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Twenty Years of Investing in Asia

Paul Matthews and Mark Headley first met in 1991, the year Paul founded Matthews. Two years later, they became better acquainted during a trip to Shanghai when the now bustling financial and commercial hub of Pudong was "basically still fields and warehouses." In 1995, Mark joined Matthews International Capital Management, LLC as Managing Director, and the two have worked closely ever since.

This month *Asia Insight* speaks with Paul Matthews and Mark Headley to get their thoughts on 20 years of investing in Asia. (In some cases their answers were given jointly during our conversation.)

- **Paul Matthews**, Director and Portfolio Manager
- **Mark Headley**, Chairman and Portfolio Manager

Why were you so convinced of Asia's growth prospects at a time when few others were?

Paul: As a young businessman trying to build an asset management firm focused on Asia ex Japan, the challenge for me was that Japan was 95% of the investment universe and also a majority of the market for asset gathering. The trend was for asset managers to move operations from Hong Kong to Tokyo. While based in Hong Kong, I was given the task of looking for ways to build the business and so I was attracted to the markets that were open and growing. At the time this meant: Hong Kong, Singapore, Taiwan and South Korea. Thailand and the Philippines were also available but they were pretty small and already considered highly volatile then. So my experiences from 1983 onward made me realize that the dynamics that allowed these relatively small countries to evolve were directly applicable to mainland China. That potential was what was behind the level of my conviction in 1991. It wasn't that I thought we could buy and sell Chinese securities and was convinced that that would be the best stock market in the world. It was more the thought that, wow, if China does just one-tenth of the things that these other smaller countries have done, it could enjoy enormous success for many, many years.

Mark, why did you join Paul at Matthews?

Mark: I had an opportunity to work with a number of seasoned veterans of Asian markets in the early part of my career. But when I ran into Paul, I found somebody who not only had that kind of experience, but also had a deep conviction that China was the core story for long-term Asian development, which was very rare, particularly in the British asset management community during the run up to the 1997 handover of Hong Kong back to mainland China. I also admired that Paul was someone who had real business integrity. To find somebody who had a very clear and ethical grounding was, frankly, what brought me back to Asian asset management after I had left in mid-1993.

Matthews has come a long way. What were the biggest challenges in founding the firm?

Paul: Raising the first US$100 million! And getting to critical mass in the face of the Asian Financial Crisis of 1997 and 1998 were probably the greatest challenges.

Mark: We had the sense that we were tremendously fortunate to have survived the Asian crisis as a small asset management firm when many comparable firms had failed. That was a huge hurdle. As we gained momentum out of the crisis, the opportunities for us were significantly greater. While many still had a negative outlook on Asia, if you did have a positive outlook, there were very few investment vehicles in the U.S. that offered access to Asia. I always thought of it as one of those periods of evolutionary extinction where suddenly the dinosaurs are gone, and the little rodents are running around with a lot of food to eat.

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Why has this partnership between you two worked so well?

Paul: Well, clearly, Mark is much more outgoing and, in that sense, is a much better communicator than I will ever be. As the primary communicator for the company, he has always been tremendous. But there are lots of other things. He also has great conviction about decisions, whether they be investment decisions or business decisions.

I think the two of us are willing to try to think outside the box. At the same time both of us have a long history of involvement in the U.S. mutual fund industry and with a very specific singular, long-term focus on Asia, pre-dating our partnership by at least a good five years. So I think our shared focus has been key. There are probably only a handful of people in the country who have dedicated their careers to investing in Asia for commingled vehicles. We've got two of them in the office and have had for 20 years. I think that's what's unique about us.

Mark: I always defer to Paul's investment principles and he has frequently deferred to my business decisions so there was a very broad division that worked for us.

If you had to do it all over again, would you still base Matthews in San Francisco?

Paul: Definitely. I started my career in the U.K., which had a very competitive international mutual fund industry, with dozens of firms focused on international investment, generally, and Asian investment, specifically. Having had the pleasure of living and working here in the U.S., I realized that the universe here was different and found that there wasn't such a plethora of competition and that the regulatory environment also allowed for us to build what we envisioned.

Mark: It's very analogous to the long-term asset managers who don't work on Wall Street because Wall Street is a "group think." And I think, similarly, we have watched our friends in Hong Kong get extremely emotionally volatile during every crisis just because of the environment they were in. Whether it was wildly negative about China or wildly positive, we've always appreciated having the distance to come back and reflect. Paul always says you shouldn't make an investment decision while you're on a trip. You should come back and think about it a bit before you push the button. There's absolutely the sensibility that you have to be there on the ground but the notion that when you come back to your office, that the office has to sit in Asia is ridiculous. San Francisco is a great neutral ground to observe Asia from.

What misconceptions do people have of Asia?

Mark: People have tended to view Asia as homogenous culturally, and the gross over-simplification of Asia as an asset class has been frustrating. Probably one of my biggest takeaways from working in Asia for a couple decades now is that even the notion that China is homogenous is ridiculous. There's enormous diversity within China or even Japan—Osaka versus Tokyo.

China is like what the European Union will be 200 years from now—a very large, very diverse entity with a lot of local flavor that has, in theory, morphed into a single country-like creature. This is, of course, why the Chinese national government is so insecure about its borders because they recognize that in the past China has broken up into many sub-settings.

People underestimate the diversity and tend to think Asia is "a good investment" or Asia is "a bad investment" and that is just like saying the S&P is a good investment or bad investment, and it ignores the various sectors and the many underlying currents.

I spent a decade with very smart people in the U.S. telling me that if Japan did not recover, it was a foregone conclusion that investing in the rest of the region would be a terrible mistake. They could not separate Japan's economic momentum from the rest of Asia. Most of these people had not been to Asia before and could not imagine the internal dynamics taking place in countries like Korea, for example, or the city states (Hong Kong and Singapore). In the last five years or so, I do think that investors have started to approach Asia with a much more nuanced view, as they have with the U.S. market. But I think that taking on the complexities of Asia is enormously daunting to most American investment professionals, considering the lack of a common

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currency and the multiple political and regulatory systems. The fragmented nature of the environment is inherently challenging.

What have been your biggest lessons learned?

Paul: It was probably a profound recognition of our own fallibility coming from the Asian Financial Crisis. We've always maintained a healthier balance sheet than we might have had we not experienced that period. It's given us a built-in caution against getting carried away by the short-term trends on the upside of markets.

Mark: There was something that Paul emphasized during those very, very tough years. And that was that if we did a good job with the portfolios, it would all work out. And that focus helped us.

Staying fully invested was another big lesson from this period. And maintaining the general belief that the day you thought you needed to be 20% in cash was the day you would destroy your long-term track record by being 20% in cash.

I'll never forget August 1998, during the crisis, when we looked around to see if there was a single buy, or even hold, recommendation for Korean banks and there was none. We made a conscious decision that given that everyone in the world—including every Korean banking analyst—seemed to have given up on Korean banking, that there just had to be an opportunity there. That didn't mean that they wouldn't go lower but with a three to five-year outlook, we felt it had to be a good time to buy the banks. So I think that sense of being willing to go against the grain was then strongly instilled.

Paul: Another thing to come out of this was that it validated the concept of offering less volatile products in highly volatile markets. Prior to that experience people didn't really think that they wanted that type of product. But as a way to participate after a crisis they realized the value of participating in a product that might not go down 80% if they were wrong.

Mark: I certainly learned from managing the Pacific Tiger strategy during the crisis that the pain of losing a great deal of money is greater than the joy of making a great deal of money.

What has been the most unexpected development in Asia?

Paul/Mark: That Japan would not participate right alongside with Asia's growth—although it seems it is starting to. The first decade of stagnation seemed to make sense but the second "lost" decade seems "self-inflicted." The unwillingness of Japan to shift with changes in certain areas has led it to endure a certain pain, and we think the new generation is going to be very cognizant of that and of the mistakes of the past generation. Hopefully, they will start correcting these mistakes because Japan has tremendous potential to grow as long as it embraces the rest of Asia much more profoundly than it has.

What investment opportunities do you feel you missed?

Paul: One of the things we failed to take advantage of was the impact Asia's growth would have on the long-term demand for commodities from countries like Australia. We thought about the rise of the middle class, and in that way we thought about the need for diapers and lattes and housing. But we considered and still consider commodities to be quite cyclical. However, we missed some longer-term impacts, for example, that iron ore would be in great demand due to increased construction and increases in the production of basic goods.

Looking back what are you most proud of that Matthews has created?

Paul: The investor experience. I would hope that it has generally been pretty positive. Obviously some of our early clients went through periods of wild fluctuations in valuations. But if they had held on long-term I would think that they could have done quite well relative to the rest of their portfolio. We believe that if we can say the same thing in 20 year's time, we'd have a really successful company.

Mark: We managed to create a company that offers investment vehicles that matched what happened in Asia pretty well. And that was a very organic process and our strategies have all evolved.

What differentiates Matthews the most from others?

Mark: Our singular focus on Asia. And also, I think that having an investment team that covers such a broad array

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of approaches all in one office, working together, both intensively in subgroups yet still as an overall investment team, is pretty unusual. I continue to believe that the synergies of having disciplines that are both growth-oriented or dividend-oriented, or value-slanted or fixed income-focused are all beneficial as a team.

What are your thoughts on countries we tend to hear less about, such as North Korea, or "frontier" nations, such as Vietnam, Sri Lanka and Cambodia?

Paul: North Korea is a challenge for the global community, but the same was true 10 years ago. Our concerns over it are not in an explicitly Asian context.

Mark: In terms of frontier markets, I think we've always seen that as the adventurous part of the business to go and see a market that's at its point of emergence into the global economy. It's important to be in these countries, and I remember a number of years ago when Paul and I took some Vietnamese Dong out of the first ATM that was installed in Vietnam.

Paul: One difference, however, is that prior to countries like Taiwan and Korea opening up, it was clear that they had companies that were capable of being globally competitive. I'm not sure I can say that about Vietnam or Sri Lanka now. I'm not aware of any Vietnamese companies that are destined for the global 500 in the next decade, though I do wish that were the case. Whereas, China and India both offer candidates clearly capable of being world leaders in the coming decade, with both huge domestic and international footprints.

For now companies in these countries may be very interesting portfolio diversifiers but so far we aren't seeing any big leading global companies coming out of these areas. They provide local exposure that can move very differently than things do on the global market.

Who is or was the most influential person coming out of Asia over the last 20 years?

Mark/Paul: Deng Xiaoping. China had been totally closed. While it had been a very successful country for a long time, it had walled itself off. And similar to the Berlin Wall coming down, Deng Xiaoping allowed the walls of a socialist ideology to come down, and allowed the country to pick up the pieces that it had left behind in the 1920s.

What's ahead for Asia?

Mark: What's remarkable has been the evolution of the political systems in Asia that we've witnessed in just the last 20 years. After the crisis, there was SARS and the bird flu, but we've seen no major episodes of social unrest that have been of any lasting significance or great consequence. Going forward, where that political evolution goes from here is the most challenging question.

Over the past 20 years, the region has been incredibly stable compared to the 50 years prior that included the Vietnam and Korean Wars—which were the notions that investors had of Asia. Will Asia find better monetary and fiscal cooperation and also be able to find the political means to further economic integration that is ongoing? For instance, the Japanese economy has been very integrated with the Chinese economy and yet, politically there's been very little movement.

It was relatively easy to see Korea, with its highly educated population, achieving a level of industrialization. But I think for a country to produce such things as tremendous cinema and fascinating online businesses, being a democracy was integral to Korea being able to make that jump. Therein lies the challenge for China. Can it easily move into knowledge industries when the political controls are such that it can be very dangerous to be an outspoken free-thinker in China?

Paul: Asia is at a tipping point now in some senses. We were talking about the growth of the middle class 20 years ago, and we still are. Per capita incomes still don't compare to the U.S. across the region, but if you took the total number of people living at income levels at a certain "middle class" range, there are more middle class people in Asia than there are in the United States. So we've passed the point, in that sense, in which Asia is now wealthier than the U.S.

And yet, in a country like China, there is still enormous potential. China, India and Indonesia are

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extremely populous countries and their collective savings can become more important than the collective savings of the U.S.

In addition, if you think about the basket of Asian investment opportunities, a large percentage of it is denominated in currencies that we still can't access freely like Chinese renminbi. And in 20 year's time, it's inconceivable that our strategies won't be freely investing in renminbi-denominated securities.

Matthews has recently offered new share classes, launched new strategies and expanded overseas. How large do you foresee Matthews becoming?

Paul/Mark: If we have too narrow a focus, it may be harder for us to reach our potential. So as long as the financial markets of Asia are evolving, we have to grow and evolve with them. We don't want to become too dominant in any one area. Very rapid growth of a single segment of our offerings is always a challenge. As active asset managers, our firm's growth is really necessary in retaining and attracting great investment professionals. We can't just feel as if we've hit a certain mark and we're done. The opportunity for the younger professionals here is that there are many decades of development and evolution in Asia to come. Being with a company that we believe can survive and thrive through the great booms and great crises requires that we be open minded, flexible and willing to make mistakes.

We hope we maintain our entrepreneurial roots to continue to offer a diversity of long-term opportunities to clients.

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