Guinness Emerging Markets Equity Income Fund

INVESTMENT COMMENTARY – April 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 31/03/2018

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	4.0	0.3	30.3	16.1	45.3	27.0
Index	1.5	-2.2	25.4	11.8	43.6	25.5
Sector	0.4	-3.2	21.7	8.5	40.5	22.7

Annualised % total return from launch

	USD	GBP
Fund	34.3%	20.7%
Index	33.0%	19.6%
Sector	30.7%	17.5%

Risk analysis (annualised, weekly, from launch)

	Index		Sector		Fund	
	USD	GBP	USD	GBP	USD	GBP
Alpha	1.5	1.5	8.2	8.2	7.7	7.7
Beta	0.9	0.9	0.8	0.8	0.8	0.8
Info ratio	-0.4	-0.4	0.4	0.4	0.3	0.3
Max drwdn	-8.7	-8.7	-7.6	-7.6	-7.6	-7.6
Tracking err	4.2	4.2	6.2	6.2	6.2	6.2
Volatility	13.2	13.2	12.7	12.7	12.7	12.7
Sharpe ratio	1.9	1.9	2.4	2.4	2.3	2.3

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

First quarter review

- After a very strong January, Emerging Markets sold off sharply in February before recovering some of the losses. In March, Emerging Markets sold off once again as fears over trade tensions prompted a return of volatility to the markets. They ended the quarter posting a small gain.

- The fund performed very well relative to the benchmark in the first quarter, protecting to the downside in the two main periods of weakness. The fund rose 4.0% in USD terms, ahead of the MSCI Emerging Markets Index which rose 1.5% (Performance data for Z share class, 0.74% OCF).

- Latin America was the stand-out region in performance during the quarter, rising 8.1%. Asia followed, returning 0.8%. EMEA (Europe, Middle East and Africa) was weakest, falling 0.9% (all returns in USD unless stated).

- Among the largest countries by index weight, Brazil was strongest, gaining 12.5%. However, other top performers were from outside Latin America. Russia (+9.4%), Thailand (+9.3%) and Malaysia (9.1%) all posted strong returns.

- The weakest countries were India (–6.8%), South Africa (–4.0%) and Korea (–0.4%).

- By sector, Energy (+7.5%) and Heath Care (+7.1%) were the best performers, followed by Financials (+4.1%). Consumer Discretionary (–6.1%) was the weakest, followed by Telecom Services (–3.6%) and Real Estate (–2.1%).

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.

- One of the exemptions to US tariffs was agreed with South Korea. The two countries agreed to revise an existing trade pact that further opens up the Korean market to the US automobile industry. The revised deal also forces Korea to become more transparent with its foreign exchange interventions, which some have criticised for keeping the won at levels that are artificially cheap.

- In Brazil, the Supreme Court rejected former President Lula da Silva's bid to avoid jail while he appeals a corruption conviction.

- Following further diplomatic manoeuvring, it was announced that a joint summit between North and South Korea will be held on 27 April. The news follows Kim Jong Un's visit to Beijing, where he met Xi Jinping. Donald Trump is due to meet Kim Jong Un at the end of May.

- In China, 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

- At present, the fund trades at an 11% 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 investment universe trades at a premium to the benchmark.

- The net yield of the holdings is 3.0%. 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.

- The escalation in trade tensions has bought risk once again to the front of investors' minds, and the accompanying volatility has unsettled some participants. While there are signs of some softness in macroeconomic data, the overall picture is reasonably healthy. It is in financial markets where signs of stress are creeping in. However, Emerging Market valuations do not appear stretched.

- 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 an attractive dividend, is an appropriate place to be positioned.

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

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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 US 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!

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

[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.

[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.

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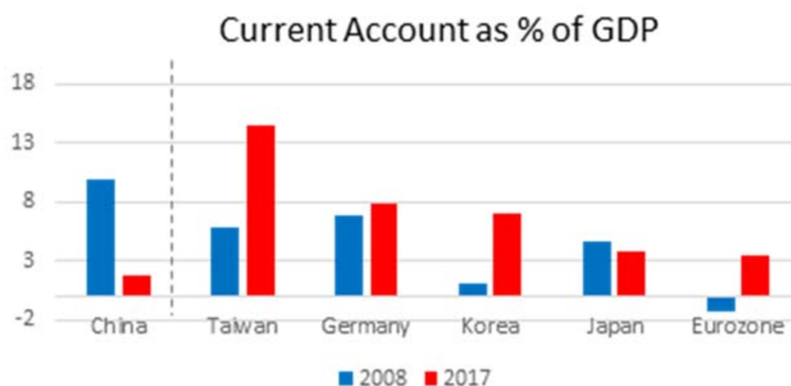
sabre-rattling by the US before tensions begin to de-escalate. China could help by agreeing to further market reforms. But already we have seen a negative reaction in the US to the trade proposals from both businesses and consumers. Further pressure could force a compromise.

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

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.

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

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Markets

Emerging Market performance in the first quarter can be split into two periods. First was the strong run-up experienced in January, as the strong momentum experienced at the end of last year accelerated for a brief period. Volatility returned for the latter two months, with the market experiencing a sharp sell-off in February sparked initially by fears of faster US interest rate rises. Markets bounced, but then saw a more protracted sell-off towards the end of March on the back of escalating trade tensions.

Brazil was the strongest country in the quarter, led by a strong performance in the Energy sector. Macroeconomic indicators reflect an economy in recovery. After falling 3.5% in each of 2015 and 2016, GDP grew in 2017 by 1%. Inflation has remained subdued, while the central bank has continued to cut interest rates (including a 25 basis points cut in March). In political developments, President Temer indicated he may seek re-election in October. The bid by former president Luiz Inácio Lula da Silva effectively ended after the Supreme Court rejected his request to avoid jail while he appeals a corruption conviction.

In addition to the de-escalation in tensions over North Korea (see above), we note further progress in corporate governance in South Korea. The country's Fair Trade Commission has ordered chaebols to simplify their ownership structure without negatively impacting minority shareholders. Hyundai is simplifying its crossholdings across its subsidiaries, by changing its holdings in Mobis (manufacturer of car parts) and Globis (logistics). This is an encouraging sign that the government's efforts to improve governance at the chaebols are moving in the right direction.

India was weak over the quarter for several reasons: the uncovering of a substantial fraud at the second-biggest state-run lender, Punjab National Bank; concern over data-sharing restrictions by the local stock exchanges; and the announcement of a long-term capital gains tax on equities. Macroeconomic data has been mixed, with the composite PMI falling from 52.5 in January to 49.7 in February.

Energy was the best performing sector of the quarter, as the price of WTI crude oil rose 7.5% over the period to reach $65/barrel.

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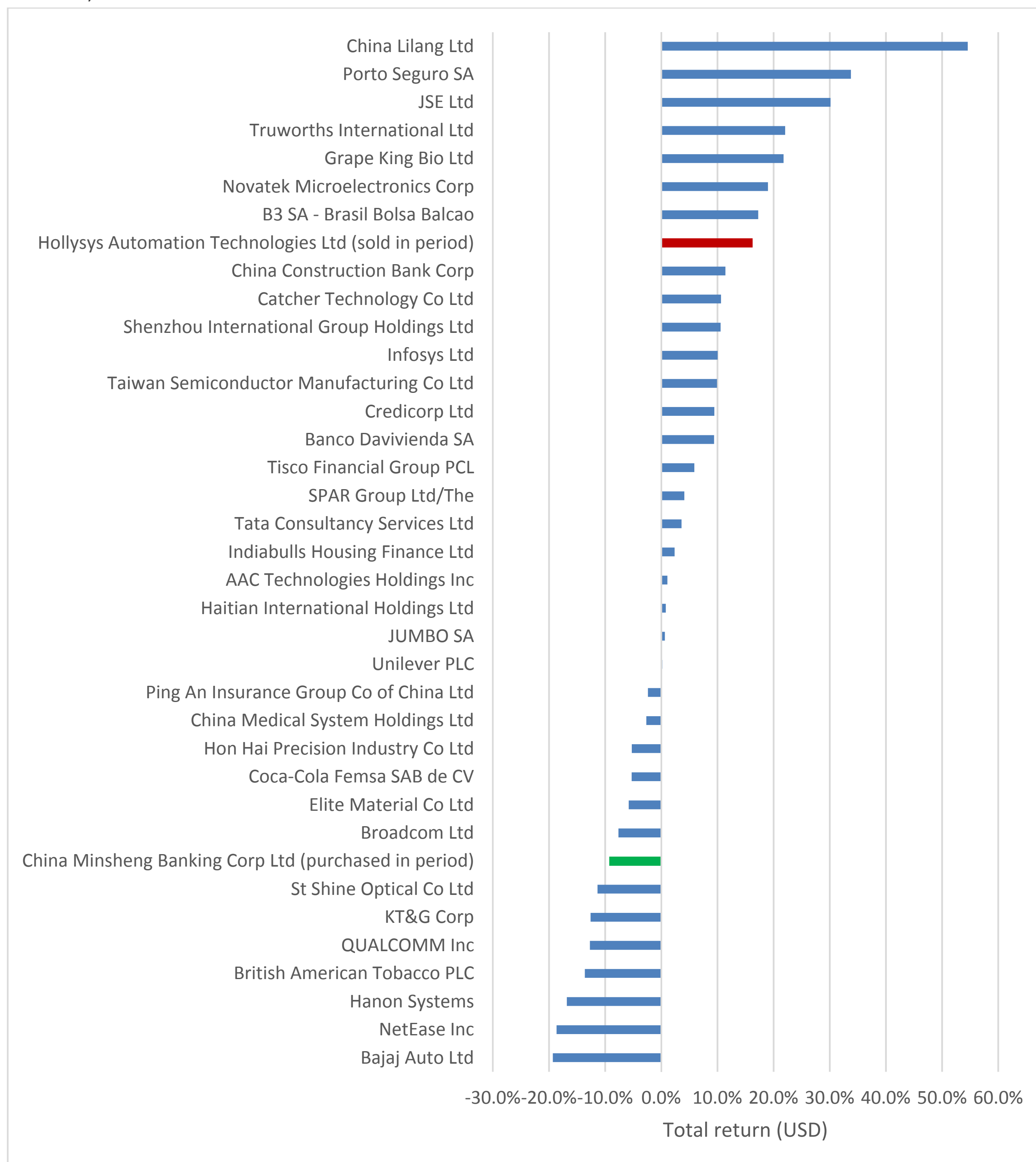
Portfolio

The following table shows the performance of the companies in the portfolio over the quarter (or period held if different):



China Lilang was the stand-out performer in the quarter, rising 54.6%. 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.

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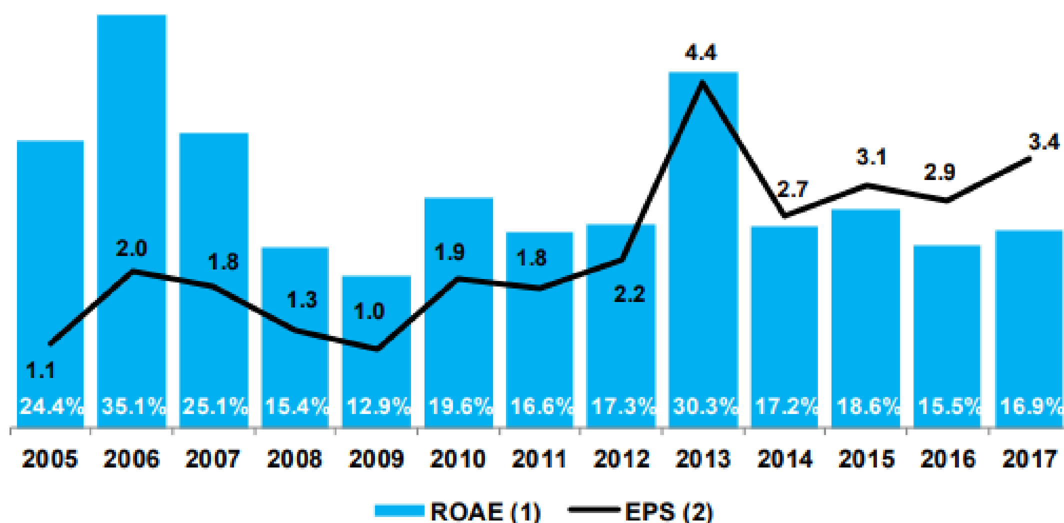
Porto Seguro was the second-strongest performing stock in the portfolio, benefiting from strength in the Brazilian market. The company is an insurer, primarily writing premiums in the insurance sectors, but also providing other property insurance, and health and life insurance. The company has a long track record of profitability with return on average equity over the past 13 years ranging from 12.9% at the lowest to 35.1% at its peak (excluding the effect of business combinations). Consistency is one of the main attributes we look for, and the company scores very well in this regard. Over the past eight years, return on average equity has generally been in the 16-18% range, as the following chart shows:



Source: company reports

The growth in earnings in 2017 was accompanied by a slight increase in the dividend payout ratio. The metric—which exhibits some variability—rose from 36% in 2016 to 40% in 2017.

Despite South Africa being one of the weaker markets over the quarter, two of our South African holdings made good gains. **JSE** announced earnings for the year that beat consensus expectations (see comments in last month's brief). **Truworths**, a South African clothing retailer, also announced good results for the first half of their financial year. Despite a difficult macroeconomic backdrop in South Africa and weak consumer sentiment, the company increased retail sales 1% with only a very slight decrease in gross margins. Good working capital management was also in evidence and inventory turns increased from 4.6 times in 2016 to 4.9 times. The health of the debtor book also improved with a reduction in the provision from 12.9% to 12.4% in 2017. Truworths benefited from another positive development towards the end of the quarter when it was announced that new consumer credit regulations ('Regulation 23A') will be less onerous than proposed. The company derives a significant proportion of revenues from credit sales, so the ruling eases potential headwinds.

Grape King, a manufacturer of probiotics and herbal supplements, performed well in March following the release of its annual results that beat consensus expectations. Revenues on a comparable basis increased 2.2%, and net income increased 4.3%. The results were sufficient to maintain return on capital at a high level – cashflow return on investment (our preferred return on capital metric) was 21.4% in 2017, down marginally from 22.2% in 2016, but still far exceeding the cost of capital.

Bajaj Auto was the weakest stock in the portfolio over the quarter, underperforming the local market especially during February and March. The company has struggled in the two-wheeler domestic market but is expecting a recovery with the upcoming introduction of two new models. In contrast, exports volume growth in FY2018 has been strong. We think that the company offers an attractive valuation.

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NetEase reported mixed results in February, including a quarterly decline in mobile games revenues. However, the segment is expected to return to growth over the coming months following the release of new games. NetEase experienced rapid growth in its e-commerce division during 2017, though the business generates relatively slim profit margins on a gross basis. Overall the company is still high profitable and has a substantial cash position.

Hanon Systems was weak in the first quarter, giving up some of the gains made in 2017. The company has seen some softness in revenues due to weaker sales by Hyundai and Kia in China. However, recent guidance from the company is for sales and EBITDA to grow 7% in 2018. Growth in electric vehicles will also help the company; electric vehicles account for 28% of the Hanon's new win backlog.

British American Tobacco declined after reporting results in February (see comments in previous month's brief). The stock also suffered in March with the announcement by the FDA that they will proceed with plans to lower nicotine levels in cigarettes.

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.

Outlook

At present, the fund trades at an 11% 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, which are selected from a quality universe which itself trades at a premium to the benchmark.

The net yield of the holdings (i.e. after withholding tax) is 3.0% (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.

The escalation in trade tensions has bought risk once again to the front of investors' minds, and the accompanying volatility has unsettled some participants. While there are signs of some softness in macroeconomic data, the overall picture is reasonably healthy. It is in financial markets where signs of stress are creeping in. One of the key factors Emerging Markets have in their favour – supporting the potential long-term returns from Emerging Market equities – is that unlike some Developed Markets, valuations do not appear stretched.

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 an attractive dividend, is an appropriate place to be positioned.

Edmund Harriss
Mark Hammonds (portfolio managers)
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Data sources

Fund performance: *Financial Express, gross total return*

Index and stock data: *Bloomberg*

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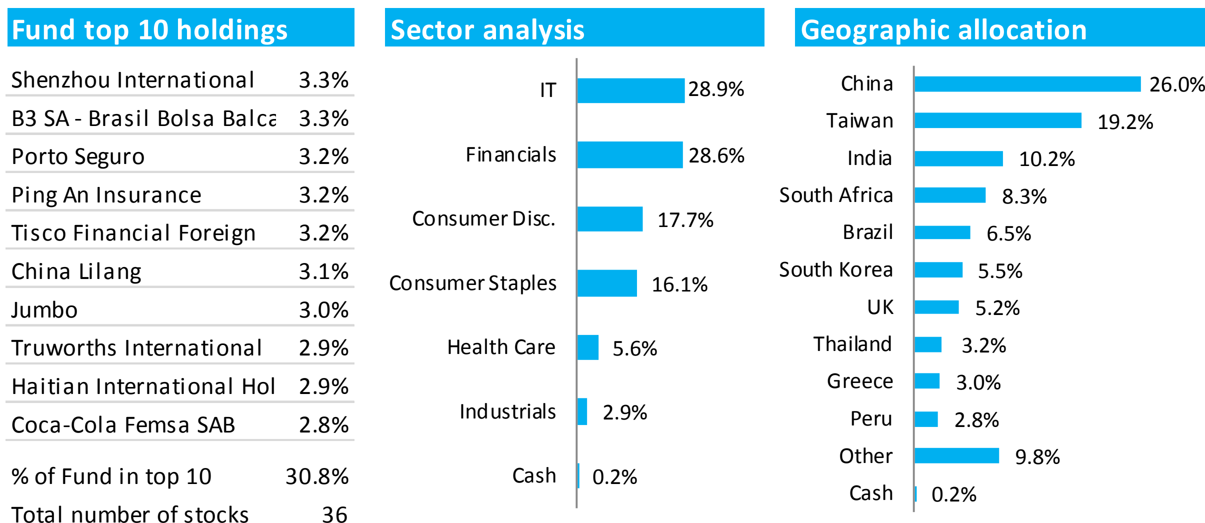
PORTFOLIO

31/03/2018



Fund top 10 holdings

Holding	%
Shenzhou International	3.3%
B3 SA - Brasil Bolsa Balca	3.3%
Porto Seguro	3.2%
Ping An Insurance	3.2%
Tisco Financial Foreign	3.2%
China Lilang	3.1%
Jumbo	3.0%
Truworths International	2.9%
Haitian International Hol	2.9%
Coca-Cola Femsa SAB	2.8%
% of Fund in top 10	30.8%
Total number of stocks	36

PERFORMANCE

31/03/2018

Discrete years % total return

	Mar '14		Mar '15		Mar '16		Mar '17		Mar '18	
	USD	GBP	USD	GBP	USD	GBP	USD	GBP	USD	GBP
Fund (Z class, 0.74% OCF)	-	-	-	-	-	-	-	-	30.3	16.1
MSCI Emerging Markets	-1.1	-9.9	0.8	13.2	-11.7	-8.8	17.7	35.2	25.4	11.8
IA Global Emerging Markets Sector	-2.6	-11.3	0.0	12.3	-12.1	-9.2	17.7	35.3	21.7	8.5

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)	0.1	-1.7	4.0	0.3	30.3	16.1	-	-	45.3	27.0
MSCI Emerging Markets	-1.8	-3.6	1.5	-2.2	25.4	11.8	30.3	37.8	43.6	25.5
IA Global Emerging Markets Sector	-2.5	-4.2	0.4	-3.2	21.7	8.5	25.9	33.3	40.5	22.7

Annualised % total return from launch

	USD	GBP
Fund (Z class, 0.74% OCF)	34.3%	20.7%
MSCI Emerging Markets Index	33.0%	19.6%
IA Global Emerging Markets	30.70%	17.5%

Risk analysis - Annualised, weekly, from launch on 23.12.2016

31/03/2018

	Index		Sector		Fund	
	USD	GBP	USD	GBP	USD	GBP
Alpha	1.5	1.5	8.2	8.2	7.7	7.7
Beta	0.9	0.9	0.8	0.8	0.8	0.8
Information ratio	-0.4	-0.4	0.4	0.4	0.3	0.3
Maximum drawdown	-8.7	-8.7	-7.6	-7.6	-7.6	-7.6
R squared	0.9	0.9	0.8	0.8	0.8	0.8
Sharpe ratio	1.9	1.9	2.4	2.4	2.3	2.3
Tracking error	4.2	4.2	6.2	6.2	6.2	6.2
Volatility	13.2	13.2	12.7	12.7	12.7	12.7

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Source: Financial Express, bid to bid, gross total return (0.74% OCF). Fund launch date: 23.12.2016.

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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

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Telephone calls will be recorded and monitored.