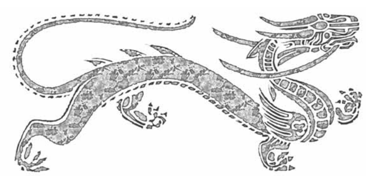
ASIAN INSIGHT www.matthewsfunds.com

MATTHEWS ASIAN FUNDS | 456 MONTGOMERY STREET, SUITE 1200 | SAN FRANCISCO, CA 94104 | 800.789. ASIA [2742]

MAY 2003



What is Asia?

As active investors with a long-term fundamental approach, we think of Asia in terms of cultures, economies, financial structures, trade flows, domestic spending and capital investment - all reflected in the companies we analyze and invest in.

For those who look at Asia from the outside, the region is a piece of the global indices, most often defined by Morgan Stanley Capital International or MSCI. We have long defined ourselves as off-benchmark investors. While every manager needs a benchmark, the Asian indices are both actively constructed and backwardly oriented. Neither attribute makes them a good foundation for portfolio construction.

Indices are quirky creatures that are often accepted with little understanding. MSCI constructs its indices based on a market capitalization that is supposed to cover 85% of a market's total capitalization. While this sounds straightforward, there are very specific determinations about what is and isn't a "developed" market as well as the choice to exclude "non-trading" shares.

From a global perspective, MSCI divides the Asia Pacific region into developed and emerging definitions. Developed Asia Pacific is Japan, Australia, Hong Kong, Singapore and New Zealand. As a group, they make up 11.4% of the MSCI World Free Index, with Japan representing the majority of that weighting. For the MSCI EAFE Index, the classic benchmark for developed markets, the same group makes up 27.2%, with Japan at 19.6%. When a core international fund benchmarks to the EAFE Index, as most do, Hong Kong and Singapore together make up only 2.3% of their universe.

When MSCI looks at emerging markets, developing Asia accounts for well over half of the universe. South Korea alone represents 22.9% of this universe, more than all of Latin America. China, despite its huge economy, is only 6.6%, half the size of South Africa, because MSCI includes Hong Kong's contribution to China's economy in the developed market index. MSCI also subtracts the portion of China's publicly traded shares that are owned by the state, the dominant owner of most Chinese blue chips. Furthermore, the Chinese "A" share market, which is available only for Chinese purchase, but is larger than the Hong Kong market, is not included in the MSCI's calculations.

There is a rationale behind each MSCI decision, but the net result is a very distorted picture when one compares index weightings to economic reality.

Beyond MSCI's efforts to exclude government ownership are their efforts to exclude dominant shareholders' interests from the "free" indices. Somehow an Asian tycoon is assumed to never sell interests while U.S. and U.K. tycoons and management ownership interests are assumed to almost always be available for sale. We are concerned that there

Continued on Page 3

CHINA
In March, China's urban unemployment rate rose to 4.1%. Chinese factories, refineries and other producer prices rose 4.6% YoY in March, the fastest rate in six years, as oil costs surged. Economists are cutting forecasts for China's economic growth as a jump in infections from SARS keeps shoppers away from stores. The benchmark Shanghai B Share Index was down 3.14% in April.

HONG KONG
Hong Kong's export growth unexpectedly picked up in March, up 15.4% YoY, as worldwide demand for Chinese made goods increased. Hong Kong Chief Executive Tung Chee-hwa said the government will cut taxes and lower fees as part of a US$1.5 BL package to help the economy cope with SARS. Hong Kong's consumer prices fell for a 53rd straight month in March as rising unemployment and SARS curbed spending. The benchmark Hang Seng Index was up 1.67% in April.

INDIA
In April, India's central bank cut its benchmark interest rate from 6.25% to 6.00% in order to spur the economy after the worst drought in 15 years pared growth to its lowest pace in two years. India's exports rose 18% to a record US$51.7 BL in the fiscal year that ended March 31, 2003. India's annual rate of inflation accelerated to 6.47% in April. The benchmark SENSEX Index was down 2.33% in April.

INDONESIA
Indonesia's exports rose for a seventh straight month in March, reflecting higher oil prices. Also in March, exports rose 11% YoY to US$5.07 BL. Tourist arrivals to Indonesia's top destination, Bali, dropped 35% YoY in March. Consumer prices in Indonesia rose 7.5% YoY in April. Indonesian consumer confidence rose 7.9% MoM in March from a record low in February. The benchmark JCI Index was up 16.38% in April.

JAPAN
According to the Bank of Japan (BOJ), Japan's monetary base rose 11.5% YoY in April. Also in April, the BOJ raised its target for reserves it makes available to lenders to as much as 27 TR yen from the previous 22 TR yen. Sales of new automobiles in Japan dropped 6.5% YoY in April, the first decline in eight months. According to the Finance Ministry of Japan, Japan's tax revenue in March fell for the 19th straight month. Steel exports fell 3.4% YoY in March due to less demand from China. The benchmark TOPIX Index was up 0.03% in April.

KOREA
South Korea's Finance Minister Kim Jin Pyo said the government plans to increase spending to help stem an economic slowdown and will seek parliamentary approval for the proposal in June. In April, South Korea's exports grew 20.3% YoY to US$15.9 BL, faster than the 16.3% YoY growth in March. South Korea's consumer prices fell for the first time in six month in April as crude oil prices came down. South Korea's consumer loan defaults rose for a ninth month in March, up 4.1% MoM. The benchmark KOSPI Index was up 15.49% in April.

MALAYSIA
Malaysia's March trade surplus surged 27.5% to US$1.65 BL. Total exports jumped 23.7% MoM in March. Malaysia's money supply expanded 6.8% YoY in March. Malaysia's tourist arrivals fell 36% YoY in April. Tourism was Malaysia's second biggest foreign exchange earner last year. Malaysia's automobile sales dropped 5.5% in March. The benchmark KLCI Index was up 0.02% in April.

PHILIPPINES
Philippine's inflation rate rose 3.1% YoY in April. Also in April, the government revised its 2002 trade balance to a US$219 MM deficit from a US$1.6 BL surplus, as it adjusted total imports. The Philippine tax bureau failed to meet its monthly collection target in March, making it harder for the government to achieve its first-quarter budget deficit estimate of US$1 BL. The benchmark PCOMP Index was up 4.75% in April.

SINGAPORE
In the first quarter of 2003, Singapore's economy shed jobs for the seventh straight quarter as manufacturers and property developers fired workers. Total employment shrank by 9,400 in the

first quarter of 2003. Singapore's unemployment rate rose to 4.5% in March. Singapore's manufacturing revived in March, up 6.5% YoY, as pharmaceutical companies expanded production by 50%. The benchmark STI Index was up 1.35% in April.

TAIWAN

Taiwan's money supply growth slowed to 2.2% YoY in March, following a 2.5% YoY growth in February. Taiwan's unemployment rate was little changed at 5.2% in March. It reported robust growth in exports and imports in March, as intra-Asia demand remained strong. Exports jumped 10.2% YoY in March. The benchmark TWSE Index was down 4.27% in April.

THAILAND

Thailand's industrial production grew more than expected in March. Production rose 12.7% YoY in March, more than the expected 9.6% growth. Thailand had a US$168 MM budget surplus in March as an expanding economy boosted tax collections. In April, Prime Minister Thaksin Shinawatra said Thailand and India may sign an agreement by September to expand trade in services, farm products and other goods. The benchmark SET Index was up 4.65% in April.

What is Asia?
Continued from front page

is some cultural bias here that structurally underweights Asian markets versus North American and European markets.

When one comes to the regional MSCI Asia Pacific universe, one has the choice of going with Asia Pacific, which includes Australia and New Zealand, or just Asia. Despite Japan's long decline, it still dominates with 59.3% of the Asia Pacific universe and 71.1% of Asia. Australia makes up 15.8% of Asia Pacific, a larger weighting than South Korea, Hong Kong and Singapore combined! When a passive portfolio (and there are a couple) uses the MSCI Asia Pacific ex-Japan index, the result is a large weighting in Australia along with some Hong Kong, Singapore and New Zealand. This is a rather unique creation from our perspective driven by the imaginary distinction between a "developed" and an "emerging" market, rather than any investment logic.

When one finally gets down to the benchmarks for our two Asia ex-Japan funds, the MSCI All Country Far East Free ex-Japan Index, one finds a fairly logical universe that has South Korea at 27.8%, Hong Kong at 20.8%, Taiwan at 18.3% and Singapore at 11%. The distorted part of the index, from our perspective, is that China accounts for only 9.2%, Thailand for only 2.7% and Indonesia at 1.7%.

If this all sounds a bit convoluted, one must realize that MSCI actually has more indices than companies that it includes in all of its universes. The decisions in "passive" index construction are actually highly active and just as prone to bias and illogic as any active managers' stock selection. Korea is an emerging market and Greece is a developed market. How many Greek cars, TVs, mobile phones or large NYSE listed ADRs are you aware of?

It also appears just as active to pick between the 11,000 plus index choices, as it is to pick stocks in a logical universe. We have long believed that indices in rapidly evolving economies and financial systems are very backward looking, reflecting the Asia that is disappearing, and not necessarily the Asia one wants to invest in. We remain comfortably off-benchmark in all of our portfolios.

Note: All MSCI weightings are as of April 13, 2003 except for the global and emerging markets weightings that are as of Oct. 31, 2002 .

Mark W. Headley
President and Portfolio Manager

Your comments are welcome. Please e-mail them to info@matthewsfunds.com.