# Guinness Asian Equity Income Fund

## INVESTMENT COMMENTARY – July 2017

| | |
|---|---|
| **Launch date** | **19.12.13** |
| **Team** | **Edmund Harriss** (manager)<br>**Mark Hammonds** (manager)<br>**Sharukh Malik** (analyst) |

### 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

30/06/2017

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

| | 2014 | | 2015 | | 2016 | |
|---|---|---|---|---|---|---|
| | USD | GBP | USD | GBP | USD | GBP |
| **Fund** | 10.7 | 17.6 | -4.4 | 1.2 | 7.5 | 28.2 |
| **Index** | 1.8 | 8.1 | -9.4 | -4.1 | 7.8 | 28.6 |
| **Sector** | 3.1 | 9.5 | -8.6 | -3.4 | 5.3 | 25.7 |

| | YTD | | 1 year | | From launch | |
|---|---|---|---|---|---|---|
| | USD | GBP | USD | GBP | USD | GBP |
| **Fund** | 19.4 | 13.6 | 22.2 | 25.8 | 38.1 | 74.0 |
| **Index** | 19.9 | 14.1 | 26.0 | 29.6 | 21.9 | 53.5 |
| **Sector** | 20.4 | 14.5 | 25.1 | 28.8 | 22.1 | 53.9 |

**Annualised % total return from launch**

| | USD | GBP |
|---|---|---|
| Fund | 9.6% | 17.0% |
| Index | 5.8% | 12.9% |
| Sector | 5.8% | 13.0% |

**Risk analysis** (annualised, weekly, from launch)

| | Index | | Sector | | Fund | |
|---|---|---|---|---|---|---|
| | USD | GBP | USD | GBP | USD | GBP |
| **Alpha** | 0 | 0.0 | 0.8 | 1.7 | 5.0 | 5.7 |
| **Beta** | 1 | 1.0 | 0.9 | 0.9 | 0.8 | 0.9 |
| **Info ratio** | 0 | 0.0 | 0.0 | 0.0 | 0.7 | 0.7 |
| **Max drwdn** | -29.1 | -26.2 | -26.7 | -24.5 | -24.3 | -20.6 |
| **Tracking err** | 0 | 0.0 | 3.9 | 3.9 | 5.7 | 5.7 |
| **Volatility** | 14.7 | 15.6 | 13.2 | 13.8 | 12.4 | 14.2 |
| **Sharpe ratio** | 0.2 | 0.6 | 0.2 | 0.7 | 0.5 | 1.0 |

**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 & Market

- We believe in concentrating our attention on good companies that we think, when undervalued, make for good investments. We try to understand our companies in the context of the world in which they operate rather than try to formulate a shape of the world and find investments to fit.
- This year the Fund has captured 97% of the gains in the MSCI AC Pacific ex Japan Index. The Index has risen 14.1%/10.9%/19.9% in GBP/EUR/USD terms and has done better than the S&P 500, as well as Europe, Japan and Emerging Markets as measured by their respective MSCI indices.
- We believe that Asia has further to go, supported by stronger economic growth than expected, rising consensus profits estimates and valuations which are still at a significant discount to developed markets. This contrasts with a US stock market that appears to us to be expensive and which we believe is pricing in expectations of reduced corporate taxes and increases in domestic investment which seem further away than expected or even receding.

## Events in 2017

- From an Asia standpoint, the good news was that bad things did not happen. President Trump did not slap trade tariffs on China or brand China a currency manipulator.
- A new South Korean President was elected in May following the impeachment of President Park. Improved relations between South Korea and China have followed.
- China's economy grew 6.9% year on year in the first quarter and may see 6.7% y/y growth in the second quarter of 2017, which would be much more positive than many were expecting last year. This has probably been a significant driver of commodity prices (ex-oil).

- European elections saw both the Dutch and French firmly reject the anti-immigration/anti-EU parties. German elections in September appear to us to favour the incumbent, Angela Merkel. This we think has helped reduce fears of EU instability. The British meanwhile continue to make a mess of it – the election failed to deliver a thumping majority and went the other way, weakening the Brexit negotiating position, which was not strong to begin with. This is a British problem and has no wider material impact.

- Asian regional currencies have strengthened 3.3% against the dollar this year on a weighted average basis (4% if we exclude the Japanese yen and the Chinese renminbi), especially the Korean won, Taiwanese dollar, the Thai baht and most recently, the renminbi.

# Outlook & Risks

- Asian markets as measured by MSCI Pacific ex Japan are still trading at a 28% discount to developed markets, as measured by the MSCI World Index, on an historic Price/Earnings (P/E) multiple basis.

- The Fund is trading at an 10% discount to Asia on a P/E basis while offering a similar forecast earnings growth profile.

- Efforts by Japan to kick-start its economy show no signs of being effective.

- India's top-down reform story, which has attracted high levels of interest, is countered from the bottom up by slower economic growth, bad debt issues in the state banking sector and the biggest downgrades to profit forecasts in the region.

- A key risk to market expectations, but one of which we are aware, is of slower Chinese growth ahead. Economic rebalancing and leverage reduction will slow growth but China is committed.

- Technology has been strong and we think the smartphone sector has further to run. But we recognise that the higher component prices that benefit Asian technology manufacturers and suppliers will eventually have an impact on end demand if passed on.

**We try to mitigate ongoing macro uncertainties by focusing investment in those companies that have achieved profitability without requiring favourable policy or cyclical support.**

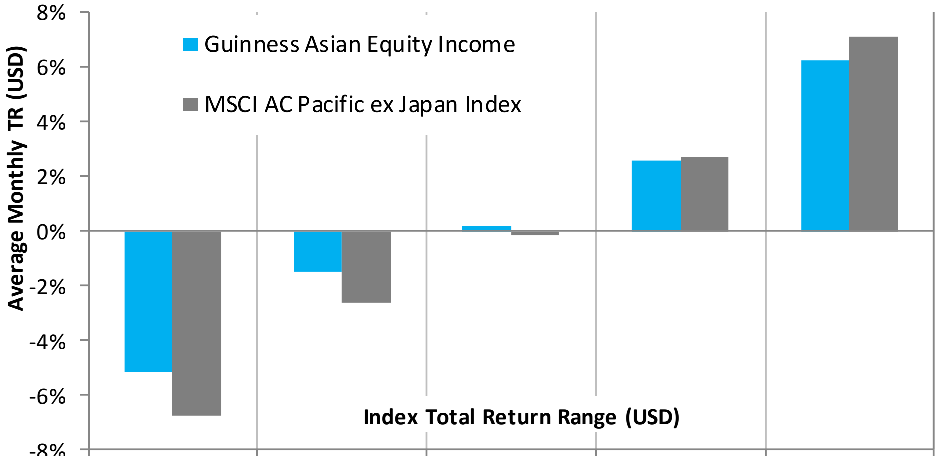
# Discussion

## Performance

We have positioned the Fund in those companies which we believe to be the best quality in the market. We define that quality in terms of their ability to convert competitive advantages into financial returns on capital that have been greater than the cost of that capital. We require these companies to have achieved this on a sustained basis for at least eight consecutive years. We think this is long enough to make it probable that these advantages and the accompanying returns on capital will be persist, making us more confident in judging whether the market is under-pricing the stock. The portfolio consists of 36 such names which are equally weighted.
The chart below shows how the Fund has performed in weaker or strong market conditions in the five years to 30th June 2017. The tendency has been to capture most of the gains in strongly rising markets while offering greater downside protection in weaker conditions:

The graph shows how the Fund has performed in months where the MSCI AC Pacific ex Japan returned:

- <-4%
- -4% to -2%
- -2% to +2%
- +2% to +4%
- >+4%




| | < -4% | -4% to -2% | -2% to 2% | 2% to 4% | > 4% |
|---|---|---|---|---|---|
| Guinness Asian Equity Income | -5.1% | -1.5% | 0.2% | 2.6% | 6.2% |
| MSCI AC Pacific ex Japan Index | -6.8% | -2.6% | -0.2% | 2.7% | 7.1% |
| Difference | 1.6% | 1.1% | 0.3% | -0.1% | -0.8% |
| Frequency | 6 | 3 | 16 | 11 | 6 |

In the first half of 2017 the Fund has performed well, rising 13.6%/10.4%/19.4% in GBP/EUR/USD terms and capturing 97% of the gains in the MSCI AC Pacific ex Japan Index. Over one year the Fund is up 25.8%/19.1%/22.2% in GBP/EUR/USD terms compared to the index, which rose 29.6%/22.7%/26.0%. This is in line with our expectations. Over the last three years, which include periods of market weakness most notably in 2015 and early 2016, the performance is very strong, with the Fund producing a total return of 66.5%/52.0%/26.4% in GBP/EUR/USD, compared to 48.9%/35.9%/13.3% for the market. We believe the key to producing performance growth over time is the preservation of prior gains when markets are weak.

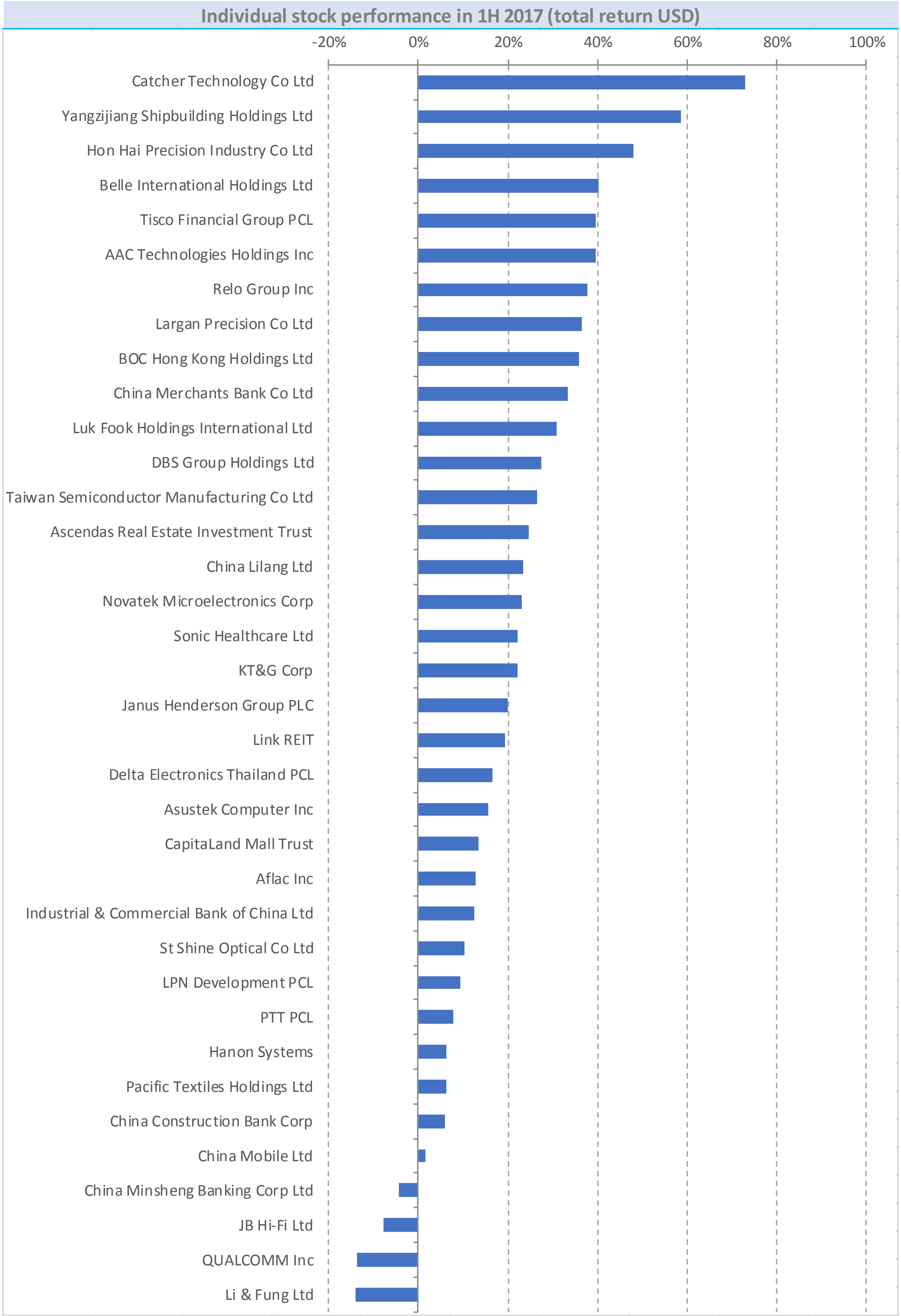
Monthly performance against the Index in USD terms in 2017


A review of the Fund's performance month by month is helpful to us when considering whether the behaviour is in line with expectations. The 36 names in the portfolio are our best ideas in the region and while we don't expect them to move independently of one another, we want to avoid over-exposure to themes that once exhausted could cause an entire section of the portfolio to roll over.

This year, for example, technology has been the best performing sector component of the MSCI AC Pacific ex Japan Index, up 38% in dollar terms, and its strength relative to the market has been almost continuous this year. Closer examination shows that it is the smartphone and memory segments that are doing best.

The smartphone sector was regarded as having reached saturation and a broad sell-off in the sector in April 2016 expressed those concerns. However, the new designs coming through from Apple, and to a lesser extent Samsung, have changed the picture. Whether it is the new casings to enable wireless charging, display technology that is both more flexible and consumes less power, improvements in camera technology, or processors and command functions – there is something for almost everyone in the supply chain. There is a view that we are in a smartphone 'super-cycle'. Related to this has been a recovery in memory pricing for both DRAM and Flash memory. Both are used in handheld devices and Flash memory is increasingly being incorporated into personal computers. Toshiba in Japan (not held in the portfolio) has been in considerable difficulty and last year put its memory business up for sale. As memory prices have picked up, multiple bidders have appeared.

From the Fund's perspective, we want to be comfortable that the stronger-than-expected performance is not purely a thematic event but comes from our stock selection. The chart below shows the performance of individual stocks through the first half 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 as a result of market and currency fluctuations.

A review of the monthly performance reveals the Fund outperformed in four of the six months in conditions that would normally lead us to expect a moderate lag. The possible concern, as discussed above, is that we might have too high an exposure to a sector or theme that could then have a significant impact if sentiment toward those areas were to turn. However, when we look at the individual stock performances we can see there is a wider spread. In the top five performers, there are two technology names but also a Chinese shipbuilder, a Chinese clothing retailer and Thai consumer finance company. The top 10 stocks also include a Chinese bank, a Hong Kong bank, a Japanese real estate services company and a jewellery retailer. Amongst the weakest names we have a Hong Kong manufacturing agency and a technology company, an Australian discount electrical retailer, and a Chinese bank and a telecom services company.

**Leaders**

CATCHER

扬子江船业（控股）有限公司
Yangzijiang Shipbuilding (Holdings) Ltd.

FOXCONN
HON HAI

Belle 百麗國際
International

TISCO

Catcher Technology is a manufacturer of smartphone casings and is most exposed to Apple. The stock did not perform well last year as concerns grew that both volumes and pricing of metal casings were coming under pressure. News that Apple was considering glass rather than metal for its next generation iPhone added to the gloom. The reality turned out to be a little different. Although Catcher does not make glass casings, the frame required to hold the glass is difficult to make and Catcher has both a good track record in its ability to produce in volume to the high standard required and in timely fashion, and it has a strong relationship with its customers. The frame is expected to sell for higher price than the previous all-metal casing and the volumes required have been revised higher as expectations have grown for the new iPhone. Stronger-than-expected 2016 results together with upgraded forecasts have made Catcher our best performer this year.

Yangzijiang Shipbuilding has a different story. Shipbuilding has been out of favour for several years as global growth, and trade growth in particular, has slowed. This has driven down shipping rates for both container and bulk transportation and a decline in orders for new ships has been the inevitable knock-on effect. However, Yangzijiang has maintained returns on invested capital at levels above the cost of capital for over ten years. It has low debt and it has scale. The company is also active in incorporating newer technology (for example in hull design) to make a more efficient vessel. While its new orders have declined in number, with lower associated margins, they have held up better than those of other firms. The valuation of the company had been driven down to low levels in line with the sector but when 2016 results came in 'not-as-bad-as expected' the stock bounced. With a recent recovery in shipping rates and orders evident in the Korean shipyards, the stock price recovery continued, making it our second best performer.

Hon Hai Precision is another technology company and trades with the name Foxconn. It is a major producer for Apple, but there is much more to the company. At present the stock price is being driven by expectations surrounding Apple and for Hon Hai, the big earnings driver is expected to be the new OLED iPhone model. OLED, which stands for Organic Light Emitting Diode, is used for displays and consumes significantly less power, helping to support longer battery life. This model will have the glass case which supports wireless charging, although Hon Hai's activities spread much further; it is involved in products ranging from Internet of Things to Artificial Intelligence. It acquired Sharp in 2016 and is still in the hunt for Toshiba's flash memory business. The company has recently expressed a commitment to shareholders to focus on cash-based returns on investment and to increase the proportion of profits distributed as dividends.

The last two names in the top five performers are Belle International and Tisco Financial Group. Belle is a Chinese designer and retailer of women's shoes and has recently expanded into sports shoes. Like most retailers, the business has been struggling with the rise in online shopping, which has had the effect of depressing margins in the core business, although its sports segment is growing well. The brand is well known in China and Belle has almost 4,000 outlets in 150 cities. This has made it an attractive acquisition target and earlier this year Hillhouse and CDH Investments agreed to acquire the business for $6.8 billion.

Tisco Financial Group does the bulk of its business in the hire-purchase segment of consumer finance, with a focus on cars and motorcycles. The business is not perceived as glamorous or high quality in the traditional sense, but from an investment perspective it is one of the best at what it does and its financial profile reflects that. The recent acquisition of Standard Chartered Bank's consumer loan book has added extra growth momentum. Tisco's results were very positive not only in growth and profits but also in asset quality, with lower credit costs and prudent provisioning combining to provide strong non-performing loan coverage of 164% at the end of the first quarter of 2017.

**Laggards**

LI & FUNG

QUALCOMM

JB HI-FI

中国民生银行 CHINA MINSHENG BANK

Li & Fung continues to test us. The company is a manufacturing agent operating between US and European retailers on one side and factories in developing markets including China on the other. They operate on slender margins and thus require volume growth, which is proving elusive. The challenges they face reflect those of the wider retail sector: high promotional activities, reduced inventories, weaker consumer demand and retail bankruptcies. Opportunities exist in making the shift with their customers to online channels, e-commerce platforms and private label. Li & Fung is an efficient business with high cash and low levels of debt; growth is the problem. A new three-year plan for 2017-19 aims to focus on the supply chain; speed of production from pre-order to delivery for an average retailer takes 40 weeks, according to Li & Fung, and they aim to cut this to 21 weeks. They seek to create a digital platform to provide visibility for the customer at each stage (end to end) and the tools for customers to manage the process. In short, there are substantial additions they need to make to the supply chain management services they provide to secure their relevance as a business.

Qualcomm's business is well-known. The technology it provides and has designed is essential to the operation of a cell phone and herein lies a problem. Qualcomm's business model is based upon its 'indispensable' technology and it requires royalty payments for the use of its patents, based on the selling price of the device that uses them. This model is now being challenged by Apple, which argues that its devices are now far more than just cell phones and that Qualcomm is riding unfairly on the premium prices being charged by Apple for additional features with which Qualcomm has no involvement. The legal challenges to Qualcomm's pricing model and the suspension of payments by Apple's suppliers, at Apple's direction, have had a negative impact on the stock price.

JB Hi-Fi in Australia is a discount retailer of electrical goods. It was the third best performer in the portfolio in 2016 which goes some way to explain the relative weakness this year. However, there have also been developments in the Australian market such as the expected arrival of Amazon, which could disrupt this segment. There is an expectation from some that Amazon could undercut the local retailers by up to 15%, while Harvey Norman, JB HiFi's major domestic competitor, is said to be cutting prices by 10%. However, this market is already competitive. The three main discount electrical retailers hold 58% market share between them and already offer some keen pricing. It is therefore not a given that Amazon will find the massive 'price-busting' opportunity they expect. Intensifying competition, rather than a disappearing market, is what we would expect to see.

The two remaining laggards among the bottom five this year are China Minsheng Banking and China Mobile. China Minsheng is a private rather than a state-owned bank and is more affected by the deleveraging underway in China than its peer China Merchants Bank (which we also hold and is one of our top 10 performers this year). As a mid-sized bank, it lacks the deposit franchise of its state-owned competitors which forces it to seek funding from the wholesale market. The focus of its lending is into mid-sized entities. The risks it faces are higher funding costs, lower loan rates as competition picks up and the possibility it will need to set aside more capital against so-called 'non-standard assets'. The issue is one of competition rather than stability.

China Mobile has nothing wrong with it beyond the fact it is large and not growing very fast. The telecom landscape in China is stable from a regulatory perspective but is competitive. Recent results from the company showed good key performance indicators with new customer additions for fixed line broadband and on the mobile side. There is regulatory pressure to cut roaming fees which exerts some downward pressure on profits, but not significantly. Further improvements in capital management would unlock further value, but even without that the stock looks attractively valued – just out of favour right now.

# Outlook

We continue to believe that Asia, along with Europe, is attractive compared to the US. US markets have remained buoyant, but imminent changes to corporate taxes in America or a rise in domestic infrastructure investment now look more distant, with a president who seems more engaged in defending his personal brand and tangling with journalists and TV presenters. We think that investors should be considering diversifying after a strong eight-year run and Asia, on a 28% discount to developed markets, is one area to look. Quality, Value, and Dividends in the region all seem attractive.

We think that focusing on good quality companies – those with returns on invested capital that have only been achieved by a minority of companies worldwide – goes some way to mitigating the risks of investing overseas. Our discipline of keeping to 36 dividend-paying names that are undervalued relative to the returns on investment we believe they can continue to generate is, we think, a sensible approach. Accordingly, our portfolio trades at a discount to Asian markets, which themselves trade at a discount to developed markets – a result of investors' neglect of the region, including the quality companies that can be found there.

**Edmund Harriss & Mark Hammonds**
(portfolio managers)
**Sharukh Malik** (analyst)

**Data sources**

Fund performance: *Financial Express, gross total return*

Index and stock data: *Bloomberg*

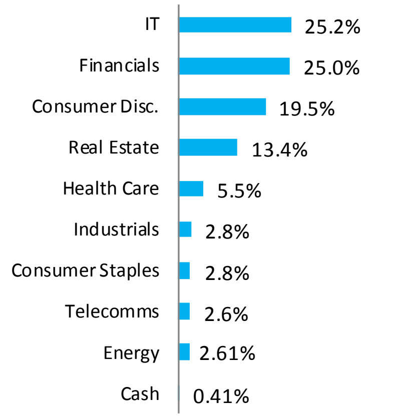
## PORTFOLIO

**30/06/2017**

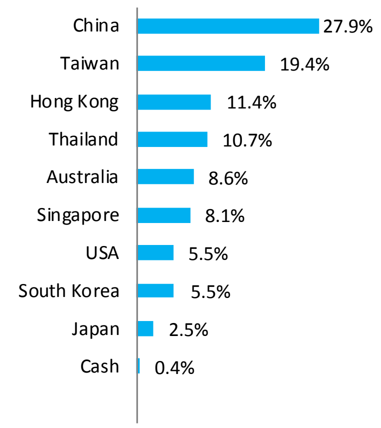
### Fund top 10 holdings

| | |
|---|---|
| AAC Technologies | 3.0% |
| Hon Hai Precision Industry | 3.0% |
| JB Hi-fi | 3.0% |
| Luk Fook Holdings | 2.9% |
| ICBC | 2.9% |
| BOC Hong Kong | 2.9% |
| Sonic Healthcare | 2.9% |
| Catcher Technology | 2.9% |
| Belle International Holdings | 2.8% |
| Li & Fung | 2.8% |
| % of Fund in top 10 | 29.0% |
| Total number of stocks in Fund | 36 |

### Sector analysis




### Geographic allocation




## PERFORMANCE

**30/06/2017**

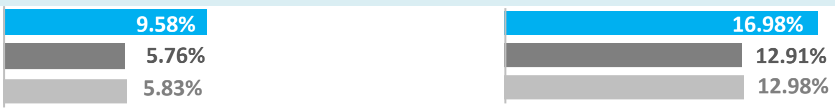
### Discrete years % total return

| | Jun '13 | | Jun '14 | | Jun '15 | | Jun '16 | | Jun '17 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | USD | GBP | USD | GBP | USD | GBP | USD | GBP | USD | GBP |
| Fund (X class, 1.24% OCF) | - | - | - | - | 12.5 | 22.3 | -8.0 | 8.2 | 22.2 | 25.8 |
| MSCI AC Pacific ex Japan Index | 9.9 | 13.7 | 17.2 | 4.0 | -0.8 | 7.9 | -10.2 | 5.6 | 26.0 | 29.6 |
| IA Asia Pacific ex Japan | 9.8 | 13.6 | 16.6 | 3.4 | -0.2 | 8.5 | -10.4 | 5.3 | 25.1 | 28.8 |

### Cumulative % total return

| | 1 month | | Year-to-date | | 1 year | | 3 years | | From launch | |
|---|---|---|---|---|---|---|---|---|---|---|
| | USD | GBP | USD | GBP | USD | GBP | USD | GBP | USD | GBP |
| Fund (X class, 1.24% OCF) | 1.9 | 1.3 | 19.4 | 13.6 | 22.2 | 25.8 | 26.4 | 66.5 | 38.1 | 74.0 |
| MSCI AC Pacific ex Japan Index | 2.2 | 1.5 | 19.9 | 14.1 | 26.0 | 29.6 | 12.2 | 47.7 | 21.9 | 53.5 |
| IA Asia Pacific ex Japan | 1.4 | 0.8 | 20.4 | 14.5 | 25.1 | 28.8 | 11.8 | 47.2 | 22.1 | 53.9 |

### Annualised % total return from launch




### Risk analysis - Annualised, weekly, from launch on 19.12.2013

| 30/06/2017 | Index | | Sector | | Fund | |
|---|---|---|---|---|---|---|
| | USD | GBP | USD | GBP | USD | GBP |
| Alpha | 0.0 | 0.0 | 0.8 | 1.7 | 5.0 | 5.7 |
| Beta | 1.0 | 1.0 | 0.9 | 0.9 | 0.8 | 0.9 |
| Information ratio | 0.0 | 0.0 | 0.0 | 0.0 | 0.7 | 0.7 |
| Maximum drawdown | -29.1 | -26.2 | -26.7 | -24.5 | -24.3 | -20.6 |
| R squared | 1.0 | 1.0 | 0.9 | 0.9 | 0.9 | 0.9 |
| Sharpe ratio | 0.2 | 0.6 | 0.2 | 0.7 | 0.5 | 1.0 |
| Tracking error | 0.0 | 0.0 | 3.9 | 3.9 | 5.7 | 5.7 |
| Volatility | 14.7 | 15.6 | 13.2 | 13.8 | 12.4 | 14.2 |

**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: 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.

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 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.

**Singapore**

The Fund is not authorised or recognised by the Monetary Authority of Singapore ("MAS") and shares are not allowed to be offered to the retail public. The Fund is registered with the MAS as a Restricted Foreign Scheme. Shares of the Fund may only be offered to institutional and accredited investors (as defined in the Securities and Futures Act (Cap.289)) ('SFA') and this material is limited to the investors in those categories

**Telephone calls** may be recorded and monitored.