Matthews China Fund

Risk Considerations

- Investment involves risk. It is possible to lose the principal capital of your investment.
- The Fund invests primarily in Mainland China-related companies. Investments in such companies may be subject to increased risks such as political, tax, economic, market, liquidity, custody and settlement, currency, legal and regulatory risks.
- The Fund invests primarily in equity securities, concentrated in China, which may result in increased volatility.
- The Fund may invest in smaller companies, which are likely to carry higher risks than larger companies.
- The Fund does not hedge to attempt to offset certain market risks. This may expose the Fund to the risk of full losses resulting from a decline in a security's value.
- Investors should not invest in the Fund solely based on the information in this website. Please read the Hong Kong Offering Document carefully for further details including risk factors before investing.

Period ended 31 December 2018

For the year ending 31 December 2018, the Matthews China Fund returned -19.89% while its benchmark, the MSCI China Index returned -18.75%. For the fourth quarter of the year, the Fund returned -11.51% versus -10.73% for the Index.

Market Environment:

2018 was a challenging year for Chinese equity markets. Negative headlines of deteriorating U.S.—China relations amid the trade war plagued market confidence for much of the year. In addition, the reversal of a multiyear global quantitative easing program and worries of higher interest rates slowing global growth contributed to weak market performance. China faced both external and internal challenges in 2018. Externally, China was cautious in its response to managing difficult trade tensions with the U.S. Internally, China continued to work through deleveraging efforts in its banking system and held a tight rein on its property market. Weak domestic stock market performance also affected local sentiment. But despite these challenges, we have seen mild easing of economic stimulus and believe that China will refrain from rolling out any major stimulus. Rather, more targeted areas of stimulus—such as personal income tax cuts and support for its domestic private sector economy—appear to support China's longer-term interests, which are the strength of its domestic economy and a reduced reliance on the outside world for economic growth.

Performance Contributors and Detractors:

In 2018, the real estate and energy sectors performed well. China Resources Land and China Petroleum & Chemical (Sinopec) were two of the top contributors to the Fund's performance. China Resources Land, a leading integrated urban developer in China, has continued to achieve strong growth in both residential development sales and investment properties rentals—even in the face of macroeconomic headwinds. With an impressive balance sheet and quality assets, the company demonstrated its ability to withstand market turbulence. Sinopec, one of China's largest energy and chemical producers, also performed well, supported by its strong cash flow and generous dividend payouts.

On the other hand, our holdings in the consumer discretionary and communication services sectors were among the major detractors to the Fund's absolute performance for the year. Brilliance China Automotive Holdings, a joint-venture partner with BMW in China, suffered a sharp sell-off after the company announced it would sell its 25% stake in the BMW joint venture at a price well below investors' expectations. We believed that the company's share price dropped significantly below its business's intrinsic value, and we added further to our position. While internet services provider Tencent Holdings and e-commerce platform provider Alibaba Group were among the top detractors to the Fund's absolute return, they were relative contributors during the year as together they accounted for a much higher weighting in the index. We believed their leadership positions remained intact in their respective arenas, and the two companies continued to represent our largest portfolio positions.

Notable Portfolio Changes:

During the fourth quarter, we initiated a position in China International Travel Service, a leading duty-free operator with over 200 duty-free stores throughout China. With the country's middle class rising and tourism increasing, we believe the firm is a direct beneficiary of these secular growth trends. Duty-free stores on China's Hainan Island have been major profit contributors for the company. To boost domestic consumption, a recent government policy increased its duty-free shopping quota in Hainan from approximately US$2,335 (16,000 renminbi) to roughly US$4,380 (30,000 renminbi) and should enable the company to deliver strong growth.

Meanwhile, we exited our position in Han's Laser Technology Industry Group, China's largest laser equipment manufacturer, due to the company's large exposure to Apple and a significant slowdown in sales of Apple products. In addition, the trade conflicts between the U.S. and China caused additional uncertainty about the company's operation. We also sold our position in China Life Insurance, a state-owned life insurer, after the company delivered results below our expectations.

Outlook:

The global macroeconomic environment remains uncertain and many market participants are bracing for more volatile trading environments in the coming year. As we reflect on the performance of China's equity markets for 2018, we believe disconnects remain between stock performance and fundamentals. We continue to position our portfolio according to our long-term beliefs that China's domestic economy remains healthy, and that there are secular growth opportunities in both China's new and old economy sectors that stand to benefit from the rising levels of affluence among domestic consumers. In China today, for example, growth opportunities are rapidly shifting from coastal areas to inland cities. We have learned that consumers in many lower tier cities have reached affordability levels that can propel a repeat of the economic growth expansion witnessed in China's major cities about a decade ago. The development of China's new economy sectors is also framed around a transition to higher value-adding services and technological development. While the trade war may have tempered what were once more ambitious plans, we believe that this progression toward technological advancements has not been derailed, and that China's ambitions for further innovation will still gradually be achieved. Elsewhere in China's economy, we think that financial risks in the banking system have remained contained. We support the government's deleveraging efforts and continued supply-side reforms as these efforts would help lower risks and enhance efficiencies at its state-owned enterprises. As in previous years, we remain most cautious about the multiyear, meteoric rise of the property market in China. A recent loosening of what has been tight policies around property purchases and resales is something to monitor and we would be highly cautious if there were meaningful relaxation of these policies.

Over the next year, we believe that China will continue negotiations with the U.S. and provide the concessions needed to repair any damage to consumer sentiment since tariffs on Chinese exports started to be imposed. It remains uncertain whether such concessions will be enough; we remain cautiously optimistic about some resolution as we believe that an extended trade war hurts everyone. It is unclear, though, how much time it will take to reach a positive outcome. We believe that China is also preparing for prolonged discussions. Unfortunately, these macroeconomic factors remain an overhang and may temporarily hinder the continuation of the strong corporate earnings growth environment we saw in China in 2017 and 2018. Given a confluence of negative headlines already reflected in prices, the risk-reward scenario remains particularly favorable given attractive, high single-digit valuations and an outlook that should increasingly improve.

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.

The information contained herein has been derived from sources believed to be reliable and accurate at the time of compilation, but no representation or warranty (express or implied) is made as to the accuracy or completeness of any of this information. Matthews International Capital Management, LLC ("Matthews Asia") and its affiliates do not accept any liability for losses either direct or consequential caused by the use of this information.

Information contained herein is sourced from Matthews Asia unless otherwise stated. The views and opinions in this commentary were as of the report date, subject to change and may not reflect the writer's current views. They are not guarantees of performance or investment results and should not be taken as investment advice. Investment decisions reflect a variety of factors, and the managers reserve the right to change their views about individual stocks, sectors, and the markets at any time. As a result, the views expressed should not be relied upon as a forecast of the Fund's future investment intent. It should not be assumed that any investment will be profitable or will equal the performance of any securities or any sectors mentioned herein. The information does not constitute a recommendation to buy or sell any securities mentioned.

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