MATTHEWS INTERNATIONAL CAPITAL MANAGEMENT, LLC

ASIANOW

ISSUE 1
2004

THE CONTEXT ISSUE

Asia Demystified

It's Time for Investors to Blow Away Asia's Cloud of Exoticism and Look at the Numbers Beneath

The mysteries of the Orient have laid claim to Western imaginations since at least the 1880s, when an English entrepreneur constructed an entire five-block Japanese village—complete with 100 actual Japanese people—in the middle of London, and *The Mikado* premiered to rave reviews. But while this embrace of Asian exoticism may have enriched Western culture, it hasn't done a lot for investors. Accuracy and precision are critical to intelligent investing, but they are death to the mysterious, which depends on dim lighting and veiled views. Captivated by Asia's mysteries, investors have tended to shy away from subjecting the region to the kind of mystery-killing analysis that we routinely apply to investment opportunities in Europe and the U.S.

Given the performance of Asia's markets over the past 12 months or so, "buying Asia" has started to look very exciting to some investors, but this excitement can be dangerous, particularly when coupled with the urge to give the region an intellectual free pass.

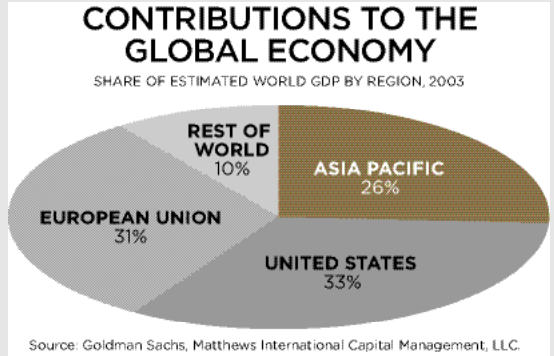
ALSO IN THIS ISSUE

ILLUSTRATION BY BRAD YEO

HOW ASIA STACKS UP:

The Asia Pacific Region vs. the Rest of the World

HISTORICAL PERSPECTIVE:
It may be popular to think of Asia as a region that is "emerging" economically, but according to *The World Economy: A Millennial Perspective*, by Angus Maddison, until the mid-19th century the region represented more than half the world's wealth. Meanwhile, the United States—that upstart nation—represented less than 10%, on average, until well after the Civil War.



Matthews International Capital Management, LLC, doesn't want to dispel the excitement; we've been excited about investing in Asia for a very long time. But the excitement should be linked to a clear-headed assessment of how Asia stacks up relative to the rest of the world. What follows is our attempt to offer some basic information.

That the Asia Pacific region has an enormous population comes as no surprise. The region includes not only the world's most populous countries—India and China—but also the substantial populations of Indonesia, Pakistan, and Japan. All told, there are nearly three billion people in the Asia Pacific region, representing 47% of the world's population. Europe, by contrast, has just 6% of the global population, and the U.S. only 5%.

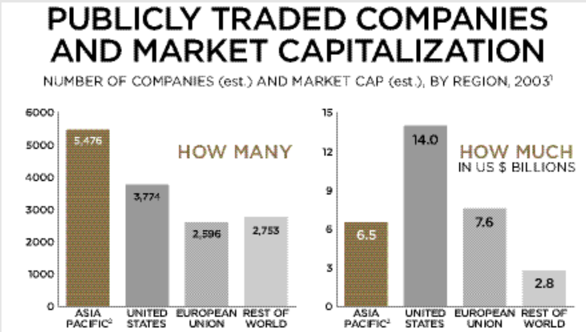
THE ASIA PACIFIC REGION REPRESENTS NEARLY HALF THE WORLD'S POPULATION, WHILE EUROPE AND THE U.S. TOGETHER ACCOUNT FOR JUST 11%.

The picture comes back into balance when one looks at the world's economies in terms of gross domestic product (GDP), the value of all goods and services the planet produces in a single year. As indicated in the chart above, Europe and the U.S. each represents about one-third of the world's GDP, while the Asia Pacific region accounts for slightly more than one-quarter. Despite its recent history of economic stagnation, Japan remains the dominant economy in Asia, making up 51% of the region's total.

Looking at global trade—who sells how much of what to whom?—presents another interesting snapshot. As might be expected, the Asia Pacific region is a very significant exporter—the East Asian nations in particular have a long history of exporting their way out of economic difficulty. What may be surprising is that Europe is the world's clear winner in terms of total amount exported, providing 39% of global exports in 2002, compared with 26% for the Asia Pacific region and a scant 12% for the U.S.

Now, trade statistics are notoriously tricky. For instance, the U.S. excels at selling services (like banking or money-management) and media opportunities (like the right to distribute *Lord of the Rings: The Return of the King*), but these may not be reflected in export figures. Furthermore, as detailed in the Fall 2003 issue of *AsiaNow* (available at www.matthewsfunds.com), a country may consume the goods it imports...or transform them into new exports, as often occurs in today's Asian economies. Nevertheless, there seems little question that Asia produces an impressive amount of stuff that other regions want to buy.

But can investors really put their savings to



[1]Includes only those companies with a market capitalization in excess of US $100 million.
[2]Asia Pacific data includes Chinese A Shares. Sources: Bloomberg & Matthews International Capital Management, LLC.

Source: HSBC, World Trade Organization. Data as of 12/31/02

work in the region? In the investment world, it's typical to look at markets in terms of both the number of publicly traded companies and the market capitalization of those companies (the total number of the companies' shares outstanding, multiplied by their current price). However, the markets of the Asia Pacific region include vast numbers of tiny companies, the equivalent of your local grocery store having gone public.

There are several reasons for this. First, Asian economies have tended to rely on bank financing rather than on the securities markets; even today, Asian companies needing money to expand are more likely to borrow from a bank than to issue shares. Second, Asian companies tend to be particularly "closely held," meaning that the founder's family members will typically control the vast majority of shares outstanding, and they're not looking to sell. Finally, until Asia's 1997-98 financial crisis forced the region to do everything but hand out ice cream in an effort to attract investors, it was very tough for foreigners to buy into the region, with countries such as Taiwan and South Korea imposing strict limitations on foreign ownership.

The combination of Asia's vast list of publicly traded companies (see chart above) and their midget market-cap may be somewhat daunting: Who wants to buy into 5,000 corner grocery stores? But that bloated list is also indicative of the region's extraordinary diversity—and diversity is Asia Pacific's chief calling card. For instance, while much of the region remains sadly underdeveloped economically, some areas are among the richest in the world. And there is a parallel range of financial maturity, from the very well developed, such as Singapore, to the all-but-experimental financial system of Vietnam.

To a certain extent, this diversity of conditions has helped dispel some of the "mysterious Asia" mentality, prompting some investors to focus exclusively on individual countries such as China or South Korea. However, that narrow focus is of little more use than the fuzzy passion for Orientalism: Neither gives a really useful picture of the region. In our view, Asia—rather like the U.S.—is both a single region *and* a group of highly diverse and individual nations/states. Analyzing Asia on both of these levels at once is something of a balancing act, but we believe it is necessary for developing anything like a clear understanding of the region. And it's that clarity that forms the basis of intelligent investing.

Sources: Goldman Sachs, U.S. Census Bureau, Asian Development Bank, World Bank, Bloomberg, Matthews International Capital Management, LLC

MORE ONLINE: a detailed presentation of the Asia Pacific region in a global context is online at: www.matthewsfunds.com/asianow/context

Unchartered Waters

Partners for More than a Century, Will Hong Kong and China Continue to Sail in Tandem?

"[HONG KONG IS] A BARREN ROCK WITH NARY A HOUSE UPON IT! IT WILL NEVER BE A MART FOR TRADE."

—LORD PALMERSTON, BRITISH FOREIGN SECRETARY, 1841

After years of confinement to Americans' back-burner, China is attracting great investment attention, thanks primarily to its growth rates, which are tearing up the charts. Over the past decade or so, the Chinese economy has grown by roughly 8% per year—and that's if you accept the government's official numbers. (Many China-watchers believe these to be inflated, but others think the growth-rate would be even higher if the "unofficial" economy, whose activities go effectively unreported, were factored in.) Despite the hoopla, however, in global terms, China's economic output remains relatively modest. For instance, in 2003 China accounted for just over 4% of global GDP. And spreading that economic output among China's 1.3 billion citizens yields a per capita GDP of barely $1,000—compared with $13,000 per person in Taiwan, for example, or $27,000 in Singapore.

But of course, the mainland isn't all there is to China. Hong Kong, China's "special administrative region," may have a population of just 7 million, but those citizens enjoy a healthy per capita GDP of approximately $21,000—about on par with Spain. Ironically, wealthy Hong Kong has traditionally owed its economic blessings to its proximity to vast, comparatively impoverished China. China's citizens may be poor, but there are an awful lot of them, and merchants—from Europe, Asia, the U.S., the Middle East—have been angling for an entrée into that enormous market for more than a thousand years. Since the mid-19th century, Hong Kong has served as just that entry point, growing rich off its role as gatekeeper. But as the Chinese economy has exploded—in relative terms—over the past several years, the mainland has simultaneously rushed to develop its own means of welcoming the foreign investors and businesses that have for so long been served by Hong Kong. We're not usually in the prediction business, but with China opening to the world, it seems important to ask what Hong Kong's role is likely to be, going forward.

Answering that question is tricky, not least because China's newfound welcome mat and Hong Kong's transfer back to Chinese sovereignty are both such recent developments. With that in mind, it may be helpful to look at the longer-term history of relations among Hong Kong, mainland China, and the global economy.

In 1842—when Great Britain's victory in the first Opium War forced the Chinese to cede formal control of Hong Kong—the balance of world economic powers looked very different from its contemporary line-up. Queen Victoria had for five years been sitting plumply on the English throne, ruling over an empire on which the sun never set. The world's three dominant powers were the great trading nations of Europe (including Germany, Russia, France and England), India (effectively controlled by the British), and China, which was an economic superpower despite having been isolated, for centuries, from the trading networks of the West. Indeed, its GDP in 1842 represented roughly 25% of the entire global output—a percentage that had held steady for some 800 years. Meanwhile, the U.S. represented just 5% of the world's wealth, and Hong Kong's contribution was too minuscule to count.

Nobody would have forecast it at the time, but over the next century and a half, the U.S. economy would roar ahead, while China's would stagnate. (By just 1870, China—paralyzed by staggering levels of opium addiction and layers of official corruption, and widely known as the "sick man of Asia"—would see its economic significance cut nearly in half, to a mere 17% of the global economy.) And Hong Kong? That "barren rock" of Lord Palmerston's infamous description would become one of the world's great trading hubs.

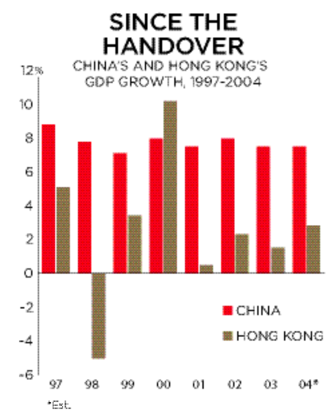
Much of the greatness was rooted in Hong Kong's large, well sheltered, deep-water harbor. The harbor had traditionally been of little interest to the Chinese Emperors, who placed a *very* low priority on trade, but it had helped make Hong Kong a popular way-station for pirates. After 1842, however, that same harbor—particularly in combination with strong, British-style administration and minimal intrusion from the government—would turn Hong Kong into a spectacular port facility, both for traders seeking access to the mainland's markets and for those exporting China's silks, tea, and other goods. Over time, Hong Kong became the primary entrepot not only for China, but for much of Asia as well.

By the time of Hong Kong's "handover"—return to Chinese sovereignty—in 1997, the barren rock had been transformed into a world-class city state, adored by entrepreneurs as one of the most profoundly capitalist economies on the planet. On a per capita basis, it was significantly wealthier than the UK, and a stunning 35 times wealthier than mainland China. But Hong Kong's citizens were not resting easy; the years leading up to the handover were marked by widespread fear that Chinese control would spell an end to the freedoms that had for more than 150 years made Hong Kong a businessperson's paradise.

Today, seven years after the handover, many of those fears have been alleviated, but the future of Hong Kong remains a subject of much debate. That splendid harbor is no longer enough to ensure the island's future, if only because mainland China's own deep-water ports are already providing strong competition. However, Hong Kong continues to enjoy three important advantages over the mainland: a free press, a convertible currency, and a well administered legal system.

Why are these so critical? Without a solid rule of law, companies have little incentive to deal honestly with their investors, and without a free

FITS AND STARTS



FACE OFF: Since it was handed back to China in 1997, Hong Kong has experienced volitile swings in its rate of economic growth. Looking with a longer historical perspective, though, it has had much more consistant growth than mainland China, which has seen its share of the global GDP shrink from about 25% in the mid-19th century to little more than 4% in 2003.

press, investors have little way of knowing when their trust is being abused. Finally, in the absence of a freely convertible currency, it is all but impossible to determine how a given investment compares to similar opportunities elsewhere in the world. Accurate information is the lifeblood of an investment community, and at present, Hong Kong is better placed than the mainland to deliver the goods. It is to be hoped that China will, at some point, be able to match Hong Kong's advantages, allowing its currency to float, and giving its press free reign. But until that day arrives, we believe that Hong Kong will remain the financial gateway to the mainland, both contributing to China's growth and profiting from it. Over the years, China and "the barren rock" have developed an elegant symbiosis, and we expect it to continue for many years to come.

Sources: JP Morgan, Goldman Sachs; CIA World Factbook, , Matthews International Capital Management, LLC

JAPAN & CHINA Economics Over History

Locked in Eternal Conflict, Can They Learn to Collaborate?

China and Japan have been at loggerheads for centuries, wrestling for dominance of the Asia-Pacific region since at least the 1400s, when China's abrupt shift into isolationism left the way clear for Japan to grab leadership of regional trade. Japan's brutal occupation of China in the 1930s, its subsequent emergence as an economic powerhouse (even as China was sinking ever deeper into a political and economic black hole), China's staggering growth over the past decade (even as Japan was sliding into all-but-permanent recession)…all of these have contributed to the belief that Japan can thrive only at China's expense, and vice versa. It's as though the two countries were characters out of classical mythology—twin gods, perhaps, eternally battling for control of the sky.

Moving beyond that myth will not be easy for either country, if only because history has left a lot of scar tissue. As recently as 2002, surveys revealed that more than half of all Japanese citizens "did not trust China," while 43% of Chinese citizens "felt unfriendly" toward Japan, thanks in large part to still deeply bitter memories of WWII. Only last year a Chinese-Japanese joint venture had to scrap its plans to go public when China's websites exploded with the news that the company's name could be interpreted as a reference to Hirohito, Japan's wartime Emperor. ("We have apologized more than 20 times [for our conduct during the war]," snapped one Japanese official, "and we are not going to apologize again.")

Despite the rancor, there are indications that China especially is taking some steps back from the epic antagonism that has for so long defined relations betweeen the two countries. Last September, for instance, in a speech in Japan, the chair of China's National People's Congress promised that relations between the two countries would "be dominated by cooperation, rather than competition." This thaw may owe something to the fact that both President Hu Jintao of China and Japanese Prime Minister Junchiro Kozumi were born in 1942, making them effectively the countries' first post-war leaders. With no personal memories of that particularly hideous period, they are well placed to launch the long march toward a scenario in which economics trump history.

But well placed or not, they don't have a lot of choice. For instance, Japan needs to start taking more advantage of China's low-cost production facilities: In 2001 there were 712 Japanese-owned factories in China...compared with 50,000 owned by companies headquartered in Taiwan. Says Andy Rothman, an economist with Credit Lyonnais Securities Asia: "If Japanese companies want to sell into China—which they do—they're going to have to produce in China, because otherwise their goods won't be competitively priced."

Nor can China afford to maintain a chilly distance. Already the largest market for Japanese goods, China has also become the world's largest supplier of exports to Japan: The two markets are critical to one another. Shipments to China represented 70% of Japan's export growth last year, as Japanese exports to the U.S. were dropping by 10%. Indeed, exports to the U.S. are fueling much of Japan's current resentment of China, which has surpassed Japan to become the world's second-largest exporter to the U.S., after Canada.

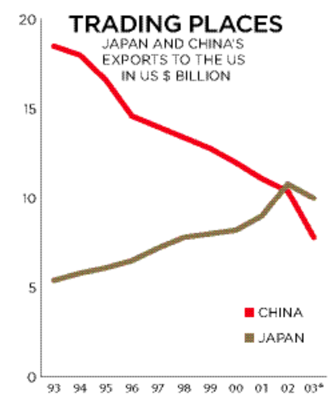
But while Japan may fume that China is swiping its market share, the sense of ferocious competition may owe more to that myth of Japan's eternal battle with China than it does to reality. According to one study, for example, of the $250 billion worth of goods that Japan and China together exported to the U.S. in 2000, only 16% represented goods that both countries were selling. In terms of the global market, only 18% of Japan's exports compete with China's; by contrast, 70% of Thailand's exports are up against the Chinese juggernaut.

To some extent, Japan appears to be getting the message. One-third of Japanese direct investment into Asia now heads for mainland China, up from 17% in 2000. And, says a senior researcher at a Japanese government-funded think tank: "We are beginning to see an end to the so-called 'China syndrome,' the perception that China is a threat to Japan." That perception can't die fast enough. China and Japan together represent nearly 80% of East Asia's GDP. The economic health of the entire region may depend on killing off the myth that the two nations are doomed to everlasting enmity—replacing it perhaps with a myth of twin gods who share the sky. That won't be easy, as entrenched habits of thought are hard to change. But pragmatism may be gaining the upper hand.

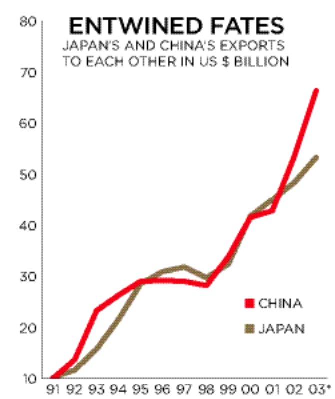
"ECONOMIC INTEGRATION WITH CHINA IS IRRESISTIBLY MOVING FORWARD."

—TOSHIYA TSUGAMI,
SENIOR FELLOW OF JAPAN'S GOVERNMENT-FUNDED RESEARCH INSTITUTE OF ECONOMY, TRADE, AND INDUSTRY, 2003

RIVALS... AND PARTNERS



*2003 data is Jan.-Nov.



*2003 data is Jan.-Nov.

Source: CLSA, Matthews International Capital Management, LLC

INFO/PAGE Asia's Economic Diversity

	THE WEALTHY			THE STRIVING		
	JAPAN	SINGAPORE	HONG KONG	CHINA	INDONESIA	INDIA
NUMBER OF LISTED STOCKS[1]	1,899	138	267	1,349[5]	71	276
MARKET CAP (US $ BILLION)[1]	$3,093	$141	$359	$995[5]	$49	$255
ESTIMATED POPULATION (IN MILLIONS)[2]	127	3[6]	7	1,287	235	1,050
PER CAPITA GDP (US $)[3]	$33,816	$26,941	$21,449	$1,096	$862	$575
TV OWNERSHIP[4]	73%	30%	50%	31%	15%	8%
PC OWNERSHIP[4]	35%	51%	39%	2%	1%	1%

[1]**Includes only those companies with a market capitalization in excess of US $100 million**, 2003(est.). Sources: Bloomberg and Matthews International Capital Management, LLC. [2]Source: U.S. Census Bureau, 2003(est.). [3]Source: Matthews International Capital Management, LLC, 2003(est.). [4]Source: World Bank, as of 2001. [5]**Includes Chinese A shares**. Source: Bloomberg and Matthews International Capital Management, LLC. [6]Source: Goldman Sachs, 2003(est.).

The "mysterious Asia" mindset rests, in part, on the assumption that Asia is essentially one large, homogeneous mass—that what is true for Singapore, for example, is equally true of, say, mainland China. As illustrated in the table above, this assumption has little basis in reality, at least from an economic standpoint. For example, India's per capita GDP is just 17% of the per capita GDP in Japan. And while, as of 2001, only 1% of Indonesia's citizens owned personal computers, more than half of all Singaporeans packed their own PCs.

ASIANOW IS A SERIES OF SPECIAL REPORTS PRODUCED FOR THE SHAREHOLDERS OF MATTHEWS ASIAN FUNDS.

TO RECEIVE FUTURE ISSUES, PLEASE SIGN UP ONLINE AT WWW.MATTHEWSFUNDS.COM OR CALL 800-789-ASIA [2742]

Investing in foreign securities may involve certain additional risks, including exchange-rate fluctuations, less liquidity, greater volatility and less regulation. Single-country and sector funds may be subject to a higher degree of market risk than diversified funds because of concentrationina specific sector or geographicreg ion.

MATAN0304V1