Guinness Best of China Fund

INVESTMENT COMMENTARY – June 2018

Launch date	**15.12.15**
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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.

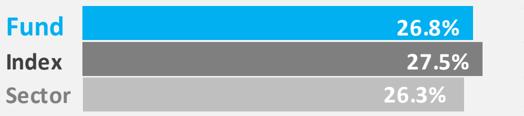
The Fund is managed for capital growth and invests in profitable companies generating persistently high return on capital over the business cycle

Performance 31.05.2018

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

	1 year	3 years	From launch
Fund	21.8	-	79.5
Index	19.3	43.5	81.9
Sector	24.2	40.6	77.6

Annualised % gross total return from launch (GBP)



Risk analysis (annualised, weekly, from launch)

	Index	Sector	Fund
Alpha	0.0	0.1	1.2
Beta	1.0	0.9	0.9
Info ratio	0.0	-0.3	-0.1
Max drwdn	-12.9	-16.8	-14.2
Tracking err	0	5	6
Volatility	18.2	17.7	17.9
Sharpe ratio	1.3	1.2	1.3

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 May the fund (Z class) rose by 6.0% in GBP terms while the benchmark rose by 4.8%.
- China was strongest with its MSCI index rising 5.5%. Health care was the standout sector, rising 23.3%, along with consumer staples which rose 16.2%. Real estate was down 4.6% as two developers dropped plans to issue bonds to finance expansion. News reports indicate regulators are aiming to tighten domestic credit and channel funds into the rental market.
- Hong Kong rose 4.2% with gains coming from the consumer discretionary, real estate and utilities sectors.
- Taiwan rose 3.4%. Information technology, which makes up more than half of the index, was up 3.7%. Better guidance from Apple saw gains for companies in the iPhone supply chain.

Events in May

- Negotiations between China and the US continue over trade. After talks in Washington the rhetoric seemed to calm down with China promising to increase its imports of American produce and energy products, though no figures were revealed. Treasury Security Steven Mnuchin said the trade war was “on hold”. However at the end of the month the US was intending to impose tariffs on $50bn worth of Chinese goods.
- ZTE, the Chinese telecommunications company which is one of the largest of its kind in the world, was effectively shut down due to a ban on sourcing US components. However the ban was lifted in early June with ZTE forced to change its management team and pay a $1bn dollar fine.
- China announced it would be cutting tariffs on imported vehicles from as high as 25% to 15%. Tariffs on a range of consumer goods are also due to be cut. For

- example tariffs on clothes and shoes are to be cut from 15.9% to 7.1% while tariffs on washing machines and refrigerators will fall from 20.5% to 8%.

- MSCI began including Chinese A shares in some of its indices, including the Emerging Markets index. As of the end of May Chinese A shares were capped at 2.5% of their free float adjusted market capitalisation, which will rise to 5.0% later in the year.

Outlook

- Earnings growth in China continue to remain attractive. Over the next year earnings of MSCI China are expected to grow 31.0% compared to 16.1% for MSCI AC Asia Pacific ex Japan and 18.8% for the MSCI World index.

- China is trading at its historic average on a forward looking price/earnings ratio. On a price/earnings basis the fund is trading at a 3% discount to the market. This is while the fund is projected to grow earnings at a faster rate than the market. This region is in turn trading at a 14% discount to developed markets.

- Our approach of investing in companies with a track record of consistent profitability (companies that have generated a return on capital above the cost of capital), combined with attractive valuations is, we believe, an attractive one.

Markets and portfolio

During May there several developments in China's capital markets. MSCI began to include 222 Chinese A shares in its Emerging Market index. Initially the A shares will be capped at 2.5% of their free float adjusted market capitalisation, rising to 5.0% later in the year. The initial impact of this change was marginal as China's share of the index will rose by less than 1%. The inflows as a result of the rebalancing were less than a day's worth of trading. The real impact will be in the long term when the inclusion factor will rise above 5%. For context it took South Korea six years to reach a full 100% inclusion factor, while it took Taiwan ten years to do the same. At a full inclusion factor China's share of the EM index could rise to 38%. The A shares included only account for half of China's total market capitalisation and so if the other half of the domestic market were opened up to foreign access, China's weight in the EM index could be close to 50%.

We believe there are many quality companies to be found in the mainland. There are 99 companies that have achieved our quality criteria in terms of return on capital and low debt. To reiterate we look for companies which have persistently generated a real, cash return on capital above the cost of capital. Interestingly of the 222 companies that MSCI included, 34 meet our quality criteria. This means there are 65 companies that MSCI have not included in their benchmarks. The vast majority of the quality stocks we can look at are accessible through the Stock Connect scheme. Encouragingly in our universe of quality stocks there is a good spread between sectors; there are only 15 companies in the financial sector while there are 18 in information technology, 13 in consumer discretionary, 9 in consumer staples and 22 in health care.

Chinese regulators also released rules over Chinese Depository Receipts (CDRs) which lets Chinese companies incorporated offshore issue depository receipts in the mainland. Eligible companies must be operating in an 'innovative industry' which includes cloud computing, artificial intelligence, high-end equipment manufacturing and pharmaceuticals. This would allow the likes of Tencent (listed in Hong Kong) and Alibaba and Baidu (listed in the US as American Depository Receipts) to issue receipts in the mainland.

In Hong Kong listing rules have recently been changed to allow for dual class share structures. To understand why the rule was changed we must go back to 2014 when Alibaba decided to list in New York over Hong Kong. This was because New York allowed dual share classes while Hong Kong did not, and Alibaba ended up raising $25bn in its IPO, the largest ever floatation in history. Dual class structures have become more popular over the past few years, especially with technology companies, where founders can retain voting control even if they hold relatively little common stock. The Hong Kong Stock Exchange's decision to admit dual class structures is motivated by the expected IPOs of several Chinese companies. Xiaomi, a manufacturer of smartphones and other consumer goods, is looking to raise as much as $100bn this year in Hong Kong and may even issue CDRs too. Several Chinese 'unicorns', such as Ant Financial, Didi Chuxing and Meituan Dianping, could list in the future and there is a reasonable chance they will seek the dual class structure. From the exchange's point of view, these are opportunities that are too big to be missed.

Economic data remains solid. Industrial profits grew 21.9% in April after a weak March. The official manufacturing Purchasing Managers Index (PMI), which is more biased towards state owned enterprises, came in at 51.9 which was better than expected. The Caixin manufacturing PMI, which is more geared towards private companies, was flat at 51.1 which still indicates expanding activity. In Hong Kong the recovery in retail sales continues with retail sales growth of 11.1% in April, with solid sales of jewellery and clothing. This is partly explained by better tourism flows from mainland China. In Taiwan first quarter GDP growth came in at 3.0% which was slightly weaker than the 3.4% growth seen in the fourth quarter of 2017. The reason for the slight deceleration in growth was because of softer export growth especially in technology, though the data does suggest a small pick up in growth in April.

In the portfolio, **Sino Biopharmaceutical (SBP)** was notably strong along with the healthcare sector. The company is a major pharmaceutical company specialising in generics, with a strong hepatitis and cardiovascular franchise. When we initially bought the stock the market was worried that new drugs would reduce the market share of SBP's older generation Runzhong product, which is used to treat hepatitis B. Since then Runzhong has fared better than expected and SBP has launched a generic version of the new competitor drug called Qingzhong. SBP has also received approval for a generic drug which treats non-small cell lung cancer. This product has the potential, along with several others, to become major drivers of growth with annual sales of over RMB1bn.

The new positions in **Autohome** and **Noah Holdings** have done well in the month we have owned them. **Yangzijiang Shipbuilding** was weak in May following weaker guidance post first quarter results. Management expect shipbuilding margins to decline though they still are confident on signing new contracts this year. Higher competition from state-owned Chinese and private Korean firms was also mentioned. Yangzijiang now trades at 8x PE on a forward basis and the stock remains attractive in our view. Bulk carriers which have been in service for decades will need to be replaced and when they do, Yangzijiang is likely to be bidding for the contract to do so.

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*

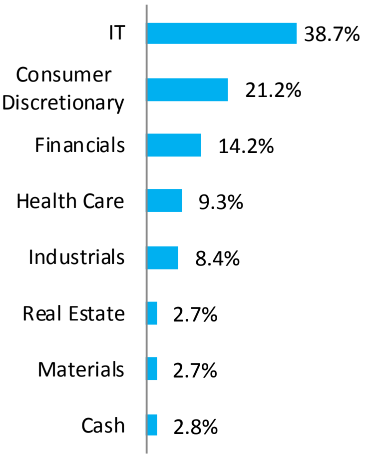
PORTFOLIO

31/05/2018

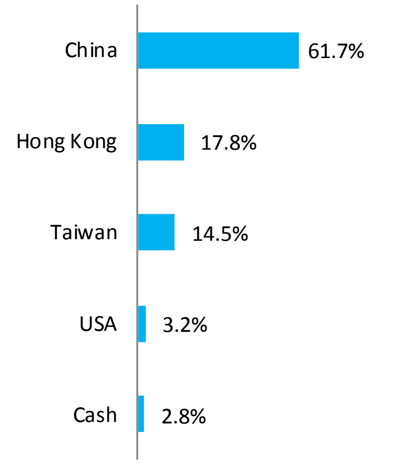
Fund top 10 holdings

Noah Holdings	3.4%
China Lilang	3.4%
Tongda Group Holdings	3.4%
Luk Fook Holdings	3.3%
Sino Biopharmaceutical	3.3%
Qualcomm	3.2%
New Oriental Education 8	3.2%
China Medical System	3.2%
Autohome	3.1%
Haitian International Hol	3.1%
% of Fund in top 10	32.6%
Total number of stocks	33

Sector analysis



Geographic allocation



PERFORMANCE

31/05/2018

Annualised % gross total return from launch (GBP)

Fund	26.8%
MSCI Golden Dragon Index	27.5%
IA China/Greater China sector average	26.3%

Discrete years % gross total return (GBP)	May '14	May '15	May '16	May '17	May '18
Fund	-	-	-	50.4	21.8
MSCI Golden Dragon Index	-2.1	36.9	-18.2	47.0	19.3
IA China/Greater China sector average	-4.8	41.1	-21.5	44.2	24.2

Cumulative % gross total return (GBP)	1 month	Year-to-date	1 year	3 years	5 years	From launch
Fund	6.0	2.8	21.8	-	-	79.5
MSCI Golden Dragon Index	4.7	4.5	19.3	43.5	92.3	81.9
IA China/Greater China sector average	6.4	5.7	24.2	40.6	88.8	77.6

RISK ANALYSIS

31/05/2018

Annualised, weekly, from launch on 15.12.15, in GBP	Index	Sector	Fund
Alpha	0.00	0.08	1.24
Beta	1.00	0.94	0.93
Information ratio	0.00	-0.29	-0.08
Maximum drawdown	-12.88	-16.84	-14.20
R squared	1.00	0.93	0.90
Sharpe ratio	1.26	1.20	1.25
Tracking error	0.00	4.60	5.80
Volatility	18.23	17.71	17.89

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.