Guinness Best of China Fund

INVESTMENT COMMENTARY – October 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.

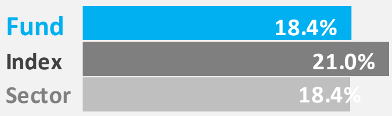
The Fund is managed for capital growth and invests in profitable companies generating persistently high return on capital over the business cycle

Performance 30.09.18

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

	1 year	3 years	From launch
Fund	0.1	-	60.4
Index	4.2	73.4	70.4
Sector	2.7	68.9	60.1

Annualised % total return from launch (GBP)



Risk analysis (annualised, weekly, from launch)

	Index	Sector	Fund
Alpha	0.0	-2.0	-1.1
Beta	1.0	1.0	1.0
Info ratio	0.0	-0.6	-0.4
Max drwdn	-12.9	-16.8	-16.0
Tracking err	0	5	6
Volatility	18.0	18.0	18.1
Sharpe ratio	0.9	0.8	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, bid to bid, total return 0.74% OCF. Returns for share classes with a different OCF will vary accordingly

Fund & Market

- In September, the Best of China Fund fell 0.7% (in GBP) while the MSCI Golden Dragon Net Total Return Index fell 0.8%.
- Regionally, MSCI Taiwan fell 0.2% while Hong Kong fell 0.9% and China fell 2.0%.
- Given the acceleration in trade tensions between China and the US over the course of the year, it is no surprise that Taiwan has performed relatively better than China, rising 10.0% vs a fall of 5.7% for China. The Information Technology sector, which makes up more than half of the MSCI Taiwan Index, is up 6.2% so far this year. The two other big sectors, Financials and Materials, are up 17.2% and 23.0 respectively.
- In September, the Energy sector was the strongest in China, rising 7.9%. The fund has no companies in the Energy sector because there are none which pass the quality test; we look for companies that have generated a return on capital of over eight per cent for the past eight years. On the other hand, Health Care and Real Estate were weak, falling 10.1% and 7.6%.

Events in September

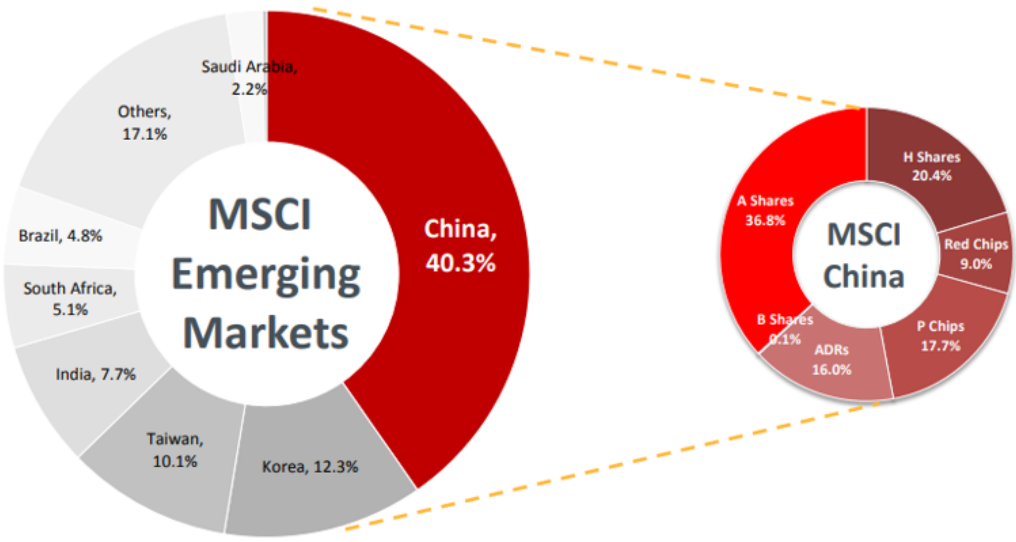
- The US introduced a 10% tariff on $200bn of Chinese imports which is due to rise to 25% at the beginning of 2019. The US is becoming increasingly likely to apply tariffs on the remaining $267bn of trade with China. In response China imposed tariffs of 5-10% on $60bn of goods imported from the US.
- Policymakers in China continue to open up the economy. In June tariffs were cut on home appliances and cosmetics, and tariffs were completely eliminated on certain imported drugs. China is now planning on reducing tariffs on over 1,500 goods by an average of 2.7 percentage points to 7.8%. Affected products include textiles, metals and machinery equipment.

- Economic data remains broadly solid. Retail sales grew 9.0% year-on-year in August, slightly higher than the 8.8% growth seen in July. Industrial production rose 6.1% in August while fixed asset investment growth continues to decelerate, with its growth for 2018 of 5.3% (as of August) being the lowest since 1990. As we have highlighted before, the slowdown is coming from state fixed asset investment, which has only grown 1.3% this year. On the other hand, private investment is up 8.7%.

The trade dispute, along with the decision by the US to temporarily shut down Zhongxing Telecommunication Equipment (ZTE), has highlighted to China just how dependent the country is on the US for its chips. For all the talk of how innovative China is becoming, China currently imports nearly all the advanced microchips it uses. Policymakers are now very vocal on the need to shift away from dependence on foreign chips and towards the domestic industry. In the past this was attempted through acquisitions of foreign firms, but many were blocked on national security grounds by the Committee for Foreign Investment into the US (CFIUS), such as Tsinghua's failed bid for Micron Technology, or Canyon Bridge's failed bid for Lattice Semiconductor Corp. It seems policymakers are willing to invest many billions of dollars into nurturing a competitive domestic industry. The government-backed China Integrated Circuit Industry Investment Fund has raised $47bn to invest in advanced chips, but it will take time to invest and build up a competitive domestic industry. For now, we see Chinese firms being most competitive in consumer-facing applications. For example, Huawei uses its own chips for most of its smartphones, rather than using Qualcomm's. In more advanced applications such as the server market, we do not see any Chinese companies threatening Nvidia in the next few years. That being said, we have read that Microsoft is considering using Huawei's chips for its data centres in China.

The Chinese healthcare sector was weak following announcements from the State Medical Insurance Administration. A pilot program will be launched in 11 major cities where prices will be cut for 33 drugs. It is possible that drugs with at least three competitors will face price cuts of 40%, while drugs with fewer competitors will face more lenient cuts. The fund's two Chinese healthcare holdings, **Sino Biopharmaceutical (SBP)** and **China Medical System (CMS)**, were weak as a result. SBP has six drugs which will be impacted by the trial. CMS has no products on the list but the worry is that two of its major products could be impacted if the pilot program is expanded nationwide. While the price cuts are significant, once a drug wins the tendering process it is very likely to see significant volume increases, which can potentially more than offset the fall in pricing. For example, on SBP's oncology side, a few years ago the price of a competing molecule called Iressa was cut by 51%; volumes in the following year increased by 121%. For now we await more details. Chinese policymakers are aiming to control the costs of healthcare and companies such as SBP are very important to this goal. SBP offers generic products in areas which are becoming increasingly prevalent in China, such as hepatitis treatment and oncology. China cannot afford to pay top-tier prices for drugs from multinational companies and so good-quality domestic companies specialising in generics are vital for keeping healthcare affordable. SBP has generated a cash return on capital around 20% for close to a decade.

FTSE Russell (a global provider of benchmarks) announced that Chinese A shares are to be promoted to Emerging Market status and will be included in its benchmarks from June 2019 onwards. The relevant stocks will be included using 25% of their investable market capitalisation and are expected to make up 5.5% of the FTSE Emerging Index. From 2019 onwards, FTSE will look at Asia in three segments: 1) China, 2) Japan and 3) Asia Pacific ex China ex Japan. FTSE's decision follows that of the MSCI to add Chinese A shares to its Emerging Market index based on a 5% inclusion factor (where inclusion is 5% of A shares' free float-adjusted market capitalisation). MSCI is now proposing to increase the weight of A shares from 5% to 20% and is considering whether to add mid-cap shares. If this were to happen, A shares' weight in the Emerging Market index would increase from the current 0.7% to 3.4% by 2020. If A shares' inclusion factor increased to 100%, China's total weight in the Emerging Market index would increase from 31.3% to 40.3%, as shown below.



Source: MSCI

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 9.8x based on estimated 2019 earnings, while the fund's discount to the benchmark has widened to 14%. We believe that now is a good time to be looking at investing in China since valuations have come down markedly since January. Fears over trade are bringing valuation multiples down, even for companies that 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 such sentiment can change quickly. The drivers of such a change would be positive progress in trade negotiations 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 0.74% OCF in GBP*

Index and stock data: *Bloomberg*

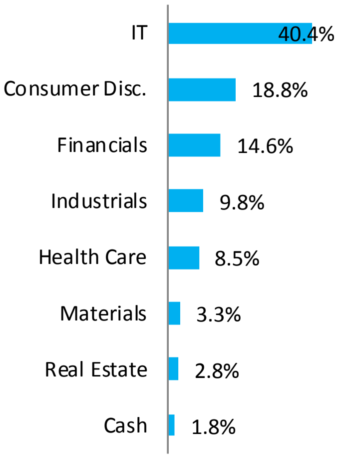
PORTFOLIO

30/09/2018

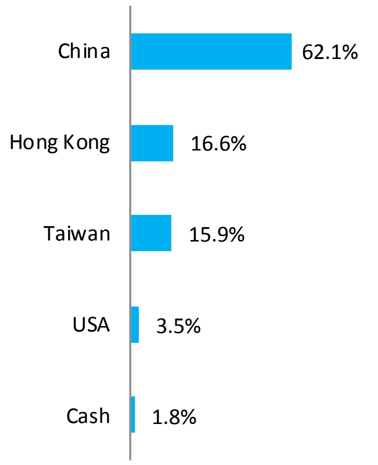
Fund top 10 holdings

Yangzijiang Shipbuilding	3.9%
Tongda Group Holdings	3.6%
Qualcomm	3.5%
Taiwan Semiconductor	3.5%
Hollysys Automation Tech	3.4%
Anhui Conch Cement	3.3%
Novatek Microelectronics	3.3%
China Merchants Bank	3.3%
Elite Material	3.3%
Ping An Insurance	3.2%
% of Fund in top 10	34.2%
Total number of stocks	33

Sector analysis



Geographic allocation



PERFORMANCE

30/09/2018

Annualised % total return from launch (GBP)

Fund	18.4%
MSCI Golden Dragon Index	21.0%
IA China/Greater China sector average	18.4%

Discrete years % total return (GBP)	Sep '14	Sep '15	Sep '16	Sep '17	Sep '18
Fund	-	-	-	27.4	0.1
MSCI Golden Dragon Index	6.8	-0.0	36.0	22.4	4.2
IA China/Greater China sector average	4.4	-0.2	33.6	23.1	2.7

Cumulative % total return (GBP)	1 month	Year-to-date	1 year	3 years	5 years	From launch
Fund	-1.4	-8.1	0.1	-	-	60.4
MSCI Golden Dragon Index	-1.1	-1.5	4.2	73.4	85.1	70.4
IA China/Greater China sector average	-0.8	-4.7	2.7	68.9	76.0	60.1

RISK ANALYSIS

30/09/2018

Annualised, weekly, from launch on 15.12.15, in GBP	Index	Sector	Fund
Alpha	0.00	-1.96	-1.14
Beta	1.00	0.97	0.95
Information ratio	0.00	-0.56	-0.36
Maximum drawdown	-12.88	-16.84	-15.97
R squared	1.00	0.93	0.89
Sharpe ratio	0.93	0.75	0.78
Tracking error	0.00	4.68	5.92
Volatility	18.02	18.04	18.12

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.