Guinness Best of China Fund

INVESTMENT COMMENTARY – February 2018

Launch date	**19.12.13**
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Aim

Guinness Best of China Fund is designed to provide investors with exposure to economic expansion and demographic trends in China and Taiwan.

The Fund is managed for capital growth and invests in profitable companies generating persistently high return on capital over the business cycle

Performance

31.01.18

Fund	Best of China Fund
Index	MSCI Golden Dragon
Sector	IA China/Greater China

	1 year	**3 years**	**From launch**
Fund	32.5	-	75.4
Index	31.6	60.1	81.9
Sector	35.5	62.1	75.8

Annualised % gross total return from launch (GBP)

Risk analysis (annualised, weekly, from launch)

	Index	**Sector**	**Fund**
Alpha	0.0	0.0	0.6
Beta	1.0	1.0	1.0
Info ratio	0.0	0.0	-0.2
Max drwdn	-12.9	-16.8	-14.2
Tracking err	0	0	6
Volatility	17.7	17.0	17.8
Sharpe ratio	1.6	1.5	1.5

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

- In a strong start to the year for global markets, China was the standout performer with MSCI China rising 7.2% vs Emerging Markets rising 3.3%, the S&P 500 rising 0.8% and MSCI Europe rising 0.1%.
- The fund rose 0.4% in GBP terms in January, lagging the index which rose 4.6%.
- The strongest sectors in China were Financials (total return of +12.7%), Real Estate (+11.7%) and Energy (+8.8%). The fund is underweight in these sectors by 9.1%, 4.8% and 2.9% respectively. Healthcare was noticeably weak, falling 2.2% after a strong run towards the end of 2017. In Hong Kong the Consumer Staples and Discretionary sectors were strongest, rising 4.6% and 2.5% respectively. In Taiwan Information Technology, which makes up more than half of the market, rose moderately by 3.2%.
- Of the stocks that contributed to underperformance, only one, Luk Fook, actually released results, and these missed expectations. 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%.
- In the Technology sector, the smartphone-related companies are seeing share price pressure due to weaker demand in both Chinese smartphones and the iPhone X. 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.

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 had 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.

- The People's Bank of China (PBoC) removed the counter-cyclical factor used in the daily fixing for the renminbi. The factor was introduced in 2017 to reduce some of the depreciation pressure on the currency. The factor's removal indicates that policymakers are more confident on the trajectory of the currency.

- Financial deleveraging efforts continued. The banking regulator introduced new rules targeting the shadow banking system, particularly in overcapacity sectors and real estate. For example, banks cannot engage in loans for mergers and acquisitions where land is the main underlying asset. This should reduce the appeal of debt-fuelled acquisitions in the property market which have become popular over the past two years. As it became clear that China will continue to reform its banking and shadow banking systems, the share prices of the Chinese banks did very well in January.

- Taiwanese economic data was solid. Fourth quarter GDP growth was stronger than expected at 3.3% on a year-on-year basis. Exports grew 14.8% in December, meaning exports grew 13.2% in 2017, compared to a fall of 1.7% in 2016.

Outlook

- We expect that reported earnings growth will decelerate in coming months. Growth was so high in 2017 because of the low base in 2016 and so it is inevitable this will come down.

- 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.

Portfolio

The Fund seeks good quality companies, defined in financial terms as those that have generated real returns on invested capital that have been above the cost of capital for at least eight years. If this criterion is met by the company, it is very likely that its returns will persist. We invest in those companies whose stock prices, in our opinion, undervalue that likely persistence. The portfolio consists of 33 stocks which are equally weighted and rebalanced from time to time.

The equally weighted nature of the fund makes it very different to the MSCI Golden Dragon Index, 18.9% of which is made up of Tencent and Alibaba, the two biggest stocks. This concentration is even more pronounced in the MSCI China Index, of which Tencent and Alibaba make up 31.6%. To put this into context, the top two stocks account for only 6.3% of the MSCI USA Index and 4.8% of the MSCI Europe Index. In our view there is a high level of concentration present in the China index which represents a significant risk. In contrast, the Best of China Fund holds 33 stocks at a neutral weight of 3.0%. A position is allowed to drift up as far as 4.2% of the portfolio, when it is cut back to neutral and the proceeds are reinvested into laggards. We expect performance to come from a range of stocks rather than one or two.

Earnings upgrades to China have been significant, as has China's equity market performance. Trailing twelve-month earnings have increased by 13.7% while estimates for 2018 earnings continue to increase. We 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 improve 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.

Portfolio activity

Though on a month-to-month basis we do not read too much into the fund's performance relative to its benchmark, we still want to understand periods of underperformance and outperformance. In China the best performing sectors were financials (total return of +12.7%), real estate (+11.7%) and energy (+8.8%). The fund is underweight in these sectors by 9.1%, 4.8% and 2.9% respectively. The stocks the fund can invest in are defined by the universe of quality companies. The universe has relatively few Real Estate companies as there are few which meet both our quality criteria and are appropriately capitalised (debt/equity no greater than one). Our universe does not contain any Energy companies because they do not show the persistent cash returns that we require.

In January the biggest laggards in the fund were Tongda (metal casings), AAC Technologies (manufacturer of speakers and haptics in smartphones), Elite Material (printed circuit boards) and Luk Fook (jewellery retailer). Luk Fook was the only case where earnings came out which disappointed the market. Given that the operating conditions for the other laggards did not suddenly change over the past month, we are not concerned by the underperformance of their share prices.

Luk Fook has underperformed because same-store sales growth in its China jewellery stores slowed by more than investors had expected. This growth slowdown has been in their sales of gem sets, which are higher-margin. 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 on overall reduction in profitability. First, in our view, the margin decline expectations have been overdone and second, if inflation becomes an issue we expect gold prices to pick up which will benefit Luk Fook. We have already 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.

The fund's stronger stocks were the Chinese banks. Policymakers in China have made it clear that their deleveraging drive will continue in 2018 with a focus on cutting credit to overcapacity sectors and reining in the shadow banking system. The Chinese banks remain, on the surface, the obvious source of value in China and the sector was the strongest in January. The fund holds two Chinese banks which have generated the persistent cash returns on investment we are looking for. These banks have a solid deposit franchise and are net lenders into the interbank market, and so have benefited from higher interbank rates.

Summary and conclusion

The fund trades at a 13% discount to the market on estimated 2018 earnings. The market, as defined as the MSCI Golden Dragon Index, in turn trades at a 12% discount to developed markets which makes the region attractively valued, in our view. The operating environment in China is the strongest it has been in years. Positive producer price inflation has led to a recovery in industrial profit growth, feeding through to lower non-performing loan formation rates for the banks. We believe policymakers are likely to continue their deleveraging efforts as economic growth is solid and the economy can handle a deceleration in credit growth. This should reduce the risks of debts growing uncontrollably in the shadow banking system which used to be one of the key risks facing the Chinese economy.

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

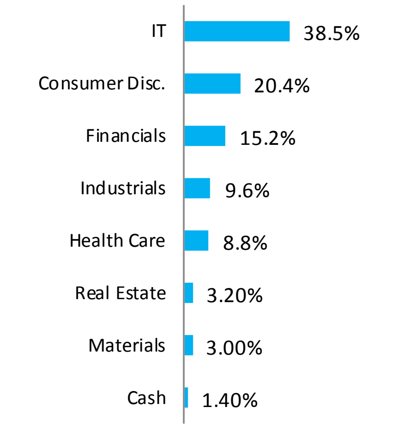
31/01/2018

Fund top 10 holdings

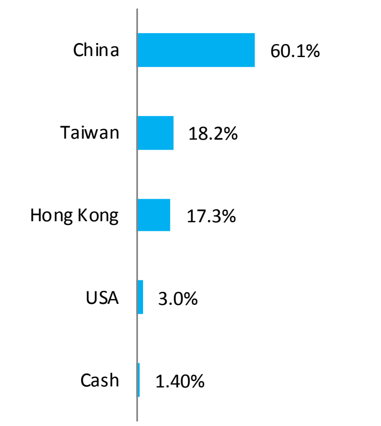
China Lesso Group	3.5%
China Construction Bank	3.4%
China Merchants Bank	3.3%
Taiwan Semiconductor	3.3%
Catcher Technology	3.2%
China Overseas Land	3.2%
Elite Material	3.1%
Yangzijiang Shipbuilding	3.1%
Lenovo	3.1%
Pacific Textiles	3.1%

% of Fund in top 10	32.2%
Total number of stocks in Fund	33

Sector analysis



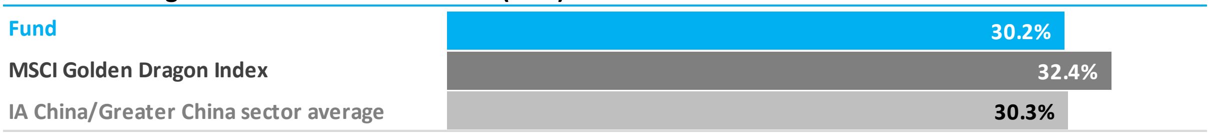
Geographic allocation



PERFORMANCE

31/01/2018

Annualised % gross total return from launch (GBP)



Discrete years % gross total return (GBP)	Jan '14	Jan '15	Jan '16	Jan '17	Jan '18
Fund	-	-	-	39.8	32.5
MSCI Golden Dragon Index	-5.5	28.4	-13.8	41.1	31.6
IA China/Greater China sector average	-3.3	20.3	-13.2	37.8	35.5

Cumulative % gross total return (GBP)	1 month	Year-to-date	1 year	3 years	5 years	From launch
Fund	0.4	0.4	32.5	-	-	75.4
MSCI Golden Dragon Index	4.5	4.5	31.6	60.1	94.4	81.9
IA China/Greater China sector average	4.6	4.6	35.5	62.1	88.6	75.8

RISK ANALYSIS

31/01/2018

Annualised, weekly, from launch on 15.12.15, in GBP	Index	Sector	Fund
Alpha	0.00	0.00	0.56
Beta	1.00	1.00	0.95
Information ratio	0.00	0.00	-0.17
Maximum drawdown	-12.88	-16.84	-14.20
R squared	1.00	1.00	0.89
Sharpe ratio	1.60	1.51	1.52
Tracking error	0.00	0.00	5.80
Volatility	17.74	17.03	17.76

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 (0.74% OCF). Fund launch date: 15.12.2015.

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 Guinness Best of China 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 Best of China 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. 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.