Matthews Asia Innovators Fund

Choose a Share Class: Investor

Period ended June 30, 2018

For the first half of 2018, the Matthews Asia Innovators Fund returned 1.34% (Investor Class), while its benchmark, the MSCI All Country Asia ex Japan Index, fell -4.65% over the same period. For the quarter ending June 30, the Fund returned -2.71% (Investor Class), while its benchmark returned -5.31%.

Market Environment:

Asian and global emerging markets suffered during the first half of 2018. Negative investor sentiment arose from the confluence of escalating trade tensions between China and the United States, as well as seemingly tighter monetary conditions in China and other parts of emerging markets. In addition, the flight to quality, strengthening of the U.S. dollar and higher energy prices exposed the vulnerabilities of some emerging market economies.

Chinese shares generated negative returns for the six months ending June 30. Significant headwinds surrounding trade and tariff disputes with the U.S. proved to be too large a risk for many investors during this time. However, resilient corporate earnings, a surprisingly stable Chinese renminbi (RMB) and robust exports were positive contributors to China's continued economic growth. Elsewhere, India's equity market posted negative returns for the first half of the year. Macro headwinds captured headlines in the second quarter as India's reliance on energy imports and a deteriorating current account pressured the Indian rupee and brought inflation concerns to investors. On a positive note, economic growth remained robust and corporate earnings momentum improved.

South Korea's equities were among the Asia region's weakest in the first half of the year as investors contemplated how trade talks between the U.S., China and Europe could affect Korean exports and how prospects of a potentially significant hike in the country's minimum wage could affect corporate earnings. In June, U.S. President Donald Trump met with North Korean leader Kim Jong Un in a historic summit. The meeting reduced military tensions on the Korean peninsula, but had little impact on South Korea's equity markets or currency exchange rates. South Korea's domestic economy remains stable despite a rising unemployment rate and the country's exports continued to support GDP growth.

Performance Contributors and Detractors:

The Fund outperformed its benchmark during the first half of the year. Holdings in the health care and consumer discretionary sectors, particularly in China, made the largest contributions to Fund performance. While China's broader equity markets were down for the first half of the year, several of our individual holdings in China generated double-digit positive returns.

The China-based health care companies we held were purely domestic, so some investors may have seen them as being potentially less impacted by a trade war. Health care demand in China remains robust and we continue to see the growth of health care companies as part of a long-term, secular trend. The top two performing securities in the portfolio during the first half of the year were Jiangsu Hengrui Medicine and Wuxi Biologics. Jiangsu Hengrui Medicine is a leading drug manufacturer, while Wuxi Biolgogics is a leading provider of outsourcing services for clinical trials.

Within the consumer discretionary sector, China International Travel Service was among the Fund's top performers during this period, demonstrating an increase in discretionary spending as household wealth rises in China. China International Travel

Service offers package tours and operates duty-free shops. The duty-free shop concept is still relatively new in China, representing an attractive growth opportunity.

Detracting from performance were our holdings in the information technology (IT) sector. Naver, which operates South Korea's largest search engine, had negative returns during the first half of the year, partly reflecting negative sentiment for South Korean equities in general. NetEase, a Chinese internet and gaming company, also delivered negative returns in the first half of the year due to worries about its ability to sustain market share. While remaining cautiously optimistic about their longer term prospects, we will continue to monitor these holdings carefully.

Notable Portfolio Changes:

There were no major changes to the portfolio during the second quarter. We took advantage of market volatility to rotate capital among our existing portfolio holdings. For example, as stock prices fell, we added to our holdings of a handful of quality companies that we believe have particularly robust business models. We also selectively trimmed from certain existing holdings that we believe may not have been positioned as well to weather additional market volatility.

Outlook:

As we enter the third quarter, we may see trade friction dampen sentiment, but other positive factors may exist. U.S. and Chinese GDP growth remains robust and supportive of the global economy. In addition, local interest rates are high enough to compensate investors for risks; and importantly, corporate earnings remain relatively strong, making current equity valuations relatively attractive. The strongest single headwind seems to be uncertainty derived from escalating U.S.—China trade tensions.

Importantly, we are proactively managing the portfolio to hedge against global trade war concerns, as well as other potentially negative macroeconomic factors. In general, we continue to look for domestically oriented companies that may be slightly less impacted by tariffs or rising oil prices. And we remain cautious about investing in companies that are more exposed to factors that are outside of their control, such as companies that may suffer a significant loss of business due to a rise in interest rates. With share prices seeming to diverge from the positive fundamental trends we are seeing at the company level, we believe current volatility may create opportunities for long-term investors. While investor sentiment remains weak, the fundamental reasons for owning innovative Asian companies serving domestic consumers with rising wealth are still intact.

As of June 30, 2018, the securities mentioned comprised the Matthews Asia Innovators Fund in the following percentages: Jiangsu Hengrui Medicine Co., Ltd. 4.0%; Wuxi Biologics Cayman, Inc. 3.0%; China International Travel Service Corp., Ltd. 3.3%; GreenTree Hospitality Group, Ltd. 2.9%; Naver Corp. 2.7%; NetEase, Inc. 2.2%. Current and future portfolio holdings are subject to risk.

Average Annual Total Returns - Investor Class (6/30/2018)

1-year 19.09%
3-year 10.61%
5-year 15.36%
10-year 10.32%
Inception (12/27/99) 4.23%

Gross Expense Ratio

1.24%

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.

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

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