

Matthews Asia Perspective

Matthews Japan Fund Reaches a Three-Year Milestone



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Three years ago when the Matthews Japan Fund launched, I was certainly bullish on the prospects for Japanese companies. The degree to which the market has risen since then has surprised on the upside. Since inception, the Fund delivered an annual performance of 11.98% versus 7.71% from the MSCI Japan Index through 30 April 2018. Allocation to small cap companies, as well as an overweight to Industrials, Health Care and Financials contributed to the outperformance of the Fund.

The last three years have proven a favorable environment in which to invest. A combination of structural reforms, a stable political environment and consistently easy monetary policy has revitalized the country's economy since 2012. Thanks to the changes in corporate governance requirements, Japan has become a more attractive investment destination.

During that time, we have also seen investor attitudes to Japan change and move away from value investing and a focus on large exporters. We believe Japan is home to many companies that take advantage of growth opportunities in both domestic and global markets where businesses and consumer have new product and service needs. These can be found across the market capitalization spectrum.

The Matthews Japan Fund's strategic allocation to small cap companies contributed to outperformance. Over the last three years, the Fund was consistently overweight small caps relative to the benchmark. They have benefited from a favorable environment with easing monetary policy, particularly targeted toward raising or improving their valuations. Will it continue at this pace? From a top-down perspective, small caps are potentially the most vulnerable to a change in monetary policy. As a bottom-up investor, however, we see a lot of new companies come to market, and on that basis, we believe there are opportunities.

One of the core themes of the portfolio is companies that benefit from the growth within the Asia region and further afield. The integration of the Japanese economy with the rest of Asia has evolved over the past 20 years. This has only strengthened, most notably in China, in the three years since the Fund launch.

From a sector perspective industrials contributed to outperformance. Rising incomes in Asia have placed greater pressure on companies that have to pay higher wages. As a result, businesses have been forced to adopt more technology into their processes to drive productivity and protect profit margins.

China is investing heavily in upgrading its manufacturing sector as it seeks to drive technology innovation. While we are still in the early stages of automation in China, meaning there may be short-term fluctuations, we firmly believe sustained growth in Asia will continue to lead to tremendous growth opportunities for select Japanese companies.

Investments in the health care sector also proved beneficial for Fund performance in the first three years. Japan has one of the largest health care markets in the world, and Japanese health care firms are building up expertise and capabilities that will increasingly be in demand elsewhere globally as China and the West all face aging populations and the rise of lifestyle diseases. As Asian economies develop, so do their populations' demands for health care. For Japanese health care companies, there are opportunities to tap growth in nascent markets where there is a need to develop health care infrastructure

Investments involve risk. Past performance is no guarantee of future results.

Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation.

and temper the cost of overall health care provision.

The economic evolution in Asia represents a great opportunity for many Japanese companies. For example the pace of income growth in China is often misunderstood in the Western world. As incomes in the region grow, local consumers increasingly can afford Japanese brands that are associated with affordable quality, thereby creating a market for Japanese brands that did not previously exist. It affects not only what people consume and how they consume it, but also leads to upgrades from products to experiences—travel, for example.

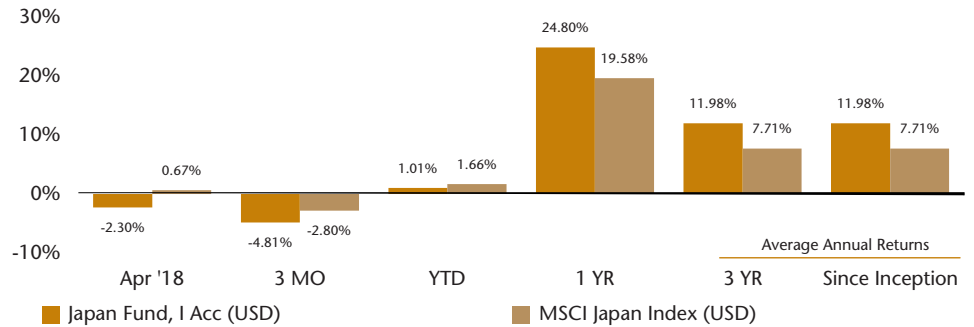
Looking forward

With opportunities come challenges. Japan’s productivity remains low relative to the rest of the world, particularly in the non-manufacturing sector. In addition, its labor market is very tight and immigration cannot solve the imbalance. There are simply not enough people to meet the demand for labor today.

We see opportunities in several business-services companies that benefit from the labor-tightening dynamic, including businesses that “outsource” information technology (IT) engineers and provide other temporary staff.

Companies that have relied on stagnant wages during Japan’s lost decades are struggling now and we expect to see some of them exit the market. Companies that are more productive and can afford to pay their workers more will enjoy a “survivor’s benefit” as they consolidate market share. We

Performance as of 30 April 2018†



Japan Fund	Average Annual Returns							Inception
	Apr '18	3 MO	YTD	1 YR	3 YR	5 YR	Since Inception	
I Acc (USD)	-2.30%	-4.81%	1.01%	24.80%	11.98%	n.a.	11.98%	30 Apr 2015
I Acc (GBP)	0.19%	-1.75%	-0.57%	17.54%	16.35%	n.a.	16.35%	30 Apr 2015
MSCI Japan Index (USD)	0.67%	-2.80%	1.66%	19.58%	7.71%	n.a.	7.71%	n.a.

Annual Returns (For the 12 month period ended 31 March)

Japan Fund	2018	2017	2016	2015	2014
I Acc (USD)	30.05%	5.14%	n.a.	n.a.	n.a.
I Acc (GBP)	15.25%	21.24%	n.a.	n.a.	n.a.
MSCI Japan Index (USD)	20.04%	14.82%	n.a.	n.a.	n.a.

All performance quoted represents past performance and is no guarantee of future results. Investment return and principal value will fluctuate with market conditions so that when redeemed, shares may be worth more or less than the original cost. Current performance may be lower or higher than performance shown. Investors investing in Funds denominated in non-local currency should be aware of the risk of currency exchange fluctuations that may cause a loss of principal.

SECTOR ALLOCATION (%) ¹	Fund Benchmark Difference		
	Fund	Benchmark	Difference
Industrials	25.3	21.3	4.0
Information Technology	16.6	12.7	3.9
Consumer Discretionary	13.3	20.2	-6.9
Consumer Staples	11.5	8.0	3.5
Health Care	9.9	7.3	2.6
Financials	9.2	12.4	-3.2
Materials	3.7	6.2	-2.5
Real Estate	2.9	4.1	-1.2
Telecom Services	2.2	5.0	-2.8
Utilities	0.0	1.8	-1.8
Energy	0.0		-1.1
Cash and Other Assets, Less Liabilities	5.3	0.0	5.3

MARKET CAP EXPOSURE (%) ^{1,2}	Fund Benchmark Difference		
	Fund	Benchmark	Difference
Mega Cap (over \$25B)	32.5	50.5	-18.0
Large Cap (\$10B-\$25B)	15.6	28.1	-12.5
Mid Cap (\$3B-\$10B)	31.4	21.1	10.3
Small Cap (under \$3B)	15.1	0.3	14.8
Cash and Other Assets, Less Liabilities	5.3	0.0	5.3

Source: FactSet Research Systems

Sector data based on MSCI's revised Global Industry Classification Standards. For more details, visit www.msci.com.
Source: FactSet Research Systems

1 Percentage values in data are rounded to the nearest tenth of one percent; the values may not sum to 100% due to rounding.
2 Percentage values may be derived from different data sources and may not be consistent with other Fund literature.
2 Equity market cap of issuer.

believe that listed companies may see an improvement in their pricing power as they gain market share from smaller unlisted companies. We expect select companies to convert this opportunity into revenue growth and improved margins.

Even though we are bottom-up investors, the top down does matter. Having been unloved for so long, Japan has become a much more attractive investment destination in recent years.

Corporate earnings growth has transformed under Prime Minister's Abe's administration, while in the three years since launch companies have worked hard to improve their governance, focusing more on payout ratios, shareholder returns and return-on-equity. While the pace of this change has started to stall in the last 12

months, it still represents a significant shift and shows companies are heading in the right direction.

A sharp decline in Abe's approval ratings is a concern politically as he seeks his re-election as party leader in September, while we are also concerned by the Trump administration's combative actions regarding trade.

Japan's economic growth is also starting to show some sluggishness, but slowing GDP growth does not mean an absence of investment opportunities. At Matthews Asia, we have invested in Japanese equities for over 19 years. We knew Japan is home to many companies that benefit from growth at home and abroad. But you cannot look to the past to identify these, you need to look forward.

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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.

Important Information

For Institutional/Professional Investor Use 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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