Matthews Asia™

Matthews Asian Growth and Income Fund

Choose a Share Class: Investor ▼

Period ended September 30, 2018

For the quarter ending September 30, 2018, the Matthews Asian Growth and Income Fund returned 1.61% (Investor Class), while its benchmark, the MSCI All Country Asia ex Japan Index, fell -1.45% over the same period.

Market Environment:

Volatility returned in earnest during the third quarter as Asian markets wobbled due to a number of policy challenges. The tightening of U.S. dollar liquidity globally hampered risk assets as the cost of capital increased to more realistic levels. Additionally, trade tensions between the U.S. and China appeared to be worsening. Hopes of resolution faded as the U.S. enacted tariffs on an additional US$200 billion of Chinese export goods at an initial rate of 10%. This could increase to 25% next year. Despite these moves, China was willing to take a tit-for-tat approach that could create a suboptimal outcome for all involved. Further, there were some concerns about a renewed rise toward a greater centralization of power in China underway, with an expansion of the Party's role in political, economic and social life at a time when the tighter monetary conditions of last year began to negatively impact corporate earnings and economic growth.

The combination of monetary policy, geopolitics and weakening expectations all led China to be the region's worst-performing market during the quarter. Amid foreign-exchange weakness for emerging markets, current account surplus countries such as Thailand and Taiwan were outperformers.

Performance Contributors and Detractors:

Despite market weakness, the portfolio rose in absolute terms during the quarter. The largest contributor to returns was semiconductor foundry Taiwan Semiconductor Manufacturing. The company rose on the potential for further market-share gains given its dominance in the latest technological leap to the 7 nanometer node. This was further compounded by a competitor's decision to stop developing this node to focus on more mature technology. Fellow technology company Advantech, an industrial and embedded computer solutions provider, gained on continued double digit revenue growth. The company is well-placed to take advantage of major automation trends such as smart cities and factories.

The portfolio's holdings in Hong Kong also performed well. The strongest of these was power tools maker Techtronic Industries. The company's first-half results were impressive with a 20% rise in revenues and a growing realization that the tariff implications for the company are less than feared and that the company remains better-positioned than a majority of its peers. Industrial conglomerate CK Hutchison Holdings gained as higher oil prices helped its subsidiary Husky Energy, as its Chinese retail assets continue to grow and as its telecom business realizes post-consolidation synergies.

The portfolio's weakest holding for the third quarter was Indonesian department store Matahari. The stock dropped as same-store sales growth came in weaker than expected and management downgraded the number of new store openings planned. South Korean insurer Orange Life Insurance fell as Shinhan Financial agreed to purchase a majority stake from an existing shareholder. This was done at a premium to the existing share price, but South Korea's continued poor corporate governance standards and lack of a mandatory tender offer for minority shareholders led the market to believe that shareholders will be left in the market so that Shinhan can acquire the rest of the company at a lower price. We believe that the current over 8%

dividend yield provides attractive protection and potential total return. Beyond these, a couple of the portfolio's holdings within India sputtered as the rupee dropped in value and a domestic non-banking financial company defaulted.

Notable Portfolio Changes:

The portfolio was fairly active during the quarter, adding six new equity holdings and three exchangeable bonds given a backdrop of increased volatility. Amid recent weakness, two of these were in China's A-share market—Baijiu company Jiangsu Yanghe and appliance maker Midea Group. We believe that both are leading companies that are attractively priced and well-placed to benefit from China's consumer growth over the medium term. We also added global leaders Prudential PLC and Pernod Ricard to the portfolio as both get the majority of incremental value from the Asian consumer. Both have strong moats, solid management teams, steady records of value creation and good corporate governance standards. We believe that they are trading below their respective intrinsic values at P/Es of 11x and 22x respectively. We added to our technology exposure through Indian IT services company Cognizant and Singaporean contract manufacturer Venture.

The portfolio now has slightly over 14% of assets invested within convertible bonds as the recent bout of volatility allowed us to add CP Foods, Lotte Shopping and China Mengniu. All of these have positive yields and attractive terms given the credit quality and underlying businesses. To fund these purchases, we exited our lower-conviction positions that included Telekom Indonesia, Matahari Department Store, Kepco Plant Service & Engineering, Kangwon Land, Telenor and Guangdong Investment.

Outlook:

Although emerging markets have been fairly weak, the litany of reasons for caution remains in place. Potential pitfalls include: rising interest rates in the U.S.; a U.S. Federal Reserve balance sheet that is being reduced; geopolitical challenges in Europe, including an aggressive Italian budget, high debt levels, and a rise in protectionism; higher oil prices; and a weakening Chinese economy relative to expectations.

Potential pitfalls do not always lead to lasting drawdowns, however, and one should always be cognizant that volatility is not risk. True risk is the potential for permanent impairment of capital. There are clearly more instances today where that is a reality as weaker companies become apparent, but increased volatility has also created significant opportunities for active fund managers to take advantage of the potential long-term returns that may be available to those who are patient.

It is our belief that the Fund is currently operating within an exciting environment. The period of reduced market volatility appears to be over. This should allow us to take advantage of market dislocations. The portfolio has added a number of these opportunities within recent months and is now trading at an attractive 14.5x P/E and a 3.5% dividend yield for what we believe are high-quality businesses capable of compounding in value over the long term.

As of 09/30/2018, the securities mentioned comprised the Matthews Asian Growth and Income Fund in the following percentages: Taiwan Semiconductor Manufacturing Co., Ltd. 3.8%; Advantech Co., Ltd. 2.0%; Techtronic Industries Co., Ltd. 2.1%; CK Hutchison Holdings, Ltd. 2.0%; Orange Life Insurance, Ltd. 1.4%; Jiangsu Yanghe Brewery Joint-Stock Co., Ltd. 1.5%; Midea Group Co., Ltd. 1.1%; Prudential PLC 1.8%; Pernod Ricard SA 1.2%; Cognizant Technology Solutions Corp. 1.6%; Venture Corp. Ltd. 1.3%; CP Foods Holdings, Ltd. Cnv., 0.500%, 09/22/2021, 1.0%; Lotte Shopping Co., Ltd., Cnv., 0.000%, 04/04/2023, 1.2%; China Mengniu Dairy Co., Ltd., Cnv., 0.000%, 06/05/2022, 0.7% The Fund held no positions in Husky Energy Inc.; Shinhan Financial Group; PT Matahari Department Store; PT Telekomunikasi Indonesia Persero; Kepco Plant Service & Engineering Co. Ltd.; Kangwon Land, Inc.; Telenor ASA; or Guangdong Investment, Ltd. Current and future portfolio holdings are subject to risk.

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

1-year 0.62%
3-year 6.58%
5-year 2.45%

10-year 6.72%
Inception (9/12/94) 9.03%

Gross Expense Ratio

1.07%

***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: 2.11%

Dividend Yield: 3.59%

The 30-Day Yield represents net investment income earned by the Fund over the 30-day period ended 12/31/17, 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.

The Dividend Yield (trailing) for the portfolio is the weighted average sum of the dividends paid by each equity security held by the Fund over the last 12 months divided by the current price as of report date. The annualized dividend yield for the Fund is for the equity-only portion of the portfolio. Please note that this is based on gross equity portfolio holdings and does not reflect the actual yield an investor in the Fund would receive. Past yields are no guarantee of future yields. Sources: FactSet Research Systems, Bloomberg, Matthews

Visit our Glossary of Terms page for definitions and additional 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.

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