Guinness Emerging Markets Equity Income Fund

INVESTMENT COMMENTARY – October 2018

Launch date	**23.12.2016**
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

30/09/2018

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	- 10.0	11.6	32.6	37.8	25.4
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	-5.9	-2.4	4.8	7.9	31.5	23.6
Index	-7.7	-4.2	-0.8	2.1	30.1	22.3
Sector	-10.4	-7.1	-4.3	-1.5	25.3	17.8

Annualised % total return from launch

	USD	GBP
Fund	16.7%	12.7%
Index	16.5%	12.5%
Sector	13.6%	9.7%

Risk analysis (annualised, weekly, from launch)

	Index		Sector		Fund	
	USD	GBP	USD	GBP	USD	GBP
Alpha	0.0	0.0	0.0	-0.6	5.7	3.6
Beta	1.0	1.0	1.0	0.8	0.9	0.8
Info ratio	0.0	0.0	0.0	-0.5	0.8	0.2
Max drwdn	-18.3	-10.7	-19.2	-11.8	-15.3	-8.1
Tracking err	0.0	0.0	0.0	4.1	6.1	6.4
Volatility	14.1	13.4	13.0	11.8	12.7	12.4
Sharpe ratio	0.8	0.6	0.7	0.4	1.0	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: 0.74% OCF, Financial Express, bid to bid, total return.

Fund & market

- The Fund was unchanged in September (Z-class, all total return in GBP unless specified) compared to the MSCI Emerging Markets Index which fell -0.9%.
- For the third quarter the Fund rose 1.2% compared to the Index which rose 0.1%. The Fund is down -2.4% for the year to date, which is 1.9% ahead of the Index.
- Latin America was the strongest performing region, up 4%, with Brazil leading the way driven by the growing success of Bolsonaro in the electoral race.
- Europe, Middle East and Africa (EMEA) also rose during the month with Russia up 9% on higher oil prices and Turkey rebounding 18%. Greece was notable underperformer, down 9%.
- Emerging Asia fell 2.4%, with China moving in line. India's market weakness continues with the MSCI India Index down a further 9.8%.
- Thailand was the only Asian market in positive territory, up 2.8%.
- The Fund's best stocks were Netease and Broadcom, both rebounding after recent weakness, followed by our two Brazilian stocks B3 SA-Brasil Bolsa and Porto Seguro.
- The weakest stocks were Indiabulls Housing Finance, China Lilang and China Medical Systems.

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.
- Polling for the Brazilian elections saw Bolsonaro build a commanding lead.
- The Turkish central bank raised interest rates to 24% to support the currency, much higher than expected and in defiance of president Erdogan's urging.
- South Africa reported second quarter GDP contracted 0.7% following a (revised) first quarter GDP figure showing 2.6% contraction. Public sector investment fell for the first time since 2010.
- Greece has emerged from its bailout programme but is looking to avoid a round of pension cuts as elections loom. The reverberations from the Italian budget are pushing bond yields higher.

Following the heavy sell-off in emerging markets since the end of September, in this update we look at some of the surrounding issues. We make a brief survey of events in Brazil and India and reproduce two commentaries from the Asian Equity Income monthly update which focus on China trade and the oil price.

It is worth remembering that our investment approach differs markedly from our peers. Our bottom-up, company-specific focus leads us to businesses whose robust profitability and cash flows have been demonstrated year after year for many years. In this way we ensure that we are buying into businesses that are not 'economically sensitive' companies dependent on long-term macro trends but those whose underlying business strength has been built on the merits of their products, services and dominant industry positions. The returns on capital above the cost of capital over time are the measure of their wealth creation and the growing dividends they pay are the tangible evidence.

Brazil

The Brazilian market has had a rough time in recent years as commodity prices, especially of iron ore, fell from their highs. The boom years supported rapid consumer growth and it also papered over the cracks of institutional weakness and corruption. This is what has led to Brazil's most divisive election in years. The leading candidate Jair Bolsonaro very nearly secured an outright victory in the first round and is expected to secure it in the second round on 28 October. He has expressed illiberal views on most subjects and is an admirer of the right-wing dictatorship which ended in 1985. The military is said to be waiting in the wings. Bolsonaro nevertheless has the support because of the repeated failures and egregious corruption of the political elite since the return to democracy. The previous president is in jail and it would appear that many cannot bring themselves to vote for the Worker's Party.

Since the end of September and following the results of the first round in the election, Brazil's equity market has risen 10% in GBP terms and outperformed the MSCI Emerging Markets index by 20%. There are, however, reasons to be cautious. The market-friendly fiscal consolidation reforms, such as of social security, will be hard to achieve. The constitutional amendments require 60% of the votes in Congress. Bolsonaro has little experience in the business of government and so we would not position ourselves for a top-down driven bull market.

South Africa

The South African market and currency have had a difficult time since April this year. The economy is primarily a commodity exporter and has been running twin deficits. The country has been running for several years both a budget and a current account deficit which need to be funded. This leaves South Africa especially exposed to portfolio flows and the market is deep and liquid enough to allow for rapid changes in portfolio positioning. Trend growth is estimated to be around 1.5% and wide-ranging reforms ranging from telecommunications to transportation to opening the domestic market and introducing greater labour market flexibility are required to lift that rate. In this regard, the elections next year will be important.

South Africa's economy continues to struggle; first quarter GDP figures were revised to record a 2.6% contraction which was followed by a 0.7% contraction in the second quarter. The finance minister, Nene, has recently been replaced as pressure on him mounted over his meetings with the Zuma-linked Gupta family. His replacement is Tito Mboweni, who previously served two terms as governor of the South African Reserve Bank. Even though the economy has been weak, fiscal discipline has been maintained, contrary to market expectations, and this is not expected to change.

India

This market is beset by contrasts. It is a favourite of many investors because of the reformist attitudes of the government and its strong GDP growth, which hit 8.2% in the June quarter this year. India's strengths in technology and pharmaceuticals have long been recognised. However, the stock market is expensive, trading on almost 23x reported earnings compared to a 10-year average of 19x. The country is running a current account deficit of around 1.9% of GDP which is forecast to widen to almost 3%, with higher oil prices a significant factor. Finally, debt issues and mismanagement at Infrastructure Leasing and Finance Services (IL&FS) have put pressure on the banking sector and especially on non-bank financial institutions.

The gap between reform-minded politicians and the implementation of those reforms remains difficult to bridge. The sudden ban on 100-rupee bills did not reveal illicit funds and triggered chaos. Far more effective perhaps is the launch of the Unified Payments Interface (UPI), which provides a common platform for technology companies to build online payments services. The UPI was initiative launched by banks and the reserve bank of India to allow the myriad payment methods (Google Pay, WhatsApp Pay, Paytm, PhonePe, Bharat Interface for Money, or BHIM) to work. Here we have contrast: heavy-handed policy moves poorly executed and innovative technology-led solutions delivering on what government has failed to do.

Our approach remains focused on the underlying companies rather than positioning for top-down themes. The Fund holds four Indian names: Bajaj Auto, Indiabulls Housing Finance, Infosys and Tata Consultancy Services.

China and the United States

If the current standoff was just a matter of trade surpluses and deficits it would be a relatively simple matter. That was how the dispute 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

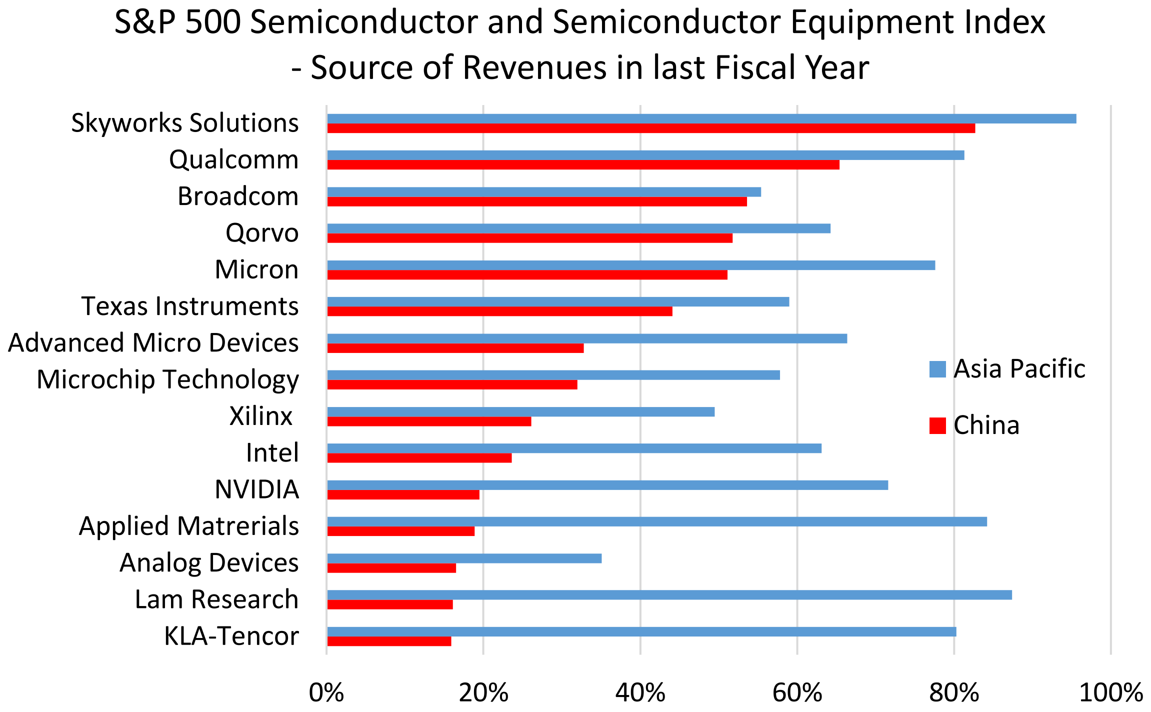
The US has imposed tariffs on $250 billion of goods and has threatened to do the same to all other Chinese imports. In addition, through the National Defense Authorization Act (NDAA), which incorporates the Foreign Investment Risk Review Modernization Act (FIRRMA) and the Export Control Reform Act (ECRA), 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 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

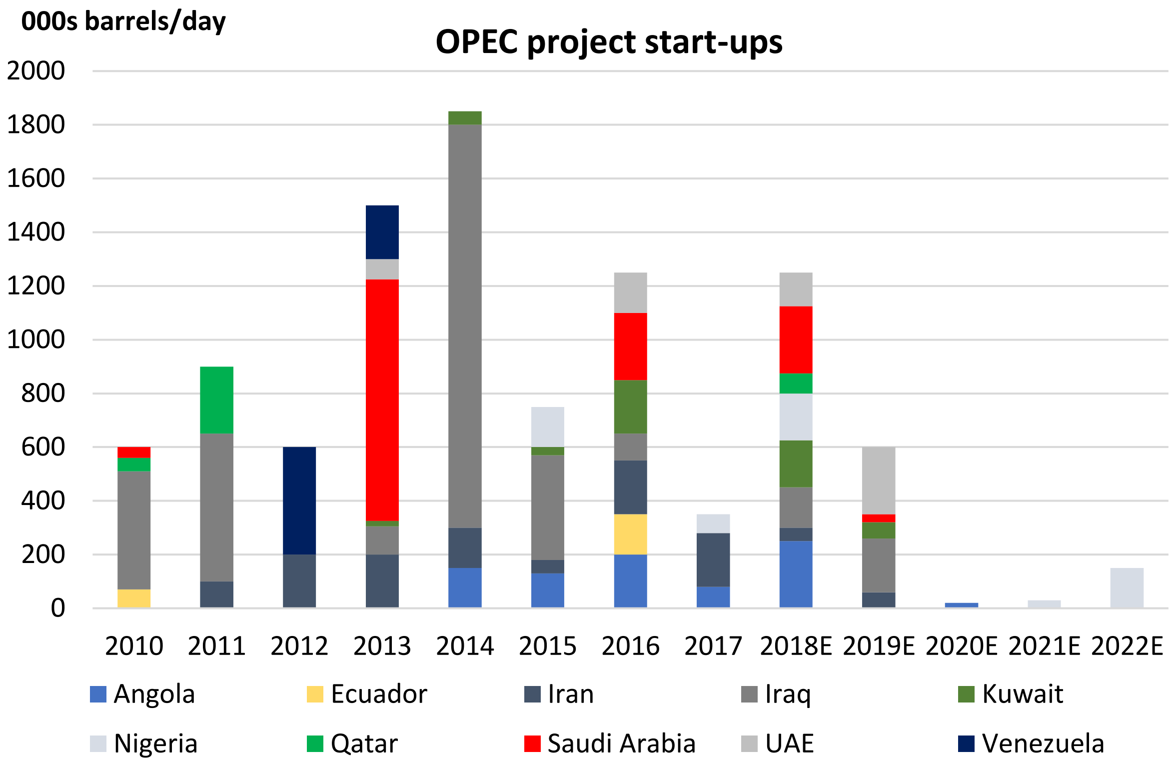
In sum, it is our impression that there is a desire to talk but short-term imperatives mean the time is not yet right. The political pressures on both sides are intense and there is to our mind a belief that both Trump and Xi Jinping are fighting to resist more aggressive responses demanded by hawks on both sides. If we are correct, we should see moves after the US mid-terms to establish more substantive talks, something which stock markets should welcome.

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.

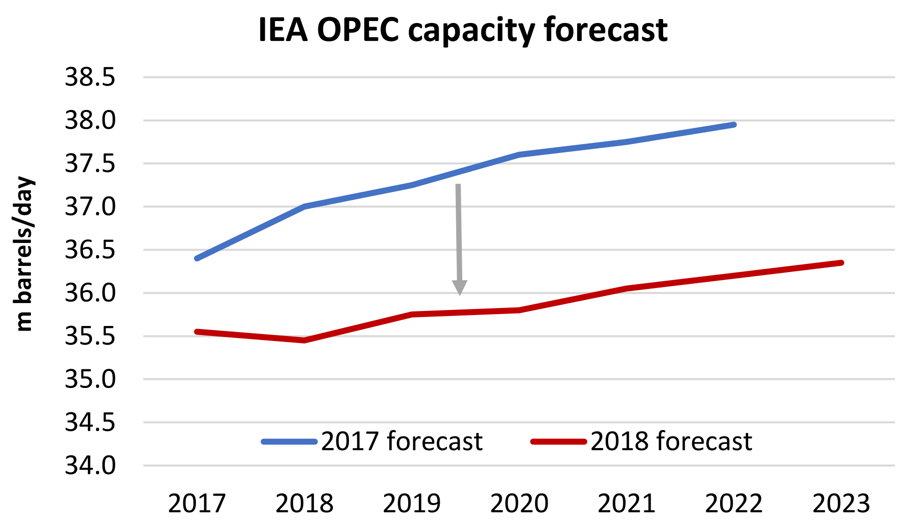
The impact on Asia has been modest so far, suggesting that the region is capable of absorbing prices around this level. Our Energy team has observed that on a global basis between 1970 and 2018 the global oil bill amounted to between 1% and 8% of world GDP (8% during the years of the oil crisis down to 1% when oil fell to $10/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 five 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 to 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 such as 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.

Outlook

Emerging markets as measured by MSCI Emerging Markets Index are now trading on a price/earnings multiple of 12.2x 2018 estimated earnings and 11.0x 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 that dividends will still flow. We therefore continue to rebalance the portfolio in line with our process and have made no portfolio changes.

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

Data sources

Fund performance: *Financial Express, total return*

Index and stock data: *Bloomberg*

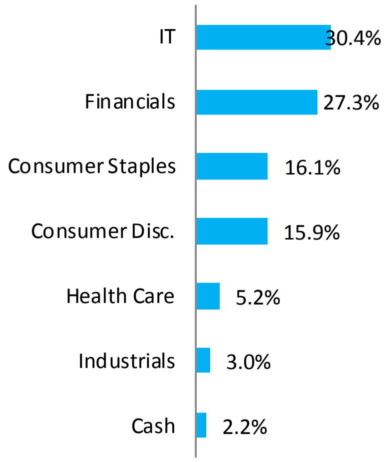
PORTFOLIO

30/09/2018

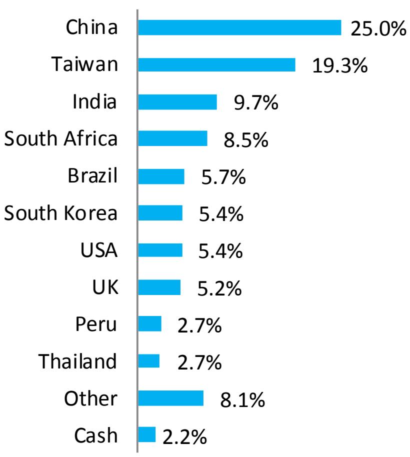
Fund top 10 holdings

Netease.com	3.2%
Haitian International Hol	3.0%
Elite Material	3.0%
JSE Ltd	3.0%
B3 SA - Brasil Bolsa Balca	2.9%
Truworths International	2.9%
Shenzhou International	2.8%
China Minsheng Banking	2.8%
St. Shine Optical Co	2.8%
Porto Seguro	2.8%
% of Fund in top 10	29.3%
Total number of stocks	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 (Z class, 0.74% OCF)	-	-	-	-	-	-	-	-	4.8	7.9
MSCI Emerging Markets	4.7	4.6	-19.0	-13.3	17.2	36.7	22.9	19.0	-0.4	2.4
IA Global Emerging Markets Sector	3.6	3.5	-20.0	-14.4	17.0	36.5	21.3	17.4	-4.3	-1.5

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)	0.3	0.0	-5.9	-2.4	4.8	7.9	-	-	31.5	23.6
MSCI Emerging Markets	-0.5	-0.9	-7.7	-4.2	-0.8	2.1	41.9	64.8	30.1	22.3
IA Global Emerging Markets Sector	-0.6	-0.9	-10.4	-7.1	-4.3	-1.5	35.9	57.8	25.3	17.8

Annualised % total return from launch

	USD	GBP
Fund (Z class, 0.74% OCF)	16.7%	12.7%
MSCI Emerging Markets Index	16.5%	12.5%
IA Global Emerging Markets	13.59%	9.7%

Risk analysis - Annualised, weekly, from launch on 23.12.2016

30/09/2018	Index		Sector		Fund	
	USD	GBP	USD	GBP	USD	GBP
Alpha	0.0	0.0	0.0	-0.6	5.7	3.6
Beta	1.0	1.0	1.0	0.8	0.9	0.8
Information ratio	0.0	0.0	0.0	-0.5	0.8	0.2
Maximum drawdown	-18.3	-10.7	-19.2	-11.8	-15.3	-8.1
R squared	1.0	1.0	1.0	0.9	0.8	0.8
Sharpe ratio	0.8	0.6	0.7	0.4	1.0	0.8
Tracking error	0.0	0.0	0.0	4.1	6.1	6.4
Volatility	14.1	13.4	13.0	11.8	12.7	12.4

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: 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.

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.