Guinness Asian Equity Income Fund

INVESTMENT COMMENTARY – February 2018

Launch date	**19.12.13**
Team	**Edmund Harriss** (manager) **Mark Hammonds** (manager) **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.

	2015		2016		2017	
	USD	GBP	USD	GBP	USD	GBP
Fund	-4.4	1.2	7.5	28.2	36.5	24.6
Index	-9.4	-4.1	7.8	28.6	37.3	25.4
Sector	-8.6	-3.4	5.3	25.7	37.2	25.3

	YTD		1 year		From launch	
	USD	GBP	USD	GBP	USD	GBP
Fund	4.7	-0.4	36.6	20.8	65.4	90.3
Index	7.0	1.8	38.7	22.7	49.3	71.8
Sector	6.3	1.1	37.1	21.3	48.0	70.3

Annualised % total return from launch

	USD	GBP
Fund	13.0%	16.9%
Index	10.2%	14.0%
Sector	10.0%	13.8%

Risk analysis (annualised, weekly, from launch)

	Index		Sector		Fund	
	USD	GBP	USD	GBP	USD	GBP
Alpha	0	0.0	0.8	1.3	4.9	4.7
Beta	1	1.0	0.9	0.9	0.8	0.8
Info ratio	0	0.0	-0.1	-0.1	0.5	0.5
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	15.1	12.8	13.4	12.0	13.8
Sharpe ratio	0.5	0.7	0.5	0.8	0.8	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

- The past month has seen Asian markets rise strongly with the MSCI AC Pacific ex Japan Index rise 7.0% in US dollar terms (and up 1.8%/3.6% in GBP/EUR terms).

- These conditions do not suit this Fund's particular style and thus it lagged the market, rising 4.7% in US dollar terms (and -0.4%/+0.92% in GBP/EUR terms).

- The best performing sectors were China Energy, Korea and Singapore Industrials, China Technology and China Financials. Among countries, China was the standout winner, rising over 12% in dollar terms, followed by Thailand and Malaysia.

- We would not expect to outperform in these conditions and although the Fund has lagged in January, it is still in touch with broad market. On occasions of market weakness at the end of the month the Fund demonstrated defensive qualities, as we would hope.

- In January all four of our Chinese banks were outperformers, beating the market by 7% or more in dollar terms. We also saw good contributions from Australian retailer JB Hi-Fi, Thai energy company PTT, Taiwan technology companies Novatek and Taiwan Semiconductor and from Chinese shipbuilder Yangzijiang.

- The Malaysian ringgit, Thai baht and Chinese yuan were the nest performing currencies; the Korean won and Philippine peso were the weakest.

- The prices of Brent crude oil and gold both rose 3%, which was in line with dollar weakness.

- Twenty-two of the thirty-six stocks lagged the market mostly because they are lower beta names, so less sensitive to market movements. There were however a couple of stocks that are facing headwinds. Luk Fook jewellery reported decelerating growth in same-store sales in China and guided next year's growth at c.8% compared to earlier forecasts of c.

14%, which disappointed the market. Li & Fung was weaker on macro concerns over a more aggressive trade stance from the US following the imposition of tariffs on Chinese-made solar panels and domestic appliances.

Events in January

- US bond yields rose and the dollar weakened. The US Government 10-Year yield rose from 2.5% to 2.7% and by Feb 2nd it reached 2.84%. At the same time the dollar weakened on trade-weighted basis by 3.2% (as measured by the DXY Dollar Index which is made up of EUR 57.6%, JPY 13.6%, GBP 11.9%, CAD 9.1%, SEK 4.2% and CHF 3.6%).

- The US announced punitive tariffs on Chinese-made solar panels and domestic appliances. This follows a generally more active stance on trade matters with respect to NAFTA. The Chinese response so far has been noticeably muted.

- In light of the weaker dollar the Chinese currency has been allowed to appreciate briskly against the dollar by 3.4%, to its strongest level July 2015. On a trade-weighted basis, the Chinese currency is effectively unchanged over the month.

- In the Technology sector, the smartphone-related companies are seeing share price pressure on weaker demand in both Chinese smartphone and iPhone X demand. Channel checks suggest that Apple is expecting more moderate demand and is thus scaling back orders for components. This is not new news and many of these stocks have been pricing this in since November.

Outlook

- Asian stock markets are well supported by earnings growth and macro-economic momentum supported by domestic activity (particularly in China, Singapore and Thailand) and by global growth, which is looking brighter than it has for several years.

- We must expect that reported earnings growth will decelerate in coming months. This is a mathematical certainty as the comparisons will be made against a higher base.

- Valuations in Asia for the most part remain supportive, especially for those businesses with a profile of consistent profitability. We are cautious on those stocks in the cyclical sectors driven by macro-factors, especially those exposed to industrial commodity prices, like the steel makers.

- We expect to see US interest rates move toward normalisation and we are already seeing the bond market move more quickly. This may remove the need for the Federal Reserve to move faster but the effects will almost certainly be felt in the equity markets.

- The best defences: focus as we do, on those companies whose return on capital has been sustained above the cost of capital because less of their investment value will be eroded by a higher discount rate; focus as we do, on companies with only moderate debt levels with the ratio of debt to equity no greater than 1.

Discussion

Asian earnings consensus forecasts were upgraded a further 2.2% for 2018 and 2019 for the MSCI Asia Pacific ex Japan Index. Chinese and Singaporean markets saw the biggest moves, up 3% and 2% respectively. These bring the totals over the past 12 months to a 16% upgrade to China estimates and 5% upgrade to Singapore. Downgrades to forecasts in January were for Taiwan, Philippines and India. Australian and Korea earnings estimates were unchanged for 2018 and up slightly for 2019.

We think that Asian markets will now be much more focused on the outlook for earnings. In our opinion, in the past eighteen months market moves have been driven primarily by an excessively low valuation relative to both Asia's history and to developed markets. Reported earnings growth has been strong in the past year and this has provided support to the rally, but now we think investors are looking ahead for reasons to continue to buy.

Upgrades to **China** have been significant, as has China's equity market performance. We continue to remind readers that A share (Shanghai and Shenzhen) market performance is not the best guide to assessing China's economic well-being. Instead, these markets tend to be more responsive to short-term liquidity conditions and this is especially true of the Shenzhen stock exchange. But China is doing well:

- Economic growth momentum is evident, with overall growth of 6.9% in 2017 vs 6.7% in 2016.
- Rising commodity prices are a benefit for China because it allows materials producers to raise prices.
- Pricing power for heavy industry and 16% growth in industrial profits improves the debt servicing capacity of the more heavily indebted sectors.
- Higher debt servicing capacity has also been evident in slowing non-performing loan formation in the banking sector.
- There is now evidence that intensified efforts at financial reform are proving effective and not destabilising as some feared; credit growth has slowed this year and deleveraging in the banking sector is being enforced.
- Domestic confidence is higher as evidenced not only in retail sales and the Real Estate sector but also in the reduction in capital outflows which has been accompanied by the renminbi strengthening against the dollar to 2015 levels.

Singapore upgrades are less significant to the world but are interesting nevertheless. The country is a developed market and has been in the economic doldrums for a number of years. Production costs are higher there and so the goal has been to find a replacement for the electronic manufacturing segment that drove growth in the years before the financial crisis. Policy missteps, possibly the greatest being the controls on immigration which forced wage costs sharply higher, further eroded competitiveness. It also had an impact on the property market, which eroded domestic confidence through a negative wealth effect. The Singapore dollar declined against the US dollar from mid-2014 to the end of 2016 after strengthening fairly steadily over the previous 13 years.

However, conditions have begun to change for the better. The shift into healthcare (biotech and pharmaceuticals) is now paying off. Singapore's financial services, especially in asset management and wealth management, have gained critical mass. Macro-economic data show a recovery in industrial production and non-oil exports.

Consumer confidence, which has been fragile, is now showing signs of firming and the Singapore dollar strengthened 8.5% in 2017 and has risen a further 1% in January.

Portfolio activity

We have kept the portfolio composition unchanged in January, but with flows into the Fund we have been able to effect rebalancing. Example beneficiaries of this have been Luk Fook, KT&G and Li & Fung. These stocks have all been underperformers this month as market attention has been elsewhere. This represents a good opportunity to top up, assuming we are correct in our two base assumptions: first that these businesses are likely to sustain their 8%-or-better cash flow return on investment (CFROI) and secondly that the market undervalues that likely persistence.

Luk Fook, as we mentioned earlier, has underperformed because same-store sales growth in its China jewellery stores has slowed by more than investors had expected. This growth slowdown has been in their sales of gem sets, which are higher-margin, but we regarded this as almost inevitable given the previous growth rate was unsustainable. The concern now is that with more growth coming from lower-margin gold products we will see an overall reduction in profitability. However, it is our view that margin decline expectations have been overdone and secondly that if inflation becomes an issue we will see gold prices pick up, which will benefit Luk Fook. There has already been a 3% rise in the gold price this month and so we consider Luk Fook's share price drop to a be knee-jerk reaction; we are buyers.

KT&G, a Korean tobacco name we like, comes in and out of favour but its profitability has been consistent. In recent months the share price was boosted by the launch of its "heat not burn" tobacco product, but some are now saying this will still result in market share loss for KT&G, margin compression due to higher production costs and marketing expenses and that it will take longer to achieve scale economies. These views have contributed to the 16% drop in the share price since its mid-November peak. We take heart from recent management guidance of a faster national roll-out this year, from signs of faster consumer acceptance of the products and additionally from management's improved dividend policy which, although easy to overstate, is more shareholder-friendly by ensuring a minimum 40% of profits will be paid out as dividends.

Li & Fung is a stock we have written about many times before. The company acts as middleman between manufacturers in Asia and retailers in the US and Europe. In recent years its business has been squeezed by slower developed market demand and by the disintermediating effects of technology. Li & Fung therefore has to reinvent itself to some degree, re-focus on the service element of its business and to divest itself of direct production activity. Its aim is to provide a product design, sourcing, production and shipping service that will reduce the time between product concept and final delivery from around 40 weeks to 20. They are making good progress and the share price rallied last year. It fell back on President Trump's imposition of tariffs on solar panels and white goods; investors worry whether broad trade relations are about to deteriorate. We believe not and that the share price weakness is an opportunity.

Summary and conclusion

The portfolio is trading on a price/earnings multiple basis at a 10% discount to the market as measured by the MSCI AC Pacific ex Japan Index. This index is in turn trading at a wider discount to developed markets than its ten-year average. A combination of above-average companies, in our opinion, paying above-average dividends and trading on a below-average valuation seems to us to be an attractive one.

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

Data sources

Fund performance: *Financial Express, gross total return*

Index and stock data: *Bloomberg*

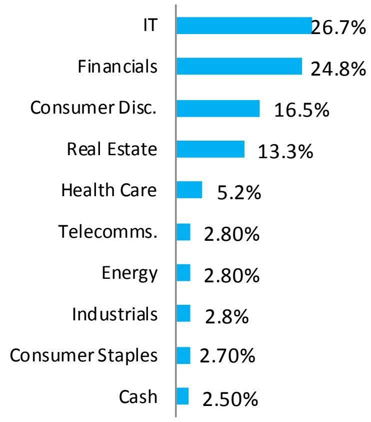
PORTFOLIO

31/01/2018

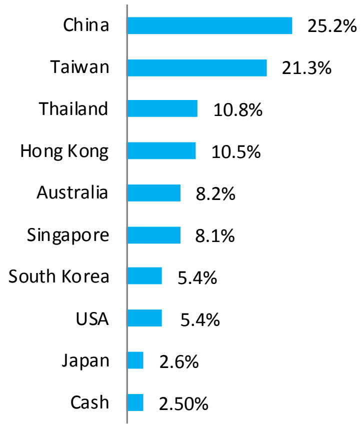
Fund top 10 holdings

JB Hi-fi	3.1%
China Construction Bank	3.1%
China Minsheng Banking	2.9%
China Merchants Bank	2.9%
China Mobile	2.8%
ICBC	2.8%
Asustek Computer	2.8%
Capitamall Trust	2.8%
Hanon Systems	2.8%
Catcher Technology	2.8%
% of Fund in top 10	28.7%
Total number of stocks in Fund	36

Sector analysis



Geographic allocation



PERFORMANCE

31/01/2018

Discrete years % total return

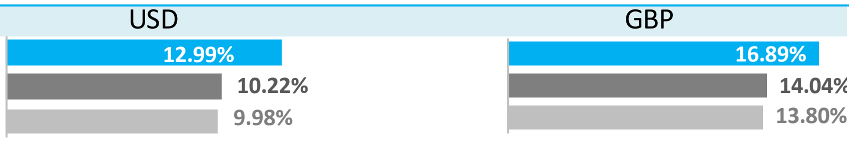
	Jan '14		Jan '15		Jan '16		Jan '17		Jan '18	
	USD	GBP	USD	GBP	USD	GBP	USD	GBP	USD	GBP
Fund (Y class, 0.99% OCF)	-	-	-	-	-10.9	-5.7	19.8	35.0	36.6	20.8
MSCI AC Pacific ex Japan Index	-3.6	-7.0	8.4	18.7	-17.4	-12.5	23.9	39.7	38.7	22.7
IA Asia Pacific ex Japan	-4.1	-7.5	9.7	20.1	-17.3	-12.4	22.3	37.9	37.1	21.3

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)	4.7	-0.4	36.5	24.6	36.6	20.8	45.8	54.0	65.4	90.3
MSCI AC Pacific ex Japan Index	7.0	1.8	37.3	25.4	38.7	22.7	42.1	50.0	49.3	71.8
IA Asia Pacific ex Japan	6.3	1.1	37.2	25.3	37.1	21.3	38.8	46.6	48.0	70.3

Annualised % total return from launch

Fund (Y class, 0.99% OCF)
MSCI AC Pacific ex Japan Index
IA Asia Pacific ex Japan



Risk analysis - Annualised, weekly, from launch on 19.12.2013

31/01/2018	Index		Sector		Fund	
	USD	GBP	USD	GBP	USD	GBP
Alpha	0.0	0.0	0.8	1.3	4.9	4.7
Beta	1.0	1.0	0.9	0.9	0.8	0.8
Information ratio	0.0	0.0	-0.1	-0.1	0.5	0.5
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	0.5	0.7	0.5	0.8	0.8	1.0
Tracking error	0.0	0.0	3.8	3.8	5.7	5.7
Volatility	14.3	15.1	12.8	13.4	12.0	13.8

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 will be recorded and monitored.