Matthews Asia™

Matthews India Fund

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Period ended 31 March 2018

For the quarter ending 31 March 2018, the Matthews India Fund returned -3.30% while its benchmark, the S&P Bombay Stock Exchange 100 Index returned -6.33%.

Market Environment:

India's economic growth and corporate earnings seemed to be on a path to recovery during the first quarter of the year. The GDP growth rate recovered to 7.2% in the fourth quarter (the last quarter for which data was available) of last year from its lows of 5.7% in June. Industrial growth—as measured by the Index of Industrial Production—also rose considerably to about 7.4% in January. The Indian rupee weakened, although within acceptable limits. In February, inflation moderated to 4.4% from a high of 5.21% in December. India's central bank (RBI) still took a neutral stance over monetary policy, however, given the upside risks. Government bond yields moderated somewhat during the first quarter, and improving macroeconomic fundamentals gave authorities the confidence to raise caps on foreign investments in debt and issued additional rupee-denominated bonds from overseas markets.

During the first quarter, foreign institutional investor flows were US$2.1 billion—in line with the pace last year when it received US$8.0 billion for the entire year. Domestic flows also have been rising and recovering as the financialization of savings has accelerated amid positive real interest rates and the implementation of both the government demonetization and the Goods and Services Tax (GST).

Despite the solid investment flows and improving growth trajectory, India's market corrected, led by cyclical stocks such as state-owned banks, metals and commodities, real estate, and automobiles, and by small and mid-cap companies whose valuations have been much higher than historical averages. Market sentiment was weighed down by the unearthing of a US$1.8 billion scandal at India's second-largest state-owned bank, the tightening of norms by the RBI for early recognition of bad loans and fears over the possibility of a rate increase. The introduction of a federal government tax on long-term capital gains also was a setback.

Performance Contributors and Detractors:

The portfolio's relative outperformance during the quarter could be attributed to limited exposure to high beta stocks such as corporate lenders, including state-owned banks, as well as metals and commodities. Our holdings in some retail-focused banks and non-banking finance companies generally held up well during the quarter, and in some cases delivered positive returns. Additionally, secularly growing auto names in the portfolio, such as Eicher Motors and Suzuki Motors, weathered the recent correction in the auto industry better than their peers.

Among the detractors to Fund performance were some stock-specific factors within the information technology (IT) and consumer-related sectors. For example, eClerx Services, a knowledge process outsourcing firm, has not benefited from the revival seen in the IT industry, as it is more adversely affected by robotics and automation compared to its peers. However, the company has been able to grow its client base, albeit at a higher cost, and should be able to eventually acclimatize to the evolving industry dynamics. Another of our holdings, personal products company Emami, posted disappointing results during the quarter, and has been slow to recover even six months after the blow caused by the implementation of the GST. Its acquisition of hair oil maker Kesh King has yet to deliver the anticipated benefits. We expect that the company should, however, return to its regular business operations as it manages its integration of Kesh King and fixes some distribution issues. We still like Emami's strong and leading brands in some key personal care categories.

Notable Portfolio Changes:

During the quarter, we added some positions across sectors such as financials, industrials and consumer discretionary. One such holding was InterGlobe Aviation, India's most profitable airline with a market share of nearly 40%. The company's sustainable competitive advantage has been its ability to source aircraft more cheaply than its peers in India. The company has benefited from rising air travel, as well as its increased market share. While the risks of rising oil prices, capacity issues at major airports and some teething issues with the introduction of newer fuel-efficient engines remain, we believe the company is better-equipped to handle these risks than other players in India.

Outlook:

India's near-term economic recovery could continue amid improved tax-collection efforts. The government has ambitious plans for infrastructure investment to create jobs in the run-up to 2019 national elections, and the fiscal deficit may exceed its target. Rising oil prices and a weakening currency could also keep upward pressure on inflation, and the RBI may need to reverse course from its accommodative stance. Private capital expenditure also may take some time to recover amid utilization rates that are still not high, but we expect this to improve within a couple of years.

There is also hope of a recovery for ailing corporate lenders as the framework offered by the recently implemented bankruptcy code has achieved some success in disposing of some large bad assets, especially in the steel sector. More groundbreaking reforms, such as the privatization of state-owned banks, may not happen anytime soon, given the political support required. The near- to medium-term reported earnings for corporate lenders also may not be positive as lenders are forced to recognize bad loans and make provisions. We believe other sectors should see a continued revival in their earnings trajectory, however, in line with the economy.

Rolling 12 Month Returns for the period ended 31 March 2018

Matthews India Fund	2018	2017	2016	2015	2014
I (Acc) (USD)	12.18%	22.51%	-15.85%	50.22%	6.67%
S&P Bombay Stock Exchange 100 Index (USD)	11.64%	25.21%	-12.92%	25.08%	9.31%
I (Acc) (GBP)	-0.49%	41.30%	-13.63%	69.20%	-2.93%
S&P Bombay Stock Exchange 100 Index (GBP)	-0.74%	43.71%	-10.19%	40.58%	-0.57%

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 currency, 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 a single-country fund may be subject to a higher degree of market risk than diversified funds because of concentration in a specific country. 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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Sources: Brown Brothers Harriman (Luxembourg) S.C.A, Matthews Asia, FactSet Research Systems, Bloomberg

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