MATTHEWS INTERNATIONAL FUNDS

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Portfolio Manager's Report

December 31, 1995

MARKET UPDATE

The Korean market remained weak for most of December. Following a brief spurt at the beginning of the month, the market fell for much of the second half to end December at 882 on the KOSPI index, a decline of 5.2% for the month and 12.9% for the year. Market weakness was generally ascribed to continued concerns raised by the arrest of two former Korean Presidents.

Investor sentiment has been focused on the potential negative impact that recent political turmoil might have on the real economy in 1996. It is widely expected that Korea's recent pace of economic expansion will decline in the coming year from approximately 9.5% to approximately 7.5%. While this would be considered a desirable "soft landing", any further slowdown would cause some downward earnings revisions. The current political environment has raised concerns that the uncertainty will lead corporations to postpone or curtail their investment plans for 1996. These uncertainties have to an extent already been reflected in Korean stock prices, whose valuations appear attractive relative to other Asian markets. Even with a slowing rate of growth in 1996 corporate earnings are expected to grow approximately 15% in the aggregate and the historic market multiple is approximately 15x.

Liquidity conditions in the domestic economy appear likely to continue to ease. Provided the current political situation does not deteriorate further, the prospects for the Korean market appear bright.

PORTFOLIO COMMENTS

Recent and likely future additions to the portfolio will be focused on companies which participate in the domestic economy as opposed to exporters. During December the Fund added a position in Dong-A Pharmaceutical, Korea's leading pharmaceutical company, and in Oriental Fire and Marine Insurance, a rapidly growing insurance company associated with the Hanjin Group.

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WHAT HAPPENED IN 1995?

After the euphoria of the second half of 1993 and early 1994, the Asian equity markets went through a second difficult year in 1995. Local retail investors have remained inactive and foreign fund flows slowed dramatically. One measure of net asset flows to a selection of Asian ex-Japan and Pacific funds shows a drop from a peak of $5.6 billion for 1993 to $573 million in 1995. We believe local investors are waiting for a return of foreign participation, while foreign investors continue to be distracted by Wall Street and adjusting to the unexpected rout in Latin America and its implications for the widely accepted emerging markets concept.

Among Asian markets in 1995, Hong Kong's familiarity with foreign investors as the biggest and the most liquid market made it the major beneficiary gaining 23%. China's improved economic picture and the stabilization of the Hong Kong property market following a 30% drop brought institutional (but not retail) investors back to the market. Taiwan lost 30% and South Korea 12% due to political jitters and scandals. The rest of the Tiger markets were subdued with concerns over inflation and rising interest rates resulting from their rapid economic growth.

Market	*% Δ 1995 Local CCY*	*% Δ 1995 US$*
China -Shanghai 'B' shs	-24.07	-24.07
China -Shenzhen 'B' shs	-31.36	-31.32
Hong Kong	+22.98	+23.06
Indonesia	+9.41	+5.20
Malaysia	+2.47	+3.00
Philippines	-6.88	-12.75
Singapore	+1.20	+4.32
South Korea	-14.06	-12.24
Taiwan	-27.46	-30.10
Thailand	-5.83	-6.17

LOOKING AHEAD TO 1996

With only 18 months till July 1st 1997, the day when Hong Kong's sovereignty reverts to China, the polarization of bulls and bears have become more and more distinct. We strongly believe that Hong Kong's position as a financial center will be maintained. Hong Kong's law and order will be enforced as stated in the Basic Law signed by both British and Chinese governments. China has every reason to preserve Hong Kong's prosperity and well-being. With President Jiang Ze-min effectively consolidating power in preparation for Deng's passing away, the chance of China going into a political turmoil after Deng's death is looking less and less likely. An improved outlook for China and Hong Kong will benefit the entire region. With economic growth having peaked in 1995, inflation and interest rates in Indonesia, Malaysia, Philippines and Thailand should be trending downwards by the end of next year. Most signs point to a more positive stock market environme nt throughout the region.

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MARKET UPDATE

Asian (ex-Japan) convertible bond prices rallied in December (+2.7%). In contrast to most of 1995, the strength primarily reflected strong equity markets- as opposed to strong fixed income markets (although they were supportive also). An equity-driven rally in convertible bonds was particularly welcome because it is equity strength- not fixed income strength- that probably offers the greatest potential for generating attractive, long-term returns for convertible bond investors.

Thai CBs (+5.0%) proved to be the strongest geographic segment of the market. Hong Kong CBs (+3.0%) actually outperformed the Hang Seng Index (+2.6%) during the month. South Korean issues (+0.9%) managed to rise despite considerable KOSPI Index (-5.2%) weakness. On the other hand, Taiwanese CB performance (+1.6%) was quite weak considering the strength in the equity market (+8.0%). This was not unexpected because during 1995 Taiwanese convertible prices (+1%) dramatically outperformed their underlying equities (-28%).

PORTFOLIO COMMENTS

As its investors know, the portfolio is designed to reflect primarily 'cuspy' or 'classic' CBs- offering both upside equity participation and downside fixed income protection. Having said that, during December, the portfolio became a bit more 'equity-like' as our confidence in the region's equity markets increased. Interestingly, this change was partially 'automatic' and partially 'manual'. CBs automatically become more equity-like as the underlying stocks rally because the equity component of the CB starts to take on more value vis-à-vis the fixed income component. In addition to these 'automatic' adjustments, we made some small 'manual' portfolio adjustments that expedite this process in Hong Kong, Malaysia, Korea and India.

ASIAN CONVERTIBLE SECURITIES IN 1995

During 1995, Asian ex-Japan CB prices (+4.4%) broadly behaved the way that they were 'supposed to' considering the weakness of the region's equity markets (MSCI: -1.5%). They exhibited less volatility (eg. less risk) than pure equities and greater return. The stronger price performance of Asian ex-Japan CBs can largely be attributed to two factors. First, falling US interest rates increased the value of the bond component of USD-denominated CBs. Second, Asian ex-Japan CBs' discounts to theoretical value (while still substantial) generally contracted, also augmenting return. Beyond pure price performance, CB interest payments also cushioned against equity market weakness.