Matthews Asia

Matthews Asia Perspective

Value Investing in the Digital Age

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Beini Zhou is a Portfolio Manager at Matthews Asia and manages the firm's Asia Value Strategy, and co-manages the Asia Small Companies Strategy. Prior to joining Matthews Asia in 2013, he was a Research Analyst with Artisan Partners on the Global Value Team, responsible for covering pan-Asia stocks across all industries. Before joining Artisan in 2005, Beini spent three years as a senior product analyst at Oracle Corp. He received an M.S. in Computer Science from the University of California, Berkeley and a B.A. in Applied Mathematics from Harvard College. He is fluent in Mandarin. Beini has been a Portfolio Manager of the Matthews Asia Value Fund since its inception in 2015 and of the Matthews Asia Small Companies Fund since 2014.

Value investing around the world has been declared practically dead in recent years for reasons including lack of exposure to technology companies. We believe, however, value investing is still very much alive and well—at least the way we practice it at Matthews Asia. We define value investing as looking for companies whose shares are trading at a 30% discount to our proprietary estimates of their intrinsic worth. Importantly, we are looking for companies whose intrinsic worth offers sustainable, long-term growth potential. The Matthews Asia Value Fund recently celebrated its three-year anniversary on November 30, 2018. As we look toward future milestones, we reflect on how to embrace the time-tested principles of value investing in today's digital age.

Active Management Can Generate Alpha

The Asia ex-Japan market has an abundance of undervalued stocks. Many, however, are undervalued for good reasons. It could be the business has not been growing and has no prospects for growth; corporate governance could be poor; management could include questionable characters or a shady past; business quality could be mediocre; or its financial numbers may seem too good to be true. A few years ago, we passed on a sizable Chinese specialty chemicals company at a single-digit price-to-earning (P/E) ratio even though all our checks, qualitative and quantitative, came back fine. We passed simply because we did not feel comfortable with the company's operating margin of almost 60%. The stock was subsequently suspended by the local stock exchange due to concerns of potential fraud.

With its less-developed economies and markets, Asia is full of such landmines if one blindly invests in statistically cheap companies. As active managers, we believe the quality of a company's underlying business and its management should be considered first and foremost in a value investing strategy within Asia, even more so than when investing in the United States or Europe. We thoroughly investigate the companies we invest in from the bottom up. Here's our approach:

- **Studying the best businesses and organizations in each sector.** This helps us establish reference points when we size up other businesses in the sector.
- **Reading people as well as numbers.** The jockey is often as important as the horse. When we meet with a founder in Asia, numbers are secondary and we use our initial first-hour meeting to inquire about the history, culture and DNA of the organization.
- **Building a mental jigsaw puzzle of global opportunities and assembling all the pieces.** These puzzle pieces can include global supply chains, global customers and global competitors. An Asia-only context is not enough despite our focus on investing in Asia. For example, when a life science equipment company tells you the consumables portion in their sales mix is 30%, is that considered good or subpar for such a business? I found myself thinking about this during one recent management meeting in Asia. Our knowledge base on U.S.-based Danaher, arguably one of the best-run companies globally, helped us put this Asian life science company into perspective.
- **Doing all the above enables us to connect dots and ask better questions.** As with so many things in life, asking the right questions is more than half the battle.

As you can imagine, our process is an art more than a science. We believe it's the repeatable and methodical application of this process that sets us apart from many of our peers.

Tech Joins the Mix

Stepping back a decade, energy companies dominated equity markets. The world's four largest companies by market cap in 2008 were Exxon Mobil, PetroChina, Gazprom and Petrobras. Today, the world's biggest companies are focused on information technology and communication services. These global tech giants include Microsoft, Apple, Amazon and Alphabet. We don't really look at technology as a separate sector. We view it very much as part of the underlying fabric that now comes to underpin every industry you can think of. Technology is ubiquitous and pervasive. When it comes to value investing in Asia, our definition of value can be a useful tool for evaluating technology companies.

My background in computer science and technology helps me look closely at the opportunity set to separate reality from hype. As we study the major technology companies in Asia today, we've established a buy price for each. As dyed-in-the-wool value investors, our approach to investing in tech stocks is to be patient and opportunistic, waiting for the share price to drop below our buy price. In fact, we've bought major technology companies for the Matthews Asia Value Fund at P/E ratios from the mid-teens and lower while still conservatively valuing the digital business at no higher than 25X P/E. We don't get to do this every day or every year. But every now and then we're presented with these opportunities. We need to have done our homework and be ready to pounce.

A Lower Volatility Approach to Capturing Asia's Growth

As volatility picks up globally, buying stocks at a substantial discount to their intrinsic value can help mitigate volatility. You get a double advantage, first when the initial discount to the fair value narrows and, second, as the fair value grows and compounds over time. These principles remain the same as when Benjamin Graham pioneered the value investing style more than a century ago. What's new is the opportunity set both in terms of geography and business model. Asia represents more than half of global growth. And technology stocks, which can include digital platform business models, are part of Asia's equity universe. We'll continue to evaluate tech stocks as part of our research process, looking for high-quality stocks to buy at a discount. As we look forward to the next three years and beyond, we find it an exciting time to be value investors in Asia. We believe the Matthews Asia Value Fund is well-positioned to capture the current opportunity set.

As of November 30, 2018, the Matthews Asia Value Fund held no positions in Exxon Mobil Corp., PetroChina Co., Ltd., Gazprom, Petrobras, Microsoft Corp., Apple Inc., Amazon.com Inc., Alphabet Inc. or Danaher Corp.