



Compounding the Growth Opportunity in Asia Ex-Japan

In a more volatile world, high-conviction, quality-focused investing is key.

July 2019

KEY INSIGHTS

- The Asia ex-Japan region offers investors a rich, highly diverse opportunity set. Particularly interesting are those often overlooked companies that can potentially deliver modest earnings growth, consistently, year after year.
- U.S.-China trade tensions have clouded the near-term outlook in the Asia ex-Japan region. However, China's domestic A shares market continues to represent a rich, longer-term opportunity set.
- In May 2019, the T. Rowe Price Asia Opportunities Equity Strategy celebrated its five-year anniversary, recording positive excess returns every year since inception.



Eric Moffett

Portfolio Manager, T. Rowe Price Asia Opportunities Equity Strategy

Asia ex-Japan offers fertile ground for finding quality, well-managed companies with the potential to grow their earnings consistently, year after year. While the U.S.-China trade conflict is a near-term headwind, long-term prospects for the region, backed by robust domestic demand, remain encouraging.

Accessing Asia's growing range of investment possibilities brings many unique challenges. Not least of which is how to uncover potential winners from a vast and extremely diverse opportunity set. This is where experience in the region and the support of a large, global research platform are crucial in helping to identify compelling opportunities at an early stage.

Managing the Uncertainty of Trade Disputes

We are constructive about the long-term outlook for the Asia ex-Japan region. Chinese economic growth, while slowing in recent years, continues to outpace other developed economies by some margin, providing a powerful engine for the region. Long-term secular themes, such as rising wealth, technological advancement, and positive demographics, add further support.

More immediately, however, the U.S.-China trade conflict is creating uncertainty, and this is clouding the earnings outlook for many Chinese companies. We have long been enthusiastic about China and the domestic A shares market, but the current trade impasse has cast a shadow over the region in the near term. Trade negotiations have been marked by expressions of tariff brinkmanship

that could ultimately have the effect of restricting both sides' negotiating stance, making it even harder to achieve a meaningful compromise.

Given this backdrop, we hold no meaningful exposure to exporters or trade-related names. At the end of May, we also reduced the portfolio's allocation to China to neutral, taking the opportunity to consolidate our exposure into fewer high-conviction holdings. Around 7% of the portfolio remains in China A shares as of the end of May 2019, down from 11% in April.¹ This weighting is still significantly above the average levels held by our peer group competitors and is a clear reflection of our longer-term optimism about the opportunity set in China.

Transformative Access to the Middle Kingdom

The implementation of the Stock Connect link between China's mainland markets and the Hong Kong Stock Exchange in 2014 and 2016 was transformative. It provided foreign investors with access to the huge potential of the China A shares market for the first time. Despite this seismic shift, however, foreign ownership of China A shares remains low, at around just 3%.

The hugely underpenetrated nature of the A shares market becomes clear when compared with other Asian markets like Taiwan or Korea, each of which are around 40% owned by foreign investors (Figure 1). This disparity highlights the untapped opportunity that exists in China and the vast potential open to foreign investors at a still early stage of the market's development.

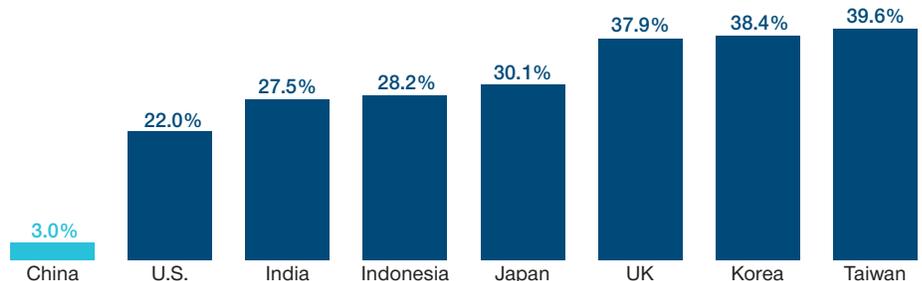
A High-Quality, Longer-Term Investment Focus

In May 2019, the T. Rowe Price Asia Opportunities Equity Strategy celebrated its five-year anniversary. Over this period, the composite outperformed its comparative MSCI All Country Asia ex Japan Index (Net), delivering positive annualized excess returns each year since inception.²

The strategy's investment approach centers on high-conviction stock picking—targeting high-quality companies and adopting a longer-term investment perspective. A lot of investors in Asia ex-Japan associate the region with high-growth investing, and, certainly, if you can pick the right companies each time, the payoff can be excellent. However, the risk is also high.

(Fig. 1) The China A Shares Market Remains Significantly Underpenetrated

Comparative foreign ownership of world stock markets
As of March 31, 2019



Source: Goldman Sachs.

¹ Source: T. Rowe Price, as of May 31, 2019.

² Source: T. Rowe Price and MSCI (see Additional Disclosures). Figures are calculated in USD, net of fees, rolling 12-month returns, covering period May 21, 2014 (Composite inception date) to May 31, 2019. Returns shown with reinvestment of dividends after the deduction of withholding taxes.

“We look to buy high-quality companies run by high-quality people and hold them for the long term.

— Eric Moffett

Portfolio Manager, T. Rowe Price
Asia Opportunities Equity Strategy

Our preference is to invest in more stable, moderate growth businesses. Companies we target might deliver more modest growth of around 15% a year, but they can potentially deliver this reliably and consistently through the investment cycle, year after year. Among the characteristics that these quality growth-compounding companies typically display include capable management teams, predictable earnings growth, strong balance sheets, and healthy free cash flows.

Allocation Channeled to High-Conviction Ideas

We favor highly cash-generative companies. As a result, the portfolio tends to have a natural bias toward domestically oriented businesses expected to benefit from growth in disposable incomes. A principal example is Yum China, the fast-food chain operator of the KFC, Pizza Hut, and Taco Bell franchises in China. We have owned this highly cash-generative business since October 2016 (and the company it spun out from, Yum! Brands, since inception in 2014), and, as of May 31, 2019, it is among the top contributors to the portfolio's outperformance during this time.

Another quality growth compounder owned since the Asia Opportunities Equity Strategy's inception is China Vanke, one of the country's largest homebuilders. The average foreign investor regards Chinese property stocks as highly volatile and only investible with a positive view of the cycle. However, looking more closely at what drives the profit and loss of Chinese homebuilders, it is principally about gains in market share. So, while some might expect the financials of housebuilders in China to fluctuate wildly, this is really a story of rapid industry consolidation, with the larger

players taking a growing share of the housing market. As such, China Vanke does not look like a cyclical story at all, but, rather, one of steady compound growth given its consistent market share gains. And as many investors remain nervous about Chinese homebuilders, the company trades at a low five or six times earnings with a 5% dividend yield.

Another business that occupies a strong position in a consolidating sector is Yixintang Pharmaceutical. The China A shares-listed pharmacy chain is looking to become the leading player in southwest China, a region with a burgeoning population of nearly 200 million people. The company focuses largely on dispensing medication, but it has the potential to diversify into other consumer products, such as beauty and health. Yixintang Pharmaceutical is another low-beta growth compounder, with a strategy that is aligned to government policy and a potential beneficiary of consolidation in China's pharmacy retail sector.

Quality Focus Helps to Mitigate Downside Risk

A clear belief in active, high-conviction investing is evidenced by the construction of the portfolio. The top 20 of the representative portfolio's 53 holdings, as of May 31, 2019, made up 62% of the total portfolio. The focus on high-quality companies that can consistently compound growth over time is duly reflected in the fact that around 30% of the portfolio has not changed since inception.³

Analysis of the strategy's outperformance since inception also provides some important insights. This confirms the composite's strong upside capture in rising markets, while limiting the potential downside participation when markets are in decline. Over the five years ended May 31, 2019, the

³ Source: T. Rowe Price, as of May 31, 2019. The representative portfolio is an account in the composite we believe most closely reflects current portfolio management style for the strategy. Performance is not a consideration in the selection of the representative portfolio. The characteristics of the representative portfolio shown may differ from those of other accounts in the strategy.

composite's upside capture ratio was 102%, while the downside capture was limited to just 79%.⁴

Opportunity Abounds as We Look to the Future

The Asia ex-Japan region continues to offer exciting opportunities, in our view. The broad and diverse universe presents a range of good-quality companies, many of which offer attractive valuations. That said, the near-term environment is not without challenges, most notably the uncertainty surrounding the ongoing U.S.-China trade conflict.

This environment is conducive to research-driven, conviction-based investing.

For the T. Rowe Price Asia Opportunities Equity Strategy, we continue to follow a consistent, time-tested approach—identifying quality, cash-generative businesses, run by capable management, and holding these companies in order that they can continue to compound growth potential over time.

WHAT WE'RE WATCHING NEXT

We maintain our long-term enthusiasm about China but are mindful of the elevated risk in the near term, due to the trade conflict with the U.S. We are keeping a close eye on developments here. After trade negotiations broke down completely in May, U.S. President Donald Trump and Chinese President Xi Jinping have recently agreed to resume trade discussions once more. For now, this is a positive, but talking can only take you so far.

⁴ Source: T. Rowe Price, as of May 31, 2019.

Key Risks—The following risks are materially relevant to the strategy highlighted in this material: Transactions in securities denominated in foreign currencies are subject to fluctuations in exchange rates which may affect the value of an investment. Returns can be more volatile than other, more developed, markets due to changes in market, political and economic conditions.

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