Q&A with Teresa Kong, CFA, Portfolio Manager of the Matthews Asia Strategic Income Fund

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Q **As the Matthews Asia Strategic Income Fund celebrates its three–year anniversary, could you reflect on its performance since inception?**

A We are pleased that our team has been able to help generate solid, risk-adjusted returns over the last three years. Furthermore, the Fund has outperformed its benchmark during this time due to a combination of sector allocation and security selection. What I am most happy with is our investment process—we have been able to "walk our talk" of delivering solid risk-adjusted returns through a flexible, unconstrained investment strategy. The three key things that we look at are credit, currencies and interest rates, and within the past three years, we have been able to find good opportunities across all three.

Q **What have been the main drivers of performance for the Fund?**

A A main driver of Fund performance has been the strength of our U.S. dollar-denominated portfolio holdings.

The best-performing securities were those with a high amount of credit premium priced in, and where we felt comfortable in taking a contrarian view. Part of our ability to have conviction, while the market was going the other way, has been due to our long-term approach. When we receive new information, we try to figure out whether the information is noise, temporary or persistent. Our objective is to invest based on what we deem to be the persistent factors. Of course, determining whether a certain piece of news or data is noise, temporary or persistent is very difficult without the benefit of hindsight.

Q **How do you parse the noise from what's relevant and gain a deeper understanding of regional and company developments?**

A This is where our 20-year experience of investing in the region comes into play. Having a strong 38-person investment team focused on Asia offers us the advantage of hearing different perspectives about the markets. Also, leveraging the deep expertise of our equity investment team is beneficial in allowing us to connect the dots in a way that tells us the full story of a company. For example, when we are looking at the credit of an Indian bank, we get the views from a member of our India strategy, our bank analyst and our accounting specialist. All these perspectives help us distill relative value cross country, industry and capital structure.

Q **What really distinguishes your investment process?**

A I would say that it is our ability to identify securities with potential asymmetric upside and downside risks. In fact, one of the hallmarks of our investment process has really been finding those asymmetrical risk situations. This has generally worked out quite well for us. For example, some of the top-performing credits were Chinese property developers, which were initiated when the sector was very much unloved and prone to tightening liquidity in China. While we are certainly not advocates of buying Chinese property as a sector, we found some solid companies with conservative balance sheets that were undervalued.

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Q **Are there other recent examples you can highlight?**

A Within our local currency holdings, we were helped by our allocations to countries offering a relatively higher risk premium, such as the Philippines and Sri Lanka. Sri Lanka provides an interesting case study in demonstrating how our process has worked relating to the three key areas we look at. Our views on Sri Lanka, which was still emerging from about 30 years of civil war, led us to be attracted to the credit, currency and interest rate opportunities that were presented by rupee-denominated bonds issued by Sri Lanka.

In terms of the Credit, the government was going into a relatively deep deficit. Sri Lanka is a major importer of oil, and oil prices were going up. And at the same time, there was still a huge gray economy that the government had to bring into the formal economy to increase tax revenues. While this was a work in progress, we felt fairly confident that they were going to be able to put through appropriate legislation and they had the willingness to do what was necessary to ensure a more robust fiscal budget going forward.

On the Currency side, the country has had a couple of hiccups. The central bank had engineered a relatively large depreciation on the currency when we started looking at it. And, in fact, it had depreciated so much that we felt that it had priced in a lot of the potential risk at that point.

Over the long run, what drives a currency is the balance of payments. We knew that Sri Lanka was going to be a major destination for things like foreign direct investment; there was a lot of interest in their hotel and hospitality industries. There was also a lot of interest in helping the country build infrastructure like ports since Sri Lanka is strategically positioned in the South Indian Ocean. We believed the country had to broaden and deepen its ports and upgrade its technology. So we felt comfortable that the currency outlook was likely to be quite positive from a balance of payments perspective.

On the Interest Rate front, Sri Lankan government bonds offered a relatively large risk premium. Part of that was to really induce the people to move their savings, which were in stacks of gold—literally gold bars—into the banking system. On top of that, there was and continues to be the risk of inflation, especially in terms of inflation that's induced exogenously by things like oil prices. When we started looking at the country's government bonds, they were yielding about 11% (December 2012). We felt strongly that interest rates actually had a lot of room to come down as the yield offered sufficient risk premia. Our confidence was well placed and today those bonds are yielding about 7%.

Q **What key risks do you see going forward?**

A Probably the dimension that I'm most worried about is currency. The reason is our anticipation that we may be headed for a strong U.S.-dollar (USD) environment. A lot of that has to do with the relative strength of the U.S. economy compared to the rest of the world. And within that context, U.S. interest rates are more likely to go up, and rise at a faster rate than economies like Europe, Japan and even China.

So when interest rates are higher in the U.S., it tends to also lead the USD to appreciate. Now that could actually be good for us in one sense since we own USD-denominated debt of Asian issuers. However, we also have an allocation to local currency bonds. So if Asian currencies are not able to keep up with the appreciation of the U.S. dollar, then we might be facing some headwinds on the currency front.

I am also concerned about the credit cycle, which is bound to turn more negative over the next three years. This is especially going to hit hard those companies that have overleveraged or are dependent on open capital markets to refinance.

Q **What are you doing to prepare for such risks?**

A We have positioned our portfolio accordingly, with a higher exposure to USD-denominated assets than locally denominated ones. However, it would be neither prudent nor desirable to sell off all of our local bonds, and hedging would negate much of our carry. Therefore, it might be a relatively difficult environment for local currency Asia bonds over the next few quarters.

On the credit side, we are seeing some industries and some management teams that have perhaps over-levered themselves and we're going to be very judicious in terms of studying the balance sheets and making sure that there really is room for credit risk premiums to come down as leverage decreases, so that is one area we look at.

Q **Looking toward 2015, what other areas of focus are noteworthy?**

A When we look across Asia, there are few countries with a rate hike bias. Indonesia and the Philippines are exceptions. The lack of inflation, coupled with tepid growth, may lead to stable, even falling rates in Asia. Given that interest rate differentials are the short-term drivers of currency returns, we see Asian currencies potentially lagging the U.S. dollar over the next few quarters. The other issue is the subset of companies that have leveraged up in foreign currency debt, many of which generate little USD revenues to offset the currency liability.

Q **How important has the development of Asia's fixed income markets been to investors?**

A I think the development of the Asia fixed income markets is one of the most significant developments in the financial markets over the last decade. The size of the overall market was less than half a trillion in 1997; today, the market is almost US$8 trillion, which is more than half the size of the U.S. Treasury bond market. More profound than the quantity of the growth is the quality of the growth. The growth of the markets really reflects the growth of the middle class in Asia. When I started in the industry almost two decades ago, there was no such thing as a 30-year Indonesian rupiah-denominated bond. Part of the reason was because there was no demand for such long-dated securities. But as the middle class grew, families traded up their motorcycles for cars, started to finance their new homes with mortgages, and started to protect their assets and families through insurance. To meet these demands, financial intermediaries such as insurance companies, mutual funds and mortgage markets grew. Fast forward to today, there are now dedicated local investors who have a natural demand for long-dated assets to match their long-dated liabilities. As such, the Indonesian government now issues bonds with 30-year maturities, for example.

Q **Has the deepening of Asia's fixed income markets been driven mostly by foreign investors?**

A Certainly, increasing interest from foreign investors has played an important role. However, the steady engine behind the deepening has been sovereign wealth funds, national treasuries and local pension funds. This is a natural consequence of the increased intra-regional trade taking place in Asia. The national treasuries must hold foreign reserves to cover imports and, as an increasing portion of these imports are coming from neighboring countries, demand for Asian bonds have increased commensurately. The media tends to focus on how foreign participation in these markets can cause significant volatility. To be sure, much of the short-term volatility in Asia bonds can indeed be attributed to the fickleness of short-term focused foreign investors. However, there is a quiet evolution taking place in the Asia bond markets which doesn't get much press. The majority of the investors in Asia local markets are in fact dedicated local investors who see their allocation to Asia as a long-term core investment.

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