GUINNESS

Best of China Fund

Annual review

2016

Edmund Harriss
Portfolio manager

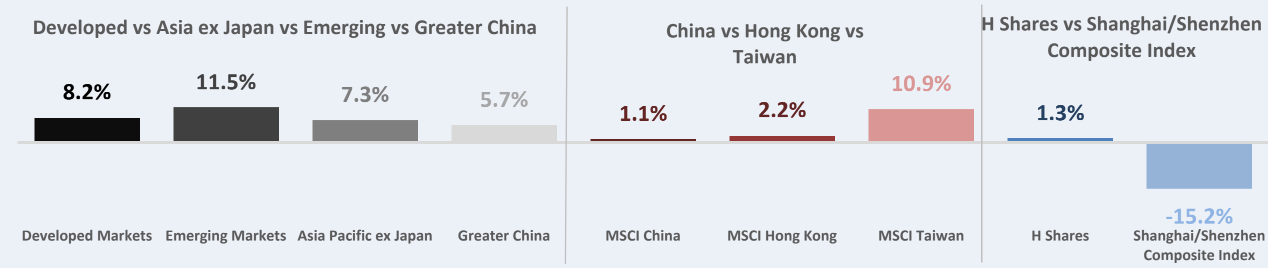
GUINNESS
ASSET MANAGEMENT LTD

2016

Fund size
Start of year **$0.6m**
End of year **$0.6m**

What happened in Greater China and the world?

- China opened the year with a stock market crash leading to fears of economic crisis accompanied by collapsing commodity prices with oil hitting $26 per barrel and iron ore $40 per tonne.
- China ended the year with evident domestic economic momentum, an end to almost 5 years of falling producer prices and a rebound in industrial profits.
- Iron ore prices rebounded to $78 per tonne to the relief of Australia and Brazil; oil prices recovered to $40 per barrel and lifted further to $50 by OPEC's decision to reverse production strategy to the relief of all oil producers.
- Big shifts in the political landscape in the US and UK with the election of Donald Trump as the next US President and the UK's decision to quit the European Union.



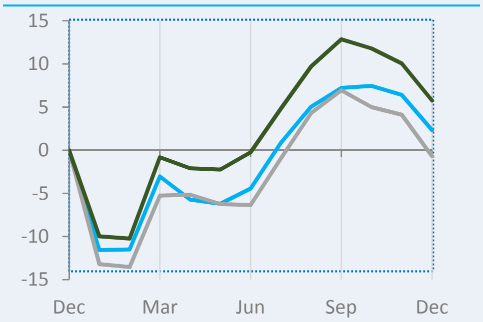
Total return in USD; MSCI World & MSCI Emerging Markets Index; MSCI AC Pacific ex Japan; MSCI Greater China individual MSCI World GICS sectors.

What happened in the Fund?

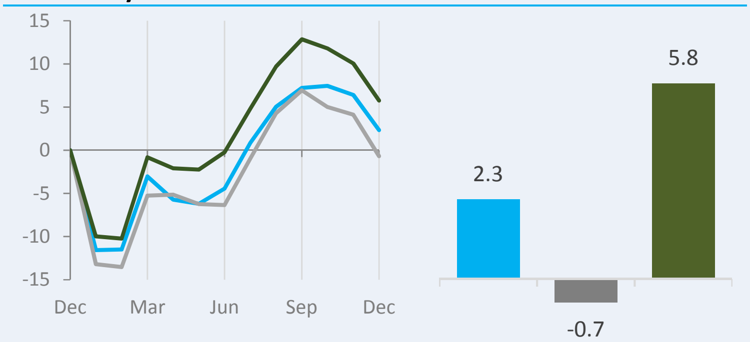
- The Fund rose 2.3% (X class, total return in USD terms) compared to the MSCI Golden Dragon Index which rose 5.8%. Underperformance in the first half of the year was followed by outperformance in the second half.
- Despite the weakness relative to the benchmark the Fund performed better than many of its peers, ending the year 13th out of 37 funds in the IA Greater China sector.
- In 2016, MSCI China rose 1.1%, MSCI Hong Kong rose 2.2% and MSCI Taiwan rose 11.7%. Taiwanese stock market strength was broad-based and appeared to be in response to Mainland China weakness.
- In the second half of the year markets settled down and the Fund performed as expected, outperforming in weaker markets and capturing most of the upside in stronger conditions.
- The top three stocks were Geely (HK, consumer discretionary), Tongda Group (HK, information technology) and AAC Technologies (HK, information technology).
- The weakest three stocks were Lenovo (HK, information technology), Li & Fung (HK, consumer discretionary) and Pacific Textiles (HK, consumer discretionary).
- **Purchases**: Sino Biopharmaceutical, PAX Global, Haier Electronics and New Oriental Education
- **Sales**: China Life Insurance, Nagacorp, PCCW and Radiant Opto-Electronics

Performance (%)

Cumulative since launch



Calendar year 2016



Fund Guinness Best of China
Sector IA Greater China
Index MSCI Golden Dragon

Cumulative % gross total return, in GBP.
Source: Financial Express.

Past performance should not be taken as an indicator of future performance. The value of investments and any income arising from them can fall as well as rise.

Fund size (31.12.16)	**$0.6m**
Launch date	**15.12.15**

Aim

Guinness Best of China Fund is designed to provide investors with exposure to economic expansion and demographic trends in China and Taiwan.

The Fund is managed for capital growth and invests in profitable companies generating persistently high return on capital over the business cycle

Performance 31.12.16

Fund	Best of China Fund
Index	MSCI Golden Dragon
Sector	IA China/Greater China

	1 year	3 years	From launch
Fund	2.3	0.0	3.2
Index	-0.7	9.5	1.6
Sector	5.8	20.4	8.5

Annualised % gross total return from launch (USD)

Risk analysis (annualised, weekly, from launch)

	Index	Sector	Fund
Alpha	0.0	0.0	5.1
Beta	1.0	1.0	1.0
Info ratio	0.0	0.0	1.0
Max drwdn	-15.5	-19.5	-17.0
Tracking err	0	0	5
Volatility	18.1	18.0	18.3
Sharpe ratio	0.6	0.3	0.5

Past performance should not be taken as an indicator of future performance. The value of this investment and any income arising from it can fall as well as rise as a result of market and currency fluctuations.

Source: Financial Express, bid to bid, gross total return
Fund X class: calculated in USD.

Annual review

2016 in review

In 2016 the Fund increased by 2.3%, while the benchmark (MSCI Golden Dragon Index) increased by 5.7%.

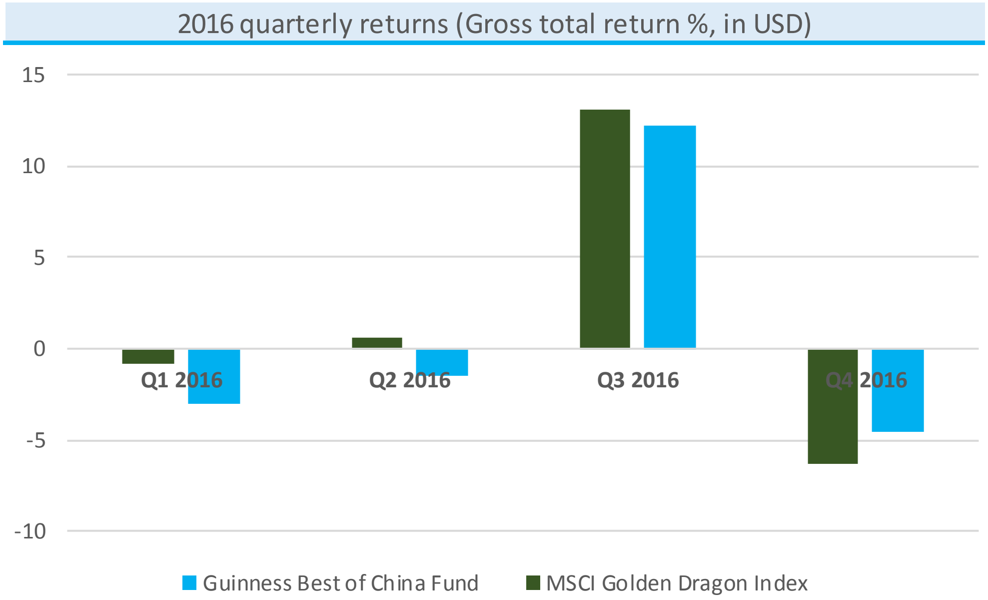
The Fund seeks good quality companies, which we define in financial terms as those that have generated returns on invested capital which have been above the cost of capital for at least eight years and which we therefore believe are likely to persist. We invest in those companies whose stock prices which in our opinion, undervalue that likely persistence. The portfolio consists of 33 stocks which are equally weighted and rebalanced from time to time. Our expectation is that the portfolio will tend to outperform in weaker or tentatively rising markets and will capture most, although not all, of the rise in stronger markets.

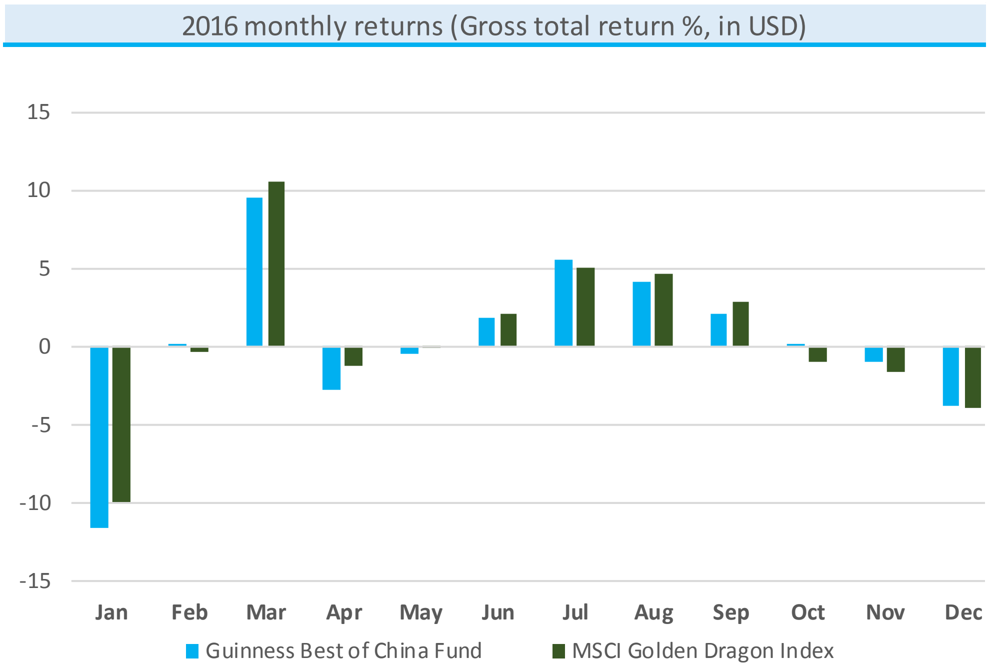
In the first half of the year this expected pattern did not occur but, as we shall see, this was due to an unusual set of circumstances which prevailed until April. For the rest of the year the Fund both outperformed and conformed to its expected performance pattern.

The MSCI Golden Dragon Index is the amalgamation of the MSCI China, Hong Kong and Taiwan indices. At the end of 2016 China accounted for 54.3% of the index, Hong Kong 21.3% and Taiwan 24.4%. For the most part at least two of the components tend to move similarly at any one time, but in 2016 Taiwan was by far the strongest, up almost 12%, while China and Hong Kong rose 1% and 2% respectively. The portfolio was and remains underweight in Taiwan and overweight in China. This is not a top-down decision but reflects where we believe the best quality (as we define the term) and value are to be found. Much (though not all) of the strength we saw in Taiwanese stocks came from companies that do not make it through our initial quality screen criteria – long track records of above average return on capital, moderate debt levels and minimum market capitalisation.

The foregoing analysis is not intended to excuse underperformance but to help understand what went on in the first few months of 2016 and whether there is anything we should learn from this. The fact that Taiwan strength came from lower quality businesses in response to unusual stresses elsewhere (in this case economic fears for Mainland China) would suggest that these moves are temporary in nature and unlikely to be sustained, and that therefore we should be confident in our process. From May onwards Taiwan stock performance remained buoyant, but China also recovered. So too did the Fund, which has been clawing back relative performance ever since.

In the next sections of the report we review the performance of the Fund on a quarterly and monthly basis, identifying some of the specific factors that caused it to deviate from the expected pattern. We then review portfolio activity, discussing specific stock changes in the portfolio during the year, and finish with a brief outlook for 2017.





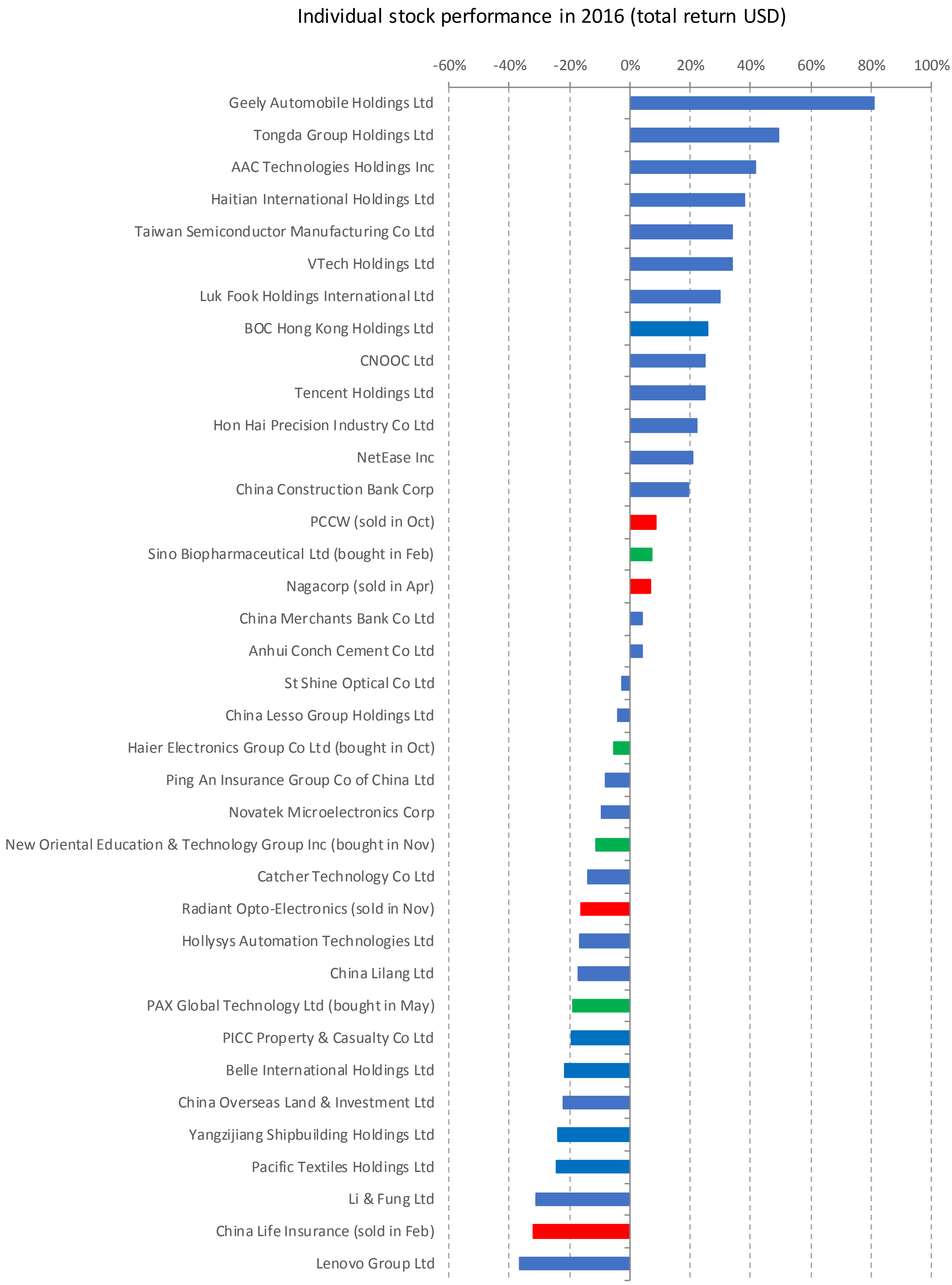
In the first two months of the year, China's domestic stock markets sold off heavily as newly applied circuit breakers on the Shanghai Exchange sparked fears among investors that they would find themselves locked in. The rest of the world looked at the falls and wondered if this was a sign that the Chinese economy was finally cracking under the weight of accumulated debt and excess industrial capacity. Commodities, industrial metals and oil all hit new lows. The price of iron ore hit its lowest level since 2008 and oil was at its lowest level since 2002.

The Fund fell by 11.6% in January while the benchmark fell 10.0%. This was contrary to our expectation that the Fund should fall less in falling markets. There were two main reasons behind this. The first was because the Fund was overweight China and Hong Kong at the beginning of the year. Since these markets fell by significantly more than the Taiwanese market, the Fund suffered. The second reason was stock specific. Three of our Taiwanese technology holdings fell: Radiant Opto-Electronics (-13.9%), Catcher Technology (-7.7%) and Hon Hai Precision (-4.8%). Concerns over the growth prospects for the iPhone and companies in Apple's supply chain hurt both Catcher and Hon Hai, while Radiant's problem was related to developments in screen technology which threaten to leave the company behind. In the consumer discretionary sector China Lilang, Geely, Li & Fung and Belle International all fell harder than most. Lilang and Belle are both apparel retailers that have been facing more sluggish consumer conditions in recent months while the automaker Geely started the year poorly as its earnings for 2015 missed estimates. Li & Fung is a widely respected and well-managed factory agent based in Hong Kong but while trade growth remains weak so too does its own growth.

Portfolio performance in April was also unexpectedly weak. This was attributable to broad-based weakness in the information technology sector. There was a sell-off in Taiwan and information technology was particularly hit (down 7.6%), with the Fund's worst performing stocks all in the sector. This was not just a problem in Taiwan but was visible in the sector throughout Asia and developed markets. There were more gloomy reports about iPhone sales at the time and this view broadened into a sense that the market for higher-end consumer electronics had become saturated. It was not just Apple phones; PC makers such as Asustek and Compal (both not held) felt the chill, as did high-end TV display and component makers such as Novatek Microelectronics and LG Display (not held). So too did Samsung Electronics (not held), which is exposed to all those segments.

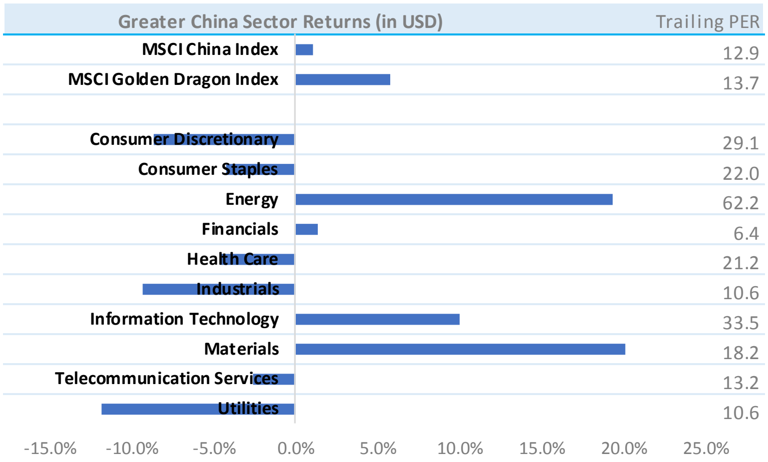
In the third and fourth quarters the Fund performed as expected, lagging a rising market in the third quarter and falling by less in the fourth quarter. June was the month when Britain voted to leave the EU. This came as a shock to everyone, inside the UK and outside. Developed markets generally were weak and Asia was notable for its relative strength. We argued at the time that this was an indication both of growing investor appreciation of the region's cheap valuations and of a more stable operating environment. Certainly, there appeared to be a rotation into Asian stocks, and as we have argued in the past, we believe that when investors buy into the region but with only moderate confidence then good quality names are likely to be the ones they go for.

In October the Fund rose by 0.2% while the benchmark fell by 0.9%. Individual stock performance, rather than geographic or sector allocation, was the driver. Luk Fook (Hong Kong & China jewellery retailer) and Geely (China automaker) both rose by more than 15%. Luk Fook continued its recovery while Geely's new models were well received by consumers. The better performing information technology stocks did not fit a particular theme; Hon Hai benefited from better iPhone sales, Netease's mobile games continued to grow strongly while 2017 growth prospects for Novatek (silicon chip controllers for displays) improved towards the end of the year.

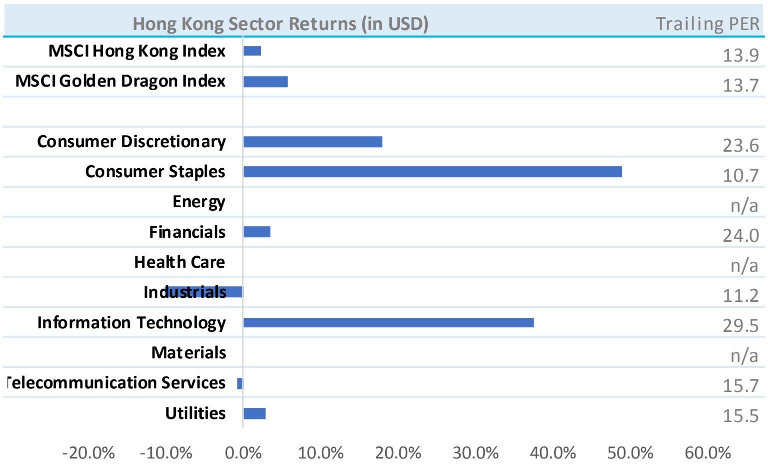


Past performance should not be taken as an indicator of future performance. The value of investments and any income arising from them can fall as well as rise.

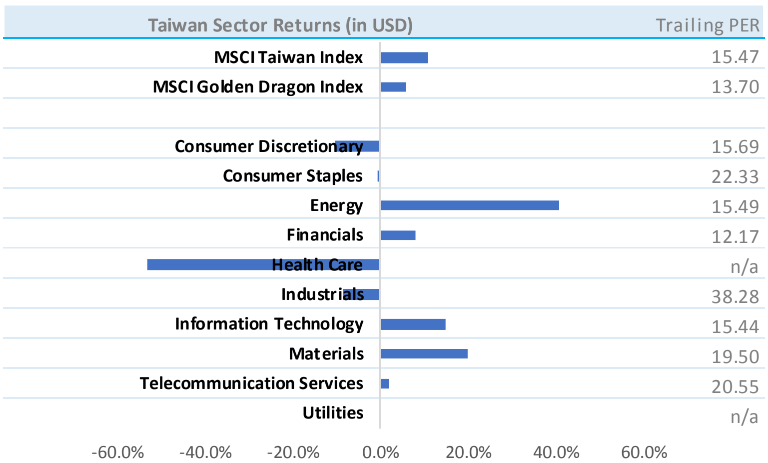
The charts below show the 3 components of the MSCI Golden Dragon Index and the performance and valuations of their sectors in 2016.



Source: Bloomberg



Source: Bloomberg



Source: Bloomberg

Leaders and laggards

In the top ten stocks, five were information technology names, two consumer discretionary, one industrial, one financial and one energy. In the ten lagging stocks, three were information technology, four consumer discretionary, one industrial, one financial and one real estate.

Geely Automobile is an automobile company whose traditional strongpoint has been sedan cars but which has recently expanded into SUVs, where its models have been well received by the market. Geely's parent company acquired Volvo in 2010 and Geely has benefited from technology tie-ups which have improved the quality of its cars; the recently launched Boyue model contains many features which its domestic competitors lack. Geely also benefited from a tax cut on cars with smaller engines; most of Geely's sedans qualify and sales grew rapidly.

As discussed above, a heavy sell-off in these information technology names hit the Fund's performance in April, but this proved to be a temporary glitch. Sales of the iPhone, to which AAC is certainly exposed, were not as weak as feared and were given a welcome boost by Samsung's stumble with the malfunctioning Galaxy Note 7 handset. However, there is more to these than just Apple and Samsung. The smartphone business is dominated by these two players but less immediately recognised are the rise of the cheaper Chinese handset makers and the growing Indian smartphone market. Domestic Chinese brands such as Oppo, Vivo, Xiaomi, Huawei and ZTE are challenging the handset market leaders with near equivalent functionality at much lower prices. AAC makes acoustic components, Tongda makes metal handset casings and TSMC is the leading independent semiconductor wafer foundry. All three are at the forefront of hardware design and production.

Lenovo Group and Li & Fung were the weakest performers in the portfolio in 2016.

Lenovo is the number one manufacturer of PCs and laptops in terms of market share and this part of the business is highly cash generative. To diversify, the company has moved into manufacturing smartphones and data centres (servers and storage). This of course requires upfront investment to build sales and distribution channels, as well as a solid brand. While the PC business generates a profit, the smartphone and data segments have been running losses and it will take time to build scale and profitability. Encouragingly, Lenovo has moved out of the low end of the smartphone segment and is now targeting the medium to high end where there is less cut-throat competition.

Li & Fung is a long-established Hong Kong business that originally made fireworks but has evolved over the last forty years into highly capable agency business. It acts as an intermediary for overseas companies looking for manufacturers, originally in China, but now throughout much of the emerging world. The business is exceptionally well run, costs are kept to a minimum, and its relationships and reputation with both customers and manufacturers are good. In recent years, times have been harder with world trade growth growing at a slower pace than world economic growth. This has depressed volume business as well as margins. The US remains the largest end market for the products they help to source and a recovery in US demand would transform the outlook. Fears about future US trade relations with China could also be turned to their advantage with their ability to source from almost anywhere in the world. Nevertheless, for the present conditions remain tough.

Portfolio activity in 2016

This year we made four changes to the portfolio. New additions were:

Sino Biopharmaceutical sells generic drugs in China with a focus on drugs to treat hepatitis and with offerings in cardiovascular treatments and orthopaedics. In January the company agreed to buy a significant number of shares in China Cinda Asset Management, a bank dealing with non-performing loans. The rationale was that Sino Biopharm would help China Cinda identify good hospitals that state-owned enterprises and ministries were selling, with Sino Biopharm upgrading the hospitals. The market viewed this deal as being outside the company's core competence and the share price dropped by more than 20%. The agreement was cancelled the next month and we felt the market was heavily penalising the company. The returns the business was generating had not changed yet the stock was 20% cheaper, which to us looked like a good deal.

PAX Global Technology is the world's third biggest producer of electronic payment terminals, with a leading market share in China. The company experienced rapid growth in 2014, which analysts expected to continue. This expectation was not met as competition in China intensified in the lower end of the market. The run-up in the share price in late 2014 was boosted by the general stock market boom in China and the stock fell hard when earning results missed. As with Sino Biopharmaceutical, we felt that the returns of the business were still good. We also believed that the market was ignoring the opportunity for growth outside of China.

Haier Electronics runs the distribution and logistics business of Haier Group. The bulk of the business represents the traditional model of distribution where their stores sell Haier-branded goods and this is the cash generative part of the business. The growth area is coming from logistics and e-commerce. Haier's logistics segment provides delivery services for customers such as IKEA in China and is the primary logistics service provider for large home appliances on Tmall.com (operated by Alibaba). Haier also has a small but rapidly growing e-commerce business which again sells Haier-branded and some non-Haier branded goods. Both the logistics and e-commerce businesses are have grown and are continuing to do so with the rise of online shopping in China.

New Oriental Education provides educational services for children ranging from kindergarten to high school. Originally the company focused on courses to prepare students for both domestic and overseas exams, especially university entrance exams. The company then began offering tutoring services to high school students as well as classes for kindergarten students with the aim of providing educational services throughout a person's entire student life. It has also integrated new technologies in its classrooms to remain competitive with online courses, such as QR codes printed on homework to access answers and a massive database of questions which can be used for custom recommendations for improvement.

We sold four positions during the year:

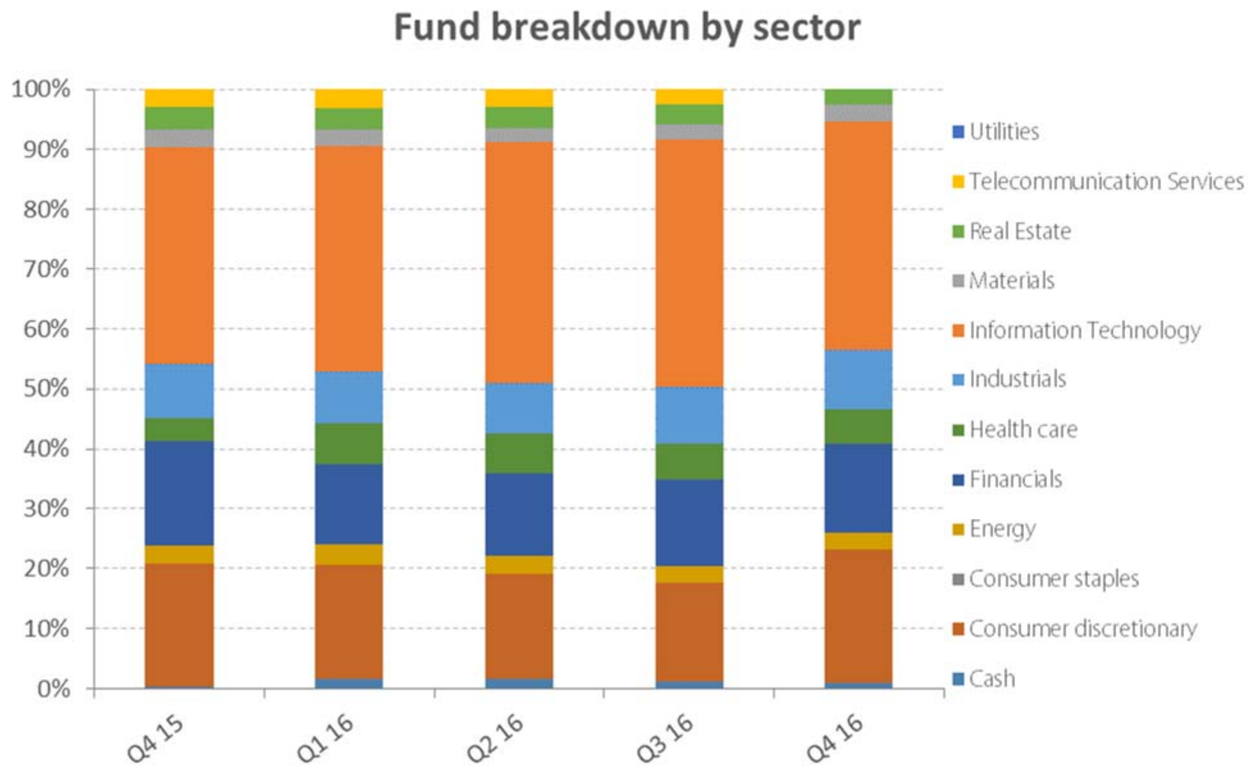
We sold China Life Insurance in February. They provide life, health and accident insurance to individuals and groups. While the company had been growing quickly, the returns seemed likely to fall below their historical level. As an insurer, China Life invests the premiums it receives from customers and therefore its returns are linked to the returns it can generate on these premiums. Bond yields in China started to fall in the beginning of 2015 and so the prospective returns China Life could generate also began to fall. Lower bond yields also meant the discount rate on reserves was higher, meaning higher reserve provisioning and significantly lower profitability. We felt that the increase in reserve provisioning meant returns were likely to fall significantly and to a level below a reasonable range of estimates of the company's cost of capital.

We sold our position in Nagacorp in April because we noted variations in the dividend payout ratio, suggesting greater uncertainty in the company's immediate prospects which further research did nothing to quell. The business runs a casino in Phnom Penh, Cambodia, and enjoys exclusive operating rights in the city and surrounds. Many of its customers are from neighbouring countries, especially Vietnam, and the company is seeking a greater share of Chinese business. To do this it has embarked on a significant expansion of the hotel and gaming areas and has also invested in an aircraft to run charter flights, with the aircraft managed and run by Cambodia airlines. A new project is the development of a site near Vladivostok, Russia, to develop a leisure resort which will also have another Chinese operator and some Russian operators. The business was starting to look complicated. We felt the flexibility in the dividend payout ratio suggested problems down the line.

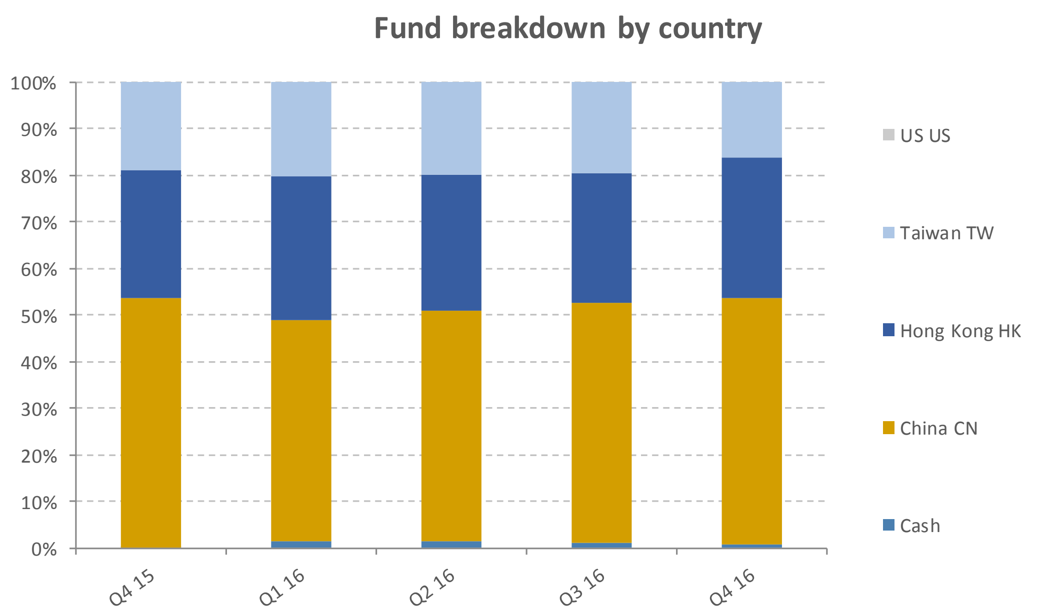
We sold PCCW in October. The company holds a majority stake in HK Telecom, which is a leading operator of fixed line, broadband and mobile services. This is the business which generates strong cash flow. PCCW also owns PCCW Media, a fully integrated multimedia and entertainment business in Hong Kong, which operates a large local pay-TV operation (Now TV) and sells over-the-top video services. The media business loses cash for PCCW and we felt it would continue to harm the cash generative ability of the overall business by lowering the return on capital.

We sold Radiant Opto-Electronics in November over concerns that the long-term demand for its products was under threat. Radiant makes standalone backlight modules (BLMs) used in smartphones, tablets and notebooks and it is the largest BLM supplier for the iPad. However, there is an on-going shift in the smartphone market to OLED rather than LCD screens. OLED screens do not use BLMs and this presents a massive problem to Radiant. The company ways it will diversify to non-Apple customers, but in our view the trend towards OLED screens is well under way and the diversification will be unsuccessful.

Portfolio position



The Fund's largest exposures are to consumer discretionary, financials, health care, industrials and information technology. There is little exposure to energy and materials because their cyclical nature makes it less likely they can produce persistently higher returns on invested capital. Utilities too tend not to make it into our universe since higher returns are often pounced upon by the regulator.



US exposure is made up of either Chinese companies listed on US exchanges in the form American Depository Receipts (ADRs) or companies that derive at least 50% of their revenues from Greater China.

Outlook

The Fund invests in quality businesses which have generated a persistent return on capital and which we believe are undervalued by the market. We do not invest in businesses in the hope that they can turn from companies that destroy value into those that create value because history shows that few companies can successfully make this transition. We say this because in the weeks following the US election, stock markets have moved very quickly to discount a more expansionary economic programme proposed by the incoming administration. This is expected not only to boost US domestic growth, which has lifted US stock prices, but also to be inflationary, which has pushed US bond yields higher in anticipation of rising interest rates. This in turn has caused the dollar to strengthen against most currencies.

But will these much-trailed policies come to fruition? Saying and doing are two very different things. At the very least, they will almost certainly take longer and be less far-reaching than some hope. From an Asian perspective, these issues are highly relevant. A stronger US dollar, if due to a stronger domestic US economy, is good; while restrictive trade policy is undeniably bad. How these competing factors will play out is unclear, but stock markets already appear to have decided that the new world offers more certainty, lifting good and bad stocks in the process.

Good quality companies as we define them, with long track records of sustained wealth creation, are still a very good place to be amidst the high probability of setbacks we are likely to see in 2017 just as we have for the past five years. The EU remains under pressure with elections in the Netherlands, France and Germany coming up and the incumbent political order under pressure in all three. (Such uncertainty in the EU will make UK negotiations with EU harder not easier, with the EU more inclined to circle the wagons than take interest in accommodating UK demands.)

The case for investing in Greater China remains unchanged:

- Of the 1,900 companies globally that meet our criteria for quality, 129 are in Greater China.
- Valuations are attractive. At the end of December, the MSCI Golden Dragon Index traded on a 13.7x price to earnings (P/E) ratio compared with the MSCI World Index on 18.1x. The fund trades at a further discount – at the end of the year the fund was on a P/E ratio of 11.6x.
- China's economy is stronger than many believe. Policymakers have stabilised the operating environment: producer price deflation has turned to inflation, the Purchasing Managers Index (PMI) has been in expansionary territory for several months, and more generally, the economy has been ticking along – in stark contrast to the apparent situation at the beginning of the year.

As ever, we would like to thank you for your continued support, and we wish you a prosperous 2017.

Edmund Harris (Fund manager)
Mark Hammonds (Analyst)
Sharukh Malik (Analyst)

January 2017

All Index and performance data source: Bloomberg, except Fund performance data, which is sourced from Financial Express and Guinness Asset Management.

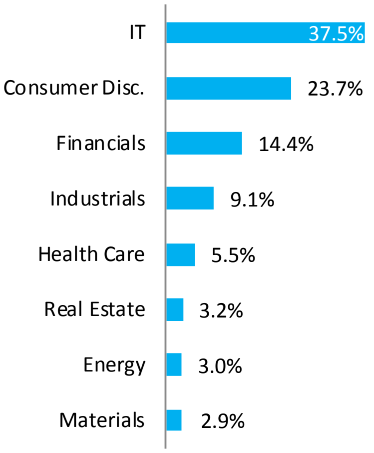
PORTFOLIO

31/12/2016

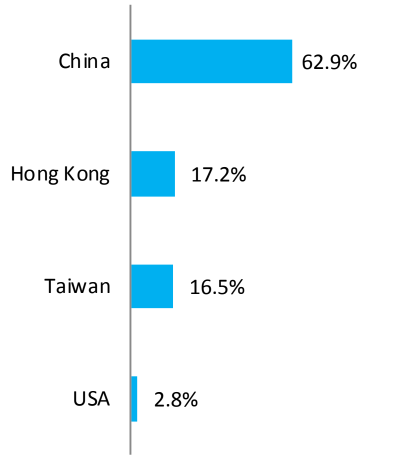
Fund top 10 holdings

Catcher Technology	4.2%
Taiwan Semiconductor	3.5%
Tongda Group Holdings	3.5%
New Oriental Education &	3.4%
AAC Technologies	3.3%
Haitian International Hol	3.3%
Hon Hai Precision Indust	3.3%
Geely Automobile Holdin	3.2%
Tencent Holdings	3.2%
China Overseas Land	3.2%
% of Fund in top 10	34.1%
Total number of stocks	33

Sector analysis



Geographic allocation



Past performance should not be taken as an indicator of future performance. The value of this investment and any income arising from it can fall as well as rise as a result of market and currency fluctuations.
Source: Financial Express, bid to bid, gross total return. Fund launch date: 15.12.15.

Performance data notes

1) The performance numbers displayed on the previous page are calculated in USD (US Dollars). Please note: The Fund's X class was launched on 15/12/2015.
2) The performance of the IA China/Greater China sector is based on the average of the highest fee share class of each constituent fund

Important information

Issued by Guinness Asset Management Limited, authorised and regulated by the Financial Conduct Authority.

This report is primarily designed to inform you about Guinness Best of China Fund. It may provide information about the Fund's portfolio, including recent activity and performance. It contains facts relating to the equity markets and our own interpretation. Any investment decision should take account of the subjectivity of the comments contained in the report.

This document is provided for information only and all the information contained in it is believed to be reliable but may be inaccurate or incomplete; any opinions stated are honestly held at the time of writing, but are not guaranteed. The contents of the document should not therefore be relied upon. It should not be taken as a recommendation to make an investment in the Fund or to buy or sell individual securities, nor does it constitute an offer for sale.

Risk
The Guinness Best of China Fund is an equity fund. Investors should be willing and able to assume the risks of equity investing. The value of an investment and the income from it can fall as well as rise as a result of market and currency movement, and you may not get back the amount originally invested. Details on the risk factors are included in the Fund's documentation, available on our website. Shareholders should note that all or part of the fees and expenses will be charged to the capital of the Fund. This will have the effect of lowering the capital value of your investment.

Documentation
The documentation needed to make an investment, including the Prospectus, the Key Investor Information Document (KIID) and the Application Form, is available from the website www.guinnessfunds.com , or free of charge from:-

- the Manager: Capita Financial Managers (Ireland) Limited, 2 Grand Canal Square, Grand Canal Harbour, Dublin 2, Ireland; or,
- the Promoter and Investment Manager: Guinness Asset Management Ltd, 14 Queen Anne's Gate, London SW1H 9AA.

Residency
In countries where the Fund is not registered for sale or in any other circumstances where its distribution is not authorised or is unlawful, the Fund should not be distributed to resident Retail Clients.
NOTE: THIS INVESTMENT IS NOT FOR SALE TO U.S. PERSONS.

Structure & regulation
The Fund is a sub-fund of Guinness Asset Management Funds PLC (the "Company"), an open-ended umbrella-type investment company, incorporated in Ireland and authorised and supervised by the Central Bank of Ireland, which operates under EU legislation. If you are in any doubt about the suitability of investing in this Fund, please consult your investment or other professional adviser.

Switzerland
The prospectus and KIID for Switzerland, the articles of association, and the annual and semi-annual reports can be obtained free of charge from the representative in Switzerland, Carnegie Fund Services S.A., 11, rue du Général-Dufour, 1204 Geneva, Switzerland, Tel. +41 22 705 11 77, www.carnegie-fund-services.ch. The paying agent is Banque Cantonale de Genève, 17 Quai de l'Ile, 1204 Geneva, Switzerland.

Telephone calls may be recorded and monitored.