Asia Insight

March 2017

A Look at Liquidity

Liquidity is a hard-to-define concept that often only comes to the fore during challenging market environments. This makes it understandable that market participants may view issues of liquidity with some trepidation.

As fundamental bottom-up stock pickers at Matthews Asia, we analyze businesses from across the liquidity spectrum. It is, therefore, important for us to consider and mitigate the associated risks where possible. While most readers will be aware of these risks during market downturns, we have found that what is often ignored is the potential for improved liquidity to augment stock returns while enhancing the opportunity set available to us as investors in the region.

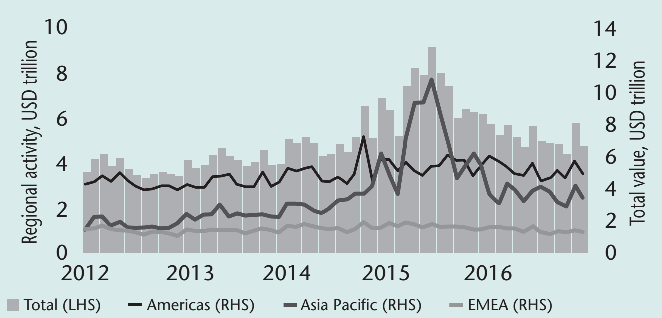
A working paper by the International Monetary Fund broadly defines liquidity as having five overlapping characteristics against which it can be assessed: (i) tightness, (ii) immediacy, (iii) depth, (iv) breadth and (v) resiliency. A liquid market—at an index or security level—would thus exhibit low transaction costs, speed of execution, a large quantity of orders, a minimal impact on price from high volumes and a rapid correction to any market imbalances in order to satisfy each of these criteria.

Given the range of characteristics implied by the concept, there is no single metric we use that captures all the elements of market liquidity. However, using available data to measure transaction costs, bid-ask spreads and security turnover, we can quickly piece together the liquidity profile of markets, portfolios and even individual stocks.

If we are to use market turnover as a basic proxy, Asia-Pacific on the whole is the second-most liquid region globally, according to the World Federation of Exchanges.

However, what is most striking has been the increase in liquidity across the region, which has risen almost six-fold since 1996. This move has been more prominent in some countries than others, with average daily turnover for China's Shanghai Stock Exchange Composite Index growing at a compound annual growth rate of 38%. Indonesia and Thailand also saw substantial compounded growth of 20% and 19% respectively. At the other end of the scale, South Korea saw the slowest growth in liquidity yet still achieved a compounded growth rate of 5%, showing that the benefit has been seen across the entire region.

VALUE OF SHARE TRADING



Source: World Federation of Exchanges FY 2016 Market Highlights

Why is Liquidity Changing in Asia?

There are a multitude of reasons for the region's improving liquidity, but the most prominent and recurring factors have included:

- Increased wealth
- Changes in shareholder structure
- Easing of regulations and improved accessibility for market participants

Wealth

Private financial wealth has been growing by double digits in the Asia-Pacific region and, according to the Boston Consulting Group, will continue to do so until 2020, around which time it is expected to surpass North America. The main driver behind this has been rising household incomes. With an increasing proportion of this wealth expected to be allocated toward equities, this should continue to improve trading conditions in local stock markets.

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Shareholder Structure

In the past, we have often seen a constraint on trading volumes where large shareholders, such as local governments, have maintained a significant stake in the business, limiting the free float available to the broader market. In such scenarios, any decision to exit or sell-down holdings have generally been positive for security liquidity. However, contrary to such action, we have seen some exceptions where new large, long-term shareholders enter the fray. For example, Japan's significant monetary stimulus in recent years has involved greater indirect government ownership, which ultimately reduces the frequency of the index's free float being traded. According to Bloomberg, the Bank of Japan will be the largest shareholder in 55 of the Nikkei 225 Index's constituents by the end of 2017, and it has already become a top five shareholder in 81 of these companies.

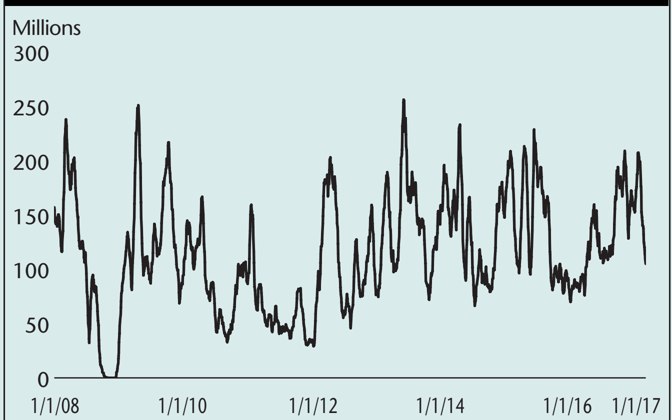
Looking beyond the restrictions imposed by government-related entities, a similar pattern has been evident in the private sector where business founders and their families often maintain significant shareholding positions. Generally, decisions to reduce the size of significant family stakes are well-received by the market in the long term.

Regulation and Accessibility

While changes in ownership structure are infrequent events, changing regulations have been far more evident in recent times across the Asia-Pacific region. For example, in Vietnam the government has removed the 49% foreign ownership limit across a number of market sectors which should be a positive development for liquidity over the long term. It will however take time before we can fully assess the impact of this measure as relatively few companies have invoked this change to date. We have seen similar sector-specific legislation in India as the government strives to open up the market to increased foreign direct investment while media reports in the Philippines suggest we could see a removal of the 40% foreign ownership restrictions on public utilities. Continued action on some of these regulations bode well for the continued growth in liquidity across these markets.

Another country that has taken similar measures is Pakistan. A lack of liquidity in the local market caused Pakistan to be downgraded in 2008 from MSCI's Emerging Market Index to the Frontier Market Index. However, following structural changes, including the removal of foreign ownership limits alongside broader economic initiatives (such as an IMF programme), Pakistan was reinstated as an Emerging Market earlier this year. This has had positive implications for stock market performance since the announcement.

SIMPLE 15-DAY MOVING AVERAGE VOLUME (KARACHI STOCK EXCHANGE 100 INDEX)



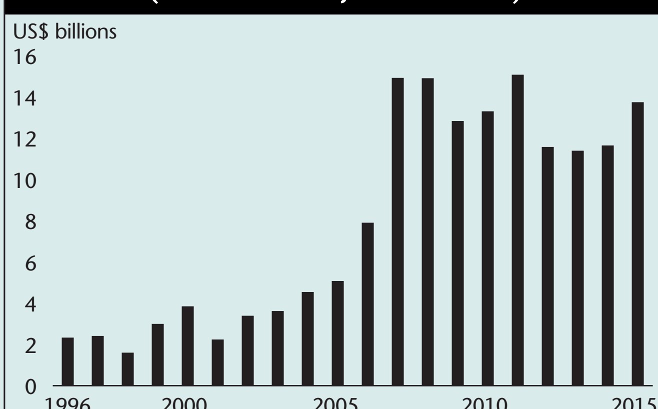
Source: Bloomberg

Elsewhere, structural change has also been particularly relevant in the Chinese market. While much focus has been placed on government intervention in trading in recent years, the growing accessibility of the market has had a large impact on turnover. For example, the 2014 formation of the Shanghai-Hong Kong Stock Connect, a cross-boundary arrangement that grants offshore investors with access to China A shares, has been a major factor in increased market participation. In the first full year of the operation of this mechanism, the Shanghai Stock Exchange Composite Index saw daily turnover increase 575% compared to the year before.

Liquidity in Times of Stress

Despite the overall positive trend in market liquidity for the reasons outlined, we have seen some periods where liquidity measures have expanded and contracted substantially over

AVERAGE DAILY TURNOVER VOLUME (MSCI ASIA EX JAPAN INDEX)



Source: Bloomberg

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short periods of time, namely around times of crisis. For example, average daily turnover rose meaningfully during the period of the Asian Financial Crisis (1997), the dotcom bubble crash (2000) and the Global Financial Crisis (2007–08) before falling in the immediate aftermath.

In most global markets, periods of stress are associated with a widening of bid-ask spreads reflecting greater levels of volatility; the experience of Asia has been no different on this front. However, the narrowing of these spreads has been evident since 2009, reflecting a more robust environment since.

The Implications of Tight Liquidity

"When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance," Charles "Chuck" Prince, former Chairman of Citigroup (2007)

One of the advantages of our long-term investment horizon is that, contrary to Mr. Prince's quote, it is largely at our discretion when we want to participate in the market. As a consequence, shortages in liquidity can often provide us with unforeseen buying opportunities. In thin markets, there is increased scope for deviation between asset prices and the underlying fundamentals and under these circumstances we are able to take advantage of the short term volatility to invest in companies that will deliver value over a prolonged period of time.

In contrast, inadequate levels of liquidity do mean that securities are more susceptible to large day-to-day swings. Why does this matter for long-term investors? Unfortunately, despite the rigor of our process, we are still liable to make errors in our stock selections. These are often not apparent at the time of purchase but poor stewardship of a business or changes in the competitive environment mean that the fundamentals supporting our investment thesis can change over time. When these issues arise, we need to be in a position to realize the value of our holdings without the detrimental impact on our exit price or associated trading costs.

It is important to realize that these concerns could be equally relevant when an investment thesis plays out as we anticipate. In this scenario, the desire to lock in our profits is also impacted. Costly execution can eat into realized gains while delays in trading can prove expensive in terms of foregone opportunity cost.

The implications of tight liquidity also extend to the overall portfolio level as we have to be cognizant of the flows to and from our shareholders. In a scenario where our clients are making redemptions on a strategy, we have to be mindful of the potential impact on asset valuations for those clients that are maintaining their holding as we exit positions to return the cash. In a similar vein, we must also be aware of the impact of inflows on our ability to add exposure to existing holdings.

How Can We Mitigate Liquidity Risk?

While we look to benefit from the opportunities created by reduced liquidity, we can also take measures to protect ourselves from the associated risks. One of the simplest methods to limit this risk is to position size appropriately. For some of our more prominent strategies, this is particularly relevant when looking at smaller companies where we may end up owning a large proportion of the free float. It is therefore important to monitor our holdings at both a strategy and a firm-wide level to ensure our own positioning does not prove detrimental to long term returns.

This positioning sizing concept intertwines with the appropriate capacity constraints for each strategy where the size of an individual mandate could prove prohibitive, particularly when looking down the market-cap spectrum. While this constraint is naturally more applicable to the small cap-focused portfolios, it remains relevant for all of our mandates and we have to consider the implications when strategies amass significant asset bases over time.

Beyond the security level, we can alleviate the risks associated with fund flows by maintaining an appropriately sized cash buffer in each portfolio. While we are effectively fully invested, a small cash balance can help to ensure large movements in the asset base have limited impact on the remainder of the fund holders.

Finally, while the monitoring of concentrated holdings, position sizing and cash management are all effective tools to combat this issue, the most effective way to address this risk factor is through continued adherence to our long-term investment philosophy. By doing so, we are better-placed to navigate the cyclical challenges posed by liquidity alongside broader risk factors.

While we emphasize the risks associated with tightening liquidity, there are a number of ways to mitigate such risks and in some cases, these circumstances can present us with rare buying opportunities.

On the whole, the continued development of capital markets in Asia has opened up a greater pool of stock markets and individual companies from which we can conduct our bottom-up analysis. Further evidence of deregulation and improved accessibility bode well for our present holdings and future opportunity set.

Colin Dishington, CA, CFA
Research Analyst
Matthews Asia

Matthews Asia

Disclosure and Notes

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The Shanghai Stock Exchange Composite Index is a capitalization-weighted index. The index tracks the daily price performance of all A shares and B shares listed on the Shanghai Stock Exchange. The index was developed on Dec. 19, 1990 with a base value of 100.

The MSCI Frontier Markets Index captures large and mid-cap representation across 30 Frontier Market countries. The index includes 123 constituents, covering about 85% of the free float-adjusted market capitalization in each country.

The Nikkei-225 Stock Average Index is a price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange. The Nikkei Stock Average was first published on May 16, 1949.

The MSCI Emerging Markets Index is an index created by Morgan Stanley Capital International (MSCI) designed to measure equity market performance in global emerging markets. It is a float-adjusted market capitalization index that consists of indices in 23 emerging economies: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and the United Arab Emirates.

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G.MATAI—March 2017

Phone: +1 (415) 954-4510
Email: globalfunds@matthewsasia.com
Web: matthewsasia.com

Hong Kong:
Phone: +852-3901-0880
Web: hk.matthewsasia.com