assets in the securities of a single issuer, which may subject the Fund to greater share price volatility. To manage these risks, we maintain a long-term investment horizon and focus on very high quality companies with strong market positions where business risk may be lower. However, we do not believe that fewer portfolio holdings necessarily increase investment risk. Academic research has shown that the majority of diversification benefits in a portfolio levels off dramatically when a portfolio reaches about 25 holdings, assuming there is an appropriate level of diversification across industries.

Additionally, despite the portfolio's concentration, it can remain liquid due to its exposure to predominantly medium and large-sized companies.

We believe that a concentrated portfolio has the potential to deliver attractive risk-adjusted returns and that holding 25 to 35 companies can provide adequate diversification if spread across different geographies and sectors. Further, this imposes a higher level of active oversight and engagement with the management of the companies within which we invest, providing a deeper understanding of their business and mentality toward minority shareholders as we are able to dedicate more time and resources to our analysis.

### Q Alongside business risk and valuation discipline, corporate governance plays a key role in risk management. How do you assess this?

A Corporate governance is essentially the process of minimizing conflicts of interest across stakeholders and to ensure accountability for those who manage the business. The Matthews Asia Focus Fund team seeks to understand whether we, as minority shareholders, are aligned with the senior management of the companies in which we invest.

The majority of the analysis that we undertake in trying to decipher "good" governance from "bad" is qualitative and revolves around five key factors:

- Interest alignment
- Discipline
- Transparency
- Independence
- Sustainability of the business

All of these elements provide an important overlay and oversight toward the quality of businesses in which we invest. While there is no foolproof method to avoid companies that abuse minority shareholders, we believe that our rigorous analysis and high hurdle rate for the quality of a franchise and management team should help to manage the risk for the overall portfolio.

### Q What is Matthews Asia's experience managing a highly concentrated portfolio?

A At Matthews Asia, we believe many of the region's widely used indices are backward looking and not representative of the industries and companies that will

## MATTHEWS ASIA FOCUS FUND

| | Investor Class | Institutional Class |
|---|---|---|
| Ticker | MAFSX | MIFSX |

Inception Date
April 30, 2013

Investment Objective
Long-term capital appreciation

Benchmark
MSCI All Country Asia ex Japan Index

Number of Holdings
25 to 35

Portfolio Managers

**Kenneth Lowe, CFA**
Lead Manager

**S. Joyce Li, CFA**
Co-Manager

**Kenneth Lowe** is a Portfolio Manager at Matthews Asia and manages the firm's Asia Focus and Asian Growth and Income strategies. Prior to joining Matthews Asia in 2010, he was an Investment Manager on the Asia and Global Emerging Market Equities Team at Martin Currie Investment Management in Edinburgh, Scotland. Kenneth received an M.A. in Mathematics and Economics from the University of Glasgow. Kenneth has been a Portfolio Manager of the Matthews Asia Focus Fund since its inception in 2013 and of the Matthews Asian Growth and Income Fund since 2011.

**S. Joyce Li** is a Portfolio Manager at Matthews Asia and co-manages the firm's Asia Focus Strategy. Prior to joining the firm in 2016 as a Senior Research Analyst, she was a Portfolio Manager and Principal at Marvin & Palmer Associates, where she co-managed equity investments in the Asia Pacific markets between 2007 and 2016. Joyce started her investment career as a Senior Investment Associate at Wilmington Trust. Joyce received an M.B.A. with honors from the Wharton School of the University of Pennsylvania and a M.S. in Computer Science from the University of Virginia. She is fluent in Mandarin and Cantonese.

be successful in the future. Our philosophy and approach is centered on taking an active approach to investing and we have been managing high conviction portfolios for over 25 years. While the Matthews Asia Focus Fund invest in a smaller number of companies compared to our other Funds, we believe this strategy is an extension of our current approach to investing. In addition, our experience conducting intensive research on companies gives us the confidence to invest in companies that we believe will perform strongly over the long term.

Q **What are the risks of investing in the Fund?**

A Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation. In addition, the Matthews Asia Focus Fund is a focused fund and may invest a larger portion of its assets in the securities of a single issuer compared to a diversified fund, which may subject the Fund to greater share price volatility.

Q **Why should long-term investors consider this Fund?**

A The Matthews Asia Focus Fund provides investors with an opportunity to gain exposure to high quality companies with the potential to benefit from the fast-growing economies of Asia. We believe that this strategy can be considered a core holding for those long-term investors seeking:

- Regional exposure to Asia
- An active approach that may help to provide risk diversification
- A product focused on absolute risk-adjusted returns

## *Contact Matthews Asia*

To learn more about Matthews Asia or how the Matthews Asia Funds can complement your globally diversified portfolio, please call 800.789.ASIA or visit matthewsasia.com.

## Disclosures and Notes

**You should carefully consider the investment objectives, risks, charges and expenses of the Matthews Asia Funds before making an investment decision. A prospectus or summary prospectus with this and other information about the Funds may be obtained by visiting matthewsasia.com. Please read the prospectus carefully before investing as it explains the risks associated with investing in international and emerging markets.**

Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation. In addition, single-country and sector funds may be subject to a higher degree of market risk than diversified funds because of concentration in a specific industry, sector or geographic location. Fixed income investments are subject to additional risks, including, but not limited to, interest rate, credit and inflations risks. Investing in small- and mid-size companies is more risky than investing in large companies as they may be more volatile and less liquid than large companies.

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