Guinness Best of China Fund

INVESTMENT COMMENTARY –April 2018

Launch date 15.12.15

Team
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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.

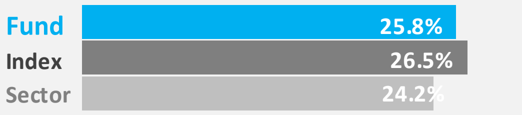
The Fund is managed for capital growth and invests in profitable companies generating persistently high return on capital over the business cycle

Performance 31.03.2018

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

	1 year	3 years	From launch
Fund	15.6	-	69.1
Index	16.3	43.7	71.3
Sector	19.1	43.4	64.3

Annualised % gross total return from launch (GBP)



Risk analysis (annualised, weekly, from launch)

	Index	Sector	Fund
Alpha	0.0	-0.6	1.5
Beta	1.0	0.9	0.9
Info ratio	0.0	-0.4	0.0
Max drwdn	-12.9	-16.8	-14.2
Tracking err	0	5	6
Volatility	18.7	18.1	18.2
Sharpe ratio	1.2	1.1	1.2

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 0.74% OCF.

Fund & Market

- In March the fund and benchmark both fell by 3.9%n in GBP terms.
- Taiwan was the strongest region with its MSCI index rising 1.0%. China and Hong Kong were weaker with their indices falling 5.0% and 4.3%.
- In Taiwan the Information Technology sector, which makes up more than half of the index, was up 1.6%. In China, Health Care and Real Estate were strong, rising 6.6% and 2.7%. On the other hand, the Consumer Discretionary and Industrials sectors were weakest, falling 9.2% and 7.8%.
- Over the first quarter China was relatively strong, falling 1.9% compared to the S&P 500 falling 4.3% and MSCI Europe falling 5.3%.
- Donald Trump halted Broadcom's bid for Qualcomm on the grounds of national security.
- China Lilang was by far the portfolio's strongest stock in March, rising over 50%, after releasing results showing a strong pickup in same-store sales.

Events in March

- Trade tensions continue to increase. The US announced tariffs on imported steel and aluminium, though exemptions have since been made for several countries. The US also announced plans to introduce tariffs on $50bn-worth of imports from China, targeting specific industries such as aerospace and industrial machinery. Initially China responded cautiously, increasing tariffs on only $3bn-worth of imported goods from the US. But as the scale and scope of tariffs directly targeted at China became clear, the country threatened to respond with its own tariffs on $50bn of US goods including soybeans and automobiles.

- Policymakers agreed to target GDP growth of around 6.5%. Noticeably the reference to achieving faster growth "if possible" was dropped.

- Renminbi-denominated debt will be added to the Bloomberg Barclays Global Aggregate Index in April 2019, being phased in over 20 months. The move represents another step in integrating Chinese markets with global markets, following MSCI's decision to include China A-shares in its Emerging Markets index.

Outlook

- Fears over trade will likely dominate the news over the coming months. While China is currently in the spotlight, we believe the US will also seek to address imbalances with its other trading partners.

- We believe it is not in the interests of the US, China or its other trading partners to start a trade war. The US is reacting to perceived unfair access to Chinese markets, including a requirement to surrender intellectual property. Reforms by China in this area could help to de-escalate tensions.

- Our portfolio of companies is attractively positioned, trading at a 10% discount to the market. The market, in turn, trades at a discount to developed equities.

Trade tensions

The escalation we have seen in trade tensions between the US and China in particular represents a return of President Trump's protectionist agenda, which was less prominent during 2017. Until recently, the biggest step taken by the administration had been to withdraw from the Trans-Pacific Partnership (TPP)[1]. That all changed with the announcement of tariffs on steel and aluminium in early March.

As we discussed last month, the tariffs were introduced on the grounds of national security, and seemed mainly directed at countries other than China. China only accounts for around 2.1% of US steel imports. Countries more in the firing line were Brazil, Canada, Mexico and South Korea, which account for around 48% of steel imports.

In the days after the announcement and as the dust settled, we got a clearer indication of the rationale behind the measures. Aside from appealing directly to Trump's supporters, the announcement seemed to be an act of brinkmanship, with countries one-by-one securing 'exemptions' from the tariffs. In the case of Canada and Mexico, for example, the *quid pro quo* is continuing to renegotiate the provisions of NAFTA.

The agreement the US reached with South Korea is particularly notable for the level of concessions the US obtained. In return for not applying the tariffs, American car manufacturers have been granted better access to the Korean market (South Korea has agreed to accept US safety regulations for 50,000 vehicles, up from 25,000 and has extended a tariff exemption on US pickup trucks). South Korea has also agreed to limit exports to 74% of 2017 levels. The US certainly seems to have caught the better end of this bargain!

[1] The TPP which was subsequently re-negotiated by the remaining participants—probably contrary to US expectations—and signed as a new agreement: the 'Comprehensive and Progressive Agreement for Trans-Pacific Partnership'. While it seems unlikely at this juncture, it remains an open question whether the US would re-join the trade agreement – President Trump indicated that this was a possibility if a "substantially better deal" for the United States could be agreed.

China's response was measured and targeted. In direct retaliation, China announced tariffs on $3bn of imports of US steel pipes, fresh fruit, wine and pork. The inclusion of agricultural products is clearly directed to send message to some of Trump's core supporters in rural areas.

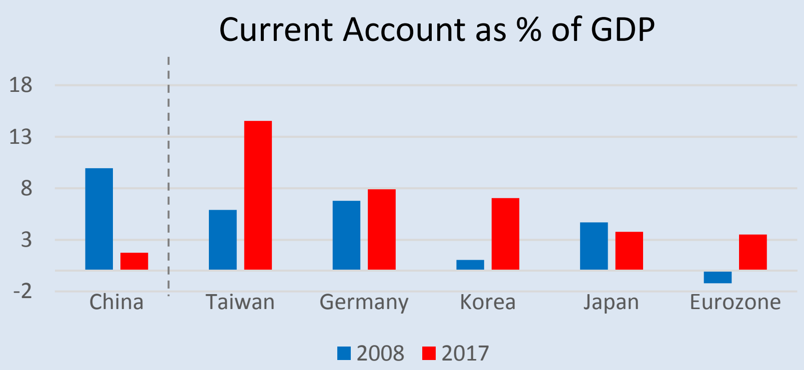
The second wave of tariffs by the US was explicitly directed at China and was announced following a review of intellectual property rights of US companies operating in or selling to China. The tariffs are explicitly designed to target Chinese companies operating in high-tech industries – the very same industries that the Chinese government has been promoting as part of its Made in China 2025 policy. Among the 1,333 products affected are construction machinery, components used in display screens, and industrial robots. China's response to this second wave of tariffs was swift, and it announced additional tariffs on 106 products from the US including soybeans, automobiles and chemical products.

The targeting of soybeans by the Chinese is notable because they are a seasonal product. At this time of year, they are mainly imported from South America.[2] But from the autumn, China imports from the US. If the tariffs are fully implemented as planned, the impact could start to be felt just before the US mid-term elections in November this year.

The market response to these developments has been volatility. Equities have swung as optimism that a trade war has been averted has shifted to pessimism as further levies are announced. Such a backdrop offers potentially a difficult climate in which to invest – and a useful reminder of why we don't attempt to make top-down macro allocation decisions. But despite the uncertainty, there are several reasons to be optimistic.

First, we note that while China's response has been robust, it has left the door open for negotiation. The involvement of Liu He in talks with Steven Mnuchin and Robert Lighthizer in Washington at the end of March reflects the importance which both sides place on the issue. Our view has always been that a trade war would not be in either China's or America's interest, and China's 'reluctant' response reflects this. But it may take further sabre-rattling by the US before tensions begin to de-escalate. China could help by agreeing to further market reforms. But already we have seen a negative reaction in the US to the trade proposals from both businesses and consumers. Further pressure could force a compromise.

Second, if we look at global trade more broadly, China's trade surplus as a proportion of GDP is much smaller than it was ten years ago. In 2008, China's current account surplus (a broader measure of trade) was 9.9% of GDP. At that time, one could make a convincing argument that China was unfairly exporting its excess savings to the rest of the world. But that argument is now harder to make. By 2017, the surplus had fallen to only 1.8% of GDP, as the following chart shows:



Source: World Bank, Bloomberg

[2] As the 'Dim Sums' blog points out, Brazil only emerged as a major soybean exporter as a result of Japan's efforts to diversify its soybean supply. Why did Japan need to do this? It faced an export embargo by the US in the 1970s.

In contrast with China, the Eurozone's current account increased from a deficit of 1.2% of GDP in 2008 to a surplus of 3.5% in 2017. Germany by itself has a current account surplus of 7.9%. Donald Trump has previously made his dissatisfaction with Germany's trade position clear, but for now the attention has been focused on China.

Looking across Asia, Taiwan and Korea have much larger surpluses, relative to GDP, than China. Since the financial crisis, China's economy has been less dependent on global trade. As Martin Wolf points out in a recent article,[3] after relying for many years on investment to sustain GDP growth, the economy is transitioning to one that is more based on consumption. As we describe below, the development of higher-complexity manufacturing is one factor that has supported wage growth, which in turn has allowed patterns of increased consumption to emerge.

Given the progress that China has made in reducing its surplus, we expect a fair amount of attention to shift to other countries with which the US has trade deficits.

Third, the targeting of China's high-tech industries reveals just how far China has come in developing advanced manufacturing capabilities, and how seriously the US takes the competitive threat. We have written before that China's manufacturing is evolving and moving up the value chain. China is determined to throw its weight behind certain national champions in high-tech industries as the Made in China 2025 plan shows.

It is difficult to see how the US will be able to suppress this trend. While technology transfer can be resisted, and direct foreign investment in the US can be blocked, we think China is fast approaching an inflection point where domestic innovation will be paramount. The development of 5G networking standards is one such example – see comments on Huawei below.

Markets and portfolio

Broadcom's bid for **Qualcomm** ended with an intervention by President Trump, who blocked the deal on the grounds of national security. The move followed a letter published by the Committee on Foreign Investment in the United States (Cfius) launching an investigation into the deal. Cfius highlighted several problems with the proposed takeover, including the possibility that Broadcom would cut R&D spending at Qualcomm. Qualcomm is at the forefront of developing mobile communication standards that will be used in the upcoming shift to 5G, as is China's Huawei. The fear is that if Qualcomm falls behind in 5G, Huawei would play the main role in the global standard-setting process. The US government has long been critical of Huawei, both because of the level of support it receives from the state, and the effect on national security of its links with the Chinese Communist Party.

China Lilang was the stand-out performer in March, rising by more than 30%. The company is a clothing retailer which targets the casual menswear segment. For more than a decade the business has generated a cash return on investment of around 15%, which is impressive for a clothing retailer. Lilang's main brand, LILANZ, was struggling in 2016 but following renovation of a number of stores, same-store sales accelerated in the second half of 2017. An important gauge of the company's prospects is its orders at trade fairs for the spring and summer seasons. We were happy to see orders increasing by 31% on a year-on-year basis.

The fund's holdings in hardware manufacturers in the Information Technology sector were weaker in March. There was a general sell-off in IT across Asia and the US. Additionally, Chinese shipments of smartphones fell 4% in the fourth quarter of 2017, and the first quarter of 2018 is likely to see weaker demand from Chinese manufacturers

[3] "The Chinese economy is rebalancing, at last", 3 April 2018

as inventories are reduced. This fed through to **AAC Technologies** (manufacturer of speakerboxes, haptics and wafer lenses). Though the stock moved lower over the month, AAC actually reported good results that met expectations. The company is already seeing progress in its wafer lens business which makes it a competitor in an industry dominated by Largan Precision. **Elite Material**, a manufacturer of halogen-free printed circuit boards used in smartphones and servers, reported margins which were weaker than expected. **Tongda Group** ,which manufactures metal casings for smartphones, reported full-year earnings which fell after a strong 2016. However, its results included one-off impairments of receivables from a customer, as well as an increase in R&D in its rapidly expanding waterproof components business. Excluding these items we believe earnings rose considerably and we have been adding to the position.

The portfolio does hold "old economy" type stocks which were out of focus in last year's strong market but have reminded us of their worth. **Anhui Conch Cement** is a large cement producer which has benefited from consolidation in the cement industry and the resulting higher prices. Its large market share gives the company some room to affect pricing power, an attractive characteristic in any industry. **China Lesso** manufactures building products such as plastic pipes. Its share price was weak for most of 2017 but reacted positively after results came out. The company saw an increase in both volume and average selling price. Management aim to expand market share but not at the expense of margins, which should preserve the return on capital the business achieves. Both companies are still trading at significant discounts to the market and may receive more attention as investors look for more opportunities in the region.

Summary and conclusion

The Best of China fund seeks good quality companies, defined in financial terms: those companies that have generated real returns on capital that have been above the cost of capital for at least eight years. We find that such returns are likely to persist, and we invest in companies whose stock prices in our opinion undervalue that persistence.

On a 2018 price/earnings multiple basis, the fund is trading at a 10% discount to the market as measured by the MSCI Golden Dragon Index. This index is in turn trading at a 14% discount to developed markets. We believe, therefore, that the fund offers an attractive combination of financial quality and value in price/earnings terms.

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

Data sources

Fund performance: *Financial Express, gross total return*

Index and stock data: *Bloomberg*

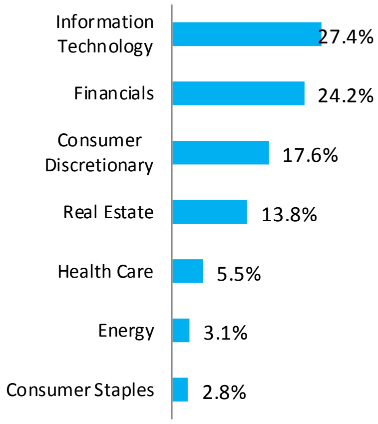
PORTFOLIO

31/03/2018

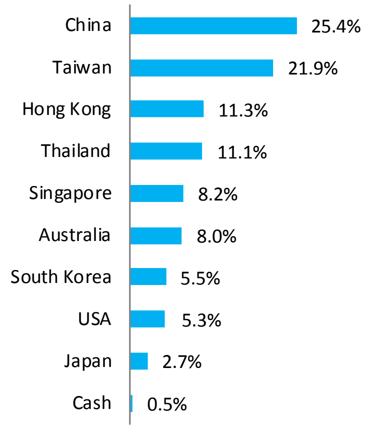
Fund top 10 holdings

China Lilang	3.7%
PTT Public Company	3.1%
Luk Fook Holdings	3.0%
Novatek Microelectronics	3.0%
Catcher Technology	3.0%
AAC Technologies	3.0%
Link REIT	2.9%
Ascendas Real Estate Trust	2.8%
KT&G Corporation	2.8%
Elite Material	2.8%
% of Fund in top 10	29.9%
Total number of stocks in Fund	36

Sector analysis



Geographic allocation



PERFORMANCE

31/03/2018

Annualised % gross total return from launch (GBP)

Fund	25.8%
MSCI Golden Dragon Index	26.5%
IA China/Greater China sector average	24.2%

Discrete years % gross total return (GBP)	Mar '14	Mar '15	Mar '16	Mar '17	Mar '18
Fund	-	-	-	42.7	15.6
MSCI Golden Dragon Index	-4.2	33.6	-10.6	38.2	16.3
IA China/Greater China sector average	-3.1	28.5	-11.5	36.0	19.1

Cumulative % gross total return (GBP)	1 month	Year-to-date	1 year	3 years	5 years	From launch
Fund	-3.9	-3.1	15.6	-	-	69.1
MSCI Golden Dragon Index	-3.9	-1.6	16.3	43.7	84.0	71.3
IA China/Greater China sector average	-4.4	-2.2	19.1	43.4	78.7	64.3

RISK ANALYSIS

31/03/2018

Annualised, weekly, from launch on 15.12.15, in GBP	Index	Sector	Fund
Alpha	0.00	-0.57	1.54
Beta	1.00	0.94	0.93
Information ratio	0.00	-0.42	-0.02
Maximum drawdown	-12.88	-16.84	-14.20
R squared	1.00	0.94	0.90
Sharpe ratio	1.15	1.05	1.17
Tracking error	0.00	4.57	5.85
Volatility	18.65	18.09	18.23

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.