

Guinness Best of China Fund

INVESTMENT COMMENTARY – November 2018

Launch date	15.12.15		
Team	Edmund Harriss (manager) Mark Hammonds (analyst) Sharukh Malik (analyst)		
Aim	<p>Guinness Best of China Fund is designed to provide investors with exposure to economic expansion and demographic trends in China and Taiwan.</p> <p>The Fund is managed for capital growth and invests in profitable companies generating persistently high return on capital over the business cycle</p>		
Performance	31.10.18		
Fund	Best of China Fund		
Index	MSCI Golden Dragon		
Sector	IA China/Greater China		
	1 year	3 years	From launch
Fund	-13.4	-	46.2
Index	-10.3	47.8	54.0
Sector	-13.0	39.7	42.6
Annualised % total return from launch (GBP)			
Fund	14.1%		
Index	16.2%		
Sector	13.1%		
Risk analysis (annualised, weekly, from launch)			
	Index	Sector	Fund
Alpha	0.0	-2.1	-1.2
Beta	1.0	1.0	1.0
Info ratio	0.0	-0.5	-0.3
Max drwn	-17.8	-21.7	-22.2
Tracking err	0	5	6
Volatility	18.4	18.4	18.5
Sharpe ratio	0.6	0.4	0.5
<p>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.</p> <p>Source: Financial Express, bid to bid, total return 0.74% OCF. Returns for share classes with a different OCF will vary accordingly</p>			

Fund & Market

- In October, the Best of China Fund fell 8.9% (in GBP) while the MSCI Golden Dragon Net Total Return Index fell 9.7%.
- Markets were weak globally; the S&P 500 fell 4.7% and MSCI Europe fell 5.7%. Companies in the US, especially in the Technology sector, are being hit hard if growth is perceived to be slowing.
- Notable outperformers in the fund were Pacific Textiles (apparel manufacturer), Vtech (manufacturer of toys) and China Overseas Land & Investment (real estate).
- Weaker stocks were Elite Material and AAC Technologies (smartphone components), Haier Electronics and New Oriental Education (discussed later).
- Valuations in China are beginning to approach the lows seen between 2012 and 2016. MSCI China is currently trading at 11.1x 2019 earnings and MSCI Taiwan is on 12.7x. While MSCI Hong Kong is trading at a relatively higher level of 14.0x, this represents one standard deviation below its historic average.
- The fund now trades on a price to earnings multiple of 9.9x, based on estimated 2019 earnings, while the fund's discount to the benchmark is 9%.

Events in October

- Economic growth for the third quarter of 2018 slowed to 6.5% compared to 6.8% in the first quarter and 6.7% in the second. Economic data points to a slowdown in some areas. Notably the Politburo has explicitly acknowledged the "downward pressure"

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the economy is facing and its aim is to ease policy. The trade-off will be between supporting growth and preventing financial excess from building up within the system. Our view is that policymakers know that the risks of debt-fuelled investment will undo the past two years of work on deleveraging. The focus will be on loosening policy in some areas but keeping a vigilant eye on speculative bubbles.

- The required reserve ratio was cut by one percentage point, the third time it has been cut this year. Policymakers are trying to channel much of the resulting extra liquidity to small and medium enterprises (SMEs), which drive the bulk of economic growth but generally find it harder to obtain credit. The problem for many of the state-owned banks is that they are used to lending to larger state-owned firms which they know well. These banks often do not have good enough information to rate the credit quality of SMEs and so are reluctant to lend to them.
- The Chinese shadow banking system, although it in some aspects grew out of control, was and will continue to be an important source of funding in China. The delicate balancing act is to rein in the more speculative parts of the system (e.g. most of the internet peer-to-peer lending platforms) while allowing enough 'sensible' credit to flow to firms who genuinely need it.
- The PBoC launched a credit enhancement facility to support private companies. The aim is to support good businesses which are battling short-term headwinds.
- The National People's Congress ruled to ease restrictions on share buybacks. Ping An Insurance announced a share buyback potentially worth \$15.8bn. The Chinese Securities Regulatory Commission (CSRC) launched a fund to invest in shares pledged as collateral for loans, aimed at preventing forced liquidation, which would further weaken prices.
- Export tax rebates on certain goods are to soon rise by between one and five percentage points. This follows rebates for other goods being cut in September.
- Reports indicate the vehicle purchase tax, currently at 10%, could be cut to 5%. This would apply to cars with engine sizes smaller than 1.6 litres, a segment which makes up 70% of the market. The tax was 5% in 2016 and 7.5% in 2017 before being increased to 10% at the beginning of 2018, so it is not surprising that the auto market has been weak this year.
- Tax rules are being changed to encourage greater consumption. The personal allowance will be increased and tax deductions are to be introduced for the first time. Deductions can be made for education, health care and care for the elderly.
- Relations seemed to be thawing between China and Japan. Shinzo Abe met Xi Jinping in China and a flurry of business deals was agreed. While there are still many unresolved issues between the two countries, it is clear Japan is hedging its bets given the unpredictability of policy coming out of the White House.

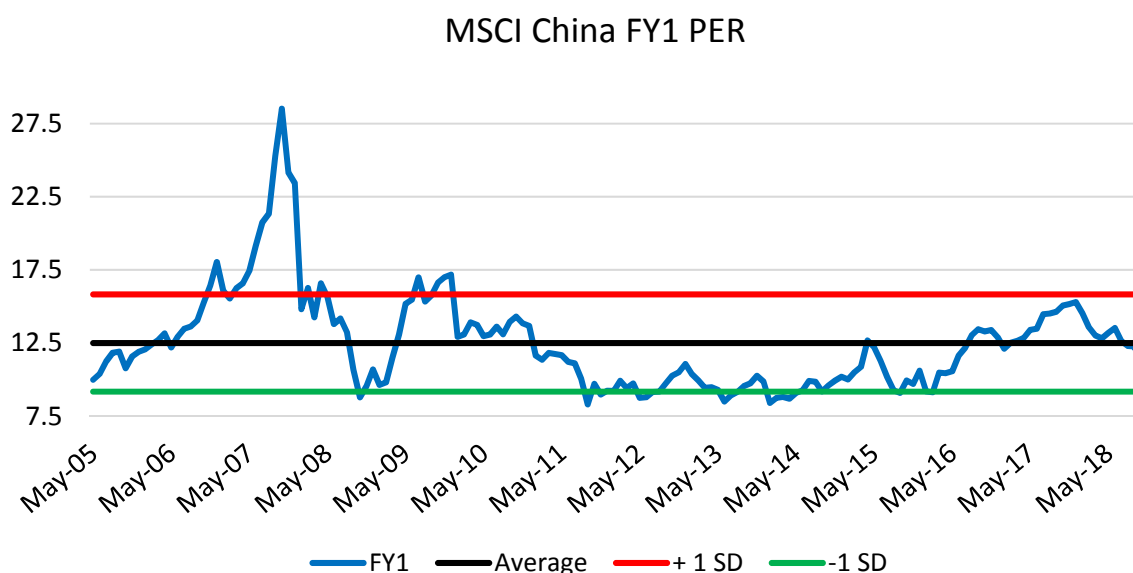
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- The Hong Kong-Zhuhai-Macau Bridge opened. It is the world’s largest sea bridge. This is one of the many steps China is taking on its path to linking together all of the cities in the Greater Bay Area, a region with a population of 67 million people.

Valuations

Valuations in the Greater China region are now approaching the lows of 2015 after a torrid period in markets. The chart below shows the forward Price to Earnings (PER) multiple for consensus expected (FY1) earnings compared to its 10-year average with bands showing +/- 1 standard deviation (for a normal distribution, +/- 1 standard deviation (SD) means that valuations should lie within these bands 68.27% of the time). At the end of October, valuations are heading towards the bottom of this range.

In contrast to the period 2010-2015, however, when Chinese earnings rose only 2.0% per annum on average, profits since 2015 have grown 15.4% on an annualised basis (MSCI China earnings 31 Dec 2015 – 11 Nov 2018).



Source: Bloomberg data, Guinness Asset Management

Portfolio update

Pacific Textiles was a notable outlier, rising 21.0% in what was otherwise a very weak month. The company produces apparel for companies including Uniqlo, M&S and Anta Sports. Until recently, the business had been facing problems in Vietnam where production in its factory had been suspended. Local residents were blocking the entrance to the industrial park where the factory is located because they were unhappy with their compensation for the land used for construction of the facilities. The problems were resolved in September 2017 and the business now seems to be growing. The importance of the Vietnamese factory cannot be understated; wages in Vietnam are significantly cheaper than in China. For any textile company, the future is no longer in China and is now in countries such as Vietnam and Bangladesh.

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New Oriental Education runs a tuition business catering to all segments of the market. The industry is very lucrative as deposits are paid before lessons begin and act a source of ‘float’ for the business. Over the past two years there has been a spate of IPOs in the sector (for both tuition and private schools) to take advantage of the potential growth opportunities. However, standards in the sector remain lax and there have been several public outcries in the broader education industry. The government has responded and is introducing several new rules to regulate the industry. For example, regulations now prevent foreign control of private schools. This barely affects New Oriental Education but has led to sell-offs for school operators in the sector. Approval is now needed to run tuition services over the internet, causing compliance costs to rise, while separately, marketing and staff costs are rising as the business expands. Although earnings growth may slow in the next year, we are not concerned because the company is keeping a close eye on the rate of expansion. In the past New Oriental was guilty of expanding too quickly at the expense of margins and return on capital. Management have learnt their lesson and we have every reason to believe that the growth in the business over the next few years will be sustainable.

In the current climate, it is easy to forget that there are structural growth opportunities such as, for example, cosmetics. Estee Lauder has recently seen sales in the Asia Pacific region grow 24% year-on-year which led to better-than-expected results. The CEO of L’Oreal does not see a slowdown in sales in China and sees “great appetite of Chinese consumers”. LG Household & Healthcare, which manufactures the increasingly popular Whoo line, saw sales in China rise 41%. China is an important region for many companies – we have highlighted in the past that for the likes of Nike and Starbucks, China is critical. There is a reason that Starbucks is planning on building 3,000 stores in China over the next five years. The growth of the Chinese consumer is real and though current conditions are slower, one must consider the outlook over the medium term, not just the short term.

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 9.9x based on estimated 2019 earnings, while the fund’s discount to the benchmark is 9%. We believe that now is a good time to be looking at investing in China as valuations have come down markedly since January.

Edmund Harriss (portfolio manager)

Mark Hammonds (analyst)

Sharukh Malik (analyst)

Data sources

Fund performance: *Financial Express*, total return
0.74% OCF in GBP

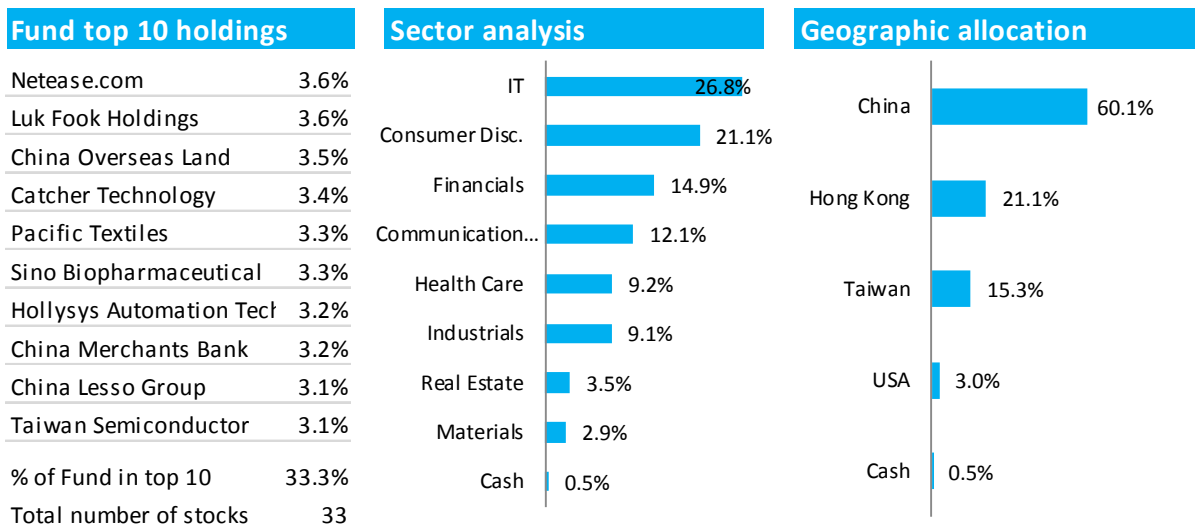
Index and stock data: *Bloomberg*

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Guinness Best of China Fund

PORTFOLIO

31/10/2018



PERFORMANCE

31/10/2018

Annualised % total return from launch (GBP)

Fund	Annualised % total return from launch (GBP)
Fund	14.1%
MSCI Golden Dragon Index	16.2%
IA China/Greater China sector average	13.1%

Discrete years % total return (GBP)

	Oct '14	Oct '15	Oct '16	Oct '17	Oct '18
Fund	-	-	-	25.2	-13.4
MSCI Golden Dragon Index	8.8	0.2	35.3	21.8	-10.3
IA China/Greater China sector average	5.3	2.3	29.7	23.8	-13.0

Cumulative % total return (GBP)

	1 month	Year-to-date	1 year	3 years	5 years	From launch
Fund	-8.9	-16.3	-13.4	-	-	46.2
MSCI Golden Dragon Index	-9.7	-11.0	-10.3	47.8	61.1	54.0
IA China/Greater China sector average	-11.0	-15.2	-13.0	39.7	50.6	42.6

RISK ANALYSIS

31/10/2018

Annualised, weekly, from launch on 15.12.15, in GBP	Index	Sector	Fund
Alpha	0.00	-2.14	-1.18
Beta	1.00	0.97	0.96
Information ratio	0.00	-0.54	-0.31
Maximum drawdown	-17.78	-21.67	-22.16
R squared	1.00	0.93	0.90
Sharpe ratio	0.61	0.44	0.49
Tracking error	0.00	4.77	5.95
Volatility	18.35	18.43	18.53

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Source: Financial Express, bid to bid, total return (0.74% OCF). Fund launch date: 15.12.2015.

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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.

GUINNESS

ASSET MANAGEMENT

Guinness Asset Management Ltd is authorised and regulated by the Financial Conduct Authority

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