# Guinness Best of China Fund

## INVESTMENT COMMENTARY – March 2019

| | |
|---|---|
| **Launch date** | **15.12.15** |
| **Team** | **Edmund Harriss** (manager)<br>**Mark Hammonds** (analyst)<br>**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

28.02.19

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

| | 1 year | 3 years | From launch |
|---|---|---|---|
| **Fund** | -12.8 | 59.1 | 53.4 |
| **Index** | -4.5 | 70.2 | 69.3 |
| **Sector** | -8.2 | 65.3 | 57.9 |

**Annualised % total return from launch (GBP)**


**Risk analysis** (annualised, weekly, from launch)

| | Index | Sector | Fund |
|---|---|---|---|
| **Alpha** | 0.0 | -2.2 | -2.2 |
| **Beta** | 1.0 | 1.0 | 1.0 |
| **Info ratio** | 0.0 | -0.6 | -0.5 |
| **Max drwdn** | -17.8 | -21.7 | -25.7 |
| **Tracking err** | 0 | 5 | 6 |
| **Volatility** | 18.5 | 18.6 | 19.0 |
| **Sharpe ratio** | 0.8 | 0.6 | 0.6 |

**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 February, the Best of China Fund rose 3.4% (in GBP, Z class) while the MSCI Golden Dragon Net Total Return Index rose 3.0%.
- MSCI Hong Kong (net total return of +4.7%) was the strongest market compared to 3.6% for Taiwan and 2.3% for China.
- The gains in Hong Kong were driven by the Financials (total return of +9.4%) and Consumer Discretionary (+5.3%) sectors. AIA Group, which makes up c.20% of the MSCI Hong Kong Index, was strong following regulatory approval to start work on expanding to Tianjin and Shijiazhaung. MGM China and Galaxy reported earnings which beat expectations.
- In China, the strongest sectors were Information Technology (+12.8%) and Consumer Discretionary (+7.4%).
- In Taiwan, the Information Technology sector, which makes up more than half of the index, was up 4.9%.

## Events in February

- The Chinese New Year festival started on February 5th. The timing of the New Year can affect economic activity leading to the event as well as after, so it is important to interpret economic data appropriately.
- Talks between China and the US seem to be progressing well. Robert Lighthizer and Steve Mnuchin went to Beijing to continue negotiations which was followed by Liu He travelling to Washington DC. It was here that Donald Trump postponed the increase in tariffs that were due to come into effect in March. Larry Kudlow said they

were "making great headway on non-tariff barriers" and "we have mechanisms with regard to enforcement, which, is – I think – unparalleled". Lighthizer said that as part of the enforcement of any deal, the Chinese are willing to meet regularly to address US complaints, with monthly meetings between lower-level officials and semi-annual exchanges between ministers. If the US were not happy with the arrangements, they would be able to act "proportionally but unilaterally".

- Lighthizer, however, cautions that he is looking for "significant structural changes" in China's economy in terms of the treatment of intellectual property and technology transfer, which suggests the Chinese will have to offer more than greater purchases of agricultural goods to cut the bilateral trade deficit.

- Credit growth, as measured by total social financing, came in higher than expected for January, at 10.4% compared to 9.8% in December. Delving deeper into the data, trust loans grew for the first time since February 2018, indicating the contraction in the shadow banking system may be over, for now. Given the weak economic data, policymakers are focusing on supporting growth, but the challenge will be in ensuring credit is not used for speculative purposes.

- Cracks are beginning to appear in the previously unified position against Huawei. 5G technology is coming and Huawei's equipment is regarded as equivalent to (or better than) Nokia's and Ericsson's and undoubtedly cheaper. Germany and the UK seem to be taking a more measured approach than the US.

## Market Update

MSCI announced it would increase the inclusion factor for A-shares from 5% to 20%, which means 20% of the relevant A-shares' free float-adjusted market capitalisation will be represented. This will happen in three steps, concluding in November 2019. Whereas the inclusion of A-shares in 2018 solely focused on large-cap shares, the coming changes will also include mid-cap and some ChiNext shares (which represent smaller, more innovative companies). This represents another step in China's integration with global financial markets. On a pro forma basis, A-shares' weight in the following indices would be as follows:

| | China A shares weight (current) | China A shares weight (Nov-19) |
|---|---|---|
| MSCI China | 2.5% | 10.4% |
| MSCI Asia ex. Japan | 0.9% | 4.0% |
| MSCI EM | 0.8% | 3.3% |
| MSCI AC World | 0.1% | 0.4% |

If we include Chinese shares (A-shares and Chinese shares listed in Hong Kong and the US), China's weight in the following indices would evolve as follows:

| | China shares weight (current) | China shares weight (Nov-19) |
|---|---|---|
| MSCI Asia ex. Japan | 35.9% | 38.0% |
| MSCI EM | 30.9% | 31.9% |
| MSCI AC World | 3.7% | 4.0% |

*Source: MSCI*

The direction of travel is clear, and investors will have to pay more attention to Chinese shares in their allocations. For the inclusion factor to increase even further, there are some operational issues that need to be resolved to satisfy institutional investors. Currently, A-shares have a settlement cycle of 0-1 days, which presents an operational problem. Once this issue is resolved, we expect the inclusion factor to increase.

We must also remember the Bond Connect which allows foreigners to buy onshore bonds. Foreign ownership of Chinese government debt, as a percentage of total government debt, is smaller in China than Thailand, Brazil, Turkey, Colombia, Poland and Mexico. One reason for this is because Chinese government bonds were historically not included in the main bond indices. However, from April 2019 onwards, Bloomberg will be adding renminbi government debt into the Bloomberg Barclays Global Aggregate Index. The process will be implemented over 20 months, and when fully accounted for, Chinese bonds will represent the fourth largest currency in the index. According to HSBC, this could result in $150bn of inflows into China's bond market. If FTSE Russell and JP Morgan did the same, close to another $300bn could follow. Note that the equity and bond flows should also lead to demand for the renminbi increasing, putting pressure on the currency to appreciate in the long term.

## Portfolio Update

After a weak January, Autohome was the strongest stock in the portfolio. In January the company increased prices for lead generation by at least 20%, with reports indicating some clients stopped dealing with Autohome as a result. During its earnings call covering fourth quarter results, however, management confirmed the reported clients were still working with Autohome. The company issued strong results for the quarter, with revenue growing 25% and operating income growing 49%. More importantly, it is still expecting revenues to grow in line with recent quarters even though the automobile market is weak. In January, retail sales of automobiles in China fell 4% while wholesale prices fell 17%. Dealers are responding to the weak market by reducing spending on sales channels with a low return on investment. This should help Autohome, as it is the dominant platform online. One estimate suggests dealers allocate 40-50% of their marketing budget online, with Autohome and Bitauto capturing half of this. Autohome is a critical platform in China and cannot be ignored – it is big enough to benefit from the network effect. The business is also growing its exposure to the used car segment through its investment in the Tiantian Paiche platform. A newer part of the business, the commission earned through loans and insurance in conjunction with parent company Ping An, is notably growing quickly.

Pacific Textiles announced it had completed building its piping network and tanks in its factory in Vietnam in order to meet the latest environmental requirements. Management are expecting the production level of the factory to reach 80-90% of capacity by April, a significant increase from the 40% level in November. The rise in utilisation should boost operating margins considerably and help Pacific Textiles diversify its customer base.

Netease reported results which broadly met expectations. Gaming revenue grew with mobile driving growth. Following the release of expansion packs for older titles, PC gaming grew by more than expected. Since gaming approvals resumed at the end of December, Netease has had one approved and has many waiting to be approved. Throughout 2019, as more games are approved, we expect Netease's revenue growth from this segment to accelerate. The e-commerce business continues to grow but is still operating at a loss. We are willing to give Netease time to grow this business – at a market share of 25%, it is now the second largest firm in China's e-commerce market for imported goods, only behind Alibaba's Tmall, with a market share of 37%. We note reports that Amazon and Netease are considering merging their e-commerce businesses in China. If this were to go through, the benefit of economies of scale should help the combined business become more competitive against Tmall.

Baidu reported growing revenues, but operating income fell due to higher spending on marketing. Baidu now has various apps and is spending more to attract users. It was, for example, the exclusive sponsor for CCTV's New Year Gala red packet campaign, where users could send a digital gift with an associated monetary value, but only on Baidu's apps. Some estimate the sponsorship will cost between RMB1,000m and RMB1,900m (equivalent to between $149m and $284m assuming USDCNY is 6.70). While this may seem high, the Gala is viewed by hundreds of millions of people – and reports indicate Baidu gained 300m users overnight.

In the smartphone supply chain, two of the Fund's companies, AAC Technologies and Tongda, put out profit warnings. It is well known that the smartphone market in China is currently weak and this is feeding through to suppliers. Nevertheless, we are looking further out to the future and we believe the market is undervaluing the returns these sorts of businesses are likely to generate. AAC should benefit from selling more advanced acoustics and haptics components as phones are upgraded. Tongda should benefit from being an early mover into glasstic casings (plastic casings which look like glass) as well as its continued partnership with Apple to supply waterproof components. If prices were to fall further from what we believe are depressed valuations, we will continue to add to these positions to take advantage of this pricing anomaly.

## 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 10.7x, based on estimated 2019 earnings, while the Fund's discount to the benchmark is 18%. Our companies earn well above the cost of capital; in 2017 the overall real return on capital (which excludes the effects of inflation) for the Fund's holdings was 14.8%. This is expected to be only marginally lower at 14.4% for 2018, which is comforting in a weakening macro environment. Our confidence in the future is based upon sustained profitability over many years covering the post financial crisis stimulus, numerous housing cycles, the four-year period of falling producer prices 2011-15, the mainland stock market bubble and the current slowdown.

**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*

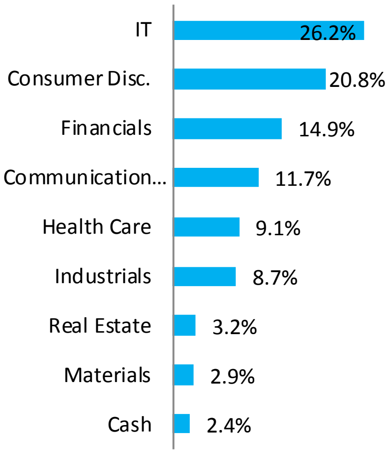
## PORTFOLIO

**28/02/2019**

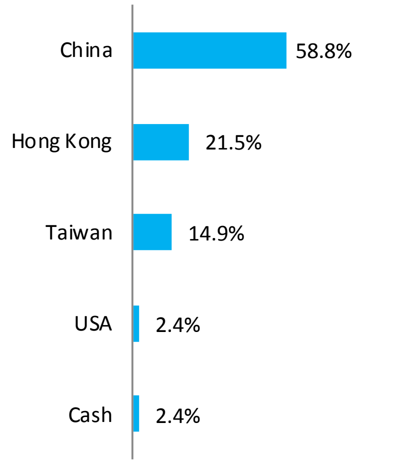
### Fund top 10 holdings

| | |
|---|---|
| Tongda Group Holdings | 3.4% |
| China Overseas Land | 3.2% |
| Sino Biopharmaceutical | 3.2% |
| Tencent Holdings | 3.2% |
| Li & Fung | 3.1% |
| China Lilang | 3.1% |
| Yangzijiang Shipbuilding | 3.1% |
| Novatek Microelectronics | 3.1% |
| Luk Fook Holdings | 3.1% |
| Noah Holdings | 3.1% |
| % of Fund in top 10 | 31.6% |
| Total number of stocks | 34 |

### Sector analysis




### Geographic allocation




## PERFORMANCE

**28/02/2019**

### Annualised % total return from launch (GBP)


| Discrete years % total return (GBP) | Feb '15 | Feb '16 | Feb '17 | Feb '18 | Feb '19 |
|---|---|---|---|---|---|
| **Fund** | - | - | 45.5 | 25.4 | -12.8 |
| MSCI Golden Dragon Index | 26.4 | -12.4 | 45.0 | 22.9 | -4.5 |
| IA China/Greater China sector average | 17.7 | -11.2 | 41.1 | 27.6 | -8.2 |

| Cumulative % total return (GBP) | 1 month | Year-to-date | 1 year | 3 years | 5 years | From launch |
|---|---|---|---|---|---|---|
| **Fund** | 3.4 | 10.2 | -12.8 | 59.1 | - | 53.4 |
| MSCI Golden Dragon Index | 3.0 | 8.1 | -4.5 | 70.2 | 88.4 | 69.3 |
| IA China/Greater China sector average | 3.5 | 9.5 | -8.2 | 65.3 | 72.8 | 57.9 |

## RISK ANALYSIS

**28/02/2019**

| Annualised, weekly, from launch on 15.12.15, in GBP | Index | Sector | Fund |
|---|---|---|---|
| Alpha | 0.00 | -2.23 | -2.23 |
| Beta | 1.00 | 0.98 | 0.98 |
| Information ratio | 0.00 | -0.58 | -0.46 |
| Maximum drawdown | -17.78 | -21.67 | -25.74 |
| R squared | 1.00 | 0.94 | 0.90 |
| Sharpe ratio | 0.78 | 0.60 | 0.59 |
| Tracking error | 0.00 | 4.62 | 6.04 |
| Volatility | 18.46 | 18.63 | 19.00 |

**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.