

Matthews Asia Funds Manager Roundtable— Seeking Dividends from Asia's Growth

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December 8, 2009

Participants

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Presentation

Operator

Greetings and welcome to the Matthews Asia webcast, "Seeking Dividends from Asia's Growth." It is my pleasure to introduce your host, Ms. Jodi Borkowitz, Senior Vice President of Matthews Asia. Thank you, Ms. Borkowitz. You may begin.

Jodi Borkowitz, CFA, CFP® – Moderator

Good afternoon, everyone. This is Jodi Borkowitz and I'd like to thank you all for participating in today's Matthews Asia webcast. Our topic today is seeking dividends from Asia's Growth. All of us have witnessed a great amount of investment rethinking over the past years. And at Matthews, in our conversations with all of you as advisors, we've been encouraging people to ask themselves two questions. First, what is your allocation to Asia, in particular to markets like China and India? Also, what strategy do you want to be employing for investing in the region? Just as there are many strategies for investing in markets like the U.S., there are various strategies for investing in Asia. And income-oriented strategies, such as those that emphasize dividends, are certainly among them. We find that dividends play an often very underappreciated role in the investment returns from Asia but it's really one that we've long recognized. In fact this fall, we celebrated the three-year anniversary of the Matthews Asia Pacific Equity Income Fund, which we commemorated by changing the name of the fund to the Matthews Asia Dividend Fund as we think it better represents the strategy.

The Fund is led by Jesper Madsen, and it emphasizes investments in dividend-growing companies across the

region—that's inclusive of Japan, Australia and New Zealand. On November 30, we launched a second dividend fund—the Matthews China Dividend Fund and it is also managed by Jesper.

So we thought it was important for you to hear today what Jesper and the team are thinking about as they invest in dividend-paying companies in Asia Pacific and China. Joining us today is Jesper, along with Matthews Chief Investment Officer, Robert Horrocks. Today's format is going to be a round table discussion. So we want to give you some specifics of what we're seeing from dividend payers in Asia, but we also want to address many of the questions that you have brought to us on Asia's growth, valuation and earnings in the region.

So let me kick off today's discussion first with Robert. Robert, obviously, Asia's growth has recovered nicely year-to-date 2009, and the equity market returns have followed. But now the concerns are: have the markets, China in particular, run up too far and run up too fast?

Robert Horrocks, PhD – Chief Investment Officer – Matthews Asia

As you say, it's a difficult question to answer in the short term, obviously, as to where markets are going to go. But let me take you back a little bit to the beginning of the year when we had the collapse in confidence in the global economy. We had a freezing of trade between Asia and the West and we had the market falling dramatically. Now one of the main things that happened around that time, from my point of view, is the ability of Asia to stabilize its growth in the short run through fiscal and monetary policies and to maintain itself on a course of growth, and growth rates in excess of the developed world for the foreseeable investment horizon. This has become more and more accepted by the investment community, I think, to the extent that the short-term tactical allocation that you could have made at the beginning of the year—and returns on that opportunity—is largely gone.

In terms of the valuations in the market, they now are reasonable in light of Asia's likely growth in the future. What is going to drive your growth over the medium- to long-term now is not going to be a bounce back in valuations, but is in fact going to be the fundamental underlying earnings growth and the dividend yield that you get from the companies. Now the main thing to note about growth in Asia as well is that it is just not the fact that Asia is going to account for more than half of global growth over the next five years. But it is also the change in structure of that growth that is going to happen over this time and we should not expect this to happen entirely



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smoothly. There will be some slip ups on the way but there are big political risks involved in achieving this shift from export-driven growth or a more outwardly looking growth to a more inwardly looking growth, and that has to be reflected in the valuations as well.

If you can refer to the “Current Valuation Levels” presentation slide (refer to presentation), you will see the long-term valuations of the region. I’ve used two different valuation metrics here, price-to-book and dividend yields because they are largely mean reverted and you can see that currently there is what I would call a marginally optimistic outlook on Asia’s prospect. Price-to-book is slightly above long-term averages and the dividend yield slightly below long-term averages. That means I think that most investors largely agree with our view on the bright outlook for the Asian economy, and largely agree with us on the bright outlook for the domestic sectors of those economies. But what I would caution investors is that, although over the long term we’re confident in the outcome, in the short term investors should not get too carried away with this as an investment scheme. I think we would all be wise to listen to Chinese President Hu Jintao’s comments when he met Barack Obama. He cautioned us not to think of the world as a Group of 2 (G2) but just to be aware of the different obstacles and the different policy measures that have to be taken in Asia, and in China in particular, to realize this internal growth.

Let me talk a little bit more about that because I do think it’s important. There are two big policy risks facing Asia at the moment. One is that with interest rates very low in the U.S., growth seems to have stabilized in the U.S. and seems to be accelerating in Asia. There is a likely huge influx of money into the Asian region and policymakers are very concerned about this. They don’t want to see markets bid up to extremely high levels so they’re taking steps right now to rein in monetary policy. We have seen it in Australia with three successive interest rate hikes, we’ve seen it in India where they face 12% urban inflation by some measures. They’ve tried to increase the amount of government bonds that banks are forced to buy for every dollar of deposit. We’re seeing it in China as they try and remove the stimulus to the property markets and the infrastructure loan segment of the economy and we’re seeing it in some of the smaller peripheral countries, pressure on exchange rates and also domestic inflation.

So there is one sense in which the policymakers will try to hold back expectations or the exuberance of the market. The other area is in government policies such as building the welfare state and health care systems to free up the precautionary savings that will allow people to consume more in the future. There will need to be a balancing of the growth in the headlines and growth rate terms with a more equal split between the incomes of coastal regions and the interior regions. It is something that is particularly prominent as a policy goal in China.

I think one way of doing this would be to allow the exchange rate to appreciate very rapidly. They’re not going to do it in one step. They’re going to allow coastal entrepreneurs time to move their business models around to serve the domestic

consumption markets that are springing up as China urbanizes. So changing cities in China from production centers to consumption centers, allowing some room for entrepreneurs to serve those new markets, is a slow process. Therefore, I think the overall watch word for Chinese economic policy going forward will be “steady as she goes.” I don’t think we’re likely to see any dramatic movements in currency and other policies.

I did want to mention one other thing in terms of the way we look at markets at the moment. I think with the attractiveness of tactical allocation to these markets diminishing, anybody who is looking to invest in Asia now should really be taking a long-term time horizon that is several years, not several months. Once you do that, you have to be very aware of the structure of the market. We’re talking about a region that is changing its structure economically. The structure of the markets will also change in tandem with that but what the chart titled “Asia’s Underlying Growth” shows is if you start on the left with China and India and move towards the right where you see Japan and the West, the market capitalization breakdown of the stock markets also changes. There is a far greater focus on the red and the orange segments of the columns, which is the domestic demand in the consumer, the health care and the technology sector as well. We would expect this to continue to happen within Asia and that’s why we maintain our focus or a bias at least towards those areas.

The second thing I would say to people is—we are often asked, “Can I not access Asian growth through buying a multinational U.S. company because a lot of their sales will be overseas?” Well that’s true but if you flip that on its head, think about how many companies in Asia are still working through the old business models of manufacturing in the East and selling to the West. And again if you’re looking for asset allocation over the long term and you want to grab hold of that long-term trend, you have to be careful that you don’t just take a blanket market approach to that and end up just buying a lot of companies in Asia that are in fact dependent upon U.S. and European demand.

That’s another reason to be careful when you’re in long-term asset allocation. Look at the underlying stocks and sectors in the stock selection process. That final element, the strategy and the stock selection process, is also the reason for the webcast today. We don’t think twice about implementing different strategies to suit different portfolios when we invest in the U.S. Until now, with the exception of a few products, when people have taken an Asian allocation, it has generally been a one-size-fits-all kind of decision. What we’ve always tried to do at Matthews is deliver different strategies, those that might be a more growth or aggressive kind of strategy and those that are, take attack trying to pursue value realization from the companies that we buy and we have traditionally done that through dividend type strategies. I think if you’re making a long-term commitment to the region, you should seriously consider your current underlying portfolio and which strategy best fits with us. I think this is an excellent opportunity for Jesper now to detail exactly how he is thinking about dividend growth.

Jodi Borkowitz, CFA, CFP® – Moderator

Well first, that'd be my first question for Jesper, because Robert, you talked a lot about the growth opportunities on a company and a sector level. So, Jesper, why should investors care about dividends when investing in Asia?

Jesper Madsen, CFA – Portfolio Manager – Matthews Asia

Well, fundamentally, it's because they matter a great deal. Not just in how we implement the strategies in terms of the actual companies that we invest in but also to invest as long-term returns. So if you take a look at this, the "Why Dividends Matter" presentation slide (refer to presentation), currently we track the MSCI Asia Pacific Index as if you invested US\$10,000 at the inception of this index back in 1987. While I think most people get an adrenaline rush from watching the stock ticker (that's the brown line as you can see at the bottom, which is obviously very volatile) on a day-to-day and monthly basis, over the long term, you'll also notice that there is a divergence. On the chart, there's a blue path that lies above that volatile price index and that is the effect to your total return of dividends reinvested over time. So just like elsewhere in the world, again and again, if you look at the facts, you'll find that dividends always tend to constitute a very substantial portion of overall returns. Obviously, it depends on where we are in a business cycle and in a market cycle. In a down market, dividends will oftentimes be the only return you will see out of a market but in a more normalized environment it can swing from 30% to 50% of your returns over the long run.

Here, for the MSCI Asia Pacific Index it's a little extreme. Seventy percent of the total returns has been derived since the inception. But if you take a look at China, for instance, over the last decade for the MSCI China Index about 40% of your total returns would have been derived from dividends reinvested. So it's a very powerful factor in the long-term returns and that's also why we're here today to talk about strategy, specifically focusing on dividends and dividend investments. Now it may be surprising to many to learn that Asia offers attractive yields. In our chart, "Asia Offers an Attractive Dividend Yield," (refer to presentation) we have a couple different regions of the world and the dividend yields expected by the sell-side analyst community, dividend yield for 2009 and as you can see the U.S. is sitting, hovering just about 2% for 2009, whereas Asia Pacific is closer to 2.5%. If you exclude Japan, which is a slightly lower yielding environment country, you end up north of 2.5% yield for that part of the region. I also included China and Hong Kong since we will look more specifically at these two countries as well later on.

However, what is important is not just the yield in absolute; it's also the yield that we would expect going forward. Obviously, future growth rates are uncertain but maybe history at least could be a guide. For instance, take a look at the MSCI constituents for Asia Pacific and compare that to the S&P 500. If you freeze the members of both those indices back in 2002 and then you track the dividend growth for each one of these companies, you would have found that Asia would have delivered about 18% growth annualized compared to 10% for

the S&P 500. So, during this period since 2002 up until 2008 Asia had delivered generally higher dividend yields, by about 50 basis points or so. At the same time it delivered a substantially faster growth rate.

Now I think we've all been told that you have to pick between yield or growth, and you can't have both. So it seems somewhat counterintuitive that Asia has delivered on both those counts. I generally think that it is an overlooked part—and as Jodi pointed out and underappreciated part—of investing in the region. This leaves opportunities for those who actually do seek out those dividend-paying companies. And also there may be a perception that dividends are just less secure and that companies do not take their policies as seriously but that also has not been proven to be true.

Jodi Borkowitz

You definitely made a case for investing globally and searching for dividends. We shouldn't just have our U.S. hat on. We should look to other regions, including Asia. I know you researched the Fund, you were involved in the research process of the Fund before we launched in 2006. I'm curious. If we're in Asia looking at the pool of dividends, what does that landscape look like? How does it look different today than it did three years ago, 2006?

Jesper Madsen

Maybe it would be helpful to take even a further step back and go back a decade from today. So back in 1998, there was a little bit more than US\$40 billion paid out in dividends by the whole region. If you then fast forward 10 years that has grown more than five-fold. Now that's tremendous growth. It's been derived from a mixture of new listings, a lot of it has come through new IPOs, which is obviously a very exciting aspect and factor of being an investor in Asia because it does allow investors new avenues and new exposures on a continuous basis. A lot of it has also been derived organically through earnings growth that has then been converted to dividend growth.

I think the sheer growth of the dividend universe has in itself changed a great deal over the last 10 years. On the presentation slide "Growth of Asia's Universe of Dividend-Paying Companies," (refer to presentation) there are three different columns. You can see Japan—given its large size in terms of the economy and in terms of how much of that economy has been listed—is the still dominant and has been throughout this period the dominant component of dividend payments in Asia Pacific. Now that is in part because of earnings growth but it is also because we actually have seen a great deal of improvement to dividend policies in that country. That's actually also why, back in 2006, we decided to include Japan as being a part of the Matthews Asia Dividend Fund's universe. However, let's look at some of the other countries. Back in 1998, China didn't even feature in the top five dividend-paying countries in the region. Now as you can see in 2005—and these are the numbers we would be looking at on the days that we launched the Fund in 2006—these are the financials we would have considered. You can see China just barely squeezed into the top five. Fast

forward three years and all of the sudden China is now the second-largest contributor to dividends in the region. If you add Hong Kong and China together you actually have the largest contributor to dividends in the region.

Jodi Borkowitz

Can you give us a sense where that growth for China is coming from? Is it the big banks that have listed? Is this all IPO driven?

Jesper Madsen

Well, that is a bit of a mix and as you'll see on the presentation slide, "China's Dividend Growth," (refer to presentation) this dividend growth has come through initial public offerings (IPOs) that have occurred—companies that have come to market and been listed since 1998. A lot of these companies are former state-owned enterprises, very large in scale such as banks and petrol chemical firms. They are companies that generate hefty cash flows, very healthy cash flows and can afford to pay dividends. Furthermore, the government is actually urging these companies to pay out a greater share of their earnings as dividends to minority shareholders. In fact, now 44% actually have listed companies in China and I'm excluding domestic A shares, 44% of listed companies pay dividends. So as you can see from this slide, back in 1998 we had payment of about US\$8 billion in China. If you fast forward 10 years, this grew to about US\$73 billion, or about 24% growth annualized.

And it was this growth and the opportunity that we saw to capture it that prompted us recently, as Jodi pointed out, to launch our China-focused dividend strategy. Now besides just the growth and the sheer scale of the dividend pool, what's also important in terms of portfolio construction is the diversity of dividend payments because if dividends were concentrated in just one or two sectors, it would be hard to create a sustainable diversified portfolio. And also here as you can see from 1998 to 2008, basically all sectors, economic sectors in China saw growth in the underlying dividend as we went from that US\$8 billion to US\$73 billion. If we just quickly glance at the numbers from 2008 you will see that a little less than half, or 45% of dividends are still paid out by financials. That's a very important component and that includes both banks, real estate and insurance companies. Energy was a sector that you could not access as a dividend-focused investor back in '98. That has changed. Now, 19% of dividends that are paid out in China are actually paid out through energy-related companies. And it's that kind of change in the diversification that has made it possible again to launch a strategy. In terms of maybe open market capitalization, again 84% of the dividends paid out are paid out by large caps—companies with a market capitalization above US\$5 billion. Then you have 12% by mid caps and 4% by small caps.

So I would say the important take away here is simply that you know China offers dividend yields in excess of what you would receive in the U.S. It has offered historical growth in the underlying dividends and it does now offer scalable and also diversified dividend yields.

Jodi Borkowitz

You had an interesting three years to run the Asia Dividend Fund, with the momentum markets of 2006 and 2007, and the global financial crisis of 2008. So I'm curious, over the last 18 months or so, did you witness the severe dividend cuts in Asia that we saw here in the United States?

Jesper Madsen

There was no doubt about it. The last 12 months were definitely tough globally and in Asia as well. That said, as you can see on the "Historical Stability of Dividends vs. Earnings" presentation slide (refer to presentation), if you compare earnings with dividends, the long-term trend will show quite clearly that dividend payments are taken very seriously by Asian management teams. You have the Asian crisis, you have the post-tech bust in 2001 and you have the crisis of last year and obviously. It's still unfolding as we speak. But as you can see in all these events, earnings were cut quite severely but dividends actually held quite firm.

Last year, for instance, we saw earnings for the MSCI Asia Pacific Index fall by a little bit more than half. Now, dividends throughout that same period fell by a little less than 15% so again dividends tend to be a lot stickier than earnings. The way that we look at it from an investment perspective is also that it is very helpful too as an analyst, and as a portfolio manager, to cut through all the day-to-day noise, the monthly, the quarterly noise in terms of earnings. It is helpful to just focus in on what is important, which is the underlying ongoing earnings. This is often signaled in that ability to pay growing and ongoing dividends. If you could find those companies, you're probably also dealing with companies that are healthy in terms of their balance sheets and cash flows. But let's dissect this and put some color on these dividend cuts between 2007 and 2008. Maybe it's not overly surprising, the countries that were the hardest hit in terms of dividend cuts were those that were open and those that rely predominantly or to a great extent on more cyclical sectors. So you can see in the presentation slide (refer to presentation), Korea and Taiwan. These are two quite open economies that have a great exposure, especially in terms of the stock markets, to more cyclical industries. These were the hardest hit and saw about a halving of the dividend in those two markets. Now if you look at the positive side, China actually managed to squeeze out a slight increase in overall dividends. Quite an impressive feat, given what was going on in the world at this point and given how much people were focusing on China's export sector and what that would mean for earnings growth and for economic growth for that country. Again, that's also why that resilience of the Chinese dividends encouraged us again to look as some of the more domestic side of the Chinese economy and we actually felt that we could launch a strategy to capture that.

If we look at the sectors you can see that again the most cyclical sectors, industrials, IT materials, not surprisingly were the hardest hit. How does this feed back into how we implement our portfolio strategy? We tend to be very much underweight

industrials and materials. We do have exposure to some IT, but again, they tend to be in some of the market leaders that are higher yielding as well. But it is that cyclical in the dividends that we just try to avoid when we can and, therefore, again focus on some of the most domestically oriented companies that tend to have the most stable track records with some of the dividends as well. Now, I also wanted to point to financials. Obviously, that was at the heart of what was going on in the U.S. We saw most dividends being wiped out and it is still unclear when we're going to see dividends from that sector in the U.S. return. But if you notice, it was only a drop of 10% in Asia last year so it was nothing compared to the U.S. And this sector as a whole, for the most part, saw an impact to their income statement. They have not been battling for their lives and shoring up balance sheets to the same extent that we saw in the U.S.

On the positive side, health care and telecommunications are two areas that we are very keen to keep the high weighting in for the Asia Dividend Fund. It actually managed to show positive growth last year.

Jodi Borkowitz

So I'd like to bring this back to the stocks that Robert, you and the team actually invested in. So I'll ask you, is there a certain way that Matthews portfolio managers look at a company when thinking to invest in it?

Robert Horrocks

I think there is and at a risk of oversimplifying things. Let me describe it using an analogy to DNA. There are two strands to the way that we look at stocks. On a very basic level we want to have a long-term commitment to the stocks or the underlying companies that we buy. The second strand is that we're very bottom up in the way that we look at things. Being bottom up means that we tend not to be overly concerned with what benchmarks are telling us, or with what the cyclical macro indicators are telling us. We build our portfolios brick by brick depending on whether we like the company or not and whether we like the valuation or not. That's the sort of style of portfolio that you see. Because we have a long-term focus, it means that the initial question that we will always ask ourselves is: if we buy this company, will it be around in decades to come? Therefore, that means that we'll lean towards companies that have relatively clean balance sheets, companies that are financially strong. This is not just because these companies are sustainable. It also means you can't really grow unless you have the balance sheet that is able to support that growth. We don't like companies that have to frequently come to the equities markets to raise more capital because that can dilute away your returns. Now there are two different expressions of this underlying philosophy. One expression, which you will see in the growth mandate, says that we are happy to see the cash reinvested in the company as long as we're confident in the management and that they can deliver acceptable returns on that cash. The other way of looking at it is to say that we would like to realize some value

in the here and now we'd like to see some sort of dividend paid. And then there's a trade off between how much dividend you want to see now and how much growth you want to see in that dividend going forward. So I see the various strategies that we offer as essentially two expressions of a single philosophy.

Jodi Borkowitz

Jesper, if you take that to your dividend-oriented strategies, what are you looking for in a company specifically?

Jesper Madsen

I thought it would be helpful to show how we approach some of these companies. So we have a presentation slide on a Malaysian glove manufacture (refer to presentation). It's the world's largest manufacturer of latex rubber gloves so it's in an area that is, I would say, very near and dear to our hearts because it has to do with health awareness. If you're looking for some underlying themes, such as domestic consumption, health awareness is one theme. As a country becomes richer, it is a growth area because people do tend to pay greater attention to their health and to the prevention of disease as they become wealthier.

So besides the fact that there was, in our minds, a fundamentally attractive industry, we also noticed through our screening process that looking at the financials, it seemed like this was a company that was moving from a pretty severe negative cash flow situation to one of improving cash flows and with the ability, in our minds, to move into a good, positive cash flow situation. Why did we look for that? As these companies move out of a heavy investment phase they tend to have a greater ability to pay out dividends. Now the question is obvious, will the management team then also follow through. Will they pay that dividend when they see that cash flow come into the business? Or will they turn around and either reinvest it (hopefully at high returns but sometimes it gets squandered)? Or will they start mergers and acquisitions (M&A) activity? This also sometimes can be disruptive to shareholder values. So we met with management on the ground—something very important to the process and Matthews. We all traveled extensively in the region and went out and kicked the tires so to speak, met the founder, the CEO and chairman of this company and had a chance to really gauge whether or not this is a committed individual in terms of dividends. And we walked away feeling pretty comfortable about the business, about its competitive strength and how that would feed back in terms of the returns on the capital that was being deployed in this business. But also we had a feeling that this is a person who was very committed to converting that growing earnings flow into dividends and as you can, over the last five years. This is a company that now has grown its dividend by 25% annualized.

So what's also important, as an example, is that this is not necessarily a particularly high-yielding company, and it's a company that would be trading at about 2%—and at times even less than that. But it is a company that is interesting for a strategy such as the Asia Dividend Fund and, now this is a Malaysian company, but you could also envision the same kind of dynamic taking

place in a Chinese company for the China Dividend Fund. These strategies are not just focusing on yield but also the growth in the underlying dividend and that's very important because it's that growth that will support the total return—i.e. the capital appreciation that investors oftentimes will enjoy as you have these companies grow their dividends over the long-term. It's an important and philosophical foundation and objective of both these dividend-focused strategies.

Jodi Borkowitz

Great Jesper, I think that really helps bring to life how you're looking at companies that you seek to invest in. I've gotten a number of questions that are more macro and a couple of questions on expectations for rising interest rates. So if we have rising rates here in the U.S. and other developed markets, what does that mean for stock prices in Asia? Robert, could you start with that? Then Jesper, can you follow on: what do those rising interest rates mean for dividend stock performance in the region?

Robert Horrocks

So I guess the question would be what's the underlying reason why interest rates are rising? If it's because of increased growth prospects and therefore an exiting of monetary policy then the pattern in the past has been this: Asian markets have tended to show their strongest performance just before short-term interest rates rise and in the early stages of a cyclical up cycle in interest rates, they've continued to perform strongly as growth has picked up. They have only started to underperform once growth starts to slow down and interest rates start to fall. So there has typically been a fairly strong positive correlation.

Now in the future, if we're assuming decades down the road that Asia has developed its capital markets, and they're more independent of said monetary policy, that correlation will have not disappeared entirely. It will be much lower, I would suspect. In the intervening years we're going to be somewhere in between, but I expect we're much closer today to historical kinds of correlations and relationships than we are to that decoupling scenario. Now if interest rates rise because of rising default risk in developed economies while Asia is able to maintain reasonably strong growth rates, I think—although there may be an initial shock—that would largely be positive when money flows into the region. But your problems then would be whether the money flows would be too strong and in too short a period of time for the Asian authorities to cope with them comfortably. You might see capital controls and these sorts of policy measures employed to try and cope with that.

Jesper Madsen

Just to add to what Robert said about the flows, I would say generally given the fact that some of these dividend-paying companies and strategies, like the Asia Dividend Fund, would pursue more conservative business models for the most part. In environments where we have inflows of foreign capital and rising markets, I would expect those kinds of strategies to underperform relatively in those kinds of market environments.

Robert Horrocks

On dividend yield stocks and interest rate cycles, I think it depends. If you're looking at stocks that just have a pure high current yield, they're probably more likely to respond to the interest rate cycles. But for stocks in which you're looking to balance yield with future growth, there isn't a very strong correlation I don't think, with that kind of strategy and interest rate cycles. There are too many other variables in the equation to make a definitive statement.

Jodi Borkowitz

Robert, you made some points on valuations in the region. Can you take us down perhaps to specific countries or specific sectors? Are there areas that still appear relatively cheap? Are there some that are relatively expensive?

Robert Horrocks

Yes there are. The view of Asia that has been accepted by the market generally is the one that we, at Matthews, have been proposing for some time now—that strong domestic demand will drive these economies and therefore the markets that tend to look more expensive are those with a very high domestic demand element. This spans from the consumer-driven India to the investment-driven China and also Indonesia as well. Those are generally the three markets where valuations look most stretched. I would caution people, though. When you see a lot of the valuations associated with China, if you look at Hong Kong-listed stocks rather than the mainland list of stocks then the valuations don't look extreme relative to other global markets. It's really the A shares that are driving a lot of that valuation. Now in terms of sectors it's the same kind of thing. So the retail sector, consumer services sectors tend to be relatively expensively priced. In areas like telecommunications, on the other hand, or technology and technology services I think you're seeing that those sectors—relative to historical averages—still actually look pretty reasonably priced. In some cases they are fairly cheap. So there are pockets of that.

Jesper Madsen

In that respect, for instance, from a yield perspective, the telecommunications sector is still one that has been pretty underappreciated by the markets year-to-date. Some of the focus has shifted to probably some of the riskier business models in the region that have also been sold down quite severely at the end of 2008 and the beginning of 2009. But again, it is a sector that continues to be higher yielding and generates ongoing and very healthy cash flow, which is an attraction for dividend-focused strategies.

Jodi Borkowitz

Robert, if I could just follow up. In implementing these views in the funds, do you hold cash positions if you think valuations get expensive if there are lessened opportunities?

Robert Horrocks

We don't tend to adjust cash positions. From my experience, even if you had perfect foresight of the cycles of things, like

interest rates and GDP, you would probably not make many value-added asset allocation decisions between equities and cash. The relationship is so complex and equities can perform in unpredictable ways. We'd rather be fully invested, if you're a big believer that Asia is going to be the leader of growth in the world for the next decade then it doesn't make sense to hold high cash positions. Ultimately, that is the decision for the underlying investor. We don't feel that we can time markets and we don't try to.

Jodi Borkowitz

Great. Jesper, when you as a portfolio manager/analyst, travel in the region, what countries do you visit? What does a typical itinerary look like? Could you share some examples from your most recent visit to the region?

Jesper Madsen

Traveling to Asia and being in touch with what takes place there is obviously of utmost importance on the investment team. We all sit in San Francisco so those trips are our window that we use to view what takes place there. It's a very important, for instance, when we get back from trips that we all sit down in one room, in a debriefing session. We go over the company meetings, sometimes we have photos from factory visits, etc. So I would say most members of the investment team would travel to Asia about once per quarter. Normally, it would be a two-week trip. Depending on whether you focus predominately regionally or on one country specifically, the trip may include up to three to four countries over that period. For the most part, we probably meet about four to five companies a day, and often times in different sectors. Sometimes we have a trip that is focused on one specific sector, but oftentimes we would be covering a pretty big range of companies within a country, or maybe the same sector but within different countries. That's pretty much how we go about setting up trips and going out in the region.

Jodi Borkowitz

Speaking of regions, there are a couple of questions on your views on particular countries. One, we talked a little bit about China. What are your thoughts on India and the growth you are seeing there? Second, Jesper, I know the Asia Dividend Fund invests in Japan so could you please offer some thoughts on Japan as well?

Robert Horrocks

With India, what's been interesting during this cycle is that Indian GDP growth probably troughed at around 6% annualized, which is similar to what China did. And it seems to be headed for a sort of medium-term growth outlook around about the 6% to 7% would be my guess. But that's probably more conservative than most forecasts out there. So like in China, only by a couple of percentage points, would be my guess and that's been quite impressive.

I think there are things India can do to improve that growth rate. The property market could be deregulated. I think that

would help a lot. I think also the, a lot of capital in India is siphoned off into government run enterprises, rather than the private sector and the private sector has much higher returns on capital and I think that is something else that could be done and if those two reforms are put in place, then the medium term growth outlook looks pretty good. Remember also it's a domestic demand and domestic consumer-driven economy so it's a relatively less prone to the global cycle. I believe the only place where it's vulnerable is in financial flows. I'll just make a quick point on Japan and whether that's a good or bad place to invest. I think you could probably say from a macro view that you probably wouldn't come up with a very attractive growth scenario for Japan but from a valuation perspective it is extremely cheap. Also remember that ultimately we're not investing in countries, we're investing in the stocks and I think there you would probably find some much better targets.

Jesper Madsen

To Robert's point, it is very easy to be down beat on Japan from a macro perspective. But when you actually start looking at the fact that there are industries there—even industries that are quite developed elsewhere in Europe and the U.S., for instance, such as the financial services sector and asset management—you will see that whole sector is still an underpenetrated, underdeveloped sector in Japan. We are also looking for companies that can deliver growth because they are now tapping the opportunities that they see in China and the opportunities that they see in Asia more broadly.

This is also something that is new in terms of Japan. Japanese companies used to pretty much ignore what was going on next door. It wasn't sizeable enough for them and it was much more interesting for them to look at the U.S. and Europe instead. That has changed quite significantly over the last five years. Where now, a lot of Japanese companies are starting to see a growing and a significant portion of their earnings actually derived from China and elsewhere in Asia. As for India, just to return to that, that is a market that has seen good growth in terms of the underlying dividends. Unfortunately, it has traditionally been a capital-starved country, as Robert was pointing out as well. And as a result there is not a lot of cash flow paid out to shareholders and for good reason, there's a lot of catch up taking place in that country. So again that is a tough space in terms of the yield that you're receiving as a shareholder there for dividend-focused strategies. For more growth-oriented strategies, it's a different story.

Jodi Borkowitz

Thanks, Jesper. As investors do both of you also need to rely on the financial data that comes out of these companies? Particularly in places like China, what is your opinion on the reliability of the data that you're getting?

Robert Horrocks

So I guess there's two sorts of data, there's the macro data and the company level data and at a very basic level, Chinese GDP data doesn't add up. But also at a very basic level, my

university lecturer in 1987 was getting paid less than US\$20 a day and there was nowhere he could even spend that. If you go back at you look at Beijing, where I was university, today and you see a thriving retail economy, you see a modern city. So growth, real growth has taken place and I think overall, do the Chinese GDP numbers give a false impression of what's been going on? No, I don't think they do at all.

Financial data: it used to be the case that company analysis was basically turning up at the factory in China and see whether it was there. Such was the lack of trust in the financial data and whereas that may still exist in some mainland companies and it may still exist in private companies, there's a much stronger, more robust analyst community looking over the stocks. And also remember that a lot of the exposure that people have to Chinese investments comes through Hong Kong-listed companies that have a very strong market structure and a fairly modern accounting and auditing structure to support it.

Jesper Madsen

Also, bringing it back to one of the softer benefits of dividend investing, it is a great tool in terms of corporate governance. And obviously financial statement analysis is part of that. The fact that you may have, say 40% to 80% of earnings leave a company means or gives you at least some greater sense of assurance that that money was actually made in the first place. It also means that minority shareholders are being put on an equal footing with majority shareholders, which is also one of the few times that you can make sure that cash is being paid back to you in line with the ownership of your company. So again the dividend is just a very handy tool for investors and analysts in the whole scheme of assessing the corporate governance and the value of the financial statements as well. It just de-risks that decision and that analysis.

Jodi Borkowitz

Jesper, you mentioned something earlier about the Chinese government urging companies to pay dividends. Are there structural incentives for these companies to pay out and actually grow their dividends over time in China versus other markets?

Jesper Madsen

I would probably widen this out a little and say, if we talk about structurally whether there are any incentives, I would actually turn as far away as you can and look at Australia. Using that as an example, you actually have a tax regime in place there. I just want to bring it up because it is quite interesting and obviously it is part of the reason that we do invest in it for the Asia Dividend Fund. You actually have companies, when they pay corporate taxes in Australia, that generate an offsetting credit that is distributed with the dividend and people then use that credit when it comes time to pay their personal taxes. Now unfortunately, this is only good for Australian citizens and residents and therefore is not something that we can take part in. But it does mean that Australian companies, for the most part, pay out a greater portion of their earnings. I'm just saying that's a very positive example of what

can be done when you try to avoid double taxation, etc. So government policy can definitely have an impact on how companies behave as well.

In terms of China and other Asian countries, what are the structural incentives? You have to remember a lot of these companies are still in the hands of first and second-generation founders or families. Or you have other large shareholders that have an interest in extracting some value throughout time. And again, the only legitimate way of doing this, is via the dividend and again seeing that from a management team does also just instil more confidence in terms of the corporate governance. You see that there is no abuse from these larger shareholders so I would say that's the main structural incentive. This is something we spend a fair amount of time on—understanding who are the main people behind each company, what is their thinking, what are the incentives and how does that feed back to how the capital is being deployed both for future investments and also for dividend policies.

Jodi Borkowitz

I'm going to take this back to Robert because there were some other macro-related questions, a couple of them on currency. Most of the questions are regarding the possible appreciation of Asian currencies including the Chinese yuan. What are your thoughts on that?

Robert Horrocks

There's certainly pressure on the Asian currencies to appreciate, partly because I suspect the U.S. government wants a weaker dollar, and partly because of the strength of growth and the productivity gap that seems to have opened up between Asia and the developed world. I think the markets generally across the board are pricing in this expectation, I think most people expect a declining U.S. dollar over the medium term and there is pressure on Asian currencies to rise. I think that's been part of what has fuelled the rally in the Asian equities as an asset class. But I would caution that the governments don't necessarily see it that way. They would be happier to see a rise in domestic prices take the strain of adjustment rather than a rapid rise in the exchange rate. Particularly in the case of small open economies, where they have built up a very large export business or even in the case of China where there is a very large presence of export and exporting manufacturers to live off very thin margins in the coastal cities. So I think governments in the region are going to be very wary about allowing their currencies to appreciate rapidly, I think they want to give their economies and their businessman and entrepreneurs a chance to adjust. I'm hopeful that the markets will recognize this and not get too carried away with inflows into the region over the coming 12 months. I think if push comes to shove, you might see some capital control-type policies implemented in the region if markets really do start to overheat dramatically.

Jodi Borkowitz

I'm going to wrap up with one last question to Robert. Robert, what do you believe are the greater risks going forward for the

Asian markets and for all the international markets? How do you, Jesper and the team, work to overcome them?

Robert Horrocks

What I was just saying about the risk of “hot money” inflows into the region is a real one and the potential for capital controls to be implemented to try and deal with it. There are certain things as a portfolio manager that you can do to try and mitigate that, we do make use of ADR's, for example. I think for some of the portfolios that invest in convertible bonds, that does give you further areas of liquidity in the portfolio. But that's a broad systemic risk that I think ultimately, we're limited in what we can do to overcome it.

Jesper Madsen

In terms of risks, as Robert pointed out earlier in the presentation, markets have moved quite a bit, and globally, it's time for companies to actually start delivering on these upgrades that have been coming to the system from the sale-side community. And obviously that is a risk if things do start falling short of those expectations. That said, from a portfolio perspective, this means that one way of getting around that to a certain extent is to perhaps not be chasing some of the most appreciated areas of the market and instead again having that focus on yield, turn around and see what has been lacking in this kind of environment and is it for good reason or are these still companies that can deliver you know solid earnings growth and convert that into dividends over the next few years.

Robert Horrocks

I think that's absolutely right to take a long-term view. Your returns are going to be generated by fundamental growth, but there are also governments in the region that also have to take a long-term view, and we've been talking about policy changes that have to come. I think one of the big ones is going to be developing and deepening the capital markets, growing the corporate bond market—not only to have some means of making more efficient use of the liquidity in the system, but also giving individuals a better way to save for their retirements. So there is an element of government policy risks. This is not just talking about China, but across economies like Korea and India as well.

Jodi Borkowitz

Thank you Robert, and thank you all for joining us today and all the great questions that you asked. I wanted to just end with some final notes here related to the webcast and the Matthews Asia Funds. First of all, many of you have asked so just to note that the Matthews Asia Funds are paying distributions tomorrow, December 9th for shareholders of record as of today, December 8th. All that information is available on our website. Thank you, Robert, thank you Jesper, thank you all for participating in today's discussion. We seek to be your resource for investing in Asia so we appreciate you joining us today.

Disclosures

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