Matthews Asia™

Matthews Asia Focus Fund

Period ended March 31, 2018

For the quarter ending March 31, 2018, the Matthews Asia Focus Fund returned -2.71% (Investor Class) while its benchmark, the MSCI All Country Asia ex Japan Index, returned 0.70%.

Market Environment:

The first quarter of the year witnessed a rise in volatility from historically low levels as a combination of troubling political problems and rising interest rates in the U.S. were accompanied by a return of trade tensions between Washington and China.

We have noted previously that we don't believe that there are many winners from trade wars, and the proposed U.S. tariffs on an initial list of goods worth US$50 billion from China is concerning. More worrying still is that there is a potential further list worth US$100 billion that is being proposed by President Trump. The Chinese are unlikely to accept such moves and have stated that they are not afraid of a trade war. Any escalation of this situation is unlikely to be helpful for stocks.

Additionally, the quarter saw the end of term limits for the Chinese presidency. This has laid the groundwork for Xi Jinping to remain in his posts of president, general secretary of the Communist Party and chairman of the Central Military Commission indefinitely if he wishes. This removes important checks and balances and appears to be another step against the medium term move toward rule of law.

This barrage of political and policy noise led to significant swings in markets that ended with mixed results. Much of Southeast Asia, China and Taiwan rose whilst other parts of the region declined.

Performance Contributors and Detractors:

The largest contributor to returns during the quarter came from the portfolio's holdings in Southeast Asia. Heineken Malaysia rose as it delivered above-market growth with its successful product marketing, particularly within Malaysia's premium beer segment. Singapore Technologies Engineering, a provider of engineering and technology services, performed well in the quarter. With its marine business rebounding from a cyclical bottom, the company has recently shown to be more confident in its business growth reacceleration, driven by military defense projects and “smart city” technological solutions in particular. Matahari Department Store in Indonesia outperformed in the quarter as its fourth quarter earnings release showed the resilience of department stores amid a weak consumption environment in Indonesia.

In terms of detractors for the quarter, Tata Motors was the worst performer among portfolio holdings. The company disappointed with results that were below management guidance and market expectation. Sales volumes for new models were insufficient in offsetting soft demand in the U.K. and Europe. We are closely monitoring Tata's sales performance over the next few quarters.

The largest detractor to relative returns during the quarter came from China/Hong Kong markets. Banks, property and utility sectors, in which we had smaller positions, were the strongest sectors year to date. Furthermore, NetEase, a Chinese online game company, declined as investors worried once again about the lack of new hit game titles and the firm's investment in e-commerce business.

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Average Annual Total Returns - Investor Class (3/31/2018)

1-year 18.73%
3-year 5.91%
5-year n.a.
10-year n.a.
Inception (4/30/13) 4.62%

Gross Expense Ratio [1]
2.47%

After fee waiver and expense reimbursement: 1.50% [2]

[1] Matthews Asia Funds' 12b-1 Plan (the “Plan”) is inactive. Although the Plan currently is not active, it is reviewed by the Board annually in case the Board decides to re-activate the Plan. The Plan would not be re-activated without prior notice to shareholders and any amounts payable under the Plan would be subject to applicable operating expense limitations. If the Plan were reactivated, the fee would be up to 0.25% for each of the Investor Class and Institutional Class, respectively.

[2] 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

We think NetEase's franchise value as the second biggest online game platform in China remains underappreciated and the gaming revenue can resume growth with upcoming game launches. We also appreciate management's disciplined approach in developing a niche e-commerce strategy in private label and cross-border e-commerce.

Notable Portfolio Changes:

We added two new positions during the first quarter. A-share listed Zhejiang Supor Cookware is a leading manufacturer of small kitchen appliances in China. The France-based small appliance company SEB acquired a 53% stake in Supor in 2007 and gradually increased its stake to 81% as of December 31, 2017. Supor is able to leverage on SEB's expertise in product development in small appliances and its own insights on the China market in building a successful product portfolio in China. The company is well-positioned for the consumption upgrade trend and consistently generates strong cash flow. It is a high-quality franchise trading at 19x 2019 P/E and 2.5% dividend yield.

Another new position is Housing Development Finance Corporation (HDFC) in India. The company is a leading financial conglomerate offering a variety of financial services including mortgage finance, banking, insurance and asset management in India. The company achieved ROE over 20% from its core mortgage business over the past three years and delivered compounding growth of 15% in consolidated profit over the past five years. It will continue to benefit from further development of the financial industry in India. The stock trades at 19x 2019 price-to-earnings ratio (P/E) and 3.5x 2019 price-to-book ratio.

During the quarter we exited our holding in medical device company ResMed, which had posted strong returns after it delivered topline growth of 13% year-over-year, driven by strength across its products and geographical markets. We shed this holding as we believed after the rally, its valuations had more than reflected its recent excellent operating track record and future growth opportunities. In addition, we exited our holdings in LG Household & Healthcare, Kangwon Land and Aerospace Industrial Development Corporation to fund new stock purchases.

Outlook:

Looking ahead, the picture for markets is rather muddy. The economy in the U.S. still appears to be in reasonable shape, but it is likely that we are in the late part of the cycle while rates are rising and debt levels are still elevated. Further, a continuation of political tumult and any escalation in trade tensions are likely to be problematic. It is certainly feasible that increased levels of volatility persist.

More pleasingly, Asia appears to be in a slightly earlier stage of its cycle. Although this year we may not witness the earnings upgrades of 2017, expectations for growth are still at a double-digit level and headline valuation multiples are reasonable at 13x P/E.

With that backdrop, the portfolio appears moderately well placed. We have consistently allocated capital to what we believe are high quality businesses trading at discounts to their intrinsic value, focusing on those that can deliver sustainable growth. Rising volatility will hopefully allow these leaders to shine and enable us to add to this stable if good businesses sell off on short-term concerns.

As of 3/31/2018, the securities mentioned comprised the Matthews Asia Focus Fund in the following percentages:
Heineken Malaysia BHD 2.1%; Singapore Technologies Engineering, Ltd. 3.0%; PT Matahari Department Store 3.6%; Tata Motors, Ltd. 1.0%; NetEase, Inc. 1.9%; Zhejiang Supor Cookware Co., Ltd. 2.8%; and Housing Development Finance Corp., Ltd. 3.0%. The Fund held no positions in ResMed, Inc.; LG Household & Health Care, Ltd.; Kangwon Land, Inc. or Aerospace Industrial Development Corp. Current and future portfolio holdings are subject to risk.

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.

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