Matthews Asia

Matthews China Small Companies Fund

Period ended March 31, 2018

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For the quarter ending March 31, 2018, the Matthews China Small Companies Fund returned 6.48% (Investor Class), outperforming its benchmark, the MSCI China Small Cap Index, which returned 2.87%.

Market Environment:

China's equity markets were off to strong start in 2018 until fears of sooner-than-expected interest rate increases and a trade war with the U.S. took over. Fundamentally, we continued to see a broad-based earnings recovery among China's smaller companies, boosted by steadily improving domestic demand growth. Considering the mild global reflation and China's 2018 nominal GDP growth target of approximately 6.5%, the outlook for revenue growth for Chinese corporations appears positive.

We see profit margins recovering, despite a rebound in the producer price index as China has been slowing its loan growth and has cleaned up overcapacity since 2009. From both a top-down and bottom-up perspective, we anticipate a sustainable recovery in the Chinese economy and in corporate earnings. We also believe that, as a result, China's equity markets will see a recovery. The market's concerns over rising interest rates and escalating trade tensions should, in our view, have little impact on China's smaller companies given their domestic focus.

Performance Contributors and Detractors:

During the first quarter of 2018, our strong stock selection in the health care, industrials and information technology sectors contributed to the Fund's outperformance versus the benchmark. The consumer discretionary and energy sectors were the top detractors to Fund performance during the period.

Our top individual contributors to Fund performance were Genscript Biotech, a global leader in gene synthesis, and CIFI Holdings Group, an emerging leader in urban property development in China's larger cities. Genscript Biotech grew by diversifying and expanding its product categories and applications while showing impressive, strong execution capabilities versus that of its competition. The firm's breakthrough into biotech oncology treatments was a key to its stock's re-rating over the past year. CIFI Holdings grew because of its focus on buying quality land banks and due to its strong execution of its fast asset turnover strategy.

Among our top detractors to Fund performance during the first quarter of 2018 was Truly International, a diversified technology component manufacturer that has expanded into the automobile electronics industry. China ZhengTong Auto Services, a leading auto dealer with a rapidly expanding auto financing business also did poorly. Both firms were hit hard during the quarter as their A-share IPO spin offs were delayed due to a volatile market environment. We believe both companies will continue to grow in the coming year as Chinese consumers are increasingly seeking cars with more advanced safety and entertainment features. We have not been fazed by the short-term volatility in the share prices for these two holdings.

Notable Portfolio Changes:

Average Annual Total Returns - Investor Class (3/31/2018)

1-year 42.95%
3-year 17.76%
5-year 13.97%
10-year n.a.
Inception (5/31/11) 7.27%

Gross Expense Ratio [1]
2.24%

After fee waiver and expense reimbursement: 1.50% [2]

[1] Matthews Asia Funds' 12b-1 Plan (the "Plan") is inactive. Although the Plan currently is not active, it is reviewed by the Board annually in case the Board decides to re-activate the Plan. The Plan would not be re-activated without prior notice to shareholders and any amounts payable under the Plan would be subject to applicable operating expense limitations. If the Plan were reactivated, the fee would be up to 0.25% for each of the Investor Class and Institutional Class, respectively.

[2] Matthews has contractually agreed 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

During the quarter we shed some “graduates” of our portfolio—stocks that did well during our holding period and saw their market capitalization reach above our small-cap “sweet spot.” Consumer discretionary holding Wuxi Little Swan and CIFI holdings are two such examples of stocks that appreciated nicely due to strong earnings growth and valuations re-rating. We continue to selectively add innovative companies to our portfolio, especially in the technology and health care sectors. China's small-cap universe continues to be a fertile hunting ground for finding cash flow-rich growth stocks at reasonable valuations, and we have been able to easily replace our “graduates” with attractive options.

During the quarter, we initiated a position in Kingdee International Software Group, a leader in small- and medium-size enterprise software. We have followed the company for years and believe it has turned a corner in terms of aligning its products toward more optimal cloud-based structures. It should benefit from this growth trend going forward. We believe work force productivity-enhancing tools such as those developed by Kingdee are addressing China's dilemma over its shortage of skilled labor.

Outlook:

We are still cautiously optimistic about China's small-cap market despite heightened market volatility as we focus rigorously on the sound fundamentals of our portfolio companies. From a macro perspective, we continue to believe China has the ability to stabilize its economy through fiscal spending, interest rate adjustments and currency management. In addition, steps taken to correct China's structural issues are continuing on the right track, despite the recent changes in presidential term limits. We are focused on seeking innovative and capital-efficient small companies that are relatively insulated from macroeconomic uncertainties. We will continue to seek companies with sustainable, quality earnings streams, strong cash flows and good balance sheets that can weather uncertain economic conditions. We believe sectors such as industrial automation, health care and technology are among the most attractive from a secular growth perspective.

As of 3/31/2018, the securities mentioned comprised the Matthews China Small Companies Fund in the following percentages: Genscript Biotech Corp. 1.7%; China ZhengTong Auto Services Holdings, Ltd. 1.3%; Truly International Holdings, Ltd., 1.3%; and Kingdee International Software Group Co., Ltd. 2.3% The Fund held no positions in CIFI Holdings Group Co., Ltd. and Wuxi Little Swan Co., Ltd. Current and future portfolio holdings are subject to risk.

Investing in small- and mid-size companies is more risky than investing in large companies as they may be more volatile and less liquid than larger companies.

The views and opinions in this commentary were as of the report date, subject to change and may not reflect current views. They are not guarantees of performance or investment results and should not be taken as investment advice. Investment decisions reflect a variety of factors, and the managers reserve the right to change their views about individual stocks, sectors, and the markets at any time. As a result, the views expressed should not be relied upon as a forecast of the Fund’s future investment intent. It should not be assumed that any investment will be profitable or will equal the performance of any securities or any sectors mentioned herein. The information does not constitute a recommendation to buy or sell any securities mentioned.

The information contained herein has been derived from sources believed to be reliable and accurate at the time of compilation, but no representation or warranty (express or implied) is made as to the accuracy or completeness of any of this information. Neither the funds nor the Investment Advisor accept any liability for losses either direct or consequential caused by the use of this information.

or extraordinary expenses such as litigation) to 1.50%. 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, 2018 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.*