Strategies for Investing in China

Matthews China Fund

Matthews China Dividend Fund

Matthews China Small Companies Fund
In the late 1970s, China was a closed society with a closed economy. Private property ownership was forbidden. Most businesses were run by the government or tightly regulated. Access to all but the most basic goods was restricted and unattainable for most people. Average citizens could not leave the country except under extraordinary circumstances.

Today, China is the world’s second-largest economy. It accounted for 28% of global economic growth in 2016—a greater share of global growth than that of the United States, Europe and Japan combined. Property rights have given the country’s rising consumer class a new way to build wealth and security. The economy is increasingly driven more by consumer demand than by government dictate. As of 2015, China was the fourth most visited country in the world, with more than 56 million foreign tourists.
For more than 25 years, Matthews Asia has been providing investors with access to opportunities created by China’s profound economic transformation.

In that time, we have seen not only rates of growth above the global average, but also a remarkable diversification of the Chinese economy. Once dominated by exports and low-cost manufacturing, China’s growth today has many drivers: growing domestic wealth, technological innovation, expanded entrepreneurship, a burgeoning services sector and financial reform, to name a few.

The scale of the opportunity for investors is enormous—and it’s growing fast. The liquidity, depth and breadth of listed companies in China is second only to the United States with approximately 5,000 companies to choose from.

Its economy requires a new perspective and a more diversified approach to the opportunities it presents.

We believe China offers opportunities beyond traditional growth investing, including opportunities for those seeking income via dividends or those pursuing the rapidly expanding universe of smaller companies.
THE ABCs OF CHINESE STOCKS

A SHARES are available to domestic investors, qualified foreign institutional investors (QFIs) and through “Stock Connect,” which links the Shanghai and Shenzhen stock exchanges to the Hong Kong Stock Exchange and enables foreign investors to access A-shares with fewer restrictions.

B SHARES are open to both domestic and foreign investors.

SAR (HONG KONG) COMPANIES are companies that conduct business in Hong Kong and/or mainland China.

CHINA-AFFILIATED CORPORATIONS (CAC), also known as “Red Chips,” are mainland China companies with partial state ownership listed in Hong Kong, and incorporated in Hong Kong.

H SHARES are mainland China companies listed on the Hong Kong exchange but incorporated in mainland China.

OVERSEAS LISTED (OL) COMPANIES are companies that conduct business in mainland China but listed in overseas markets such as Japan, Singapore, Taiwan and the United States.

OVER THE COUNTER (OTC) MARKET, which was established in 2014 in China, allows for shares of non-public companies to be traded.

China as an Asset Class

In our view, size, growth and increasing complexity determine whether a market merits a separate allocation in investor portfolios. Based on these indicators, we believe China should not only be part of a diversified portfolio, but also deserves separate and distinct treatment.

Size

With 1.3 billion people, demography is the single-most obvious factor of China’s growing economic might. But China’s vast population is not the whole story. Consider that the market capitalization of China already stands second only to the U.S. in terms of share of global market size.

China’s domestic mainland markets were established less than three decades ago in Shanghai and Shenzhen. In recent years, China’s A-share market has evolved, not only in terms of the number of listed companies, but also in overall quality, with the combined market capitalization for the exchanges reaching more than US$9.4 trillion as of December 2017, up significantly from about US$402 billion at the end of 2005. Add to that the stocks listed in Hong Kong—accounting for roughly another US$3.2 trillion in market capitalization—and the diversity of China’s equity universe, including a greater variety of investment options accessible to foreigners, becomes apparent. Today, foreign investors can take advantage of the unique opportunities for global investors to take part in the dynamic economy that is taking shape as China shifts away from exports and manufacturing and more toward innovation, consumer consumption and services.

Growth

The size of an economy alone is not enough to declare a separate asset class. Growth also has a role. The growth of profit-making opportunities is what matters, however, not the headline rates of growth. This is where China appears to stand out. Its growth has come from increased productivity in the form of total factor productivity (TFP)—the ingenuity with which inputs of labor and capital are combined. China’s rate of TFP growth between 2000–2014 was 3.5%, exceeding the average of Asia nations, which itself exceeded the growth rates in the U.S. and Western Europe. We believe this means that growth is more likely to be sustainable and profitable.

Such growth has been achieved across a diverse range of industries. China increasingly has commercialized its economy, first by embracing market forces and then by transitioning from a centrally planned economy to one that is driven by changing consumer preferences. China’s once moribund state-owned enterprise economy has ceded more power to
market forces, capitalist production and entrepreneurial spirit. Over the past few decades, private businesses have been a large contributor to providing consumer-oriented goods and services, generating employment, and leading to innovation. Today, about 85% of urban employment is in privately owned firms.

**Complexity**

Historically, China has been a peripheral part of many portfolios—a “leveraged play on global growth.” But the country has developed beyond the stereotype of an “export-driven economy” and its market is diversifying into new areas to meet a growing domestic demand for goods and services. These developments are in part what make China a separate opportunity that deserves consideration as a core part of investment portfolios.

We believe the complexity of accessing China’s growth potential as its economy diversifies calls for an actively managed approach to building a portfolio with exposure to China. The faster growing services and consumption portion of the economy, for example, now accounts for more than half of China’s GDP. Yet the slowing industrial, construction and export-driven sectors combined with less efficient state-owned enterprises (SOEs) still occupy an outsize representation within the MSCI China Index, making passive investments in the country less attractive than active management, in our opinion.

**Strategy Matters**

The decision is more complex than “to buy China or not.” Because there is more than one way to invest in Chinese markets, strategy matters. But the choice of strategy, which seems second nature when applied to U.S. investments, is still a new concept when applied to China.

Investors need to now consider which approach to investing in China makes the most sense for their long-term goals. For that reason, we now offer three distinct strategies for investing in China.

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**Market Access**

Historically, the Chinese government has made it difficult for foreigners to access local shares. Foreign asset managers were limited to mechanisms like the QFII Scheme (Qualified Foreign Institutional Investor), whereby qualified institutional investors were given limited access to China’s capital markets. Foreigner access has been improving lately, however. China’s regulators made a significant effort to further open its capital markets by creating “Stock Connect,” a trading link that connects the Shanghai and Shenzhen stock exchanges to the Hong Kong Stock Exchange, enabling foreign investors to buy A-shares with fewer restrictions. As a testament to China’s ongoing market reforms, index provider MSCI recently marked a vote of confidence in China’s markets and efforts to enlarge global access to its capital markets—allowing 222 of China’s large-capitalization domestic A-share stocks to be gradually included into its Emerging Market Index, starting in mid-2018.
Matthews China Fund

Launched in 1998, Matthews Asia’s first China-focused Fund pursues a multi-cap, long-term growth approach providing access to opportunities created by the world’s fastest economy.

As China’s economy and stock markets have evolved, so have the Fund’s holdings. Our managers have sought to identify companies that stand to benefit from domestic consumption generated by rising personal wealth among Chinese consumers. Today, that means companies in a wide variety of sectors, as consumer spending patterns have evolved from basic goods and necessities to more discretionary, high-end products and services.

Companies in the Matthews China Fund are selected with the goal of holding them over a long period of time. For that reason, we seek companies with strong financials, disciplined management and good prospects for long-term sustainability at attractive valuations. In fact, many of the holdings that were acquired as small- or mid-cap companies in the Fund’s early days have grown to be among China’s larger companies.

Expanding China Universe

The universe of Chinese companies (excluding A-shares) with a market cap of greater than US$50 million has nearly tripled since 2000. The universe expanded to more than 5,000 when including A-shares. It has also diversified, with consumer discretionary products and services growing as an ever larger share, reflecting the rise in personal wealth.

Sources: FactSet Research Systems and Bloomberg
Matthews China Dividend Fund

The gradual opening of China’s economy initially attracted investors for its growth potential. Even as growth has been an important characteristic of Chinese companies, dividend policies have changed substantially for the better. Today, the universe of dividend-paying companies in China has expanded significantly, creating opportunities not only for capital appreciation but also for current and future income for investors.

In 1998, listed companies in China and Hong Kong paid roughly the equivalent of US$8 billion in dividends. By 2017, the total dividend payout had grown more than 14 times to approximately US$114 billion. Significantly, the bulk of that growth came from companies that listed after 1998, primarily large state-owned enterprises (SOEs) such as banks and utilities that have gone public. Unlike typical U.S.-based IPOs, Chinese SOEs offering shares to the public are mature companies that pay dividends from day one. As a result, China has become one of the largest and fastest-growing Asian markets for dividend payments.

Dividends from Chinese companies are important not only for income but for total return. From 2000 through 2017, approximately half of the MSCI China Index’s total return is attributable to dividends or dividend reinvestment.

Matthews Asia has gained significant experience investing in dividend-growing companies throughout Asia with the Matthews Asia Dividend Fund. The Matthews China Dividend Fund is an extension of the same stock selection process applied exclusively to China. The Fund takes a total return approach, focusing on investing in a combination of stable dividend payers and dividend growers. This combination attempts to provide investors with the opportunity to benefit from an attractive dividend yield as well as exposure to companies that are growing their dividends at a faster rate than typically seen in developed markets. As China’s markets continue to evolve, we anticipate that the pool of dividend-paying companies will further increase. We also believe that consistent payment of dividends helps reduce some of the volatility in the long-term returns, and is an effective gauge of a company’s overall strength, stability and quality of corporate governance.

China’s Dividend Growth

The total dividend payout from Chinese companies increased more than 14 times since 1998. Most of the growth has come from large state-owned enterprises that went public after 1998.

<table>
<thead>
<tr>
<th>1998</th>
<th>2017</th>
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</thead>
<tbody>
<tr>
<td>US$8.2 BILLION</td>
<td>US$114.0 BILLION</td>
</tr>
</tbody>
</table>

Excludes A-Share Market
Sources: FactSet Research Systems, Matthews Asia
There are no guarantees that a company will continue to pay or increase its dividend. Dividend payouts from companies do not represent or predict the performance of any fund.
Matthews China Small Companies Fund

China’s economic growth and reform have sparked an unprecedented wave of entrepreneurship.

The number of listed small companies in China has grown more than five-fold in the last 10 years and now stands at more than 4,500.

Moreover, their impact on the economy is growing. Small and medium-sized enterprises (SMEs) as of 2012 accounted for approximately 60% of China’s GDP and have been growing at a faster pace than the Chinese economy as a whole. Small-cap companies account for 65% of patent registration and innovation, 75% of technology innovation, 75% of new product development and 80% of urban employment.

The Matthews China Small Companies Fund seeks to tap into this growth by investing in companies in China, its administrative and other districts such as Hong Kong, with market capitalizations generally under US$3 billion. Our managers look for well-managed, well-funded companies in their initial stages of growth at attractive valuations, with distinctive business models and what we believe to be a sustainable competitive advantage.

Our pool of potential candidates for the Fund is comprised of more than 4,500 companies. As most of these companies are not widely known or covered by sell-side analysts, Matthews Asia generates ideas from internal resources, trade contacts, industry experts and local media. We then conduct our fundamental, bottom-up analysis to screen for risks and other investment criteria. Recognizing that many small Chinese companies may have limited track records, we are especially rigorous in our due diligence, with frequent face-to-face, onsite meetings and consistent follow up to see whether our portfolio companies are sticking to their business plans and delivering on their promises.

Small businesses have played an important role in China’s economy

SMEs in China account for a majority of China’s GDP and surpass larger enterprises in the critical measures of innovation and urban employment.

<table>
<thead>
<tr>
<th>% of GDP</th>
<th>% of Patents and Innovation</th>
<th>% of New Product Development</th>
<th>% of Employment in Urban Areas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-SMEs</td>
<td>SMEs</td>
<td>Non-SMEs</td>
<td>SMEs</td>
</tr>
<tr>
<td>40%</td>
<td>60%</td>
<td>35%</td>
<td>25%</td>
</tr>
<tr>
<td>65%</td>
<td>65%</td>
<td>80%</td>
<td>80%</td>
</tr>
</tbody>
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Funds at a Glance*

### Matthews China Fund

<table>
<thead>
<tr>
<th>Lead Manager</th>
<th>Investor Class</th>
<th>Institutional Class</th>
</tr>
</thead>
<tbody>
<tr>
<td>Andrew Mattock, CFA</td>
<td>Symbol: MCHFX</td>
<td>Symbol: MICFX</td>
</tr>
<tr>
<td>Winnie Chwang</td>
<td>Inception Date: February 19, 1998</td>
<td>Inception Date: October 29, 2010</td>
</tr>
<tr>
<td>Co-Manager</td>
<td>Investment Objective: Long-term capital appreciation</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Strategy: Under normal market conditions, the Fund invests at least 80% of its total net assets, which include borrowings for investment purposes, in the common and preferred stocks of companies located in China. China includes its administrative and other districts, such as Hong Kong.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Benchmark: MSCI China Index</td>
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</tbody>
</table>

### Matthews China Dividend Fund

<table>
<thead>
<tr>
<th>Lead Manager</th>
<th>Investor Class</th>
<th>Institutional Class</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sherwood Zhang, CFA</td>
<td>Symbol: MCDFX</td>
<td>Symbol: MICDX</td>
</tr>
<tr>
<td>Yu Zhang, CFA</td>
<td>Inception Date: November 30, 2009</td>
<td>Inception Date: October 29, 2010</td>
</tr>
<tr>
<td>Co-Manager</td>
<td>Investment Objective: Total return with an emphasis on providing current income</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Strategy: Under normal market conditions, the Fund invests at least 80% of its total net assets, which include borrowings for investment purposes, in dividend-paying equity securities of companies located in China. China includes its administrative and other districts, such as Hong Kong. The Fund may also invest in convertible debt and equity securities.</td>
<td></td>
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<tr>
<td></td>
<td>Benchmark: MSCI China Index</td>
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### Matthews China Small Companies Fund

<table>
<thead>
<tr>
<th>Lead Manager</th>
<th>Investor Class</th>
<th>Institutional Class</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tiffany Hsiao, CFA</td>
<td>Symbol: MCSMX</td>
<td>Symbol: MICHX</td>
</tr>
<tr>
<td></td>
<td>Inception Date: May 31, 2011</td>
<td>Inception Date: November 30, 2017</td>
</tr>
<tr>
<td></td>
<td>Investment Objective: Long-term capital appreciation</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Strategy: Under normal market conditions, the Fund invests at least 80% of its total net assets, which include borrowings for investment purposes, in the common and preferred stocks of small companies located in China. China includes its administrative and other districts, such as Hong Kong.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Benchmark: MSCI China Small Cap Index</td>
<td></td>
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<tr>
<td></td>
<td>Redemption Fee: 2% within 90 calendar days</td>
<td></td>
</tr>
</tbody>
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### About the Portfolio Managers

**Andrew Mattock, CFA**, joined Matthews Asia in 2015 after working as a Fund Manager at Henderson Global Investors for 15 years, managing Asia Pacific equities. He holds a Bachelor of Business in Accounting from ACU. Andrew began his career at PricewaterhouseCoopers and is qualified as a Chartered Accountant.

**Sherwood Zhang, CFA**, joined Matthews Asia in 2011 after working as an Analyst at Passport Capital from 2007 to 2010, where he focused on such industries as property and basic materials in China as well as consumer-related sectors. He received his M.B.A. from the University of Maryland and his Bachelor of Economics in Finance from Shanghai University.

**Tiffany Hsiao, CFA**, joined Matthews Asia in 2014 after working as a Research Analyst at Goldman Sachs Investment Partners in Hong Kong and Tokyo from 2007 to 2013, researching Asia Pacific investments. Previously, she spent six years at Franklin Templeton Investments, where she managed the firm’s global communications fund. Tiffany earned her Masters of Science and Information Technology from Carnegie Mellon University and received a B.A. in Economics from the University of California, Berkeley.

**Yu Zhang, CFA**, joined Matthews Asia in 2007 after having worked as an Analyst researching Japanese companies at Aperta Asset Management.

Yu received a B.A. in English Language from the Beijing Foreign Studies University, an M.B.A. from Suffolk University and an M.S. in Finance from Boston College.

**Winnie Chwang** joined Matthews Asia in 2004 and has built her investment career at the firm. She earned an M.B.A. from the Haas School of Business and received her B.A. in Economics with a minor in Business Administration from the University of California, Berkeley.

*Updated as of January 2019*
Our Approach to Investing in Asia

Active management
We believe many of the region’s widely used equity indices are backward looking and are not representative of the industries and companies that will be successful in the future. With respect to the region’s debt indices, we believe they are representative of the most indebted countries as opposed to the most creditworthy.

Long-term focus on Asia
We believe a long-term approach is the most effective way to capitalize on Asia’s evolution.

Matthews Asia has been investing in the region since 1991 and we draw on our experience to identify investment opportunities that stand to benefit from the growth and development of markets throughout the region.

Bottom-up research
We employ a fundamental, bottom-up investment process. For equities, we seek to identify companies with sustainable long-term growth prospects, strong business models, quality management teams and reasonable valuations. For debt securities, we look for issuers that demonstrate strength in credit, currencies and interest rates.

This research process involves more than 2,500 company meetings each year.

Defining Asia’s investment strategies
We strive to provide investors a range of Asia strategies across the risk-reward spectrum and launch new strategies when there are compelling investment opportunities in the region.
STRATEGIES FOR INVESTING IN ASIA

ASIA FIXED INCOME
- Asia Strategic Income
- Asia Credit Opportunities

ASIA GROWTH AND INCOME
- Asian Growth and Income
- Asia Dividend
- China Dividend

ASIA GROWTH
- Asia Focus
- Asia Growth
- Pacific Tiger
- Asia ESG
- Emerging Asia
- Asia Innovators

ASIA VALUE
- Asia Value

ASIA SMALL COMPANY
- Asia Small Companies
- China Small Companies

Contact Matthews Asia
To learn more about Matthews Asia or how the Matthews Asia Funds can complement your portfolio, please call 800.789.ASIA or visit matthewsasia.com.
You should carefully consider the investment objectives, risks, charges and expenses of the Matthews Asia Funds before making an investment decision. A prospectus or summary prospectus with this and other information about the Funds may be obtained by visiting matthewsasia.com. Please read the prospectus carefully before investing as it explains the risks associated with investing in international and emerging markets.

Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation. Fixed income investments are subject to additional risks, including, but not limited to, interest rate, credit and inflation risks. In addition, single-country and sector strategies may be subject to a higher degree of market risk than diversified strategies because of concentration in a specific industry, sector or geographic location. Investing in small companies is more risky and more volatile than investing in large companies.

Funds that invest in China through the QFII quota of their manager are subject to risks such as QFII rules and restrictions on repatriation of assets. The QFII status of the manager could be revoked and funds may not be able to invest directly in China A Shares pursuant to the applicable QFII rules and regulations. Funds may also invest via the Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect (together the “Stock Connects”), and would be subject to risks such as quota limitations, suspension in trading and operational risk. China listed companies and trading of China A Shares are subject to market rules and disclosure requirements in the China stock market. Any changes in laws, regulations, rules and policies of the China A Share market may affect share prices. There are foreign shareholding restrictions and disclosure obligations applicable to China A Shares. Funds will be subject to restrictions on trading (including restriction on retention of proceeds) in China A Shares as a result of their investments in China A Shares.

The views and information discussed herein are as of May 2018, are subject to change and may not reflect current views. The views expressed represent an assessment of market conditions at a specific point in time, are opinions only and should not be relied upon as investment advice regarding a particular investment or markets in general. Such information does not constitute a recommendation to buy or sell specific securities or investment vehicles. Investment involves risk. Past performance is no guarantee of future results. The value of an investment in the Fund can go down as well as up. 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. Matthews Asia and its affiliates do not accept any liability for losses either direct or consequential caused by the use of this information.

Matthews Asia is the brand for Matthews International Capital Management, LLC and its direct and indirect subsidiaries.

Matthews International Capital Management, LLC is the advisor to the Matthews Asia Funds.

Index Definitions

The **MSCI China Index** is a free float–adjusted market capitalization–weighted index of Chinese equities that include China-affiliated corporations and H shares listed on the Hong Kong exchange, and B shares listed on the Shanghai and Shenzhen exchanges.

The **MSCI China Small Cap Index** is a free float-adjusted market capitalization-weighted small cap index of the Chinese equity securities markets, including H shares listed on the Hong Kong exchange, B shares listed on the Shanghai and Shenzhen exchanges, and Hong Kong-listed securities known as Red Chips (issued by entities owned by national or local governments in China) and P Chips (issued by companies controlled by individuals in China and deriving substantial revenues in China).

Indexes are unmanaged. It is not possible to invest directly in an index.