Guinness Asian Equity Income Fund

INVESTMENT COMMENTARY – December 2017

Launch date	**19.12.13**
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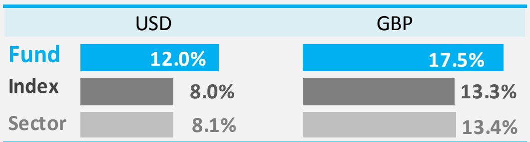
Aim

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.

	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	35.4	23.5	34.6	24.1	56.7	89.3
Index	33.3	21.7	31.8	21.7	35.5	63.8
Sector	34.0	22.3	31.9	21.8	35.9	64.3

Annualised % total return from launch



Risk analysis (annualised, weekly, from launch)

	Index		Sector		Fund	
	USD	GBP	USD	GBP	USD	GBP
Alpha	0	0.0	0.9	1.6	5.4	5.6
Beta	1	1.0	0.9	0.9	0.8	0.9
Info ratio	0	0.0	0.0	0.0	0.6	0.6
Max drwdn	-29.1	-26.2	-26.7	-24.5	-24.3	-20.6
Tracking err	0	0.0	3.8	3.8	5.7	5.7
Volatility	14.3	15.2	12.9	13.5	12.1	14.0
Sharpe ratio	0.4	0.7	0.4	0.8	0.7	1.1

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

- The Fund performed well again in November, ending the month up 1.1%/0.7% in GBP/EUR terms, and ahead of the MSCI AC Pacific ex Japan Index, which fell –1.2%/–1.6%.

- Year-to-date, Asia remains ahead of the US, Europe, Global Emerging Markets, and Global Developed Markets. (MSCI AC Pacific ex Japan: +33.7%, S&P 500: +20.5%, MSCI Europe: +23.9%, MSCI Emerging Markets: +32.9%, MSCI World: +21.4%. All returns are total returns in USD, unless specified.)

- The best performing sectors in November in Asia were Health Care, Consumer Staples and Financials. The worst performing sectors were Industrials, Information Technology and Utilities. On a country basis, Singapore and Hong Kong were strong; Taiwan and Indonesia lagged.

- For the year to date, the best performing sectors are Information Technology (+63.6%), Healthcare (+43.7%) and Real Estate (+34.9%). The worst performing sectors are Telecom Services (+7.3%), Utilities (+17.1%) and Industrials (+19.4%). China, Korea and Singapore have been the better performing countries, while New Zealand, Indonesia and Australia have lagged.

- Technology stocks sold off towards the end of the month as investors in both Asia and the US took profits and moved into other sectors. As highlighted above, technology has been the stand-out best performing sector this year, and we were not surprised to see a degree of price correction. We find many companies with the characteristics we look for—returns on capital persistently above the cost of capital, reasonable valuations and an attractive dividend capable of growing over the long term—in the Information Technology sector.

Events in November

China's Ministry of Finance announced significant cuts to import taxes on consumer goods. Reductions will be applied to 187 product categories from the start of December. The tax reductions should benefit both consumers and multinational consumer goods companies, particularly those manufacturing products where quality and product safety are treated with high importance, such as infant milk formula.

Shortly after President Trump's visit to China, the country announced further measures to liberalise its financial sector. The limits on foreign ownership of companies operating in the banking, securities, asset management and insurance industries will be eased. Though the changes will take place over several years, they are an important step in China's ongoing liberalisation of its markets, and they should promote greater competition among domestic companies.

Also in China, the financial regulators jointly issued a consultation paper on the asset management business, covering Wealth Management Products and Asset Management Plans. The new regulations should be beneficial for the long-term health of the Chinese banking sector, and follow other regulatory announcements earlier in the year.

The Australian government agreed to hold a Royal Commission of Inquiry into the financial services sector, following political pressure from opposition parties. The government introduced the inquiry after several scandals that have undermined public confidence in the banks. The reaction from the market was negative, and Australian banks underperformed during the month.

Outlook

Earnings in 2017 for Asian companies look set to be much improved over those in 2016. Stronger global growth and recovering commodity prices over the past two years have translated into higher profits and improved cashflows.

Asian stock market valuations have re-rated during 2017, but the strength in Asian markets has primarily been led by earnings growth. The region still trades at an attractive level – both, we believe, on an absolute basis and relative to developed markets.

The path of interest rate rises in the US remains closely watched. We believe the path of slow and steady increases is most likely at this point, with the Fed unwilling to jeopardise a modest economic recovery.

Portfolio

Three stocks significantly outperformed during November: Qualcomm rose 31.1%, St Shine was up 18.5% and KT&G rose 18.4%.

Qualcomm

For Qualcomm's share price, it has been a volatile year. The stock started 2017 with a sharp sell-off following the company's legal dispute with Apple over royalty payments. But earlier last month, the stock staged a dramatic recovery when rumours that the company was the subject of a takeover bid sent the price up as much as 13 per cent in a single day.

The bid—which was confirmed shortly afterwards—from Broadcom, offered $70 to Qualcomm shareholders – $60 in cash and $10 in stock. Including $25bn of net debt, the bid valued Qualcomm at $130bn, giving the combined company a market value of over $200bn. The deal would be the largest ever public tech deal—surpassing the $67bn acquisition of EMC by Dell in October 2015—and would create the world's third-largest semiconductor company.

Broadcom is a chip designer, specialising in networking and communication. The company's consumer products include WiFi and Bluetooth chips. Broadcom recently announced that it was changing domicile and moving its headquarters from Singapore to the US – the decision was originally interpreted as an effort to help its proposed (separate) $5.5bn takeover of Brocade to proceed, but should be seen in a new light after the Qualcomm bid. Broadcom is run by Hock Tan and has a history of M&A – the name itself was retained after Avago's acquisition of Broadcom, which completed in 2017.

The new proposed deal comes at a time of flux for Qualcomm, with the company's share price significantly weakened by the Apple dispute.

At the heart of Qualcomm's legal disagreement with Apple have been the licensing fees Qualcomm demands for using its intellectual property in smartphone modems. The fees are based on a percentage of the overall product price, and as smartphones have become more sophisticated—and more expensive—the fees based on overall device price have increased. Apple's complaint is that Qualcomm is abusing its position and unfairly charging too much. The smartphone manufacturers argue that the modem is of diminishing importance as a portion of the overall product; Qualcomm retorts that the modem is nevertheless an essential component of the device.

January represented a turning point in the dispute. Apple instructed its contract manufacturers, who were responsible for making the royalty payments, to suspend payments to Qualcomm. As the tensions have stacked up, the uncertainty has weighed on the company's share price. More recently, news reports were circulated that Apple were planning to reduce its reliance on the Qualcomm's products, potentially developing its own in-house alternatives.

Despite the negative headlines, we believe there is the potential for the dispute with Apple to be resolved. While we were surprised by the ferocity at which Apple has escalated the matter, Apple is known for playing hard-ball with their suppliers. Also, there is precedent for these kinds of conflicts to be resolved. In 2015, following the resolution of a dispute with the Chinese regulator (Qualcomm settled by agreeing to pay a $975m fine), many of the local smartphone manufacturers withheld royalty payments until new commercials agreements had been reached. Eventually the disputes were solved, and new terms were signed with the manufacturers. Catch-up payments allowed Qualcomm to recoup some of the payments that had been previously withheld. We think Qualcomm is well-placed to renegotiate a licensing agreement that is acceptable to Apple.

There is even the suggestion that it is in Apple's interests to negotiate with Qualcomm. The dispute has left the company vulnerable to takeover, and the proposed acquisition would create a supplier with significant market heft and pricing power. As the New York Times points out: "Broadcom's chief executive, Hock Tan, is said to be open to renegotiating the Qualcomm contract should his company prevail," but Apple is unlikely to want a supplier with such leverage (Broadcom is already a significant supplier for Apple). This threat could be enough to make Apple swiftly return to the negotiating table.

Prior to the bid, we thought that Qualcomm's shares represented good value. Analyst earnings estimates appeared to reflect Apple withholding royalty payments, with little or no contribution expected from their major customer. Essentially, the bad news had already been 'baked into' the share price.

As expected, Qualcomm's board rejected the bid, saying that it "dramatically undervalues" the company. The bid has since gone hostile, with Broadcom proposing to replace all 11 of Qualcomm's directors as part of a proxy battle.

A deal between Broadcom and Qualcomm might also encounter regulatory stumbling blocks – a fact that Qualcomm made clear in their rejection. Broadcom does earn revenue from similar areas to Qualcomm and NXP, such as wired infrastructure, and there is potentially a high degree of overlap in some more narrow areas.

Setting aside the recent bid, the company still has an exciting future ahead of it. Qualcomm's current products are technically superior to those of its rivals. In the new iPhone 8 and 8 Plus, Apple has used both Qualcomm and Intel chips, but it has had to restrict the Qualcomm chip to ensure that there is not a performance difference between two versions in what should be a homogenous product. The Qualcomm chips are compatible with gigabit LTE technologies, but the restrictions mean that iPhones are slower than some Android handsets.

The industry is also about to undergo is the roll-out of 5G. Qualcomm has been working on this technology for many years, and holds numerous patents related to 5G technology. The introduction of the technology will involve upgrading equipment in existing mobile telephone infrastructure (phone masts etc.), but also another round of handset upgrades (yes, you will have to buy another new phone). This upgrade cycle may also be dramatic than the previous 4G roll-out; China, for example, implemented 4G slower than Western countries, but that won't necessarily be the case this time around.

Qualcomm is already trying to close a deal of its own. In October 2016, it agreed to buy NXP Semiconductors, based in Amsterdam, for $38bn. NXP developed near field communication (NFC) technology with Sony, which is now used in mobile payments. The company is also a market leader in automotive chips, including automotive networking, and technology used in 'Internet of Things' devices. These areas are both exciting in their own right – cars are expected to have ever-increasing 'silicon content', while more and more devices are expected to feature internet connectivity – but they are particularly so for Qualcomm as they allow it to extend its networking technology outside of smartphone handsets. The deal has been held up by antitrust investigations in Europe, but is expected to go though by early next year.

Qualcomm has many of the characteristics we look for in a company. Its returns on investment, measured in cashflow terms, have significantly exceeded the cost of capital, and those high returns have persisted over many years. The company's attractive business model (so attractive that it has triggered the ire of one of its key customers) has led to persistent cash generation – earning high profit margins, with low capital investment.

Despite its relatively modest physical capital base, Qualcomm has demonstrated an ability to invest in R&D, as the company's patents and its position at the heart of connectivity standards show. Qualcomm has proven that it can innovate in order to maintain its competitive position as technology evolves.

But it is not enough to be a good company; we also have to believe that the investment case stacks up. Qualcomm offers an attractive valuation – multiples look reasonable, and there are plenty of factors that could offer upside to current earnings estimates. Despite growth slowing recently, we believe there are many reasons—both cyclical and structural—to be optimistic about it returning.

We think the bid from Broadcom does undervalue the company, and in that sense, is opportunistic. However, there are multiple ways that the situation to could play out. Now that the bid has gone hostile, we are likely to see significant developments in the near future.

Other stocks

KT&G had a strong month as the company unveiled its new 'Lil' product to the market. The Lil is KT&G's heat-not-burn product, which as the name suggests, heats tobacco to a lower temperature than a normal cigarette. The product and refills will be sold at a competitive price to rivals' offerings. K&G are initially launching the product for sale at stores in Seoul and online.

St Shine Optical is a stock we have written about as optimism around the company has ebbed and flowed over the past three years. The company is enjoying another upswing and the share price has now pushed through the high of 2014. Recent results came in 9% ahead of consensus estimates reflecting the reacceleration in sales growth, which the company reports monthly. Expansion into the US market is the recent positive development driving St Shine's share price. A new online client was added in 2016 and now accounts for 85% of US sales. The belief is that sales in this channel could be more stable than those from Bausch & Lomb in China. Even more encouragingly, the gross profit margin for US sales has now increased to match that of Chinese sales. Margin expansion, increased production capacity as well as new sales areas are combining to make for a strong story.

The weakest performers in the month were: Li & Fung, which fell 12.6%, Hon Hai Precision which fell 10.4% and Largan Precision which fell 9.8%. Li & Fung has been a disappointing performer for the year overall, though the company has recently begun to show improving operating results. The sell-off in November gave up some of the gains made in past months, but earnings expectations remain relatively unchanged. Hon Hai and Largan, two Information Technology companies, both suffered in a month where tech was the second-worst performing sector. However, IT remains the best performing sector year to date, and shares in both companies have returned more than 30% this year.

Edmund Harriss and **Mark Hammonds** (portfolio managers)
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Data sources

Fund performance: *Financial Express, gross total return*

Index and stock data: *Bloomberg*

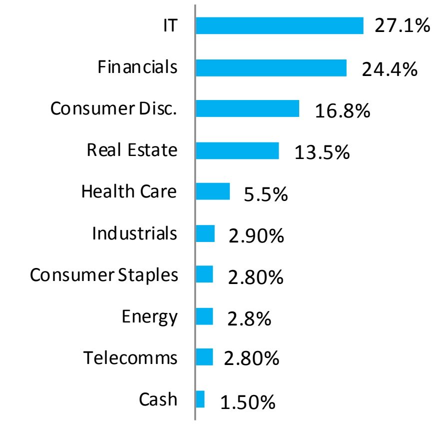
PORTFOLIO

30/11/2017

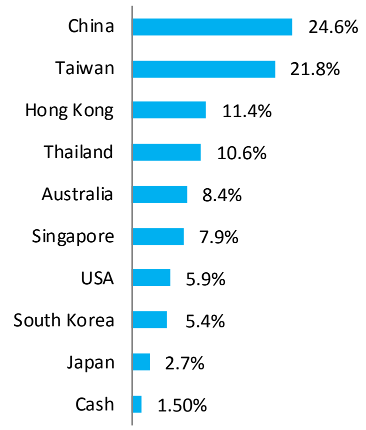
Fund top 10 holdings

Qualcomm	3.0%
BOC Hong Kong	3.0%
JB Hi-fi	2.9%
St. Shine Optical Co	2.9%
Aflac	2.9%
Yangzijiang Shipbuilding	2.9%
Luk Fook Holdings	2.9%
Janus Henderson	2.8%
Pacific Textiles	2.8%
China Lilang	2.8%
% of Fund in top 10	28.9%
Total number of stocks in Fund	36

Sector analysis



Geographic allocation



PERFORMANCE

30/11/2017

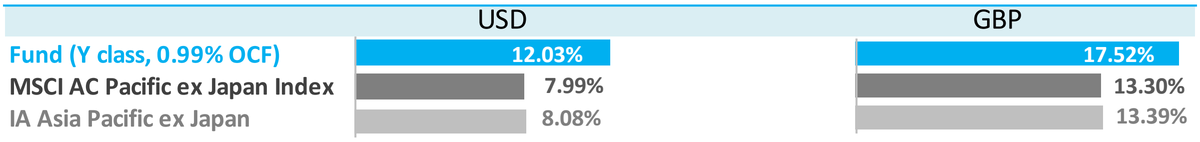
Discrete years % total return

	Nov '13		Nov '14		Nov '15		Nov '16		Nov '17	
	USD	GBP	USD	GBP	USD	GBP	USD	GBP	USD	GBP
Fund (Y class, 0.99% OCF)	-	-	-	-	-3.8	0.1	5.8	27.4	34.6	24.1
MSCI AC Pacific ex Japan Index	9.3	7.0	2.1	6.8	-11.2	-7.6	9.2	31.5	31.8	21.7
IA Asia Pacific ex Japan	8.0	5.6	4.5	9.3	-10.0	-6.4	6.4	28.1	31.9	21.8

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 (Y class, 0.99% OCF)	3.0	1.1	35.4	23.5	34.6	24.1	36.9	58.3	56.7	89.3
MSCI AC Pacific ex Japan Index	0.7	-1.2	33.3	21.7	31.8	21.7	27.9	48.0	35.5	63.8
IA Asia Pacific ex Japan	1.5	-0.4	34.0	22.3	31.9	21.8	26.3	46.1	35.9	64.3

Annualised % total return from launch



Risk analysis - Annualised, weekly, from launch on 19.12.2013

30/11/2017	Index		Sector		Fund	
	USD	GBP	USD	GBP	USD	GBP
Alpha	0.0	0.0	0.9	1.6	5.4	5.6
Beta	1.0	1.0	0.9	0.9	0.8	0.9
Information ratio	0.0	0.0	0.0	0.0	0.6	0.6
Maximum drawdown	-29.1	-26.2	-26.7	-24.5	-24.3	-20.6
R squared	1.0	1.0	0.9	1.0	0.9	0.9
Sharpe ratio	0.4	0.7	0.4	0.8	0.7	1.1
Tracking error	0.0	0.0	3.8	3.8	5.7	5.7
Volatility	14.3	15.2	12.9	13.5	12.1	14.0

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 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: Link Fund Manager Solutions (Ireland) Ltd, 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.