Guinness Asian Equity Income Fund

INVESTMENT COMMENTARY – February 2016

Launch date	**19.12.13**
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Aim

The Guinness Asian Equity Income Fund is designed to provide investors with exposure to high quality dividend-paying companies in the Asia Pacific region. The Fund aims to provide long-term capital appreciation and a source of income that has the potential to grow over time.

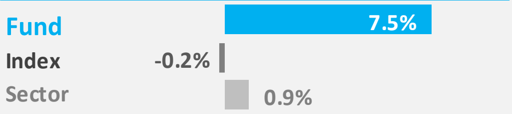
Performance (in GBP) 31/01/2016

Fund	Guinness Asian Equity Income (X)
Index	MSCI AC Pacific ex Japan Index
Sector	IA Asia Pacific ex Japan

	2013	2014	2015
Fund	-	17.6	1.2
Index	2.0	7.8	-4.4
Sector	1.9	9.5	-3.4

	YTD	1 year	From launch
Fund	-2.4	-5.7	16.6
Index	-4.3	-12.8	-0.4
Sector	-4.8	-12.4	1.8

Annualised % total return from launch (GBP)



Risk analysis (annualised, weekly, from launch)

	Index	Sector	Fund
Alpha	0	0.8	7.7
Beta	1	0.8	0.8
Info ratio	0	0.2	1.3
Max drwdn	-25.6	-23.2	-20.3
Tracking err	0	3.8	5.9
Volatility	15.1	13.0	13.8
Sharpe ratio	0.0	0.0	0.3

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, total return in GBP.

Fund Review

In January the Fund was down 2.4% (in GBP), outperforming the MSCI AC Pacific ex Japan Index by 1.9%.

The behaviour of markets this year has been puzzling. No one has yet been able to point to any particular development; as it stands, the market falls appear to be a classic case of herd behaviour. Investors worry that other investors know something bad, and so just sell although they themselves have no new information. It may be that increasing balance sheet fragility in recent years means that what might in the past have been regarded as incidental perturbations now take on a new significance. There has been little in the way of new news: interest rates in the US have increased, as the Federal Reserve has flagged for almost two years; oil prices have come down as Saudi Arabia declined to cut production to accommodate new supply from US shale; and China's domestic stock market bubble continues the process of unwinding that began in July 2015 against the backdrop of an economy whose decelerating growth has been evident since 2012.

The rise in US interest rates is perceived by some to be a policy misstep resulting in a dangerous monetary tightening reflected in a higher cost of credit and a cripplingly high exchange rate.

This is not the place to discuss the dollar spot exchange rate, but we will point out that it can, does, and has moved sharply on changes in sentiment (Alan Greenspan likened forecasting the spot rate to the toss of a coin). We also point out that exports are a comparatively small part of the US economy. A greater concern is whether liquidity has actually tightened. While surveys of financial conditions may point that way, high frequency data on US commercial bank lending from the Fed show no sign of it: 3-month annualised growth to the end of January of 10% in overall lending and 12% growth in commercial and industrial loans. There is no sign of tightness in the bond market either, with high grade corporate bond issuance of $458 billion in 2015, stronger than each of the prior two years; and although issuance was weak in December (the month of the rate rise), in January 2016 it was a surprisingly strong $48 billion in the midst of all the market turbulence.

The US economy does not appear so weak that a single interest rate rise could knock it off its stride; the Federal Reserve has signalled its sensitivity to external as well as domestic conditions.

Recent cuts to 2016 growth estimates from private sector forecasters focus on an inventory build-up, indicators of weaker capital spending, lower oil prices and a stronger dollar – the relative importance of each we can leave the reader to decide. For us, increased job creation, higher labour-force participation and the accelerating increase in hourly wages up 2.5% year-on-year (0.5% month-on-month) are all encouraging signs of fundamental strength, given the importance of the consumer to overall economic health.

We believe the Federal Reserve is looking at this too, but the markets will seek to understand how the Fed views the sustainability of these factors and the degree to which their contribution to inflationary pressures may still be countered by the deflationary forces of lower commodity prices and the stronger dollar. Increased market volatility and falling bank valuations on the back of loan exposure to the energy sector muddies the picture further.

Falling oil prices have been taken as indicative of substantially weaker global demand.

The problem with this argument is that this has come about following growth in output from US shale producers that, without an adjustment in world supply, outstripped the growth in demand. The supply adjustment could be voluntary or involuntary. The world's largest and lowest cost producer has chosen to enforce the adjustment on the high-cost producers in the US. We are sceptical about the demand-collapse version of the argument because, first, we haven't seen a collapse in demand, and second, energy equities appear to be pricing in an oil price of $50 per barrel that is approximately $20 above the current spot price, suggesting that current low prices are likely temporary.

The low oil price is also exercising financial markets as fears grow about banks' loan exposure to the sector. For reference, it is estimated that US and European banks may have up to $250 billion of loan exposure to the energy sector, roughly split $120:$80 billion between European and US banks. A rough sum assuming that over the next two years 25% of these loans go bad and a 40% recovery rate is achieved would suggest bank losses of $37.5 billion; one can see why markets would be nervous. But much of the debt is investment grade, and only a fraction is lent out to the speculative end of the sector.

The trading view suggests that oil could test new lows in the next few months, but the fundamental view is that the current oversupply of C. 1.2 million barrels per day is diminishing by around 200,000 barrels per day each month and that while Iranian supply of 300-600,000 barrels per day (depending on who you read) could lengthen the process by a month or two, we could see the market back in balance by early next year. That's what the market appears to be pricing into equities, while those trying to interpret the spot price come to a different conclusion. For further detail on this we recommend readers to look at our Global Energy monthly and annual outlooks.

China – managed by geniuses or incompetents?

The answer, of course, is neither. There have been some missteps this year, although no worse than we have seen in past years, but the markets are in an unforgiving mood. The year began with markets taking fright at falls in share prices on the Shanghai Exchange, then at an unexpected fall in the renminbi exchange rate. Now the debate has moved on to whether or not the Chinese are lying about economic performance data as well as their policy intentions, especially currency policy. Right now there is a communication problem between Chinese policymakers and the markets and also, it would appear, between policymakers. (The decision by someone in the central bank to move the renminbi's central parity rate against the dollar by 0.7% on 6th and 7th January (just when the Shanghai stock exchange looked stable after a 5% fall on the first day of the year no doubt resulted in some blunt policy discussion. That central parity rate barely moved for the rest of the month.)

So how should we try to understand China?

The question over the accuracy of China's GDP data is something of a diversion. The number itself is more politicised than other data, but less so than in the past. The talismanic 8% growth level was breached a while ago, and its calculation no longer depends on reports from provincial officials whose careers depended on delivering growth. Industrial data is collected directly from 60,000 of China's largest businesses and sampled from consumer and services sectors. It is calculated using the production method by totting up the value-added output rather than expenditure method that is more familiar, but it still complies with international standards of computation. A drawback to the production method is that it is not good at capturing services output, which is why in the last three five-yearly economic censuses (2004, 2009 and 2014) the economy turned out to be 16.8%, 4.3% and 4% larger than they thought it was. Chinese economic data could benefit from improved collection methods but they are not a farce. In any event, to focus on this misses the main challenge.

To understand the problem China faces we can use an example we give to potential new analysts. We present them with the profit and loss account, balance sheet and cash flow statement of a nameless business and ask them to analyse and project its performance based purely on the reported numbers. Sales growth has been strong and margins improving, delivering rising operating profit that maintains coverage of interest expense and reports strong net profit growth. The picture looks rosy. The problem is that the company is going broke. Why?

The problem lies in the balance sheet. The company is producing and delivering product and is recognising those sales as invoices are issued. But it isn't receiving cash fast enough; it has to pay for raw materials to make more product and isn't being paid quickly enough for the goods it has already finished. They therefore have to take on debt to cover the shortfall and the faster they grow the more debt they have to take on. Eventually they run out of cash and can take on no more debt; the high growth will kill them unless they can rebalance the model.

China's economic model has some similar characteristics, and it is this that needs to change and is what policy makers are trying to change. Our assessment of the usefulness of Chinese policies should be looked at in terms of their contribution to increasing the share of consumption on the profit and loss account and asset side of the balance sheet and to the reduction of excess capacity and debt on the liability side. Increasing the share of household spending in GDP by 10 percentage points would constitute a rebalancing, and it would also provide an engine of near debt-free economic growth. In the 2015 GDP report from China's National Bureau of Statistics, real GDP grew 6.9% while household income grew 7.4%. At those relative rates of growth a 10% increase in household share will take 38 years to achieve.

But China does not have 38 years under the current model because of what we see on the liability side of the balance sheet. Debt formation accelerated sharply in the years following the financial crisis. Prior to 2008 a $1 increase in the stock of corporate debt was associated with roughly $1 of GDP. In 2015, each extra $1 of GDP was accompanied by $4.45 of debt. Higher growth under this model cannot be sustained indefinitely. However, it can be sustained for a while and this is where some get tied up in knots. China's low levels of government debt, pools of savings and relatively closed capital accounts that keep domestic deposits in the banking system combine to make a financial crisis unlikely, probably for years.

The debt burden can be reallocated and shared around to prevent that, but at a cost. This cost will be in the form of sub-par growth, sub-par living standards and a drift into middle income stagnation; and that is not China's plan. China's responses to this are both long-term and short-term. Many economists stress the need for China to move, and to move fast, glossing over the politics that must be overcome. How easy is it for the democracies of the developed world to enact spending reforms, tax reforms, industrial reforms… any reforms?

For China, policies for the long term focus on the supply side, including most recently the commitments to close 17% of coal capacity over the next five years and the reduction of 100-150m tonnes of steel capacity. What we have yet to see are plans regarding the supply of debt. In 2015 credit growth grew at twice the pace of GDP (and at 1.7 times GDP in the three years prior). As a first step we need to see the rate of debt accumulation slow to keep pace with GDP, as it did in the years 2004-8. The closure of excess capacity is entwined with this endeavour, since excess production capacity is – by definition – surplus to requirements, and thus what cannot be sold must therefore be funded by debt.

Any understanding of China's economic growth and what level is achievable or even desirable has to be looked at alongside the growth in debt. A slower rate of growth but one that is debt-light is more cash generative, more sustainable and thus more genuinely profitable than a higher rate that is debt dependent producing more than is wanted or needed. So we watch both.

Corporate news

We look at companies in just the same way, seeking to identify those businesses whose operations continue to generate cash profits greater than their cost of capital with surplus cash to reinvest and to pay out, and that do not require high debt levels to achieve growth. Our Taiwanese technology names reported results in January. Having sold off in December ahead of expected weakness in Apple sales, they outperformed in the first month of this year.

Catcher Technology, which makes metal smartphone casings, guided for flat growth in the first half of 2016, which - given the importance of Apple's expectations for its sales to decline 10-15% in the first half of 2016 - suggests that Catcher is taking market share. Catcher's production skills and increasing market share is the reason we own this stock, and we are further encouraged by the company's forecast of NT$10 dividend per share (compared to NT$6 in 2015.) Largan Precision makes high end camera lenses for smartphones. Its results were better than the market expected and the stock rose 10% in January, in local currency terms. While margins are still good the company faces competitive pressure from Japanese and Chinese makers.

Outside the smartphone area, Novatek, a leading designer of chips for high definition screens, reported results that were above expectations. While guidance into the early part of 2016 was weaker, it was at least in line with seasonality. Like Largan it faces ongoing competitive pressures and while it is a market leader in designing chips to drive displays, the new battleground is in display drivers that incorporate touch.

Weaker results were reported by Digi.com, a mobile telecom services provider in Malaysia. Tougher competition, a weak Malaysian economy and a weak currency all contributed. The dividend fell, although the payout ratio remained steady, but it is the muted outlook for growth that gives us pause. Similarly, amongst our Chinese banks exposure, it is the likely absence of dividend growth rather than underlying stability that concerns us. These banks look to us to be undervalued, but we need to see growth attached to those valuations to make them attractive.

China Lilang, a designer and retailer of men's fashion, has seen weak share price performance over the past nine months, but operating performance continues to be good. The recent spring trade fair brought order growth of 11-12% for the core brand, while sub-brand L2 saw order growth of 4-5%, with average selling prices maintained for both. Trade fair orders through 2015 and into 2016 have been better than the company was initially expecting, and reflecting well on their distribution network and same-store sales growth.

Outlook

At a time when discount rates appear to be rising, those companies with cash profits above the cost of capital are more likely to see their stocks retain their value, because the underlying operations are creating value.

Financial market conditions may look difficult, but we believe that the operating environment is nowhere near as stressed as share prices appear to indicate. Market valuations will settle and they are likely, in our opinion, to settle faster for those companies that display an ability to generate and grow cash flows and a willingness to distribute some of that cash to shareholders.

Edmund Harriss (portfolio manager)
Mark Hammonds & **Sharukh Malik** (analysts)

February 2016

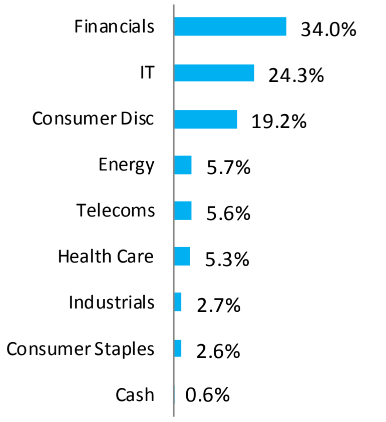
PORTFOLIO

31/01/2016

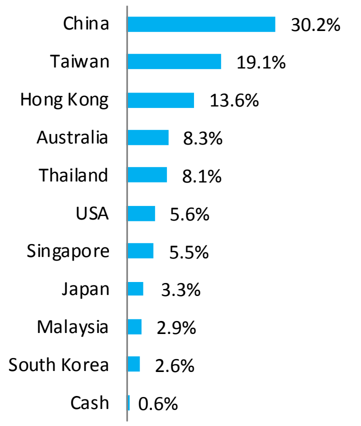
Fund top 10 holdings

Relo Holdings	3.3%
JB Hi-fi	3.0%
PTT Public Company	2.9%
DiGi.COM	2.9%
Henderson Group	2.9%
Qualcomm	2.9%
China Minsheng Banking	2.9%
Novatek Microelectronics	2.9%
China Merchants Bank	2.8%
Li & Fung	2.8%
% of Fund in top 10	29.3%
Total number of stocks in Fund	36

Sector analysis



Geographic allocation



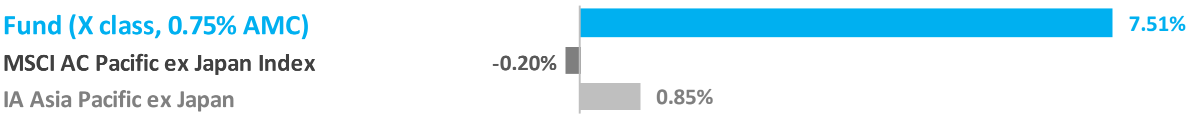
PERFORMANCE

31/01/2016

Discrete years % total return (GBP)	Jan '12	Jan '13	Jan '14	Jan '15	Jan '16
Fund (X class, 0.75% AMC)	-	-	-	28.7	-5.7
MSCI AC Pacific ex Japan Index	-3.7	13.7	-7.2	18.3	-12.8
IA Asia Pacific ex Japan	-7.3	13.9	-7.5	20.1	-12.4

Cumulative % total return (GBP)	1 month	Year-to-date	1 year	3 years	From launch
Fund (X class, 0.75% AMC)	-2.4	-2.4	-5.7	-	16.6
MSCI AC Pacific ex Japan Index	-4.3	-4.3	-12.8	-4.3	-0.4
IA Asia Pacific ex Japan	-4.8	-4.8	-12.4	-2.7	1.8

Annualised % total return from launch (GBP)



Risk analysis - Annualised, weekly, from launch on 19.12.2013, in GBP

31/01/2016	Index	Sector	Fund
Alpha	0	0.79	7.72
Beta	1	0.84	0.84
Information ratio	0	0.24	1.32
Maximum drawdown	-25.55	-23.20	-20.27
R squared	1	0.95	0.85
Sharpe ratio	-0.01	0.00	0.30
Tracking error	0	3.84	5.88
Volatility	15.09	13.03	13.81

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, total return. Fund launch date: 19.12.2013.

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 equities and equity markets invested in by the Guinness Asian Equity Income 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.

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Risk
The Guinness Asian Equity Income 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. The Fund invests only in stocks of companies that are traded on Asian stock exchanges or that do at least half of their business in Asia; it is therefore susceptible to the performance of that region, and can be volatile. 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.

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