Matthews Asia

Matthews Asia Focus Fund

Period ended 30 September 2018

For the quarter ending 30 September 2018, the Matthews Asia Focus Fund returned -3.65% while its benchmark, the MSCI All Country Asia ex Japan Index, returned -1.45%.

Market Environment:

The third quarter of the year continued the resumption of volatility that has defined 2018 as riskier assets such as emerging market equities sputtered. Some of the reasons for such choppiness have emerged as longer duration in nature than previously anticipated with tightening U.S. dollar liquidity and trade tensions continuing to bite. It appears that the strength of U.S. economic data has emboldened U.S. political leaders toward greater conflict with China as the latter is deemed a medium-term threat to the former's global leadership. During the quarter, the U.S. government imposed tariffs on an additional US$200 billion of Chinese exports at an additional rate of 10%. This could increase to 25% next year. Although the trade dispute is detrimental to all involved, China is also refusing to back down as tensions remain high and hopes for a resolution appear remote. Additionally, some concerns around Chinese growth arose as tighter liquidity conditions from earlier this year and weaker sentiment began to weigh on earnings.

Due to the above factors, China was the region's weakest-performing market over the quarter. Thailand and Taiwan were the outperformers as large current account surpluses provided some ballast against tightening liquidity.

Performance Contributors and Detractors:

During the third quarter of 2018, the largest contributor to returns came from the portfolio's holdings in Taiwan, Singapore and China/Hong Kong. Among the best performers was Taiwan Semiconductor Manufacturing (TSMC). TSMC has solidified its technology leadership in 7-nanometer product developments and is well-positioned for the rising demand for high-performance computing and artificial intelligence applications. Another top contributor was our long-held position in Techtronic Industries. The manufacturer of power tools and floor care appliances reported year-over-year sales growth of 19% and net profit growth of 25% in the first half of 2018. The better-than-expected results illustrated Techtronic's brand power amid global trade uncertainties.

In addition, our holdings in the telecommunication services and consumer staples sectors contributed positively as the market volatility increased. Singaporean supermarket chain Sheng Siong Group outperformed as it offered earnings certainty with its store network optimization and defensive operating cash flow.

The largest detractor to relative returns during the third quarter came from our holdings in the consumer discretionary sector. Investors worried about a slowdown in consumption amid recent declines in emerging market currencies and equity prices. Among our holdings, Xiabuxiabu Catering Management China, a leading hot pot restaurant chain in China, declined as investors worried about slowing same-store sales growth. Despite a near-term cyclical slowdown, we continue to like Xiabuxiabu for its good operational track record, ability to generate strong operating cash flow and sensible store expansion strategy. The stock is now attractively priced at 8x 2019 Enterprise Multiple (EV/EBITDA) with an expected dividend yield of 2.5% for 2019.

Notable Portfolio Changes:

During the third quarter, we initiated a position in Jiangsu Yanghe Brewery, a Chinese A-share listed company. Jiangsu Yanghe is a leading “white alcohol” (baijiu) company in China that stands out among peers with its strong capabilities in branding and supply chain management. Additionally, management interest is aligned with investors through the firm's stock ownership plan. Yanghe has delivered return on equity of approximately 25% between 2014 and 2017 and raised its dividend payout during the period to 58%. Amid the market correction, the stock is attractively priced at 11x forward EV to EBITDA ratio and offers a 2.7% dividend yield.

Another new position is Cognizant Technology Solutions, a major information technology consulting and technology service provider from India that is listed in the U.S. Recent acquisitions have enhanced Cognizant's expertise in digital transformation, a growth area in enterprise information technology expenditure. A weaker rupee has further aided earnings. During the third quarter, the stock was reasonably priced at 14x 2019 price-to-earnings (P/E) ratio.

During the quarter, we exited our holding in Hang Lung Group, a property company with retail properties in Hong Kong and China. The company faces fierce competition from strong local competitors in its newer markets and there is uncertainty in consumption pattern changes in China's retail industry. The challenges may lead to a prolonged period of weak return on invested capital.

Outlook:

Despite some meaningful downward lurches in markets since the end of January, the list of reasons to maintain a cautious stance remains long. The confluence of tightening U.S. dollar liquidity; political risk in Europe; rising debt levels and funding costs in Italy; high debt levels globally; weakening growth in China; and an ongoing trade war all create the potential for further market disruption.

It should be noted, however, that market volatility should be viewed as both a risk and an opportunity. This is especially true for those, like ourselves, who view true risk as the permanent impairment of capital. For an active fund manager, backdrops such as this are often critical to be in a position to add value for our clients. We will endeavor to continue taking advantage of such market dislocations, adding to our stable of high quality holdings as we are able to find them at discounts to their intrinsic value. Further, the portfolio is already attractively valued with a prospective P/E ratio of approximately 15x and a 3% dividend yield, despite these businesses being leaders or emerging leaders within their respective fields.

Offering Document for further details of the risk factors.

Sources: Brown Brothers Harriman (Luxembourg) S.C.A, Matthews Asia, FactSet Research Systems, Bloomberg