Matthews Asia

Matthews Asia Value Fund

Choose a Share Class: Investor

Period ended June 30, 2018

For the first half of 2018, the Matthews Asia Value Fund returned -2.96% (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 -3.79% (Investor Class), compared to the benchmark return of -5.31%.

Market Environment:

In the first half of the year, trade war rhetoric, rising interest rates, falling emerging market currencies and geopolitical tensions on the Korean peninsula dominated the news. The only apparent bright spot was the June summit between North Korean leader Kim Jong Un and U.S. President Donald Trump in Singapore, although denuclearization of North Korea is far from guaranteed, pending further negotiations. Following a buoyant run-up over the past year or so, the Asia ex Japan market dropped more than 5% in the second quarter, with most of the decline occurring in the second half of June. The Chinese renminbi (RMB) also depreciated sharply against the U.S. dollar in late June, dropping more than 5% in the second quarter.

Performance Contributors and Detractors:

The Fund outperformed its benchmark in both the first and second quarters of the year, due to stock selection and despite its significant exposure to South Korea, which was one of Asia's worst performers in the first half of the year in U.S. dollar terms. The two biggest contributors to Fund performance in the second quarter were both in the consumer staples sector. Shares of Nissin Foods, the biggest premium instant noodle company in Hong Kong/China, jumped more than 30% in the quarter. It is the newly Hong Kong-listed subsidiary of Japan-based Nissin Foods Group. Its major competitors announced decent earnings in the instant noodle segment in the quarter, partly driven by a pricing increase. We believe this brought positive sentiment change toward Nissin, whose share price had been fairly depressed. We trimmed our position in the company in the quarter as its valuation discount narrowed.

Shares of Anhui Gujing Distillery, a leading local liquor company in China, did well in the second quarter after the company announced a big profit jump. We attended its annual shareholder meeting in the Anhui province in the second quarter (as the only U.S.-based investor). While we were there, we learned first-hand that it continues to upgrade its product mix toward premium products with higher retail selling prices. Along with containing its sales and marketing expenses, the company has managed to improve its formerly low operating margin substantially.

On the other hand, the biggest detractor to performance during the second quarter was China National Accord Medicines. It is a listed subsidiary of state-owned Sinopharm, one of the country's three biggest pharmaceutical distributors. We initiated this position in Q3 last year. Since then, its share price has continued to decline. China has been implementing a new two-invoice system in the drug distribution industry to eliminate layers of middlemen in the supply chain. This has led to earnings pressure at National Accord in the short term. In the long run, we believe an industry leader like National Accord will benefit from market consolidation triggered by this two-invoice policy. We added to our position in the quarter at a high single-digit price-to-earnings ratio.

Clear Media was also a big detractor to performance in the quarter. Trading remains suspended for shares of Clear Media, the largest bus shelter advertising company in China, due to a past incident in which some junior-level employees misappropriated company funds. We commented on this company extensively last quarter. During the second quarter, we met with company management twice in Hong Kong and China. Though it is unknown when its shares will resume trading, we came away from our meetings feeling incrementally positive. There seems to be no further damage to the company beyond the misappropriation of approximately US$12 million (77 million RMB) already disclosed. Management is working hard, along with external consultants, to strengthen the company's internal control processes to avoid any recurrence of such incidents. We believe Clear Media will emerge out of this incident as a better and more tightly managed company.

Notable Portfolio Changes:

We trimmed our positions in a couple of companies, such as Nissin Foods, when they neared our estimated intrinsic value. We also took advantage of the substantial market decline in the second half of June to add to several positions.

During a major market correction, we closely evaluated whether to add to some of our existing positions or to initiate new positions. We do not follow a formula and instead make case-by-case decisions. In general, we like to upgrade the overall quality of the portfolio during a market downturn, while keeping valuations approximately the same or lower.

During the second quarter, we initiated a position in China's Huangshan Tourism Development. Huangshan, which means Yellow Mountain in Chinese, is also a famous tourist spot in eastern China. The mountain is in the Anhui province and attracts over three million visitors a year. The company is a local state-owned enterprise. Recent weak traffic along with potential government regulation of pricing for admission tickets to certain tourist spots has driven down its share price in the past year. We believe these negative factors have been more than discounted in the price of its B-shares, which we were able to acquire at less than 8x P/E ex cash. One thing to note is that it has not raised its admissions prices since early 2009. Yellow Mountain is poised to receive many more tourists for years to come, despite sometimes volatile tourist traffic from quarter to quarter. We view this investment as akin to buying Yellowstone National Park in the U.S. at a single-digit P/E.

Outlook:

The two biggest concerns for investors currently are the U.S.—China trade war and rising interest rates. On both fronts, we believe our portfolio is well-positioned. On the former, most of our holdings are either domestic in nature or have little exposure to China-U.S. trade. On the latter, all of the companies in our portfolio have strong balance sheets and thus we do not expect a direct negative impact if U.S. interest rates rise faster than expected later this year.

In fact, given our long-term investment horizon and double-digit level of cash in the portfolio, as value investors we welcome negative news resulting in more market dislocation in the near future. This opens opportunities to buy more shares, in either some of our existing positions or new companies, at a cheaper price. In the second quarter, we evaluated companies that will likely be affected by the U.S.—China trade war. We have put some of them on our watch list and established “buy” prices that are lower than their current share prices. We remain patient and ready to take advantage of buying opportunities if investor sentiment turns extremely negative.

As of 06/30/2018, the securities mentioned comprised the Matthews Asia Value Fund in the following percentages: Nissin Foods Co., Ltd. 1.3%; Anhui Gujing Distillery Co., Ltd. 1.8%; China National Accord Medicines Corp. 5.0%; Clear Media, Ltd. 4.3%; Huangshan Tourism Development Co., Ltd. 1.5%. The Fund held no position in Sinopharm Group Co., Ltd. Current and future portfolio holdings are subject to risk.

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

1-year 8.64%

3-year n.a.
5-year n.a.
10-year n.a.
Inception (11/30/15) 13.91%

Gross Expense Ratio

2.32%

After fee waiver and expense reimbursement: 1.50% [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 (which is offered through a separate prospectus to eligible investors) to 1.25%, 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 1.25% 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 1.25%. 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.*

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

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