Matthews Japan Fund

Matthews Asia Funds

Risk Considerations

- Investment involves risk. Past performance is not a guide to future performance. It is possible to lose the principal capital of your investment.
- The Fund invests primarily in Japan-related companies. Investments in such companies may be subject to increased risks such as political, social, tax, economic, policy, market, liquidity, trading, custody and settlement, currency, legal and regulatory risks.
- The Fund invests primarily in equity securities, 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 may invest in financial derivative instruments ("FDIs"). Risk associated with FDIs include counterparty/credit risk, liquidity risk, valuation risk, volatility risk and over-the-counter transaction risk. The Fund will not use FDIs extensively for investment purposes.
- The Fund may use hedging techniques to attempt to offset certain market risks but there is no guarantee that hedging techniques will fully and effectively achieve their desired result.
- 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 30 June 2019

For the first half of 2019, the Matthews Japan Fund returned 12.68% while its benchmark, the MSCI Japan Index, returned 7.97%. For the quarter ending 30 June, the Fund returned 0.81%, underperforming its benchmark, which returned 1.05% over the same period.

Market Environment:

Japanese equities posted solid gains in the first half, even as global markets experienced swings in sentiment. Early this year, the U.S. Federal Reserve's pause in rate hikes improved investor sentiment and Japan equity valuations came back from their lowest levels since the start of the Abenomics era. In May, however, trade friction between the U.S. and China intensified, with tariff hikes and a temporary U.S. ban of Huawei products dampening export companies and the technology sector in particular.

The larger macro environment, meanwhile, continues to slow. The global manufacturing purchasing managers' index (PMI) for May came in at 49.8, its lowest level since October 2012. A reading of below 50 indicates a contraction of manufacturing activity. The Bank of Japan's most recent Tankan Survey (announced July 1) showed further deterioration in the outlook among respondents within the manufacturing sector, reflecting the weakness of exports, especially among semiconductor-related products. Domestic consumption remained sluggish, and we expect this will continue with Japan's consumption tax increasing in October to 10% from the current 8%.

Performance Contributors and Detractors:

The Fund's outperformance during the first six months of the year was driven by strong stock selection among smaller and midsize companies, which make up roughly half of the portfolio. While index returns were largely driven by large-cap companies performing better than small caps, we were able to overcome the overall trend with stock selection. From a sector perspective, stock selection in information technology (IT), industrials and health care were positive contributors to performance. Our focus on productivity improvement through software, IT services and automation helped us capture attractive returns within the sector, despite the cyclical downturn in semiconductors and sluggish industrial production. Meanwhile, our holdings in the consumer discretionary sector detracted from performance.

Turning to individual securities, Net One Systems was a strong contributor in the first half. The company is transforming from a hardware-centric business model to one that is maintenance- and service-oriented, experiencing margin expansion along the way. Telecom and venture capital firm SoftBank also contributed to performance. SoftBank's share price rose following the announcement of a massive 600 billion yen (US$5.5 billion) stock buyback. The recent IPO of transportation network company Uber in the U.S. and other unicorn companies going public also spurred interest in other pre-IPO companies that SoftBank and its Vision Fund currently hold.

The largest detractor from performance was dollar-shop retailer Seria. Seria has long enjoyed much higher operating margins than its peers. Competition has intensified, however, while the overall retail environment remain sluggish. Home fashion goods retailer Ryohin Keikaku also was a detractor to performance after the company reported fiscal year earnings below the guidance that was revised down only three months earlier. Although we believe in the long-term brand equity of the firm's marquee products, we continue to monitor and evaluate its growth prospects and execution abilities.

Notable Portfolio Changes:

During the half, we continued to reduce our exposure to cyclical stocks, taking advantage of the market rally in January. We reallocated proceeds to higher-quality companies that were sold off toward the end of last year, which were trading at the lower end of their price range despite their ability to grow in a slower macro environment. We also conducted research on high-quality growth companies in cyclical sectors, but we still think it would be premature to build a substantial position in these sectors.

Regarding new positions, we initiated a position in Yahoo Japan. The company in May announced a corporate structure change resulting in Altaba and SoftBank Group selling out and Yahoo Japan coming under the umbrella of SoftBank's domestic telecom business. The company can now focus on online ads and e-commerce, two bright spots of growth in Japan. We also initiated a position in SBI Holdings, the largest online broker and second-largest among all brokerages in Japan. Unlike its competitors where a majority of assets under management are held by clients in their 60s and 70s, SBI Holding's core demographics are customers in their 30s and 40s, which is set to grow given that Japanese pensions are no longer sufficient to support retirement life. And we initiated a position in Shionogi, a pharmaceutical company focused on small molecule drugs in infectious disease areas. During the quarter, we exited two positions—ORIX and Suzuki Motor—and found more compelling investment themes elsewhere.

Outlook:

While Japanese equities experienced healthy gains in the first quarter, the macro environment remained muted and second-quarter broad market equity returns were mixed. Underlying fundamentals are still on a downward path, and developments surrounding trade frictions remain unpredictable. We do not expect any dramatic outcomes or resolution of current issues. On a positive note, corporate inventory levels have declined quickly in the past six months. Recent earnings results showed an earnings decline in many sectors but absolute profit levels remain higher than during past downturns.

Additionally, given earnings growth no longer drives return-on-equity improvement, share buybacks by Japanese companies are at a record level, with many companies using their cash holdings to bolster equity performance. While valuations have risen a bit, they remain near the low end of their historical range. The MSCI Japan Index's price-to-book ratio is now 1.20X, up from the lows of a 1.16X level at the end of 2018. While Japanese corporate earnings tend to be procyclical with higher earnings volatility than developed-market peers, we continue to believe the earnings capability of Japanese companies has improved meaningfully over the past economic cycle, driven by better corporate governance and a higher focus on capital efficiency.

Annual Returns For the Years Ended 31 December

Matthews Japan Fund	2018	2017	2016	2015	2014
I (Acc) (USD)	-20.58%	33.40%	0.19%	4.00%*	n.a.
I (Acc) (GBP)	-16.16%	21.57%	20.43%	8.20%*	n.a.
I (Acc) (USDH)	-20.85%	27.10%*	n.a.	n.a.	n.a.
I (Acc) (EURH)	-23.30%	25.30%*	n.a.	n.a.	n.a.
MSCI Japan Index (USD)	-12.58%	24.39%	2.73%	-3.81%*	n.a.

* Performance shown from share class launch date to calendar year end.

For YTD performance figures, please refer to the Quarterly and Monthly Performance pages.

Additional performance, attribution, liquidity, value at risk (VaR), security classification and holdings information is available on request for certain time periods.

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