Matthews Asia

Matthews Japan Fund

I (Acc)

Commentary

Period ended 31 March 2022

For the first quarter of the year, the Fund returned -14.18%, while its benchmark, the MSCI Japan Index, returned -6.45% over the same period.

Market Environment:

The first quarter saw two significant trends in Japanese equity markets. Japanese stocks performed better than their international peers, excluding U.S. markets, despite the yen weakening to the lowest level since 2015. Ongoing improvements in Japan corporates' margin capabilities and reasonable valuation levels contributed to this performance. At the same time, Japanese markets experienced a historic quarter for value style investing that was induced by the sharp repricing of bond yields. The month of January saw the largest spread between growth performance and value performance in 30 years.

Performance Contributors and Detractors:

Overall, the first three months of the year were not dissimilar to the first three months of 2021 as our focus on high-quality growth struggled amid a surge in U.S. 10-year bond yields. From a sector perspective, allocations in the key areas of information technology, health care and industrials were the largest detractors to the relative performance of the portfolio. Industrials was notably impacted due to its inclusion of commodity price- sensitive trading companies and cyclical- transport enterprises — businesses that have been challenged by surging fuel prices and supply-chain disruption. On the other hand, our overweight and stock selection in consumer staples was the largest contributor to relative performance.

From a market cap point of view, our overweight in small cap stocks—those under $3 billion—was also a detractor to performance. Our underweight and stock selection in mega cap and overweight and stock selection in mid cap stocks were also large detractors.

Turning to individual securities, technology conglomerate Sony Group Corp. was the largest detractor to Fund performance. Soon after the stock approached near all-time high prices on the second trading day of 2022 it faced profit- taking selling pressure even after reporting strong third- quarter results. Like Sony, Recruit Holdings Co., a leading HR and media marketing- solution provider, was one of the portfolio's top contributors last year. But in the first quarter of 2022, Recruit was the second- largest detractor. Its HR Tech segment, comprising indeed.com and Glassdoor, has reported record high margins with over 40% in topline growth and so it will face tough year-over-year sales comparisons in the next fiscal year.

On the positive side, Seven & i Holdings Co., the operator of 7-Eleven stores in Japan and the U.S., was the largest contributor to performance. We believe the company's U.S. operation (7-Eleven Inc. and Speedway, the gas-station/ convenience-store chain) will continue to benefit from high fuel prices, as well as from the group's ability to achieve synergies and pass-through costs. Longer term, there's also potential for improved corporate governance. Trading giant Mitsubishi Corp. was another top contributor. The company continues to benefit from high commodity prices and a weaker yen. Additionally, we think Mitsubishi will improve its focus on total shareholder return along with its investments for renewable energy.

Notable Portfolio Changes:

One significant adjustment within our portfolio is the increase in defensive sectors such as consumer staples. While we still see economic growth recovery as the world reopens from the pandemic, ongoing uncertainty over the war in Ukraine, coupled with inflation risks and a rising interest- rate environment, warrant a more balanced approach towards growth in our view.

In the first quarter, we initiated a position in NTT Data Corp., an IT service company that is benefiting from domestic government demand for digital transformation projects and restructuring efforts bearing fruit in its overseas business. We took advantage of recent market weakness which sent the shares down to lower valuation levels.

We also initiated a position in IHI Corp. We believe the heavy machinery company will benefit from an aircraft-parts recovery as economic activity reopens. We also think the company's liquified natural gas (LNG) boilers and nuclear facility after-service businesses will gain from high energy prices.

In order to make positions for new names we exited Advantest Corp., Eisai Co., Ibiden Co., JMDC Inc., Kakaku.com Inc., Mitsui High-tec Inc., Net Protections Holdings Inc., Nintendo Co., OBIC Business Consultants Co., Sansan Inc. and Sysmex Corp.

Outlook:

2022, just like 2021, is off to a tough start for high-quality growth strategies. The velocity of the widening of growth-value spreads has made it challenging to adapt our strategy quickly. But while extremely loose monetary policy from all major central banks has come to an end and the Federal Reserve has officially started to tighten, we believe that the long-value/short-growth trade has now fully unwound back to pre-pandemic levels. And during the first quarter, growth companies continued to improve their margins and strengthen their cashflow generation abilities.

So, while we are taking a more balanced approach towards multiple stages of growth and valuation levels, we believe the earnings capability of Japanese companies has improved meaningfully over the past economic cycle, helped by productivity improvements, better corporate governance, innovation and a higher focus on capital efficiency.

For many years, Japanese equities have not been considered a place to invest but rather a place to trade in and out of. However, the dynamic has meaningfully changed since 2010 as Japanese corporates have been generating improving levels of profits in each bottom of the cycle. 2020 showed another resiliency of Japanese corporate profits. We believe Japanese equity market fundamentals have turned from pure value to cyclical growth. While many global investors are skeptical of this change, we believe that is where the investment opportunity lies.

Rolling 12 Month Returns For the period ended 31/03/2022 - I (Acc)

Name	2022	2021	2020	2019	2018	Inception Date
Matthews Japan Fund (USD)	-11.08%	51.61%	-6.89%	-14.13%	30.05%	30/04/2015
MSCI Japan Index (USD)	-6.14%	40.18%	-6.31%	-7.50%	20.04%	
Matthews Japan Fund (GBP)	-6.68%	35.92%	-1.31%	-7.76%	15.25%	30/04/2015
MSCI Japan Index (GBP)	-1.64%	25.98%	-1.54%	-0.42%	7.00%	
Matthews Japan Fund (USD Hedged)	-2.34%	55.00%	-7.90%	-8.73%	N.A.	03/04/2017
MSCI Japan Index 100% Hedged to USD (USD Hedged)	3.11%	44.05%	-6.58%	-1.76%	N.A.	
Matthews Japan Fund (EUR Hedged)	-3.62%	52.77%	-9.63%	-11.48%	N.A.	03/04/2017
MSCI Japan Index 100% Hedged to EUR (EUR Hedged)	2.24%	42.42%	-9.35%	-4.75%	N.A.	

Sources: Brown Brothers Harriman (Luxembourg) S.C.A, Matthews Asia, FactSet Research Systems, Bloomberg

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