




Matthews Asia™

Matthews Japan Fund

Period ended March 31, 2018

For the quarter ending March 31, 2018, the Matthews Japan Fund returned 5.22% (Investor Class), outperforming its benchmark, the MSCI Japan Index, which returned 0.98%.

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Market Environment:

Japan's equity markets ended the quarter near the same level at which they started the year on a dollar basis as a January rally gave way to a correction in February and March. Though equity prices declined on a local currency basis, the roughly 6% gain by the yen versus the U.S. dollar offset those declines. The Trump administration's moves to levy tariffs on steel and aluminum imports and on imports from China prompted fears of an escalating trade war, dampening investor sentiment in global equity markets. At the same time, Prime Minister Shinzo Abe and his wife confronted allegations of cronyism in connection to a discounted sale of state-owned land to a private school. This resulted in a sharp decline in his approval ratings.

Meanwhile, Japan's economic growth is starting to show sluggishness. Annualized real GDP growth during the last quarter of 2017 was 1.6%, but those figures were supported by inventory buildup, which could result in issues over the coming quarters. Business investments and private consumption remain solid but we believe a contraction in net government expenditures will lead to slower growth in 2018.

Performance Contributors and Detractors:

The Fund outperformed its benchmark during the quarter, driven by stock selection primarily within our mid- and small-cap holdings. Among the mid-caps, Nihon M&A Center, which facilitates mergers and acquisitions among small- and medium-size enterprises (SMEs) in Japan, was the top performer on the back of robust revenue growth as demand for its services continues to expand.

The top contributor by sector was information technology. Semiconductor production equipment manufacturer Lasertec rallied on the back of healthy order inflows for equipment to be used in advanced lithography processes at a major logic foundry customer. Cloud software service company Infomart also performed well as its growing online billing platform enters the monetization phase.

On the negative side, our holdings in the consumer discretionary sector were the largest detractor to relative performance. 100 yen shop operator Seria performed poorly as sales and profits fell short of expectations. Shares of fashion e-commerce company Start Today also declined as its long-awaited smart body suit that promises a "guaranteed fit" has been plagued by production delays.

Notable Portfolio Changes:

During the quarter, we initiated a position in Otsuka, a distributor of IT products targeting SMEs in Japan. SMEs have been particularly affected by labor shortages and are aiming to improve productivity by adopting more IT into their operations. We expect Otsuka to be a major beneficiary as it aims to cross-sell its various products. We also initiated a position in Shimadzu, Japan's leading producer of analytical and measuring equipment. Shimadzu is one of the global "big four" in the analytical and measuring equipment market along with U.S. companies such as Agilent, Waters and

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

1-year 30.46%
3-year 13.12%
5-year 14.18%
10-year 8.11%
Inception (12/31/98) 7.05%

Gross Expense Ratio ¹

0.98%

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.

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

Thermo Fisher Scientific. Shimadzu boasts a leading position in China's measuring equipment market where demand is accelerating for R&D and environmental monitoring purposes.

been waived. Please see the Fund's most recent month-end performance.

To fund these positions, we exited our holdings in Oracle Japan and optical components company Hoya. Oracle Japan rallied last year on the back of solid growth for its cloud services but valuations had become stretched. We deemed Otsuka to be a more attractive way to invest in the growing IT sector. We expect Hoya to face an increasingly challenging environment for its glass media products used in hard disc drives.

Outlook:

We remain cautious about the outlook for Japanese equities. We believe profit growth for listed companies will slow in the fiscal year starting April 2018 due to tougher comparables, a stronger Japanese yen and higher fuel costs. Though Japanese equity valuation levels remain reasonable, we see little room for multiple expansion in light of the lack of near-term growth prospects. Additionally, we are concerned by the Trump administration's combative actions regarding trade. Japanese corporate activity remains sensitive to global trade. Prime Minister Abe's declining approval ratings are also a concern for political continuity as he is seeking re-election as the leader of the ruling Liberal Democratic party in September.

The bright spot for Japanese companies lies elsewhere within Asia, particularly among opportunities in China. China is investing heavily in upgrading its manufacturing sector as it seeks to drive technology innovation. Rising wages also are leading to increased spending on consumer products. We firmly believe that sustained growth in Asia will lead to tremendous growth opportunities for select Japanese companies and we will continue to focus our research efforts on identifying such companies.

As of 3/31/2018, the securities mentioned comprised the Matthews Japan Fund in the following percentages: Nihon M&A Center, Inc. 1.7%; Lasertec Corp. 1.3%; Infomart Corp. 1.3%; Seria Co., Ltd. 1.2%; Start Today Co., Ltd. 1.5% and Otsuka Corp. 1.8%. The Fund held no positions in Oracle Corp. Japan and Hoya Corp. Current and future portfolio holdings are subject to risk.

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