Introduction

A key element of investment success is a long-term perspective. With it, investors can assess the long-term impact on their portfolios of fundamental, economic and demographic changes. They can then allocate their portfolios more effectively, focusing on increasing returns over an extended time horizon. This paper is designed for those long-term investors, and seeks to help them understand and evaluate the benefits of making a meaningful allocation to Asian investments. Markets in Asia can be volatile. But for investors who see the potential in establishing strategic allocations to Asia, periods of short-term price volatility can provide an excellent opportunity to establish or increase positions. The global investment environment currently shows clear differences between regions, highlighting the growing importance of “Allocating to Asia”:

- The United States economy has returned to growth, rising employment and much-improved investor sentiment. But this recovery has turned on ultra-low interest rates and quantitative easing. As this support is removed and rates begin to rise, there is some uncertainty as to the implications for the economy.

- Europe continues to suffer from lackluster growth and persistent high levels of unemployment. Meanwhile, quantitative easing by the European Central Bank continues with the aim of improving the region’s weak economic outlook.

- Many emerging markets ex-Asia are saddled with debt (often denominated in U.S. dollars), and struggling with falling commodity prices and softening export demand in Europe, Japan and China. Brazil and Russia—among the world’s largest emerging economies and the non-Asian components of the BRICs—are in recession and burdened with hard currency debts incurred when commodity prices were robust in the half-decade after the financial crisis.

- Asia stands apart, with 2015 regional economic growth of 5.5%, accounting for 35% of global output. Notwithstanding the impact of the financial crisis, Asia today is harvesting the fruits of a generation of improving fiscal indicators, robust economic growth and rising standards of living.

Despite the volatile start to 2016 and concerns around the general health of the global economy, from a relative standpoint Asia’s economic fundamentals remain attractive. While it continues to represent a sizable part of the global economy it remains a very small part of an investor’s portfolio. This paper aims to explain why portfolios are typically underweight and show how investors can most effectively consider increasing their allocation. It begins by setting out the economic and fundamental case for Asia, looking at some of the key indicators that highlight the region’s growing role on the world stage. This is followed by a discussion on how benchmarks typically under-represent the region and how this can lead to an underweight portfolio allocation. Finally, the paper looks at the approaches investors can take when adding an Asia-focused strategy to their portfolio and the importance of taking an active management approach. Given Asia’s rising economic importance and growing equity and fixed income markets, we believe investors now need to take this into consideration in a globally diversified portfolio. In future white papers, we will examine these important aspects further and take a deeper look at portfolio construction, risk and the benefits of active management.
A Broad Opportunity Set

Asia encompasses half the world’s population and, according to the Economist Intelligence Unit, will account for half of global GDP by 2050 (Figure 1). Asia is also expected to account for two-thirds of middle class spending globally by 2050. The region is highly diverse, ranging from mature economies like Japan to the emerging giant, China. There are other large emerging economies (India and Indonesia) plus those still at early stages of global engagement (Philippines, Bangladesh, Laos, Sri Lanka, Cambodia, Myanmar).

When assessing what makes an attractive investment destination, investors should consider a range of factors. From a top-down perspective, these include economic, social and political factors. From the bottom-up, the focus is more on companies, their growth potential and attitudes toward minority shareholders. In our view, Asia scores highly across all these factors.

Savings, Productivity and Structural Change

Many Asian economies have experienced faster rates of per capita GDP growth than other emerging market economies (Figure 2). 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. Economic growth does not necessarily imply outperformance of any individual asset class or market. The characteristics of Asia’s many regional equity markets range from highly mature in Japan, to emerging in China and many ASEAN states. Bond markets are similarly heterogeneous in character and composition. But long-term investors should align themselves with broad themes that transcend short-term market volatility. We believe active management of investments across asset classes and in different national markets is the best way to align investment goals with regional growth.
High 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 (Figure 3) 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. With the exception of major oil exporters with small populations, the world’s leading national savings rates, measured as a percentage of GDP, are in Asia. For example, according to IMF estimates, China’s national savings rate of nearly 50% of its GDP is more than double the world average of 25%, or Germany’s at 24% and nearly triple the U.S. rate of 17.3%. And Asia’s savings rates are markedly higher than other emerging markets. For example, developing Asia countries like Thailand and Indonesia have a savings rate of 30.2% and 29.9%, respectively, as compared with 23.2% in Russia and 13.5% in Brazil.

Total Factor Productivity (TFP): Often seen as the true driver of productivity gains, resource use and long-term economic growth, total factor productivity 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, increased use of information technology, and the migration of workers from rural areas to cities where their labor contributes more to GDP and where their children have the opportunity to become better educated. Another factor in a country such as China is the migration of economic activity from the labor-intensive state-owned enterprises that—because of their size—dominate China’s standing in investment benchmarks, toward more productive private enterprises that are the country’s main source of economic and employment growth. Long-term savings rates are a particularly critical element in total factor productivity and Asia has some of the highest savings rates in the world.

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, entrepreneurial environments, technology and education. The combination of these factors has contributed to the region’s remarkable economic success relative to other markets, in particular Latin American countries (Figure 4).

**FIGURE 3. GROSS NATIONAL SAVINGS AS % OF GDP**

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**FIGURE 4. AVERAGE TFP GROWTH, 2009–2013**

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TOTAL FACTOR PRODUCTIVITY IN CHINA

In a broadly held misconception, it is often assumed that China’s remarkable economic success has been driven by a large and growing pool of cheap labor. In fact, labor force growth has been a very small contributor to productivity. Far more important has been total factor productivity (TFP).

Based on the numbers published by the Asian Productivity Organization, during the period from 2000 to 2010, China has had one of the fastest annual rates of TFP growth at 4.1%. China’s vast and accumulative investment in research and development, attraction of large amounts of foreign direct investment and its deepening of industrialization are some of the reasons behind the outstanding TFP growth rate during the decade. Even more important, in the case of China, has been the creativity and efficiency with which capital and labor have been combined.

In the past few years, as regional economies have matured, TFP growth in China and the ASEAN states has begun to plateau. Economic planners see accelerating TFP as key to rekindling economic growth. To do this, they are focusing on more sophisticated goods and services that tend to move activity up the value-added chain, increasing TFP and, eventually, overall economic growth. Services will be a critical factor, given the ever-increasing criticality of ICT (information and communications technologies). Modern services exports and export diversification generally bodes well for India, Philippines, Singapore, Thailand and—especially—China.

China—Separating Fact from Fiction, Matthews Asia Perspectives, December 2014

Structural Changes: Asia’s economies are in continual change. 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 through a shift from low-productivity activities such as agriculture and mining toward consumption and sophisticated services that will help businesses generate profits and make a greater contribution to economic growth.

Today’s economies are focused more on domestic demand and this should be just the beginning of a sustained growth in the kinds of businesses that will help generate profits from a revolutionary change in lifestyles that now include consumer brands, restaurants, leisure, media, insurance, property, consumer banking and wealth management. By incorporating new technologies, together with physical and human capital, Asia will continue this move up the value chain toward higher value-added industries.

GREATER PURCHASING POWER AMONG ASIAN HOUSEHOLDS

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 should continue in coming years as Asia’s middle class continues to expand. According to a 2010 Brookings report, in 2009, Asia accounted for 28% of the world’s total middle class population; this is expected to increase to 54% by 2020 when Asia could boast more than 1.7 billion middle class citizens, accounting for 42% of total middle class consumption.
Economic reforms across Asia are supporting rising wages across the region. China, India, Japan and Indonesia all have relatively new prime ministers focused on reform. But what distinguishes the region from the West is that economic reforms are targeting the economy at its founda-

tion—at the corporate and consumer level, designed to both deepen the markets and broaden their participant base. Asia continues to embark on supply-side reform and institutional improvements, such as refocusing on corporate governance and driving economic efficiency.

- In India, Prime Minister Narendra Modi is wresting an ambitious pro-growth reform agenda (including land reform) past vested interests. Reserve Bank of India Governor Raghuram Rajan, previously a highly regarded academic at the University of Chicago, is among the few central bankers globally who is actually a recognized expert in global monetary policy.

- In China, the Qualified Foreign Institutional Investor (QFII) program now allows select global institutional investors to invest in its renminbi-denominated capital markets. Simultaneously, the Shanghai-Hong Kong Stock Connect program is allowing greater capital flows from Mainland China to Hong Kong from local Chinese investors. In addition, through Stock Connect, foreign investors can access the A-share market directly without the need for a QFII license.

- In South Korea, policymakers have encouraged corporate reforms such as the distribution of dividends, improved use of cash and refined ownership structures within conglomerates.

- Myanmar—a frontier market long considered beyond the reach of international investors—launched its first official stock exchange as the nation opens its economy after decades of isolation.

- Investors are expressing rising interest in Asia’s frontier markets, such as Pakistan and Bangladesh—the latest example of capital market expansion across the region that is expected to offer new investment opportunities for international investors.

**Beyond the Benchmarks**

While Asia’s growing economic importance is well known, investors continue to be typically under-allocated to the region. One problem turns on benchmark construction—specifically a lag between the rapidly changing economic and financial landscape and market indices and other metrics that are slow to evolve and backward looking.

Financial indices for equities and fixed income are an expression of where markets are here and now—and where they have been. There are no investment indices that are representative of the sectors, industries and companies that may be successful in the future. So if investors are allocating in accordance with the financial map of the present and the near past, they may miss emerging trends and opportunities.

Most investors prefer highly developed securities markets in economies with world-standard accounting and transparent, impartially applied regulation. This leads to a structural

**FIGURE 6. CUMULATIVE REAL WAGE GROWTH IN ASIA PACIFIC AND THE WORLD, 1999–2013**  
(INDEX: 1999 = 100)

<table>
<thead>
<tr>
<th>Year</th>
<th>2005</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>113.0</td>
<td>125.8</td>
<td>127.0</td>
<td>129.8</td>
<td>132.4</td>
</tr>
<tr>
<td>Developed economies</td>
<td>103.3</td>
<td>106.5</td>
<td>106.0</td>
<td>106.0</td>
<td>106.3</td>
</tr>
<tr>
<td>Asia</td>
<td>149.8</td>
<td>205.7</td>
<td>216.7</td>
<td>229.6</td>
<td>243.3</td>
</tr>
<tr>
<td>East Asia</td>
<td>165.2</td>
<td>245.4</td>
<td>261.6</td>
<td>281.7</td>
<td>301.8</td>
</tr>
<tr>
<td>Southeast Asia and the Pacific</td>
<td>124.8</td>
<td>136.6</td>
<td>139.9</td>
<td>145.1</td>
<td>152.8</td>
</tr>
<tr>
<td>South Asia</td>
<td>114.4</td>
<td>147.9</td>
<td>152.8</td>
<td>155.1</td>
<td>158.8</td>
</tr>
</tbody>
</table>

Source: ILO: Global Wage Database 2014/15, based on national statistics

**FIGURE 7. RISING WAGES AND PRODUCTIVITY BEHIND ASIA’S RISING SHARE OF CONSUMPTION**  
Global middle class consumption (2000–2050)∗

In the coming decades, middle class spending in Asia is expected to outpace that of North America, Europe, Africa and the Middle East combined. Increases in Asian wages are lifting regional standards of living toward European and North American levels, further expanding an emerging consumer group that is becoming a pillar of global consumption.

**REFORMS BENEFIT DIVERSIFIED ECONOMIES**

Economic reforms across Asia are supporting rising wages across the region. China, India, Japan and Indonesia all have relatively new prime ministers focused on reform. But what distinguishes the region from the West is that economic reforms are targeting the economy at its founda-

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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

*Data represented beyond November 2011 are estimates only.
EMERGING ASIA’S RISING PRODUCTIVITY

Productivity is the key to emerging opportunities in Asia. Productivity growth creates economic growth, raises living standards and improves opportunities for business profits and investment. From the perspective of productivity, it is easy to be optimistic about Asia. Notwithstanding a generation of high growth, Asia is still a relatively unproductive part of the world.

While city states like Singapore and Hong Kong have per capita GDP comparable to the United States, productivity per hour of their workforce is still 20% to 30% lower than the United States. This suggests that there is increased room for greater productivity in the region, which could lead to higher per capita GDP.

Over the past decade, per capita GDP in China has tripled in purchasing power parity (PPP) terms, and yet Chinese workers still have their most productive years ahead of them. Since the global financial crisis, consumption in Asia has increased by more than a third, even as the West has languished.

A sense of optimism pervades Asia—optimism that lives are changing and that the future is going to be wealthier than the past.

Emerging Asia’s Rising Productivity, Matthews Asia Insight, November 2012

over-allocation to North America and Europe, where capital markets have a long history. For their part, Asian markets have been making significant progress with reforms and improving accountancy standards. Asia’s equity markets have also grown significantly to represent almost 40% of the world’s total stock market value (as represented by the World Federation of Exchange Members in Figure 8).

Another benchmark issue results from the fact that widely used indices do not include China A-shares (renminbi-denominated stocks in mainland-based companies, traded on Chinese exchanges and generally available for purchase only by mainland citizens). If A-shares were to be included, by some estimates, China’s proportion of global equity market cap would expand significantly.

Indices also tend to not include vast blocks of share cross holdings (when publicly traded companies own blocks of each others’ stocks). By failing to account for these substantial portions of Asian market cap, it could be argued that the widely used indices effectively under-state the market cap of Asian exchanges.

Broad emerging market indices, because they include all regions and factor in mass commodity exporters—many of whom are not located in Asia—chronically underweight Asia and fail to reflect the region’s growth potential. Not all emerging markets are created equal. While most emerging markets have experienced a historic expansion of the middle class, this expansion has been most pronounced in Asia.

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.

TOO LITTLE ASIA

The MSCI EAFE Index of developed markets in Europe, Australasia and the Far East (excluding the U.S. and Canada) is a popular benchmark for U.S. investors seeking...
international equity exposure (Figure 9). The MSCI EAFE Index is market-capitalization weighted, which means that it measures its securities’ market capitalizations today. With stock and bond market-to-GDP ratios in Asia significantly lower than in the U.S., this cap weighting demonstrates Asia’s undersized securities markets rather than the growth potential of the continent’s expanding economies.

In addition, it should be borne in mind that the deep market liquidity and relatively familiar market standards and practices of North America and Europe contribute to the systemic home country preference on the part of many investors.

**THE WRONG KIND OF ASIA**

If global benchmarks that systematically underweight Asia, lead to “too little” Asia, Asian regional benchmarks, when compared to GDP and GDP growth, illustrate how investors can end up with the “wrong kind” of Asia.

Asian economies are expected to grow faster than those of Europe and North America in coming decades. And their securities markets are expected to grow even faster as a combination of economic development and reform deepen markets and broaden out the insurance and financial services sectors. This process of modernization and rapid change is often captured late in benchmarks. For investors, it’s important to understand the areas of Asia’s economy that will potentially benefit. The consumer is likely to become the dominant driver of the region’s economy. When thinking about companies that will benefit from rising wealth across the region, the Asia of the next decade tends to look very different from current benchmark sector weightings. Rather than focus on large banks, petrochemical and industrial companies, the Asia of the future should look more like Western economies, with a focus on consumer goods, health, leisure, travel and technology. These assumptions lead to a very different allocation than that found in benchmarks.

**How Portfolios Underweight Asia**

Historically, many professional investors have constructed global portfolios using a combination of developed and emerging market strategies. Within listed equities, we find a common approach is to achieve the targeted international weightings by using a combination of MSCI EAFE-based developed international market strategies and MSCI emerging markets-based strategies.

Let’s assume an equity portfolio invested roughly 30% internationally, with 75% of this allocation in the MSCI EAFE Index and 25% invested in the MSCI EM Index. Using these two indices, the investor’s total exposure to Asia ex-Japan would be about 8% of their total equity holdings (Figure 10), despite the fact that the region accounts for 27% of global GDP and expected an economic growth rate of 5.5%—over twice the global growth rate of 2.5%.

**FIGURE 9. UNDERWEIGHT ASIA**

International indices can underweight Asia, creating a missed opportunity for benchmark-driven investors

**FIGURE 10. PORTFOLIO ALLOCATION BY REGION**

<table>
<thead>
<tr>
<th>% Equity Allocation</th>
<th>Market Cap (USD billions)</th>
<th>Expected GDP Growth Rate 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>5%</td>
<td>4,485</td>
</tr>
<tr>
<td>Asia ex-Japan</td>
<td>8%</td>
<td>17,556</td>
</tr>
<tr>
<td>Europe</td>
<td>15%</td>
<td>15,510</td>
</tr>
<tr>
<td>United States</td>
<td>72%</td>
<td>26,053</td>
</tr>
</tbody>
</table>

Sources: World Federation of Exchanges, International Monetary Fund, FactSet Research Systems, MSCI and Matthews Asia; Equity Allocation data as of December 31, 2015; Market Cap Data as of January 2015; GDP Growth Rate for 2016 Data as of April 2015

Let’s leave aside for the moment the sizable allocation to the United States, which is derived in part by home-country bias among dollar-holding investors, the desirability of U.S. dollar-denominated assets and the unrivaled depth and liquidity of U.S. stock and bond securities markets. By almost any measure, under-allocation to Asia seems egregious.

- Europe’s equity market cap, at US$15.5 trillion, is marginally smaller than that of Asia ex-Japan (US$17.5 trillion) but Europe receives almost twice the equity allocation—15% to Asia ex-Japan’s 8%.
- Perhaps the greatest allocation shortfall, in terms of capitalizing on future economic growth, is that Asia ex-Japan receives less than half the equity allocation of Europe despite the fact that its projected GDP growth of 5.5% is nearly triple the 1.8% foreseen in Europe.

Whether measuring by market cap, GDP or GDP growth, the most commonly used investment indices seem considerably off target with respect to Asia, and more generally for investors seeking to capture future economic growth. For example, investors relying on the MSCI EAFE Index for the
majority of their Asia exposure would be overweight Japan while having only a sliver of exposure to Asia’s fastest-growing economies—notably China.

Because of this benchmark distortion, investment in Asia calls for an active, hands-on approach to allocation that is flexible and attuned to economic cycles and investor behavior. Active managers must make educated assessments regarding prospects for economic growth and investment market appreciation rather than relying on passive allocations predicated on backward-looking indices.

Closing the Gap: New Approaches to Asia

Given the systematic under-allocation to Asia, a reasonable question to ask is how to bridge the gap? Once investors begin to look beyond the widely used benchmark allocations and toward a more nuanced approach to investing, there are a number of ways to improve their process of allocating to Asia. Before this can happen, there needs to be a consideration of how best to add Asia to an investor’s portfolio. This could be complementing existing exposure or replacing an existing approach. There also needs to be a decision on the type of Asia exposure an investor is looking to add to their portfolio. For instance, Asia can be allocated geographically through regional and country strategies that include the region’s developed, emerging and frontier economies. This is one approach that has been gaining more attention with investors globally. Investors can also focus by style, concentrating on dividends or growth strategies that may be more aligned to their overall portfolio objectives. Irrespective of the approach and strategy taken, clearly one of the key objectives is to improve the overall risk-adjusted returns on the portfolio.

INVESTING GLOBALLY BY REGION

Investors could consider splitting the world into three main blocs—U.S., Europe and Asia Pacific. A simple breakdown into thirds brings the portfolio close to the world breakdown by GDP. It also brings it more in line with how the world is represented from an equity market capitalization perspective (Figure 11). Investors can refine this strategy by using active managers to select investment targets in particular regions, while being careful to rebalance regional allocations to the preferred strategic allocation.

Others use Asia to represent their entire emerging markets allocation, dropping the use of emerging market benchmarks altogether, with the understanding that Asia is expected to generate the lion’s share of the growth among emerging market countries.

INVESTING GLOBALLY BY STRATEGY

Rather than treating a region like Asia as an investment destination within an international allocation, investors could enhance their existing investment strategy with exposure to specific Asian strategies. For instance, income-oriented investors in the U.S. could double the universe of dividend paying stocks available to them by making an allocation to an Asian dividend-paying strategy. The growth rate and stability of dividends in Asia may be higher than those in the U.S., while investing by strategy potentially helps to capture overlooked investment opportunities globally.

Apart from dividends, other strategies are now available to investors given the extent to which Asia’s financial markets have deepened. Investors can now add dedicated exposure to strategies that focus on single countries, small companies, or frontier and emerging Asian economies to meet specific strategic objectives.

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**FIGURE 11. WORLD MAP BY EQUITY MARKET CAP (IN US$BN)**

Sources: Mapping Worlds, Bloomberg, July 2015
ASIA AS A COMPLEMENT TO CORE INTERNATIONAL STRATEGIES

Depending on the core international funds used, increasing a portfolio’s existing Asia weight might involve adding Asia Pacific as a whole, Asia ex-Japan or just China and India—the countries that tend to be most under-represented relative to their economic size. The decision to add country strategies rests in part with how comfortable an investor is in making allocation decisions in order to create more customized portfolios with specific country risk exposures.

Investors looking for even greater diversification opportunities may want to consider Asia fixed income, in addition to Asia equities. A multi-currency portfolio of Asia fixed income investments has different and more diverse drivers of return than a single currency fixed income portfolio.

For example, U.S. government bond returns are driven primarily by changes in interest rates. In contrast, returns for a multi-currency fixed income portfolio, such as a diversified Asia fixed income portfolio, are driven by three distinct elements—credit, currencies and interest rates. The diversity of these risk and return drivers results in low correlations with mainstream fixed income segments, as well as with U.S. and European equities.

The potential benefits of global diversification from an investment standpoint are clear. But it is important to understand the growth and risk exposure offered by various approaches. Most broad-based international and emerging market mandates leave investors under-allocated to India and China, as well as other Asian markets poised to benefit from future economic trends. Asia offers investment targets from a spectrum of maturity, from frontier to emerging and developed. And with the various stages of economic development across the region, greater diversity means there are greater numbers of investment targets, offering a wider range of risk and return scenarios.

The Essential Role of Active Management

In our view, passive investment allocations using backward-looking benchmarks allocate more to Asia’s past than to its future, with outsized weightings in the agricultural or commodity sectors that have historically accounted for much of Asian GDP, and undersized allocations to the urban consumption and service industries that will define the region’s future. We believe there is no substitute for informed active management to identify the companies and securities poised

ASIAN BONDS AND PORTFOLIO EFFICIENCY

Asia fixed income offers investors attractive total return potential and distinct investment characteristics that can help improve the overall risk/return profiles of fixed income holdings. For U.S. investors whose fixed income portfolios are predominantly exposed to the U.S fixed income markets, Asia fixed income provides currency diversification, the potential for yield enhancement and exposure to markets that follow different economic and credit cycles.

Treating Asia fixed income as a distinct asset class offers investors clear benefits that include a low correlation to U.S., European and global fixed income markets, exposure to attractive regional fundamentals and attractive historical performance compared to other high-yielding fixed income sectors.

As the U.S. begins to consider tightening monetary policy while large parts of the developed and developing world are heading in the opposite direction, the potential impact on bond markets could be pronounced. It seems prudent, therefore, for investors to assess the composition of their fixed income portfolio and look deeper at the underlying risk/return characteristics.

Asia fixed income comprises a relatively small allocation within global bond indices (19%) and emerging market bond indices (21%). This systematic underrepresentation is accounted for by the fact that Asian countries have less debt than do other regions. With Asia fixed income being systematically under-weighted in both global and emerging market benchmarks, investors could benefit from treating Asia fixed income as a distinct allocation within their broader fixed income portfolios.

to benefit from the world’s fastest-growing, fastest-changing economies.

Passive investment can set investors on a wayward course that doesn’t come close to capturing Asia’s true opportunity set. We believe active management is essential for investors to navigate the future of Asia’s economies and to avoid the permanent loss of capital that could result from investment in the wrong sectors and countries.

Successful investing in Asia does not come from passively following market indices, macro regional trends or “hot” countries. Rather, it requires actively identifying individual companies that stand to benefit from Asia’s rising wealth and changing consumption patterns. In fast-growing economies, active management can play a key role in helping investors manage risks and generate attractive, sustainable long-term growth.

GOOD CORPORATE GOVERNANCE ENHANCES RETURNS

Corporate governance can be defined by many inputs, ranging from metrics such as ownership structures, interest alignment, historic capital allocation, transparency and independence, all of which provide valuable insights into the way a business is managed.

According to a 2000 McKinsey & Company survey, over 75% of investors would pay more for a well-governed company and over time, companies that score well in terms of corporate governance can potentially benefit from a “governance premium” in their valuation. Within Asia, corporate governance remains a work in progress and while overall there has been some progress, in many countries it has been mixed (Figure 12). Given how widely corporate governance varies across the region, this is another factor that underscores the importance of active management. From evaluating corporate governance to the basic fundamentals of a company’s balance sheet and a company’s competitive position within its own industry, a skilled active manager can potentially add significant value to investors. The choice of active versus passive is an important decision for investors considering allocating to Asia.

INVESTING IN QUALITY

Passive strategies in Asia have an implicit bias toward larger-capitalization stocks thereby favoring popular and expensive stocks that have enjoyed successful runs over many years. Investors accept these strategies because they understand that it is difficult for active managers to produce excess returns in more efficient markets such as Europe and the United States. But in Asia, where competition is less intense and markets are less efficient, active management can still uncover potential opportunities for profit.

Through an active management strategy, investors can put long-run opportunities front and center and focus on the underlying businesses’ ability to survive dislocations in growth and economic structure. This allows investors to gain exposure to “quality,” as expressed by returns on capital, margins, cash earnings, dividend growth and the sustainability of competitive advantage and management expertise. This implies a focus not on the pace of growth but on its sustainability expressed either as cash earnings or dividends. This leads active managers to scrutinize the survivability of businesses by assessing the strength of the balance sheet and the competitive position of the business franchise over longer-term time horizons.

LOOKING AT ASIA IN A NEW LIGHT

Asia will be a major contributor to global growth and consumption over the next several decades. With a combination of large populations, relatively high economic growth, rising wages and productivity, a shift toward sophisticated services and consumption and deepening capital markets, the region should continue to create new and attractive investment opportunities for investors.

In this dynamic region, the future will look different than the past, so investors should not rely on backward-looking benchmarks alone to calculate their allocations. Rather, they might take a fresh look at Asia using a broad range of investment indicators in collaboration with experienced active managers in pursuit of reduced risk and more sustainable long-term results.
What Differentiates Matthews Asia?

At Matthews Asia, we believe in the long-term growth of Asia. For 25 years, through all types of market environments, we have stayed committed to our distinct philosophy for harnessing Asia’s growth. To help manage risk and enhance long-term performance, we conduct extensive proprietary research, conducting over 2,500 meetings a year with companies, suppliers and customers in Asia. We have successfully managed client portfolios through the Asia financial crisis of 1997, the SARS outbreak of 2002 and the global financial crisis of 2008. As an independent, privately owned firm, Matthews is the largest dedicated Asia-only investment specialist in the United States. We employ a fundamental, research-driven investment philosophy with a sharp focus on Asia’s future.

Serving both individual and institutional investors globally, our strategies range from country-specific to pan-regional solutions that provide diverse exposure across sectors, themes and market capitalizations. As active, bottom-up investors, we are particularly focused on uncovering smaller-cap and smaller-market opportunities for diversification and growth potential. As a result of our stock selection and active management style, the composition of our portfolios tends to be very different than that of Asia indices, emerging market benchmarks and other active emerging market managers who tend to tilt those portfolios to larger cap allocations because the geography is so broad.

When thinking about companies that will benefit from rising wealth across the region and the Asia of the next decade, we tend to choose sector allocations that typically look very different from current benchmark sector weightings. For example, rather than focus on large banks, petrochemical and industrial companies, we think the Asia of the future will look more like western consumer markets, with a focus on consumer goods, leisure, travel, education and healthcare.

Finally, we are steadfast in maintaining a long-term focus. A key tenet of our investing, right from our founding to today, has been to ask two questions when investing in an Asian company: “Will it be around in 10 years? And if so, how big will it be?” When you think longer term, you ask different, more strategic questions, resulting in different investments.

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