Matthews Asia shines a light for active investment strategies

Matthews Asia has been investing in Asia's small-cap stocks since the firm's inception in 1991. More than 25 years later, the firm sticks to its long-term, active management, bottom-up strategy. For the firm's Asia small companies strategy, this philosophy is reaping solid rewards.

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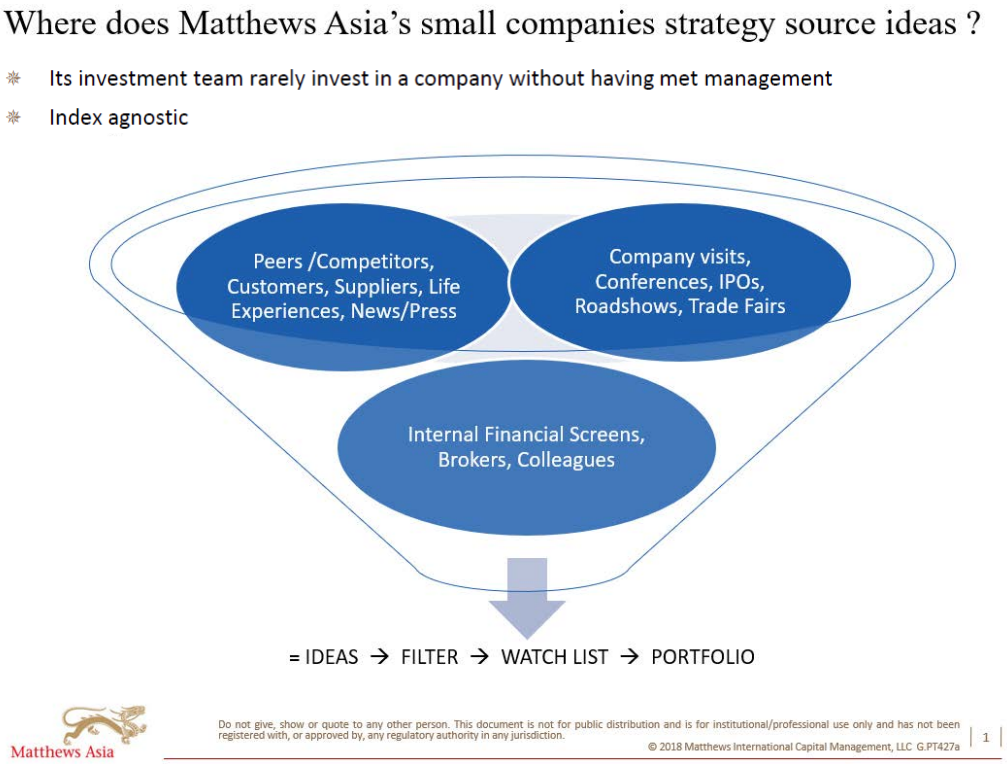
ASSET MANAGEMENT FIRM MATTHEWS ASIA has since 1991 established an enviable reputation in Asian small-cap companies. The firm launched the Matthews Asia Small Companies dedicated strategy in 2008 and has grown to approximately USD450 million in strategy-level assets.

"Matthews Asia applies a quality growth approach to selecting opportunities in the Asian small-cap universe with a bottom-up analytical strategy," reported Jeremy Sutch, senior small cap analyst at Matthews Asia, as he presented his Workshop to delegates at the Hubbis Investment Solutions Forum in Singapore. "We select stocks on the basis of detailed financial analysis, and then almost forensic investigation of the markets, the customers, the supply chains and of course of the management and the controlling shareholders."

JEREMY SUTCH
Matthews Asia

A deep experience of Asia

Sutch has long experience in the region. From his base in Hong



Kong, he has covered Asia's small-cap stocks since 1994, first focusing on Hong Kong and China and then expanding his remit to the wider Asia region.

He explained that smaller-cap stocks - in the valuation range of USD100 million to USD3 billion - have various features that set them apart from larger groups. They reflect rising entrepreneurship and new business models across Asia. They are sufficiently nimble to react to changing patterns of domestic demand.

They lend themselves to bottom-up stock selection given the scarcity of sell-side research coverage. They often complement existing Asian or emerging markets larger-cap exposures.

The universe Sutch and his team have on their radar screen, based on their second filter process, is more than 1200 companies out of a total of around 5600 in Asia excluding Japan and Australia. And that number of 5600 stocks has already been cut down from more than 17,000 small-cap stocks based on a variety of other metrics.

A dedicated team of experts

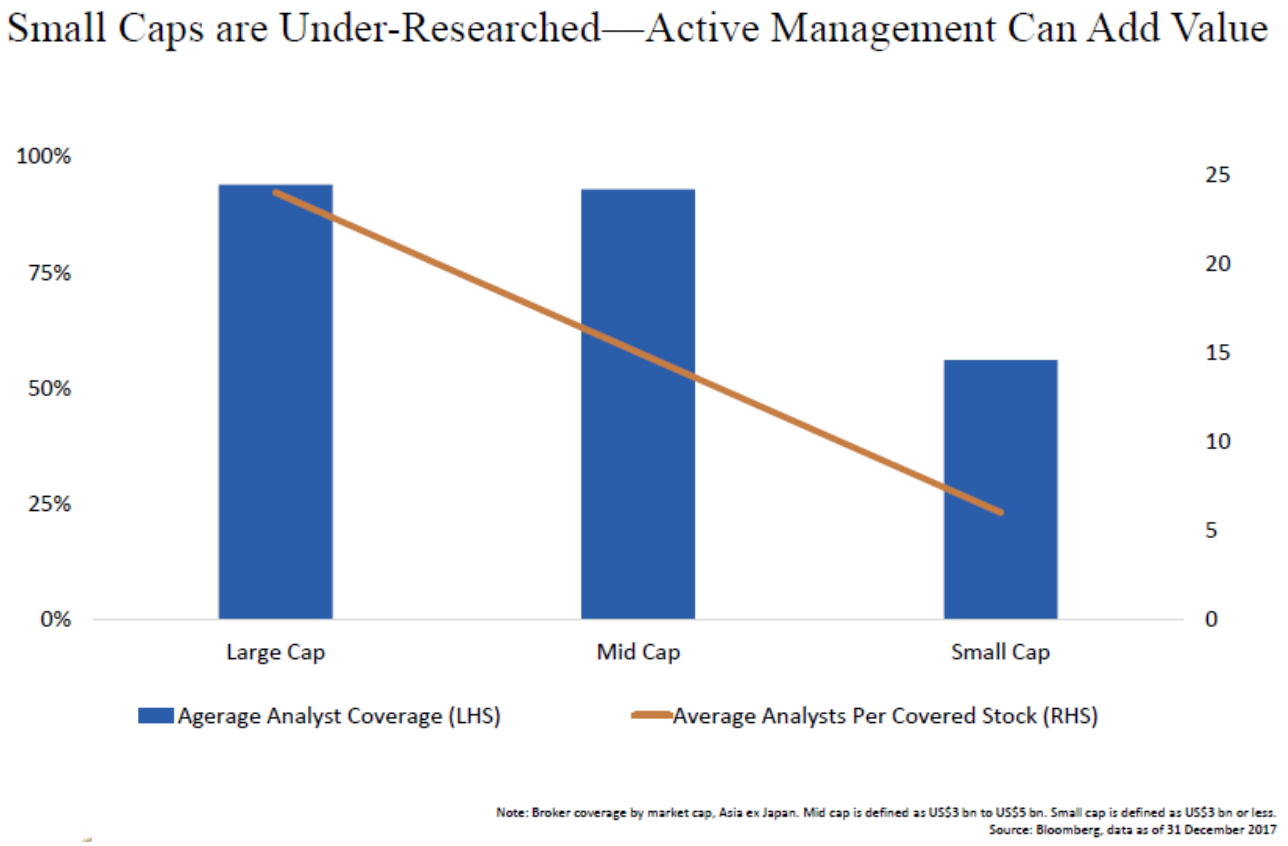
The Matthews Asia team comprises six dedicated small-cap analysts. "This is a labour-intensive asset class," Sutch observed, "but we have the team, the size, and the experience, to take advantage of the inefficiencies in the market. Some of the inefficiencies are essentially due to low coverage levels, for example only about 55% of companies have any coverage and those that are covered are not covered by many analysts. Small-cap stocks have roughly five firms following them, while large-cap stocks have about 25 analysts looking at each one."

"We are truly active, we are all about turning over lots of stones to find those hidden gems," Sutch added. "I do well over 200 company visits a year and that means with our team we are making more than 1200 small cap visits a year." The initial 1200 stock universe on the Matthews Asia radar has a market value range from US$100 million to US$3000 million, they must have a positive 3-year average revenue growth history and 3-year average operating income growth.

Return on equity should be greater than 10% and return on invested capital more than 8% per annum.

"There are several other key features that allow stocks into our radar screen," he explained. "We seek a positive capital spread, above industry average revenue and earnings growth, consistent cash flow generation and organic financing, margin sustainability, as well as looking at barriers to entry and pricing power. The mission ultimately is to then find the 60 to 80 stocks we actually hold in our small companies' strategy."

To narrow down to the actual investments selected, there are other characteristics of considerable importance, including dis-



ciplined capital utilisation track record, the sensibility of capital budgeting and allocation, management team incentives and corporate governance oversight. "Layer on top of all this the valuation multiples, plentiful company visits, and we can select the best of the best," Sutch explained.

Looking beneath the surface

Matthews Asia aims to minimise risk by looking deeply into the management background and incentives, checking that there are few or no related-party transactions, that businesses are not simply on the acquisition trail, and check with upstream suppliers and downstream customers.

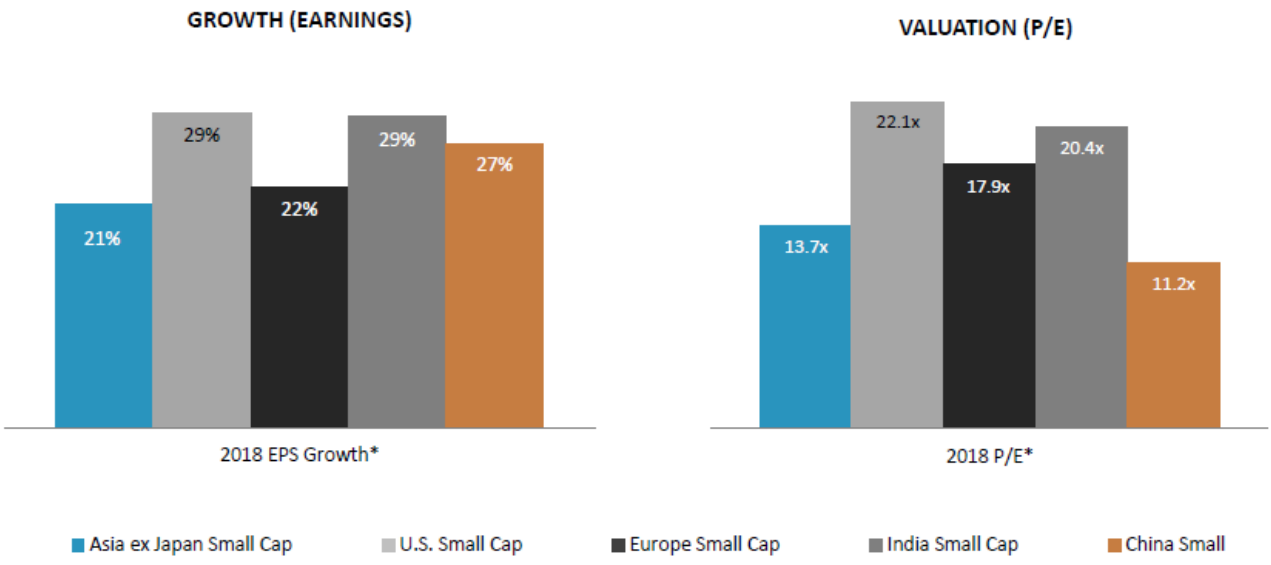
Small cap, Sutch explained, tends to be more idiosyncratic and less macro driven. Secondly, although he conceded this sounds counter-intuitive, looking for example the China small-cap sector, the stocks are generally less volatile than the big-cap sector. He said he thinks this is because there is less ETF money flowing in and out of small caps and secondly the index is more diversified within small cap, whereas large cap tends to be more dominated by key sectors such as financials, oil and gas, tech and other inherently high beta sectors. "But, as we are longer-term in our view and patient whatever volatility is out there represents an opportunity for us."

Sutch highlighted that there are two different types of money flowing into the small cap asset class. On the one hand there are 'traders'. This would be more local money, such as Asia based funds and retail investors, who tend to be more tactical in the way they approach stocks and the sector generally. On the other hand there are 'investors'. This would be longer-term more patient and disciplined money from international funds like ourselves. The short-term horizon of the former often provides decent (lower entry) opportunities for the latter. He also addressed concerns that smaller cap in Asia tends to be more mysterious in its activities. "Yes, there are plenty of small caps to avoid but we are only investing in what we consider to be about the top 1% of what is a pre-selected universe of about 5600 companies to begin with."

A silver lining

"The negative sentiment which is out there affects valuations, so again this creates investment opportunities," he added.

Asia Small Cap Valuations Against Global Small Cap



*Estimates as of May 16, 2018 for Asia ex Japan Small Cap (MSCI All Country Asia ex Japan Small Cap Index), India Small Cap (MSCI India Small Cap Index), U.S. Small Cap (Russell 2000 Index), China Small (MSCI China Small Cap Index), and Europe Small Cap (MSCI Europe Small Cap Index, USD) for companies that provided forward looking EPS and P/E. There is no guarantee that estimated EPS growth and/or P/E will be achieved. Indexes are unmanaged and it is not possible to invest directly in an index. Universe includes Chinese companies listed on the Hong Kong Exchange, and B shares listed on Shanghai and Shenzhen exchanges.

Source: Bloomberg

Sutch expanded on his views of governance. "It is all about management integrity," he explained. "We like to ensure that the top management and owners have interests aligned with the minority shareholders. So, for example, we try to talk to the early angel or private equity investors, if there were such, to see that the path has been followed. We also try to talk to investment bankers involved for example in the IPO process and have seen the history of the company. Moreover, we try to understand more about the social context and reputation of the individuals involved."

In short, Sutch and colleagues are seeking out earnest, hard-working owners and management teams and trying to avoid the all-too-often repeated stories of dubious activity and related-party deals designed to obscure and to skim

ADVOCATING THE ACTIVE APPROACH IN A WORLD OF PASSIVE INVESTMENT VEHICLES

Driverless cars might be the next thing on our roads, just as driverless investment vehicles such as ETFs are ever more proliferating in the global financial markets. But, people will still want to drive their own cars, just as investors still want to buy into actively managed funds.

Jeremy Sutch, a senior analyst at Matthews Asia in Hong Kong, made a presentation to the Hubbis Investment Solutions Forum in Singapore. He observed that in the past decade investment flows have increasingly shifted from active funds into passive instruments. But, he said that his near 25-year experience analysing stocks in Asia has taught him that active still has a great future.

"I am still a champion of the active management approach to add value and give investors solid returns, especially in more volatile conditions."

"The merits of active versus passive have obviously been debated and I am not here to denigrate the passive approach," Sutch told the delegates. "But certainly, in the context of our remit, namely

the cream off the top. "I prefer not to name companies or countries," Sutch noted, "but there is clearly plenty of scope for the family owners who control some of these companies to bleed the listed company for personal gain."

Sutch moved on to idea generation. "It is all about filtering, with numerous financial metrics, market and customer and other assessments, and then the much more esoteric concerns such as governance. We have our portfolio and we have a watchlist, where perhaps there are many great features but where the valuations do not yet fit our portfolio."

Returns based on reason

"Remember," he said, "this is about filtering a huge universe down to just 60 to 80 holdings in the fund."

As to the outlook, Sutch maintained that even though markets were off to a roller-coaster start earlier in 2018, Matthews Asia believes the long-term growth trajectory and the fundamentals of most Asian economies remain sound. "Our core focus remains bottom-up, fundamental research and while geopolitical movements and interest rates cycles over the shorter term can impact all firms on both the industry and company level," he concluded.

"Moreover, we see positive long-term structural trends taking place in Asia, and we aim to uncover lesser-known companies that are poised to benefit from such trends including productivity improvements, lifestyle upgrades and innovation-driven growth opportunities. We especially like what we see of the innovation within the technology and medical fields, and the use of automation in industrial functions and even in the service industries to boost productivity." ■

Asian equities, we see a great future for active."

Sutch observed that the underperformance that the active approach has seen in the last 24-36 months is what he termed a passing phase, which is neither unprecedented nor structural.

"Historically, for example," he noted, "we have seen that as interest rates rise so does volatility, and there is rising divergence in the performance of individual stocks, all of which provide more conducive conditions for the active approach and especially for our bottom-up, individual stock selection investment style."

Sutch observed that while a veritable wall of money has piled into passive strategies, gaining a larger percentage of the total investment funds pie, there is no evidence to suggest that larger share has any predictive bearing on future alpha.

"We want to be in control," he reported, "so we have different metrics, for example, we consider that indices are somewhat backwards-looking and often fail to capture key trends in the making. We follow an unconstrained, benchmark-agnostic approach, so we are not restricted to any particular index, we are flexible to adapt our portfolio."

Sutch noted that Matthews Asia is excited about a number of themes and sub-themes currently emerging in Asia and that have negligible or zero exposure in some of the indexes. "That is an opportunity for us, because as I said we do not follow any indices."

Sutch then went into further detail about Matthews Asia's approach to bottom-up analysis and investment. "We might begin with corporate governance, a broad term that incorporates a lot – from ownership and management, incentive structures, sensible capital allocation, checks and balances of committees and boards, and so forth – but that distilled down to us simply means focus and transparency. There are plenty of rogues out there and we do our best to avoid them."

He highlighted as an example the case of a company currently suspended at a suspended market valuation of USD21 billion and which had reputedly cooked the books on sales of thin film solar module manufacturing lines by falsifying transactions with a related party.

"This stock was in one of the major indices," Sutch noted, "and therefore numerous passive strategies would have been drawn in based on their market valuation, whereas hopefully, our approach would have red-lighted such a business."

Sutch expanded on the qualitative due diligence that Matthews Asia layers on top of its quantitative analysis. "Numbers are very important but often one cannot rely purely on management's word or published financials," he explained.

"I would stress that the overriding philosophy that we follow is 'when in doubt avoid' and that approach has worked consistently for us for many years."

Sutch added that the active investment approach is maintained throughout the life of any holding. "When we are invested, we keep very active," he explained, "constantly questioning margins, growth and other projections and assumptions. I almost get to the point that saying we are paranoid about potential risks to stocks in our portfolio. That keeps us highly focused and highly selective."