Surviving Chinese Volatility

Matthews Asia | June 2016

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China Faces Many Challenges

- High corporate debt
- High residential property inventories
- ‘Zombie’ state-owned enterprises (SOEs)
- Absence of the rule of law
- Exchange rate management and capital outflows
- Aging population
- Pollution
Causing The Imminent Crisis Some Have Predicted For Many Years?
Or Continuing To Result In Gradually Slower Growth And Volatility?

GDP growth peaked in 2007

Sources: CEIC, Matthews Asia estimates
Recent Noise In The Markets On China

Groups exposed to China hit hardest in market rout

‘It’s Just a Mess’: China Turmoil Leaves Traders Gasping for Air

Chaos in Chinese stock market sends economic waves around the world

The Coming Chinese Crackup

China stock market: the 29 minutes that shook the world

CHINA STOCK MARKET CRASH GOES GLOBAL

Will the stock crash in China take down the US economy?

Mexico warns of China triggering ‘perverse’ currency wars

Markets Routed Again Over China Economy Fears
How Many Pundits Understand the Dominant Role of the Private Sector?

Source: CEIC Data
Or That Chinese Students Aspire to be Entrepreneurs?

**College and Graduate Students Interested in Building Their Own Business**

- **China**: 40.8%
- **Korea**: 6.1%
- **Japan**: 3.8%

Source: Korea International Trade Association
Or that Most Bank Loans go to Private Firms?

STOCK OF BANK LOANS

Share

0%
10%
20%
30%
40%
50%

2006 2007 2008 2009 2010 2011 2012 2013

Private Sector
State-Owned Enterprises
Consumer and Mortgage Loans
Government and Public Institutions

Sources: People’s Bank of China, CEIC, Matthews Asia estimates
China has Been the U.S.’ Fastest Growing Export Market…by Far

Growth rate of U.S. goods exports to its 10 biggest markets, since China joined the WTO in 2001

- China: 618%
- Hong Kong: 155%
- Belgium: 145%
- Mexico: 112%
- Total U.S. Exports: 92%
- Netherlands: 86%
- Total U.S. Exports ex China: 81%
- Germany: 70%
- Canada: 57%
- South Korea: 56%
- U.K.: 36%
- Japan: -4%

During this period, U.S. imports from China rose 354%

Source: CEIC; data for period 2000 to 2015
Understanding China Is Important As It Drives Global Growth

China accounts for about one-third of global growth

CONTRIBUTION TO GLOBAL GROWTH (PERCENTAGE POINTS)

Sources: IMF, World Economic Outlook (April 2014); IMF staff calculations
China’s Debt Problem In Context

REAL ECONOMY DEBT-TO-GDP RATIO, 2Q14

<table>
<thead>
<tr>
<th>Country</th>
<th>Debt-to-GDP Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>400%</td>
</tr>
<tr>
<td>France</td>
<td>280%</td>
</tr>
<tr>
<td>Italy</td>
<td>259%</td>
</tr>
<tr>
<td>U.K.</td>
<td>252%</td>
</tr>
<tr>
<td>U.S.</td>
<td>233%</td>
</tr>
<tr>
<td>Canada</td>
<td>221%</td>
</tr>
<tr>
<td>China</td>
<td>217%</td>
</tr>
<tr>
<td>Germany</td>
<td>188%</td>
</tr>
</tbody>
</table>

Source: McKinsey Global Institute, February 2015
Privately-Owned Firms In Much Better Shape Than State-Owned Enterprises (SOE)

Industrial firms with annual principal business revenue over RMB 20 million (US$ 3 million)

Number of firms

Share of firms losing money (by ownership)

Amount of the loss, RMB million

SOE=State-Owned Enterprise
Source: CEIC
Downstream Industry Very Weak, Upstream Far Better

Profit growth of larger industrial firms by sector

Source: CEIC

Profit Growth of Industry

-80% -60% -40% -20% 0% 20% 40%

Petroleum & Natural Gas Acquisition
Coal Mining & Dressing
Ferrous Metal Mining & Dressing
Agricultural Food Processing
Chemical Material & Product
Wine, Beverage & Refined Tea Manufacturing
Food Manufacturing
Electrical Machinery & Equipment
Medical & Pharmaceutical Product
A State-Owned Enterprise (SOE) Debt Problem

Majority of problem loans were made at the direction of the state, by state-controlled banks to state-owned firms

DEBT-TO-ASSET RATIO BY OWNERSHIP

- SOEs
- Private Firms

Source: Hong Kong Institute for Monetary Research
First Steps Towards Another Round of SOE Restructuring

**JOB REDUCTION BY INDUSTRY IN 2015**

<table>
<thead>
<tr>
<th>Industry</th>
<th>Job Reduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall Industrial Enterprise</td>
<td>-5.8 Million</td>
</tr>
<tr>
<td>Coal Mining</td>
<td>-460,000</td>
</tr>
<tr>
<td>Shipbuilding</td>
<td>-429,000</td>
</tr>
<tr>
<td>Ferrous Metal Smelting &amp; Pressing</td>
<td>-419,000</td>
</tr>
<tr>
<td>Textile</td>
<td>-415,000</td>
</tr>
<tr>
<td>Computer and Communication Equipment</td>
<td>-339,000</td>
</tr>
<tr>
<td>Food Processing</td>
<td>-307,000</td>
</tr>
<tr>
<td>General Equipment</td>
<td>-306,000</td>
</tr>
<tr>
<td>Garment &amp; Apparel</td>
<td>-282,000</td>
</tr>
<tr>
<td>Automobile Manufacturing</td>
<td>-282,000</td>
</tr>
<tr>
<td>Electrical Machinery &amp; Equipment</td>
<td>-281,000</td>
</tr>
</tbody>
</table>

Source: CEIC
A Very Liquid Banking System
Household savings roughly equal to combined GDP of Brazil, India, Russia and Italy

China's Bank Deposits in 2015

GDP

Household Deposits
Deposits on Non-Financial Enterprises
Government Deposits
Deposits of Non-Banking FI*

Brazil
India
Russia
Italy

US$ BN

*FI=Financial Institutions
Sources: CEIC, World Bank
High Savings Rate Helps China Deal With Debt

GROSS SAVINGS AS A % OF GDP IN 2014

<table>
<thead>
<tr>
<th>Country</th>
<th>Savings Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>49%</td>
</tr>
<tr>
<td>Singapore</td>
<td>47%</td>
</tr>
<tr>
<td>South Korea</td>
<td>35%</td>
</tr>
<tr>
<td>India</td>
<td>31%</td>
</tr>
<tr>
<td>Germany</td>
<td>27%</td>
</tr>
<tr>
<td>Australia</td>
<td>24%</td>
</tr>
<tr>
<td>World</td>
<td>23%</td>
</tr>
<tr>
<td>Euro area</td>
<td>23%</td>
</tr>
<tr>
<td>Japan</td>
<td>22%</td>
</tr>
<tr>
<td>United States</td>
<td>18%</td>
</tr>
<tr>
<td>Brazil</td>
<td>16%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>12%</td>
</tr>
<tr>
<td>Ukraine</td>
<td>10%</td>
</tr>
<tr>
<td>Liberia</td>
<td>4%</td>
</tr>
</tbody>
</table>

Source: World Bank
Assessing Exchange Rate Volatility—1
Devaluation of RMB reflects U.S. dollar strength, not RMB weakness

DXY = The U.S. Dollar Index, a geometrically-averaged calculation of six currencies weighted against the U.S. dollar. The U.S. Dollar Index originally was developed by the U.S. Federal Reserve in 1973 to provide an external bilateral trade-weighted average value of the U.S. dollar as it freely floated against global currencies

Assessing Exchange Rate Volatility—2
RMB movement driven by USD movement

EXCHANGE RATE CHANGE OF THE MAJOR CURRENCIES AGAINST USD IN 2015 AND 1Q16

- U.S. Dollar Index
- CFETS RMB index
- Hong Kong Dollar
- Japanese Yen
- Swiss Franc
- Chinese RMB
- Indian Rupee
- British Pound
- South Korean Won
- Singapore Dollar
- Thai Baht
- Indonesian Rupiah
- Euro
- Brazilian Real

Note: The light blue bars represent exchange rate changes for the 1st Quarter 2016. The CFETS (China Foreign Exchange Trade System) RMB Index measures the yuan’s performance against a basket of 13 currencies, published by CFETS. Sources: Bloomberg, China Foreign Exchange Trading Center
Assessing Exchange Rate Volatility—3

No need for currency wars; China’s exports remain competitive

Over the last decade, the RMB appreciated by 49% in real effective terms, yet the Chinese share of total U.S. imports rose to 21.5% from 14.5%

Sources: CEIC, International Monetary Fund, Datastream
No Longer an Export-led Economy

Percentage Points

-6 -4 -2 0 2 4 6 8 10 12 14 16


Final Consumption  Gross Capital Formation  Net Exports of Goods and Services  GDP Growth Rate, YoY (RHS)

Sources: CEIC, Matthews Asia estimates

*Estimates
Capital Outflow vs. Capital Flight

FX reserves US$3.2TN (next highest is Japan, US$1.2TN).

China’s FX reserves increased in March and April after declining for 17 of the prior 20 months

Source: CEIC
China, Too, Has A Rust Belt

Resource extraction and heavy industry concentrated in the northeast
But the rest of the country accounts for 84% of population and 85% of GDP

GROWTH RATES BY PROVINCE FOR GDP AND VALUE-ADDED OF INDUSTRY (VAI) IN 2015

Source: CEIC
Steady Wage Growth Signals a Healthy Job Market

WAGE GROWTH OF UNSKILLED FACTORY WORKERS AND SKILLED MANAGERIAL WORKERS

YoY

*Surveys for the 4Q11 and 1Q12 time periods were not conducted.

Sources: CLSA

*Surveys for the 4Q11 and 1Q12 time periods were not conducted.

Sources: CLSA
China’s Imports: Volume vs. Value
Year-on-Year growth rate of China’s key commodity imports, 1Q2016

Source: CEIC
Rebalancing Means Slower Growth is Inevitable, but Remember the Base

*2020 Matthews Asia Estimate
Source: CEIC
New Home Prices Picking Up Again

Tier 1 cities: include Beijing, Shanghai, Guangzhou and Shenzhen
Tier 2 cities: include provincial capital cities, plus Dalian, Qingdao, Ningbo and Xiamen
Tier 3 cities: all other cities not included in Tier 1 and Tier 2

Source: CLSA
Ghostly, or a Different Business Model?

Photos on left from cbsnews.com. Photos on right by Matthews Asia. Upper right photo taken in same location as upper left. Lower right photo is not the same location as lower left, but is illustrative of traffic conditions observed in Zhengdong in February 2015.
Rebalancing of the Chinese Economy Well Underway
Services and consumption now bigger than manufacturing and construction

SHARE OF GDP BY PRODUCTION APPROACH

Primary industry refers to agriculture, forestry, animal husbandry and fishery and services in support of these industries
Secondary industry refers to mining and quarrying, manufacturing, production and supply of electricity, water and gas, and construction
Tertiary industry refers to all other economic activities not included in the primary or secondary industries, including real estate, finance, wholesale and retail, transportation and other service industries

Source: CEIC
All Net New Job Creation Has Come from Tertiary Sector Since 2012
And Average Wages In Services Are Higher Than In Manufacturing

Average Monthly Wages in 1Q16, RMB

<table>
<thead>
<tr>
<th></th>
<th>Service SMEs</th>
<th>Manufacturing SMEs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unskilled workers</td>
<td>4,100</td>
<td>3,279</td>
</tr>
<tr>
<td>Skilled/managerial workers</td>
<td>6,924</td>
<td>4,758</td>
</tr>
</tbody>
</table>

Share of Total Employment by Industry

SME=Small/Medium Sized Enterprise
Sources: CLSA, CEIC
China is the World’s Best Consumer Story
Real compound annual growth rate of final consumption from 2009 to 2014

- China: 8.7%
- Germany: 1.1%
- United Kingdom: 1.0%
- India: 7.2%
- Japan: 1.3%
- Korea, Rep.: 2.7%
- HK: 5.0%
- Thailand: 3.0%
- United States: 1.6%

Sources: World Bank, International Monetary Fund (IMF) estimates
# The World’s Best Consumption Story

Year-on-Year changes in some consumer categories

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Description</th>
<th>Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>56%</td>
<td>Express parcel deliveries</td>
<td>January-April 2016</td>
</tr>
<tr>
<td>50%</td>
<td>Movie box office revenue</td>
<td>January-March 2016</td>
</tr>
<tr>
<td>50%</td>
<td>Chinese visitor arrivals in Japan</td>
<td>January-April 2016</td>
</tr>
<tr>
<td>46%</td>
<td>SUV sales</td>
<td>January-April 2016</td>
</tr>
<tr>
<td>39%</td>
<td>New home sales</td>
<td>January-April 2016</td>
</tr>
<tr>
<td>35%</td>
<td>Mercedes vehicle sales in China</td>
<td>January-April 2016</td>
</tr>
<tr>
<td>33%</td>
<td>Nike shoe sales in Greater China</td>
<td>Three months ending Feb 2016</td>
</tr>
<tr>
<td>17%</td>
<td>Furniture sales</td>
<td>January-April 2016</td>
</tr>
<tr>
<td>15%</td>
<td>Gasoline consumption</td>
<td>January-February 2016</td>
</tr>
<tr>
<td>11%</td>
<td>Airline passenger traffic</td>
<td>January-April 2016</td>
</tr>
<tr>
<td>10%</td>
<td>Electricity demand, services &amp; consumer sector</td>
<td>January-April 2016</td>
</tr>
<tr>
<td>7%</td>
<td>Ford vehicle sales in China</td>
<td>January-April 2016</td>
</tr>
</tbody>
</table>

As of December 31, 2015, no accounts managed by Matthews Asia held positions in Mercedes, Ford, and Nike

Sources: Japan National Tourist Office; Company Data; CEIC; National Bureau of Statistics of China
Strong Consumer Spending Driven by Strong Income Growth

Real income rose more than 130% over the last decade in China, vs. about 11% in the U.S.

REAL GROWTH RATE OF PER CAPITA HOUSEHOLD INCOME

Sources: CEIC, St. Louis Fed, Germany Federal Statistical Office, UK Office for National Statistics
Consumer Confidence Remains Healthy

Q: MY HOUSEHOLD INCOME WILL SIGNIFICANTLY INCREASE IN THE NEXT 5 YEARS

Percent of respondents who strongly agree or agree

![Bar chart showing consumer confidence in China, U.S., and U.K.](image)

**CHINA**
- 2012: 57%
- 2015: 55%

**U.S.**
- 2011: 32%

**U.K.**
- 2011: 30%

Beijing’s More Serious Mistakes

✖ Putting the Party above the law
✖ Lack of trusted institutions, and inhibiting the development of civil society
✖ Blocking freedom of expression and political dissent
✖ Slow to fix China’s environmental disaster
✖ Overly aggressive approach to neighbors in the South and East China seas
Chinese Equities have Been Extremely Volatile

Since 1994, there have been 32 bear markets in A-shares, vs. two in the S&P 500

SHANGHAI STOCK EXCHANGE COMPOSITE (SHCOMP) INDEX SINCE YEAR 1994

Despite this volatility, over last 20 years, SHCOMP up 537% vs. S&P 500 up 382%

Past performance is no guarantee of future results. It is not possible to invest directly in an index.

Sources: CEIC; Bloomberg
The A-share Market Does Not Reflect the Economy, is Not Widely Held

- 50m active investors in China = 7% of the urban population
- 73% of active accounts have less than US$15,000; less than 1% have more than US$1MN

SHCOMP Index

Real retail sales rose 10.5% YoY in 1H15
New home sales rose 4.5% YoY

Real retail sales rose 10.7% in 2H15
New home sales rose 8.5% YOY

Source: CEIC

It is not possible to invest directly in an index.
Source: CEIC
End of China’s One-Child Policy

Politically important, but no change to demographic trends

Births per Woman

1980: Enforcement of China’s one-child policy

Source: World Bank
No Sign of Significant Stimulus

Growth in total credit outstanding decelerating in line with slower nominal GDP growth

Sources: CEIC, Matthews Asia estimates

TSF=Total Social Financing

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Modest Consumer Price Inflation; PPI Follows Global Commodity Prices

Deflation is not a concern

Sources: CEIC, World Bank
Active vs. Passive for China

Market cap of MSCI China by sector and ownership

The MSCI China Index is a free float–adjusted market capitalization–weighted index of Chinese equities that include China-affiliated corporations and H shares listed on the Hong Kong exchange, and B shares listed on the Shanghai and Shenzhen exchanges. It is not possible to invest directly in an index.

Source: CLSA; data as of November 26, 2014
How We Deal With This at Matthews Asia

Exposure to sectors benefiting from secular trends

China

China Dividend

China Small Companies

Matthews Aggregate Portfolio*

Asia**

- Services
- Consumer
- Health Care
- Finance
- Manufacturing
- Commodities

*Consists of Matthews’ 17 strategies.

**Asia is a market cap weighted universe as defined by FactSet’s geographic classification.

Sector exposures of largest account in each strategy.

Sources: FactSet Research Systems, Matthews Asia; Data as of March 31, 2016
Andy Rothman is an Investment Strategist at Matthews Asia. He is principally responsible for developing research focused on China’s ongoing economic and political developments while also complementing the broader investment team with in-depth analysis on Asia. In addition, Andy plays a key role in communicating to clients and the media the firm’s perspectives and latest insights into China and the greater Asia region. Prior to joining Matthews in 2014, Andy spent 14 years as CLSA’s China macroeconomic strategist where he conducted analysis into China and delivered his insights to their clients. Previously, Andy spent 17 years in the U.S. Foreign Service, with a diplomatic career focused on China, including as head of the macroeconomics and domestic policy office of the U.S. embassy in Beijing. In total, Andy has lived and worked in China for more than 20 years. He earned an M.A. in public administration from the Lyndon B. Johnson School of Public Affairs and a B.A. from Colgate University. He is a proficient Mandarin speaker.
Index Definitions

The MSCI China Index is a free float–adjusted market capitalization–weighted index of Chinese equities that include China-affiliated corporations and H shares listed on the Hong Kong exchange, and B shares listed on the Shanghai and Shenzhen exchanges.

The MSCI Japan Index is a free float–adjusted market capitalization–weighted index of Japanese equities listed in Japan.

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

The S&P Bombay Stock Exchange 100 (S&P BSE 100) Index is a free float–adjusted market capitalization–weighted index of 100 stocks listed on the Bombay Stock Exchange.

The S&P 500 Index is a broad market-weighted index dominated by blue-chip stocks in the U.S.

The NASDAQ Composite Index is a market-capitalization weighted index of the more than 3,000 common equities listed on the Nasdaq stock exchange.

The FTSE 250 Index is a capitalization weighted index consisting of the 101st to the 350th largest companies listed on the London Stock Exchange.

The Shanghai Composite Index (SHCOMP) is a capitalization-weighted index that tracks the daily performance of all A-shares and B-shares listed on the Shanghai Stock Exchange.

The U.S. Dollar Index is a measure of the value of the U.S. dollar relative to majority of its most significant trading partners.

It is not possible to invest directly in an index.
Contact Us

To learn more about Matthews Asia or how our strategies can complement globally diversified portfolios, please contact the Matthews Asia Client Services Team.

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Glossary

CAGR (Compound Annual Growth Rate) is the year-over-year growth rate of an investment over a specified period of time.

DCF (Discounted Cash Flow) is a valuation method used to estimate the attractiveness of an investment opportunity. DCF analysis uses future free cash flow projections and discounts them to arrive at a present value estimate, which is used to evaluate the potential for investment.

EBIT Margin (Earnings Before Interest and Taxation Margin) is a profitability measure equal to EBIT divided by net revenue. This value is useful when comparing multiple companies, especially within a given industry, and also helps evaluate how a company has grown over time.

EBITDA (Earnings Before Interest and Taxation, Depreciation and Amortization) is a measure of a company’s earnings before considering the financing of that company (the share of equity capital and debt employed), and disregarding potential depreciation and amortization policies, which can be very different. EBITDA allows like-for-like comparisons between different companies’ performance.

EPS (Earnings per Share) is the amount of annual profit (after tax and all other expenses) attributable to each share in a company. EPS is calculated by dividing profit by the average number of shares on issue.

EVA (Economic Value Added) is a measure of a company’s financial performance based on the residual wealth calculated by deducting cost of capital from its operating profit (adjusted for taxes on a cash basis).

EV/EBITDA (Enterprise Multiple) is a ratio used to determine the value of a company. The enterprise multiple looks at a firm as a potential acquirer would, because it takes debt into account - an item which other multiples like the P/E ratio do not include.

EV (Enterprise Value) is a measure of a company’s value, often used as an alternative to straightforward market capitalization. Enterprise value is calculated as market cap plus debt, minority interest and preferred shares, minus total cash and cash equivalents.

FCF (Free Cash Flow) is a measure of financial performance calculated as operating cash flow minus capital expenditures. Free cash flow (FCF) represents the cash that a company is able to generate after laying out the money required to maintain or expand its asset base.

Forward P/E (Forward Price to Earnings) is a measure of the price-to-earnings ratio (P/E) using forecasted earnings for the P/E calculation. While the earnings used are just an estimate and are not as reliable as current earnings data, there still may be benefit in estimated P/E analysis. The forecasted earnings used in the formula can either be for the next 12 months or for the next full-year fiscal period.

Gross Margin is a company’s total sales revenue minus its cost of goods sold, divided by the total sales revenue, expressed as a percentage. The gross margin represents the percent of total sales revenue that the company retains after incurring the direct costs associated with producing the goods and services sold by a company.

Net Margin is the ratio of net profits to revenues for a company or business segment—typically expressed as a percentage—that shows how much of each dollar earned by the company is translated into profits. It is calculated by dividing net profit by revenue.

Operating Margin is a ratio used to measure a company’s pricing strategy and operating efficiency. Operating margin is a measurement of what proportion of a company’s revenue is left over after paying for variable costs of production.

P/E Ratio (Price-to-Earnings Ratio) is a valuation ratio of a company’s current share price compared to its per-share earnings, calculated as marketing value per share divided by earnings per share (EPS).

P/B Ratio (Price-to-Book Ratio) is used to compare a stock’s market value to its book value. It is calculated by dividing the current closing price of the stock by the latest quarter’s book value per share. A lower P/B ratio could mean that the stock is undervalued.

PPP (Purchasing Power Parity) is an economic theory that estimates the amount of adjustment needed on the exchange rate between countries in order for the exchange to be equivalent to each currency’s purchasing power.

ROE (Return on Equity) 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.

ROIC (Return on Invested Capital) is a calculation used to assess a company’s efficiency at allocating the capital under its control to profitable investments. The return on invested capital measure gives a sense of how well a company is using its money to generate returns.