



Matthews Asia Perspective

Q&A: Matthews Asia Small Companies Fund

For growth-oriented investors, what do Asia's small companies bring to the table?

Asia's smaller companies offer attractive growth potential, as well as the opportunity to gain highly differentiated portfolio exposures. For many global investors, Asia small companies are unlikely to overlap with existing investments. An allocation to Asia small caps can therefore help improve the risk/reward profile of an overall portfolio, while providing access to nimble, entrepreneurial businesses in fast-growing economies.

Is small-cap investing the same worldwide?

Some benefits of investing in small companies tend to be universal. For example, small companies everywhere have the potential to help investors capture the size factor, which is the historical performance advantage that small company stocks have had over larger company stocks over longer periods, such as five to 10 years. Another potential benefit is that stocks of smaller companies may be inefficiently priced, creating a marketplace where active management can add value. And finally, smaller companies tend to offer access to businesses whose earnings and market share are growing faster than that of larger companies.

What makes investing in small companies in Asia different than other regions?

Small companies in Asia may enjoy some distinct advantages over other regions. First, many Asian economies are growing faster than the U.S., Europe and Latin America, according to the International Monetary Fund's (IMF) World Economic Outlook.¹ Accordingly, the structural growth potential of Asia tends to be much higher than other regions. The IMF projects that GDP across Asia could grow by as much as 6.5% in 2019, compared to 2.7% projected GDP growth for the U.S., 2.6% for Latin America and 1.9% for Europe. Second, the absence of older technologies in parts of Asia has encouraged leapfrogging, where new technologies and distribution channels can come to the fore more quickly. And third, the middle class in Asia is expanding more rapidly than in any other part of the world. We believe this combination of qualities makes Asia small companies an appealing asset class for growth-oriented investors.

Risk Considerations

Investments involve risk. Past performance is no guarantee of future results. The value of an investment in the Fund can go down as well as up. Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation.

How do you define small companies?

We typically invest in companies that have a market capitalization under US\$3 billion at the time of purchase. We tend to focus on companies at the lower end of the spectrum. The Fund's weighted average market capitalization was US\$1.3 billion as of September 30, 2018, according to data from FactSet Research Systems. We typically sell out of a position when a company becomes a midcap or large cap stock. This keeps our style purely oriented toward small caps.

How big is Asia's universe of small-capitalization companies?

If you include small-cap and micro-cap companies, the universe is huge. As of September 2018, more than 18,000 small and micro companies were listed on the stock markets of Asia, excluding Japan and including China ADR (American Depositary Receipts). If you include only small caps, the universe is still impressive. For the same period, more than 8,000 small companies were in the same category of stock markets of Asia, excluding Japan and including China ADR. Importantly, the universe has also deepened, with small companies now operating across all key sectors within the region's economy.

¹ Estimates as of July 2018.

What impact are trade conflicts having on Asia's small companies?

Trade conflicts often have a clear impact on investor sentiment, as well as on some of the more export-oriented segments of the small-cap universe in Asia. As portfolio managers, we try to look past short-term sentiment and examine the long-term fundamental drivers of growth across the region, so temporary price drops attributed to sentiment can occasionally present buying opportunities. Furthermore, the Matthews Asia Small Companies Fund tends to focus on companies whose growth is driven by domestic consumption, rather than exports. This provides our Fund with a small degree of insulation against trade skirmishes. Still, a risk remains that as U.S.–China trade relations further deteriorate, the productivity gains accrued from more efficient manufacturing and global supply chains will start to unwind. In this case the consumer, globally, will have to bear at least part of the pain.

What are structural drivers of growth for small companies in Asia?

Rising domestic demand will be an increasingly important driver of regional economic growth as wealth and the size of the middle classes grow. The Brookings Institute estimates that more than 50% of middle-class consumption and spending globally will come from Asia by the year 2030.² As economies shift from being export dependent to more consumption driven, they will be less influenced by the broader macro environment and issues affecting developed markets. We believe small companies in Asia are well-positioned to take advantage of these important trends, and are small and nimble enough to react quickly to the region's changing patterns of consumption.

What is the role of entrepreneurs in Asia?

Asia is synonymous with an entrepreneurial spirit and small companies have always been central to Asian economies. As the number of small companies continues to grow and their access to capital increases, they are driving both innovation and employment. Many small companies in Asia are also helping economies transition from industrials to services. Small companies can more easily cater to local populations, designing and developing products and services that appeal to local markets. Large Western multinationals, in contrast, often have a harder time gaining traction in Asian markets because they tend to have an insufficient understanding of local market nuances. As the products and services from small companies become brands in their own right, this leads to more sustain-

able returns on equity and returns to shareholders, making small companies an attractive investment proposition.

Are Asia's capital markets conducive to funding small companies?

Asia's capital markets continue to gain increased breadth and depth. We see small companies gaining access to capital markets as a result of several trends, including:

- ✿ A desire by owners to expand their business and create wealth
- ✿ Further deregulation in some markets
- ✿ Improved access to credit and capital
- ✿ Next-generation family management teams that have more entrepreneurial spirit
- ✿ A need for greater transparency

Local regional entities are trying to create lending channels for various countries in the region. If the availability of capital becomes challenging due to global monetary tightening, it may constrain the pace at which Asia's economies can grow. On balance, however, we see local sources of funding for small companies expanding.

What is your investment process?

At Matthews Asia, we employ a fundamental, bottom-up investment process. We seek to identify companies with sustainable long-term growth prospects, strong business models, quality management teams and reasonable valuations. In particular, we believe this bottom-up process is particularly suited for this asset class. We screen for companies with the following general criteria in mind: attractive revenue growth rates, capital efficiency, superior profitability and healthy valuations relative to industry peers or historical valuations. We spend a considerable amount of time on the ground visiting management teams in Asia to help us make qualitative and quantitative assessments of a company's operations and integrity. It is important to evaluate whether companies have both the aspiration as well as the financial ability to implement their growth strategies.

What attributes do you look for in a company?

We seek companies with high-quality business models and management teams. It is important that companies hold a sustainable competitive advantage in the marketplace that may enable them to grow and compete effectively over the long run. We prefer

² Source: Brookings, Global Economy and Development Working Paper, February 2017, "The Unprecedented Expansion of the Global Middle Class."

companies that focus on domestic or regional markets as opposed to those dependent on exports to developed markets. We also tend to favor companies with strong balance sheets and a track record of prudent capital deployment and operational spending. We seek motivated owners, and find that many of the region's small companies are typically majority family-owned businesses that possess notable entrepreneurial spirit.

How do you construct the Fund's portfolio?

The Fund's portfolio is benchmark-agnostic and is fairly concentrated, holding around 60 to 80 names. It is constructed via bottom-up, fundamental stock selection. Our position sizes are determined by several factors such as liquidity, valuations and our conviction in corporate fundamentals. If a company grows and exceeds the upper end of the Fund's market-cap range, we are not required to sell our holdings. We will look at the relative attractiveness of holdings in the Fund and sell if we deem there are more compelling investment opportunities.

What risks should investors keep in mind when investing in Asia small companies?

Investing in Asia brings a number of risks. These include political, social and economic risks together with the potential for higher volatility and adverse movements in foreign exchange. In addition, some small companies may have limited product lines, markets or financial resources. Smaller companies may also be more dependent on one or a few key persons and may lack depth of management. Other issues can include poor stock liquidity due to larger portions being held by a small number of investors (including founders and management) than is typical of larger companies. Additional potential issues facing investors in the asset class include difficulty in obtaining information about smaller companies and the way in which changing market, economic, regulatory and other factors may impact businesses.

How do you manage these risks?

At Matthews Asia we take the risks associated with investing in Asia and small companies seriously. Our in-depth due diligence process is an important form of risk control. We manage the risks of investing in small companies through our knowledge of the

markets and the intensive research conducted on the companies in which we invest. We conduct onsite visits as well as conference calls with management and in-person in our offices. We also carefully consider the size of each position, as well as monitor our overall sector and country exposure in the Fund to ensure we maintain diversification.

What role does good governance play in helping companies to grow quickly?

Small companies often have management teams closely aligned with shareholder interests. This is because management teams typically have significant share holdings, creating an incentive for the company to succeed. In many cases, small companies are managed by entrepreneurs whose ambitions for their company lie beyond any short-term price movement in their stock. Their primary desire is to see the company grow. In addition, small companies often operate in industries that are in the early stages of development. Since they could become future regional or global brand leaders, they represent an attractive investment opportunity. Finally, small companies also may benefit from mergers and acquisitions activity as sectors and industries consolidate—an increasingly important trend as Asia's economy continues to grow and competition increases. Small companies also are of particular interest to large multinational companies looking to penetrate the Asian market by acquiring existing companies with strong management.

What makes the Matthews Asia Small Companies Fund special?

Each of our portfolio team members has lived in Asia and seen first-hand the importance of the small-cap universe. We also spend considerable time on the road, researching companies and speaking to management teams. While the Fund has the ability to invest in small caps and micro-cap stocks, we generally sell those that become mid-cap or large-cap stocks, helping us to maintain a clear style discipline toward small-cap investing. Importantly, we aim to build the Fund so that it looks different from its benchmark and generate high active share, offering investors diversification and attractive long-term growth potential.

PORTFOLIO MANAGEMENT TEAM



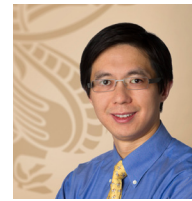
Lydia So, CFA
Lead Manager

Lydia So is a Portfolio Manager at Matthews Asia and manages the firm's Asia Small Companies Strategy. Prior to joining Matthews Asia in 2004 as a Research Associate, Lydia was a Portfolio Associate at RCM Capital Management. She started her investment career at Kochis Fitz Wealth Management. Lydia received a B.A. in Economics from the University of California, Davis. She is fluent in Cantonese and conversational in Mandarin.



Tiffany Hsiao, CFA
Co-Manager

Tiffany Hsiao is a Portfolio Manager at Matthews Asia. She manages the firm's China Small Companies Strategy and co-manages the Asia Small Companies and Asia Innovators Strategies. Prior to joining the firm in 2014, she was a Vice President and Research Analyst at Goldman Sachs Investment Partners in Hong Kong and Tokyo from 2007 to 2013. She was responsible for researching Asia Pacific investments, with an emphasis on equities in China. Previously, she spent six years at Franklin Templeton Investments, where she managed the firm's global communications fund. Tiffany earned her Master of Science and Information Technology from Carnegie Mellon University and received a B.A. in Economics from the University of California, Berkeley. She is fluent in Mandarin and Taiwanese, and conversational in Cantonese.



Beini Zhou, CFA
Co-Manager

Beini Zhou is a Portfolio Manager at Matthews Asia and manages the firm's Asia Value Strategy, and co-manages the Asia Small Companies Strategy. Prior to joining Matthews Asia in 2013, he was a Research Analyst with Artisan Partners on the Global Value Team, responsible for covering pan-Asia stocks across all industries. Before joining Artisan in 2005, Beini spent three years as a senior product analyst at Oracle Corp. He received an M.S. in Computer Science from the University of California, Berkeley and a B.A. in Applied Mathematics from Harvard College. He is fluent in Mandarin.

Benchmark

The **MSCI All Country Asia ex Japan Small Cap Index** is a free float-adjusted market capitalisation-weighted small cap index of the stock markets of China, Hong Kong, India, Indonesia, Korea, Malaysia, Pakistan, the Philippines, Singapore, Taiwan and Thailand. Index is for comparative purposes only and it is not possible to invest directly in an index.

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