Guinness Best of China Fund

INVESTMENT COMMENTARY – August 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

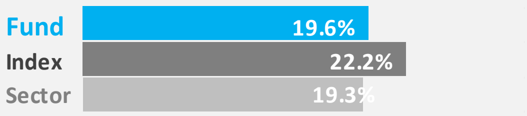
Performance

31.07.18

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

	1 year	3 years	From launch
Fund	-3.0	-	62.6
Index	0.9	74.2	72.4
Sector	0.7	69.3	61.4

Annualised % total return from launch (GBP)



Risk analysis (annualised, weekly, from launch)

	Index	Sector	Fund
Alpha	0.0	-2.0	-1.0
Beta	1.0	1.0	1.0
Info ratio	0.0	-0.6	-0.4
Max drwdn	-12.9	-16.8	-14.2
Tracking err	0	5	6
Volatility	18.1	18.0	18.1
Sharpe ratio	1.0	0.8	0.9

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, total return 0.74% OCF. Returns for share classes with a different OCF will vary accordingly

Fund & Market

- The US introduced 25% tariffs on $16bn worth of imports from China, with China retaliating in kind with its own tariffs. In September the US imposed a 10% tariff on $200bn of imports from China.

- The MSCI Golden Dragon Net Total Return Index fell 1.2% in August (in GBP) while the Best of China Fund fell 3.9%.

- Year-to-date, the fund is down 6.8%, while the benchmark is up 0.1% (in GBP). Much of the fund's underperformance came in January, where markets were extremely strong and the fund lagged c.4%. The rest of the fund's underperformance comes down to individual companies with their own headwinds - Netease, Li & Fung and Tongda were weak in August.

- Li & Fung suffered after releasing disappointing results. The difficulties being faced by US retailers are leading to store closures and inventory destocking, which have harmed Li & Fung's core business. Management's strategy has been to slim down and refocus the business, and a planned IPO of its logistics business is further evidence of this process.

- AAC has struggled this year, but we attribute a large part of the underperformance to expectations getting too far ahead of themselves. Results in the second quarter disappointed after the company faced foreign exchange headwinds and an adverse product mix. We expect the company's results to improve in the second half of 2018 on increased adoption of the company's products by Android manufacturers and as a result of the new iPhone launches.

- On the other hand, Ping An and TSMC reported good results.

- As was the case in July, Taiwan was the strongest region with its MSCI index rising 2.2% for the month. Hong Kong and China were weaker, falling 1.0% and 2.5% (in GBP).

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- In China, the weakest sectors were Utilities, Consumer Staples and Information Technology, which fell 7.8%, 6.3% and 5.1% (in GBP). On the other hand, the strongest sectors were Telecommunications, Energy and Real Estate. The fund has no exposure to the first two sectors and has one holding in Real Estate.

- In Taiwan the strongest sectors were Energy, Consumer Staples and Real Estate, rising 5.3%, 4.7% and 3.9%. Information Technology, which makes up more than half of the index, rose 1.6% (in GBP).

Outlook

- Chinese markets still offer attractive earnings growth compared to developed markets, while trading at reasonable valuations.

- The imposition of additional trade tariffs seems probable and their effects are likely to become evident from 2019. (President Trump has recently upped the ante by suggestion tariffs be imposed on all Chinese goods imported into the US).

- We believe our core focus on good companies with demonstrably stable businesses is a sustainable long-term approach. We continue to focus on macro-environment but only insofar as it impacts upon our businesses.

- We think the best long-term stories are to be found in the Consumer, Financial, Health Care and Technology sectors and amongst certain Industrial companies.

- At a time of uncertainty, we think that holding quality companies that have achieved consistently higher cash returns on capital is a sensible approach.

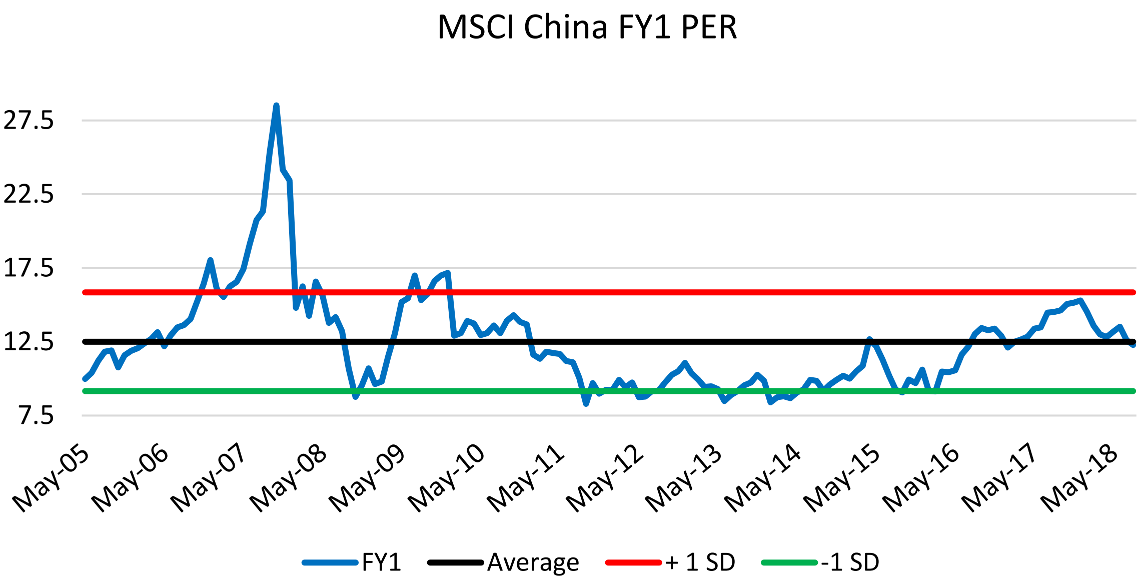
Why invest in China?

We do not think investors pay enough attention to Chinese companies. We often hear the argument that there are very few worthy companies in the country to invest in, or that Chinese companies are ‘low-quality’ (where quality is never defined). While it is certainly true there are many examples of Chinese companies that are poorly run and inefficient, it does not follow that this applies to all. Ten years ago, it is true, there were few good quality Chinese companies to invest in, by our definition. Contrary to popular thinking, we argue that today there are many good quality Chinese companies which, if listed in developed markets, investors would be comfortable buying.

We define quality companies as those that generate a persistently high cash return on invested capital – we use 8% as a minimum threshold. We look for companies that have achieved this over eight years, as it is this persistence which is a good predictor of whether a company continues to achieve a high return on capital. Out of 19,302 companies worldwide, only 2,235 companies (12%) meet our quality criteria.

The fund invests in companies listed in Greater China or which derive more than 50% of their revenues from the Greater China region. In 2005, only 24 Chinese and 6 Taiwanese companies met our quality criteria. Today 82 Chinese companies and 96 Taiwanese companies pass the test. After excluding companies with a market capitalisation of less than $500m and those with too much leverage on their balance sheets, we are left with 122 quality companies in the Greater China area. These companies are a select few with the characteristics we look for.

We have established that quality Chinese companies can be found. What about valuations? We start off by looking at the valuation of MSCI China which, on a forward-looking price/earnings basis, is now trading at about its historic average. Fears over a slowdown in economic growth and a potential trade war are weighing on valuations, but earnings are still expected to grow relatively strongly with a consensus growth forecast for 19% in 2018 and 16% in 2019.



Source: Bloomerg (May 2009 to August 2018)

The overall valuation of MSCI China Index needs to be considered in the light of its construction. The index is dominated by Tencent and Alibaba, whose weights are 15.4% and 12.6%. To put things into context, these concentrations are significantly larger than in other markets; for example, as of the end of June the largest company in MSCI USA was Apple with a 3.9% weight. In MSCI Europe the largest company was Nestle with a 2.7% weight. In addition to the company-specific risk within the benchmark, the valuation of the China index is significantly impacted by Tencent and Alibaba. MSCI China trades at around 12.3x on 2018 earnings and 10.6x on 2019 earnings. As the table below shows, Tencent and Alibaba trade at much higher valuations. If we strip out these two companies, the valuation of the region becomes much more compelling, trading on 9.8x on 2018 earnings and 8.6x on 2019 earnings.

Name	2018 PE	2019 PE
MSCI China	12.3	10.6
Tencent	34.4	26.8
Alibaba	33.0	23.8
MSCI China ex Tencent & Alibaba	9.8	8.6

Company updates

Tongda Group, which produces casings for smartphones, fell 24.4% in August. The company put out solid first-half results with adjusted operating profits growing 6% (adjusting for write-offs last year so we can compare on a like-for-like basis). Given the current environment in the industry, where smartphone shipments in the second quarter fell 5.9% year-on-year, we think Tongda's results are respectable. The market may be worried that Tongda's margins are falling and will remain lower than their historical level because Tongda is producing more plastic-like casings for its major client Xiaomi which have a lower average selling price than the company's traditional metal casings. Management argue that in the initial ramp-up for these newer plastic casings the margin will be lower, but as production increases the company will benefit from economies of scale and the margins will end up higher than those on metal casings. We believe the share price of Tongda does not currently reflect the efficiency and quality of the business, which has returned a 10% return on capital since 2010 and is likely to do so this year. The stock trades, however, at 4.7x FY18 earnings – more than one standard deviation below its average and now approaching two standard deviations. It is one of the cheapest stocks in the smartphone supply chain.

Netease's share price has been weak. Myopia, or near-sightedness, is a common problem in China and is attributed to some degree to online games. Several government departments have issued rules to tackle the problem including a cap on the number of online games, an attempt to introduce an age-based reminder system and a cap on gaming time for children. This news has weighed heavily on game developers with exposure to China. On the other hand, more reports are coming out indicating the government will soon begin approving monetisation of games. In China a game needs one approval to launch and another to be monetised. This system has been in limbo for several months due to internal government restructuring and it has not been possible to monetise newly launched 'battle royal' style games across the industry. The resumption of approvals should provide a boost to sentiment around the company. China is the largest gaming market in the world. Tencent (held in the fund) controls more than half of the mobile gaming market while Netease is second with a 15% share – more than the next seven largest companies combined.

Ping An, an insurance conglomerate, reported strong results, with most key metrics coming in ahead of consensus. Though there is much room for the insurance industry in China to grow, competition is intensifying and we cannot assume the returns that the industry generated in the past will be the same as will be generated in the future. This is one of the main reasons we sold PICC P&C earlier this year, a company whose efficiency has decreased over the past three years. On the other hand, Ping An has maintained its return on equity and is likely to do so this year. We believe its use of technology in aiding its strong distribution capacity means the company has a high chance of maintaining its return on capital in the future.

TSMC also announced results recently, but it was an announcement from a competitor that is particularly relevant in understanding TSMC's competitive edge. GlobalFoundries, a semiconductor foundry like TSMC, announced that it was putting on hold its plans to pursue developing the next-generation 7 nanometre (7nm) production process. With one of the company's main competitors dropping out of the race, TSMC will potentially receive 100% of its customers' order allocations for newer chips. TSMC has a history of leading in technology and has built its business around being a cutting-edge, independent semiconductor foundry. Semiconductor manufacture is a scale business, requiring huge – and sustained – capital investment to stay ahead. Many competitors are simply not able to invest at the scale needed, as the GlobalFoundries example illustrates. By maintaining its competitive edge, TSMC has been able to earn high margins and consequently high returns on capital. Moreover, in a typically cyclical industry, management has been able to maintain returns at a relatively stable level. As the business has grown significantly over the past 20 years, so returns to shareholder have been very impressive. We think that the recent strengthening of the company's competitive positioning will help to sustain shareholder returns in the future.

Summary view & outlook

We expect the fund's focus on companies persistently earning a return on capital well above the cost of capital to do well in the long term. The fund now trades on a price to earnings multiple of 9.7x, based on estimated 2019 earnings, while the fund's discount to the benchmark has widened to nearly 14%. We believe that now is a good time to be looking at investing in China as valuations have come down markedly since January. Fears over trade are bringing valuation multiples down, even for companies that actually have little exposure to a trade war. This has been a frustrating period of performance for the Fund but we have high confidence in the continuation of these companies' operating performance. The 'market' may not like them at the moment, but we attribute this to sentiment, which can change quickly. The drivers of such a change would be positive progress in trade negotiations and/or a Chinese domestic growth response to recent fiscal support efforts (of which we have seen some signs already).

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

Data sources

Fund performance: *Financial Express, total return*

Index and stock data: *Bloomberg*

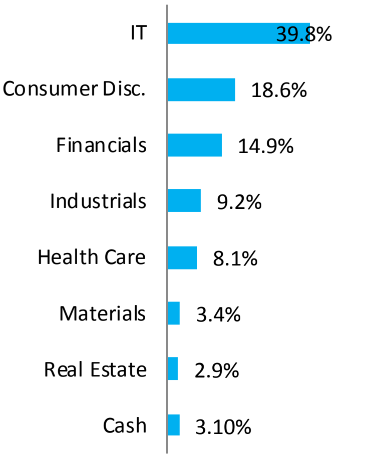
PORTFOLIO

31/08/2018

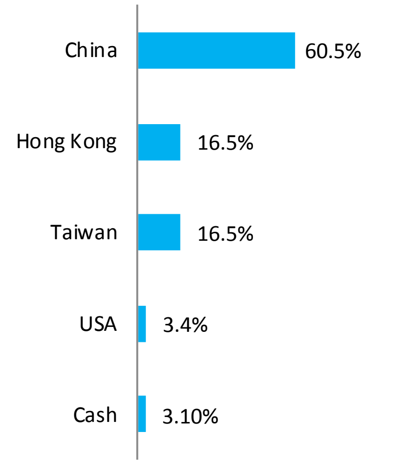
Fund top 10 holdings

Hollysys Automation Tech	3.5%
Taiwan Semiconductor	3.4%
Elite Material	3.4%
Qualcomm	3.4%
Yangzijiang Shipbuilding	3.4%
Catcher Technology	3.4%
Anhui Conch Cement	3.4%
Novatek Microelectronics	3.3%
China Merchants Bank	3.1%
Ping An Insurance	3.1%
% of Fund in top 10	33.5%
Total number of stocks	33

Sector analysis



Geographic allocation



PERFORMANCE

31/08/2018

Annualised % total return from launch (GBP)

Discrete years % total return (GBP)	Aug '14	Aug '15	Aug '16	Aug '17	Aug '18
Fund	-	-	-	37.4	-3.0
MSCI Golden Dragon Index	11.8	-3.9	30.3	32.5	0.9
IA China/Greater China sector average	8.4	-3.0	28.5	30.8	0.7

Cumulative % total return (GBP)	1 month	Year-to-date	1 year	3 years	5 years	From launch
Fund	-3.9	-6.8	-3.0	-	-	62.6
MSCI Golden Dragon Index	-1.5	-0.4	0.9	74.2	87.2	72.4
IA China/Greater China sector average	-3.4	-3.9	0.7	69.3	78.2	61.4

RISK ANALYSIS

31/08/2018

Annualised, weekly, from launch on 15.12.15, in GBP	Index	Sector	Fund
Alpha	0.00	-2.04	-0.98
Beta	1.00	0.96	0.95
Information ratio	0.00	-0.59	-0.35
Maximum drawdown	-12.88	-16.84	-14.20
R squared	1.00	0.93	0.90
Sharpe ratio	0.99	0.80	0.85
Tracking error	0.00	4.69	5.85
Volatility	18.08	18.02	18.07

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, 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.