
Matthews Asia Dividend Fund

Period ended 30 September 2018

For the quarter ending 30 September 2018, the Matthews Asia Dividend Fund returned 0.43% while its benchmark, the MSCI All Country Asia Pacific Index, returned 0.62%.

Market Environment:

The third quarter of 2018 was another volatile period for Asia's equity markets. An escalating trade war between the U.S. and China weighed heavily on investor sentiment toward the region. Fears of global emerging market contagion, triggered by a rising U.S. interest rate, also spread into Asia, sending regional currencies lower for the most part. Within the region, China's domestic A-shares and Hong Kong-listed stocks entered a technical "bear market" after a sharp correction during the quarter. Outside of China, Asia's equity markets managed to deliver slightly positive returns in local currency terms, which was mostly offset, however, by weakening exchange rates against the U.S. dollar.

Performance Contributors and Detractors:

During the third quarter, China Petroleum & Chemical (Sinopec), a major oil and gas company, was among the top contributors to Fund performance. Owing to its vertically integrated business model, Sinopec's upstream exploration and production business is benefiting from steadily recovering global crude oil prices. Its midstream refinery business has also been aided by a supply shortage in China's domestic market, and its downstream oil marketing division continues to earn decent returns and generate strong cash flow. Sinopec delivered a 40% earnings growth and dividend growth during this year's first half earnings, which were announced during the quarter, and its share price reacted favorably.

On the flip side, some of the portfolio's China and Hong Kong holdings, including Hua Hong Semiconductor, China Gas, and Shanghai Jin Jiang International Hotels, were among the main detractors to Fund performance during the quarter. As market sentiment continued to be swayed by the ongoing trade war between China and the U.S., Chinese stocks as a whole experienced a sharp, broad-based sell-off. Despite the fact that growth for the above-mentioned holdings is driven mostly by domestic demand within China, which remains healthy, their stocks were aggressively sold off.

Notable Portfolio Changes:

During the quarter, the Fund initiated a new position in Beijing Capital International Airport (BCIA), an airport infrastructure asset owner listed in Hong Kong. During the quarter, the company was notified by China's aviation regulator that its airport surcharge rebate revenue is to be discontinued starting next year. While the market had anticipated the loss of this rebate revenue, the actual timing came much earlier than expected. At the same time, the market also started to price in the potential traffic dilution impact from a second airport in Beijing, which is expected to become operational in the second half of 2019. Those two negative events drove a roughly 30% decline in the BCIA's share price. While we share concerns over the potential challenges facing the aeronautics business, we also think that BCIA has several positive drivers that could offset some of the negatives, including an improving air traffic mix with a growing portion of high-margin international flight routes and robust non-aeronautic business growth anchored by its duty-free store leasing business. At current valuations, BCIA is one of the cheapest airport assets globally. From an income investing perspective, BCIA already completed its major capital expenditure program and its balance sheet has been de-leveraged significantly, suggesting that future free cash flow should start to improve and dividends are well-supported.

On the other hand, the Fund exited its positions in a few companies, including Sands China, Sohgo Security Services and Bharti Infratel. We believe the underlying fundamentals for these companies have significantly changed, invalidating our initial investment thesis.

Outlook:

Asian companies continue to deliver solid earnings growth. Equity valuations are now below the region's long-term average, making Asia's equities more attractive from a bottom-up perspective. The jury is still out, however, over whether Asian companies can sustain such positive growth momentum and overcome negative impacts from a protracted trade war and a rising interest rate cycle. As we follow a total return-focused dividend strategy, we have shifted away from the more pro-growth portfolio positioning we took in 2017. At this point in time, we feel it is more prudent to position our portfolio to be more balanced between stable dividend payers and cyclical dividend growers to cushion further market volatility.

There is no guarantee that a company will pay or continue to increase dividends.

Performance figures discussed in any of the Fund Manager Commentaries reflect that of the Institutional Accumulation Class Shares and have been calculated in USD, including ongoing charges and excluding subscription fee and redemption fee investors might have to pay. 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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