Matthews Asia

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Capturing Growth and Quality in Emerging Markets

FOR OVER A DECADE, emerging markets have been considered a core allocation for investors seeking long-term growth. The asset class has evolved and Asia now dominates the emerging markets in terms of economic growth, consumption, and trade. Today, Asia comprises over 75% of the benchmark universe, the MSCI Emerging Markets Index.

The drivers of growth within emerging markets are also changing. China is the new geographic epicenter of growth within emerging markets and its economic and political influence extends through Central Asia, through emerging Europe and into the heart of the EU itself. Initiatives such as One Belt One Road reach beyond Asia and Europe with its scope of influence encompassing the raw material producers in South America as well.

New sources of emerging market growth include industry leaders in innovation. Innovation in areas such as communication services, retail, entertainment, digital platforms and health care is moving to the fore and becoming a larger part of the opportunity set. Many of the world's best companies are increasingly located in emerging markets and/or generate their earnings there. To capture the opportunity set in emerging markets, active security selection is key.

We believe constructing an emerging markets portfolio built for sustainable growth requires identifying companies that have higher growth metrics, as well as higher quality metrics, than the broader market. Good companies worldwide share common traits. They require a strong competitive position and the ability to allocate capital well.

In the following pages, we will:

- Examine Asia's outsized role in emerging markets
- Discuss the five common traits of strong companies worldwide
- Explore why/how a country informs—rather than drives—investment decisions
- Review why a core, quality-growth approach to emerging markets is optimal

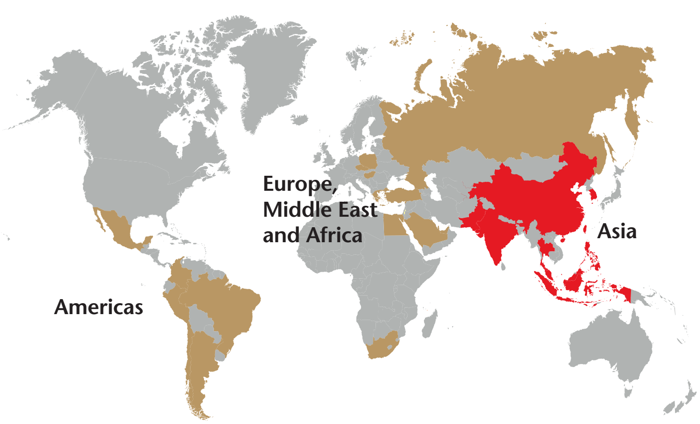
Asia Forms the Economic Hub of Emerging Markets

Asia is the core of growth, rising consumption and innovation within emerging markets. Within the MSCI Emerging Market Index, Asia's representation today comprises more than 75%[1] with the increasing inclusion of China's domestically listed A-shares driving changes in benchmark weights. While some countries such as South Korea[2] and Taiwan play an outsized role in the index relative to the size of their economies, others are poised to grow. And within emerging markets, the drivers of growth are changing.

Ten years ago, the MSCI Emerging Markets Index had few innovative companies targeted at the consumer and geared towards consumption. Formerly, consumption meant food and cement. Today, innovation in areas such as communication services, retail, entertainment, digital platforms and health care is moving to the fore and becoming a larger part of the opportunity set. Video streaming, e-commerce and other forms of digital consumption are growing rapidly alongside other forms of service-driven consumption—driven by Asia's consumers. This shift toward an innovation-driven economy can sometimes further the competitive advantage of established leaders, but also means that small companies can quickly become relevant. We believe such opportunities are ripe for alpha capture that only an active approach can provide, and is one area where dedicated investment teams can add value. Innovative companies demand specialization and insight. Innovative companies invest more in research and development, compete on intellectual property and offer products and services that are hard to replicate.

At Matthews Asia, we have a 29-year heritage of understanding rapidly changing markets, having focused our research and investment capabilities within a region that now dominates the emerging markets. Matthews Asia has a long history of covering China A-shares and has deep experience in markets like India and Indonesia as well meaningful frontier geographies like Vietnam.

FIGURE 1. ASIA PLAYS AN OUTSIZED ROLE IN EMERGING MARKETS



At its heart, investing in emerging markets is about looking forward. Identifying companies that can power their own growth as opposed to being dependent on external financing is an important part of capturing the opportunity. Investing in emerging markets requires the ability to identify good companies at good prices, as well as the ability to look past the noise of the marketplace and maintain a long time horizon. Having invested in some of the largest constituents within the emerging markets universe for decades, we believe we can leverage this expertise in other emerging markets and apply the same established fundamental investment process in order to evaluate a company, its management team, corporate governance and valuation.

Quality Matters in Emerging Markets

Quality can be broadly defined to include of return on assets, capital or equity; the strength and appropriateness of balance sheet; and cash flow conversion and alignment of interests between a company's management and other shareholders. A company with high margins or exceptional asset turnover will generate a higher return on equity, holding leverage constant. We believe quality companies may have better potential to translate conceptual growth into revenues, into profits and eventually into real cash flow. In addition, quality management teams may be able to grow market share, allocate capital well while treating minority shareholders fairly.

In our research, we find that many stocks in the MSCI Emerging Markets Index are perpetually cheap for a reason. This is either because of little pricing power combined with high cyclicality, serious governance issues or poor capital allocation. Many others are either state-owned businesses that are not run primarily for the purposes of all shareholders or have regulatory structures that are unfavorable to investors. The bottom line is that we believe investors can find better "value." Low value creators can be found in every sector and every geography. A big part of the task for active managers is avoiding them. Capturing the "quality value factor" is not easy. Active managers cannot rely on a single valuation metric like price to earnings. Rather, the question in front of active managers is if the price paid is fair for the ownership stake that is received. Our history of investing in quality companies across Asia informs our approach to identifying quality companies in parts of emerging markets outside of Asia.

We believe investing in emerging markets requires deep expertise in Asia, including China, India and Southeast Asia. To capture this opportunity, active security selection is key. For the Matthews Emerging Markets Equity Strategy, our portfolio construction process begins from the bottom up with what we believe to be well-run companies. Long-term value creators often share five characteristics that feature prominently in our analysis. Country weights in our portfolio are a result of bottom-up security selection, rather than top-down allocations. Our philosophy to investing in emerging markets is to invest without borders. We are more concerned with where and how a company makes money than where the headquarters is. What matters is where the earnings are, not where the CEO sits. Our approach to emerging markets is fundamental, company-led and long-term in focus.

1. Data as of March 31, 2020. Source: MSCI
2. Note: South Korea is excluded from the definition of emerging markets by FTSE and select other index providers

Strong Companies Worldwide Share Common Traits

Leo Tolstoy's novel Anna Karenina starts with an oft-cited quote, "Happy families are all alike; every unhappy family is unhappy in its own way." Similarly, good companies tend to be more alike than they are different, regardless of where they are domiciled. We expect that both the absolute number and percentage of the world's investable companies will be increasingly located in or driven by emerging markets. Our philosophy to investing in emerging markets is shaped by Matthews Asia's long history of focusing on bottom-up security selection. We concentrate our efforts on investing in companies that in our view have the potential to provide attractive, sustainable growth, with management teams who can ultimately translate growth and innovation into positive cash generation.

In our security selection process, we start with some basic questions: Do we want to be involved with this company as a partial owner? Is management working for us as a non-controlling shareholder? How much are we paying for implied growth opportunity and is the price fair?

To begin to answer some of these questions, we consider five traits that we believe good companies worldwide share. Our analysis naturally extends beyond these traits, but these form the foundation of our bottom-up research process.

FIGURE 2. THE FIVE C'S OF GOOD COMPANIES

Competitive Position
- Analyze strength or weakness of a company's competitive position
- Review depth of a company's competitive moat and how likely is a company to sustain it or expand it

Capital Allocation
- Identify businesses that demonstrate good capital allocation—provides strong signal for the future of the business
- Seek companies that can generate big profits and small assets

Capital Structure
- Prefer businesses that run with a somewhat suboptimal balance sheet
- Look for businesses that can strengthen competitive position during hard times, or times of volatility

Cash Flow
- Seek companies that are able to produce cash from operations and fund their growth organically from the cash they generate

Character
- Seek companies with robust corporate governance that fairly considers the needs of non-control minority investors
- Strive to take a holistic look at a company's character—from management quality to how a company treats its customers, employees and vendors

1. Competitive Position

Economic textbooks posit that an industry that generates outsized returns should attract new entrants until those returns (which academics call "economic rents") fall. Of course, certain companies maintain a competitive advantage for long periods, defying this adage. Therefore, our analysis begins with the strength or weakness of a company's competitive position. What is the depth of a company's competitive moat and how likely is a company to sustain it or expand it?

Most businesses have some form of competitive advantage. While they do not figure prominently in our thinking, we are open minded and even companies who produce something undifferentiated might have something unique about them. A copper company might receive a global price for the ore it produces (an electric vehicle consumes about five times the copper of a traditional car), but the company might have a sustainable cost advantage because of its assets or operating environment that allows it to generate good returns on capital.

Of the thousands of companies in emerging markets, few have sustainable advantage. We tend to eschew businesses where the advantage is limited to access to capital or proximity to government. While these advantages are common in emerging markets, they can change on a dime. While counterintuitive, "soft" advantages like brand or process can sometimes be the most durable. The "hot" gadget might be relevant for only a few quarters, but, once a business has determined a particular software program is valuable, the switching costs are high and the relationship is long. A demure perfume brand may last centuries. In our research, the absence of competitive advantages usually shows up in low margins, poor asset turnover or both. A business with a competitive moat has often grown through innovation, scale or via unique intellectual property.

2. Capital Allocation

Good businesses tend to do one of two things as they grow: either they improve their marginal capital allocation or the business deteriorates because capital begins to be wasted. We seek to identify businesses that demonstrate good capital allocation, as this is a strong signal for the future of the business. Businesses struggle with capital allocation for a multitude of reasons. Management teams can pursue aggressive M&A either in terms of scope or price without creating value for their shareholders. Family-controlled businesses can be among the best capital allocators and the worst. A family might have a long-term view that allows it to invest and grow the business in a way that is sheltered from the vicissitudes of the local market. Conversely, a family controlled business may decline over time by reinvesting operating cash flow into unrelated business lines or real estate.

Intuitively, people may think big assets are a good thing. However, in my view it is actually better to keep assets as small as possible relative to the amount of earnings that can be generated from them. Would an investor rather generate $100,000 in profits from a restaurant that costs a million dollars to open, or $100,000 in profits from an inexpensive food truck? If the amount of sales are the same, then a low asset base is preferable. The first has a return on assets of 10%, the second and return on assets of 100%. Big profits and small assets is the best combination. What is critical is a company's potential return on its assets. Companies that are good capital allocators tend to think deeply about return on assets and marginal return on capital. These are frequent topics of dialogue in our due diligence process.

3. Capital Structure

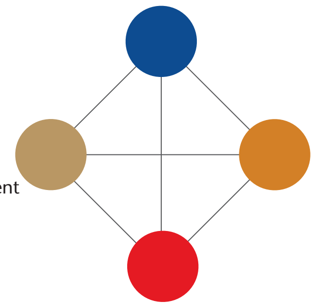
Economic textbooks may tell you debt is cheaper than equity, and therefore a business should optimize its capital structure by having an appropriate debt load to maximize a shareholder's return on equity. Emerging markets, however, can exhibit high levels of volatility. The best businesses strengthen their competitive position during such times, which is only possible with a clean balance sheet. An equity-financed balance sheet might be "lazy" but the benefit is flexibility. The aggressiveness of a company's balance sheet should really be related to the operating leverage inherent in the business. A conservative balance sheet is a nod to humility and long-term thinking. It is a good sign. We tend not to invest in companies where as portfolio managers, we would need to call the direction of the cycle for success.

A company's capital structure can be closely related to the cyclicality of its business. All businesses are subject to cycles but some are driven by them. Let us assume the "hot thing" is adding another camera to a smart phone. For a time, the manufacturer of the camera lens will be a market darling and generate expanding margins. Eventually either production capacity expands or the trend ends. Such companies are classified as technology, but they lack durable structural advantage and are at the whim of extreme product cycles. Within technology, we focus on software-enabled companies or those with process advantage of semiconductors. Where possible, we like businesses with structural tailwinds and long cycles.

4. Cash Flow

The reason many investors allocate to emerging markets is for growth. Growth for growth's sake is not a strategy though. It has to come back to the bottom line and cash. A good business should be able to produce cash from operations and fund its growth organically from the cash it generates. Some of the highest growth companies have attractive cash flow potential. This is not to say that certain early stage businesses who need external sources of capital do not play a role in our portfolio construction. However, such businesses should exhibit a pathway to positive unit economics and cash generation or have massive non-linear opportunities. Buying a business assuming it will be an acquisition target is seldom prudent for long-term investors. Starting a business expressly with the intent of being acquired by another larger business rarely works, in our history of investing, and is not that applicable to the public markets.

FIGURE 3. AN INTEGRATED APPROACH TO ESG



5. Character (what many call ESG)

A company's character is more than just its financials. In our experience, well run, high-quality companies tend to survive better in a time of stress, grow better in a time of prosperity, and generate more cash than a company that has a bad character. There are few shortcuts in life; we believe sustainable growth is best achieved by treating stakeholders fairly.

In considering environmental, social and governance (ESG) factors, corporate governance is the input we consider most closely. Governance influences social and environmental factors, and is near universal in its objective. We seek robust corporate governance that fairly considers the needs of non-control minority investors like ourselves. Companies require strong, ethical management teams and solid board oversight to maximize long-term returns for shareholders. In emerging markets, and especially in Asia, family-controlled companies are more common than in the U.S. Such companies can often score poorly by third party ESG data providers because their structure can appear to lack independence. However, an advantage of active management is to think deeper than the score. Sometimes our interests are best aligned with a family that is investing for the long term and thinking carefully about its positioning and balance sheet.

EXAMPLES OF COMPETITIVE ADVANTAGES IN EMERGING MARKETS

Potential Advantage	Examples
Brand Image	• A cosmetics brand image might actually be enhanced by being exclusive—sometimes a brand is enhanced by its scarcity • A large sports brand may have more resources to spend on promotion further distancing itself from the competition—sometimes the ubiquity of something is precisely what makes it attractive.
Size	• An e-commerce platform where more buyers attract more sellers. A video game platform with more players attracts more players. Bigger is better • A niche software solutions company might provide better depth in its domain area than a gigantic multinational
Efficiencies of scale	• A large food retailer will have meaningfully lower logistics costs than a smaller one
Process	• Decades of cumulative experience might lead to better yields in semiconductors—something that capital alone cannot dislodge
Intellectual property	• Companies that update software continuously might make pirated versions useless
Natural monopoly	• An airport terminal may have a natural monopoly on local or regional air traffic, as new terminals cannot be built quickly or easily

A company with a great culture might find it easier to attract and retain employees. Retaining employees is not something financial statements discuss, but it merits a discussion with company management. When we meet with company management, we probe for instability and risks, such as whether it can or cannot attract and retain the best employees. Turnover of employees is common in ESG assessment but not a generally accepted accounting principal (GAAP) criterion. Turnover is a basic yet important metric that provides insight into how a company is treating its internal constituents—its employees.

Qualities that may determine whether a company succeeds or fails can be both present and absent from a company's balance sheet. Accordingly, we strive to take a holistic look at a company's character. A company that treats its customers, employees and vendors fairly is more likely to grow and thrive. A company that cuts corners with any of these groups is less likely to be a sound long-term investment. In addition to understanding a company's basic conduct, we want to understand: "Do we benefit as a minority shareholder or is it being run for another purpose, such as for the benefit of its management team, government objectives or the vanity of its founder?" No country or sector has a monopoly on poor behavior. In addition, factors other than poor behavior may cause us to answer this question in the negative. A utility that is run for the benefit of the population that it serves might be a good company but may be a poor fit for our basic investment philosophy.

Country Informs, Rather Than Drives, Investment Decisions

The country of headquarters or listing is both a backdrop and a driver for security selection and investment decisions. Growth in aggregate metrics such as GDP or personal income are germane for consumption. The nature of a country's economy, its sensitivity to trade and to changes in prices of commodities all factor into portfolio construction. The regulatory framework, dispute resolution process, stability and convertibility of currency and financial conditions all matter. Individual companies however, might react very differently to the same stimuli. A software company in India might actually benefit from a weak rupee if its contracts are overseas, but a producer of toothpaste might get hurt on margin if the rupee is weak. What matters is how aggregates translate to the firm level.

As the developmental diversity of emerging markets is high, we cannot afford to think simplistically about the countries within the asset class. South Korea by most metrics should be a developed country; some index providers like FTSE already consider it such. South Korea is not a particularly attractive market for domestic consumption growth but does have some world-class companies. Thematically, we are more interested in the potential consumption growth in China or India, but this does not preclude us from investing in a South Korean company. In fact, there are numerous health care and cosmetics companies domiciled in Korea but their earnings are driven by China. As we noted earlier, what matters is where the earnings are, not where the CEO sits.

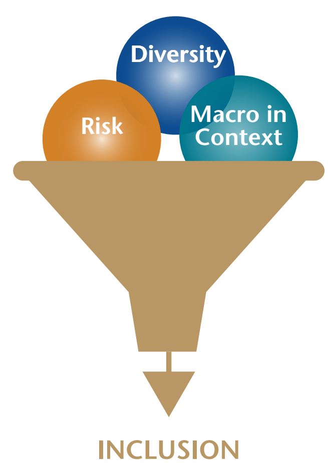
China presents the largest opportunity set in terms of wealth creation, growth and innovation and therefore the largest allocation in our emerging markets strategy. In our view, there are some exceptionally great companies in China. However, one must be selective. China's low cost of capital means mediocre businesses can sometimes hang on longer than they should through inertia and cheap financing. Brazil is a smaller opportunity set than China, but innovation can also be found in Brazil. Brazilian companies, for instance, are on the leading edge in several fields such as Fintech and digital payments. On balance, Brazil has a smaller number of innovative companies than China does and it is not an emerging presence in potentially large segments such as biotech. The high cost of capital in Brazil has been detrimental to innovation and local entrepreneurship, but it means that those who have achieved scale tend to be of a very high quality. From our bottom-up perspective, we are excited about opportunities across the investment universe wherever we find them. Our insight is to be inclusive and not dismissive. Opportunity can be found anywhere. Country provides context, not a predetermined conclusion.

Portfolio Construction Framework

Building on these security selection criteria, we consider diversity of holdings, macro in context and risk when constructing the portfolio. Balancing these three considerations helps us design a portfolio that seeks to capture growth across various parts of the market cycle. A well-constructed portfolio is not one comprised of solely "best ideas." The future is unwritten and inevitably takes twists and turns. Therefore, a portfolio is a collection of positions that work together, with some offsetting exposure to account for the unknown.

Diversity refers to having factors behave differently when exposed to different external realities. Direction and magnitude both matter. For example, a benign decline in the price of oil may benefit consumption in India, but a crash in oil might signal issues for risk assets in general, which will not be supportive of stock price multiples. Diversity does not refer to the number of holdings, but rather the correlations between them. In portfolio construction, we seek some natural offsets for exposures such as currency movements, commodity prices and interest rates. Finally, to manage risks, we believe liquidity is key, which is paramount in portfolio construction.

FIGURE 4. INPUTS TO PORTFOLIO CONSTRUCTION



A Core, Quality Growth Emerging Markets Equity Strategy

Approaching emerging markets through a bottom-up lens, the Matthews Emerging Markets Equity Strategy seeks to offer a core, quality-growth orientation. Asia forms the core of the Strategy and we approach the region holistically. At Matthews Asia, we believe our deep expertise in Asia helps us to construct an emerging markets portfolio built for sustainable growth. Notably, we typically look for companies that have higher growth metrics, as well as higher quality metrics, than the broader market. The Strategy also tends to focus on companies that can serve the needs of domestic consumer within their markets, although we may invest in commodities and companies that serve a global marketplace. We tend to look for companies that are less cyclical (even within cyclical sectors). In addition, the Strategy takes an all-cap approach, believing that smaller cap companies may offer attractive potential for generating alpha. Our investment team spends considerable time on the ground researching ideas and uncovering what makes good companies tick. We believe that the Strategy's quality bias can help long-term investors meet their objectives for sustainable growth within emerging markets.

We focus on where and how a company makes money, not on where a company's shares trade. We seek to find high-growth, high-quality companies across emerging markets and across the market capitalization spectrum. We want trends as tailwinds, but they are not the primary driver of our investment decisions. Consumption growth in emerging markets—particularly Asia—is the largest singular theme of the strategy. We aim for long-term and sustainable growth through the cycle. As bottom-up portfolio managers, we seek to see ourselves as partial owners of the businesses in which we invest. Sound balance sheets, good capital allocation, and sustainable competitive advantage are of limited relevance to short-term traders, but critically compound value over time for long-term investors. At Matthews Asia, we believe we are distinctively positioned to put the growth potential of emerging markets to work in investors' portfolios.

At its heart, investing in emerging markets is about looking forward. Identifying companies that can power their own growth as opposed to being dependent on external financing is an important part of capturing the opportunity. Investing in emerging markets requires the ability to identify good companies at good prices, as well as the ability to look past the noise of the marketplace and maintain a long time horizon. Having invested in some of the largest constituents within the emerging markets universe for decades, we believe we can leverage this expertise in other emerging markets and apply the same established fundamental investment process in order to evaluate a company, its management team, corporate governance and valuation.

MSCI Emerging Markets Index: Captures large and mid-cap representation across 24 Emerging Markets (EM) countries. With 1,138 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. EM countries include: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

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