

Matthews China Small Companies Fund

Choose a Share Class: Investor 

Period ended September 30, 2020

For the quarter ending September 30, 2020, the Matthews China Small Companies Fund returned 1.88% (Investor Class) and 1.97% (Institutional Class), while its benchmark, the MSCI China Small Cap Index, returned 10.79% over the same period.

Market Environment:

Chinese monthly economic data continues to show signs of recovery as reflected in the latest manufacturing and service purchasing managers' index (PMI) data as well as business recovery statistics. Domestic recovery is occurring alongside a stabilizing export sector and improving labor market, both of which should support better earnings prospects going forward.

COVID-19 remains a risk for economies globally, including China. While small pockets of coronavirus infections still occasionally emerge, China remains successful at flattening its curve of COVID-19 infections. Vigilant about testing, quarantining known cases and contact tracing, China has had the most success among large economies in our view in combatting the virus.

Small- and mid-cap equities in China—companies with market capitalization between US\$1 billion and \$10 billion—generated attractive stock price gains calendar year to date. Much of these gains occurred within the information technology, health care and the consumer staples sectors. At the same time, the strong stock price performance of these sectors has largely been driven by expansions in price-to-earnings multiples, resulting in higher valuations.

Performance Contributors and Detractors:

Flat Glass, which manufactures solar glass that goes into the solar panel module, was a notable contributor. China is very close to achieving grid parity, where the price of renewable energy becomes more competitive with the price of energy produced through fossil fuels. The trajectory of renewable energy expansion in China is very clear in our view and we expect continued solar growth in China given the government's supportive policies, such as a goal of carbon neutrality by 2060. We believe Flat Glass is well-positioned within the competitive landscape of China's solar industry, where scale matters and there are only a few key players in the space.

On the other hand, a detractor in the quarter was Times China, which focuses on developments in the Greater Bay Area in Guangdong province. China's policymakers have earmarked the region for further development in high-value-adding sectors such as the technology and financial industries, and is likely to see growth in infrastructure connectivity over time. Times China has an ample land bank in this region, allowing it to continue to grow its footprint. The real estate industry has been sluggish as the pandemic has disrupted sales in China, but we continue to like the company's long-term prospects in land banking, as well as its attractive valuations.

From a sector perspective, stock selection and an overweight in health care detracted from relative returns in the quarter. Health care names generally saw a pull back over the quarter, and investors became more valuation conscious and took profit off names that did very well in the earlier half of the year. Many biotech related names also saw a correction given less of a risk appetite. Turning to sectors that were contributors, stock selection in industrials contributed to relative performance.

Notable Portfolio Changes:

Given the strong run-up in the market earlier in the calendar year, we trimmed or exited some holdings in the quarter where valuations had significantly increased since the start of year. For example, we took profits in sectors such as information technology, health care and consumer staples, reallocating the proceeds into other areas where valuations look more attractive. In areas where we've trimmed back, such as the information technology, health care and consumer staples sectors, we expect to re-invest and maintain meaningful exposure of these sectors over time.

Many of our closed positions in the quarter were in the biotech industry, reflecting rising valuations, as well as the difficulty of assessing which product pipelines may yield game-changing new drugs and treatments. Biotech holdings we exited in the quarter include Genscript Biotech Corp., Cansino Biologics and Burning Rock Biotech. With a keen interest in the health care sector, we rotated the capital into other health care area that we believe have more visible earnings growth profiles. New positions in the quarter include independent clinical laboratory service provider Dian Diagnostics Group.

Dian Diagnostics is an independent clinical laboratory services provider that has just gone through an expansion phase. The company's heavy investment period has just come to an end, and in the next few years, the company will begin to ramp up the operations of its new laboratories, and will likely see an expanding margin profile as

Average Annual Total Returns - Investor Class (9/30/2020)

1-year 78.52%
3-year 24.93%
5-year 24.47%
10-year n.a.
Inception (5/31/11) 11.30%

Gross Expense Ratio

1.62%

After fee waiver and expense reimbursement: 1.38%¹

¹ Matthews has contractually agreed (i) to waive fees and reimburse expenses to the extent needed to limit Total Annual Fund Operating Expenses (excluding Rule 12b-1 fees, taxes, interest, brokerage commissions, short sale dividend expenses, expenses incurred in connection with any merger or reorganization or extraordinary expenses such as litigation) of the Institutional Class (which is offered through a separate prospectus to eligible investors) to 1.20%, first by waiving class specific expenses (e.g., shareholder service fees specific to a particular class) of the Institutional Class and then, to the extent necessary, by waiving non-class specific expenses (e.g., custody feeds) of the Institutional Class, and (ii) if any Fund-wide expenses (i.e., expenses that apply to both the Institutional Class and the Investor Class) are waived for the Institutional Class to maintain the 1.20% expense limitation, to waive an equal amount (in annual percentage terms) of those same expenses for the Investor Class. The Total Annual Fund Operating Expenses After Fee Waiver and Expense Reimbursement for the Investor Class may vary from year to year and will in some years exceed 1.20%. If the operating expenses fall below the expense limitation in a year within three years after Matthews has made a waiver or reimbursement, the Fund may reimburse Matthews up to an amount that does not cause the expenses for that year to exceed the lesser of (i) the expense limitation applicable at the time of that fee waiver and/or expense reimbursement or (ii) the expense limitation in effect at the time of recoupment. This agreement will remain in place until April 30, 2021 and may be terminated at any time by the Board of Trustees on behalf of the Fund on 60 days' written notice to Matthews. Matthews may decline to renew this agreement by written notice to the Trust at least 30 days before its annual expiration date.

All performance quoted is past performance and is no guarantee of future results. Investment return and principal value will fluctuate with changing market conditions so that shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the return figures quoted. Returns would have been lower if certain of the Fund's fees and expenses had not been waived. Please see the Fund's most recent [month-end performance](#).

utilization increases. We remain convinced that outsourced clinical laboratory services will be a secular trend as hospitals become more budget and efficiency conscious and look to outsource services to scaled providers such as Dian, who are able to perform required services at lower fees.

Outlook:

Schools have reopened in Wuhan, the first city to be hit by the pandemic earlier in the year. China's effective health care response has played an important role in reopening school, businesses and government offices across China. Keeping the coronavirus under control is key to maintaining China's economic recovery, and the portfolio team continues to see reasons for optimism on the public health front. Positive sentiment among domestic Chinese consumers is spurring increased economic activity. Fiscal stimulus in China has been incremental in scope and highly targeted, a trend the portfolio team expects may continue. Interest rates in China have moved higher, reflecting China's economic resilience amid the pandemic.

Chinese manufacturing data points to a continued V-shaped recovery and a bright spot within the data suggests that small, private businesses are beginning to participate within the rebound. Even the slow-to-recover consumer-oriented sectors are starting to show improvement including restaurant sales, cinema box office receipts and domestic travel. Domestic recovery is occurring alongside a stabilizing export sector and improving labor market, both of which should support better earnings prospects going forward.

Purchasing Managers Index (PMI) is a benchmark indicating the direction of economic trends in the manufacturing and service sectors.

As of 9/30/2020, the securities mentioned comprised the Matthews China Small Companies Fund in the following percentages: Flat Glass Group Co., Ltd. H Shares, 2.9%; Times China Holdings, Ltd., 2.4%; Dian Diagnostics Group Co., Ltd. A Shares, 1.6%. The Fund held no positions in Genscript Biotech Corp., Cansino Biologics and Burning Rock Biotech. Current and future portfolio holdings are subject to change and risk.

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.

Visit our [Glossary of Terms](#) page for definitions and additional information.

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