

Guinness Best of China Fund

INVESTMENT COMMENTARY – May 2018

Launch date	15.12.15		
Team	Edmund Harriss (manager) Mark Hammonds (analyst) Sharukh Malik (analyst)		
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	30.04.2018		
Fund	Best of China Fund		
Index	MSCI Golden Dragon		
Sector	IA China/Greater China		
	1 year	3 years	From launch
Fund	17.5	-	69.2
Index	19.0	35.1	73.7
Sector	22.2	31.8	66.9
Annualised % gross total return from launch (GBP)			
Fund	24.8%		
Index	26.2%		
Sector	24.1%		
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 drwn	-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 April the Best of China Fund (Class Z) rose by 0.1% (in GBP terms), while the benchmark rose by 1.4%.
- Hong Kong was the strongest region with its MSCI benchmark rising 5.3% (in GBP terms) versus 1.9% for China. Taiwan was weaker, falling 3.0% after weaker guidance from Taiwan Semiconductor Manufacturing led to weakness in the smartphone supply chain. The Information Technology sector fell 6.3%.
- In Hong Kong the gains were led by Financials and Real Estate, which rose 8.0% and 6.1%. HIBOR rose over the month as a result of the Hong Kong Monetary Authority buying HKD on the back of currency weakness.
- In China, Energy and Materials were strongest, rising 11.1% and 9.3%. Oil prices were strong due to the following: 1) global energy demand forecasts were raised; 2) Venezuelan supply was very weak; 3) Trump threatened to exit the Iran nuclear deal (which, in fact, he did in May).
- Three switches to the portfolio were made. The positions in PICC Property and Casualty, Lenovo and Hon Hai were sold. They were replaced with Baidu, Autohome and Noah.

Events in April

- The US released a list of Chinese products on which it plans to introduce tariffs. The list targets those industries that China plans to make competitive as part of its “Made in China 2025” initiative. These industries include aerospace, robotics and telecommunications. China responded with its own list of American goods that it would subject to tariffs.

Past performance should not be taken as an indicator of future performance. The value of investments and any income arising from them can fall as well as rise as a result of market and currency fluctuations.

- The US introduced a denial of export privilege on ZTE which bans the company from sourcing US components for seven years. ZTE is one of the largest telecommunications companies in the world and as a result, it said, “the major operating activities of the company have ceased”.
- The US Department of Justice is looking into Huawei and whether it violated sanctions over dealing with Iran. Huawei is the largest telecom company in the world and is also one of the largest smartphone companies.
- Representatives from the US travelled to Beijing to continue negotiations over trade. Reports indicate the US aims to cut the bilateral trade deficit by \$200bn (more than half of the 2017 deficit) and wants China to remove foreign ownership limits and drop any disputes at the World Trade Organisation (WTO). In turn China demanded the US recognise it as a market economy at the WTO.
- Kim Jong-un met with Xi Jinping in Beijing, before meeting with South Korean President Moon Jae-in at the border between the two countries. Donald Trump is due to meet Kim Jong-un in June.
- Regulators released new rules on the asset management industry which will bring it more in line with global standards. Fund management companies will not be allowed to provide implicit guarantees on performance and caps will be introduced to limit leverage and reduce systemic risk.

Markets and portfolio

While China and the US continue to negotiate over trade, China has offered some near-term concessions. China will remove the foreign ownership limit on electric vehicle manufacturers. Tesla has already registered and received approval for a new wholly-owned project in the Shanghai Free Trade Zone. China also plans to lower its tariff on imported cars which currently stands at 25%, compared to 10% in Europe and 2.5% in the US. In addition, foreign banks are now allowed to take majority control in securities companies and JPMorgan, UBS and Nomura immediately applied for a licence to take majority stakes.

The informal cap on deposit rates was lifted. China is unusual in that it has two sets of rates – one set in the interbank market through open market operations and another set published as benchmark deposit and lending rates. Banks technically can set their own rates on deposits and loans but were restricted by informal rules on how far they could deviate from benchmark rates. Banks effectively could not offer a deposit rate more than 50% above the benchmark rate, meaning deposit rates offered by banks were lower than the market rate. The removal of the cap has two significant implications. The first is this represents another step in interest rate liberalisation in China. The second is that this move is an effective interest rate hike. Note, however, that the required reserve ratio was also cut by 1% for certain banks which will release liquidity into the system, offsetting the contractionary impact of the removal of the cap.

In the portfolio results were positive for **Tongda** and **Luk Fook**. **Tongda** is a manufacturer of metal casings for smartphones. Its customers are the main Chinese brands Huawei, Oppo, Vivo and Xiaomi. Chinese smartphone shipments fell 14% in the fourth quarter of 2017 and 21% in the first quarter of 2018, so the share prices of the companies in the supply chain have been weak. But in the first quarter certain companies did better than others. Xiaomi grew shipments 37% while Huawei grew 2%. On the other hand, Oppo and Vivo both saw shipments fall 10%. Sales in the second quarter may pick up as several new models are launched. In addition to its casings business Tongda has a newer segment which manufactures waterproof components used in smartphones. It currently manufactures these components for the iPhone and growth in this business has offset the weakness in the Chinese market.

Past performance should not be taken as an indicator of future performance. The value of investments and any income arising from them can fall as well as rise as a result of market and currency fluctuations.

Luk Fook is a retailer of jewellery with stores in Hong Kong and mainland China. In January it reported weak same-store sales growth in China which surprised the market and its share price fell sharply. During this period of weakness we added to the position and in April the company reported surprisingly strong sales growth in Hong Kong. This was attributable to more mainland tourists, who tend to spend more, possibly explaining some of the slowdown in the mainland business.

Apart from Tongda, our companies in the smartphone supply chain were weak. **Taiwan Semiconductor Manufacturing** was guided for softer results in the second quarter on the back of lower smartphone demand. **AAC Technologies** (acoustics and haptics) and **Catcher Technology** (metal casings) saw their share prices lag as a result. Results may be weak in the second quarter but we believe that the market has now priced this in and so we have been adding to our smartphone supply chain companies. **Elite Material** is a manufacturer of laminates used for printed circuit boards and specialises in halogen-free laminates, which are environmentally friendly. Since the initiation of the position the performance of the business has been disappointing. We were aware that the company had lost a contract to supply for the iPhone, but the impact on margins was higher than expected. The company is facing more competition in servers than expected and is affected by the weakness in the Chinese smartphone market. We believe the stock has been excessively hit but the reasons for holding the stock still hold. Chinese smartphone companies are expected to upgrade to halogen-free laminates due to new regulations and are likely to upgrade to the older, cheaper technology which Elite dominates. Elite is also likely to benefit from the upcoming build-out of 5G in China. We have therefore been adding to the position in its current weakness.

Energy was particularly strong in April and this is a sector to which the fund has no exposure. The fund seeks to invest in companies which have generated a persistent cash return on investment over time. Energy companies do not meet this criterion because of the collapse in oil prices in 2014 and 2015. The fund also has no exposure to Hong Kong real estate. Though there are companies that meet our quality criteria in Real Estate, there are few which pass our gearing criteria, whereby we look for debt/equity no greater than one. Our only Real Estate holding, China Overseas Land and Investment, is geared towards mainland China rather than Hong Kong.

Portfolio switches

The positions in **PICC**, **Lenovo** and **Hon Hai** were sold.

PICC is an insurer which has a very high return on equity relative to our quality universe. The problem is that the property and casualty insurance industry is becoming more competitive and we question whether the business can maintain its returns over the next few years. The insurance regulator further added to our concerns when it increased the maximum discount insurers are allowed to offer in several regions, potentially leading to lower margins for the business.

Lenovo has been in the portfolio since launch and has disappointed. Despite a seemingly low valuation we decided a recovery is unlikely. Its PC business remains very cash generative, although it is facing more competition and recently lost its number one spot to HP. The underperforming areas have been the smartphone and data centre segments. It is very hard to generate persistent profits in smartphones and we had little confidence that Lenovo could turn losses in its smartphone segment into a profit, let alone a persistent profit. The data centre business may possibly be turning around but is still generating a loss.

Hon Hai is a contract manufacturer with most of its revenues coming from assembling the iPhone. The portfolio has a fair amount of exposure to smartphones and of the group, the prospects for Hon Hai look less appealing. It is relatively less efficient when looking at cash flow return on investment and we believe there are better alternatives in our quality universe.

Past performance should not be taken as an indicator of future performance. The value of investments and any income arising from them can fall as well as rise as a result of market and currency fluctuations.

These positions were replaced with **Baidu**, **Autohome** and **Noah**.



Baidu's search engine is dominant in China with a market share of over 75%. In the past Baidu has been guilty of throwing money at new businesses without realising a positive return. As a result, its cash return on investment has fallen from 30% in the 2007-2012 period to 12% in 2017. But we believe the business is a better allocator of capital today than it was in the past. For example, it recently sold its share in its food delivery business, "Ele.me". Food delivery is a rapidly growing industry in China but at the moment competition is fierce as incumbents try to win market share. We have seen instances where companies are discounting so much one can order dinner for only 1RMB, or £0.12. It is unsurprising that profits are non-existent in this sector, so we view the exit as a positive move. Baidu's investments in artificial intelligence could also prove to be lucrative. Its operating system, DuerOS (akin to Amazon's Alexa or Google's Assistant), is being developed so it can be used on any hardware from any manufacturer. Over the next decade, as consumer electronics become more connected, Baidu's OS could become an integral part of each household in the same way its search function became an integral part of everyday life. Baidu's autonomous vehicle network, Apollo, is in development and in our view is being backed by the government. Though it is still very early days, the Apollo network could eventually become a key part of China's digital infrastructure.



Autohome is an automotive classified advertising business which has a dominant market share in China. On average 10.1 million people used its app daily in the first quarter of 2018. Its revenue comes from adverts and from the fees it charges to dealers to list on the website. It benefits from the network effect as it is now the go-to destination to buy and sell cars online. The business also benefits from its controlling shareholder, Ping An Insurance, which has the ability to sell car insurance on every transaction. Since it listed, Autohome has persistently generated a cash return on investment above 20%, which is amongst the highest in our quality universe.



Noah is a wealth and asset manager targeting high net worth individuals. It distributes onshore and offshore products throughout China. As Chinese financial markets mature, investors are becoming more accustomed to the idea of diversified asset allocation, so in addition to equity offerings Noah also gives investors access to fixed income, private equity and fund-of-funds products denominated in RMB and USD. The recent improvement in rules for the asset management industry, which brings them closer to global standards, should serve Noah well as it already positions and operates itself as a sophisticated asset manager.

Past performance should not be taken as an indicator of future performance. The value of investments and any income arising from them can fall as well as rise as a result of market and currency fluctuations.

Summary and conclusion

On a 2018 price/earnings multiple basis, the fund is trading at a 4% 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 that investing in a well-diversified set of business which have generated a persistent return on capital should serve investors well for the long term.

Edmund Harriss (portfolio manager)

Mark Hammonds (analyst)

Sharukh Malik (analyst)

Data sources

Fund performance: *Financial Express, gross total return*

Index and stock data: *Bloomberg*

Guinness Best of China Fund

PORTFOLIO

30/04/2018

Fund top 10 holdings

Tongda Group Holdings	3.4%
Luk Fook Holdings	3.3%
Noah Holdings	3.2%
Taiwan Semiconductor	3.1%
St. Shine Optical Co	3.1%
Baidu	3.1%
Li & Fung	3.1%
Qualcomm	3.1%
China Lilang	3.1%
Netease.com	3.0%
% of Fund in top 10	31.5%
Total number of stocks	33

Sector analysis

Information Technology	38.3%
Consumer Discretionary	20.6%
Financials	14.9%
Health Care	9.1%
Industrials	8.6%
Real Estate	3.0%
Materials	2.9%
Cash	2.6%

Geographic allocation

China	61.6%
Hong Kong	17.8%
Taiwan	14.9%
USA	3.1%
Cash	2.6%

PERFORMANCE

30/04/2018

Annualised % gross total return from launch (GBP)

Fund	24.8%
MSCI Golden Dragon Index	26.2%
IA China/Greater China sector average	24.1%

Discrete years % gross total return (GBP)

	Apr '14	Apr '15	Apr '16	Apr '17	Apr '18
Fund	-	-	-	47.3	17.5
MSCI Golden Dragon Index	-5.3	46.0	-19.7	41.5	19.0
IA China/Greater China sector average	-5.7	47.4	-21.3	37.1	22.2

Cumulative % gross total return (GBP)

	1 month	Year-to-date	1 year	3 years	5 years	From launch
Fund	0.1	-3.1	17.5	-	-	69.2
MSCI Golden Dragon Index	1.4	-0.2	19.0	35.1	86.9	73.7
IA China/Greater China sector average	1.6	-0.7	22.2	31.8	83.2	66.9

RISK ANALYSIS

30/04/2018

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.

Past performance should not be taken as an indicator of future performance. The value of investments and any income arising from them can fall as well as rise as a result of market and currency fluctuations.

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'Île, 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.

GUINNESS

ASSET MANAGEMENT

Guinness Asset Management Ltd is authorised and regulated by the Financial Conduct Authority

Tel: +44 (0) 20 7222 5703

Email: info@guinnessfunds.com

Web: guinnessfunds.com