Income investing has long been a core strategy for investors seeking total return with an emphasis on income and capital preservation. The current environment of slower global growth, low interest rates and low to negative bond yields is prompting a search for “yield,” as investors need income options and exposure to asset classes that lower volatility and diversify their portfolios.

In this paper, we will discuss the benefits of equity dividend and fixed income strategies in Asia for income-seeking investors. These include the evolution of the dividend-paying universe over time, the performance of equity dividend strategies as well as the importance of Asia fixed income as a complement to a U.S. and/or European fixed income portfolio. Lastly, we will briefly highlight our approach to income investing in Asia and our five core equity dividend and fixed income funds for varying levels of risk tolerance.
Historically, investors have looked for growth strategies when allocating to Asia. But Asia can provide both capital growth and income opportunities for investors looking to diversify their portfolios and enhance yield. Asia offers equity income and fixed income strategies as the region’s capital markets have deepened and liquidity has improved.

Market volatility highlights a further potential benefit to income-based strategies, as they typically exhibit lower volatility than growth strategies. Many faster-growing companies also pay dividends in Asia, and dividends can help provide downside protection in volatile markets. Thus, investors who are attracted to high dividends may not have to forgo growth opportunities.

In Asia, the contribution of dividends to equity returns has been significant over time, and we believe it offers a more stable means to access the faster-growing economies in the region while mitigating risk. The current environment is one in which interest rates across developed bond markets offer little or even negative yield while being subject to significant duration or interest rate risk when rates eventually move higher.

Furthermore, allocating to Asia exposes investors to a diverse set of countries with varying economic conditions and monetary policy cycles, supporting the diversification potential to investors concerned about low yields in alternative investments.

GROWING UNIVERSE OF DIVIDEND-PAYING COMPANIES IN ASIA

We believe Asia dividend investing should form a core part of any global income portfolio. The region’s equity markets have grown to represent nearly 40% of global stock market capitalization. Along with the expansion in the region’s equity markets, dividend payments by Asian companies on an annual basis have also grown to about US$286 billion (see Figure 1), approaching the size of the dividend pool in developed Western markets.

As the market has grown, the dividend-paying universe has also expanded to include a broad set of countries and sectors in different stages of development, from recent IPOs to established blue-chip companies of varying market capitalization. The heterogeneity of dividend-paying companies is important from a portfolio construction perspective as it reduces the concentration on any one country or industry for investment.

Figure 1. Dividend Pool in Asia Approaching Size of Western Markets (US$ Billions)

![Figure 1](https://example.com/fig1.png)

As of March 31, 2016
2015 dividends by index members as of December 2014; Europe (Bloomberg European 500 Index), Asia Pacific (MSCI AC Asia Pacific Index), U.S (S&P 500 Index).
There is no guarantee companies will maintain or continue to pay dividends. It is not possible to invest directly in an index.
Source: FactSet Research Systems, MSCI, S&P, Bloomberg

The long-term growth of dividends in Asia has been higher than in both the U.S. and Europe (see Figure 2), and about 92% of companies in the MSCI AC Asia Pacific Index paid a dividend in 2015, compared to roughly 60% in 1998. About 22% of dividend-paying companies in the MSCI AC Asia Pacific Index pay a dividend yield over 4%. While the current dividend yield of 2.8% in Asia trails that of Europe, it still outpaces that of the U.S.

Figure 2. Long-Term Regional Dividend Growth (2002–2015) and Dividend Yields (%)

![Figure 2](https://example.com/fig2.png)

*Trailing dividend yield estimates for 2015, as of 09/30/16, based on Factset Aggregates.
†Compound annual growth rate (CAGR) based on index constituents of Europe (Bloomberg European 500 Index), Asia Pacific (MSCI AC Asia Pacific Index), U.S. (S&P 500 Index), as of 12/31/02, excluding those that are no longer in existence as of fiscal year 2015.
Past yields are no guarantee of future yields. It is not possible to invest directly in an index.
Sources: Factset Research Systems, MSCI, S&P, Bloomberg

The culture of paying dividends in Asia has also improved considerably over time (see Figure 3). The governments of Japan and South Korea have been encouraging companies to better utilize cash sitting on their balance sheets, and
this has resulted in a shifting attitude by corporates toward shareholder distributions. Taiwan has also changed its tax guidelines in order to encourage companies to pay dividends and as a result, the country is now one of the larger countries by total dividends paid in Asia. This propensity to pay dividends is important in an environment where interest rates are close to zero or even negative in many developed markets.

The ownership structure of many firms across Asia can also play a role in a company’s dividend payout policy. Many of these firms are family-owned businesses, in which the original founder or the founding family continues to retain a controlling stake. These listed businesses, often the so-called “crown-jewel” assets of the family business, are a significant source of income and cash flows to the founding family, and they often rely on these steady income streams. These larger shareholders have an incentive to extract value via dividends as a stable income source, and this aligns the interest between minority and majority shareholders as everyone is paid based on their ownership; this also helps support the lower volatility of dividends compared to earnings. Various studies by Kumar (2003) and Kouki and Guizani (2009) also suggest there may be a positive association between dividends paid and corporate and director ownership.

Similarly, in the case of listed state-owned enterprises (SOEs), the government is the main shareholder, and dividends paid by listed SOEs can be an important source of funding for government spending.

**DIVIDENDS ARE A SIGNIFICANT DRIVER OF TOTAL RETURN**

Historically, investors have perceived Asian markets to be fertile ground for growth-oriented investments, leading to a focus on earnings expansion rather than yield. In reality, nearly all markets, dividends in Asia have played a vital role in generating historic total returns as they have in nearly all markets. Returns from equity dividends in Asia have been significant as dividends have accounted for two-thirds of the total return of the MSCI AC Asia Pacific ex Japan Index since 2005 (see Figure 4). If the contribution made by reinvesting dividends was excluded, the cumulative return would have been 25%, versus 71%, if dividends are included.

In periods of market volatility, dividend-paying stocks typically outperform growth-oriented stocks. While capital growth and dividends are both drivers of return, dividends are income streams that do not tend to exhibit the volatility of share prices. Dividends are realized, while capital appreciation is often unrealized, and can quickly dissipate. Dividend income from a diversified portfolio tends to exhibit stability over time as dividends are unlikely to be cut across companies and sectors simultaneously. This can help dividend-paying shares to weather market cycles and volatility.
DIVIDENDS SERVE A MORE FUNDAMENTAL ROLE THAN JUST YIELD

At Matthews Asia, we believe dividends play a more fundamental role than just yield enhancement. First, dividends are paid out in cash and not subject to manipulation. A track record of dividend payments also tends to indicate that the company has a healthy underlying business. We often get asked whether we can “trust the numbers” and there is no better way to see this than when our due diligence on a company’s cash flow is confirmed through the issuance of dividends. Lastly, dividend payments can instill greater discipline on a management team’s capital allocation decisions, often resulting in better corporate governance standards.

Overall, corporate governance practices have generally been improving in Asia along with an increasing emphasis on shareholder returns (see Figure 6).

ASIA FIXED INCOME: AN ATTRACTIVE COMPLEMENT TO U.S. AND EUROPEAN BONDS

For much of the last 30 years, interest rates across developed markets have been on a declining trend, resulting in an extended bull-market for fixed income investors. This prolonged period of low interest rates in the U.S and Europe results in a risk-return profile that has become asymmetric, as developed bond markets offer little or even negative yield while being subject to significant duration or interest rate risk if rates move higher. A recent estimate suggests that the total amount of negative yielding global sovereign debt is equivalent to US$11 trillion.

In this environment of persistent low-yields, investors are seeking alternative income options to enhance yield and diversify their fixed income exposures. In a challenging environment for fixed income, some investors may consider adding high yield, global or emerging market bonds to their portfolios. We believe Asian bonds serve as an attractive complement to a U.S. and/or European fixed income portfolio. Historically, U.S. dollar-denominated bonds of Asian issuers have delivered attractive risk-adjusted returns, particularly when compared with other higher-yielding assets (see Figure 7).
Income Investing in Asia

COMPELLING RISK-ADJUSTED RETURNS

Over a 15-year period, Asia U.S. dollar-denominated credit has offered one of the most favorable risk-adjusted returns of any asset class, with both higher returns and lower risk than the U.S. and Europe.

The long-term returns of Asia fixed income also carry a low to medium correlation with other asset classes thereby providing diversification potential to investors seeking to enhance their total returns while mitigating risk (see Figure 8).

SOUND FUNDAMENTALS

Economic fundamentals in Asia remain sound as the region’s contribution to global GDP is expected to grow over time. Although growth in Asia has slowed in recent years due to China’s transition from a manufacturing to service-oriented economy, it is still expected to outpace the rest of the world, largely driven by domestic demand. Growth in Asia is propelled by high savings rates, productivity growth and urbanization. Institutional reforms have also resulted in more prudent fiscal and monetary policy.

Correlations shown from 12/31/1999 (or inception) to 12/31/2015 based on monthly-returns for Local Currency Denominated Asia Bond (HSBC Asian Local Bond Index), Asia USD Credit (J.P. Morgan Asia Credit Index—JACI), Global High Yield (BofA Merrill Lynch Global High Yield Index), Asia High Yield (high yield portion of J.P. Morgan Asia Credit Index), Asia Local Currency Bond (HSBC Asian Local Bond Index), Euro High Yield (Barclays Pan-European High Yield Index), U.S. Bond (Barclays U.S. Aggregate), Euro Bond (Barclays Euro Aggregate Index), Global Bond (Barclays Global Aggregate), Emerging Market Bond (J.P. Morgan Emerging Markets Bond Index Global), U.S. High Yield (BofA Merrill Lynch U.S. High Yield Master II), U.S. Equity (S&P 500 Index), Asia ex Japan Equity (MSCI All Country Asia ex Japan Index), U.S Credit (BAML U.S. Corporate Master Index), Asia USD Investment Grade (Investment Grade portion of JACI Index).

*2000 to December 2015
Source: Bloomberg

Figure 8. Long-Term Correlations of Asia Fixed Income with Other Asset Classes

<table>
<thead>
<tr>
<th></th>
<th>U.S. Bond</th>
<th>Euro Bond</th>
<th>Global Bond</th>
<th>U.S. Equity</th>
<th>Asia ex-Japan Equity</th>
<th>Emerging Market Bond</th>
<th>Asia Credit</th>
<th>Global High Yield</th>
<th>Euro High Yield</th>
<th>U.S. High Yield</th>
<th>Asia High Yield</th>
<th>Asia Local Currency Bond*</th>
<th>Asia USD Investment Grade</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Bond</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Euro Bond</td>
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<tr>
<td>Global Bond</td>
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<tr>
<td>U.S. Equity</td>
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<td>Asia ex-Japan Equity</td>
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<td>0.24</td>
<td>0.73</td>
<td>1.00</td>
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<td></td>
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<tr>
<td>Emerging Market Bond</td>
<td>0.48</td>
<td>0.25</td>
<td>0.47</td>
<td>0.52</td>
<td>0.59</td>
<td>1.00</td>
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<td></td>
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<td></td>
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<tr>
<td>Asia Credit</td>
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<td>0.41</td>
<td>0.55</td>
<td>0.37</td>
<td>0.51</td>
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<tr>
<td>Global High Yield</td>
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<td>0.29</td>
<td>0.65</td>
<td>0.67</td>
<td>0.66</td>
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<td>1.00</td>
<td></td>
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</tr>
<tr>
<td>Euro High Yield</td>
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<td>0.08</td>
<td>0.13</td>
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<td>0.62</td>
<td>0.52</td>
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<td>0.06</td>
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<td>0.64</td>
<td>0.66</td>
<td>0.66</td>
<td>0.63</td>
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<td>0.86</td>
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<tr>
<td>Asia High Yield</td>
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<td>0.51</td>
<td>0.66</td>
<td>0.77</td>
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<td></td>
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<tr>
<td>Asia Local Currency Bond*</td>
<td>0.45</td>
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<td>0.67</td>
<td>0.40</td>
<td>0.59</td>
<td>0.62</td>
<td>0.59</td>
<td>0.48</td>
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<td>0.49</td>
<td>0.60</td>
<td>1.00</td>
<td></td>
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<tr>
<td>U.S. Credit</td>
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<td>0.60</td>
<td>0.67</td>
<td>0.20</td>
<td>0.30</td>
<td>0.65</td>
<td>0.81</td>
<td>0.55</td>
<td>0.41</td>
<td>0.56</td>
<td>0.62</td>
<td>0.52</td>
<td>1.00</td>
</tr>
</tbody>
</table>
| Asia USD Investment Grade | 0.73   | 0.49      | 0.58        | 0.25        | 0.38                 | 0.73                 | 0.97        | 0.52             | 0.40          | 0.52          | 0.77          | 0.53                    | 0.84                  | 1.00

Figure 9. Growth Projections in Major World Economies

Over a 15-year period, Asia U.S. dollar-denominated credit has offered one of the most favorable risk-adjusted returns of any asset class, with both higher returns and lower risk than the U.S. and Europe.

The long-term returns of Asia fixed income also carry a low to medium correlation with other asset classes thereby providing diversification potential to investors seeking to enhance their total returns while mitigating risk (see Figure 8).

SOUND FUNDAMENTALS

Economic fundamentals in Asia remain sound as the region’s contribution to global GDP is expected to grow over time. Although growth in Asia has slowed in recent years due to China’s transition from a manufacturing to service-oriented economy, it is still expected to outpace the rest of the world, largely driven by domestic demand. Growth in Asia is propelled by high savings rates, productivity growth and urbanization. Institutional reforms have also resulted in more prudent fiscal and monetary policy.

Over time, Asia’s bond markets have also experienced improvements in liquidity, transparency and diversification. After significant structural reforms in the past decade, most Asian sovereign credit ratings have been upgraded by international rating agencies and are now amongst the highest in the emerging market universe.
The region also has a large and liquid local corporate bond market; following rapid growth, the Chinese corporate bond market is now one of the world’s largest. Fundamentals in credit in Asia also generally remain sound, as liquidity profiles and levels of leverage are similar to those found in the U.S. and Europe. While default rates in Asia have started to gradually rise, thus far, it has been relatively contained to lower quality corporates with excessive leverage or sectors that are highly dependent on commodities.

LIQUID AND DIVERSE BOND MARKETS

Asia has two distinct bond markets—local currency and U.S. dollar-denominated bonds. For example, if a South Korean corporation issues a bond denominated in the Korean won, it qualifies as a local currency bond; similarly a U.S dollar-denominated bond is if the same Korean corporation issues bonds denominated in U.S. dollars. The local currency bond market, as represented by the Markit iBoxx Asian Local Bond Index, is about US$1.64 trillion (larger than the entire U.S. high yield bond market, as of December 2015) and offers exposure to the Asian credit, currency and interest rates. The J.P. Morgan Asia Credit Index has a total market value of US$623 billion as of December 2015, and offers exposure to Asia credit while retaining exposure to the U.S. dollar and U.S. interest rates.

Asia fixed income tends to have a lower representation in global indices than one would expect based on the region’s contribution to global GDP. As of 2015, Asia contributed 40% to global output and two-thirds to global growth. If we consider the widely used J.P. Morgan Emerging Market Bond Index or the Barclays Global Aggregate Index, Asian issuers represent a small portion of the indices.

LOW SENSITIVITY TO CHANGES IN U.S. INTEREST RATES

For those investors concerned about interest rates eventually moving higher in the U.S., the analysis below shows how Asia bonds have a relatively low sensitivity to U.S. Treasuries, particularly Asia high-yield and local currency bonds.

Asia credit, and particularly high yield, typically has a lower duration, and therefore, lower sensitivity to changes in interest rates, as their performance is driven to a greater extent by fundamentals of the issuer rather than the interest rate cycle.

Over the short term, however, it is important to note that Asia fixed income has the potential to be more volatile than U.S. bonds or global bonds and fixed income investments are subject to additional risks, including, but not limited to, interest rate, credit and inflation risks. Investing in emerging markets involves different and greater risks, as these countries are substantially smaller, less liquid and more volatile than securities markets in more developed markets, and therefore investors should have a time horizon of at least three to five years in mind when considering Asia fixed income.

Figure 10. Beta of Asian Bonds relative to 5-year Treasuries Reasonably Low Among Various Asset Classes

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Beta</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. High Yield</td>
<td>-0.42</td>
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<tr>
<td>Asia USD High Yield*</td>
<td>0.19</td>
</tr>
<tr>
<td>Asia Local Currency Bond</td>
<td>0.36</td>
</tr>
<tr>
<td>Emerging Market Bond</td>
<td>0.37</td>
</tr>
<tr>
<td>Euro Bond</td>
<td>0.46</td>
</tr>
<tr>
<td>U.S. Municipal</td>
<td>0.49</td>
</tr>
<tr>
<td>U.S. Mortgage</td>
<td>0.50</td>
</tr>
<tr>
<td>Asia USD Credit</td>
<td>0.51</td>
</tr>
<tr>
<td>Asia USD Investment Grade†</td>
<td>0.51</td>
</tr>
<tr>
<td>U.S. Credit</td>
<td>0.68</td>
</tr>
<tr>
<td>U.S. Bond</td>
<td>0.68</td>
</tr>
<tr>
<td>Global Bond</td>
<td>0.79</td>
</tr>
</tbody>
</table>

VOLATILITY HIGHLIGHTS THE IMPORTANCE OF ACTIVE MANAGEMENT

Investors often equate volatility with more risk. Recent bouts of heightened volatility serve as a reminder of the importance of active management in navigating market cycles. To capitalize on Asia’s growth potential, we believe a long-term approach is essential. Our view is that a long-term outlook helps investors to better understand and tolerate the region’s inherent volatility. Identifying investment opportunities that hold potential not yet realized by the market also requires a research-driven, bottom-up approach.

MATTHEWS ASIA APPROACH TO INCOME INVESTING

What does our approach to income investing entail? First and foremost, our focus is on quality and this involves many elements. Our view is that an emphasis on quality investing provides the benefit of possible capital preservation during more volatile times; something which is not always recognized by the market.
What exactly do we mean when we say we focus on quality? When we consider quality, we look for competent management teams with established track records that are able to generate a sustainable return on capital over longer periods of time and through economic cycles. We also look for companies that maintain an efficient allocation of capital and high corporate governance standards. We assess a company’s capital structure by evaluating various factors, including, but not limited to, reinvestment in their business, dividends, share buybacks, balance sheet strengthening and the number and scale of acquisitions. And lastly, we favor companies with an economic “moat”—that is, a proven and sustainable competitive advantage relative to their peers.

Valuation is also of utmost importance to us, and we aim to identify companies whose intrinsic value is not fully reflected in the share price. This involves extensive due diligence, including on-the-ground research and in-person company meetings both before and after we invest in a company.

By investing in quality companies that demonstrate an efficient allocation of capital, high corporate governance standards, and proven track records of superior return generation, we believe that we have the potential to generate favorable returns through market cycles, with a lower risk of permanent loss of capital.

CONCLUSION

Given a backdrop of low or even negative interest rates in many developed countries, income-seeking investors need alternatives, and we believe income strategies in Asia serve as an effective way to add yield and diversification to a portfolio. The contribution of income strategies in Asia has been meaningful over the long term, and we believe it offers a more stable means to access the faster-growing economies in the region while mitigating risk. Investors who would like exposure to faster growing global economies but prefer some downside protection may want to consider income strategies in Asia. In an environment of low rates and disinflationary pressure, we believe income investing is becoming an increasingly important tool for investors seeking attractive returns.

Founded in 1991, Matthews Asia is the largest dedicated Asia investment specialist in the United States. We have witnessed first-hand Asia’s dynamic transformation and maintain a long-term strategic view of growth in the region. We believe the key to generating returns is to maintain a long-term perspective through market cycles, and some investors may prefer to invest in a portfolio that aims to be less volatile than the market. Our team has invested in Asia through a variety of market environments, and we have a proven track record built on an investment process that has remained consistent over the past two decades.

MATTHEWS ASIA CORE INCOME STRATEGIES

From our earliest days 25 years ago, we at Matthews Asia have recognized the importance of income strategies for investors looking to diversify their portfolios and enhance yield. While investors saw value in participating in Asia’s growth, many were also uncomfortable with the volatility in the region’s capital markets. To accommodate these differences in risk tolerance, we offer a range of Asia investment strategies across the risk-reward spectrum.

In 1994, we launched the Matthews Asian Growth and Income Fund as a way of offering some participation in Asia’s growth while maintaining a keen eye on protecting capital. In its early years, the Matthews Asian Growth and Income Fund sought stability and income largely by investing in convertible bonds. Today, however, convertibles represent only about 9% of the portfolio’s holdings. This is a direct reflection of the growing number of high-quality dividend paying companies that have benefited from Asia’s growth.

The Matthews Asia Dividend Fund was launched in 2006 to benefit from the expanding dividend-paying universe in Asia. In 2009, we launched the Matthews China Dividend Fund to capitalize on the growing universe of dividend-paying companies in China. To further expand our offering, we launched the Matthews Asia Strategic Income Fund in 2011 as sovereign and corporate bond markets in Asia deepened and liquidity improved. In April 2016, we launched the Asia Credit Opportunities Fund with a primary focus on Asia’s U.S. dollar-denominated investment universe.

1 As of 9/30/16
Definitions

**Dividends per share:** The sum of all declared dividends divided by the weighted average number of common shares outstanding.

**Standard deviation:** Standard deviation is a mathematical measurement of the dispersion of a set of data from its mean. For investors, standard deviation is applied to the annual rate of return of an investment to measure the investment’s volatility. A volatile investment will have a high standard deviation. A lower standard deviation means less variance of returns and therefore lower level of risk.

**Correlation:** A measure that determines the degree to which two variable's movements are associated.

**Beta:** Measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole.

Disclosure and Notes

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.

Diversification does not ensure a profit or protect against a loss. In addition, there is no guarantee that a fund or the companies in its portfolio will pay or continue to pay dividends.

Investment involves risk. Past performance is no guarantee of future results. 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 funds may be subject to a higher degree of market risk than diversified funds because of concentration in a specific industry, sector or geographic location. 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 large companies. An investment in a fixed income fund is subject to credit, currency, and interest rate risks. Credit risk is the change in the value of debt securities reflecting the ability and willingness of issuers to manage principal and interest payments. Currency risk is a decline in value of a foreign currency relative to the U.S. dollar which reduces the value of the foreign currency and investments denominated in that currency. Interest rate risk is the possibility that a fund’s yield will decline due to falling interest rates and the potential for bond prices to fall as interest rates rise. The Matthews Asia Strategic Income Fund and the Matthews Asia Credit Opportunities Fund (the “Fund(s)”) may invest in the following: derivatives which can be volatile and affect Fund performance; high yield bonds (junk bonds) which can subject the Funds to substantial risk of loss; and structured investments which can change the risk or return, or replicate the risk or return of an underlying asset. The Funds are non-diversified and may invest a larger portion of their assets in a single issuer and may entail greater risk than a diversified fund.

The views and information discussed in this report are as of the date of publication, 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. Past performance is no guarantee of future results.

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References