Matthews Asia Credit Opportunities Fund

Choose a Share Class: Investor

Period ended September 30, 2018

For the quarter ending September 30, 2018, the Matthews Asia Credit Opportunities Fund returned 0.56% (Investor Class) while its benchmark, the J.P. Morgan Asia Credit Index (JACI), returned 1.17% over the same period.

Market Environment:

The third quarter of the year was notable for volatility in emerging markets around the world. U.S. Treasury yields continued to move higher as the U.S. Federal Reserve raised interest rates. Continued solid economic data in the U.S., on the margin, has increased rate hike expectations for the remainder of 2018 and 2019. Meanwhile, concerns around trade wars, the rise in oil prices and slowing growth in China led to a sell-off across Asia.

Asian credit markets performed surprisingly well despite the volatility in the third quarter. After widening significantly in the second quarter, high yield credit spreads tightened 25 basis points (0.25%) from July to August. Chinese and Indonesian issuers performed well as concerns over tight liquidity in onshore China eased and policy actions from the Indonesian central bank lessened the likelihood of an uncontrolled sell-off in the rupiah. By sector, real estate and commodity-linked industries, such as oil and gas and metals and mining, performed well.

Performance Contributors and Detractors:

In the third quarter, among the biggest contributors to portfolio returns were our holdings in the bonds of Lippo Karawaci,[1] Alam Sutera Realty and SoftBank Group. Lippo Karawaci and Alam Sutera are both Indonesian property developers. After selling off as the Indonesian rupiah depreciated in the second quarter, the bonds of both companies rebounded in the third quarter. SoftBank bonds also rebounded as the firm moved closer to the planned IPO of its Japanese wireless business, which may be among the largest IPOs ever.

The largest detractors to Fund performance in the third quarter were our holdings in the bonds of Ctrip.com, Qingdao Haier, and Tsinghua Unigroup. Both Ctrip.com and Qingdao Haier are convertible bonds of Chinese issuers. Ctrip.com is one of the largest online travel agencies in China, and its bonds performed poorly as the value of the underlying equity fell over 20% in the quarter on rising competition and a weak domestic market. Qingdao Haier manufactures household appliances, and its bonds fell as the company faced a challenging environment and battled revenue growth deceleration. Tsinghua Unigroup fell as government policy increased uncertainty around the credit quality of the issuer.

Notable Portfolio Changes:

We made a number of changes to the portfolio in the third quarter, adding short duration corporates while exiting our holdings in in a handful of Chinese credits. We added a number of U.S. dollar-denominated bonds that we believe have attractive yields relative to the risk we are taking. By buying high quality sub-investment grade bonds with maturities from 2019 to 2021, we were able to lock in attractive yields without taking on excessive interest rate or credit risk. For instance, bonds of Aluminum Corporation of China (Chinalco Capital Holdings), Olam and West China Cement have minimal default risk and solid balance sheets. We also added bonds of Krung Thai Bank in Thailand. Krung Thai is a high-quality bank, and because the coupon on the bonds increases significantly late next year, they are likely to be repaid by the company before the higher coupon takes effect.

We sold a number of our holdings in Chinese companies, exiting our renminbi-denominated credits and the dollar-denominated bonds of Tsinghua Unigroup. As the yield fell as both interest rates fell and credit spreads tightened, we exited our holdings of renminbi-denominated credits, including China Southern Power Grid, State Grid Corporation of China and Air China. We also exited our holdings in Tsinghua Unigroup after the company announced a plan to divest part of its business, in line with the government's policy to reorganize university assets.

Outlook:

In our view, Asian high yield bonds appear attractively valued, while U.S. and European high yield bonds appear overvalued. Credit spreads for Asia high yield bonds are almost 75 basis points (0.75%) higher than historic averages. In contrast, spreads for U.S. and European high yield bonds are about 250 basis points (2.5%) below average. In simple terms, Asian high yield bonds are compensating investors for taking credit risk even with continued volatility.

To be sure, there continue to be risks on the horizon. If a further slowdown in global growth materializes, we expect investor appetite for emerging markets to be diminished. Any escalation in trade shocks or further outflows stemming from policy normalization in the U.S. could also put pressure on Asian fixed income markets. Finally, the demand for Asian credit from Chinese wealth managers might fall as the wealth management channels through which buyers purchase bonds are being more closely regulated.

These risks may increase, but we believe that much of this is already being priced in. We have been expecting volatility to rise in 2018 and it certainly did in the second quarter. Asian credit markets will likely remain volatile for the remainder of 2018. We believe it is imperative, however, that we continue to stay the course and not sell into the volatility. Based on our solvency and liquidity analysis, we do not expect any of the securities in the portfolio to default. As such, the relatively attractive yields in Asia offer a strong base for positive returns. A bond that starts with a 5% to 8% yield and has 25 basis points (0.25%) of credit spread compression, for example, could potentially generate attractive returns for investors over the course of the year.

As of 9/30/2018, the securities mentioned comprised the Matthews Asia Credit Opportunities Fund in the following percentages: (Lippo Karawaci) Theta Capital Pte, Ltd., 6.750%, 10/31/2026 2.2%; Theta Capital Pte, Ltd., 7.000%, 04/11/2022 0.6%; Alam Synergy Pte, Ltd., 6.950%, 03/27/2020 2.0%; SoftBank Group Corp., 6.000%, 07/19/2049 3.2%; Ctrip.com International, Ltd., Cnv., 1.250%, 09/15/2022 4.2%; Olam International, Ltd., 4.500%, 04/12/2021 3.4%; West China Cement, Ltd., 6.500%, 09/11/2019 4.3%; and Krung Thai Bank Public Co., Ltd., 5.200%, 12/26/2024 3.1%. The Fund held no positions in Qingdao Haier (Harvest International); Tsinghua Unigroup; China Southern Power Grid Co., Ltd.; or State Grid Corp. of China. Current and future portfolio holdings are subject to risk.

[1] Lippo Karawaci is listed as Theta Capital Pte, Ltd.

Average Annual Total Returns - Investor Class (9/30/2018)

1-year -1.54%
3-year n.a.
5-year n.a.
10-year n.a.
Inception (4/29/16) 4.16%

Gross Expense Ratio

1.76%

After fee waiver and expense reimbursement: 1.15% [1]

[1] Matthews has contractually agreed (i) to waive fees and reimburse expenses to the extent needed to limit Total Annual Fund Operating Expenses (excluding Rule 12b-1 fees, taxes, interest, brokerage commissions, short sale dividend expenses, expenses incurred in connection with any merger or reorganization or extraordinary expenses such as litigation) of the Institutional Class to 0.90% first by waiving class specific expenses (i.e., shareholder service fees specific to a particular class) of the Institutional Class and then, to the extent necessary, by waiving non-class specific expenses of the Institutional Class, and (ii) if any Fund-wide expenses (i.e., expenses that apply to both the Institutional Class and the Investor Class) are waived for the Institutional Class to maintain the 0.90% expense limitation, to waive an equal amount (in annual percentage terms) of those same expenses for the Investor Class. The Total Annual Fund Operating Expenses After Fee Waiver and Expense Reimbursement for the Investor Class may vary from year to year and will in some years exceed 0.90%. If the operating expenses fall below the expense limitation in a year within three years after Matthews has made a waiver or reimbursement, the Fund may reimburse Matthews up to an amount that does not cause the expenses for that year to exceed the lesser of (i) the expense limitation applicable at the time of that fee waiver and/or expense reimbursement or (ii) the expense limitation in effect at the time of recoupment. This agreement will remain in place until April 30, 2019 and may be terminated at any time by the Board of Trustees on behalf of the Fund on 60 days' written notice to Matthews. Matthews may decline to renew this agreement by written notice to the Trust at least 30 days before its annual expiration date.

All performance quoted is past performance and is no guarantee of future results. *Investment return and principal value will fluctuate with changing market conditions so that shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the return figures quoted. Returns would have been lower if certain of the Fund's fees and expenses had not been waived. Please see the Fund's most recent month-end performance.*

Yield as of 9/30/2018

30-day Yield: 4.79%

30-day Yield Excluding Expense Waiver: 4.51%

The 30-Day Yield represents net investment income earned by the Fund over the 30-day period ended 9/30/17, expressed as an annual percentage rate based on the Fund’s share price at the end of the 30-day period. The 30-Day Yield should be regarded as an estimate of the Fund’s rate of investment income, and it may not equal the Fund’s actual income distribution rate. Source: BNY Mellon Investment Servicing (US) Inc.

Fixed income investments are subject to risks, including, but not limited to, interest rate, credit and inflation risks. Investing in emerging markets involves different and greater risks, as these countries are substantially smaller, less liquid and more volatile than securities markets in more developed markets.

Visit our Glossary of Terms page for definitions and additional information.

The views and opinions in this commentary were as of the report date, subject to change and may not reflect current views. They are not guarantees of performance or investment results and should not be taken as investment advice. Investment decisions reflect a variety of factors, and the managers reserve the right to change their views about individual stocks, sectors, and the markets at any time. As a result, the views expressed should not be relied upon as a forecast of the Fund's future investment intent. It should not be assumed that any investment will be profitable or will equal the performance of any securities or any sectors mentioned herein. The information does not constitute a recommendation to buy or sell any securities mentioned.

The information contained herein has been derived from sources believed to be reliable and accurate at the time of compilation, but no representation or warranty (express or implied) is made as to the accuracy or completeness of any of this information. Neither the funds nor the Investment Advisor accept any liability for losses either direct or consequential caused by the use of this information.

You should consider the investment objectives, risks, charges and expenses of the Matthews Asia Funds carefully before making an investment decision. This and other information about the Funds is contained in the prospectus or summary prospectus, which may also be obtained by calling 800-789-ASIA (2742). Please read the prospectus carefully before you invest or send money as it explains the risks associated with investing in international and emerging markets. These include risks related to social and political instability, market illiquidity and currency volatility. Investing in foreign securities may involve certain additional risks, exchange rate fluctuations, less liquidity, greater volatility and less regulation. Fixed income investments are subject to additional risks, including, but not limited to, interest rate, credit and inflation risks. Single-country and sector funds may be subject to a higher degree of market risk than diversified funds because of a concentration in a specific sector or geographic region. Investing in small companies is more risky and more volatile than investing in large companies.

Matthews Asia is the brand for Matthews International Capital Management, LLC and its direct and indirect subsidiaries.

Matthews Asia Funds are distributed in the United States by Foreside Funds Distributors LLC, Berwyn, PA
Matthews Asia Funds are distributed in Latin America by HMC Partners