Guinness Emerging Markets Equity Income Fund

INVESTMENT COMMENTARY – March 2018

Launch date **23.12.16**

Team
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Aim

The Guinness Emerging Markets Equity Income Fund is designed to provide investors with exposure to high quality dividend-paying companies in Emerging Markets world-wide. The Fund aims to provide long-term capital appreciation and a source of income that has the potential to grow over time.

Performance

28/02/2018

Fund	Guinness Emerging Markets Equity Income (Z)
Index	MSCI Emerging Markets Index
Sector	IA Global Emerging Markets

	2015		2016		2017	
	USD	GBP	USD	GBP	USD	GBP
Fund	-	-	-	-	38.4	26.4
Index	-14.6	-9.7	11.6	33.1	37.8	25.8
Sector	-15.1	-10.2	9.7	30.8	36.2	24.4

	YTD		1 year		From launch	
	USD	GBP	USD	GBP	USD	GBP
Fund	3.9	2.0	33.1	20.2	39.8	26.7
Index	3.4	1.5	31.0	18.3	41.5	28.2
Sector	2.9	1.0	29.1	16.6	39.9	26.8

Annualised % total return from launch

	USD	GBP
Fund	37.1%	24.2%
Index	37.9%	24.9%
Sector	36.1%	23.3%

Risk analysis (annualised, weekly, from launch)

	Index		Sector		Fund	
	USD	GBP	USD	GBP	USD	GBP
Alpha	1.3	1.3	4.6	4.6	4.1	4.1
Beta	0.9	0.9	0.8	0.8	0.8	0.8
Info ratio	-0.5	-0.5	0.1	0.1	0.0	0.0
Max drwdn	-6.2	-6.2	-5.6	-5.6	-5.7	-5.7
Tracking err	3.9	3.9	6.4	6.4	6.4	6.4
Volatility	12.2	12.2	12.6	12.6	12.6	12.6
Sharpe ratio	1.5	1.5	1.7	1.7	1.6	1.6

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: 0.74% OCF, Financial Express, bid to bid, gross total return.

Fund & Market

- Volatility returned to global stock markets in February, prompting a correction in the S&P 500. Emerging Markets also experienced a correction (typically defined as falling more than 10%).

- The fund performed well relative to the benchmark in February, protecting to the downside in weak markets. The fund ended down 2.9% in USD terms, ahead of the MSCI Emerging Markets Index which fell 4.6%. (Performance data is for X share class with OCF 1.25%).

- In the month of February all regions in the benchmark produced negative returns. The best performing was EMEA (Europe, Middle East and Africa), down 1.8%. Latin America was down 3.6% and Asia was down 5.4%.

- Among the largest countries by index weight, Thailand was strongest (+2.1%), followed by Russia (+0.9%) and South Africa (unchanged). Mexico was weakest (–7.1%), followed by India (–6.6%) and China (–6.4%).

- Leading sectors were Healthcare (–1.8%), Energy (–2.0%) and Utilities (–2.5%). Weaker sectors were Real Estate (–10.2%), Industrials (–5.7%) and IT (–5.5%).

- For the year to date, the benchmark is still in positive territory following January's strong performance and is up 3.3%. Latin America is the best performing region, up 9.1%, followed by EMEA, up 4.3% and Asia, up 2.2%.

- Among the largest countries, the best performing have been Brazil (+14.6%), Russia (+13.6%) and Thailand (+10.7%). India has been weakest (–3.5%), followed by Korea (–3.1%) and Mexico (+0.2%).

Events in February

- The Communist Party's Central Committee recommended removing the two-term limit for the presidency from China's constitution. This will pave the way for Xi Jinping to stay in power beyond 2022, highlighting his power within the party.

- The Chinese insurance regulator took control over management of Anbang Insurance, and its founder is being prosecuted for fraud. Anbang's model of funding purchases of trophy assets abroad with short-term insurance products was beginning to become too big a problem for policymakers to ignore. The move is evidence that China is serious about controlling systematic risks within its economy.

- In banking, the PBoC issued a notice encouraging Chinese banks to issue capital-supportive bonds that could be converted into equity on triggering events. The intention is for Chinese banks to meet global standards for Total Loss Absorption Capacity (TLAC), a set of principles to ensure that banks with systemic importance can be resolved in an orderly manner without putting public funds at risk.

- In South Africa, President Jacob Zuma resigned after being ordered to do so by the African National Congress. Cyril Ramaphosa was sworn in as president within the week and shortly afterwards announced significant changes to the cabinet.

- The Winter Olympics in South Korea marked a major point of rapprochement between the host country and North Korea, with the two countries marching together in the opening ceremony under a 'unification flag.' Further diplomatic efforts have brought the possibility of talks between the US and North Korea closer.

- Shortly after the month end, trade tensions between the US and China stepped up a level. President Trump announced a plan to impose a 25% tariff on imported steel and a 10% tariff on aluminium. The proposal was justified on the grounds of national security.

Outlook

- At present, the fund trades at a modest 7% premium to the benchmark on a 2018 P/E ratio. We think that this is attractive given the quality of the companies we are investing in.

- The net yield of the holdings is 2.9%. On average, the companies in the portfolio pay out roughly half of their earnings and have grown their dividends at around 15% per annum over the past five years.

- Global growth has been robust and broad-based, helping to sustain earnings expectations for emerging market companies. But as the recent increase in volatility shows, investors are still sensitive to changes in expectations – particularly those governing inflation, and correspondingly the rate and pace of US interest rate rises. Recent events have also shown that the potential for escalation in trade conflict remains a risk.

- At times of uncertainty, we think a portfolio of quality companies that have achieved persistently high returns on capital over time, that are being undervalued by the market, and which pay attractive dividends, is an appropriate place to be positioned.

Markets

Volatility returned to global stock markets in February, prompting a correction in the S&P 500. Emerging Markets also experienced a correction (typically defined as falling more than 10%). The sell-off was sharp, but so was the rebound that followed, and after a very strong period of positive performance in January, markets remain ahead of where they began 2018.

The sell-off was attributed to stronger US jobs data, which prompted fears of a faster pickup in inflation than previously expected, with consequent faster rises in US interest rates. However, prior to this month, equity markets had experienced an extended run of positive performance and a long period of unusual calm. Whether the data was the cause, or whether the sell-off was simply overdue doesn't matter much. The return of (more normal) volatility in markets has reminded investors that stocks can go down as well as up.

The fund performed well relative to the benchmark in February, protecting to the downside in weak markets. The fund ended down 2.9% in USD terms, ahead of the MSCI Emerging Markets Index which fell 4.6% (performance data for X share class).

If we look at a narrow period covering the correction (26 Jan to 9 Feb), the fund outperformed by 2.6%. The fund fell 7.6% versus the benchmark fall of 10.2%.

We discuss the contributors to the portfolio's performance in the 'Portfolio' section below.

What happened in February?

Aside from the heightened volatility we saw in equity markets, a number of significant events occurred in emerging markets in February.

In China, the Communist Party's Central Committee recommended removing the two-term limit for the presidency from the country's constitution. Of Xi Jinping's three main titles this is the only one with a formal limit. His other two main titles, chairman of the party and head of the Central Military Commission, have no formal limits. Though the timing of the announcement was perhaps a surprise, the move to scrap the limit was virtually confirmed in October 2017 when the new politburo was unveiled with no apparent heir to Xi. The committee is also proposing to engrain "Xi Jinping Thought" into the party's constitution. Hitherto only Mao and Deng Xiaoping have had their ideas named after them. This shows how powerful Xi has become, in stark contrast to his immediate two predecessors, Hu Jintao and Jiang Zemin, who governed as "first among equals". His predecessors ruled in accordance with Deng's famous motto "hide your strength, bide your time" but Xi himself apparently aims to govern differently. He seems to want China to become much more prominent in foreign policy; to develop trade and infrastructure links through the Belt and Road Initiative; and to become a leader in technologies such as electric vehicles, aerospace and cybersecurity.

Also in China, we have seen continued steps by the authorities aimed at promoting financial stability. The Chinese insurance regulator took control over the management of Anbang Insurance and its founder, Wu Xiaohui, is being prosecuted for fraud. Wu is the husband of Deng Xiaoping's granddaughter and is politically well connected – the fact that this did not help him means China is serious about controlling the risks in its economy. The problem with Anbang was the way it structured its growth. It relied on short-term insurance products to fund purchases of longer-term assets, creating a duration mismatch. This is potentially dangerous as if most of these liabilities are redeemed at the same time it is impossible to sell the long-term assets to match them. Another problem was the long-term assets itself. Anbang bought trophy assets like hotels and real estate in the US, with little relevance to insurance. This is not what the Chinese government intends when it encourages domestic companies to expand abroad.

In banking, the PBoC issued a notice encouraging Chinese banks to issue capital-supportive bonds that could be converted into equity on triggering events. The intention is for Chinese banks to meet global standards for Total Loss Absorption Capacity (TLAC, a set of principles to ensure that banks with systemic importance can resolved in an orderly manner without putting public funds at risk. The efforts by China to comply with global regulatory developments represents another step closer to an open capital account and currency convertibility. There are, of course, many more steps in this direction that China will be required to take before a fully open capital account can be achieved.

The Winter Olympics in South Korea marked a major point of rapprochement between the host country and North Korea, with the two countries marching together in the opening ceremony under a ‘unification flag’. Following diplomatic efforts at the games, the US indicated that it would be open to talks with North Korea. In March, South Korean officials have met with Kim Jong Un in Pyongyang. Reports stated that North Korea was open to negotiating with the US over giving up its nuclear weapons. While this would clearly be a breakthrough in relations between North and South Korea and the US, we are sceptical that recent developments will bring an immediate thaw in relations. The first challenge is simply getting to the negotiating table, the second is actually negotiating an agreement, which will likely be a very difficult and demanding task for all parties. Clearly, this is a big step forward for diplomatic relations, but we will see if the overtures amount to anything tangible over the coming months.

In South Africa, President Jacob Zuma resigned after being ordered to do so by the African National Congress. Cyril Ramaphosa was sworn in as president within the week and shortly afterwards announced significant changes to the cabinet.

There is a gathering bull case for South African equities based upon leadership change, falling inflation, low household debt and the potential for interest rate cuts. Economic growth has been dismal since the global financial crisis as the country has been mired in economic and political mismanagement. Investors are looking to the new leadership to reinvigorate the economy and bring about fundamental changes. But the issues of inequality, poor education and skills, with sky-high unemployment amongst the young, are all deeply embedded. The ANC is deeply divided and Ramaphosa came in on a wafer-thin majority. Many remain loyal to Zuma. Some are calling 2018 South Africa’s year and there is plenty of optimism, but we remain cautious on what the new leadership can actually deliver.

Within the portfolio, we have exposure to three South African companies: Truworths (clothing and jewellery), Spar Group and the Johannesburg Stock Exchange. Falling inflation and lower interest rates will be beneficial to domestic retailers like Truworths and Spar and these stocks were among the better performers in February.

Shortly after the month end, trade tensions between the US and China stepped up a level. President Trump announced a plan to impose a 25% tariff on imported steel and a 10% tariff on aluminium. The proposal was justified on the grounds of national security, though this provision in the World Trade Organisation rules is rarely used. The introduction of tariffs on steel and aluminium follows those introduced in January on washing machines and solar panels (a move aimed predominantly at China, and to a lesser extent, South Korea), but trade tensions have been an undercurrent in US politics ever since the election campaign. US steelmakers have long complained that the Chinese government subsidises its steelmakers, allowing Chinese companies to become competitive at artificially low prices. However, out of 34.5 million tonnes of steel imported into the US in 2017, China accounted for only 0.74m, or 2.1%. In fact, steel producers in Brazil, Canada, Mexico and South Korea, which together account for 48% of steel imports to the US, are the ones that stand to lose the most. The details are still being worked out and at the time of writing it seems possible that Canada and Mexico will be offered exemptions. However, the threat of retaliatory action from the EU and from China means that the potential for further trade conflict remains a risk for emerging markets.

Portfolio

The best performing stocks in the portfolio as at month end were AAC Technologies (+19.1%), and two of our South African holdings: JSE (+9.6%) and SPAR Group (+7.6%).

AAC Technologies was the strongest stock over the period, rising 19.1%. AAC is known for its speakerboxes and haptics in smartphones. The company is now diversifying into new areas such as metal casings for smartphones and hybrid lenses using a proprietary production technique. The share price was weak towards the end of 2017 due to 1) weaker-than-expected sales of the iPhone X, for which AAC is a supplier, and 2) a smartphone inventory correction in China which affected most firms in the supply chain. We hold AAC because we think it has innovative product development capabilities which give the company an edge. For example, Samsung's new GS9 phone incorporates stereo sound and is 1.4x louder, and AAC is one of two suppliers. Chinese smartphone maker Vivo launched its new concept phone which boast a 98% screen-to-body ratio with hidden in-display speaker system called 'Screen SoundCasting'. The all-screen design will need either a compact speaker grille or an under-display speaker. Either solution will lead to a meaningful average selling price increase.

JSE, the Johannesburg Stock Exchange, announced earnings for 2017 in February that beat expectations. In a challenging domestic environment, 2017 saw a decline in value and volume of trading, and revenues and profits declined year over year. However, the fourth quarter saw an uptick in trading. Expenses were well controlled over the year, with a 17% reduction in planned headcount. Capital expenditure also declined, helped by spending related to regulatory changes coming to an end. The cash-generative nature of the business allowed management to increase the dividend by 8% in 2017 while maintaining sufficient cover. We are optimistic that the improvements in the political environment in South Africa will translate into a more supportive environment for financial markets.

The weakest stocks were British American Tobacco (–13.4%), our Mexican holding Coca-Cola Femsa (–11.6%), and Bajaj Auto (–11.6%).

British American Tobacco (BAT) also reported results for 2017 during the month. The cigarette company reported a 2.6% annual decline in volumes, though this outperformed the market, which declined by 3.5%. BAT experienced strong growth in its heated-tobacco product, glo, which is expected to be launched in more countries this year. Earnings in 2017 were boosted by currency effects, though these are expected to be a headwind in 2018. However, the changes to the US tax code will provide a lift to earnings this year.

Coca-Cola Femsa reported full year results for 2017, showing a 3.6% rise in comparable total revenues and a 6.2% rise in comparable operating income ('comparable' means adjusted for mergers, acquisitions and divestitures and exchange rate movements). Total volumes for all product categories were broadly flat in the two main regions: Mexico & Central America and South America (Brazil, Colombia, Argentina and Venezuela).

Elsewhere in the portfolio, Broadcom reduced its takeover offer for Qualcomm from $82 to $79 per share, after Qualcomm raised its own offer to buy NXP from $110 to $127.50 per share. While Broadcom had initially said that its bid for Qualcomm was contingent on Qualcomm not increasing its offer for NXP, Qualcomm instead bowed to pressure from NXP shareholders for a better deal.

The change in Broadcom's offer came ahead of a crucial shareholder meeting where the company was seeking to elect six directors to Qualcomm's board. The meeting was scheduled to take place on 6 March, but the day before the meeting, the Committee on Foreign Investment in the US (Cfius) ordered the company to delay it by 30 days while it investigated the deal. We own both Qualcomm and Broadcom and will continue to monitor developments closely.

Activity

We made one switch in the portfolio during the month, selling Hollysys Automation and buying China Minsheng Bank. Hollysys has been a decent performer for the fund, particularly over the second half of last year. The company released good results in February, showing new orders in its railway division and an increase in revenues from Industrial Automation. However, the yield contribution from the stock was insufficient, so we exited the position.

It its place we purchased China Minsheng Bank, which joins China Construction Bank as the second Chinese bank in the portfolio. Minsheng has lagged the broader market notably over the past year as deleveraging efforts by the authorities have hurt the bank's business model, which is dependent on borrowing in the interbank market.

Consequently, Minsheng has been restructuring its balance sheet on the funding side as well as addressing regulatory requirement for off/on balance sheet items. As we have mentioned previously, asset quality in the banking sector in general has improved, as the slowdown in non-performing loan formation has demonstrated.

At a 0.6x price-to-book ratio and a 5x P/E ratio, we felt that the stock was seriously undervalued. The stock also offers a 4% dividend yield.

We expect the stock to provide total return primarily in the form of multiple expansion, though it may also achieve modest earnings growth (alongside a stable dividend). Where earnings growth is better than expected, for example, due to improving margins and loan growth, this could act as a catalyst for the stock.

Outlook

At present, the fund trades at a modest 7% premium to the benchmark on a 2018 P/E ratio. We think that this is attractive given the quality of the companies we are investing in.

The net yield of the holdings (i.e. after withholding tax) is 2.9% (2018 forecast). On average, the companies in the portfolio pay out roughly half of their earnings and have grown their dividends at around 15% per annum over the past five years.

Global growth has been robust and broad-based, helping to sustain earnings expectations for emerging market companies. But as the recent increase in volatility shows, investors are still sensitive to changes in expectations – particularly those governing inflation, and correspondingly the rate and pace of US interest rate rises. Recent events have also shown that the potential for escalation in trade conflict remains a risk.

In times of uncertainty, we think a portfolio of quality companies that have achieved persistently high returns on capital over time, that are being undervalued by the market, and which pay an attractive dividend, is an appropriate place to be positioned.

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

Data sources

Fund performance: *Financial Express, gross total return*

Index and stock data: *Bloomberg*

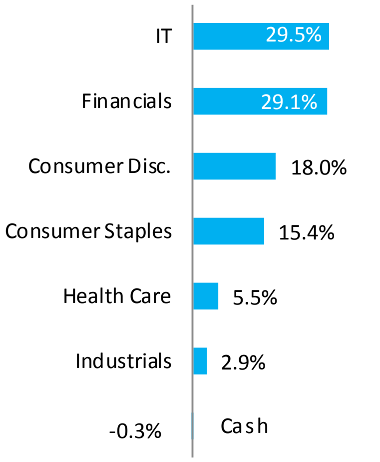
PORTFOLIO

28/02/2018

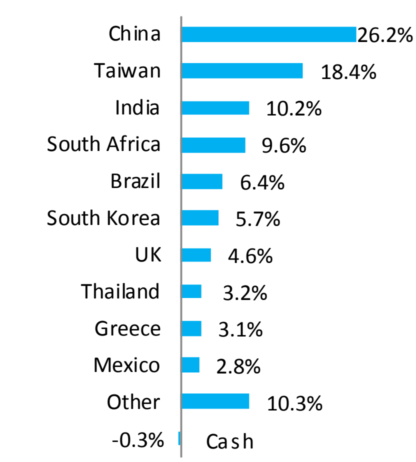
Fund top 10 holdings

Truworths International	3.6%
Ping An Insurance	3.4%
Bovespa	3.2%
Tisco Financial Foreign	3.2%
AAC Technologies	3.1%
Shenzhou International	3.1%
Porto Seguro	3.1%
Jumbo	3.1%
JSE Ltd	3.1%
Coca-Cola Femsa SAB	3.0%
% of Fund in top 10	31.9%
Total number of stocks	36

Sector analysis



Geographic allocation



PERFORMANCE

28/02/2018

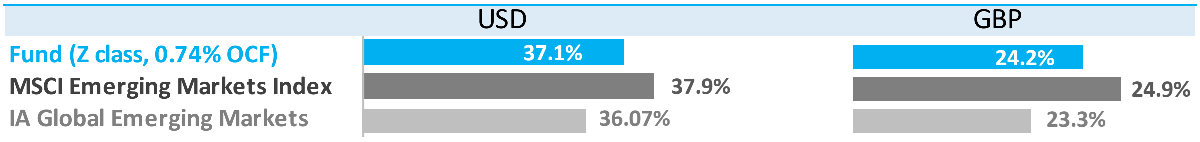
Discrete years % total return

	Feb '14		Feb '15		Feb '16		Feb '17		Feb '18	
	USD	GBP	USD	GBP	USD	GBP	USD	GBP	USD	GBP
Fund (Z class, 0.74% OCF)	-	-	-	-	-	-	-	-	33.1	20.2
MSCI Emerging Markets	-5.7	-14.6	5.4	14.3	-23.1	-14.8	29.9	45.5	31.0	18.3
IA Global Emerging Markets Sector	-5.4	-14.3	4.0	12.8	-22.8	-14.4	26.8	42.0	29.1	16.6

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 (Z class, 0.74% OCF)	-2.9	0.2	3.9	2.0	33.1	20.2	-	-	39.8	26.7
MSCI Emerging Markets	-4.6	-1.5	3.4	1.5	31.0	18.3	30.8	46.7	41.5	28.2
IA Global Emerging Markets Sector	-4.3	-1.3	2.9	1.0	29.1	16.6	26.5	41.8	39.9	26.8

Annualised % total return from launch



Risk analysis - Annualised, weekly, from launch on 23.12.2016

28/02/2018	Index		Sector		Fund	
	USD	GBP	USD	GBP	USD	GBP
Alpha	1.3	1.3	4.6	4.6	4.1	4.1
Beta	0.9	0.9	0.8	0.8	0.8	0.8
Information ratio	-0.5	-0.5	0.1	0.1	0.0	0.0
Maximum drawdown	-6.2	-6.2	-5.6	-5.6	-5.7	-5.7
R squared	0.9	0.9	0.8	0.8	0.8	0.8
Sharpe ratio	1.5	1.5	1.7	1.7	1.6	1.6
Tracking error	3.9	3.9	6.4	6.4	6.4	6.4
Volatility	12.2	12.2	12.6	12.6	12.6	12.6

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: 23.12.2016.

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 Emerging Markets 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 Emerging Markets 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. 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.