Matthews Asia

Matthews China Small Companies Fund

Choose a Share Class: Investor

Period ended September 30, 2018

For the quarter ending September 30, 2018, the Matthews China Small Companies Fund returned -14.51% (Investor Class), underperforming its benchmark, the MSCI China Small Cap Index, which returned -10.16% over the same period.

Market Environment:

Trade war tensions and geopolitical risks dominated headlines during the third quarter. Additional uncertainty over the near-term outlook for the market was brought on by Chinese domestic policies toward deleveraging and regulating the consumer services economy. These factors all negatively impacted Chinese equity markets in terms of both performance and volatility. For the first time in a while, we saw a noticeable slowdown in domestic retail consumption of large-ticket items, such as autos and home decorations, driven by domestic deleveraging. Even though retail sales and industrial production figures continued to meet expectations through August, investors worried about a downward trajectory in the near term—thus ignoring the strong August data. China's central bank, the People's Bank of China, appeared to be cognizant of the near-term policy and geopolitical headwinds and therefore continued to be accommodative by lowering interest rates twice during the quarter. The government's determination in steering China's longer term structural reform, however, remains solid as it maintained its strict controls over the riskier parts of the nation's lending system.

From both a top-down and bottom-up perspective, we continue to anticipate long-term sustainable growth in the Chinese economy and in corporate earnings. The market's concerns over the rising cost of funding and escalating trade tensions should, in our view, have little impact on China's smaller companies given their domestic focus and lower dependence on financial leverage. However, China's recent policies toward the consumer services economy does have near-term negative impacts on sentiment for smaller companies.

Performance Contributors and Detractors:

For the third quarter, our poor stock selection in the information technology and consumer discretionary sectors contributed most to the Fund's underperformance versus the benchmark. The consumer staples and health care sectors provided positive support to Fund performance.

Silergy, China's analog semiconductor company, and TK Group, China's largest precision molding company, were among the top individual detractors to Fund performance in the third quarter. Over the long run we firmly believe Silergy will continue to benefit from China's plans to become self-sufficient in semiconductor production. However, during the third quarter, Silergy was hit with a wall of worry as the global semiconductor industry was sold off on cyclical concerns. We believe these concerns are misplaced for Silergy because analog semiconductors are much less cyclical and the trade war actually accelerates China's need for self-sufficiency in the production of semiconductors. TK Group was also sold off as investors worried about trade tariffs that could impact its plastic molds and parts. We see some risk for short-term front loading of inventory by TK's customers. Longer term, TK's global competitiveness remains strong despite the threat of tariffs. We focus on companies with pricing power as a result of a sustainable moat. TK's pricing power within the plastics mold industry is high, such that we believe it will be able to pass on incremental costs related to tariffs.

Among the top contributors to Fund performance during the third quarter were Huaxin Cement and Yihai International Holding. Huaxin Cement continued to benefit from China's overall supply-side reform to clean up the environment. Yihai International Holding manufactures and sells a leading hot pot soup base and condiment brand for both restaurants and retail consumers. We believe the company has strong growth visibility given the popularity of its associated hot pot restaurant chain and its rapidly growing new business in restaurant supplies.

Notable Portfolio Changes:

During the third quarter, Huaxin Cement “graduated” from our portfolio—meaning it did well enough while we held it in our portfolio that it saw its market capitalization exceed our typical small-cap range. We also exited Yuzhou Properties and China Zhengtong Auto Services due to their relatively high leverage levels and the continued unfavorable funding environment toward these two sectors. We continue to selectively add innovative companies to our portfolio, especially in the technology and consumer-related 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 new holdings.

During the quarter, we initiated a position in Microport Scientific, a leading medical device company in China. We believe the company has strong growth visibility given its product cycle in orthopedics, stents and pacemakers. We believe the company has passed the toughest parts of its business integration process and will be able to deliver much better profitability ahead.

Outlook:

We remain 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 macroeconomic 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 near-term pains of a deleveraging economy. 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 9/30/2018, the securities mentioned comprised the Matthews China Small Companies Fund in the following percentages: Silergy Corp. 8.3%; TK Group Holdings, Ltd. 3.7%; Yihai International Holding, Ltd. 2.8%; and Microport Scientific Corp. 1.5%. The Fund held no positions in Huaxin Cement Co., Ltd.; Yuzhou Properties Co., Ltd.; or China ZhengTong Auto Services Holdings, Ltd. Current and future portfolio holdings are subject to risk.

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

1-year 1.49%
3-year 15.86%
5-year 8.99%
10-year n.a.
Inception (5/31/11) 4.84%

Gross Expense Ratio

2.34%

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

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.*

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

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.

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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.