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## Matthews China Small Companies Fund

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### Period ended 30 June 2018

For the first half of 2018, the Matthews China Small Companies Fund returned 7.96%, outperforming its benchmark, the MSCI China Small Cap Index, which returned 0.91% over the same period. For the quarter ending 30 June, the Fund returned 3.07% while its benchmark fell -1.90%.

### Market Environment:

Trade war tensions and geopolitical risks dominated headlines during the first half of the year, particularly in the second quarter. This negatively impacted Chinese equity markets in both performance and volatility. Fundamentally, however, China's domestic consumption economy remains relatively unaffected. Home sales through the end of May 2018 increased more than 12% since last year, following an already high base in 2017. Retail sales and industrial production figures also continued to meet expectations in the second quarter. China's central bank, the People's Bank of China, also continued to be accommodative, tightening controls on riskier parts of the nation's lending system.

From both a top-down and bottom-up perspective, we anticipate sustainable growth in the Chinese economy and in corporate earnings. The market's concerns over the rising cost of funding and escalating trade tensions should, in our view, have little impact on China's smaller companies given their domestic focus and lower dependence on financial leverage.

### Performance Contributors and Detractors:

For both the first half of the year and the second quarter, our strong stock selection in the information technology, materials and industrials sectors contributed most to the Fund's outperformance versus the benchmark. The consumer discretionary sector was a laggard during both periods and our health care sector holdings were the top detractors to Fund performance in the second quarter.

Hua Hong Semiconductor, China's second-largest foundry, and China Maple Leaf Education Systems, China's largest international school operator, were among the top individual contributors to Fund performance in the second quarter. Hua Hong Semiconductor benefited from China's accelerated plan to become self-sufficient in semiconductor production and also from favorable supply and demand dynamics. China Maple Leaf continued to execute well in the high-demand segment of consumer discretionary services. We believe both companies will do well in China's structural change toward intellectual property development and consumption upgrades.

Among the top detractors to Fund performance during the second quarter were Joy City Property, a leading mall developer in China that targets millennial consumers, and Precision Tsugami (China), a leading industrial automation tool maker. Joy City was impacted by negative sentiment toward the real estate sector, which has relatively higher financial leverage. Precision Tsugami was negatively impacted by fears of a factory automation slowdown related to escalating trade tensions. We believe both companies will continue to grow as Chinese consumers upgrade their consumption patterns and Chinese industrial firms seek higher productivity. We have not been fazed by the short-term volatility in the share prices for these two holdings.

### Notable Portfolio Changes:

During the second quarter we shed some "graduates" of our portfolio—stocks that did well during our holding period and saw their market capitalization exceed our typical small-cap range. China Resources Cement and KWG Property are two such examples of stocks that appreciated nicely due to strong earnings growth and valuations re-ratings. We continue to selectively

add innovative companies to our portfolio, especially in the technology and consumer-related sectors. China's small-cap universe continues to be a fertile hunting ground for finding cash flow-rich growth stocks at reasonable valuations, and we have been able to easily replace our “graduates” with attractive new holdings.

During the quarter, we initiated a position in Yihai International Holding, a leading hot pot soup base and condiments brand for both restaurants and retail consumers. We believe the company has strong growth visibility given the popularity of its associated hot pot restaurant chain and its rapidly growing new business in restaurant supplies.

## Outlook:

We are still cautiously optimistic about China's small-cap market despite heightened market volatility as we focus rigorously on the sound fundamentals of our portfolio companies. From a macro perspective, we believe China has the ability to stabilize its economy through fiscal spending, interest rate adjustments and currency management. In addition, steps taken to correct China's structural issues are on the right track, despite the recent changes in presidential term limits. We are focused on seeking innovative and capital-efficient small companies that are relatively insulated from macroeconomic uncertainties. We will continue to seek companies with sustainable, quality earnings streams, strong cash flows and good balance sheets that can weather uncertain economic conditions. We believe sectors such as industrial automation, health care and technology are among the most attractive from a secular growth perspective.

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Investing in small- and mid-size companies is more risky than investing in large companies as they may be more volatile and less liquid than larger companies.

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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