THE ASIAN MARKETS: A LONG-TERM VIEW FROM THE TRENCHES

Regional funds focusing on the Asian "tigers" have been at the bottom of the rankings for some time now, as the region has been going through severe economic dislocations. And that makes it tough to sort through the funds, since the regional problems have overwhelmed individual stock-picking abilities. While investors should not necessarily abandon the region, they have to have strong stomachs for volatility—perhaps stronger than many investors previously had realized.

One fund manager with an interesting approach to the region is G. Paul Matthews, who had garnered an enviable track record as manager of the G.T. Pacific Fund in the 1980s, and started his own management firm in 1991. His Matthews Tiger Fund has done well relative to its index (Morgan Stanley Far East ex-Japan) since inception, in 1994. However, it is his Matthews Asian Convertible Securities Fund that has attracted some attention. Although it is tiny—just over $4 million—the fund has avoided much of the regional volatility due to its investments in convertibles, which are hybrid equity/debt securities that provide some of the upside from equities while limiting downside risk. Needless to say, this has served the fund extremely well over the past 4½ years; the fund has outperformed its peers as well as the index.

The funds are just under five years old and are not covered in AAII's Guide to Low-Load Mutual Funds*; performance figures here are from Morningstar.*

In early August, portfolio manager G. Paul Matthews discussed the management of the two funds, as well as his outlook for Asian stocks, with Maria Crawford Scott.

FUND FACTS

MATTHEWS PACIFIC TIGER
MATTHEWS ASIAN CONVERTIBLE

CATEGORY:
International

PERFORMANCE: (thru 6/30/98)

	Tiger Fund	MSCI FE ex Jap
1 Year	–60.0	–57.2
3 Years	–18.8	–22.4

	Asian Convert'l	MSCI FE ex Jap
1 Year	–29.7	–57.2
3 Years	–4.5	–22.4

RISK:
Average (Pacific Tiger)
Low (Asian Convertibles)

TOTAL ASSETS: (as of 6/30/98)
$40 million (Pacific Tiger)
$4 million (Asian Convertibles)

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What is the investment philosophy of the Matthews Tiger fund?

We are long-term growth investors, seeking growth companies that trade at reasonable prices. We think that these companies exist all across the board in Asia, but that they are particularly well represented in what we think of as the mid-cap part of the market, companies that have market capitalizations (share price times number of shares outstanding) between $500 million and $2 billion, although that definition would now include most companies that a year ago would have been considered large-cap.

How do you determine which companies are growth-oriented?

We start with the universe of all listed companies in Asia across the nine markets we follow, which is about 3,000 companies. We then eliminate the very smallest, those below $200 million in market capitalization, and then we screen them by their expected growth rates, based on analysts' consensus estimates, over the next two years.

Once we've done the initial screening, we refine that to produce a smaller universe based on our own expectations of four- to five-year growth. We have our own team of analysts here that spend a lot of time on those estimates, and, in particular, they spend quite a bit of time visiting the companies.

Are there aspects of gathering the financial data from managements that are particularly difficult to deal with?

Yes, the real problem in China is that most companies are not required to produce accounts that are up to international accounting standards. That is one of the reasons why we have tended to invest more in A shares rather than B shares—the A shares are listed in Hong Kong, and listings there are required to produce accounts up to international accounting standards.

However, the disclosure issues are not always as straightforward as one might think. Some of the Chinese companies are reluctant to disclose information, not because they don't want you to see it, but because they don't want people in China to see it. I've come across Chinese companies that issue English-language accounts with far more information than their local language accounts, and that's really because they don't want their competitors to see, for instance, that they've made a particular capital investment.

Once you've found potential investments, what do you examine?

Mark Headley [co-portfolio manager] and I spend a great deal of time visiting companies to make sure we are comfortable with our forecasts. And we've found that it really comes down to the quality of management.

And what do you look for to determine the quality of management?

We look at all the same things one would look for in U.S. companies or companies anywhere. We focus on shareholder value, whether management's interests are in line with the shareholders, that sort of thing.

Do growth companies tend to cluster in particular countries?

Yes, but the key issue for us is to find growth companies at reasonable valuations. For example, Taiwan would appear to be full of growth companies, but none of them are trading at reasonable valuations, whereas Korea would appear to have very little growth in the near term, but the valuations are extremely attractive.

That said, in the Tiger Fund we are pretty well diversified. We've increased our exposure in Korea this year, partly deliberately and partly because of how it performed, so Korea is now about 21% of the portfolio. Outside of Korea, we have about 24% in Hong Kong and just under 20% in mainland Chinese companies. Those three markets are our largest exposures. The next in order of size would be Singapore, Thailand, and the Philippines.

Do you have any holdings in Indonesia?

We actually have two small holdings in Indonesia that we bought recently, but it is a tiny position, less than half a percentage of the portfolio. One is a small position in the largest supermarket chain. It was hit hard by the instability there, but the management is intact and, more importantly, a Singapore firm has bought a 30% stake in the business, guaranteeing their survival. It is just an extraordinary value situation, but with all the risks in Indonesia, we don't want a big position in it.

What would cause you to sell a stock?

Finding something better in terms of growth and valuations would be the primary reason to sell something. However, we like to think that when we buy a stock, we're buying it for the next two to five years.

Can you talk just a little bit about the Convertible Fund? First, how do the underlying securities work?

The convertible bonds work just as they do in the U.S. [they pay a yield and are convertible into stock at a pre-stated price]. However, they are denominated in U.S. dollars, so if you hold the instrument to maturity and the company doesn't go bust, you get 100% of your money back in dollars. Now, the cost of achieving that same thing through owning local currency instruments and then hedging would be totally out of the question. The way I look at it is that the companies are paying for the cost of hedging the currency, although I don't think that is what the companies thought of when they issued the bonds. And that's what's allowed that fund to hold up so well relative to both the Asian equity markets and the other Asian funds.

I think we're still a year away from the recovery of the real economies, but we're already at that stage of the cycle where we could expect recovery of the financial markets, and I think the first indicator of that would be in the fixed-income markets. So there is an argument for being in fixed-income instruments as opposed to equity.

Another compelling argument for the convertible bonds is that the yields on them are becoming very attractive relative to U.S. instruments of comparable maturity, but unfortunately the structure of the bonds is such that very often the yield is in the form of return on capital at maturity, so it doesn't show up necessarily as a high level of current income. However, if you look at the history of the fund, it has consistently paid out quite a high level of gross dividends, even though a component of that is reported as return on capital.

How large is the market?

It is a shrinking market on a six-month view, but on a long-term basis it has been a growing market. The biggest issuance over the years has been out of Hong Kong, Taiwan, Korea, and Thailand, with lesser issuance out of Singapore, the Philippines, and Indonesia, but it is pretty well spread out. There are about 350 Asian companies that have issued dollar-denominated convertibles, and the current universe is probably under $10 billion in current value, but that still is a big enough universe for us to build a portfolio in these things.

Originally, I believe, you started the fund because you felt that this market was inefficient. Will the market continue to grow and become more efficient?

Originally, I felt that it was undervalued relative to its components and I think that has proved to be correct. Unfortunately, the way in which the undervaluation has come out is that they've held up better than we would

have expected given the declines in the equity market, so investors haven't made money out of that inefficiency but they've lost less than they would have.

There are still enormous inefficiencies, although I think the biggest inefficiency is that the convertibles did not accurately reflect the implied value of the currency put options that they included.

I think as the market for these develops, companies will stop issuing foreign currency instruments, and in time we will be investing in local convertibles and having to bear the cost of that hedge ourselves, but as long as they're issuing dollar-denominated instruments, we will take advantage of them.

In both the Tiger and Convertible Funds, do you make your valuation judgements based on local values?

No. We're always looking at international comparisons. If we looked at local values only, we probably would have a much higher weighting in the Tiger Fund in some of the Taiwanese growth companies, but we have to look not just at the relative valuations within the region but relative valuations internationally.

And I have to think that right now these valuations are very attractive. The question is: What will the growth be?

And that gets to the big question everyone is focusing on now concerning the region. Clearly, the situation right now is looking very bleak. What is your opinion on the problems in Asia and how quickly will the region be able to turn around?

Well, that is an enormous question.

I think that these countries have addressed the principal long-term problem, which was actually a problem based on policy decisions made in the early '80s, as far as the management of Asian currencies and domestic monetary policy is concerned. The root of the crisis was the attempt of countries like Thailand, Korea, Indonesia, Malaysia, and the Philippines to fix the rate of exchange of the local currency to the U.S. dollar while maintaining independent monetary policies.

In my opinion, the long-term problem of the management of the exchange rates and domestic monetary policy was solved between July of last year and January of this year, when one by one these countries adopted floating rate regimes, with the obvious exception of China and Hong Kong.

Unfortunately, in solving the big currency issue problem, they brought about either voluntarily or in some cases involuntarily the sharpest contraction in domestic demand that we've seen in any economy anywhere in the last 50 years. So, we now have six of nine Asian economies that are not going to run out of foreign exchange reserves, but are in the midst of very severe economic contractions.

We are starting to see money growing again in some of these countries, but I think that the earliest we could hope to see positive indicators would be the first or second quarter of next year.

Some analysts feel that Japan's recovery is the key to the region.

I don't think that is necessary. I think what the economies need is some confidence that total trade worldwide will not be shrinking.

What about other problems—corruption and lack of complete disclosure on the part of many companies?

We're already seeing the willingness of companies in Asia to disclose more, because they have to if they are going to be able to raise capital. Their willingness to give up management control, if they have to, to stay in business is something that didn't exist two years ago. Foreign investors are becoming a much more significant factor in some of these markets—maybe because they are now allowed to be. So all of those things are changing, but they are changing marginally. I think we will look back in five years and see the improvements, but I don't think there would be any one day that we could turn to and say, "Ah, that's the day that they fixed the problem."

If the economy starts improving next year, would the Asian markets lead?

I believe they would—the financial markets are going to move ahead of the real economy. Interest rates in some of these countries have halved from where they were in January and February and that to me indicates that liquidity is improving in some of these countries, even if that is not yet having an impact on the real economy.

What's your five-year outlook then for the equity markets?

In the near term, the best prospect for making money is simply a contraction of the risk premium currently being put on the region by international investors, which by itself could lead to a substantial recovery in value. But on a five-year view, I believe that these countries will have better-managed economies and that the average company will be better-managed. And since we're looking at a cyclical situation where markets and financial values are very depressed—more depressed than any of us have experienced in our lifetimes—the potential returns to be made when the recovery comes are very significant.

Could the returns be greater than, say, U.S. returns?

Very much so. I think we are looking at an Asia that is priced to go out of business right now. Goldman Sachs [which is going public] is going to be worth significantly more than some of these countries—it's going to be worth twice that of Thailand and on par with the whole of Korea, which is a country that is a very significant industrial manufacturing country. However, the problem is that in the meantime the stocks can still go lower. ✦