Matthews Asia

Matthews Asia Focus Fund

Period ended 30 June 2018

For the first half of 2018, the Matthews Asia Focus Fund fell -7.33% while its benchmark, the MSCI All Country Asia ex Japan Index, returned -4.65%. For the quarter ending 30 June, the Fund returned -4.16% compared to the benchmark return of -5.31% over the same period.

Market Environment:

Following almost two years of extremely low volatility and strong equity market performance in Asia, the first half of the year was far choppier and markets ended lower. This can be attributed to a number of macroeconomic and policy-related factors. Monetary tightening in the U.S. through interest rate rises and a reduction of the U.S. Federal Reserve's balance sheet has tightened U.S. dollar liquidity, while monetary conditions also tightened in China. Additionally, significant political risks re-emerged within Europe in the first half of the year. But the resumption of President Trump's trade war rhetoric and planned tariffs swung sentiment into negative territory. This has focused on China in particular, with an initial US$34billion of tariffs to be imposed on imports from China in early July. This number will increase over time. China has responded in equal measure, resulting in an escalated trade war that is economically disruptive for all.

These factors have sparked concern that the globally synchronized growth environment of the past couple of years has passed. Asian equities and currencies have dropped significantly from their peaks in January, with the markets of China and Taiwan holding up marginally better than others.

Performance Contributors and Detractors:

During the first six months of 2018, the largest contributors to returns came from the portfolio's holdings in Australia. The best performer, Macquarie Group, has diversified its business beyond investment banking to become a vertically integrated asset manager capable of delivering stable growth among Australian financial institutions through business cycles. The stock rallied as the market started to appreciate this business model transformation.

In addition, our holdings in the consumer staples sector contributed positively. Heineken Malaysia, a leader in Malaysia's premium beer segment, performed strongly as it delivered above-market growth and benefited from the new government's policies. Meanwhile, shares of Singaporean supermarket chain Sheng Siong Group gained as it offered earnings certainty amid market volatility with its store network optimization and defensive operating cash flow.

The largest detractor to relative returns during the first six months of 2018 came from holdings in the China/Hong Kong markets. Shares of NetEase, a Chinese online game company, declined as investors worried about the lack of new hit game titles and the firm's investment in e-commerce. We think NetEase's franchise value—as the second-largest online game platform in China—remains underappreciated. We also like management's disciplined approach in developing a niche e-commerce strategy. More recently our holdings in Indonesia and the Philippines declined amid global emerging market volatility and foreign fund outflow. For instance, shares of Bank of the Philippine Islands declined to 1.9x price to book, their lowest valuation since 2010. We believe this strong franchise is now attractively valued, as its business is holding up well on measures including loan growth, nonperforming loan ratio and capital sufficiency.

Notable Portfolio Changes:

We added three new positions during the second quarter: ING Life Insurance Korea, Johnson Electric Holdings and JNBY Design.

ING Life Insurance Korea is a high-quality life insurance company in South Korea with a strong management team. Its solvency margin is significantly higher than its peers, making it well-positioned to gain market share amid tighter capital rules. The stock is attractively priced at 9x forward price-to-earnings ratio and offers a 6% dividend yield.

Hong Kong-listed Johnson Electric Holdings is a leading micro-motor maker that benefits from demand driven by the global trend of vehicle electrification. Market concerns of trade wars led to broad weakness in automotive parts manufacturers including Johnson Electric, even though the impact to the company is limited. At 5x enterprise value-to-EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) and 8x forward price to earnings, Johnson Electric is undervalued for its long-term growth in our view.

Additionally, we initiated a position in JNBY Design, an emerging leader in the designer fashion industry in China. Through its successful social media marketing and customer analytics, JNBY Design rides on the tide of consumption upgrades in China and has built a large number of loyal customers, whose purchases accounted for 63% of its total retail sales in the fiscal year ending in June 2017.

During the second quarter, we exited our holding in Heineken Malaysia. The company operates in a duopolistic industry and benefits from the newly elected government's plan to remove Malaysia's goods and services tax (GST). However, after the recent rally, we believed its valuation fully reflected its moderate growth opportunities. In addition, we exited our holding in Tata Motors, which had disappointed investors with its sales performance and investment plans.

Outlook:

The reasons for caution in allocating capital have been increasing and are fairly plentiful at this late stage of the global equity market cycle. The reduction in U.S. dollar liquidity alongside rising autocracy, protectionism, trade wars, reasonably high valuations, significant leverage and the dangers of market dislocations perpetuated by the rise of passive investing are all concerning. Although these may not spark major market declines, particularly against a backdrop of seemingly solid economic growth, these are likely to contribute to a sustained rise in volatility.

For the Matthews Asia Focus Fund, this is an appealing backdrop. Not only is there still solid economic and corporate profit growth in Asia over both the short and long term, but this volatility may provide long-term investors with the ability to purchase shares of high-quality companies at attractive price points. We will look to take advantage of any dislocations to add to our stable of emerging and established leading companies, while the Fund was already trading by 30 June at an appealing 15.0x forward P/E after recent declines.

Rolling 12 Month Returns for the period ended 31 December 2017

Matthews Asia Focus Fund	**2017**	**2016**	**2015**	**2014**	**2013**
I (Acc) (USD)	36.78%	4.13%	-12.71%	n.a.	n.a.
MSCI All Country Asia ex Japan Index (USD)	42.08%	5.76%	-8.90%	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. 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. The Fund invests primarily in equity securities, which may result in increased volatility. Investments in focused funds may be subject to greater share price volatility as a larger portion of their assets may be invested in the securities of a single issuer compared to diversified funds. 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 Accumulation 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 before investing.

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