Matthews China Dividend Fund

Period ended 30 September 2018

For the quarter ending 30 September 2018, the Matthews China Dividend Fund returned -6.19%, while its benchmark, the MSCI China Index, fell -7.42%.

Market Environment:

In the third quarter in 2018, Chinese equities experienced their worst sell-off since 2016. The quarter began with a currency crisis in both Turkey and Argentina that raised serious concerns for overall emerging markets. Then in September, escalating trade tensions between China and the U.S. weighed heavily on Asia's equity markets. President Trump threatened to impose tariffs on all Chinese imports. China retaliated with additional tariffs on U.S. goods, and also canceled once-revived trade negotiations. Even more concerning, these trade tensions spilled over into other areas—the U.S. imposed sanctions against China's military for purchasing Russian military equipment. On the positive side, global index provider MSCI announced that it is considering significantly increasing the weight of China A-shares within its global indexes next year.

Performance Contributors and Detractors:

During the quarter, our stock selection in the financials sector detracted from the Fund's relative performance, while the portfolio's underweight in the information technology sector contributed the most to relative performance.

Two leading telecom operators, CITIC Telecom International Holdings and HKBN, in Macau and Hong Kong respectively, were among the top performance contributors during the quarter. As both firms have been operating in a stable market environment, we believe investors should feel confident in their operating currencies, as the currencies in both Macau and Hong Kong are pegged to the U.S. dollar. China Petroleum & Chemical (Sinopec), which benefited during the quarter from rising oil prices, was the second-best contributor to Fund performance.

On the flip side, Hua Hong Semiconductor, whose share price rose significantly during the first half of the year, suffered a heavy sell-off of its shares during the quarter due to profit-taking and concerns over the potential negative impacts of a trade war. Tencent Holdings, which reported its slowest earnings growth in recent years, posed the second-largest drag on performance during the quarter. Investors were surprised to discover new Chinese government regulation pertaining to the online gaming industry. It is important to note, however, that regulation changes tend to benefit larger companies such as Tencent, which have more resources to adapt in new environments. In addition, investors should view Tencent as a firm that goes well beyond online gaming.

Notable Portfolio Changes:

During the third quarter, we initiated a position in Yangzijiang Shipbuilding Holdings, China's largest privately owned ship builder. We believe Yangzijiang stands out among Chinese shipyards due to its product quality. After years of a global shipping slump, a potential recovery of demand for new ships and higher environmental standards for new ships should benefit Yangzijiang. A weaker Chinese currency can also be a tailwind for Yangzijiang.

We also exited our positions in Guangshen Railway as we believe its business may suffer following increased competition from a new high-speed rail project connecting Guangzhou and Hong Kong. In addition, we also sold our position in NetEase as the company continued to struggle in developing popular game titles. Its operations outside of gaming have not seen any meaningful progress in terms of profitability.

Outlook:

After the severe sell-off in China's equities markets, the economic damage of a full-blown trade war appears to already be reflected in current valuations. Investors should be mindful of China's policy responses in adverse trade environments. While we believe China's government may have been rash in implementing new regulations in several industries, we continue to find compelling opportunities in China's equity markets.

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

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