Matthews Asia

Matthews Asia Credit Opportunities Fund

Period ended 30 June 2018

For the first half of 2018, the Matthews Asia Credit Opportunities Fund returned -3.26% while its benchmark, the J.P. Morgan Asia Credit Index (JACI), returned -2.55% over the same period. For the quarter ending 30 June, the Fund returned -3.92% compared to the benchmark return of -1.20%.

Market Environment:

The first half of the year was notable for the volatility in financial markets across the world. U.S. Treasury yields moved higher as the U.S. Federal Reserve raised interest rates. Continued solid economic data in the U.S. has increased rate hike expectations for the remainder of 2018 and 2019. Meanwhile, concerns around trade wars, the reversal of investor flows and politics in Latin America led to a sell-off across emerging markets.

Asia's credit markets were not immune to this volatility. In the second quarter, Asian high yield credit spreads widened by 100 basis points (1.0%). Returns were largely negatively correlated to risk, with longest duration and highest spread bonds selling off the most. By country and sector, Chinese issuers came under pressure as policymakers onshore kept credit markets tight, while Indonesian issuers were weak as the Indonesian central bank raised interest rates to combat depreciation of the Indonesian rupiah. Rising interest rates and widening credit spreads created a challenging market environment in the second quarter.

Performance Contributors and Detractors:

Our holdings from China were broadly positive performance contributors for the first half of the year. In the second quarter, the biggest contributor to portfolio returns was our holdings in the bonds of Chinese property developer KWG Property Holding, as well as the bonds of DFCC Bank in Sri Lanka. The bonds of Chinese property developers have been under pressure this year as spreads have widened and credit conditions continued to be tight in onshore China. KWG is a high-quality developer with ample liquidity and solid prospects. DFCC Bank bonds mature in October, and given their short remaining life, we earned attractive coupon with little price volatility by owning them.

Among the largest detractors in the second quarter were sub-investment grade Indonesian corporate bonds issued by Lippo Karawaci[1] and Modernland, and the convertible bonds of CP Foods, a Thai company. Lippo Karawaci and Modernland are both property developers in Indonesia. Bonds performed poorly in the quarter as high yield spreads widened, and the Indonesian central bank raised interest rates to help stabilize the rupiah, potentially dampening property purchases in the country. CP Foods's convertible bonds performed poorly as its subsidiary CP All's shares corrected on softer growth.

Notable Portfolio Changes:

In the second quarter, we started a number of new positions in high yield and convertible bonds. As high yield spreads widened and expectations for rate hikes from the U.S. Federal Reserve increased, we added shorter duration bonds with mid-single digit yields, which we expect will have limited interest rate sensitivity while earning reasonable returns. We opportunistically added bonds of Chinese property issuers such as KWG Property Holding after they fell in price. We also added the convertible bonds of companies, including those of Johnson Electric, one of the largest producers of micro motors in China; Zhongsheng Group, a leading Chinese auto-dealership; and China Overseas Land & Investment, a high-quality Chinese property developer.

We also closed a handful of positions during the second quarter. We exercised our put on the convertible bonds of Saratoga Investama[2], an Indonesian holding company with stakes in leading Indonesian companies, as we saw limited upside in continuing to hold the bonds. Our bonds of China Hongqiao Group, the largest aluminum producer in the world, matured.

Outlook:

In our view, Asia high yield bonds appear attractively valued, while U.S. and European high yield bonds appear overvalued. Credit spreads for Asia high yield bonds are almost 100 basis points (1.0%) higher than historic averages. In contrast, spreads for U.S. and European high yield bonds are about 200 basis points (2.0%) below average. In simple terms, Asian high yield bonds are compensating investors for taking credit risk, in our view, while U.S. and European high yield bonds are not.

To be sure, risks remain on the horizon. If a further slowdown in global growth materializes, we expect investor appetite for emerging markets to diminish. Any escalation in trade shocks or further outflows stemming from policy normalization in the U.S. also could put pressure on Asian fixed income markets. Finally, the demand for Asian high-yield bonds from Chinese wealth managers might fall as the wealth management channels through which buyers purchase bonds are being more closely regulated.

While these risks could increase, we believe that much of this is already being priced in. We have been expecting volatility to rise over the course of 2018, and that was certainly the case in the second quarter. Asian credit markets will likely remain volatile in the second half of 2018, but we believe it is imperative that we stay the course and not sell into the volatility. Based on our solvency and liquidity analysis, we do not expect any of the securities in the portfolio to default. As such, the relatively attractive yields in Asia offer a strong base for positive returns. A bond that starts with a 5% to 8% yield and has 25 basis points (0.25%) of credit spread compression, for example, could generate attractive returns for investors over the course of the year.

[1] Lippo Karawaci is listed as Theta Capital Pte, Ltd.
[2] Saratoga Investama is listed as Delta Investment Horizon International, Ltd.

Rolling 12 Month Returns for the period ended 31 December 2017

Matthews Asia Credit Opportunities Fund	**2017**	**2016**	**2015**	**2014**	**2013**
I (Dist) (USD)	8.16%	10.42%	n.a.	n.a.	n.a.
J.P. Morgan Asia Credit Index (USD)	5.77%	5.81%	n.a.	n.a.	n.a.
I (Dist) (GBP)	-1.38%	32.84%	n.a.	n.a.	n.a.
J.P. Morgan Asia Credit Index (GBP)	-3.38%	26.21%	n.a.	n.a.	n.a.

Risk Considerations

The value of an investment in the Fund can go down as well as up and possible loss of principal is a risk of investing. Investments in international and emerging market securities may involve 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. The Fund may invest in the following: derivatives which can be volatile and affect Fund performance; high yield bonds (junk bonds) which can subject the Fund 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 Fund invests in holdings denominated in foreign currencies, and is exposed to the risk that the value of the foreign currency will increase or decrease. These and other risks associated with investing in the Fund can be found in the Prospectus.

Performance figures discussed in the Fund Manager Commentary above reflect that of the Institutional Distribution Class Shares and has been calculated in USD. Performance details provided for the Fund are based on a NAV-to-NAV basis, with any dividends reinvested, and are net of management fees and other expenses. Past performance information is not indicative of future performance. Investors may not get back the full amount invested.

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Investors should not invest in the Fund solely based on the information in this material alone. Please refer to the Prospectus for further details of the risk factors.

Sources: Brown Brothers Harriman (Luxembourg) S.C.A, Matthews Asia, FactSet Research Systems, Bloomberg

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before investing.

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