Matthews Asia

Matthews China Dividend Fund

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Period ended 31 March 2018

For the quarter ending 31 March 2018, the Matthews China Dividend Fund returned 0.52% while its benchmark, the MSCI China Index, returned 1.82%.

Market Environment:

China's equity markets experienced another roller coaster ride during the first quarter of 2018, reminding investors of the volatile nature of this market. Chinese equities were strong in January, but quickly ran out of steam in February as the U.S. 10-year Treasury bond yield increase caused a global sell-off in equity markets. Strong financial results reported by internet giants Tencent and Alibaba Group also led investors to scrutinize the declining margins at these leading firms. The quarter also saw the end of term limits for the Chinese presidency. Shortly afterward, any political concerns were accompanied by a return of trade tensions between Washington and Beijing.

Performance Contributors and Detractors:

During the quarter, the Fund's holding in Chinese insurance brokerage firm Fanhua was a top contributor to performance. Over the past two years, Fanhua's management successfully restructured its insurance distribution business mix, and moved away from low-margin auto insurance to focus more on growing its life insurance distribution business. It has especially concentrated on protection-type products, which carry higher margins and for which the underlying commission income is more frequently recurring. With these changes Fanhua's profitability began improving significantly. Since the insurance distribution business is capital-light and does not bear underwriting risk, Fanhua's ability to pay higher dividends is also enhanced with improving profitability. The company recently announced a new dividend policy that raised its minimum dividend payout from 30% to 50%, and instituted a quarterly dividend payment schedule.

Conversely, Sinopec Kantons, an energy infrastructure company, was among the top performance detractors during the quarter. The company announced strong earnings growth of 20% for 2017, but its stock price fell sharply after the earnings release due to its weaker-than-expected second half results. We are closely watching the new gas pipeline tariff the company was subject to in the last quarter of 2017, which led to lower profitability. We still believe management can improve profitability within the framework of the new tariff.

Notable Portfolio Changes:

During the quarter, we added a position in Shanghai Baosight Software, which provides IT software services in China. We are glad to see the firm's industrial software development business benefiting from the increasing profitability of Chinese steel mills, which are placing a higher priority on automation. As the largest software vendor in this segment, Baosight is seeing strong growth in its orders. In addition, its data center business, which utilizes empty land at vacant steel mill plants, has begun to contribute significantly to revenue and profits. More importantly, the company finally adopted a stock-based incentive program to better align management and shareholder interests.

During the quarter, we exited a few positions, including China Everbright and Tarena International, which were facing structural challenges that impacted their earnings and dividend growth. We decided to redeploy capital elsewhere.

Outlook:

Currently, the strong fundamentals and attractive valuations for companies in China are being overshadowed by market concerns over a potential U.S.-China trade war. If not averted, this trade tussle could have broader economic and geopolitical implications. In terms of our strategy, we believe it is prudent to increase the portfolio's defensiveness by increasing our weight of high dividend-yield stocks with stable underlying cash flow to balance the portfolio's exposure to dividend growth names. While near-term market conditions could remain volatile, we believe China already has transformed its economy into one led by consumption growth rather than export-driven growth. Any potential sell-off would increase the attractiveness of companies that can sustain and grow their earnings and dividends in this environment. We continue to seek these types of compelling opportunities.

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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Investors should not invest in the Fund solely based on the information in this material alone. Please refer to the Hong Kong Offering Document for further details of the risk factors.

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