Matthews Asia

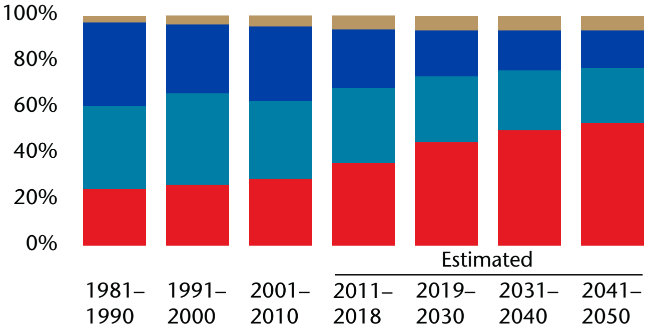
Asia: An Overlooked Opportunity

The Opportunity in Asia

Asia encompasses half the world's population and continues to experience rapid economic growth. The region is highly diverse, ranging from mature, developed economies like Japan to large emerging markets such as China and India to smaller, frontier economies such as Vietnam. Collectively, the region's share of global GDP has been rising and is expected to exceed 50% by 2050.

Figure 1. The Rise of Asia Continues

Regional share of global GDP



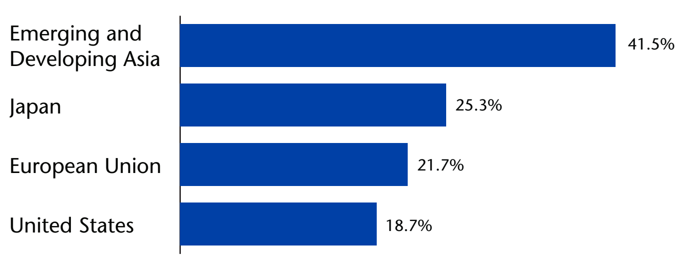
Source: The Economist Intelligence Unit

This dramatic economic "lift-off" has been driven by three key factors: high savings rates, total factor productivity and structural economic changes. While each is significant, it is the combination of these factors, together with other supporting elements, that account for the region's more rapid relative growth compared to other emerging markets.

Savings Rates: Asia's ability to save and invest efficiently in its economy—and its high savings rate as compared with other developed and emerging economies—drives much of its appeal as an investment destination. The region's savings rate has far-reaching implications for its economic growth, social stability and productivity. Domestic savings are an inherently more stable investment source than are foreign-sourced investment flows that vary with economic cycles. Domestic savings are a particularly valuable source of investment for long-term projects in infrastructure and education.

Asia has been uniquely successful in this regard, generating robust savings for investment and providing the region with investment capital for future growth. Led by China's 46% savings rate, the Emerging and Developing Asian countries rank among the highest in the world on this measure.

Figure 2. Gross National Savings as % of GDP

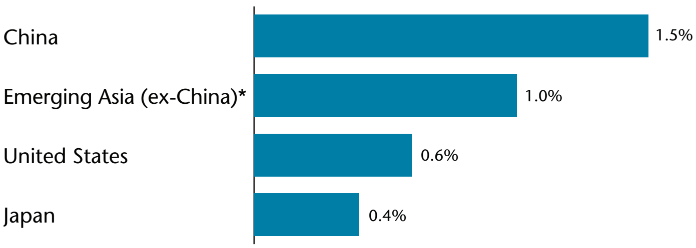


Source: Economy Watch, IMF, 2015 statistics

Total factor productivity ("TFP"): TFP captures all the contributors to an economy beyond the traditional measures of labor and investment. Examples of TFP in contemporary Asia include a shift from manual industrial production to robotics, the increased use of information technology, and the migration of workers to cities where their labor contributes more to GDP and where they find educational opportunities for their children.

Many economists believe that TFP may be the single biggest factor driving GDP growth. And TFP growth is notably high in Asia, influenced by supply-side reforms, market friendly policies, entrepreneurialism, technology and education.

Figure 3. Average TFP Growth, 2009–2013

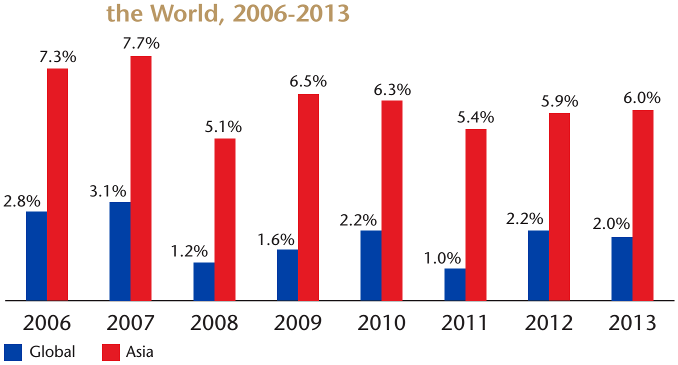


Source: APO databook, OECD

* This regional definition includes, in order of TFP growth: Taiwan, S. Korea, India, Hong Kong, Philippines, Indonesia, Thailand, Singapore, Malaysia

Structural Changes: Rising personal wealth and consumption, combined with gradual economic liberalization and the spread of technology, have transformed Asia's economies and markets. The region's economies are evolving rapidly from agriculture and mining toward a higher productivity structure led by consumption and service activities. The tendency to see Asia's economic model as one based on low wages is inherently flawed. In recent years, the Asia-Pacific region has experienced wage growth roughly three times higher than the rest of the world.

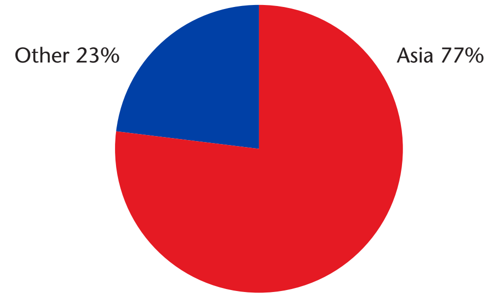
Figure 4. Growth of Average Real Wages in Asia-Pacific and the World, 2006-2013



Source: International Labour Organization: Global Wage Database 2014/15, based on national statistics

In addition to productivity gains, factors including rising wages, personal wealth and urbanization are driving Asia's consumption of physical goods, such as automobiles and property. At the same time, the region is accelerating the build-out of social infrastructure like health care and insurance. This will continue in coming years as Asia's middle class continues to expand. Over three-quarters of this decade's growth in the world's middle class population will come from Asia.

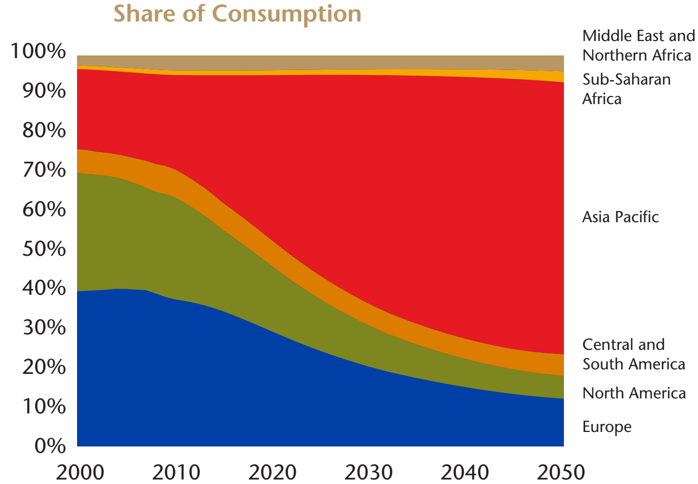
Figure 5. Asia's Share of Middle Class Population Growth



Source: Trillion-Dollar Growth Trends to 2020, Bain & Company, 2011

In sum, the influence of these three factors (savings rates, productivity and structural change) is expected to result in Asia attaining a dominant share of global middle class consumption in the coming decades.

Figure 6. Rising Wages and Productivity Behind Asia's Rising Share of Consumption



*Data represented beyond November 2011 are estimates only.

Notes: Global middle class consumption is defined here as household consumption between USD 10 and USD 100 Purchasing Power Parity (PPP)/day. Projections hold most recent distribution constant (from PovcalNet database) and assume consumption equals income growth (projected by a Cobb-Douglas production function, a model of Real Exchange Rate (RER) convergence based on the Balassa-Samuelson model, and UN population projections).

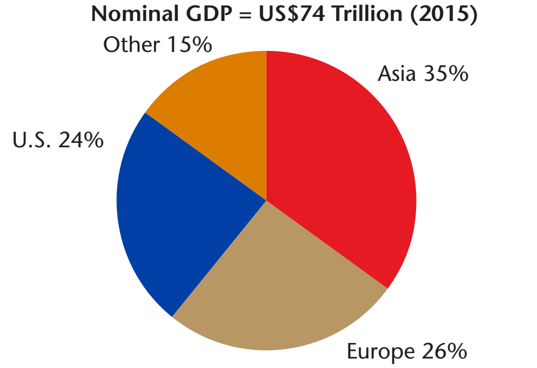
Source: Organisation for Economic Co-operation and Development (OECD) 2011, Perspectives on Global Development 2012: Social Cohesion in a Shifting World; Data as of November 2011

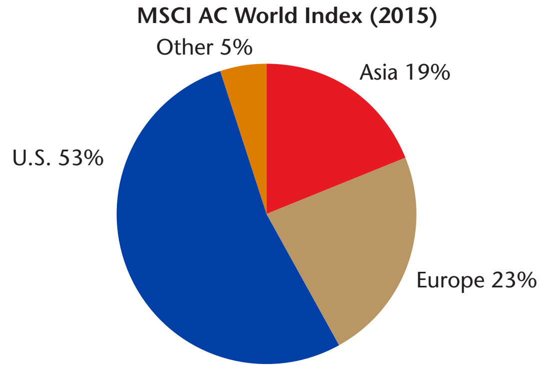
Investing in Asia

While the opportunity in Asia is substantial, investors are not yet taking full advantage. Generally, they not only under allocate to Asia but then invest in the "wrong kind of Asia", thereby missing out on the potential of some of the region's fastest growing sectors.

There is a mismatch between Asia's share of world GDP (over a third, as shown earlier in Figure 1) and its share of world stock market capitalization (under one-fifth). Over the long-term this may provide a substantial opportunity for investors.

Figure 7. Asia's Share of World GDP is Significantly Greater than its Share of World Market Capitalization

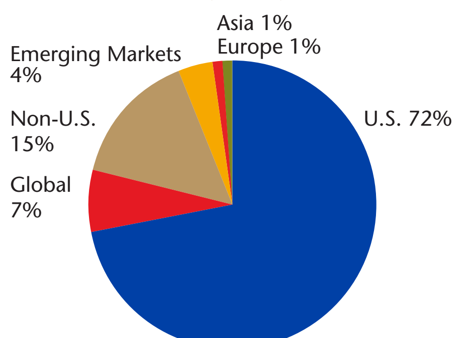




Sources: MSCI, International Monetary Fund; IMF GDP data as of Dec. 2015; MSCI All Country World Index as of Dec. 31, 2015

But investors do not allocate even this proportion of their assets to Asia. At present, U.S. mutual fund investors still have over three-quarters of their equity allocations in the domestic market. Most of the rest is in non-U.S. or global portfolios. Assuming these funds have an implicit Asian exposure equal to the region's index weight, the aggregate investor exposure to Asia is still below 10%, under half of the region's share of the world's market capitalization. Just 1% of equity mutual fund assets are in dedicated Asian regional funds.

Figure 8. Domestic Equity is Still Dominant
Mutual Fund Equity Allocations by U.S. Investors, as of December 31, 2015; Total Assets: US$9.1 Trillion



Source: Investworks, Dec. 31, 2015

Note: "Global" includes strategies investing in the U.S. and substantially all developed countries outside the United States; "Non-U.S." includes strategies investing in substantially all developed countries outside the United States; "Regional" includes strategies investing in segments of the world markets, including regions such as Europe or Asia, or individual country strategies. For this chart, emerging market strategies are included in Regional.

Investors should be aware that market capitalization weighted indices may not fully reflect the underlying potential, especially in Asia. To give two examples:

- Asia benchmarks largely exclude China A-Shares[1] and hence are underexposed to a significant number of companies in this rapidly growing economy.
- Emerging market indices have significant weightings in commodity exporters (mostly non-Asian) and, hence, fail to reflect Asia's growth potential, especially given the region's surge in middle class consumption.

As a result, a benchmark-only approach to Asia means investors may not have any exposure, not enough exposure, or the wrong kinds of exposure to the region's dynamic growth potential. This suggests that a "non-benchmark," active management approach may be more effective when trying to invest in the "right kind of Asia."

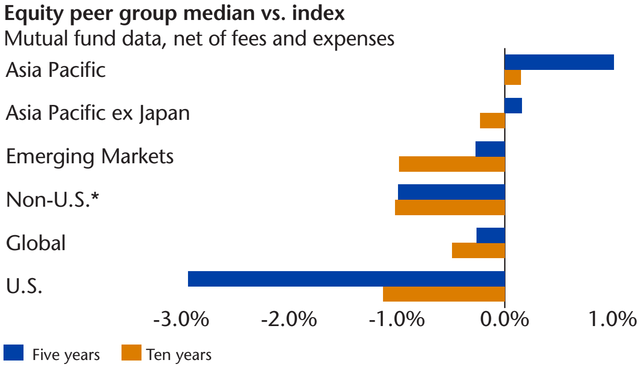
While the success of active management in U.S. equities is widely debated, Asian active funds, on average, have done materially better against their benchmarks than their U.S. counterparts. Compared to Asia, the U.S. is a relatively efficient market dominated by institutional investors. To a significantly greater degree than in the U.S., Asia-focused professional money managers compete with individuals and entities that do not always appear to rely on company fundamentals. Ultimately, markets follow those fundamentals and so in the short-term this can lead to big gaps between a company's stock price and its intrinsic value, providing opportunities for active managers.

That's the theory. But how has it worked in practice?

Using the rather stringent test of mutual fund performance net of fees and expenses, we show how the median equity fund has performed against its index over five and ten years for the Asian region and the global fund universe. The only peer groups in this list where the median equity fund beat its index over the five years to end 2015 were Asia and Asia ex-Japan. Reflecting the more competitive and efficient U.S. market environment, the median U.S. equity fund finished at the bottom of this ranking in both periods. This tends to support the hypothesis that active managers can find more opportunities in Asia than their competitors can in the U.S. or across the range of non-U.S. markets.

1 Renminbi-denominated stocks in mainland-based companies, traded on Chinese exchanges and generally available for purchase only by mainland citizens

Figure 9. Asian Mutual Fund Peer Groups Have Shown the Ability to Add Value
Annualized Difference in Percentage Returns of Median versus Benchmark, Mutual Fund Peer Groups



*Average of medians for growth, core and value international equity categories as defined by Investworks

Source: Investworks, March 31, 2016. Investworks labels Asia Pacific as "Pacific Basin" and Asia Pacific ex Japan as "Pacific Basin ex Japan"

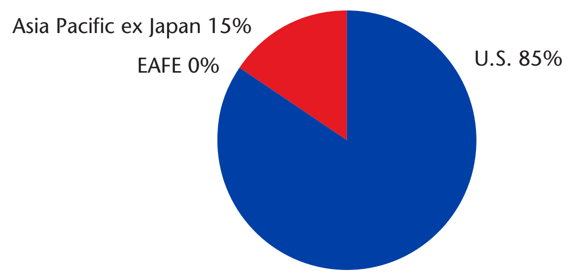
Peer group data calculated and compiled by Investworks. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

Investors seeking to enhance their returns and improve their diversification generally use non-U.S. (i.e. EAFE) or global funds when investing overseas. We believe this has been, and will likely continue to be, a mistake. Instead of using Asian funds primarily as "exotic" additions, investors should consider using them as the anchor of their international diversification. The logic behind using less EAFE and more Asia is simply that Asia can provide a better combination of return potential and diversification than EAFE.

A long-held tenet of international diversification has been that the low correlation with U.S. stocks provides a diversification benefit by reducing the volatility of the investor's total portfolio. With increasing globalization of the developed markets, the correlation between MSCI EAFE and the S&P 500 has increased in recent years. Asian market indices have lower correlations with the U.S. than the MSCI EAFE Index, and the opportunities outlined in this paper show the potential for high returns. In hindsight, Asia Pacific ex Japan was better at increasing risk-adjusted returns for a U.S. equity investor portfolio over the 25 years ending 2015 than was EAFE, the benchmark approach actually used by many allocators.

The benefit of low correlation becomes clear when calculating the most efficient portfolio, i.e. the one that maximizes the risk-adjusted return (or Sharpe ratio). Comparing the historical returns for the S&P 500, MSCI EAFE and MSCI AC Asia Pacific ex Japan indices over the 25-year period 1991–2015, the most efficient empirical portfolio over that period would have held only 85% U.S. equity. The other 15% in that efficient portfolio however was not EAFE (which received a zero allocation), but Asia Pacific ex Japan.

Figure 10. Efficient Portfolio: 25 Years to December 31, 2015
Allocation that Provided the Maximum Risk-adjusted Return of a Three Asset Class Equity Portfolio (U.S., EAFE, Asia Pacific ex Japan)



For illustrative purposes only. Not intended as investment advise or an investment recommendation.
Source: Portfolio Visualizer

Summary: Investing in Asia

Investors can capture much more of the potential for investing in Asia than they currently do. Underweighted, and often allocating to the "wrong kind of Asia," investors may benefit from rethinking how they approach Asia. The region's markets demonstrate low correlations with the U.S., significant return potential, and evidence that active management has worked. Instead of looking at Asia as an exotic "add-on" to an EAFE allocation, there's a strong case for using Asia rather than EAFE as the anchor of international diversification. The original motivation for investing abroad was to find faster growing companies in markets with low correlations with the U.S. That concept today is far more applicable to Asia than anywhere else in the investing world. Instead of looking at Asia as an exotic "add-on" to an international allocation, we believe there's a strong case for using a dedicated and substantial Asia exposure to improve both returns and international diversification.