

# The Taiwan Fund

Growth-biased with an emphasis on technology

The Taiwan Fund, Inc. (TWN) seeks long-term capital appreciation, primarily through equity investments listed in Taiwan. It is a closed-end company listed on the New York Stock Exchange. The current investment adviser took over portfolio management in July last year and the profile of the fund has changed noticeably with the move to an overweight position in technology sectors and a doubling in the number of holdings. This, signs of stabilisation in performance following a soft period and a resumption of a discount management programme suggest TWN may now attract broader interest among investors looking for managed exposure to the Taiwan market.

12 months ending	Total share price return (%)	Total NAV return (%)	Taiwan SE weighted	MSCI Asia Pac ex-Japan	S&P 500 TR US\$
31/01/12	(18.3)	(15.8)	(16.1)	(5.5)	4.2
31/01/13	8.5	5.5	8.6	14.2	16.8
31/01/14	11.7	13.9	8.2	(4.2)	21.5
31/01/15	0.4	0.2	9.6	10.2	14.2

Note: \*Twelve-month rolling discrete performance.

## Investment strategy: Filtering for growth and quality

Portfolio manager, Shumin Huang, and the team at investment adviser JF International Management (part of J.P. Morgan Asset Management) select stocks primarily on a bottom-up basis. There is a bias towards growth and considerable time is allocated to company meetings by the five portfolio managers and four analysts dedicated to the Taiwan market. Within a universe of over 1,500 stocks, a focus list of 100-200 names is selected and the manager constructs a portfolio of between 50 and 75 holdings from this list.

## Taiwan market outlook: Maturity and growth

For investors attracted to Asian and technology growth themes, the Taiwan market may represent something of a Goldilocks solution: neither too hot nor too cold. As an advanced economy with a parliamentary democracy, Taiwan can be seen as sitting in the comfortable middle ground between faster growth but potentially more volatile economies and larger, more mature, western markets. The potential for increased tensions in relations with China needs to be recognised but the mutual interest in cooperation reduces the likelihood of long-term difficulties. While near-term earnings growth may not be as strong as last year, GDP and earnings are still expected to outpace Western markets over time. Relative to history, prospective P/E multiples are significantly below those of the US and Europe, for example (see page 3).

## Valuation: Discount just above long-term average

In September 2014 the board announced details of its resumed discount management policy; the company may purchase up to 10% of the outstanding shares when they trade at a discount of more than 9% to net asset value and the purchases are reasonably expected to enhance shareholder value. The discount of 9.7% stands just above the three-year average. The discount management policy may act to limit any further widening while any positive shift in global/greater- China growth expectations could lead to a smaller discount.

## Investment companies

11 February 2015

Price*	US\$16.32
Market cap*	US\$134m
AUM*	US\$149m

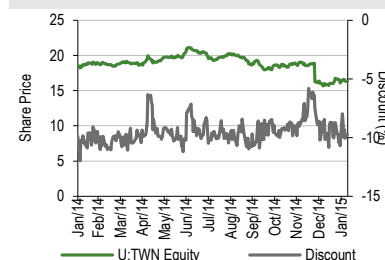
NAV*	US\$18.08
Discount to NAV	9.7%
Yield**	N/A

\*As of 9 February 2015

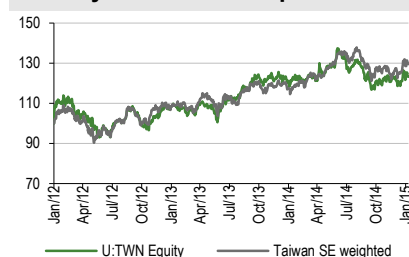
\*\*Latest dividend paid 6 January 2015, \$2.6332, previous dividend 9 January 2012, \$0.5605.

Ordinary shares in issue	8.2m
Code	TWN
Primary exchange	NYSE

## Share price/discount performance\*



## Three-year cumulative performance



52-week high/low	US\$21.15	US\$15.71
NAV* high/low	US\$22.96	US\$17.20

\*Including income.

## Gearing

Gross	0.0%
Net	0.0%

## Analyst

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### Exhibit 1: Fund at a glance

#### Investment objective and fund background

The Taiwan Fund seeks long-term capital appreciation, primarily through equity investments listed in Taiwan. Launched in 1986, the fund has changed asset manager on four occasions from 2010, with the latest change taking place on 22 July 2014 when the current investment adviser, JF International Management Inc. (part of J.P. Morgan Asset Management) was appointed. The portfolio is diversified and the intention is to maintain exposure to a broad spectrum of Taiwan's economy.

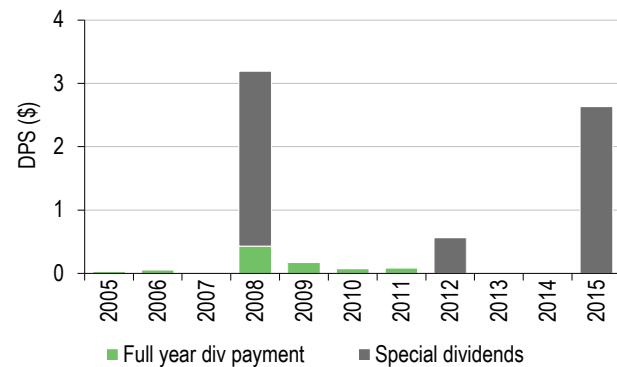
#### Recent developments

16 December 2014: Dividend announcement: \$2.6332 per share, paid 9 January 2015.  
 22 September 2014: Shareholders approve appointment of JF Intl. Mgmt as investment adviser.  
 11 September 2014: Board authorises management to buy back up to 10% of shares at a discount of more than 9%.  
 17 July 2014: JF Intl. Mgmt selected as new investment adviser. Previously announced Managed Distribution Policy not to be implemented.

Forthcoming		Capital structure		Fund details	
AGM	May 2015	Total expense ratio	1.80% (FY 2014)	Group	JF Intl. Management Inc.
Year end	31 August	Net gearing	0%	Manager	Shumin Huang
Dividend paid	January	Annual mgmt fee	Tiered, see page 10	Address	One Lincoln Street P.O. Box 5049, Boston, MA
Launch date	1986	Performance fee	None	Phone	+1 877 864 5056
Continuation vote	None	Fund life	Indefinite	Website	<a href="http://www.thetaiwanfund.com">www.thetaiwanfund.com</a>
		Loan facilities	N/A		

#### Dividend history (shown by financial year to end August)

The fund distributes to shareholders at least annually substantially all taxable ordinary income any net realised gains.

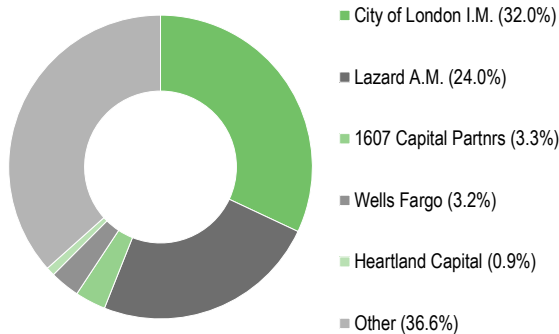


#### Taiwan stock market characteristics

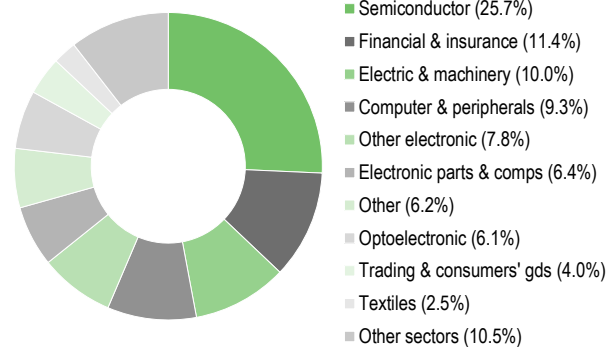
The data for the Taiwan equity market and TAIEX index indicates the market context for the Taiwan Fund.

Taiwan Stock Exchange (end-December)	
Companies listed	880
Market cap	US\$850.9bn
% of Asia-Pacific regional market cap	4.0%
% of world market cap (WFE members)	1.3%
Share turnover/market cap (turnover velocity Jan-Dec 2014)	78%
TAIEX index (30 January 2015)	
Constituents	826
Average market cap	US\$1,041m
Median market cap	US\$212m
Largest market cap (TSMC)	US\$115,807m
Top 10 companies' percentage of market cap	36%
P/E (Est)	13.0
Price/book value	1.7
Price/sales	0.9
Dividend yield	3.1%

#### Shareholder base (as at 18 December 2014)



#### Sector exposures of portfolio (as at 30 December 2014)



#### Top 10 holdings (as at 31 December 2014)

Company	Sector	Portfolio weight %	
		30 December 2014	30 December 2013
Taiwan Semiconductor Manufacturing Co.	Semiconductor	11.3	5.3
Hon Hai Precision Industry	Other electronic	5.2	0.0
MediaTek	Semiconductor	3.9	0.0
Fubon Financial Holding	Financial & insurance	3.5	0.0
Delta Electronics	Electronic parts & components	3.2	0.0
Advanced Semiconductor Engineering	Semiconductor	3.0	0.0
Largan Precision	Optoelectronic	2.5	0.0
Advantech Electronics	Computer & peripheral	2.5	5.3
President Chainstore	Trading & consumers goods	2.4	0.0
Chaillese Holding	Other	2.4	0.0
<b>Total for top 10 December 2014 and 2013</b>		<b>39.9</b>	<b>50.1</b>

Source: The Taiwan Fund, Morningstar, Bloomberg, WFE, Edison Investment Research.

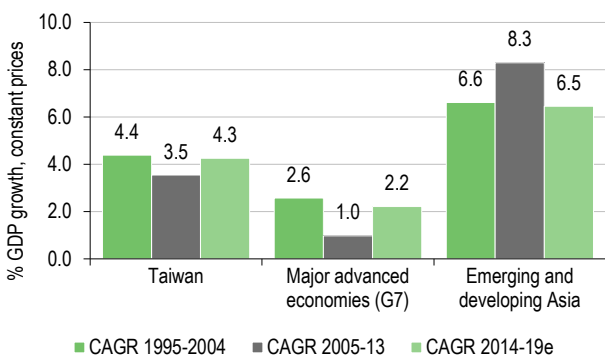
## Taiwan market outlook: Tech and China growth

While Taiwan is classed as a developed economy it has recorded, and is expected to continue to record, GDP growth between that of the major advanced economies and the emerging Asian countries (Exhibit 2). Many of the companies listed on the Taiwan exchange provide exposure to the above-average growth expected regionally (China and Asia more broadly) and in the technology and electronics sectors that account for more than 50% of the index. The open nature of Taiwan's economy, with exports equivalent to over 60% of GDP, means that growth is linked to regional and global trends so that, while above average growth is likely over time, Taiwan would be sensitive to setbacks in global growth. Signs that the US economic recovery has reached a self-sustaining stage are encouraging in a general sense and more particularly for the technology sector. Commentators look for further growth within the Apple eco-system even after the success of iPhone 6 while the move to 4K televisions and "the internet of things" promise broader opportunities.

While global economic and stock market trends are likely to be the main influences on the Taiwan market, on the political front it is worth noting that the ruling KMT party has become unpopular because of its efforts to create closer economic relations with China and relatively subdued recent economic growth. This unpopularity was evident in recent regional and municipal elections and has raised questions over the potential for increased tensions with China, but in practice mutual interest argues strongly for the maintenance of a satisfactory working relationship.

From a valuation perspective, the Taiwan market has moved from a P/E premium to a discount versus the world market (from +5% at the beginning of 2014 to -12% currently) and, as shown in Exhibit 3, is rated more modestly than western markets as measured by the forward P/E compared with its 10-year average or in comparison to the US in absolute terms. This, and the potential for above average growth mean a fund providing managed exposure to this market offers an interesting play on technology and Chinese/Asian growth.

**Exhibit 2: Real GDP growth comparison**



Source: IMF October 2014 WEO. In January 2015 IMF global forecasts for 2015 and 2016 were trimmed by 0.3 percentage points with a small increase for the G7 and decrease for emerging and developing Asia.

**Exhibit 3: Valuation comparison (February 2015)**

	Forward P/E	P/E as % of 10 Yr Ave.	Price/Book	Yield (%)
Taiwan	13.2	99	2.2	2.8
Asia	13.0	97	1.6	2.2
Europe	14.3	124	1.8	3.0
UK	15.1	130	2.0	3.1
US	17.3	123	3.0	2.0
World	15.1	117	2.1	2.4

Source: Thomson Datastream (9/2/15)

## Fund profile: Selective Taiwanese exposure

Launched in 1986, TWN is a closed-end investment company quoted on the New York Stock Exchange that aims to deliver long-term capital appreciation primarily through investment in companies listed in Taiwan. The fund is currently fully invested in Taiwanese equities, but up to 20% of assets can be invested in fixed income and other assets. The fund's benchmark is the TAIEX Index expressed in US dollars and currency exposure is not hedged.

The fund has changed manager on three occasions since 2010 when Martin Currie took over as investment adviser; in late February 2012 when APS Asset Management was appointed as sub-advisor to the fund, then in February 2014 when Allianz Global Investors become interim manager and, finally, 22 July, when the current manager, JF International Management was appointed asset manager (JFIMI is part of a group of companies branded as J.P. Morgan Asset Management). JFIMI has a well-resourced team that follows an investment process with an emphasis on bottom-up analysis but also taking into account top-down views: there is a bias towards growth in its stock selection.

## **The fund manager: Shumin Huang**

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### **The managers' view: Favourable risk/reward**

The manager notes that with the municipal elections out of the way, there is the potential for Taiwan's President Ma to use the time ahead of the 2016 presidential elections to win back confidence in his KMT party. Easy liquidity and the lower oil price are likely to augment consumption and investment. The introduction of a capital gains tax on stock market investors has been delayed until 2018 and this is seen as a helpful factor for retail involvement in the market. While reduced global economic growth expectations and the uncertain outlook in Europe are negative factors, Huang points to strong fundamentals and modest valuations as providing a favourable risk/ reward balance for investors in the Taiwan market.

We spoke with William Tong CIO in the Taiwan office and he explained that, when JFIMI took over as manager of the portfolio, the changes included exiting a number of relatively illiquid smaller cap names that were not among the manager's preferred list. The growth bias in the team's selections means that there is still a smaller/mid cap element in the holdings and this helps to explain why the number of holdings (75) is at the upper end of the guided range.

The tech sector is important within the Taiwan market (c 50%<sup>1</sup>) and there are a number of themes expected to provide growth for portfolio companies in this area. While iPhone related growth may be seen as something that has already happened the cycle of new models is set to continue and companies such as Taiwan Semiconductor Manufacturing Co. (TSMC) and Largan Precision are potential beneficiaries. Growth in the use of 4G mobile phones should also help TSMC and MediaTek. The move from 2K to 4K televisions is positive for Novatek and Au Optronics. Increasing use of automation (notably in China) should play into demand for products provided by Advantech and Ennoconn. Finally, looking ahead to the development of the internet of things, United Microelectronics and Mediatek are seen as beneficiaries.

## **Asset allocation**

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### **Investment process: Fundamental with a growth bias**

In implementing the investment process, the manager has the benefit of the resources and substantial collective experience of the Greater China team within J.P. Morgan Asset Management. There are five portfolio managers based in Taiwan and four research analysts focused on the Taiwan market with a further analyst who dedicates half their time to it. A further four portfolio managers, four analysts and head of the team, Howard Wang, complete the Greater China team. Shumin Huang, the primary portfolio manager for TWN, is based in Hong Kong and also heads up

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<sup>1</sup> We have summed the weights of the following sectors: electronic parts & components, electronic products distribution, semiconductor, computer & peripheral equipment, communications and internet, optoelectronic and other electronic.

the research team. She has 22 years' experience in the market, including eight years at J.P. Morgan Asset Management.

The investment approach has an emphasis on a bottom-up assessment of companies with consideration given to a range of factors including: growth (industry, company specific drivers and upside/downside risks to earnings estimates), valuation, management quality and the liquidity/volatility of the shares. In selecting stocks the team have a growth bias and in filtering the Taiwan universe of over 1,500 stocks devote significant time to management meetings and company visits; on average the managers have 50-100 meetings a year each. The team maintain a focus list of 100-200 names (currently 180) and the manager constructs the portfolio from within this reflecting the level of conviction on individual stocks and sector/industry preferences.

Internal guidelines used by the manager include an investment horizon of one year, sector positions within 5-7% of the benchmark, between 50 and 75 holdings, maximum exposure of 10% to one stock and under/overweights limited to 2-3 percentage points versus the benchmark.

## Current portfolio positioning

The profile of the portfolio has changed substantially over the last year following the changes in the fund's investment adviser. The number of holdings has more than doubled to 75, while the weighting of the top 10 holdings is lower at just under 40% compared with 50% at the end of 2013 (bottom table page 2) pointing to a less concentrated, less idiosyncratic exposure under the current manager.

Looking more closely at the sector exposures, the main change that stands out is that the fund's weighting to technology related areas has increased significantly over six or 12 months. Between June and December 2014 the "technology" weighting increased from just under 50% to nearly 65% moving to a collective overweight versus the benchmark of 11 percentage points compared with an underweight of 3 points. The largest individual sector increase was for semiconductors and this and the electric & machinery sector were the two largest overweights for the fund (see Exhibit 4). At the other end of the scale most of the underweight positions at the end of December were in more traditional industrial sectors although the largest underweight was in communications and internet, albeit the negative bet here has been reduced.

<b>Exhibit 4: Main active sector weights end December 2014</b>				
<b>%</b>	<b>Fund weight end December 2014</b>	<b>Fund weight end June 2014</b>	<b>Change (percentage points)</b>	<b>Active weights end December 2014 (pp)</b>
Electric & machinery	11.2	8.5	2.7	9.4
Semiconductor	28.9	16.4	12.5	5.3
Computer & peripheral equipment	10.5	5.5	5.0	3.9
Other	7.0	4.5	2.5	3.8
Electronic parts & components	7.2	5.0	2.2	2.8
Automobile	0.0	0.0	0.0	-1.9
Iron & steel	0.0	0.0	0.0	-2.3
Oil, gas & electricity	0.0	0.0	0.0	-2.7
Plastics	2.1	2.5	-0.4	-3.8
Communications & internet	2.2	0.0	2.2	-4.1
Other sectors, cash	30.9	57.6	-26.7	-10.4
<b>Total</b>	<b>100</b>	<b>100</b>	<b>0.0</b>	

Source: The Taiwan Fund. Note: Current manager assumed responsibility 22 July 2014.

The net result of these changes has been to give investors in the fund a more diversified exposure to the Taiwan market with a significant emphasis on the technology sectors, a profile that may well be more appealing to international investors seeking managed investment in Taiwanese companies linked to secular growth in technology related businesses.

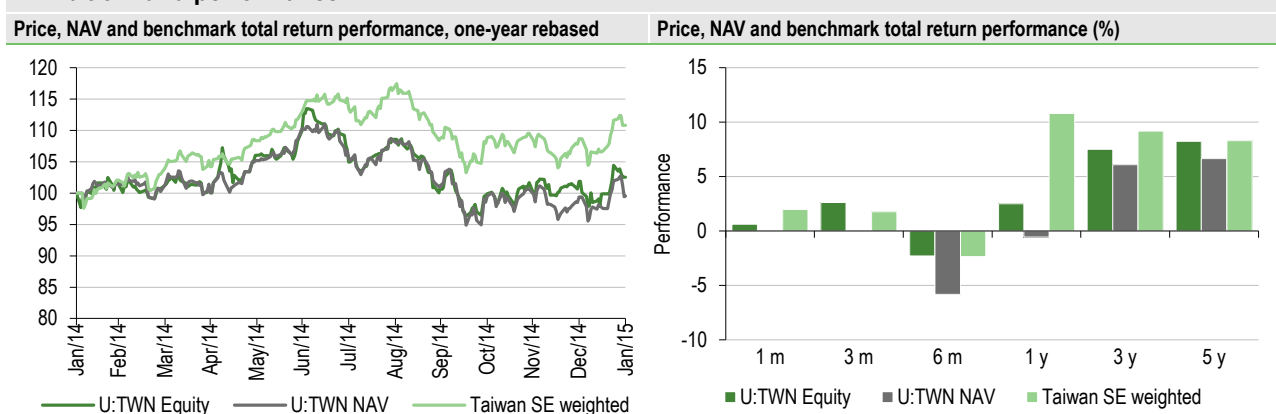
While the fund has a single country focus, the high level of exposure to exports means that the Taiwan economy and many of the portfolio companies are sensitive to global macroeconomic trends. The increased exposure to technology related companies also means additional sensitivity

to the specific trends within that section of the market where the high pace of innovation makes for a dynamic background for stock selection.

## Performance: Stabilising after soft period

The fund's cumulative NAV total return performance (Exhibit 5) has been held back by weak relative performance over the last year (-11%), a period that included the handover between investment advisers (portfolio turnover was 181% for the year to end August 2014 compared with an average of 48% for the previous three years). Even so, NAV performance has been only moderately below the benchmark and the MSCI Asia Pacific ex-Japan index over five years (-11% and -5% respectively). While the NAV relative performance for the fund compared with the US market (S&P 500) is weaker over most of the periods shown, this is mainly a reflection of the underperformance of the Taiwan index during a period of particular strength for the US market.

**Exhibit 5: Fund performance**



Source: Thomson Datastream, Edison Investment Research. Note: Total returns for three years and five years are annualised.

**Exhibit 6: Share price and NAV relative total return (all US\$, geometric calculation)**

	1 month	3 months	6 months	1 year	3 years	5 years
Price relative to Taiwan SE weighted	(1.4)	0.8	0.1	(8.3)	(5.9)	(0.6)
NAV relative to Taiwan SE weighted	(1.9)	(1.8)	(3.5)	(11.4)	(10.7)	(11.0)
Price relative to MSCI Asia Pac ex-Japan	(1.3)	4.1	3.1	(8.2)	3.1	5.7
NAV relative to MSCI Asia Pac ex-Japan	(1.9)	1.4	(0.4)	(11.2)	(1.7)	(4.8)
Price relative to S&P 500	2.3	2.0	(8.0)	(13.2)	(40.0)	(60.6)
NAV relative to S&P 500	1.8	(0.7)	(11.6)	(16.3)	(44.8)	(71.1)

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-January 2015.

## Discount: Management policy reintroduced

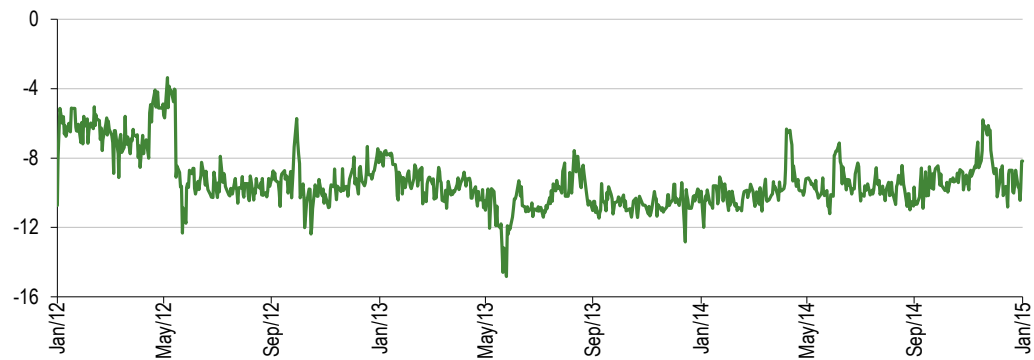
Following a period when the fund suspended its previous discount management policy in tandem with the planned introduction of a managed distribution policy, the board, after consultation with stockholders, decided not to implement the proposed distribution policy and reintroduced a discount management policy. Details of this were announced 11 September 2014; management are authorised to purchase up to 10% of the outstanding shares when they trade at a discount of more than 9% to net asset value and the purchases are reasonably expected to enhance shareholder value.

The fund implemented a significant one-time tender offer in June 2012 as a result of which 9.3m shares, or 50% of the outstanding number in issue were repurchased (US\$144.4m consideration).

Over the last year the discount has fluctuated in a band between 5.8% and 12.0% (Exhibit 7) spending most of this time around the average of 9.3%. The reintroduction of the discount

management policy may help to maintain a generally stable discount while positive surprises in terms of macroeconomic progress globally and hence sentiment towards the Taiwan stock market could encourage a narrowing below this level. Additionally, evidence that the relative performance of the fund has stabilised or strengthened would tend to have a similar effect.

**Exhibit 7: Discount over three years**



Source: Morningstar, Edison Investment Research. Note: negative values indicate a discount.

## Capital structure and fees

The fund has 8.22m ordinary shares outstanding. The fund has an unlimited life.

The fund is currently ungeared but may employ gearing for temporary purposes up to a maximum of 5% of total assets.

The management fee paid by the company is 0.90% on the first US\$150m in total net assets under management, 0.80% on the next US\$150m and 0.70% over US\$300m. The total expense ratio for the last financial year was 1.76% (or 1.80% including taxes paid on stock dividends received by the fund) compared with an average of 1.51% for the previous four years.

## Dividend policy

In 2013 the board announced the introduction of a managed distribution programme but this was not implemented and in 2014 the fund announced that it would revert to its earlier dividend policy. Under this it distributes to shareholders, at least annually, substantially all taxable ordinary income and expects to distribute its taxable net realised gains.

The dividend history is illustrated on page two; the company announced an annual dividend of \$2.6332 on 16 December 2014, comprised entirely of long-term capital gain. Prior to this the last dividend was announced in December 2011. In view of the irregularity of dividends we have not shown a dividend yield although the latest payment was equivalent to c 16% of the share price as at end January.

## Peer group comparison

Exhibit 8 shows a broad closed-end peer group for the fund and four open-ended Taiwan funds. The closed-end funds are those classified within the China Region and Greater China Equity Morningstar classifications. None of the other closed-end funds are purely Taiwan focused funds, with varying levels of China, Hong Kong and other exposures too.

When looking at the comparison, it should be remembered that TWN's current investment adviser has only been in place since 22 July 2014 and there have been earlier changes in investment adviser, each with their own approach and transitional turnover that may have impinged on performance.

Compared with the closed-end funds shown here, TWN outperformed the average over five years but underperformed over other periods and also underperformed the open ended funds. As noted in the performance section, the relative weakness of the Taiwan Fund as it navigated its change in investment adviser over the last year appears to have acted as a significant drag on these cumulative performance figures.

#### Exhibit 8: China region and Taiwan funds comparison

% except where shown	Market cap GBPm	NAV TR 1 Year	NAV TR 3 Year	NAV TR 5 Year	NAV TR 10 Year	Sharpe ratio 1y (NAV)	Sharpe ratio 3y (NAV)	Discount	Latest ongoing charge	Perf fee	Net gearing	Yield
<b>Closed-end funds</b>												
Aberdeen Greater China Fund	62.4	22.0	12.1	13.0	221.6	0.1	0.4	-10.2	2.3	No	99	0.7
China Fund Inc	198.7	24.3	42.9	47.6	333.3	0.5	1.0	-9.2	1.3	No	100	1.6
J.P. Morgan China Region Fund	74.2	32.9	49.1	52.9	218.9	0.5	1.0	-10.1	2.0	No	111	0.7
J.P. Morgan Chinese	141.6	26.0	51.4	62.1	285.3	0.9	1.2	-9.4	1.4	Yes	108	0.9
MS China A Share	439.4	61.2	72.6	62.5		1.0	0.7	-10.6		No	101	0.9
<b>Taiwan Fund</b>	<b>89.7</b>	<b>11.2</b>	<b>33.2</b>	<b>49.4</b>	<b>138.5</b>	<b>-0.1</b>	<b>0.8</b>	<b>-8.2</b>	<b>1.7</b>	<b>No</b>	<b>98</b>	<b>0.0</b>
Templeton Dragon Fund	556.3	28.6	17.4	53.3	281.0	0.0	0.5	-9.4	1.3	No	96	0.2
<b>Closed-end fund average</b>	<b>223.2</b>	<b>29.4</b>	<b>39.8</b>	<b>48.7</b>	<b>246.4</b>	<b>0.4</b>	<b>0.8</b>	<b>-9.6</b>	<b>1.7</b>		<b>101.9</b>	<b>0.7</b>
<b>Open-ended funds</b>												
Fidelity Funds - Taiwan Fund		24.1	55.4	51.5					1.3			
J.P. Morgan Taiwan A		17.4	36.1	50.1					1.9			
Schroder ISF Taiwanese Equity A		18.5	39.2	65.8	204.5				2.0			
UBS (Lux) Equity Fund Taiwan		30.7	41.7	42.0	147.6				1.9			
<b>Open-ended fund average</b>		<b>22.7</b>	<b>43.1</b>	<b>52.3</b>	<b>176.1</b>				<b>1.8</b>			

Source: Morningstar 30 January 2015. Note: the Sharpe ratio is a measure of risk-adjusted return. The ratios we show are calculated by Morningstar by dividing a fund's annualised excess returns over the risk-free rate by its annualised standard deviation. Net gearing is total assets less cash/cash equivalents as percentage of shareholders' funds. TR = total return.

## The board

The board (five members, all independent of the fund manager) are Joe O Rogers (chairman since 2012 and a founding director since the fund's launch in 1986), Michael Holland (appointed 2007), M Christopher Canavan, Jr (2003), Anthony Kai Yiu Lo (2003) and William Kirby (2013). TWN has announced the nomination of two candidates for the fund's board to be considered at the AGM 19 April 2015: Chih Cheung and Lawrence Kudlow.

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