Matthews Pacific Tiger Fund

Period ended 30 June 2018

For the first half of 2018, the Matthews Pacific Tiger Fund returned -5.74% while its benchmark, the MSCI All Country Asia ex Japan Index, returned -4.65%. For the quarter ending 30 June, the Fund returned -3.90% while its benchmark returned -5.31% over the same period.

Market Environment:

Asian equities ended the first half of the year on a weak note. Market volatility continued during the second quarter as investors worried about global trade issues. Some markets were also affected by domestic concerns, including local politics and elections. Nonetheless, many Asian currencies proved resilient, especially when compared to other emerging market currencies. Exceptions to this trend included the Indonesian rupiah, Indian rupee and Philippine peso, which depreciated relative to the dollar.

Semiconductors were among the worst-performing sectors during the second quarter, despite being a top performer in the first quarter. Share prices among semiconductor manufacturers dropped amid concerns over decreasing demand for crypto currency and smartphones. This weakness chipped away at the luster that semiconductor stocks enjoyed during the first quarter.

India was one of the region's better-performing equity markets during the first half of the year, though its currency depreciated. This dichotomy highlights a tussle between macro and micro viewpoints over India's direction. Some macro factors are turning unfavorable for the Indian economy, while many individual companies remain optimistic about their prospects. Meanwhile, domestic Chinese markets experienced the sharpest drop in equity prices in the region during the first half of the year. The drop stemmed from trade concerns, as well as potential fallout from a government financial de-risking exercise that is being misconstrued as deleveraging. China, however, is no longer an export-oriented economy. Net exports accounted for only 3.4% of China's GDP in 2017. Domestic consumption and a growing middle class continue to be the key drivers of China's growth.

Performance Contributors and Detractors:

The Fund outperformed its benchmark on a relative basis during the second quarter, providing a bit of shelter against broader market declines. Stock selection contributed to the Fund's favorable relative performance during the quarter, offsetting the negative allocation effect that was partly driven by large swings in currency for some south Asian economies. From a sectoral perspective, the strength within a few of the consumer-related holdings across the region was a key driver of returns during the quarter.

Turning to performance detractors, the Fund's health care holdings faced headwinds during the quarter. Drug distributors in China struggled against a stricter regulatory environment and increasing financial costs as hospitals are extending payment terms to deal with their own inability to charge a markup on drug sales. In spite of some setbacks, we continue to believe in the long-term growth prospects for health care-related spending in China and across the region, but are also mindful of the expectations that are starting to be reflected in certain health care subsectors.

Notable Portfolio Changes:

Market volatility created opportunities for rotating capital within the portfolio. We added to our position in Naver, an IT firm operating South Korea's top search engine. A blip in sentiment around the stock during the second quarter caused a temporary price decline, and created a buying opportunity. Likewise, Inner Mongolia Yili Industrial Group, a producer of dairy products in China, suffered a pullback in its stock price with no real change to its long-term prospects, in our view, providing another attractive buying opportunity. We also exited our position in Astra International, an Indonesian conglomerate with a range of manufacturing operations, to fund the inclusion of two new small-cap holdings during the course of the first half.

Outlook:

In contrast to the robust confidence among consumers and corporations in parts of Asia, the region's equities finished the first half on a soft note. We believe the health of many Asian economies remains sound. The continued expansion in wages and increasing household wealth is leading to rising aspirations for consumers, most notably in China. Elsewhere in the region, policymakers in India and Indonesia have sacrificed growth over the past few years to deal with longer-term structural issues, including current account deficits, fiscal deficits and persistent inflationary pressures. The more recent attempts at boosting growth are yielding mixed results, although there are some encouraging signs— particularly in India where businesses are finally seeing a more normalized economic environment following policy- and taxation-related changes over the past two years.

An oft-repeated concern within some parts of the investment community is the vulnerability of Asian businesses and economies to rising interest rates in the U.S. We believe Asian businesses, however, may be less affected by rising U.S. rates as sources of capital and liquidity for Asia's businesses continue to expand and diversify. U.S. and European institutions traditionally may have played a larger role in providing capital and liquidity, but local institutions across Asia are starting to exert their presence more visibly, and policymakers are more amenable to releasing some of the built-up pressures through the exchange rate. The odds of a sharp and sudden shock in the face of rising rates have diminished, although the squeeze in availability of capital may weaken the ensuing recovery in growth.

Furthermore, the potential disruption from trade squabbles may lead to greater uncertainty about the investment outlook, thereby deferring private capital expenditure. Given our emphasis on service-oriented businesses catering to domestic demand, we expect the impact of global factors on our portfolio holdings to be somewhat muted. Worries about the global macro-economy and political developments have led to attractive valuations across many parts of Asia, in our view creating an opportunity to invest in the long-term growth of the region without undue risk.

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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