Guinness Asian Equity Income Fund

INVESTMENT COMMENTARY – October 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 USD)

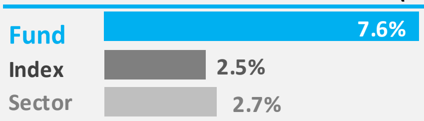
30/09/2016

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

	2013	2014	2015
Fund	-	10.7	-4.4
Index	3.4	2.8	-9.4
Sector	3.8	3.1	-8.6

	YTD	1 year	From launch
Fund	14.0	16.1	22.7
Index	12.3	18.1	7.0
Sector	11.9	17.4	7.7

Annualised % total return from launch (USD)



Risk analysis (annualised, weekly, from launch)

	Index	Sector	Fund
Alpha	0	0.3	5.5
Beta	1	0.9	0.8
Info ratio	0	0.0	0.9
Max drwdn	-28.5	-26.7	-24.3
Tracking err	0	3.8	5.8
Volatility	15.5	14.0	13.2
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 USD.

Quarterly review

Over the past five years developed markets, and the US in particular, have been the place to be. Developed markets, as measured by the MSCI World Index, have delivered a total return of 78.56% in the five years to September 30 2016 and the US, measured by the S&P 500 Index, has delivered a whopping 113.20% or 16.33% per annum. Emerging markets by contrast, as measured by the MSCI Emerging Markets Index, have returned 18.06% over the same period or a sorry-looking 3.37% per annum. Will this continue? Will the US deliver another 16% per annum for the next five years? That seems unlikely. Market leadership has changed this year and investors now need to look a little deeper and get behind the headlines.

In 2016, emerging markets have risen 16.25%, compared to developed markets which are up 6.04% and the US up 7.82%. The Asian component is up 13.17% while emerging markets ex-Asia are up 24.27%. What are we to make of this? If we want to invest in this area for the next three to five years we need to be confident that there is a real story here and that we're not about to be sucked into a market bounce, another false dawn.

We would argue that many of the economies of the ex-Asia component of emerging markets are as uncertain and volatile as they have ever been. Looking at Brazil and Russia, the two main stock markets in this group, the strength was in the first half of the year and was driven by the recovery in commodity prices from the beginning of March and recovery in the Brazilian Real and the Russian Ruble against the dollar on the back of that, both from depressed levels. It is also worth pointing out that these two specific and linked moves in commodities and currencies occurred once it became clear that the China's imminent economic and currency collapse was not so imminent after all.
Since the middle of the year emerging markets ex-Asia have been more subdued, rising 5.62%;

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leadership has been taken up by Asia which is up 10.62% and the best market, surprisingly for some, was China. China has had its best quarter since 2009 with the MSCI China Index up 13.97%. Should we be surprised? Not really. We have been arguing, in the face of relentless negative press coverage, that China's economic challenges are significant but not overwhelming. The music reached a climax this year with warnings that a stock market crash presaged an economic collapse – it did not happen; that capital was flying out of the country which presaged a currency collapse – it did not happen; that overbuilding and unsold apartments presaged a property collapse – it did not happen.

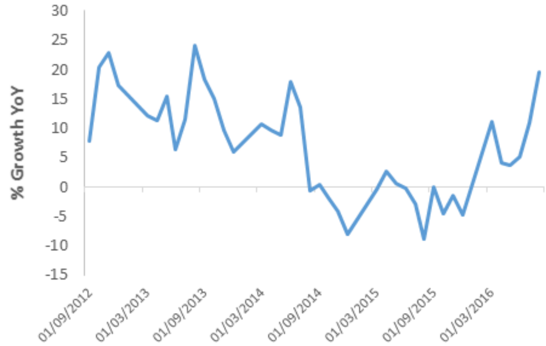
Now the focus is on debt: the bad loans in the banking system, rising debt to GDP and the warnings that China's economy is about to collapse. Debt is rising but China's economy isn't collapsing. It appears to be growing at over 6%, running a trade and current account surplus of almost $600 billion (5.7% of 2015 GDP) and still just about getting by after all that capital flight with $3.2 trillion of foreign exchange reserves. China and Asia have been priced for a crisis that has not happened. In the last quarter Asian markets have moved higher and while the first move was the result of cheap valuations and improving sentiment we are now seeing economic data and earnings numbers moving in support.

Asian economic review

China

The most important development has been the recovery in Chinese **Producer Price Inflation** (a measure of the prices companies charge for intermediate goods, as opposed to Consumer Price Inflation measuring the prices paid by consumers for finished goods). Producer prices have been falling in China over four years, declining at a rate of 5.9% per annum by the end of 2015. In 2016, that rate of decline has eased with prices now down 0.8% in August compared to the same time last year. We expect to see prices rises come through before the year is out. This is important because it means that industrial profits should pick up, that operationally geared business in particular will see improved conditions and that the more heavily indebted companies will see their debt burdens ease, cash flows strengthen and an improvement in their debt servicing capacity.

China's **industrial profits** have indeed picked up with the latest reading in August showing a 19.5% rise compared to August last year.



Source: China National Bureau of Statistics

Much of this growth is related to the oil and commodities sector but in spite of higher commodity prices the profits of light industry and machinery have also held up. The next question is whether this recovery will lead to renewed growth in industrial investment, one of the major factors behind China's slowing growth in GDP. For the present, excess capacity in the heavy industrial sectors makes an investment rebound less likely but it makes a stabilisation in investment more probable and is another step toward stabilising GDP growth.

China's **trade** figures have also delivered a positive surprise in the last quarter. Exports were up in August by 3.2% compared to July (although down year on year), but even more importantly so too were imports. In the import numbers commodities certainly played their part, rising 8% compared to July, but it was the jump in imported products for the processing trade, i.e. technology components for assembly and onward export which increased over 12% month-on-month, that was most notable. We have seen before that China's fundamental economic strength lies in its success in evolving its manufacturing economy from lower-end toward higher value-added products. The increasing local content in Chinese exports means that more value-add is being created in China which supports the long-term goal of boosting the consumer sector through higher wages and consumer spending.

The **renminbi** has been stable during the quarter. This is dismissed by many as the product of government manipulation and intervention. The story that many have missed is that in the last few months *the government has not needed to intervene*. Downward pressure on the currency has eased not only because the US dollar has been comparatively stable (the US Dollar Index began the quarter at 96.1 and ended it at 95.5) but also because capital outflows have slowed significantly. **Capital flows** from China have been seriously, perhaps wilfully, misunderstood. Capital inflows in 2013-14 which drove China's **foreign exchange reserves** from $3.2 trillion to just under $4 trillion were the product of a rising trade surplus but also of currency speculation. While the renminbi was strengthening steadily against the dollar, Chinese companies borrowed dollars knowing they could repay in three years with a stronger renminbi. When the currency stopped appreciating companies repaid the dollar debt, resulting in capital outflows, bringing foreign exchange reserves back down to $3.2 trillion. Looking at the breakdown of China's balance of payments, it is evident that this process has now played out and flows linked to foreign borrowings are now inflows not outflows.

China **bank debt** growth has slowed in recent years. In the heady days of 2005-10 credit was growing at over 25% year-on-year (and that does not include the 2009 response to the global financial crisis). This year it has slowed to around 10% (it was 4% in 2013, 7% in 2014 and 9% in 2015) and actually contracted in the last 3 months, but with economic growth slowing the debt to GDP ratio is still climbing. We have argued before how little value can be attached to this ratio – in 2001, just before Argentina defaulted it had a government debt to GDP ratio of around 60%. Those using the metric as a warning signal would not have seen the default coming. Most people did not. Instead we need to look in more detail: who are the borrowers, who are the lenders, how are lenders funded and what capacity is there to service the debt? We can also look to distinguish between new debt and legacy debt. And since the call that China is about to experience a debt crisis is a significant one with global economic implications, the question of Chinese debt merits a more detailed consideration than that offered in the newspaper columns.

Most of China's debt has been extended through the banking channel, specifically the two policy banks, China Development Bank and Export Import Bank of China, and the four major state-owned commercial banks. These are primarily owned by the government and are primarily funded by government or domestic depositors. China is sovereign over its banking sector – there is no dependence on external funding, there are no EU-type rules governing the provision of support and the government has the ability to control private capital flows. There has been much debate about the level of non-performing loans in the banking system. The most pessimistic estimates suggest it could be as much as 25%-30% of GDP, and these assume nothing for recovery rates. But China has deep pockets. If it came to it, the Chinese government could bail out the lot and take its government debt to GDP ratio from 50% currently to 80%. That would be high (the US's is 75% and the UK's is 90%) but not intolerable; and China's economy is still growing faster than the US, UK or EU. A revealing contrast was recently drawn by Capital Economics with the situation in Italy, where non-performing loans are running at 20%, the Italian government is circumscribed by EU rules forbidding intervention (though the German government is said to be considering flouting these for Deutsche Bank), government debt to GDP is 133% and the economy is stagnating. Now that's a problem.

New debt formation is now the focus but the purposes and direction of lending are key. China cannot simply pull the plug on credit provision while the economy is still undergoing capacity cuts and deleveraging in the legacy sectors that drove growth over the last 30 years. Fundamentally this whole process is a ten year (and perhaps longer) programme rather than the 3 years that some call for. The redirection and re-training of labour and the social and political consequences of economic transformation make it wholly impractical and unrealistic to expect it to move faster. The economy needs support to generate 'good' growth and to manage the slowdown in 'bad' growth.

Policy-driven economic support comes in two broad forms. First, financial support is delivered by the lowering of market interest rates, both through open market operations that have brought the Chinese government bond yields across all maturities down by 1% over the past year and through debt restructuring, for example swapping some local government bank debt into municipal bonds. Improving the transmission mechanisms for lower rates through the economy and lowering the debt burden have been crucial but less immediately visible changes. Secondly, government spending on infrastructure has prioritised useful areas including water conservation and flood prevention, rural electricity transmission networks and telecom and internet infrastructure. Interestingly, the government is also seeking to promote public-private partnerships in some of these projects. Railway spending planned for the next five years is lower than for the last five but is still substantial and is expected to come to over $400 billion for another 23,000 km (14,375 miles) of new lines.

This has implications for how investors should look at China in the coming years. Rather than 'Buy China' for a China boom, investors need to take an active approach looking for the businesses that will thrive in an evolving economy and are not dependent on policy-driven economic growth.

Rest of Asia

In north Asia both **Korea** and **Taiwan** are more dependent on external demand for growth while domestic activity remains sluggish. **Exports for both Korea and Taiwan** are below 2015 levels, in line with overall sluggishness in global trade, but for both the declines have been becoming less severe and both had positive year-on-year growth in June. **Interest rates in Korea** have been coming down since 2012 from 3.5% to 1.5% at the start of this year. In 2016 the central bank has been in watch mode and cut once more to 1.25% in June. **Taiwan interest rates** have also come down by 1% over the past 12 months with cuts amounting to 0.25% this year. Boosts in the technology sector and industrial production have still not been enough to address stagnant wages and falling property prices, but recent strength led the central bank to adopt a wait-and-see approach for now.

In south-east Asia, **Thailand's** growth has been driven in recent months by stronger tourism growth and improving external demand coming through from China and from Europe. A bounce in exports to 6.5% year-on-year in August has reduced pressure on the central bank to support growth. The policy interest rate has remained at 1.5% all year and looks unlikely to change soon. The government is expected to embark on increased fiscal spending supporting both infrastructure spending and consumption ahead of the elections next year. A strong Thai Baht remains an issue but the central bank has favoured intervention, preferring to hold back the option to cut the interest rates in order to support growth if necessary next year.

Malaysia has seen an improvement in economic growth as the impact of earlier shocks such as the introduction of a goods and sales tax has faded. A recovery in oil prices has also helped. Investment growth (both public and private) has picked up in consequence of large infrastructure projects now underway: one is the second Mass Rapid Transit rail line running for 52 km (13.5 km underground) through densely populated areas to Putrajaya, with 37 stations. **Singapore** remains mired in slow growth and higher wage costs that impact upon competitiveness. Singapore's ongoing focus on controlling immigration and foreign labour is particularly to blame for its travails. Industrial production weakness is evident across the board in biomedical, transport and precision engineering segments as well as in general manufacturing. Lower interest rates seem likely and pressure on the Singapore dollar is expected to continue.

Markets

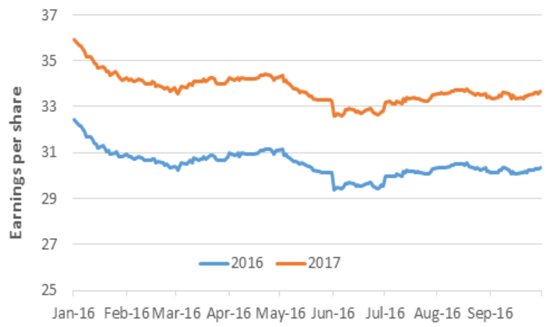
In the third quarter stock markets in the Asia Pacific region (including Australia) excluding Japan as measured by MSCI AC Pacific ex Japan Index rose 10.2%, which put it on a forward Price to Earnings multiple of 14.4 times consensus estimated earnings for 2016. The best performing markets as measured by their respective MSCI country indices in US dollar terms were China with +14.0%, New Zealand +13.6% Taiwan +12.3%, Hong Kong +12.0% and Korea +11.2%. The weakest markets were Philippines -4.6%, Malaysia -2.3%, Singapore +0.1% and India +5.9%. For completeness, Japan rose 9.1% in the quarter, given a 2% lift in dollar terms by a stronger Yen.

Asian currencies have been steady over the quarter. The Korean Won was the strongest, up 4.6% against the dollar followed by the Taiwanese dollar up 2.9% and the Thai Baht up 1.5%. The Chinese renminbi was almost unchanged, down -0.3%, while weakness was evident in Malaysia and Philippines with the Ringgit and Peso both down 2.7%. In aggregate, on a weighted average basis Asian currencies were 0.7% up in the quarter.

By sector, markets were led by Information Technology +18.4% and Materials +14.3% followed by Consumer Discretionary +11.1%. Among the laggards were Utilities +2.7%, Telecommunication Services +2.8%, Health Care +3.4%, Industrials +5.2% and Energy +5.4%. The strength in the Information Technology sector explains the strength evident in Taiwan and, to some extent, Korea and has been a notable theme for much of the year in both emerging markets and in the US, but less so in Europe. Handheld devices still dominate but it is also apparent that after 18 months in the doldrums, notebook PC sales are picking up once again.

Earnings revisions are an important short-term gauge of market sentiment but need to be treated with caution over the longer term.

Chart 2: Estimated earnings for MSCI AC Pacific ex Japan Index over the course of 2016



Source: Bloomberg

Analysts tend to be over-optimistic in their estimates and the subsequent twelve months are often spent paring them back. We see this across all markets. In the case of Asia Pacific we see 2016 estimates are 14% lower than they were a year ago while 2017 estimates have come down 13.3% (Source: IBES & JP Morgan). In the last quarter however these downward revisions have moderated with 2016 estimates down 0.1% and 2017 estimates 0.4% higher. Thailand and Korea have seen the most significant upward revisions, over 3% in each case to 2016 estimates. China is the weakest and is down 3%-3.5% in the past quarter for 2016 and 2017. Still, this is a significant moderation to the pace of downgrades which unsurprisingly are dominated by the large cap state-owned enterprises in the over-capacity sectors.

Fund performance and activity

In the third quarter the Fund rose 8.6% in USD terms compared to the benchmark which rose 10.2%. In the year to date, the Fund rose 14.0% and is 1.7% ahead of the benchmark.

Amongst the top ten performers in the portfolio over the quarter five were in the Information Technology sector led by Largan Precision and Qualcomm (which generates over 50% of its revenues from the region). However, also in that group were two Chinese banks, China Merchants and China Minsheng, which are both beneficiaries of brighter conditions in China. JB Hi-Fi was the third best performer over the period following a successful rights issue to fund their acquisition of home goods store The Good Guys in Australia. There was also good news from Belle International, a footwear designer and retailer in China whose stock price has suffered in the wake of tougher trading conditions. We have been adding to the position during the weakness and performance has now turned and was sustained through the last quarter and the last month as margins and same-store sales growth has stabilised.

Other than some modest rebalancing there has been little fund activity and no changes have been made to the portfolio.

Outlook

The Asian region, and China in particular, is one whose stock markets have been priced for a crisis that has not occurred. As we have said many times, we only need for things *not* to go catastrophically wrong and there is value. Every article that drums up fears of a debt crisis, quoting World Bank, IMF or BIS officials, contains the same message: at the current level of debt (even after all the growth), no debt crisis is imminent. They say that *left unchecked* the risk of such a crisis grows - this is not the economic equivalent of discovering fire, but is a statement of the obvious recognised by investors, bankers, company management and policymakers alike. China is checking this, but at a slower pace than many economists would like (though their record in such circumstances is hardly unblemished) in recognition of the political, economic and social realities of implementation.

We expect to see economic and market data in Asia continue to improve in coming months, which is likely to be supportive of share prices into 2017. The picture is not one where all the lights are green, but one where many of the red lights are changing to amber. World trade growth is still weak but EU demand has not been impacted as severely by Brexit as was expected, prompting upgrades. The weaker Chinese currency, once the lagged effect kicks in, is likely to boost China's share of world export trade in 2017 and could provide support to GDP growth through a net exports contribution, even as heavy domestic industry continues to slow. Chinese growth and investment is not about to take off but is less, rather than more, likely to take a tumble. Elsewhere in Asia we expect to see better trade growth support Korea and Taiwan and we expect to see domestic spending in Indonesia, Malaysia and Thailand in areas such as infrastructure to support growth. All these areas lead sentiment toward upgrades rather than downgrades.

While Asian growth has factors that are becoming more supportive, the region is always vulnerable to the dollar and the interest rate cycle. Asian policymakers have been using a mix of interest rate cuts, fiscal support and liquidity operations to support their economies over the past 2 to 3 years. A rise in US interest rates is clearly coming, although whether in November, December, or next year some time, who knows? – but it will happen. However, a rapid ratcheting up of interest rates is not on the cards and we do not believe that monetary easing in the region is about to come to an abrupt halt. Bond yields in the US, UK and Europe are still abnormally low and as we have seen the word 'tentative' rather exaggerates the moves so far to normalise them.

In such a world, where all of us have been and will probably continue to be blind-sided by events, we believe the best approach is to invest from the bottom up: find a good business that has demonstrated over a long period its ability to generate returns on investment above the cost of capital in cash flow terms and is undervalued by the market and invest in it. Then, when the world pivots once again, you know what it is you've bought and you might have a terrific opportunity to buy more.

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

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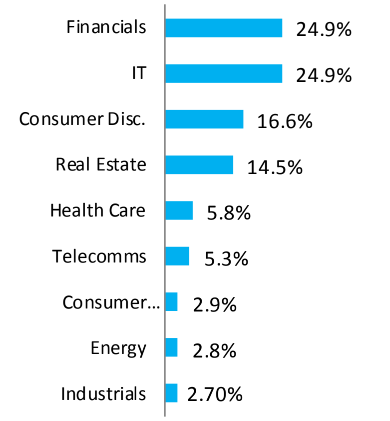
PORTFOLIO

30/09/2016

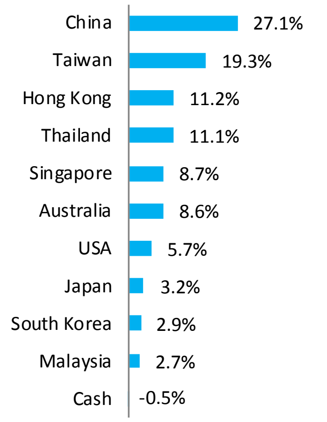
Fund top 10 holdings

Relo Holdings	3.2%
Sonic Healthcare	3.1%
China Minsheng Banking	3.0%
Qualcomm	3.0%
Ascendas Real Estate Trust	3.0%
Luk Fook Holdings	3.0%
DBS Group Holdings	2.9%
Taiwan Semiconductor	2.9%
KT&G Corporation	2.9%
LPN Development	2.9%
% of Fund in top 10	29.8%
Total number of stocks in Fund	37

Sector analysis



Geographic allocation



PERFORMANCE

30/09/2016

Discrete years % total return (USD)	Sep '12	Sep '13	Sep '14	Sep '15	Sep '16
Fund (X class, 1.24% OCF)	-	-	-	-3.6	16.1
MSCI AC Pacific ex Japan Index	20.4	7.2	6.0	-14.5	18.1
IA Asia Pacific ex Japan	18.8	7.5	7.0	-14.0	17.4

Cumulative % total return (USD)	1 month	Year-to-date	1 year	3 years	From launch
Fund (X class, 1.24% OCF)	1.6	14.0	16.1	-	22.7
MSCI AC Pacific ex Japan Index	1.8	12.3	18.1	7.0	7.0
IA Asia Pacific ex Japan	1.7	11.9	17.4	8.0	7.7

Annualised % total return from launch (USD)

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

30/09/2016	Index	Sector	Fund
Alpha	0	0.27	5.48
Beta	1	0.88	0.79
Information ratio	0	0.01	0.86
Maximum drawdown	-28.49	-26.72	-24.26
R squared	1	0.95	0.87
Sharpe ratio	0.00	0.00	0.32
Tracking error	0	3.75	5.80
Volatility	15.50	13.98	13.19

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Source: Financial Express, bid to bid, total return. Fund launch date: 19.12.2013.

Important information

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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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