Matthews Asia

Matthews Japan Fund

Period ended 30 June 2018

For the first half of 2018, the Matthews Japan Fund returned -0.50% while its benchmark, the MSCI Japan Index, returned -1.85%. For the quarter ending 30 June, the Fund returned -3.76%, underperforming its benchmark, which returned -2.80% over the same period.

Market Environment:

Following a somewhat euphoric rise in January and quick correction in February, Japan's equity markets traded in a tight range before retreating toward the end of the second quarter. Tariff measures by the Trump administration signaled an escalation in trade war rhetoric and heightened uncertainty, resulting in a compression of valuations across global markets, including Japan. Foreign investors remained net sellers of Japanese equities, likely related to fund flows out of non-U.S. equities.

Japan's first-quarter GDP figures, meanwhile, showed the economy shrank for the first time in two years on a quarter-on-quarter basis due to weak private residential investment, inventory drawdown and a slight decline in consumer spending. We expected this contraction and believe it is reasonable after the longest spate of growth in almost three decades.

Performance Contributors and Detractors:

For the year-to-date period, the Fund's information technology and health care holdings did well, while our lack of exposure to utilities and stock selection in telecommunication services posed a drag on performance. During the second quarter, the Fund's underperformance versus its benchmark was largely due to stock selection, particularly in the industrials and health care sectors. Within industrials, shares of human resource solutions provider Persol Holdings corrected after the company announced weaker-than-expected guidance for the March 2019 fiscal year. Shares of automation-related companies such as CKD and Harmonic Drive also weakened as concerns have emerged about a cyclical peak in orders. In health care, shares of biopharmaceutical company PeptiDream declined after particularly strong performance in the previous quarter despite positive business developments for the company.

On the other hand, our positioning in the materials and financials sectors contributed positively to performance. Our lack of exposure to large-cap chemical and steel companies helped as tariff actions and rising oil prices compressed valuations in the materials sector. In financials, our core holding Tokio Marine, Japan's leading non-life insurer, outperformed on the back of an improved earnings outlook combined with higher scope for shareholder returns in the form of dividends and share buybacks.

On an individual basis, fashion e-commerce company Start Today was the top performer as it announced its long-awaited entry into private label apparel. The company aims to deliver custom-made apparel using body size measurement data collected through their proprietary app. Conversely, shares of Ferrotec, a manufacturer of silicon wafers and components for semiconductor production equipment, corrected sharply as production at its Shanghai silicon wafer fab was temporarily halted to comply with environmental regulations.

Notable Portfolio Changes:

During the quarter, we initiated a position in Terumo, a leading Japanese medical equipment company. Terumo saw growth accelerate for its neurovascular and access devices, which carry higher margins relative to corporate averages. The field of neurovascular treatments is an exciting area with new devices and procedures being developed to treat brain aneurysms and strokes. Terumo's U.S. subsidiary Microvention, acquired back in 2006, is a major player in the neurovascular market. We also initiated a position in real estate technology company Tateru. Tateru's main business is to plan and construct apartment buildings in urban areas for individual investors. Most of the sales and servicing is conducted through its app, allowing it to be more cost-efficient than brick-and-mortar competitors. Recently, it has expanded into room share-type properties that could benefit from the influx of foreign tourists.

To fund these positions, we exited our positions in Japan Tobacco, Sumitomo Mitsui Financial Group and Dai-ichi Life Holdings. Japan Tobacco lost market share in the domestic Japanese market as reduced-risk products, also known as heat-not-burn products, from Philip Morris International gained significant market share over the past several years. Japan Tobacco has released its own reduced-risk product but we deemed that it faced a significant hurdle to regain pricing power in the market. Sumitomo Mitsui Financial Group and Dai-ichi Life Holdings are two financials that we expected to benefit from rising interest rates in the U.S. Broader concerns about growth prospects, however, kept a lid on their stock prices and we decided that the funds could be better deployed elsewhere in companies with more attractive growth prospects.

Outlook:

We remain cautious about the outlook for Japanese equities. The biggest risk is with the Trump administration's continued actions on trade. We believe a trade war is bad for all global market participants, including U.S. consumers and Japanese businesses. The most recent Bank of Japan quarterly Tankan survey results showed a downward revision in corporate earnings forecasts compared to the previous quarter, likely reflecting a heightened level of uncertainty among corporate managers. In addition, rising fixed costs and higher fuel costs also are expected to weigh on earnings.

However, the same survey results also showed an upward revision on capital expenditures as the near-term demand environment remains robust. The recent acceleration in wage growth amid record levels of employment gives us some encouragement regarding the outlook for the domestic economy. Wage growth combined with continued strength in business spending may drive an improvement in domestic growth. While we retain a generally cautious tone, we believe valuations in Japan have compressed to levels where equities are modestly attractive and reasonably priced.

Rolling 12 Month Returns for the period ended 31 December 2017

Matthews Japan Fund	**2017**	**2016**	**2015**	**2014**	**2013**
I (Acc) (USD)	33.40%	0.19%	n.a.	n.a.	n.a.
MSCI Japan Index (USD)	24.39%	2.73%	n.a.	n.a.	n.a.
I (Acc) (GBP)	21.57%	20.43%	n.a.	n.a.	n.a.
MSCI Japan Index (GBP)	13.62%	22.53%	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. 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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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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