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# Matthews China Fund

Choose a Share Class:  ▼

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## Period ended June 30, 2018

For the first half of 2018, the Matthews China Fund was mostly flat, returning -0.14% (Investor Class), while its benchmark, the MSCI China Index, fell -1.69% over the same period. For the quarter ending June 30, the Fund returned -5.94% (Investor Class and Institutional Class), while its benchmark returned -3.44%.

### Market Environment:

A global trade war, currency devaluation and rising interest rates have triggered high levels of concern for China investors. As a result, Chinese equity markets returned all the positive performance they experienced in January this year, ending the first half of 2018 in negative territory. Despite lingering global macro concerns, China is moving ahead with its micro agenda, deleveraging its financial system and placing tighter restrictions on its booming property market. This may derail short-term growth but seems to put the country in a better position economically longer term. Even in the face of this challenging environment, we see opportunities for market consolidation across many industries in China. In “old economy” and “new economy” sectors alike, a tougher operating environment enables market leaders to shine and capture profitability that might have once been eroded by intense competition. These factors may bode well for industrial profits.

### Performance Contributors and Detractors:

The Fund outperformed its benchmark in the first half of 2018 thanks to both sector allocation and stock selection. During the second quarter, the information technology sector was the main cause for the Fund's relative underperformance versus its benchmark, while the health care sector made the largest contribution.

Chinese telecommunications equipment producer ZTE was a major detractor to Fund performance during the quarter. The firm settled previous violations of a U.S. export ban by paying fines of US\$1.4 billion. It also replaced its board of directors and senior management, reached an agreement with the U.S. Department of Commerce and said it would adopt compliance as the strategic cornerstone of its development. Although the settlement was a positive development, we believe ZTE continues to face uncertainties due to the business disruptions and its significant exposure to foreign suppliers and customers. We decided to exit this holding during the quarter. Software service provider Chinasoft International also declined as investors grew concerned about its business exposure to the telecommunications sector. We continue to hold this position because we believe the firm is a major beneficiary of the secular growth in IT outsourcing and cloud adoption.

Among the top individual contributors to Fund performance were Sino Biopharmaceutical, a leading Chinese pharmaceutical company, and China Gas Holdings, a major natural gas distributor. In addition to its diversified product portfolio and a robust pipeline, Sino Biopharmaceutical recently launched a new hepatitis drug and received approval from the China Food and Drug Administration for a major blockbuster oncology drug. China Gas Holdings delivered strong operational results because of the government's increasingly stringent environmental control and continuous rural coal-to-gas conversion initiative.

### Notable Portfolio Changes:

During the quarter, we initiated a position in Brilliance China Automotive, a joint-venture partner with BMW in China, as the stock valuation became attractive to us. Chinese auto stocks pulled back sharply after China announced some new policies toward foreign investment in the automotive sector and lowered tariffs for imported cars and car components. We believe Brilliance China's partnership with BMW continues to be strategic and mutually beneficial for both parties. Brilliance China should benefit from new model launches and achieve above-industry-average growth in the luxury car market. We also initiated a position in China Jushi, the largest global glass fiber producer. The company should benefit from its growing economies of scale, improving average selling prices and lowering unit costs.

## Outlook:

At the end of the quarter, Chinese companies that generated more than 15% of their revenues from the U.S. accounted for less than 3% of the portfolio's total exposure. This means that while trade tariffs imposed on China have dominated headlines and worried investors, our portfolio holdings rely more on the health of China's domestic consumption and services-led economy. By most metrics, such as income growth and corporate profitability, these areas continue to trend positively. Amid current market uncertainty, we continue to focus on the corporate earnings growth story in China. The MSCI China Index—China's broad equity market index—is expected to see high single digit earnings per share (EPS) growth this year and EPS growth in the mid-teens next year. Valuations for the index are also attractive at 11x price-to-earnings (P/E) this year, and 9x P/E next year. We remain cautiously optimistic about China's growth outlook but remain mindful of the potential negative impacts should trade relations continue to deteriorate.

As of 6/30/2018, the securities mentioned comprised the Matthews China Fund in the following percentages: Sino Biopharmaceutical, Ltd. 2.1%; China Gas Holdings, Ltd. 0.6%; Chinasoft International, Ltd. 2.4%; Brilliance China Automotive Holdings, Ltd. 2.0%; China Jushi Co., Ltd. 1.0%. The Fund held no positions in ZTE Corp. or Bayerische Motoren Werke AG (BMW). Current and future portfolio holdings are subject to risk.

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

1-year 22.37%  
3-year 9.33%  
5-year 11.72%  
10-year 7.10%  
Inception (2/19/98) 10.38%

## Gross Expense Ratio

1.09%

***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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