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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.

Matthews Asia Perspective

A Primer on the Matthews India Fund

Key Points

- ✿ India remains in the early stages of economic development, providing a long runway for growth.
- ✿ Volatility is a constant companion when investing in India.
- ✿ India’s economy can make headlines for any number of macroeconomic reasons.

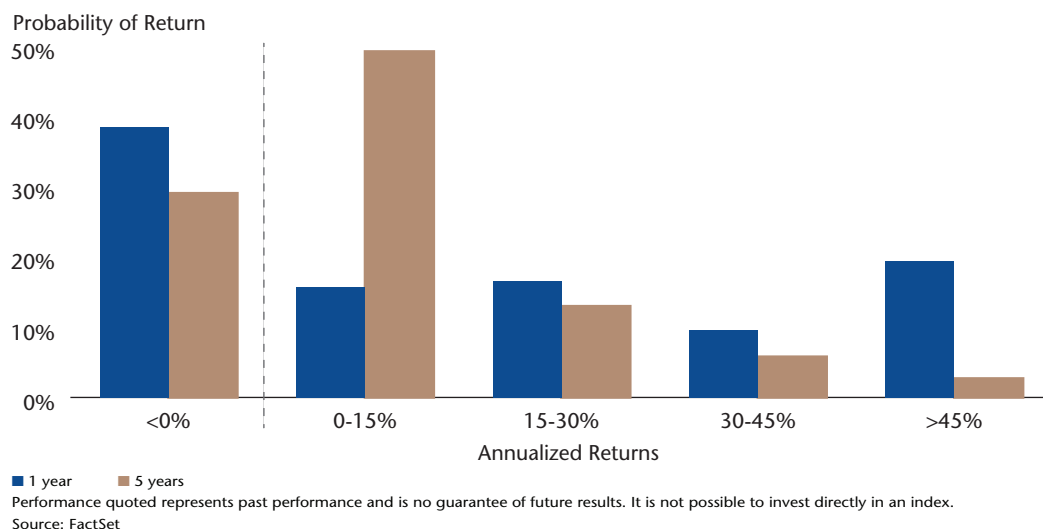
Why should investors consider an allocation to Indian equities?

With a large and youthful population, India remains in the early stages of economic development, providing a long runway for growth. More than 50% of India’s citizens are younger than 25,¹ creating a substantial workforce to help foster continued development. Annual GDP growth has averaged 6.21% from 1951 until 2018,² and we believe growth could continue within a similar range. In addition, market reforms are building a stronger foundation for India’s domestic economy. The Goods & Services Tax (GST), for example, makes trade easier between India’s regional states, favoring businesses with national aspirations and operations. The GST is also moving more money out of the informal economy into the formal economy by way of bank accounts and investment accounts, enabling more efficient tax collection. While it is exciting to tap into the growth of India, investing in Indian equities requires a very long time horizon and a clear understanding of the risk profile of the asset class.

What are some of the risks investors should consider before investing in Indian equities?

Volatility is a constant companion when investing in India. In any rolling 12-month period over the past 20 years, the Indian equity market has produced negative returns nearly 40% of the time (See Figure 1). The Indian stock market can quickly drop (and quickly rebound), so investors should carefully consider their risk tolerance and time horizon. In contrast, the market has often generated attractive positive returns over five-year rolling time periods. Investors need the patience and fortitude to stay invested through the market cycles to realize those longer term gains.

Figure 1. Distribution of Rolling Returns for the Bombay Stock Exchange 100 Index (December 1989–March 2019)



What drives the volatility of India's equity market?

Macroeconomic conditions can shift based on changes in oil prices, inflation, currency fluctuations and election cycles. India imports virtually all of its energy, so rising oil prices tend to dampen short-term economic growth and can contribute to inflation. India's currency can be highly pegged to changes in commodity prices, such as oil, so the Indian rupee is particularly exposed to trends in global capital markets in that regard. And while investors may feel bearish or bullish toward India depending on the outcome of any individual elections, the longer trend in India's political landscape tends to be one of rotating power among different political parties every couple of election cycles. As active, bottom up managers, we look for companies that can grow with or without macro tailwinds, a process we'll discuss in detail later in this article.

What does it mean to take a macro-agnostic approach to investing in India?

India's economy can make headlines for any number of macroeconomic reasons, from election results to the progress of economic reforms. We generally look for companies that can thrive regardless of the macro environment. Inflation can often erode the bottom line for Indian companies, so we seek to invest in companies with pricing power that can keep pace with inflation and the high cost of capital. This requires an active approach to security selection and in-depth proprietary research to identify those companies that can sustain their growth across a range of macroeconomic conditions. We tend to prefer companies with management that has more control over the companies' destinies and can better navigate headwinds in the macro environment. Such companies do tend to benefit from growth sparked by reforms, but these companies are not necessarily uprooted if reforms do not take place.

What defines an attractive growth company?

We seek to invest in companies with a sustainable competitive edge and pricing power, which are able to perform throughout economic cycles and are not tied to—but may benefit from—economic reforms. The Matthews India Fund is positioned to potentially benefit from a rise in India's capital spending, with limited exposure to policy-dependent companies and sectors. We also take an all-cap approach to investing. Small- and mid-size companies continue to be an important focus due to the availability of quality companies with solid growth potential. Some small caps in India can be less liquid, which we discuss in the next section, but other small caps offer enough liquidity for us to consider as long-term investments and we find this segment a compelling piece of the market.

Why does active security selection matter when investing in Indian equities?

India's stock market universe is large and diverse, representing more than 5,000 stocks. However, more than three quarters of these companies are microcaps and small-caps. Many of the smallest companies have very low trading volumes, making them essentially illiquid. This lack of liquidity creates a natural barrier for ETFs and other index strategies trying to match the benchmark because many securities cannot be bought and sold daily. Accordingly, ETFs tend to skew toward larger stocks and are not necessarily representative of their underlying benchmarks.

Once you get past the liquidity issue, there's also a broad range of quality in the marketplace. We tend to avoid public sector banks, for example, because of lack of transparency and poor corporate governance in that particular industry. We also tend to be underweight state owned enterprises for the same reasons.

Finally, with higher inflation rates and interest rates compared to other countries in the region, Indian companies have a high hurdle rate regarding cost of capital right out of the gate. Thus, to compensate, Indian companies need to have a high return on equity. As active investors, we look at a company's cost of capital as well as its return on capital very closely so as to pick those companies that can create value over the long-term, in contrast to the indexes which simply track the universe. Identifying companies that can generate sustainable growth even when macroeconomic conditions are unfavorable requires skill, expertise and deep knowledge of the individual companies that make up the marketplace.

What type of investors might be interested in the Fund?

The Fund may appeal to investors who are building their emerging markets exposure country-by-country and who seek an active approach to portfolio construction and risk management. For these investors, the Fund can complement other emerging markets holdings within the context of a broadly diversified portfolio. Regardless of the size of the investor or investment, we encourage all investors to carefully consider their goals, risk tolerance and time horizon before investing in the Fund.

What differentiates the Matthews India Fund from its peer group?

First and foremost is the culture of our investment team, a culture fostering independent thinking based on informed, bottom-up research. Within the Matthews Asia investment team, we actively debate ideas and bring in multiple perspectives. In contrast, some asset managers based in India tend to be built around a hierarchical

pecking order, in which analysts cannot openly challenge their boss with a dissenting viewpoint. At Matthews Asia, we encourage civilized dissent to make sure that we are examining investment ideas from every angle. Second, taking an investment approach that is market-cap agnostic allows us to go where the value is. And third, working within a firm focused exclusively on Asia brings in a rich range of perspectives on sectors such as technology and health care, where innovation tends to drive returns.

Using a team-based approach means we can draw upon multiple perspectives when making investment decisions. Investing in India is exciting, challenging and volatile, but we believe we have the right expertise and team to generate long-term alpha for investors. As always, we take a long-term approach, stay diversified and seek to invest in companies with the potential to generate attractive returns across a full market cycle.

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1 Source: India Census
2 Source: Trading Economics

For Institutional/Professional Investors Only

The Fund is a sub-fund of Matthews Asia Funds SICAV, an umbrella fund, with segregated liability between sub-funds, established as an open-ended investment company with variable capital and incorporated with limited liability under the laws of Luxembourg.

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