Guinness Asian Equity Income Fund

INVESTMENT COMMENTARY – October 2018

Launch date	**19.12.2013**
Team	**Edmund Harriss** (manager) **Mark Hammonds** (manager) **Sharukh Malik** (analyst)

Aim

The Guinness Asian Equity Income Fund is designed to provide investors with exposure to high quality dividend-paying companies in the Asia Pacific region. The Fund aims to provide long-term capital appreciation and a source of income that has the potential to grow over time.

Performance

30/09/2018

Fund	Guinness Asian Equity Income (Y)
Index	MSCI AC Pacific ex Japan Index
Sector	IA Asia Pacific ex Japan

	YTD		1 year		From launch	
	USD	GBP	USD	GBP	USD	GBP
Fund	-3.9	-0.3	3.6	6.7	51.9	90.5
Index	-5.2	-1.6	2.1	5.0	30.8	64.1
Sector	-6.7	-3.2	0.9	3.8	29.9	63.0

Annualised % total return from launch

	USD	GBP
Fund	9.1%	14.4%
Index	5.8%	10.9%
Sector	5.6%	10.8%

Risk analysis (annualised, weekly, from launch)

	Index		Sector		Fund	
	USD	GBP	USD	GBP	USD	GBP
Alpha	0	0.0	0.5	1.2	4.5	5.0
Beta	1	1.0	0.9	0.9	0.8	0.8
Info ratio	0	0.0	0.0	0.0	0.6	0.6
Max drwdn	-29.3	-26.4	-26.7	-24.5	-24.3	-20.6
Tracking err	0	0.0	3.7	3.7	5.9	5.8
Volatility	14.6	15.0	13.2	13.3	12.4	13.8
Sharpe ratio	0.2	0.5	0.2	0.5	0.5	0.8

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, Y class 0.99%, bid to bid, total return.

Fund & Market

- September was a turbulent month, but after recovering ground in the latter part of the month the MSCI AC Pacific ex Japan Net Total Return Index ended down -1.0% GBP terms (-0.8% in EUR, -0.7% in USD). For the third quarter as a whole, the market was down -0.2% in GBP terms (-0.8% in EUR, -1.4% in USD terms).

- The fund was down in September but outperformed the market and ended the quarter in positive territory. After a difficult first half, the Fund is now ahead of its benchmark for the year to date.

- The last quarter marked a sharp turnaround from the first half in terms of relative performance. In the first six months, 16 out of the 36 stocks in the portfolio outperformed. In the last three months, 28 stocks out of 36 were outperformers.

- While first half performance was influenced by macro-economic headwinds, it was individual company operating performance that drove the Fund's recovery in third quarter.

- In stock terms our weakest names were Yangzijiang Shipbuilding, Hanon Systems, Elite Material, Delta Electronics Thailand and Qualcomm, which had fallen between 11% and 37% (in USD terms) in the first half but which turned into our leading performers in the third quarter, rising between 13% and 37%.

- We reviewed the Fund's underperformance in the first half through the framework of the total shareholder return. We concluded that underlying operating performance was still good and thus our expectations of earnings growth were maintained; while the growth in cash flows for these companies has been closely aligned with profits growth (this indeed is a measure of their quality) and so we remained confident too in the dividend.

- We concluded that the primary driver of weakness was multiple compression and thus an expression of market sentiment rather than fundamental weakness. We therefore held our position and as companies began to report their interim earnings – generally ahead of market expectations but in line with ours – we saw a broad-based recovery in the portfolio.

Events in September

- US interest rates were increased 0.25%. The market is looking toward a steady increase over the next 18 months.
- Trade tariffs on a further $200 billion of Chinese goods were announced with China imposing retaliatory tariffs on $60 billion of US goods.
- President Trump upped the ante by threatening to impose tariffs on a further $267bn of Chinese imports.
- The leaders of North and South Korea met for a third time and signed a joint declaration committing to denuclearisation of the peninsula.
- In India, Infrastructure Leasing & Financial Services (IL&FS) announced more debt defaults. The government has replaced the board with its own appointees.
- Asian currencies saw only modest downward pressure in September. The Indian rupee and the yen were weakest and down over 2%. The Indonesian Rupiah was 1% lower, but the market has looked favourably on the central bank's proactive response.

Fears reach crescendo

After the market falls in the first half of October we take a look at some of the main factors that we think impact the most on our region. China-US relations are now dominating thoughts and higher energy prices are not far behind. We do not ignore the issues surrounding interest rates, rising bond yields and the stronger dollar but we suspect our readers will find more in-depth analysis elsewhere.

From our narrow fund perspective, we think that the returns on capital our companies generate are high enough to withstand erosion from a higher discount rate and with their low indebtedness are not vulnerable to rising interest expense. Even at a macro level the region is not left especially vulnerable to a strong dollar or weaker local currency due to the preponderance of current account surpluses in Asia and lower levels of US dollar debt than in the past.

China and the United States

If the dispute between China and the US were just a matter of trade surpluses and deficits, it would be relatively straightforward. That was how it was framed initially, and that was what the Chinese thought it was about. However, it rapidly changed into something far more profound. China's economic rise, which used to be seen in the US as a challenge, is now perceived and presented as an existential threat. China has upgraded its industrial base and know-how at a speed with which the US economy cannot keep pace and so the focus is now on the methods China is using to do so. Even in a deeply partisan US political environment this is a unifying issue. China is beginning to recognise this.

In China, there is a pressing need to continue the transformation of its domestic economy to escape the so-called middle-income trap and to deliver the on-going rise in the standard of living that underpins the current political system. The new pillar industries in technology, alternative energy and electric vehicles are the alternative to the debt-funded construction-led growth of the past. Security through self-sufficiency in technology is bound up with this process, which comes under the 'Made in China 2025' banner. The methods of acquiring intellectual property have been transactional (in return for market access), through acquisition, reverse engineering (copying), and 'taking without permission'. Some or all these approaches have been adopted by industrialising countries (UK, US, Germany, Japan, Korea, Taiwan) at one time or another. However, all have recognised that to be sustainable in the long term, they must create. But politically, China cannot be seen to simply roll over.

Progress so far

On the face of it there has been little. The US has imposed tariffs on $250 billion of goods and has threatened to do the same to all other Chinese imports. In addition, through the National Defense Authorization Act (NDAA), which incorporates the Foreign Investment Risk Review Modernization Act (FIRRMA) and the Export Control Reform Act (ECRA), Congress has tightened controls over both inbound investment and outbound sales of 'foundational technologies'. Both can be blocked. In this dispute so far, the US has made all the running.

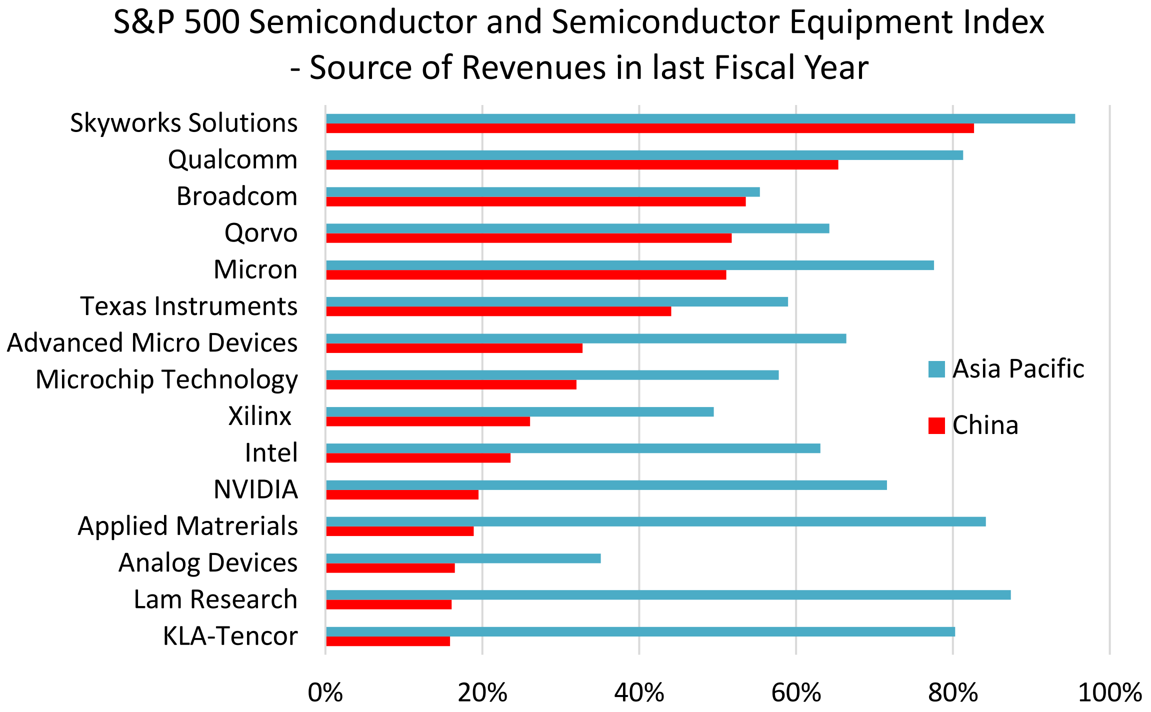
By contrast, China has been very cautious. Retaliatory tariffs have been placed on fewer goods (inevitably, because the Chinese buy fewer US goods) although they have been targeted. Importantly, however, the level is only 5%-10%, rather than 25%. The Chinese currency has weakened, but only by 6% this year, which is less than the Australian dollar. Devaluation as a weapon has not been employed; indeed, intervention has been directed at preventing weakness, not generating it. Vulnerable industries have been supported with fiscal measures such as the acceleration (but not the increase) of export subsidy payments. China's demeanour appears to suggest a desire to talk, but the US shows little inclination to do so; rather it seeks to emphasise toughness.

The US approach is in fact Donald Trump's direct and personal approach. The US will be ready to talk when he is ready. It also means that should there be a significant, and from the US perspective, successful resetting of US China economic relations, the credit will be his and could well propel him to a second term.

What's next

Although the US has set the pace, this dispute is not a one-way street. The US stands to be hurt by further escalation and one way to see this is to look at the companies in the S&P 500 Index Semiconductor and Semiconductor Equipment sub-sector.

The fifteen companies in this group have a combined market capitalisation of $881 billion. In the last reported fiscal year they generated sales of $211 billion and net profits of $52 billion. This sector therefore has a net profit margin of 24.5%, 2.5 times greater than the average 9.8% net margin for the rest of the S&P 500. The chart below shows where their sales came from in the last reported fiscal year.



Source: Bloomberg & company data

The sector derives 36.6% of its sales from China and 70% from Asia Pacific as a whole, with Korea, Singapore and Taiwan making up most of the balance. To consider this more broadly, while we can identify direct China sales we can safely assume that a significant share of Asia ex-China sales end up going through the China manufacturing and assembly complex. Aggressive tariffs could have a huge impact on the future of these companies; and what will happen to the many small businesses in the US that supply them?

The dangers are evident and the arguments against such a blunt tool are mounting from both inside and outside the US administration. The negotiations that need to take place are complicated. There are reports that the US has presented China with a list of over a hundred specific demands. We hear that China is willing to move on around a third of these and is open to discussions on a further third. One area of discussion is China's status under WTO rules as a developing nation, which gives it certain rights and exemptions. For Central and Western China this categorisation is appropriate, but for its wealthy eastern provinces it clearly is not. The frustration for the Chinese side at the moment is that there is no one mandated to speak for the US administration, but that could be attributable to the US election cycle.

China's recent actions give grounds for optimism, and it should be remembered these come against a political backdrop that is just as fiery as that in the US. The Chinese authorities have maintained their commitment to stabilise and not devalue the currency. They have stood by their commitment to open up market access. In the last few days BMW announced it will increase its stake in its venture with Brilliance Automotive for 50% to 75%, making it the first automaker to take majority control (the irony is that BMW is the largest exporter of vehicles to China from the US, shipping over 100,000 SUVs from its plant in South Carolina per year). In the realm of intellectual property, on the same day as the BMW announcement, the South China Morning Post reported that the UK luxury brand Alfred Dunhill has been awarded damages of RMB10 million (US$1.44m) for trademark infringement in a "ground-breaking decision" by Foshan Intermediate People's Court in Guangdong Province. They have held the individual responsible for the business personally liable.

Photo: Handout

Photo: Zunapress

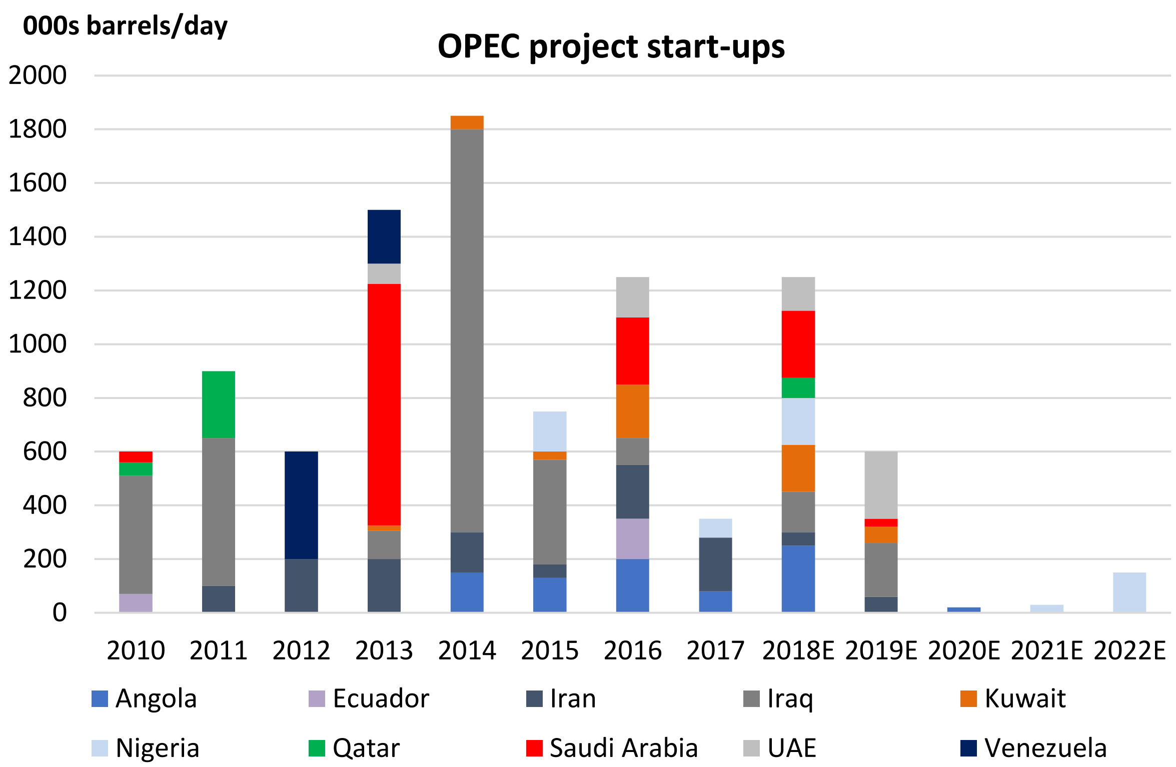
In sum, it is our impression that there is a desire to talk, but short-term imperatives mean the time is not yet right. There has been a view that this dispute is about China containment and that a new Cold War has been declared. However, at the IMF gathering in Bali held 12-14 October there was reportedly a growing view that the US is really after free and fair trade. While complicated to achieve, this points to a much more constructive position.

Energy and Oil

Recent discussions with our Energy colleagues have given us to cause to re-think our views on the oil price. It has been apparent that the immediate cause of higher oil prices has been attributable to supply disruptions especially from Iran and Venezuela. Libya has managed to increase its output but will not increase it further. Brazil's major oil company has been embroiled in scandal. Finally, US shale output has been growing rapidly, but this has not been disruptive, as it was in 2014.

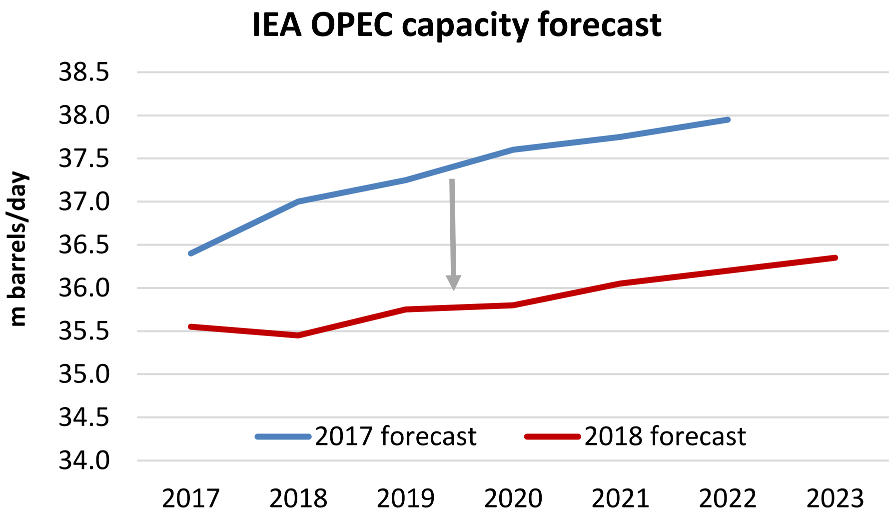
The impact on Asia has been modest so far, suggesting that the region is capable of absorbing prices around this level. Our Energy team has observed that on a global basis between 1970 and 2018 the global oil bill amounted to between 1% and 8% of world GDP (8% during the years of the oil crisis down to 1% when oil fell to $10 per barrel). At a price of $75/barrel the oil bill stands at around 3.5% of GDP and is tolerable; at $100/barrel it reaches 4.5% of GDP and the exerts a drag on growth that erodes demand.

Our change in thinking is that oil prices may well hold around $70-$80 rather than $50 (recession or geopolitical events would alter this in the short term). Temporary disruptions to supply are likely to be replaced by structural tightness based on our team's projections of new investment and thus reserves replacement.



Source: Simmons (Piper Jaffray)

New projects fall away dramatically after 2018 and come nowhere close to keeping up with domestic demand growth. OPEC capacity forecasts by the IEA in 2017 have been cut by 1.5 – 1.8 million barrels per day over the next 5 years:



Source: IEA Medium-term Oil Outlook

Given most non-OPEC supply growth looks similarly weak, this now leaves US shale as the main source of additional supply and together with Saudi Arabia a major source of influence over the longer-term oil price. India is the only economy in the region so far to have been significantly affected. The country is running a current account deficit which stood at 1.9% of GDP at the end of June. This is expected to widen close to 3% of GDP with high oil prices seen as a major contributor. India needs to provide fuel subsidies and recently moved to share that burden with the oil refiners who promptly saw their share prices drop over 10%. In countries like Malaysia and

Indonesia, which also have subsidy mechanisms in place, the pain is offset by their own energy exports. For the present, we see oil at current levels as manageable but 'higher for longer' is our expectation.

To read more about Guinness' views on Energy please see the Guinness Global Energy Report.

Outlook

Asian markets as measured by MSCI AC Pacific ex Japan Index are now trading on a price/earnings multiple of 11.9x 2018 estimated earnings and 11.1x 2019. On an absolute basis and relative to developed markets, the region looks cheap. We think about our stocks in terms of the total shareholder return (profit, multiple and dividend) and the risks in terms of the discount rate we should apply to assess the value of cash flows from the companies. It is our view that the earnings of our companies and their dividends have held up well (based on the last reporting season) and we expect them to continue to do so. We think that if trade tariffs are heavier than expected then even after building in margin and sales volume compression there is still value in these companies and dividends will still flow. We therefore continue to rebalance the portfolio in line with our process and have made no portfolio changes.

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

Data sources

Fund performance: *Financial Express, total return*

Index and stock data: *Bloomberg*

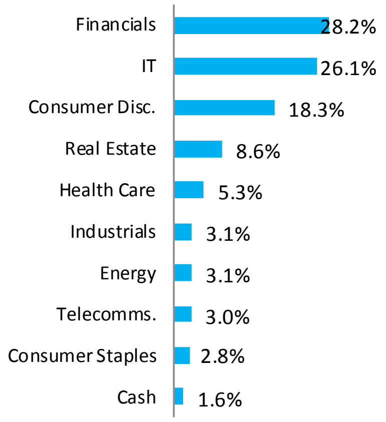
PORTFOLIO

30/09/2018

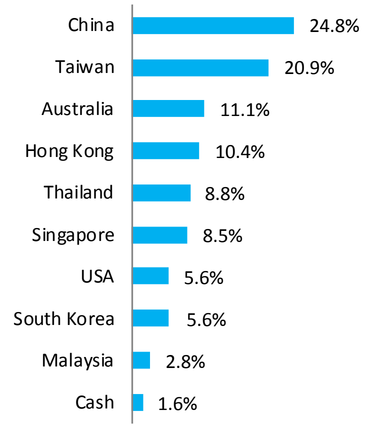
Fund top 10 holdings

Yangzijiang Shipbuilding	3.1%
PTT PCL	3.1%
JB Hi-fi	3.0%
Tisco Financial Foreign	3.0%
China Mobile	3.0%
Taiwan Semiconductor	3.0%
Novatek Microelectronics	2.9%
China Minsheng Banking	2.9%
Capitamall Trust	2.9%
Link REIT	2.9%
% of Fund in top 10	29.9%
Total number of stocks in Fund	36

Sector analysis



Geographic allocation



PERFORMANCE

30/09/2018

Discrete years % total return

	Sep '14		Sep '15		Sep '16		Sep '17		Sep '18	
	USD	GBP	USD	GBP	USD	GBP	USD	GBP	USD	GBP
Fund (Y class, 0.99% OCF)	-	-	-	-	16.1	35.3	19.5	15.6	3.6	6.7
MSCI AC Pacific ex Japan Index	4.1	4.0	-15.2	-9.2	19.1	38.8	21.3	17.4	2.1	5.0
IA Asia Pacific ex Japan	7.0	6.8	-14.0	-7.9	17.3	36.8	19.5	15.7	0.9	3.8

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 (Y class, 0.99% OCF)	-0.3	-0.6	-3.9	-0.3	3.6	6.7	43.8	66.9	51.9	90.5
MSCI AC Pacific ex Japan Index	-0.7	-1.0	-5.2	-1.6	2.1	5.0	47.5	71.3	30.8	64.1
IA Asia Pacific ex Japan	-1.3	-1.6	-6.7	-3.2	0.9	3.8	41.5	64.4	29.9	63.0

Annualised % total return from launch

	USD	GBP
Fund (Y class, 0.99% OCF)	9.13%	14.42%
MSCI AC Pacific ex Japan Index	5.77%	10.91%
IA Asia Pacific ex Japan	5.61%	10.75%

Risk analysis - Annualised, weekly, from launch on 19.12.2013

30/09/2018	Index		Sector		Fund	
	USD	GBP	USD	GBP	USD	GBP
Alpha	0.0	0.0	0.5	1.2	4.5	5.0
Beta	1.0	1.0	0.9	0.9	0.8	0.8
Information ratio	0.0	0.0	0.0	0.0	0.6	0.6
Maximum drawdown	-29.3	-26.4	-26.7	-24.5	-24.3	-20.6
R squared	1.0	1.0	0.9	1.0	0.9	0.9
Sharpe ratio	0.2	0.5	0.2	0.5	0.5	0.8
Tracking error	0.0	0.0	3.7	3.7	5.9	5.8
Volatility	14.6	15.0	13.2	13.3	12.4	13.8

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. Fund launch date: 19.12.2013.

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 equities and equity markets invested in by the Guinness Asian 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 Asian 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. The Fund invests only in stocks of companies that are traded on Asian stock exchanges or that do at least half of their business in Asia; it is therefore susceptible to the performance of that region, and can be volatile. 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.