Guinness Emerging Markets Equity Income Fund

INVESTMENT COMMENTARY – July 2018

Launch date	**23.12.16**
Team	**Edmund Harriss** (manager) **Mark Hammonds** (manager) **Sharukh Malik** (analyst)

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

30/06/2018

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	-6.0	-3.6	10.1	8.3	31.5	22.0
Index	-6.5	-4.2	8.6	6.8	32.3	22.8
Sector	-8.2	-6.0	5.4	3.7	28.4	19.2

Annualised % total return from launch

	USD	GBP
Fund	19.7%	14.0%
Index	20.3%	14.5%
Sector	17.9%	12.3%

Risk analysis (annualised, weekly, from launch)

	Index		**Sector**		**Fund**	
	USD	GBP	USD	GBP	USD	GBP
Alpha	0.0	0.0	0.0	0.0	3.6	3.6
Beta	1.0	1.0	0.9	0.9	0.8	0.8
Info ratio	0.0	0.0	-0.5	-0.5	0.1	0.1
Max drwdn	-15.0	-15.0	-14.9	-14.9	-13.4	-13.4
Tracking err	0.0	0.0	4.3	4.3	6.2	6.2
Volatility	14.1	14.1	13.0	13.0	13.1	13.1
Sharpe ratio	1.1	1.1	1.0	1.0	1.2	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: 0.74% OCF, Financial Express, bid to bid, gross total return.

Fund & market

- Emerging Markets (EM) equities were down 4.2% in GBP terms in the first half of 2018 (measured by MSCI Emerging Markets Index) in contrast to the UK and US which were up. EM is looking attractive in our opinion and could be set for a rally.

- The Fund was not immune to the declines, but still outperformed by 0.6% over the half year with our focus on quality businesses providing the support.

- Concerns from a top-down viewpoint included country-specific issues (Brazil, Argentina, Turkey), trade tensions and late-cycle concerns related to growth and US interest rates.

- EM equities are trading at a 31% discount to US equities (as measured by the respective MSCI indices) compared to their 10-year average of 26%.

- We believe that an easing of trade or interest rate worries would prompt investors, who have turned net sellers in the last three months, to rebuild positions.

- In spite of the comments above, the Fund does not take positions based on top-down themes. We look for businesses that are profitable and have been for many years, and whose dividend streams are the result of cash generation above the level needed for re-investment.

- The Fund is trading on a forward price/earnings multiple of 13.7x 2018 estimated earnings and 12.3x 2019 earnings. This is a 12% premium to the market. We believe, however, there is greater confidence in the earnings outlook for the Fund given significantly higher returns on capital (14.5% CFROI in 2017) which have been sustained over time, supported by average dividend growth of 15% per annum over the last five years.

Events in 2018

- Trade tensions dominated the news headlines for much of the first half of the year, with the announcement of steel and aluminium tariffs by the US. A temporary exemption to Canada and Mexico was granted on the grounds of renegotiating NAFTA provisions.

- Attention then turned squarely towards China. The strident views expressed by President Trump were initially met with a more conciliatory tone by China and dialogue ensued (leading the US Treasury Secretary at one point to declare that the trade war was "on hold"). But towards the end of the period, relations deteriorated as both parties' views seemed to remain some distance apart. The result was the announcement by the US of a 25% tariff to be applied to $34bn of Chinese imports, with another $16bn likely to follow. China retaliated by imposing tariffs of an equivalent size.

- Currency pressures were evident in Argentina, Brazil, Indonesia, South Africa and Turkey. While exacerbated by dollar strength and rising interest rates, they were reflections of country-specific issues and not a broad-based EM problem.

- A deal on Greek debt relief allows the country to defer repayment of €100bn for 10 years (equivalent to 40% of the debt owed to the Eurozone).

- Elections took place (or are approaching) in Brazil, Colombia, Mexico, Malaysia, Peru, Turkey. Many EM strategists attempt to position for outcomes – an approach we feel is fraught with uncertainty. We prefer to begin with good companies and then assess possible outcomes in terms of the risks to the specific business.

Portfolio positioning

Macro thinking dominates the approach of many Emerging Markets managers and analysts and this is a key differentiator for us. We don't ignore macro issues; we simply focus primarily on identifying good businesses (those which are profitable today and have been for many years, by a return on capital metric with a threshold of 8% for eight consecutive years) and then seek to assess the risks to each one posed by the industry, country or global environment.

Economic growth in the world is forecast to be above 3% in 2018, with developed economies growing 2.4% and emerging economies growing almost 5%. If we look a little deeper, EM growth is dominated by Asia, which is forecast to grow around 6%, while EM Europe is forecast to grow 3% and Latin America by less than 2%. Deeper still, within Asia we see China and India growing by more than 6.5%, but we can also find countries like Indonesia, Malaysia, Philippines and Thailand expect to grow almost 5% this year. In Latin America, the weakest region, we can still see growth of 3-4% in Chile, Colombia, and Peru. It is Brazil, Argentina and Venezuela that bring down the averages. EM European growth is not bad either, at closer to 4%, but is dragged back by Russia, which is forecast to grow 1.7%.

Our observation from this 'helicopter view' is that the picture across EM is very uneven. While EM is considered as a bloc for asset allocation purposes, homogeneity is lacking at ground level. Asia has grown to be 75% of the MSCI Emerging Markets Index because of its developed industrial manufacturing sector and growing domestic economies fuelled by rising wages and household incomes. But economic drivers vary widely: for example, Peru's economic well-being is closely related to the price of copper; that of Brazil relates to iron ore and soy; while Russia is heavily influenced by the price of oil and gas. The strength of political, financial and legal institutions can also vary widely.

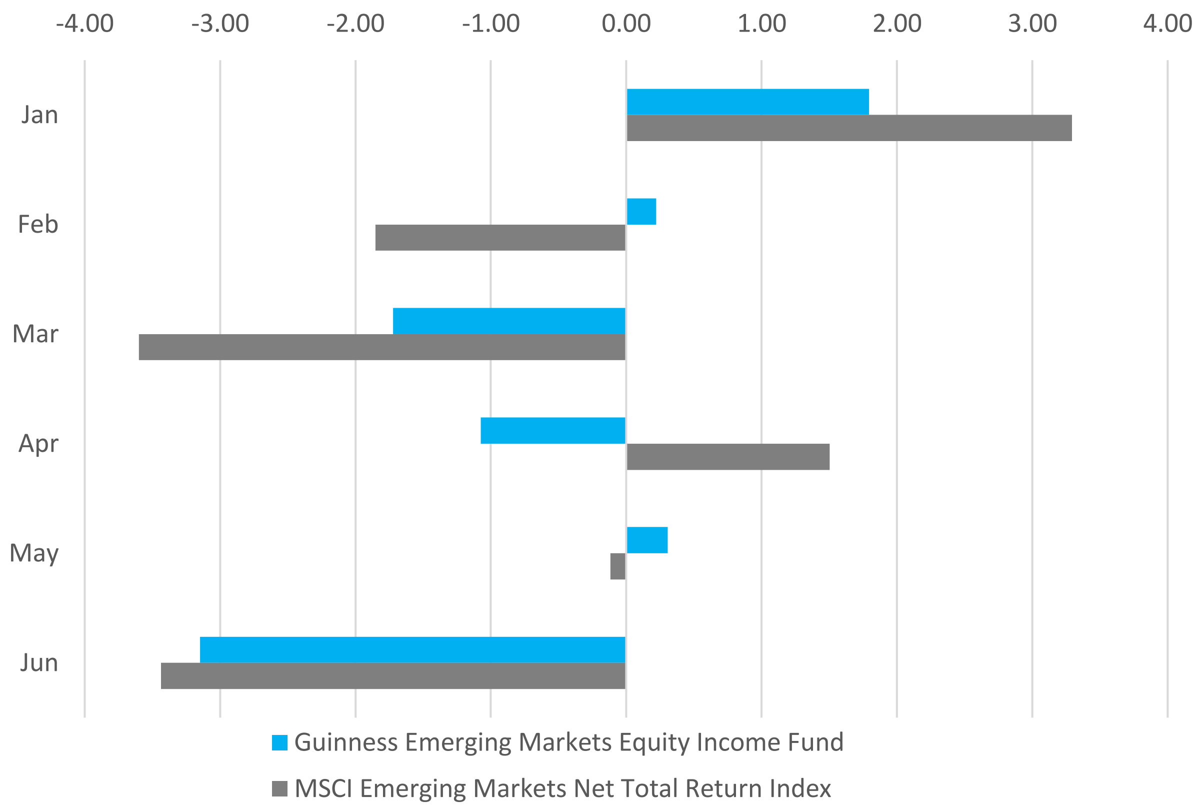
Top-down managers who build a shape of the world often employ a matrix-based scoring system to decide how best to play the various themes. The big risk is that things don't play out as expected and if the companies invested in depend on matters that are essentially out of their hands then there can be significant downside. Our approach is wholly different. We are looking for companies that have demonstrated their superior competitive position by generating a return on capital of 8% (higher than the long run average cost of capital) for eight consecutive years. This is high enough for the company to be considered wealth-creating and long enough to make it unlikely to have been a fluke. We think that focusing on the shares we are buying and assessing the environment specifically in the context of the individual investments provides greater focus and better downside protection.

Performance review

The Fund outperformed in the first six months of the year, returning -3.6% versus the benchmark -4.2% (Z share class, total return in GBP).

To analyse the Fund's performance in detail, we first look at the monthly returns versus the benchmark, as the following chart shows, to assess whether its behaviour is in line with expectations.

2018 YTD monthly returns (%) in GBP



Source: Bloomberg, Guinness Asset Management

Our two main periods of underperformance were in January, when we underperformed in a strong market environment, and in April, when the Fund fell in mildly positive markets. Both merit further examination.

January saw the acceleration of the run-up in markets following positive performance for most of 2017. While we would expect to underperform in such an environment, we would have liked the Fund to have kept up a little better. Brazil and Russia performed especially well, driven by higher commodity prices and a resurgent energy sector, as did China, which was led by the internet names. We tend not to have much in commodity stocks due to their inability to sustain stable returns above the cost of capital and Chinese internet names are precluded because they don't pay sufficient dividends.

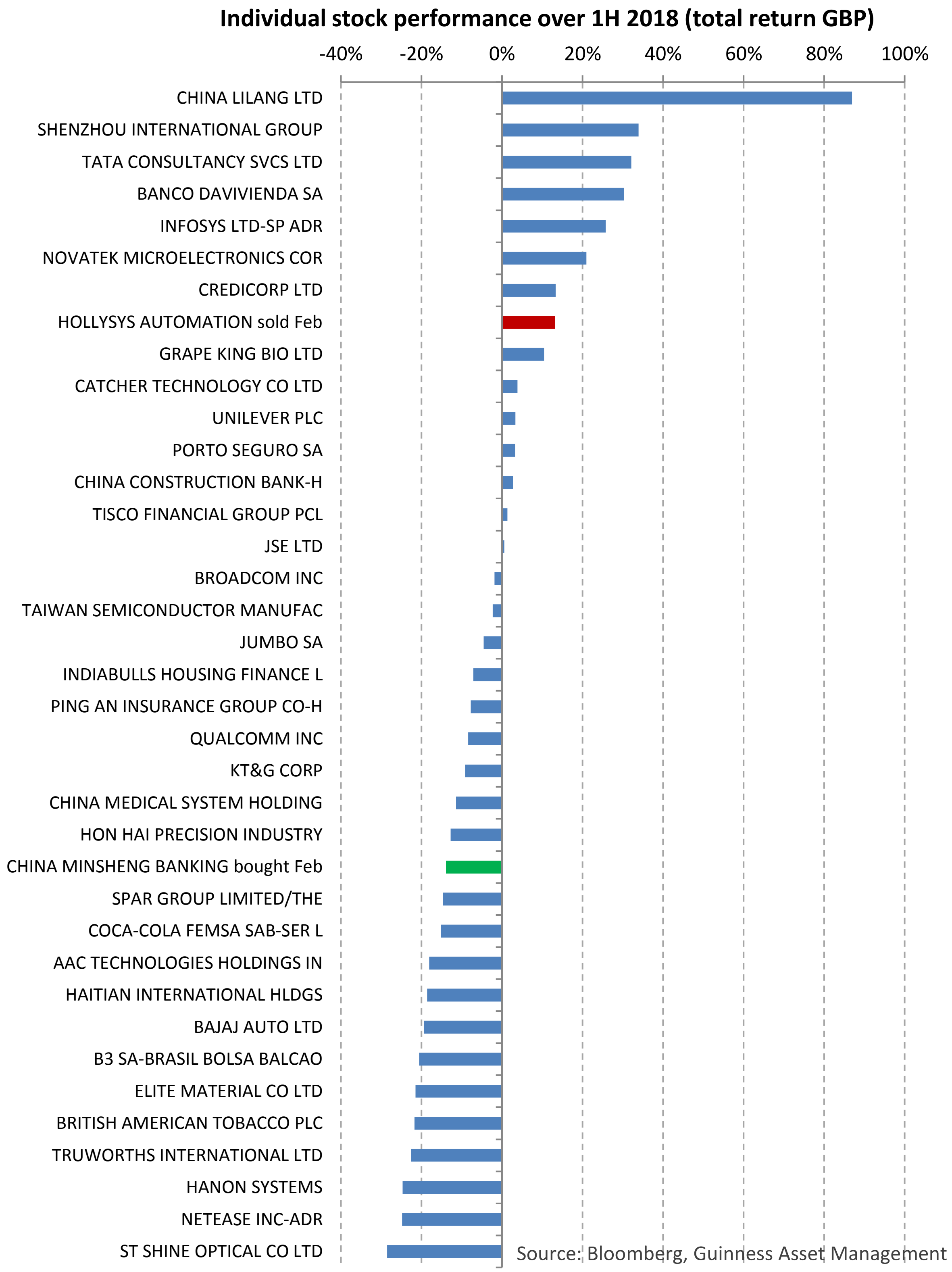
However, the Fund did especially well in the weakness that followed when the markets peaked on 26th January. Our biggest period of outperformance came in February. The better relative performance came from individual stocks such as AAC Technologies and China Lilang (a clothing retailer) and from Porto Seguro (a Brazilian insurer). We also saw a significant contribution come through from our three South African holdings (Johannesburg Stock Exchange, Spar and Truworths) following the election of Cyril Ramaphosa which boosted both share prices and the currency.

In April, Fund performance was held back by weakness related to Chinese and technology stocks combined with lower exposure to Energy, Materials, Utilities and Real Estate. To focus on the stocks we do hold: China trade tensions weighed on export manufacturing businesses specifically and market valuations more broadly; while in the technology space, hardware manufacturers also had to contend with slower smartphone sales in the earlier part of the year which brought in cuts to earnings forecasts. There is a seasonal element to this which we have seen before and we took the opportunity to build positions.

June was a weak month in absolute terms and though many of the stocks in the portfolio demonstrated defensive qualities the Fund still captured more of the downside than we would have hoped. The problem here was South Africa, where currency weakness spilled into stock market weakness. The rand is one of the five currencies mentioned earlier that have been struggling with US dollar strength and it fell 8% in June (but has recovered 4% since then). South Africa is more exposed to portfolio flows to provide government financing. Some 40% of government debt is held by foreigners, who poured in following Cyril Ramaphosa's victory. Inevitably, the unwinding of prior economic mismanagement is more complex and is taking longer than optimists hoped. Having made some of the best returns in Emerging Markets in the first quarter, these fixed income flows reversed in June. With EM sentiment improving in July, they have stabilised.

Our view is that significant swings in portfolio flows in fixed income is part and parcel of Emerging Market investing. We believe that the flows in this case reflected changes in sentiment and expectations around timing rather than a sign of trouble. We have looked at this an opportunity to add to positions which we had cut earlier in the year following their outperformance in February.

The chart below shows the performance of individual stocks through the first half of the year:



In the top five performers there is a mix of industries: retail, textile manufacture, technology consultancy services, and banking. The companies are spread across China, India and Colombia (and within the top 10 we can add Peru and Taiwan to the list). Among the weaker names we have a similar mix of industries: healthcare products, internet services, auto components, retail and tobacco. Again, a variety of countries are represented: China, Taiwan, Korea and South Africa.

Portfolio review

Leaders

China Lilang was the stand-out performer over the first half of the year, returning more than 80% in GBP terms. The company is a clothing retailer based in China and focussed on casual menswear in the young adult segment. Lilang's main brand LILANZ has recovered after a difficult period in 2016, with same store sales accelerating over the second half of 2017 and continuing into 2018. The company also reported very strong year-on-year sales growth in both its autumn and winter trade fairs.

Shenzhou is likely win more orders from customers such as Nike, Adidas and Fast Retailing as it takes the lead in developing new fabrics and clothing designs to help clients meet growing demand from Chinese consumers. The three global sportswear and apparel leaders make up 70% of Shenzhou's revenue, and all anticipate sales growth in China as consumer spending climbs faster than in Europe and the US. The weaker yuan should also lower Shenzhou's expenses in China, where it produces two thirds of its clothing, while new capacity in Southeast Asia ramps up.

TCS provides IT services to the finance, manufacturing, retail and telecoms industry. It has seen a pickup in orders from the finance industry as banks have stabilised their efforts to insource operations. Revenues have accelerated over the last couple of years, propelled by digital services sales (targeted marketing and marketing analytics, for example) which attract higher margins. The business has also benefitted from a recovery in North American sales, especially in banking and financial services focusing on data privacy and cybersecurity.

Interest rates in Colombia have been coming down this year in an improving macro environment brought about by a higher oil price and the election of a more 'market-friendly' candidate as president. Banco Davivienda is less sensitive to lower interest rates and trades at lower multiples than peers and is also working on new sales platforms to increase cross-selling of products.

Infosys has been through a long period of uncertainty with tensions between the founder and the management board culminating in the sudden resignation of the CEO. The return of Nandan Nilekani last August has steadied the ship and the company now has a three-year growth plan, having effectively stalled. The focus now is on digital services (Internet of Things, Cloud, Mobility, cybersecurity and analytics), stemming the loss of high performing staff and reviving its consultancy business. These issues have resulted in a substantial valuation gap between Infosys and its peers and good share price performance this year reflects efforts made so far.

Laggards

St Shine has been faced with higher costs, resulting in lower gross margin levels and prompting analysts to reduce their earnings expectations for the stock. Lower margins are partly a result of higher labour costs, but they are also a result of depreciation as the company expands its capacity. St Shine is forecast to achieve strong revenue growth in 2018 as a result of its new US direct-to-consumer customer, Hubble. The effect will be to decrease exposure to Japan, which currently accounts for more than half the company's revenues.

Netease develops games for mobiles and PCs and is the second largest developer in China. The start to the year has been tough, with revenues from a major game, Onmyoji, falling sharply. While Netease has released battle-royale style games that have done well, they have not become popular enough to offset weakness in more established games. Additionally, the company has expanded into cross-border e-commerce through Yanxuan and Kaola. Yanxuan sells unbranded versions of mass market and luxury goods while Kaola sells a range of high-quality international goods. Both websites are doing well and although currently loss-making, they have the potential to become very cash-generative given the size of the e-commerce market in China.

Hanon Systems was weak over the first half, giving back some of the gains achieved in 2017. The company, an automotive parts supplier specialising in thermal management systems, saw some softness in revenue from weaker sales by Hyundai and Kia in China. However, Hanon's efforts to diversify sources of revenue have helped to reduce the impact of China weakness, and Hyundai Motor Group (which includes Kia) now represents less than half of Hanon's sales. Hanon is also attractively positioned with respect to electric vehicles; sales of parts for new energy vehicles rose to 7.5% of sales in the first quarter and account for 30% of the company's backlog. As emissions continue to be an area of focus in China and elsewhere, demand for Hanon's products, which are optimised for fuel efficiency, is likely to increase. We expect the company to recover over the second half of the year, as conditions in China appear to be improving. The stock trades on an attractive valuation and we are happy to continue to hold.

Truworths is a South African department store company which also owns Office, a shoe retailer in the UK. The South African business is holding steady but the UK business has been softer in recent months on slower footwear sales. Cash sales in South Africa have been robust but these normally account for around 40% of overall sales; credit sales are a much larger proportion and although we have seen growth in new accounts we have not yet seen credit sales pick up. The stock has de-rated (in terms of valuation) but earnings forecasts have remained reasonably firm, leading to the obvious question: are analysts (and we) too optimistic? We take the view that the South African side is satisfactory and the Office business in the UK is one we need to watch carefully.

British American Tobacco is London-listed but derives over half its revenues from Emerging Markets. This year the stock took a hit following downbeat news from Philip Morris on the adoption of electronic (heat-not-burn) products in Japan. This prompted some downgrades to profit forecasts and a much greater compression in valuations. In recent weeks we have seen earnings revisions pick up and an accompanying share price recovery. The latest management call was notably positive for second half acceleration of next-generation products in both the US and Japan. We see the last few months as a hiccup.

Portfolio changes

We made one switch in the portfolio during the first half, selling Hollysys Automation and buying China Minsheng Bank. Hollysys has been a respectable 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. As a consequence, Minsheng has been restructuring its balance sheet on the funding side as well as addressing regulatory requirements for off/on balance sheet items. 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 acutely undervalued. The stock also offers a 4% dividend yield.

Outlook

We believe that after a tricky first half in 2018 the outlook is improving for Emerging Markets. While there have been significant outflows from the region since April, it should be remembered that these follow significant inflows in the first quarter. We do not see a broad-based 'Emerging Markets problem'. A stronger dollar has historically been a significant headwind and for some countries that is indeed the case. But as we discussed above, these remain largely idiosyncratic. There is no large bloc up to its neck in foreign currency debt with hefty current account deficits. Even Argentina, which was under enormous strain, has been able to reach a financing arrangement with the IMF. Greece too has relieved its immediate pressures with the Eurozone.

As ever, there is much to challenge the top-down investor and world developments are not becoming any easier to forecast. This is why we don't try. Our focus is on the businesses themselves and whether we think the market is pricing in the risks to that business and its ability to remain profitable. The Fund has done well through a challenging period and we are optimistic that conditions for our businesses will improve in the rest of the year.

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

Data sources

Fund performance: *Financial Express, gross total return*

Index and stock data: *Bloomberg*

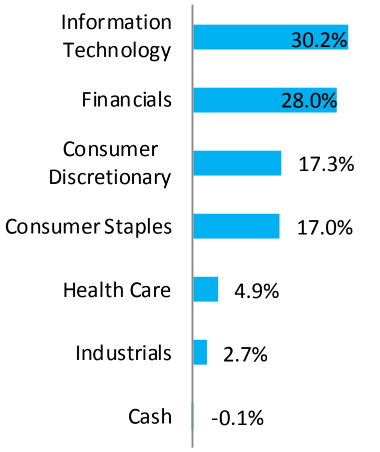
PORTFOLIO

30/06/2018

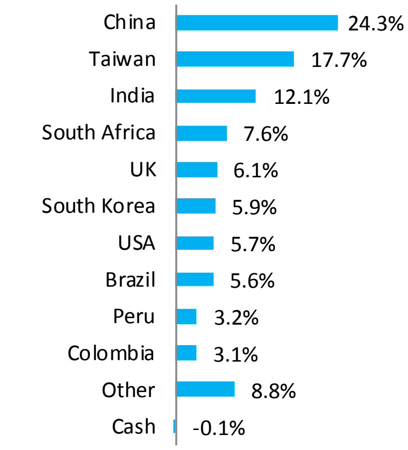
Fund top 10 holdings

Credicorp	3.2%
Shenzhou International	3.2%
Infosys	3.2%
TATA Consultancy Service	3.2%
Banco Davivienda	3.1%
KT&G Corporation	3.1%
Unilever	3.1%
British American Tobaccc	3.0%
Jumbo	3.0%
Coca-Cola Femsa SAB	2.9%
% of Fund in top 10	31.0%
Total number of stocks	36

Sector analysis



Geographic allocation



PERFORMANCE

30/06/2018

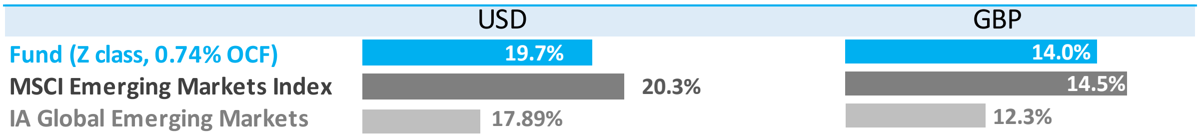
Discrete years % total return

	Jun '14		Jun '15		Jun '16		Jun '17		Jun '18	
	USD	GBP	USD	GBP	USD	GBP	USD	GBP	USD	GBP
Fund (Z class, 0.74% OCF)	-	-	-	-	-	-	-	-	10.1	8.3
MSCI Emerging Markets	14.7	1.7	-4.8	3.5	-11.7	3.9	24.2	27.8	8.6	6.8
IA Global Emerging Markets Sector	14.7	1.7	-7.2	0.9	-11.7	3.9	23.9	27.5	5.4	3.7

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)	-3.9	-3.2	-6.0	-3.6	10.1	8.3	-	-	31.5	22.0
MSCI Emerging Markets	-4.1	-3.3	-6.5	-4.2	8.6	6.8	19.0	41.8	32.3	22.8
IA Global Emerging Markets Sector	-4.1	-3.4	-8.2	-6.0	5.4	3.7	15.3	37.4	28.4	19.2

Annualised % total return from launch



Risk analysis - Annualised, weekly, from launch on 23.12.2016

30/06/2018	Index		Sector		Fund	
	USD	GBP	USD	GBP	USD	GBP
Alpha	0.0	0.0	0.0	0.0	3.6	3.6
Beta	1.0	1.0	0.9	0.9	0.8	0.8
Information ratio	0.0	0.0	-0.5	-0.5	0.1	0.1
Maximum drawdown	-15.0	-15.0	-14.9	-14.9	-13.4	-13.4
R squared	1.0	1.0	0.9	0.9	0.8	0.8
Sharpe ratio	1.1	1.1	1.0	1.0	1.2	1.2
Tracking error	0.0	0.0	4.3	4.3	6.2	6.2
Volatility	14.1	14.1	13.0	13.0	13.1	13.1

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.

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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.