Guinness European Equity Income Fund

INVESTMENT COMMENTARY – October 2018

Launch date	**19.12.2013**
Team	**Ian Mortimer** (manager) **Matthew Page** (manager) **Nick Edwards** (analyst)

Aim

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

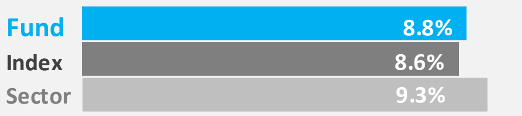
Performance

30.09.18

Fund	European Equity Income
Index	MSCI Europe ex UK
Sector	IA Europe ex UK

	1 year	3 years	From launch
Fund	0.4	50.2	49.8
Index	1.4	47.7	48.5
Sector	1.9	47.0	52.8

Annualised % total return from launch (GBP)



Risk analysis (annualised, weekly, from launch)

	Index	Sector	Fund
Alpha	0.0	1.7	1.3
Beta	1.0	0.9	0.9
Info ratio	0.0	0.1	0.1
Max drwdn	-18.0	-15.0	-16.5
Tracking err	0	5	5
Volatility	13.6	12.8	12.9
Sharpe ratio	0.4	0.4	0.4

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, Z class 0.74%, bid to bid, total return.

Fund & Market

At the end of September, the Guinness European Equity Income Fund was up 2.7% (in GBP) over the quarter versus the MSCI Europe Ex UK Net Return Index which was up 3.0% (in GBP). The fund therefore underperformed the index by 0.3% over the quarter.

Year-to-date the fund is +0.7% (in GBP), versus the benchmark, which is +1.3% (in GBP). The fund has therefore underperformed the index by -0.6% YTD. Over three years the fund's performance is in line with the benchmark. For performance data in EUR please see the table below.

MSCI Europe ex UK rebounded a little in Q3 following the weakness of the first half. Performance continued to be led by the rebound in oil and energy equities, to which the fund has an underweight exposure.

Quarter in review

Domestic events affecting European equity markets over Q3 2018 were largely benign in nature. European economic data remained supportive and GDP growth was affirmed at 0.6% for Q2 versus 0.5% for Q1. Leading indicators such as the German IFO expectations index and the Belgium business sentiment index, also known as the Courbe, both ticked higher towards the end of the quarter. Euro area unemployment fell to 8.1% in August, the lowest level since November 2008. These data all came against a backdrop of indications of slowing global economic growth; for example, new global export orders continued to roll over in September.

The ECB confirmed a slowing pace of bond repurchases and plans for rate rises from Q3 2019. We will hear more on these plans in October from ECB President Mario Draghi. In the face of these supportive factors the Euro tried to make headway but was knocked back by continued rate rises in the US. The US Federal Reserve indicated it may raise rates one more time in December, followed by three more rises in 2019, which would see the Fed funds rate at 3.25% at the upper bound by the end of next year. This being so, in the context of positive European data, and the region's large and growing current account surplus, we should be mindful of the risk of Euro strength from H2 2019 onwards, as the spread between EU and US rates may plateau and ultimately start to reverse – a scenario which could have negative implications for US deficit funding.

European sector rotation continued to be dominated by global trade tariff concerns (in spite of Trump's settlement with Europe) and the ongoing rebound in commodities. At the end of the quarter the Euro softened due to a weak election showing by Angela Merkel's CDU/CSU alliance. Soon after, at the very end of the quarter, the Euro, European banks and related financials were knocked hard by the high 2019 2.4% Italian budget deficit proposal from Italy's new anti-austerity populist government (a coalition of Five Star and the anti-immigrant Northern League).

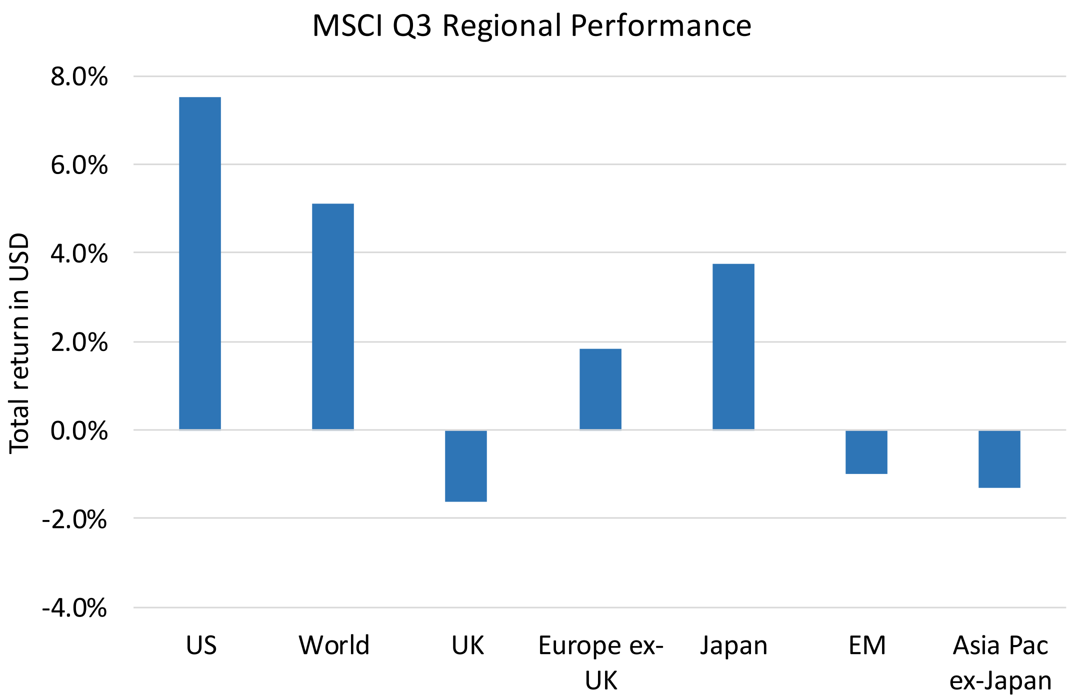


Chart 1: MSCI World Index geographic total return breakdown for Q3 2018, in USD. Source: Bloomberg

As the chart below shows, most Dollar Index (DXY) gains were made in Q2 and both DXY and Euro traded in a range over the quarter. Dollar strength has been a tailwind for European exporters and international European listed companies with high USD exposure, and conversely a headwind for Emerging Markets equities and currencies. If the USD does weaken in later 2019 as regions such as Europe and even Japan eventually start to tighten, one could see a reversal of this dynamic in a potential boon for lowly-rated domestic European and Emerging Market equities.

Chart 2: Euro vs Dollar Index (DXY) YTD 2018. Source: Bloomberg

Italy, with its high 130% debt to GDP and unstable political backdrop, remains a key risk for Europe and the on-going recovery, but one where existing concern already runs high and the alignment of incentives suggests that sense will prevail.

The Italian 2019 budget deficit proposal, which was released at the end of September, was at 2.4% well above this year's 0.8% level. Since 2% was the threshold for an expected negative reaction, this was a clear provocation by the coalition, which came to power on an anti-austerity ticket. The EU may or may not reject the proposal following submission on the 15th October, having previously reacted at around the 3% mark. Di Maio's Five Star and Salvini's League are keen to be seen to live up to their campaign pledges, although it remains likely that the widely-feared eventuality of a Euro departure will not come to pass. It is in Germany's interest to make things work, since they have lent over €1trn mostly through the T2 system. On the other side, despite their hardline stance, Salvini's La Lega (which is now more popular than its coalition partner Five Star) and its supporters based in the north of the country would stand to lose significantly in financial terms in the event of a Euro departure. There are already signs of a willingness to soften; Di Maio and Salvini have suggested that many of the proposals in the budget would come into effect in a piecemeal manner. Furthermore, the rise in popularity of Salvini's anti-migrant Northern League potentially leaves room for the EU to address the situation by answering the migrant situation but pushing back harder on the financial demands.

Italy's 10Y yield rose back above +3% in the last week of September to close the quarter at 3.15%. De Maio's comments from the penultimate week of the quarter that there is "no chance Italy will leave the Eurozone" appeared to have been completely forgotten. We are of the view that this situation, like many others, will blow over with time for the reasons above. The Guinness European Equity Income Fund holds no banks and only one company listed in Italy, the asset manager Azimut, which itself has just 3% exposure to Italian domestic equities by AUM (equities 44% of total AUM, of which Italian Equity is 6.5%).

Our focus on quality companies, characterised by persistently high cash returns and prudent balance sheets, means we do not need to spend much time worrying about noise.

Performance Drivers

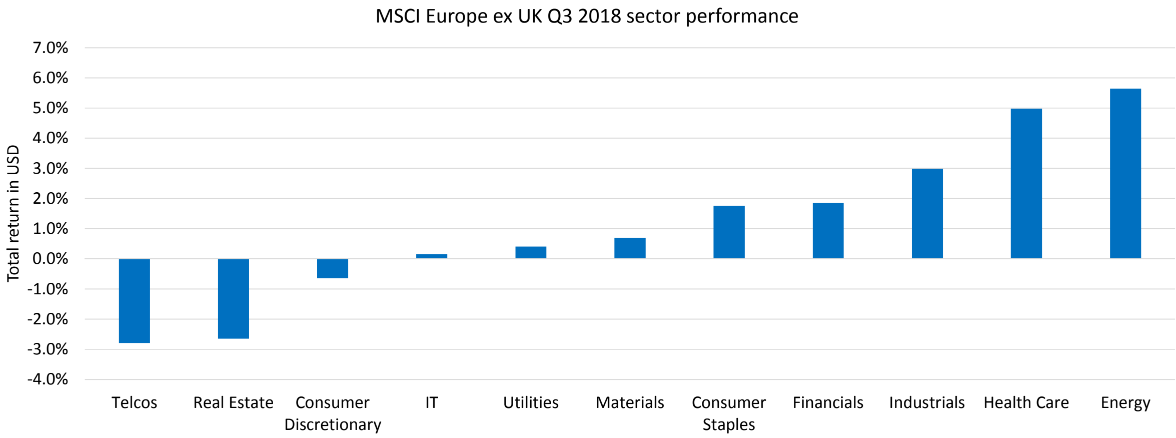


Chart 3: MSCI Europe ex UK Index sector total return breakdown for Q3 2018, in USD. Source: Bloomberg

Over the quarter, Energy, Health Care and Industrials performed well, while Financials gave up gains but still managed to close in positive territory despite the last-minute sell-off in European banks (to which the fund has no exposure) at quarter end. Telcos and Real Estate underperformed for the quarter as a cessation of concerns around a European trade war with the US saw investors rotate back away from more defensive sectors, and gradually rising bond yields proved a headwind for indebted companies and bond proxies. A notable example of this effect was Telecom Italia (6.5x Net Debt / EBIT - not held by the fund), which fell -18.4% over the quarter.

Shares of European-listed E&P companies benefitted from the continued strong run in oil prices, with Brent crude rising a further 4% over the quarter to $82.7/barrel. The Guinness European Equity Income Fund remains underweight the Energy sector due to its focus on long-term cash returns which excludes many of these companies from our investible universe. Shares of companies in the Health Care sector traded well, helped by supportive Q2 earnings. Industrials, where the fund is overweight, picked up on an alleviation of concerns about trade tariffs.

Positioning

The fund is characterised by a high 82% active share against the Europe Ex UK benchmark. A focus on companies with high and durable cash returns on capital employed means the fund has low or no exposure to capital-intensive sectors such as Materials, Utilities, Real Estate, Energy or to subsectors such as banks, while Consumer Staples, Communication Services and Industrials, in which the fund is heavily overweight (around 8%), contain many companies with such attractive characteristics.

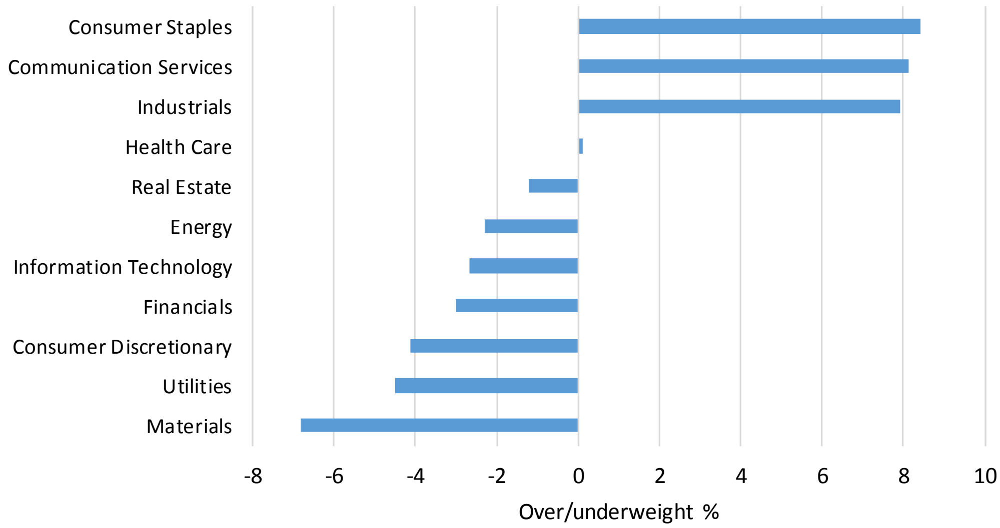


Chart 4: Sector weights of the fund versus MSCI Europe ex UK Index. Guinness Asset Management, Bloomberg (data as at 30.09.2018).

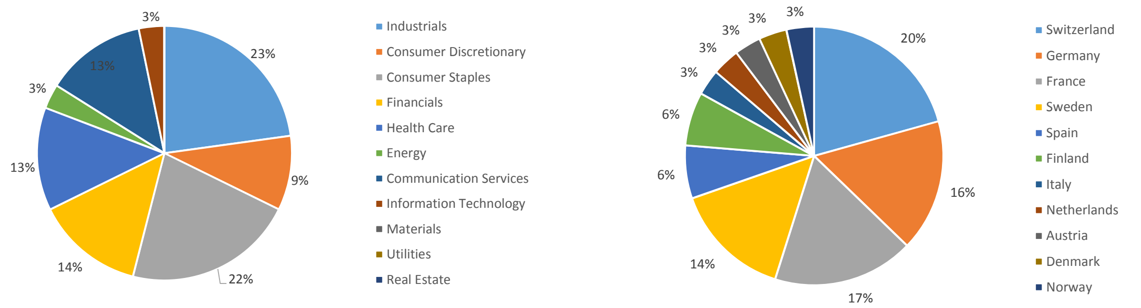


Chart 5: Regional and sector breakdown of the fund. Guinness Asset Management, Bloomberg (data as at 30.09.2018)

The Guinness European Equity Income Fund's country over and underweight positions result from a pull between two factors. France and Germany naturally represent high absolute weights in the index at 24% and 21% respectively, but it is also the case that we simply find a relatively greater number of high-quality companies with strong prospects in 'high IP' markets with good corporate governance such as Sweden and Switzerland.

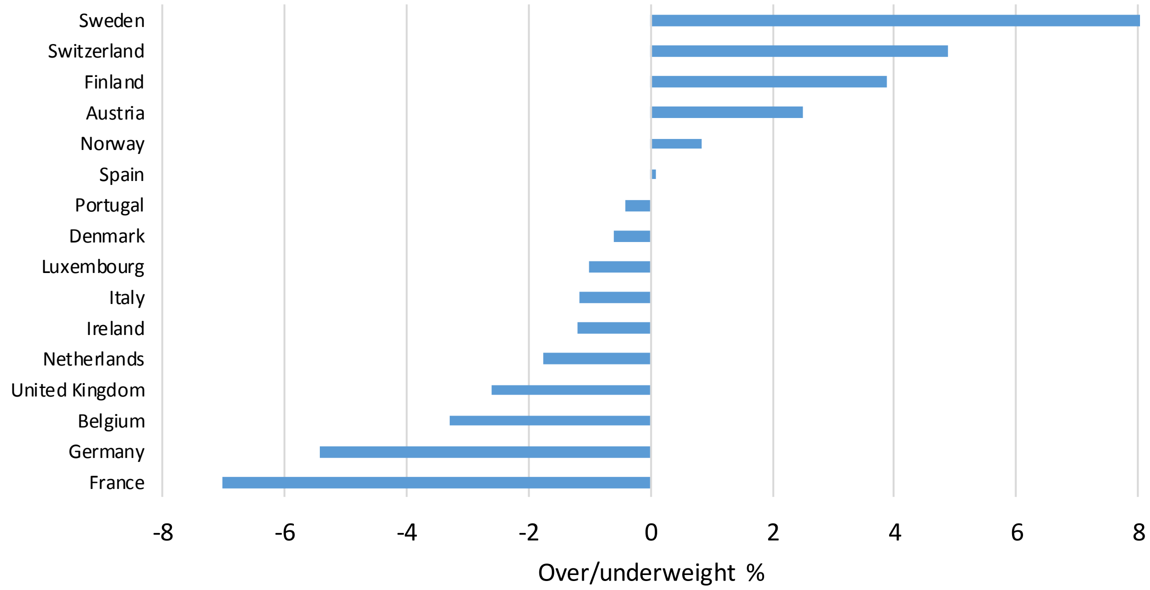


Chart 6: Regional breakdown of the fund versus MSCI Europe ex UK Index on a geographic basis. Guinness Asset Management, Bloomberg (data as at 30.09.2018)

We are fully cognisant of the potential for returns to improve in, for example, unloved French domestic equities. EU Politicians (such as Emmanuel Macron and Angela Merkel) and regulatory authorities (including the French telecoms regulator ARCEP) have been vocal recently in their encouragement of sector consolidation and the need to create European champions that can compete on a global stage with Chinese and US market leaders. We expect this dynamic may benefit several of our large-cap holdings.

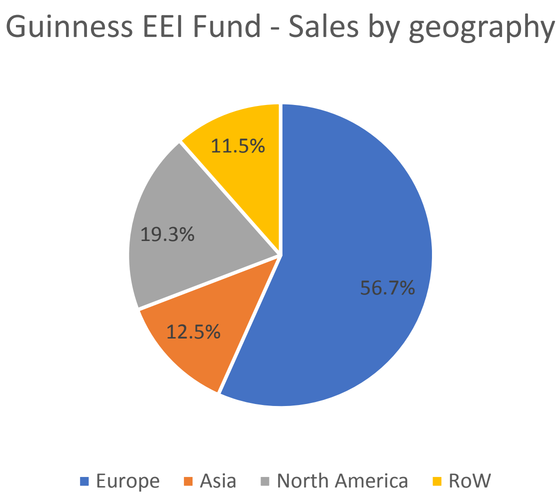


Chart 7: Sales exposure of fund holdings on a geographic basis. Guinness Asset Management, Bloomberg (data as at 30.09.2018)

The Guinness European Equity Income Fund holds a mixture of high-quality European listed international and domestically orientated companies. If the Euro does strengthen significantly in the future, or trade wars flare up, the fund is conservatively placed, with 57% of fund holdings' total sales deriving from Continental Europe itself. We view this number as more likely to rise than fall given the dual risks of Euro currency strength and trade barriers.

Individual Holdings

Individual companies that performed well over Q3 were Hennes & Mauritz AB, Salmar ASA and Novartis AG. Companies that had weaker performance over Q3 were Hugo Boss and Publicis Groupe SA.

Best 5 performing stocks	Total return
Hennes & Mauritz AB	24.0%
Salmar ASA	19.1%
Novartis AG	13.9%
Sanofi	10.9%
JM AB	10.0%

Worst 5 performing stocks	Total return
HUGO BOSS AG	-15.4%
Publicis Groupe SA	-13.1%
Modern Times Group MTG AB	-12.3%
Adecco Group AG	-10.9%
Freenet AG	-7.6%

Source: Bloomberg data

Hennes & Mauritz (+24%), the global fashion retailer, rebounded from lows in Q3 after we reweighted the holding at the lows to portfolio weight (3.33%, 30 positions). This followed a difficult period characterised by an inventory overhang and capex required to optimise the IT system. We are aware of the marginalisation of bricks and mortar retailers by online competitors and the fixed costs associated with operating leases. In the short-term however, the positive surprise looks likely to continue to feed through into the share price, as the company adopts a leaner and more efficient operating model.

Salmar ASA (+19.1%) continued its strong run in Q3, having cited an expectation for cost improvements and rising volumes at Q2. Despite Salmar's strong performance so far this year, we continue to like the stock and the subsector. Farmed aquaculture benefits from a notably superior feed conversion efficiency ratio versus other animal products, making it the fastest growing source of animal protein. The potential for scarcity of supply is high, given rapidly increasing demand from China and other emerging markets, which have consumption levels well below those in developed markets. Current annual EU consumption of salmon stands at approximately 1mmt; in the US it is <500kt, while in China it is closer to 150kt. If US and Chinese consumption alone were to converge on European levels of around 2kg per capita (DNB), this could add another 1mmt to demand. We also note the 2013 acquisition of Smithfield Foods by China's Shuanghui International, which was motivated by security of porcine supply in China.

Novartis (+13.9%) is a global pharmaceutical company. The new CEO Vas Narasimhan is in the process of making significant changes to its portfolio which should result in an improved cost position, greater visibility and higher returns. Following the spin-out of Novartis' 36.5% share of the consumer health joint venure to partner GlaxoSmithKline, there are plans to spin off lower-returning business lines Sandoz (generics) and Alcon (optical care). Sale of Novartis' 6% stake in Roche is also a possibility. The resulting direction of change, to quote the CEO, is towards "a medicines and data science company centred on innovation and access." On top of these portfolio changes the CEO estimates the potential to reduce costs by a quarter – a meaningful amount for a global blue-chip franchise. We think that patient investors should be rewarded as margins rebound and a more focused group emerges.

Hugo Boss (-15.4%) was the worst performer in the quarter. Hugo Boss is a premium fashion retailer with potential to make good returns on tangible capital. However, earnings growth has recently been lacklustre as the company has responded to softer physical store sales by investing in new collections, distribution centres and in online. Cash flow and visibility should improve as these measures take effect, and in the shorter term there is potential that summer trading has been better than feared, as we have seen at H&M. Boss estimates that it can improve retail sales productivity in from €11,100/m2 in 2017 to around €13,000/m2 over the next three years.

The company markets under two related brands, Boss and Hugo; the former focused on formalwear and the latter on casualwear. By geography, 62% of 2017 sales came from Europe (within which Germany was 18%, GB 12% and France 6%), the Americas account for 21% (US 15%, Canada 3% and Central & South America 3%) and Asia Pacific 14% (China 8% and Japan 2%). Sourcing was largely split between Asia (38%) and Eastern Europe at (44%). In 2017 the split between Retail and Wholesale was 63% and 34% respectively. Dividend policy is to pay out between 60% and 80% of net income. Leverage was zero at year-end 2017, or 1.3x adjusted for operating leases. Importantly for alignment of interests, company employees own 2% of shares outstanding, while Italy's Marzotto family own 10% of shares through Zignago Holding S.p.A. Q3 2018 results are scheduled for November 6th, followed by the investor day in London on November 15th.

Publicis (-13.1%) has a long track record of generating consistent high returns on capital. In the short term, returns have been dampened by a rise in capex as the company invests to lead in digital advertising. Despite some €350m attrition to mature business, Publicis sees potential for €1.5bn of revenue in 2020 vs. €850m in 2017 as its Data and Digital Business Transformation lines win new clients and cross-sell to existing clients. Alongside this, Publicis is in the middle of some €450m of cost reductions through to 2020 as it adapts to the changing and increasingly online landscape. These measures include a mixture of headcount adjustments, automation, shared costs and client portfolio adjustments, which should result in organic growth returning towards the 4% mark by 2020 and margin improvement of 30-50bps per annum. The group has headroom for up to €300-500m of bolt-on acquisitions per annum through to 2020. With the stock on a current year PE of just 10.8x and offering a dividend yield of 4.1%, there is plenty of room for multiple expansion if confidence in this global market leader improves. By geography some 55% of sales stem from North America and 29.2% from Europe, leaving shareholders positively exposed to a stronger USD but relatively negatively disposed to possible strengthening of the Euro.

Key Fund Metrics Today

The four key tenets to our approach are: quality, value, dividend, and conviction. We follow these metrics at the portfolio level to make sure we are providing what we say we will. At the quarter end we are pleased to report that the portfolio continues to deliver on all four of these measures relative to the benchmark MSCI Europe ex UK Index.

		Fund	MSCI Europe ex UK Index	Difference
Quality	Average 8 year CFROI %	15.0	10.8	4.2
	Weighted average debt / equity %	40.7	65.4	-24.7
	ROE %	23.8	11.5	12.2
Value	PE (2018e)	15.3	14.8	0.5
	FCF Yield (2017) %	5.8	5.3	0.5
Dividend	Dividend Yield (LTM) %	3.9	3.4	0.5
	Weighted average payout ratio %	0.46	0.59	-0.13
Conviction	Number of stocks	30.0	344.0	-314
	Active share	81.0	NA	High

Chart 8: Portfolio metrics versus index. Guinness Asset Management, Credit Suisse HOLT, Bloomberg (data as at 30.09.2018)

Outlook

With the increasing influence of geopolitics on market returns and volatility, we believe that our approach to finding quality companies at low to fair valuations is more important than ever. We are pleased to note that our high-conviction fund has companies which are on better quality at better value versus the index.

We also believe that now is a good time to be invested in European equities:

- European leading indicators are mostly improving while global indicators roll over.
- The Eurozone trade and current account surplus continues to grow.
- MSCI Europe ex. UK on a PE of 16.2x trades at a wide discount to the S&P500 on 21.1x.
- The potential for European returns to improve is higher than in the US, with double the number of listed companies for a similarly-sized market. On top of this, there is a growing move at the policy level to encourage cross border M&A and the creation of global champions.

We will continue to work hard to deliver long-term capital growth and a steady, growing income stream. The Guinness European Equity Income Fund offers an attractive mix of high-quality companies with a global opportunity set, and more domestically-focused companies shielded from the risks of trade and currency wars, where returns have potential to benefit from European market consolidation.

We thank you for your continued support.

Dr Ian Mortimer, CFA and **Matthew Page, CFA** (portfolio managers) **Nick Edwards** (analyst)

Data sources

Fund performance: *Financial Express, total return*

Index and stock data: *Bloomberg*

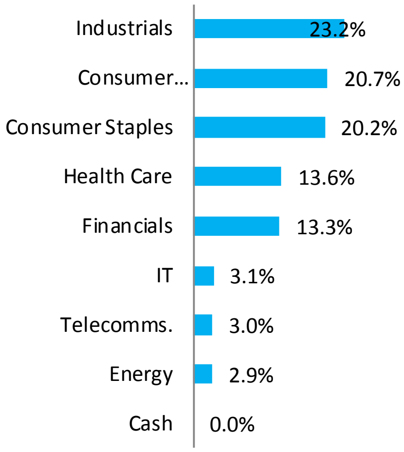
PORTFOLIO

30/09/2018

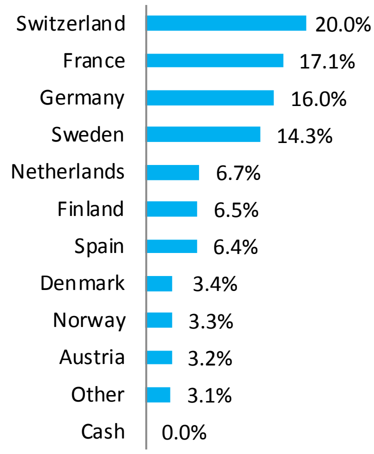
Fund top 10 holdings

Hennes & Mauritz	4.4%
Sanofi	3.5%
Danone	3.5%
Mapfre	3.5%
Unilever	3.4%
Konecranes	3.4%
Siemens	3.4%
Novo Nordisk	3.4%
Axfood	3.4%
Schneider Electric	3.4%
% of Fund in top 10	35.2%
Total number of stocks	30

Sector analysis



Geographic allocation



PERFORMANCE

30/09/2018

Annualised % total return from launch (GBP)

Discrete years % total return (GBP)	Sep '14	Sep '15	Sep '16	Sep '17	Sep '18
Fund	-	1.3	28.9	16.1	0.4
MSCI Europe ex UK Index	5.6	-1.6	20.0	21.5	1.4
IA Europe ex UK sector average	4.0	3.6	18.4	21.9	1.9

Cumulative % total return (GBP)	1 month	Year-to-date	1 year	3 years	5 years	From launch
Fund	-1.4	0.7	0.4	50.2	-	49.8
MSCI Europe ex UK Index	-0.5	1.3	1.4	47.7	53.5	48.5
IA Europe ex UK sector average	-1.4	0.9	1.9	47.0	58.5	52.8

RISK ANALYSIS

30/09/2018

Annualised, weekly, from launch on 19.12.13, in GBP	Index	Sector	Fund
Alpha	0.00	1.69	1.30
Beta	1.00	0.87	0.89
Information ratio	0.00	0.13	0.08
Maximum drawdown	-17.99	-14.98	-16.49
R squared	1.00	0.86	0.88
Sharpe ratio	0.36	0.44	0.42
Tracking error	0.00	5.05	4.75
Volatility	13.59	12.76	12.88

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: 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 European 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 Europe 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 European 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.