Matthews China Small Companies Fund

Choose a Share Class: Investor ▼

Period ended June 30, 2018

For the first half of 2018, the Matthews China Small Companies Fund returned 9.00% (Investor Class), outperforming its benchmark, the MSCI China Small Cap Index, which returned 0.91% over the same period. For the quarter ending June 30, the Fund returned 2.37% (Investor Class) while its benchmark fell -1.90%.

Market Environment:

Trade war tensions and geopolitical risks dominated headlines during the first half of the year, particularly in the second quarter. This negatively impacted Chinese equity markets in both performance and volatility. Fundamentally, however, China's domestic consumption economy remains relatively unaffected. Home sales through the end of May 2018 increased more than 12% since last year, following an already high base in 2017. Retail sales and industrial production figures also continued to meet expectations in the second quarter. China's central bank, the People's Bank of China, also continued to be accommodative, tightening controls on riskier parts of the nation's lending system.

From both a top-down and bottom-up perspective, we continue to anticipate 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.

Performance Contributors and Detractors:

For both the first half of the year and the second quarter, our strong stock selection in the information technology, materials and industrials sectors contributed most to the Fund's outperformance versus the benchmark. The consumer discretionary sector was a laggard during both periods and our health care sector holdings were the top detractors to Fund performance in the second quarter.

Hua Hong Semiconductor, China's second-largest foundry, and China Maple Leaf Education Systems, China's largest international school operator, were among the top individual contributors to Fund performance in the second quarter. Hua Hong Semiconductor benefited from China's accelerated plan to become self-sufficient in semiconductor production and also from favorable supply and demand dynamics. China Maple Leaf continued to execute well in the high-demand segment of consumer discretionary services. We believe both companies will continue to do well in China's structural change toward intellectual property development and consumption upgrades.

Among the top detractors to Fund performance during the second quarter were Joy City Property, a leading mall developer in China that targets millennial consumers, and Precision Tsugami (China), a leading industrial automation tool maker. Joy City was impacted by negative sentiment toward the real estate sector, which has relatively higher financial leverage. Precision Tsugami was negatively impacted by fears of a factory automation slowdown related to escalating trade tensions. We believe both companies will continue to grow as Chinese consumers upgrade their consumption patterns and Chinese industrial firms seek higher productivity. We have not been fazed by the short-term volatility in the share prices for these two holdings.

Notable Portfolio Changes:

During the second quarter we shed some “graduates” of our portfolio—stocks that did well during our holding period and saw their market capitalization exceed our typical small-cap range. China Resources Cement and KWG Property are two such examples of stocks that appreciated nicely due to strong earnings growth and valuations re-ratings. 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 Yihai International Holding, a leading hot pot soup base and condiments 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.

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 6/30/2018, the securities mentioned comprised the Matthews China Small Companies Fund in the following percentages: Hua Hong Semiconductor, Ltd. 2.7%; China Maple Leaf Educational Systems, Ltd. 2.1%; Joy City Property, Ltd. 2.3%; Precision Tsugami China Corp., Ltd. 2.0%; Yihai International Holding, Ltd. 2.0%. The Fund held no positions in China Resources Cement Holdings, Ltd. or KWG Property Holding, Ltd. Current and future portfolio holdings are subject to risk.

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

1-year 36.21%
3-year 13.52%
5-year 14.78%
10-year n.a.
Inception (5/31/11) 7.36%

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 (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.

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