
Matthews Japan Fund

Period ended 30 September 2018

For the quarter ending 30 September 2018, the Matthews Japan Fund returned 0.07% while its benchmark, the MSCI Japan Index, returned 3.82%.

Market Environment:

Japan's equity markets traded within a tight range for most of the third quarter followed by a strong rally into the quarter end. Market sentiment around the deepening trade spat between the U.S. and China resulted in a compression of valuation multiples despite better-than-expected earnings reported by Japanese listed companies. Overseas investors remained net sellers of Japanese equities during the quarter, though the pace of selling subsided.

Meanwhile, Japan's economy delivered solid annualized growth, at a rate of 3% in the second quarter of 2018, driven by robust private sector capital expenditure. This comes on the heels of a slight contraction during the previous quarter and provides comfort that domestic economic conditions remain healthy. Strong demand conditions, rising wages and labor shortages are prodding companies to reinvest in their business to enhance productivity. Steady job creation combined with rising wages is leading to an increase in total employment income, supporting domestic consumption.

Performance Contributors and Detractors:

During the quarter, the Fund underperformed the benchmark as both sector allocation and stock selection detracted from returns. The largest detractor was the consumer discretionary sector as fashion e-commerce company Zozo (formerly known as Start Today) slumped as it failed to meet heightened expectations for its private-brand apparel business. We had trimmed our position, but not enough, as valuations became expensive. Dollar-store operator Seria also struggled amid weak sales delivery and higher costs. Holdings in the health care sector also detracted from performance. Hematology equipment company Sysmex, a core long-term holding for the Fund, missed quarterly consensus estimates as some order deliveries were pushed out to future quarters. Japan Lifeline, a manufacturer and wholesaler of cardiovascular equipment, declined following weak quarterly earnings that resulted from reimbursement price cuts and increased expenses in preparation for new product launches.

On the other hand, our telecom holding SoftBank performed well. SoftBank traded at a significant discount to estimated net asset value, and transparency should rise as it gears up to list its domestic mobile telecom business. Marketing media and HR technology company Recruit Holdings also contributed positively on the back of the rapid growth of job search engine business Indeed. Indeed continues to drive revenue growth as it expands into non-U.S. markets, including Japan.

The largest negative contribution came from real estate tech company Tateru, which was a recent addition to the portfolio. During the quarter, Tateru disclosed that one of its employees had intentionally falsified loan application documents in order to obtain an apartment loan for a customer. Although the stock declined significantly following the disclosure, we immediately exited the position.

Notable Portfolio Changes:

We did not initiate any new positions in the portfolio during the third quarter. We did, however, exit our long-held position in mining and construction equipment company Komatsu. We expect sales momentum in its construction equipment business in China will likely weaken going forward due to the slower-than-expected progress of infrastructure projects. At the same time,

profit margins for its mining equipment have improved substantially and we believe further improvements have already been priced in.

We also exited robotic gear company Harmonic Drive Systems. This was another long-term holding for the Fund that had contributed significantly over the years. We believe orders for robotics reached a cyclical peak last year and expect growth momentum to slow going forward. Additionally, we saw new participants in the robotics gears industry and were concerned that increased competition might erode the company's future pricing power.

Outlook:

We are turning slightly more optimistic regarding the outlook for the Japanese economy. Robust job creation combined with a structural labor shortage is translating to faster growth of employment income. This, combined with an expected expansion of fiscal spending, may allow Japan to better cope with the consumption tax hike scheduled for 2019. Additionally, based on our bottom-up research, it seems consumer prices are actually rising faster than what the government's consumer price index statistics suggest as companies adjust pricing to account for higher wages. This is prompting aggressive investment into automation and IT systems, which we believe will serve to enhance productivity and improve margins in the future.

However, we remain cognizant of the external risks for Japan's economic growth and equity markets. Higher U.S. dollar interest rates and a tighter dollar supply are raising funding costs in many emerging economies and leading to a softening of demand. With our emphasis on growth in the region, we are starting to feel the impact through our portfolio companies. We are actively revisiting the investment thesis for our Asia-exposed businesses and will continue to focus our research on identifying unique bottom-up opportunities that we believe will add value over the long term.

Rolling 12 Month Returns for the period ended 30 September 2018

Matthews Japan Fund	2018	2017	2016	2015	2014
I (Acc) (USD)	8.21%	13.69%	21.10%	n.a.	n.a.
MSCI Japan Index	10.57%	14.46%	12.52%	n.a.	n.a.
I (Acc) (GBP)	11.01%	10.01%	41.74%	n.a.	n.a.
MSCI Japan Index (GBP)	13.76%	10.82%	31.21%	n.a.	n.a.
I (Acc) (USDH)	11.07%	n.a.	n.a.	n.a.	n.a.
MSCI Japan 100% Hedged to USD	13.64%	n.a.	n.a.	n.a.	n.a.
I (Acc) (EURH)	8.41%	n.a.	n.a.	n.a.	n.a.
MSCI Japan 100% Hedged to EUR	10.73%	n.a.	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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Sources: Brown Brothers Harriman (Luxembourg) S.C.A, Matthews Asia, FactSet Research Systems, Bloomberg

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