

**Matthews Asia**

Matthews Asia Small Companies Fund

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Period ended 31 March 2018

For the quarter ending 31 March 2018, the Matthews Asia Small Companies Fund returned 2.68%, outperforming its benchmark, the MSCI All Country Asia ex Japan Small Cap Index, which returned -0.44%.

Market Environment:

Asia's markets began the year with strong performance amid optimism over a solid outlook on earnings, encouraging macroeconomic data from China and momentum that had carried over from 2017 among broad equity markets regionally. Sentiment took a sharp turn in February, however, as investors grew nervous that rising wages and inflationary pressure in the U.S. would lead to more interest rate hikes than previously expected. Finally, in March, the U.S. Federal Reserve raised interest rates by 25 basis points (0.25%). Meanwhile, U.S.—China trade tensions created further market volatility as the Trump administration threatened to impose various tariffs on products from China. The trade-war rhetoric continued late into the first quarter, causing significant swings to global markets. Another noteworthy event during the quarter was China's decision to end presidential term limits. This created some uncertainty about long-term political risks relating to a consolidation of power by a “key-man.”

Performance Contributors and Detractors:

Some of our holdings in China, South Korea and Indonesia performed strongly during the quarter, and helped Fund performance. Our enterprise software holdings in South Korea's Duzone Bizon and China's Kingdee International Software were significant performance contributors as their strong business momentum resulted from healthy demand and good user experience from cloud-based products.

Some holdings in Taiwan and Malaysia, however, experienced lackluster performance and posed a drag on absolute returns. Advanced Ceramic X, a Taiwanese radio frequency component maker, suffered some delays with product launches, and this led its share price to correct sharply. Karex, a Malaysian condom manufacturer, was another performance detractor. The company's share price corrected because of its slowing revenue growth and margin compression in recent quarters.

By sector, our exposure to health care helped performance amid a fairly volatile market environment as our holdings showed solid execution of their business strategies on the company level. Some of our financial sector holdings also did well. Long-term holding Bank Tabungan Peniunan Nasional, an Indonesian micro-finance lender, contributed to Fund performance following a bottoming out of the company's fundamentals and news over possible merger and acquisition plans.

During the quarter, the portfolio's industrials sector holdings detracted from performance. Ten Pao, a Chinese power supplier component maker, was among the firms that did not do well. It experienced a severe input cost escalation causing profit margins to contract more steeply than market expectations, and we ultimately exited this position.

Notable Portfolio Changes:

During the quarter we made adjustments to the portfolio and exited or trimmed several firms that had performed well in 2017, including two China-based health care holdings: Hutchison China Meditech and Genscript.

Pharmaceutical firm Hutchison China Meditech saw its market capitalization rise to nearly US\$5 billion. We exited this holding as we

believed most of the positives had already been factored into the share price. Similarly, we trimmed our holdings in Genscript, a life science service company, due to valuation considerations after its share price saw a strong run-up that began in 2017 and carried over into 2018.

We also detected some headwinds facing our portfolio holdings, such as weakness in the mobile handset supply chain; and decided to exit our positions in Unisem, a Malaysia semiconductor packaging company. We were concerned that the company's earning visibility for the short to medium term might be compromised and instead sought more attractive investments candidates elsewhere.

We initiated positions in several new companies that we believed to be poised for reasonably healthy growth trajectories. Chinese enterprise software firm Kingdee Software has done a good job penetrating the small- to medium-enterprise market over the years. In addition, it has shown some growth momentum in its cloud service segment, which should increase user stickiness over the long term. We also initiated a position in Rich Sport in Thailand. The company markets and retails branded athletic footwear products across Thailand and is looking expand its business in neighboring countries. We like the company's capital discipline, as well as its sensible growth strategies.

Outlook:

Despite the fact that markets were off to a roller-coaster beginning in 2018, we believe that the long-term growth trajectory and the fundamentals of most Asian economies remain sound. Over the nearer term, interest rates cycles and ever-evolving geopolitical dynamics will potentially impact firms at the industry or company level. We aim to identify those companies that are poised to benefit from the long-term structural trends we see occurring in Asia, such as productivity improvements, lifestyle upgrades and innovation-driven growth opportunities. We will continue to be vigilant in terms of identifying risks facing our portfolio companies in terms of their impact to profitability trends and competitiveness within their respective industries. The opportunity sets in our small companies universe remain broad and diverse—an ideal hunting ground for long-term investors such as ourselves.

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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