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## Matthews Asia Small Companies Fund

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### Period ended 30 June 2018

For the first half of 2018, the Matthews Asia Small Companies Fund returned 1.91% while its benchmark, the MSCI All Country Asia ex Japan Small Cap Index, returned -7.14%. For the quarter ending 30 June, the Fund returned -0.74%, outperforming its benchmark, which fell -6.73%.

#### Market Environment:

Asian markets were volatile early in the year and became relatively steady by April and May. Investor sentiment turned fragile, however, late in the second quarter due to several events. As anticipated, the U.S. Federal Reserve raised interest rates by 25 basis points (0.25%) in mid-June. Amid this rising rate environment, the strong U.S. dollar coupled with higher oil prices further pressured broader emerging market equities. Within Asia, Indonesia, India and the Philippines tend to be more vulnerable due to their relative dependence on foreign currencies that can affect trade deficits. Meanwhile, trade war rhetoric between the U.S. and China also caused further volatility for Chinese equities as concerns spread over the potential negative economic impact to global corporations. Lastly, after months of back and forth regarding bilateral U.S.-North Korea talks, the leaders of both countries held a summit meeting in June and signed an agreement to work toward nuclear denuclearization of the Korean Peninsula.

#### Performance Contributors and Detractors:

Our holdings from China and South Korea were broadly positive performance contributors for the first half of the year. During the second quarter, the portfolio's Chinese and Indian holdings performed considerably better than holdings from elsewhere in the region, which suffered due to the challenging environment. Our stock selection in China and India also significantly contributed to both the portfolio's absolute and relative performance for the second quarter. Indian pharmaceutical and chemical company Merck, for example, performed strongly due to improving fundamentals and asset divestment news at the parent company level.

By sector, several portfolio holdings in health care and information technology were bright spots due to company-specific factors during the uneasy second quarter. Chilisin Electronics, a Taiwan-based manufacturer and distributor of inductors and coils, performed robustly thanks to the company's bold industry consolidation moves that may pave the way for future growth.

Some consumer discretionary and financials holdings were among the weakest performers within the portfolio for the second quarter. The stock prices of Hong Kong's Guotai Junan International and Ho Chi Minh City Securities in Vietnam—both brokerage businesses—experienced sharp declines due to a high correlation between their profitability and the performance of capital markets. In addition, two of our largest detractors to performance for the second quarter were Valuetronics Holdings, a Hong Kong-based electronics manufacturing service provider, and Japan's CKD, a manufacturer of factory automation equipment. Shares of both firms experienced sharp price corrections following pullbacks in revenue momentum in some segments of their businesses.

#### Notable Portfolio Changes:

During the second quarter, we exited several China positions for a variety of reasons. We shed our entire position in GDS Holdings, an independent data center operator, due to its robust share price run-up. As this company's market capitalization reached mid-cap status, we opted to invest proceeds in other less richly priced companies. We also exited Lifetech Scientific as its share price rose sharply due to a recent change among its major shareholders. We believe that such large and sudden increases in valuations were not supported by fundamentals and chose to sell our stake and lock in profits. Unfortunately, not

all of our holdings performed up to our expectations. We exited Beijing Urban Construction, a mass transit design and engineering company, due to our concerns over capital allocation decisions that we felt could compromise the company's cash flow and profitability.

Additionally, we took profits by trimming other holdings in Taiwan and South Korea that had appreciated significantly in price. We exited our long-term holdings in Ultrajaya, an Indonesian UHT milk producer. Although we deem Ultrajaya as a reasonably well-run company, we are concerned that competition will intensify, which could lead to margin contraction.

We introduced over a dozen new companies to the portfolio as we find their long-term growth trajectories attractive and supported by favorable industry tailwinds. Saigon Cargo Service Corporation is one of Vietnam's leading air cargo service providers. We believe the company is well-positioned to meet the growing air cargo handling throughputs in the country as trade volume grows. Similarly, we initiated a position in SUNeVision, one of Hong Kong's leading independent data center operators. The company is well-positioned to capture the burgeoning data traffic in the region. After the recent correction of the share price, the risk-reward profile turned more favorable in our opinion.

## Outlook:

Similar to what we observed during the first quarter, concerns over rising interest rates and dynamic geopolitical factors appear to have heightened market volatility. Such sentiment could persist for the remainder of 2018. Over the medium term, many Asian countries are poised to hold elections in the next 12 to 18 months, which can add to market uncertainty. While we are mindful of these challenges, we are encouraged by the earnings recovery thus far among many Asian corporations. We remain constructive on businesses that are well-positioned to address the needs of Asia's evolving domestic demand from services to infrastructure to technologies. As we meet with corporate managers across Asia on our research trips, we find that many small-cap companies are at the forefront of delivering innovative products and solutions to households and businesses. Such a dynamic and expansive investment landscape is a reminder of how Asia's entrepreneurialism has strived and progressed in the past decade. We look to continue uncovering attractive investment candidates that possess the attributes to grow and compound in size in a sustainable manner for the long run.

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Offering Document for further details of the risk factors.

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

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