Matthews China Small Companies Fund

What is the objective of the Matthews China Small Companies Fund?

The Matthews China Small Companies Fund seeks long-term capital appreciation by investing primarily in small companies in China. China includes its administrative and other districts, such as Hong Kong.

How do you define small companies?

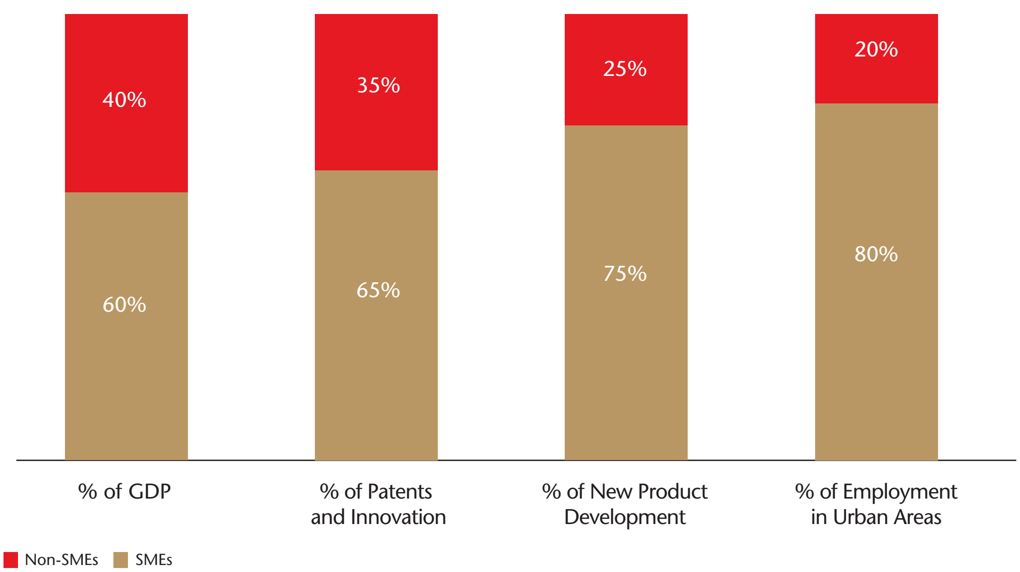
Typically, Matthews China Small Companies Fund invests in companies that have a market capitalization between US$100 million to US$3 billion at the time of purchase. We are able, however, to invest in companies as large as the largest company in the benchmark—the MSCI China Small Cap Index.

The value of an investment in the Fund can go down as well as up and possible loss of principal is a risk of investing. Investments in international and emerging market securities may involve risks such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation. The Fund invests in holdings denominated in foreign currency, and is exposed to the risk that the value of the foreign currency will increase or decrease. The Fund invests primarily in equity securities, which may result in increased volatility. Investments in a single-country fund may be subject to a higher degree of market risk than diversified funds because of concentration in a specific country. The Fund invests in smaller companies, which are more volatile and less liquid than larger companies. These and other risks associated with investing in the Fund can be found in the Prospectus.

What is the appeal of investing in China's smaller companies?

Small-cap companies in China are at the forefront of the country's economic shift away from fixed asset investments toward innovation, consumption and services. Small-cap companies tend to thrive in productivity- and value-enhancing industries such as automation, health care, e-commerce and education. These areas are underrepresented in large-cap-oriented benchmarks and portfolios. We believe these small-cap companies have the entrepreneurial spirit and flexibility to recognize and respond to changing local market trends, including changing patterns of consumption.

Figure 1. Small Businesses Play an Important Role in China's Economy



SME: Small and medium enterprise
Source: Ambassador Cheng Jingye's Speech at China SME Global Development Forum, June 2012

What type of companies are you looking to identify?

Through rigorous on-the-ground research and due diligence, in a market that is relatively uncovered by the sell-side research community, we aim to identify quality businesses run by disciplined management teams that can grow sustainably and survive over a full market cycle. The portfolio invests in asset-light businesses with low leverage. These companies tend to have faster average earnings growth and higher average return in invested capital compared with the overall China small-cap equity market.

What makes China's smaller companies attractive investments?

Smaller companies in China may lack access to capital, meaning they must be more competitive, innovative and capital-efficient than their larger peers both to survive and thrive. This capital efficiency can drive a strong return on invested capital. While smaller companies in China are perceived to be a higher risk investment, the historical volatility of Chinese small caps has been lower than the overall Chinese equity universe and even the U.S. small-cap universe.* In our opinion, small companies provide opportunities for higher growth at lower valuation because they are less well-known. This allows active managers to uncover opportunities among high-quality companies with good corporate governance at lower valuations.

On which areas of the small-cap market does the Fund focus?

The Fund focuses on innovative, efficient and sustainable growth companies, with an emphasis on businesses oriented toward domestic demand and rising income levels. The structural attributes of the portfolio include a consistent overweight allocation in the consumer and health care sectors, as well as selective businesses within the industrials and information technology sectors. In addition, the Fund generally is structurally underweight in companies with cyclical business models, such as those in the materials sector.

Is innovation a key consideration when selecting stocks for the portfolio?

Yes, it is an important consideration when we look to invest in small companies in China. Smaller companies don't have much capital to compete with their larger peers. The most sustainable way of winning against the bigger companies, therefore, is through sustainable innovation. This could be a technology innovation that results in an intellectual-property moat or a business-model innovation where the smaller company has figured out a better way to do business.

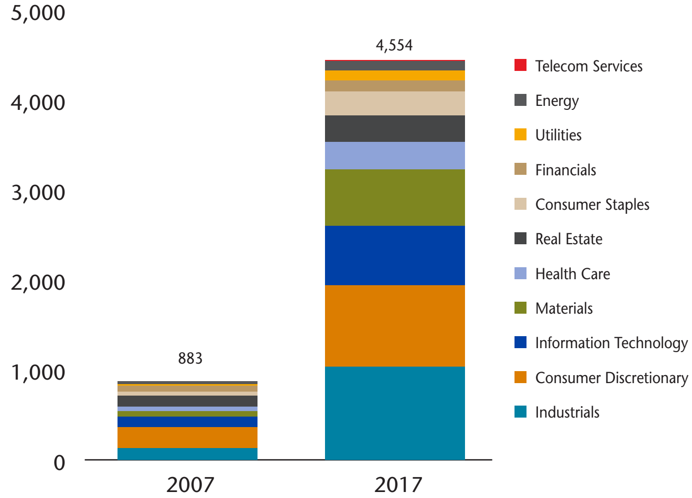
How big is China's universe of small-capitalization companies?

Over 4,500 companies domiciled in China have a market capitalization of less than US$3 billion.

What is your investment process?

At Matthews Asia, we employ a fundamental, bottom-up investment process. We seek to identify companies with sustainable long-term growth prospects, strong business models, quality management teams and reasonable valuations. We believe this bottom-up process is particularly well-suited for the small-cap asset class.

Figure 2. China's Small Company Universe is Expanding for Foreign Investors



Includes all companies domiciled in Hong Kong, Macau and mainland China with market cap of US$50MN to US$3BN. 2007 figures do not include companies listed on the Shanghai or Shenzhen exchanges as they were not available to foreign investors at the time.
Sources: FactSet Research Systems and Bloomberg as of December 31, 2017

Our pool of potential candidates for the portfolio is comprised of over 4,500 companies. As most of these companies are not widely covered by sell-side analysts, we first screen for companies with these attributes: return on invested capital, sales growth, gross margins, liquidity and net debt to equity. We then employ technical analysis to identify a subset of around 300 to 350 companies. In the next stage, we conduct a deeper analysis into the industry dynamics and secular growth trends in China in order to identify sectors, subsectors and companies that we believe offer the most attractive long-term growth potential. These measures of attractiveness include: relative independence from government regulation and changes in policy; parts of the economy that offer long-term growth prospects; sectors that have the ability to benefit from pricing power; and sectors that have lower competition. This narrows our investment universe down to some 100+ companies for potential inclusion in the portfolio.

How do you then construct the portfolio?

Once a quality company and management team has been identified, we consider valuation from multiple angles, including measuring the value of the company's business as a whole in order to determine whether the current entry point is sensible, both in the context of its current business, and its future growth prospects. In constructing the portfolio, our position sizes are determined by several factors such as liquidity, valuations and our conviction in corporate fundamentals. Our portfolio is benchmark-agnostic and is fairly concentrated. We tend to have 40 to 60 holdings with position weightings typically ranging between 1% and 5%. While we put no upper limit on the holding size, a typically high-conviction holding size is higher than 2.5%.

*Between 2008 and 2017. Chinese small-capitalization stocks as represented by the MSCI China Small Cap Index. U.S. small-capitalization stocks are represented by the Russell 2000 Index.

We believe benchmarks are backward-looking and do not accurately reflect how China's economy and society will develop. While we are mindful of diversification, it does not dictate our portfolio construction decisions. The outcome of this approach is a high active share of more than 90%.

What happens when a company grows to the size that no longer can be considered "small cap"?

The Fund's portfolio managers are disciplined about reallocating capital once certain holdings become mid-cap companies. The overall aim is to build a balanced portfolio of companies that come from China's diverse markets and sectors. For those in the same sector, we look to diversify across subsectors.

How important is meeting with management?

Meeting with management is a critical component of our investment process. Over 3,100 actively traded small companies in China lack any analyst coverage. With little or no broker coverage of Chinese small-cap companies, our analysis is comparable to what would be done on a typical private-equity investment—using rigorous due diligence to uncover the many untapped high-quality opportunities in this space. The aim of the portfolio managers is to peel away the layers of the company in order to understand the cohesiveness of its past, present and future. As part of this, we aim to meet with a company's management team before investing in it. A sense of trust in the team is of central importance. A key aspect is to understand management's strategic vision and how it expects to deliver on its expectations for its product or service innovation. We also assess the founder's background for experience and integrity in order to judge the overall governance of the firm.

What is your investment horizon when investing in smaller companies?

Contrary to many investors in small-cap stocks, we aim to extend our investment horizon to a minimum of three years and ideally to five years or longer when investing in a business.

What's a key misconception an investor may have about China's small companies?

There are misconceptions about the level of volatility in China's small-cap market. In fact, China's small-cap stocks tend to be less volatile than large-cap Chinese stocks because they are more macro-agnostic and carry less debt. More surprisingly, compared with U.S. small caps as represented by the Russell 2000 Index, Chinese small caps were less volatile, had higher return on equity (ROE) and lower leverage ratios.* We continue to believe that small caps in China offer very attractive risk-adjusted return potential compared with equity markets globally.

What risk measurement tools do you use?

We seek to directly address the risks of investing in China's smaller companies within our research and due diligence process. This includes corporate governance oversight, limited product lines, markets or financial resources, dependency upon key individuals or lack of management depth, limited access to capital, or limited stock liquidity. We believe that embedding risk management in the due diligence process can help to mitigate risk and contribute to a portfolio with lower volatility than the overall small-cap market.

What experience does Matthews Asia have investing in China's smaller companies?

For more than 20 years, Matthews Asia has provided investors with access to opportunities created by China's profound economic transformation. We have invested across the market-cap spectrum, including smaller companies, since the launch of the Matthews China strategy in 1998. Our experience across market cycles provides us with a thorough understanding of what it takes for companies to be successful in the rapidly changing Chinese economy.

What experience does the Lead Manager have investing in small companies in China?

Tiffany Hsiao, CFA, is the Lead Manager† of the Matthews China Small Companies strategy, and has 15 years of industry experience researching and investing in Chinese equities, as well as innovative companies across the technology and services sectors in Asia. Tiffany joined Matthews Asia in 2014 and has been Lead Manager of the Fund since July 2015. Tiffany is supported by a 45+-strong investment team at Matthews Asia.

Why should investors consider this fund?

The Matthews China Small Companies Fund provides investors with exposure to a growing universe of small companies that account for an increasingly meaningful share of China's economic growth. Through participation in the Fund, investors can gain access to private sector entrepreneurialism and transformational areas of China's economy, such as the burgeoning services and consumer sectors that we believe will drive China's growth during the coming decades. The Fund may be suitable for risk-tolerant investors seeking greater exposure to China's long-term economic development and looking to supplement their existing portfolio of Asian or Emerging Market equities.

* Between 2008 and 2017. Chinese small-capitalization stocks as represented by the MSCI China Small Cap Index.
†Updated as of January 2019

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Disclosures and Notes

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Matthews International Capital Management, LLC (“Matthews Asia”) is the Investment Manager to Matthews Asia Funds.

Investment team members in this report include employees of Matthews Asia and its subsidiaries.

The Fund is a sub-fund of Matthews Asia Funds SICAV, an umbrella fund, with segregated liability between sub-funds, established as an open-ended investment company with variable capital and incorporated with limited liability under the laws of Luxembourg.

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The Funds invest primarily in equity securities, which may result in increased volatility. It is possible to lose the principal capital of your investment. The Funds may invest in Asian countries and economies. Investments in Asian economies involve certain risks and special considerations such as greater political, tax, economic and regulatory risks. Additional risks relate to liquidity and the repatriation of capital and income due to currency controls which may adversely impact the value of Fund holdings. In addition, single-country funds may be subject to a higher degree of market risk than diversified funds because of concentration in a specific geographic location. 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 large companies. Focused funds may be subject to greater share price volatility as a larger portion of their assets may be invested in the securities of a single issuer compared to diversified funds. Distribution of dividends, if any, is not guaranteed. There can be no guarantee that companies that the Funds invests in, and which have historically paid dividends, will continue to pay them or to pay them at the current rates in the future. The Funds do not hedge to attempt to offset certain market risks. This may expose the Funds to the risk of full losses resulting from a decline in a security’s value. The Funds may hold investments denominated in multiple currencies. Movements in the exchange rate between these currencies and the base currency of the Funds may adversely affect performance.

The Fund may, at their discretion, pay dividends out of the capital or effectively out of capital in respect of the distribution shares. Payment of dividends out of capital and/or effectively out of capital represents a return or withdrawal of part of an investor’s original investment, or from any capital gains attributable to that original investment. Such dividends may result in an immediate decrease of the net asset value of the relevant shares.

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Index Definitions

The MSCI China Small Cap Index is a free float–adjusted market capitalization–weighted small cap index of the Chinese equity securities markets, including H shares listed on the Hong Kong Exchange, B shares listed on the Shanghai and Shenzhen exchanges, and Hong Kong-listed securities known as Red Chips (issued by entities owned by national or local governments in China) and P Chips (issued by companies controlled by individuals in China and deriving substantial revenues in China).

The MSCI China Index is a free float–adjusted market capitalization–weighted index of Chinese equities that include China-affiliated corporations and H shares listed on the Hong Kong exchange, and B shares listed on the Shanghai and Shenzhen exchanges.

The Russell 2000 Index measures the performance of the small-capitalization segment of the U.S. stock market.

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