Matthews Asia

Matthews Asian Growth and Income Fund

Choose a Share Class: Investor

Period ended June 30, 2018

For the first half of 2018, the Matthews Asian Growth and Income Fund returned -6.21% (Investor Class), while its benchmark, MSCI All Country Asia ex Japan Index, fell -4.65% over the same period. For the quarter ending June 30, the Fund returned -4.46% (Investor Class), while its benchmark returned -5.31%.

Market Environment:

Following the market correction and swift recovery in the first quarter of the year, volatility continued in the second quarter as asset values ended the period lower. The case for globally synchronized growth appears to have weakened amid concerns about European politics, tightening monetary conditions and rising tensions about a U.S. trade war with multiple countries.

President Trump's belief that trade wars are “good and easy to win” has weighed on sentiment, specifically regarding China as the U.S. is set to enact the first wave of tariffs in July on US$34 billion of goods from the country. This number will rise over time and China has responded in kind, imposing its own tariffs on U.S. goods such as soybeans and beef. A continuation of such moves could result in significant economic damage. The quarter also saw tightening monetary conditions in China amid new rules in the US$15 trillion asset management industry, targeting deleveraging in riskier areas.

All of these factors led market participants to question valuations and earnings growth expectations. Risk assets such as Asian equities, credit and currencies dropped in value, with China and Taiwan holding up marginally better than other countries in the region.

Performance Contributors and Detractors:

As volatility returned, the portfolio had a reasonable second quarter, although it underperformed its benchmark in the first half due to a challenging January. The largest contributors in the first half came from our Australia holdings, including blood plasma derivatives manufacturer CSL. The company's stock rallied in the second quarter on a guidance upgrade due to a strong flu season and as a competitor had a supply issue with a key product. Fellow health care company Resmed, a maker of sleep apnea devices, rose due to impressive earnings as its connected-care strategy gained traction. Macquarie Group was also strong as the company announced solid earnings and outlook across divisions on the maturation of infrastructure funds, the realization of principal investments and as the rise of volatility helped its markets business.

Elsewhere, a couple of the portfolio's consumer holdings rose over the quarter. Newer holding Zhejiang Supor Cookware, a leading small-appliance maker in China, delivered 22% earnings growth for the second quarter despite fears of rising competition. Japan's Kao also delivered steady performance as the company is restructuring its cosmetics division to better suit Chinese demand.

The largest detractor to performance over the half came from Chinese online games developer and platform NetEase. The company has suffered earnings downgrades as it reinvests cash into user acquisition and builds its e-commerce initiatives in private label and luxury goods. A couple of the portfolio's telecom holdings also sputtered, with the worst of these being Bharti Infratel. Shares of the Indian tower company fell as consolidation in the wireless industry threatened tenancy ratios, a key driver of profitability.

Beyond this, a few of the Fund's financial holdings struggled. Weak sentiment, foreign outflows and currency weakness hurt Indonesian holding Bank Rakyat, compounded by rumors that the bank would bail out a faltering Sharia bank. Bank of the Philippine Islands faced similar macroeconomic conditions as well as undergoing a share issuance. ING Life Insurance in Korea struggled despite good earnings growth as private equity owner's MBK Partners looked to offload its stake.

Notable Portfolio Changes:

The second quarter was active for the portfolio with six new additions. Four of these were convertible bonds, including Qingdao Haier, Zhongsheng Group, China Overseas Land and Investment and LG Chem. The convertible bond market has witnessed some new issuance and terms have become more attractive. The commonality across all of these is that they are solid credits offering flat to positive yields and reasonable conversion premiums. In our view, the prospective risk-adjusted return, given such positive asymmetry in potential outcomes, is attractive amid such volatile markets.

Within equities, we added China's leading dairy company, Inner Mongolia Yili Industrial Group. The company is an established leader that generates a healthy 20% return on capital, operates with a net cash balance sheet, and was trading at approximately 20x price-to-earnings ratio (P/E) and a 3% dividend yield. We believe that growth looks attractive from a combination of market share gains, growth in lower tier cities and new product launches. Elsewhere in China, we added Minth Group, an auto parts company specializing in structural parts, trims and decorative parts. The company is well-established with major auto brands and has a product set that is likely to benefit from the industry's movement toward lighter weighting and new technologies. For this leader, we paid around 13x P/E and the stock also has a 3% dividend yield.

These new positions were funded through the sales of our holdings in CSL, British American Tobacco Malaysia, Brambles, Hyundai Motor and Glow Energy Public.

Outlook:

The list of reasons for investors to remain cautious is long and includes: tightening interest rates in the U.S.; the removal of quantitative easing; European political challenges; an ongoing trade war; high levels of leverage across corporates and households globally; tightening monetary conditions in China; and a fairly late cycle equity market.

These concerns, however, do not necessarily result in a significant decline in asset values. Market timing is certainly not our strongest suit and, in our opinion, the same could be said for the vast majority of capital allocators. We believe market timing should be ignored to focus on what is important—protecting and growing our client's wealth over full market cycles. What these concerns are likely to produce is a sustained increase in volatility. Against that backdrop, the portfolio will look to both weather that volatility and take advantage of it. We will look to add those leaders that are sold off in line with others when they don't deserve to be, particularly as growth in Asia is still plentiful. This will augment a portfolio that we firmly believe is already well-placed, trading at around 14.5x P/E and a 3.6% dividend yield for high quality companies capable of sustainable growth over the long term.

As of 6/30/2018, the securities mentioned comprised the Matthews Asian Growth and Income Fund in the following percentages: Macquarie Group, Ltd. 1.5%; Zhejiang Supor Cookware Co. Ltd. 1.5%; Kao Corp. 1.6%; NetEase, Inc. 1.7%; Bharti Infratel, Ltd. 1.6%; PT Bank Rakyat Indonesia Persero 1.5%; Bank of the Philippine Islands 1.6%; ING Life Insurance Korea, Ltd. 1.6%; Harvest International Co. (convertible bond issuer for Qingdao Haier) 1.1%; Zhongsheng Group Holdings, Ltd. 1.3%; China Overseas Finance Investment Cayman V, Ltd. 1.6%; LG Chem Ltd., 1.2%; Inner Mongolia Yili Industrial Group Co., Ltd. 1.4%; Minth Group, Ltd. 1.4%. The Fund held no positions in Resmed, Inc.; CSL, Ltd.; British American Tobacco Malaysia BHD; Brambles, Ltd.; Hyundai Motor Co., Ltd.; Glow Energy Public Co., Ltd. Current and future portfolio holdings are subject to risk.

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

1-year -0.51%
3-year 2.25%
5-year 2.51%
10-year 4.99%
Inception (9/12/94) 9.06%

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 6/30/2018

30-day Yield: 2.12%

Dividend Yield: 3.62%

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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