Guinness Asian Equity Income Fund

INVESTMENT COMMENTARY – April 2019

Launch date	19.12.2013
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Aim

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

Performance

31/03/2019

Fund	Guinness Asian Equity Income (Y)
Index	MSCI AC Pacific ex Japan Index
Sector	IA Asia Pacific ex Japan

	2016		2017		2018	
	USD	GBP	USD	GBP	USD	GBP
Fund	7.5	28.2	36.5	24.6	-15.5	-10.3
Index	7.8	28.6	37.3	25.4	-14.5	- 9.2
Sector	5.3	25.7	37.2	25.3	-15.1	- 9.8

	YTD		1 year		From launch	
	USD	GBP	USD	GBP	USD	GBP
Fund	12.9	10.3	-3.8	3.6	50.6	89.1
Index	11.9	9.4	-4.3	3.0	31.9	65.7
Sector	11.7	9.2	-4.3	3.1	32.1	65.8

Annualised % total return from launch

	USD	GBP
Fund	8.1%	12.8%
Index	5.4%	10.0%
Sector	5.4%	10.1%

Risk analysis (annualised, weekly, from launch)

	Index		Sector		Fund	
	USD	GBP	USD	GBP	USD	GBP
Alpha	0	0.0	0.6	1.2	3.7	4.1
Beta	1	1.0	0.9	0.9	0.8	0.9
Info ratio	0	0.0	0.0	0.0	0.5	0.5
Max drwdn	-29.3	-26.4	-26.7	-24.5	-24.3	-20.6
Tracking err	0	0.0	3.6	3.6	5.8	5.8
Volatility	14.9	15.2	13.5	13.5	12.8	13.9
Sharpe ratio	0.1	0.4	0.1	0.5	0.4	0.7

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, Y class 0.99%, bid to bid, total return.

Fund & Market

- Asian markets ended the quarter 9.4% higher in GBP terms (14.2% in EUR and 11.9% in USD) as measured by MSCI AC Pacific ex Japan net return Index.

- The main market drivers were low valuations following the global sell-off at the end of 2018, the Federal Reserve's reversal of course on interest rates, and improving narrative surrounding US-China trade talks and the deferral of additional tariff measures.

- Fund performance was initially driven by a 'relief' rally but pushed higher as company results came through in February and March.

- Over the quarter the best performers were IT names Elite Material, Largan Precision and Novatek Microelectronics. These were followed by retailer China Lilang, China Merchants Bank, Janus Henderson and Corporate Travel (both listed in Australia) and then by Yangzijiang Shipbuilding and JB HiFi.

- On the weaker side, Public Bank in Malaysia was the only decliner. The other main laggards were KT&G Corp, Pacific Textiles, Qualcomm, AAC Technologies, Hanon Systems, Hon Hai and Chinese banks ICBC and China Construction Bank.

- Leading regional markets and sectors in the quarter were China/Hong Kong and Australia/New Zealand and Consumer Discretionary, Real estate, Materials and IT.

- Lagging markets were the south-east Asian markets, with Malaysia barely moving, and Korea/Taiwan. Lagging sectors were Utilities, Health Care, Industrials and Financials.

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Events in March

- US-China trade talks remain front of mind and there is clearly impetus from both sides towards reaching a conclusion.

- The Federal Reserve confirmed its change of course on interest rates, saying they could be on hold for "some time" as its focus shifted to global risks. They have also decided to slow the pace of drawing down the central bank's bond holdings.

- Thailand held its first election since 2014. It seems likely that the new government will be pro-military, which amounts to a continuation of the last five years, with a democratic veneer. This will not lead to any change to the Fund's Thai exposure.

- Weakness in Europe as seen by the drop in German industrial activity is weighing on Korea and Taiwan trade in both technology and machinery. Both countries report slowing industrial production.

- Commodity prices rose, with alumina, iron ore and oil up 3%-5% in March.

- The US Dollar index strengthened in March, but this was largely explained by Euro weakness; Sterling and the Japanese yen both strengthened. In Asia, currencies were largely unaffected with the exceptions of a weaker Indonesian rupiah and Philippine peso.

With their rise this year Asian markets have recovered the losses incurred since 30 June 2018. We have observed across global markets that quality names have done well in the rally where we might have expected 'distressed' companies to have led. This leads us to believe that behind the apparent bullishness there is nervousness about what may lie ahead. We can see weakness coming out of Europe and the further deferral of expectations for a normalisation of monetary policy. This is also evident in the reappearance of negative bond yields in Europe, including among some of the high-grade European corporate bonds. We also see this nervousness in the recent change in US monetary policy direction, where the prior focus on domestic strength has now broadened to take account of global risks.

Some of these risks were deemed by markets to have diminished a little following the release of China's Purchasing Managers Index (PMI) data. This measure seeks to provide a measure of manufacturing activity and outlook where a reading above 50 denotes expansion and below, contraction. The components of the index include measures of output, new orders, employment, supplier times, inventory, export orders among others, all expressed in terms of expansion or contraction. In China, this indicator of industrial health jumped back into expansion after four months of weakness and was led by domestic output, new orders and services, while the export side remained weak. It appears that China's efforts to support the domestic economy as growth slowed last year (one of the factors behind the market sell-off) are beginning to bear fruit.

Other interesting data concern the impact of the trade dispute between China and the US on the Asia region. We discussed last month how the US is losing approximately $40 billion of exports to China on

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an annualised basis out of the total of $130 billion, but China of course, is losing too. We can see from US data that the import prices of goods from China are holding up, suggesting that US consumers are bearing the costs of tariff increases and that the impact on China is felt through lower volumes. This is consistent with the contraction in export orders reported in China's PMI data discussed above. However, while China's exports to the US have fallen, its exports to the rest of the world are stable.

Moreover, in emerging Asia, exports from the region into China have dropped while trade with the US and within the region excluding China has also been stable. It suggests that supply chains are evolving, something that has been underway for a while, and this evolution has accelerated since the trade dispute intensified. If we were to identify one major beneficiary, it would be Vietnam. There are still plenty of bottlenecks in Vietnamese production including the availability of skilled labour and the development of industrial clusters that are a significant and hard-to-replicate element of China's competitiveness. But Vietnam is following China's template and is busily scooping up the lower-end manufacturing that China is in fact happy to lose.

Our summary view of the trade issue is that it is unlikely to de-rail the Asian manufacturing story. What it will do is speed up the alteration in structure. China has sought to divest itself in recent years of lower-end, labour and material-intensive manufacturing in favour of higher-value-added, capital-intensive production which better reflects the changing stages of demographic and economic development. This restructuring process has accelerated, and we expect it to accelerate the rise of nations such as Vietnam, Cambodia and Laos which are likely to follow the Chinese development model. On the immediate question of resolution, our view remains that both sides have moved beyond the megaphone stage and into the negotiation process with a view to avoid further intensification. The costs are evident to the US, to China and to world trade and world growth – and there is a US presidential election coming up soon.

Portfolio change

We have made a change to the portfolio with the purchase of China Medical Systems to replace **Delta Electronics (Thailand).** Delta is in process of being taken private by its largest shareholder, Delta Electronics of Taiwan. The process has been agreed and the share price has hit a ceiling, so we decided to sell rather than wait for the corporate action to complete.

China Medical Systems is a stock we have been watching for a while. The company acts as a pharmaceutical distributor to doctors and hospitals for both branded and generic drugs. The regulatory structure in China is changing as the government, as with governments everywhere, seeks to reduce healthcare costs. The changes have introduced significant new competition, with alternative offerings available resulting in substantial price cuts in certain cases. China Medical Systems has seen a significant drop in its share price which we believe significantly exceeds its exposure to these changes. In addition, the company has tied up with companies in the US, UK, France, Switzerland and Israel to secure rights to sell formulations to treat strokes, brain cancer and respiratory distress down to onychomycosis (toenail fungus, which we needn't dwell on). The recent 2018 results delivered the consistency we look for: gross profit, operating profit, net profit and dividend growth all moving in line, up 10.5%-12.5%, and an unchanged dividend payout of 40% of earnings.

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Portfolio update

DBS Group in Singapore reported good results back in February and releases its annual report at the end of March. We are very happy with this position and think that the market has overlooked the potential for this business. The bank reported the highest return on equity (net profit divided by equity) since 2007 at 12.1%, which is impressive given the increased capital adequacy requirements imposed on banks over the last 10 years. The earnings outlook remains very positive. Valuations, however, remain well below the historic average. We think that investors are concerned about the impact of the trade dispute between China and the US and have underestimated the progress DBS has made in developing its technology platform. In the annual report the chairman addressed the first concern by noting not only that the proportion of China's economy represented by trade has shrunk, but that the US share is now down to c.19%. He also observed that while China's competitive advantages mean that supply chains are unlikely to see a sudden shift, those that do are likely to remain in the region and that this would have a minimal impact on DBS's business. This is in line with argument we made above. The cost reductions, stability and asset quality, especially in China, and improved profitability speak to the success the bank has made with its technology investment and integration. The ordinary dividend for 2018 increased 30%, in line with a 28% growth in net profit.

Chinese banks mostly issued preliminary results in the earlier part of the year. More detail has come out since then which makes us happy to continue holding them. In sum, net profit was slightly lower than expectations but balance sheet quality improved. The key metrics that we focus on are profits before provisions, which grew 10%, to assess profits from operations; and on the balance sheet side we focus on non-performing loan recognition and write offs. A tightening on the balance sheet side should be reflected in higher provisioning costs in the income side which will mean lower net profits, which grew 5%. However, if operating profits are strong enough at the pre-provision level then the banks can afford to address the bad debt issues more aggressively, which is what they have been doing. Reported non-performing loans (NPL) are still around 1.5%, not much changed from the level in 2013, but adjusted for those the banks have disposed of or written off, the figure is 6%. Over the last five years banks have increased their clean-up efforts and year by year the NPL level adjusted for disposals and write-offs has risen by around 1% per annum.

This is in line with the argument we have made over the last five years, that the China bank clean-up is a 10-year project, not a two-year project; that the write-downs will progress as profitability allows and that stability can be maintained because of the domestic nature of both debt and bank funding sources. The low valuations of Chinese banks, in our opinion, have represented a wider misunderstanding of China's domestic debt dynamics and have presented us with an opportunity.

Our investment case for holding shares in China Construction Bank, ICBC and China Minsheng Bank is that we believe them to be undervalued because of concerns about balance sheet strength and doubts about the ability and willingness of managements to address it. In the recent results we have seen faster loan write-offs and tighter non-performing loan recognition, which should be supportive of our valuation argument. The net profit number is therefore more a function of how aggressive the banks are willing to be in provisioning. The steady growth of pre-provision operating profit lies behind the 5%-8% dividend growth seen from the big banks and strong growth in cash dividend (as opposed to shares)

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delivered by Minsheng Bank. We do not expect to see much net profit growth while this is under way and thus the total return thesis is based upon valuation expansion and modest dividend growth.

Hon Hai Precision reported results on the last day of the quarter which beat expectations. The primary driver was cost-cutting, but there were also more positive signs, with additional smartphone orders coming through. Margins were also helped by lower prices for memory chips. The market has been looking for cost controls to deliver meaningful margin expansion and this appears to have come through in the last quarter of 2018 with gross margin 1% higher to 7% and operating margins back up to 3.6%. In recent news we hear that Foxconn Technology, a subsidiary of Hon Hai, is to trial production of the new iPhone in India at its facility outside Chennai. Apple is not a major player in the Indian smartphone market but has been facing increased pressure in China. India has 500 million smartphone users and 140 million devices were sold in 2018, many of them Chinese brands; only 1.7 million were iPhones.

China Mobile reported some uninspiring results with revenue, profits and dividend fractionally higher than last year. The focus remains on the personal mobile business where the company aims to develop 4G VoLTE, which puts voice traffic over the LTE network. LTE which is a data-only technology, unlike the 2G/3G connections which are currently used. VoLTE has three times the voice and data capacity of 3G and six times that of 2G and is an intermediate step before 5G technology. As we have noted previously, the 5G story is more about operators than consumers: it allows for greater capacity on the networks, which will allow greater speed and connectivity between devices, and is less about simply accelerating download speeds for smartphones. China Mobile's outlook for the coming year could best be described as cautious. There are no plans for additional capital management to reduce the substantial cash pile on the balance sheet.

Outlook

Trade issues remain to be resolved but there appears to be a growing impetus toward reaching an accommodation. The best outcome we think will be a pause on escalation and a period of assessment. A wholesale tariff roll-back seems unlikely to us.

In the technology sector it appears that managements in both the US and Asia are pinning their hopes on a recovery in the second half. To our minds there appears to be a lack of detail in precisely what these hopes are based on. An inventory adjustment seems to be part of the story, as new orders for components have been weak in recent months so presumably these will rise. However, we know that in the memory space conditions are difficult, prompting an unusual profit warning from Samsung Electronics. From our perspective, it is another reminder to focus on those names with unique selling propositions – for example, Largan Precision with its next-generation lenses; Novatek Microelectronics with its combined touch controller and display driver chips; and Elite Material with its environmentally-friendly halogen-free laminate for printed circuit boards.

As for the rest, the structural themes of growing consumption and regionally-focused economic activity remain in place and we seek to capture these through leading companies in retail, health care, finance and manufacturing. We believe long track records of superior profitability are likely to show persistence and deliver a strong basis for us to take a view on valuations. The portfolio can be categorised as Large Company/Value but unlike many in the 'Value' category our strategy has incorporated profit growth

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which has been visible to investors in the form of dividend growth over time. At the time of writing the portfolio valuation is at a 17% discount to the market as measured by the MSCI AC Pacific ex Japan Index, and has earnings growth as forecast by the consensus of 7% per annum over the next two years.

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Data sources

Fund performance: *Financial Express, total return*

Index and stock data: *Bloomberg*

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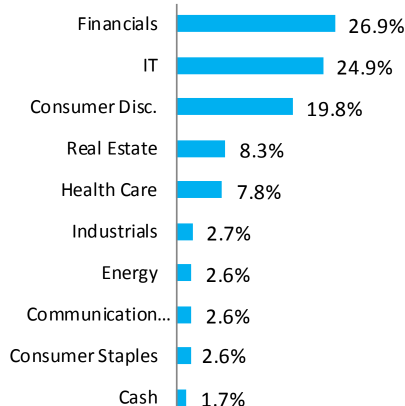
PORTFOLIO **31/03/2019**

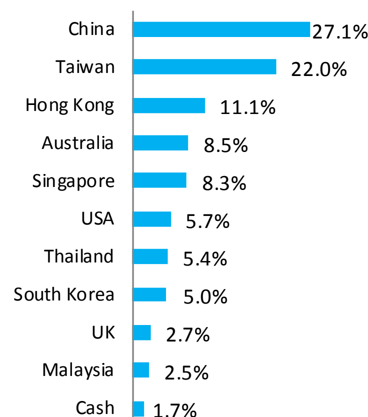
Fund top 10 holdings

Holding	%
China Lilang	3.4%
Elite Material	3.1%
China Merchants Bank	3.0%
Novatek Microelectronics	3.0%
Qualcomm	2.9%
Corporate Travel Management	2.9%
Ascendas Real Estate Trust	2.9%
JB Hi-fi	2.9%
Link REIT	2.8%
Li & Fung	2.8%
% of Fund in top 10	29.7%
Total number of stocks in Fund	36

Sector analysis



Geographic allocation



PERFORMANCE

31/03/2019

Discrete years % total return

	Mar '15		Mar '16		Mar '17		Mar '18		Mar '19	
	USD	GBP	USD	GBP	USD	GBP	USD	GBP	USD	GBP
Fund (Y class, 0.99% OCF)	-	-	-	-	17.6	35.2	20.8	7.6	-3.8	3.6
MSCI AC Pacific ex Japan Index	5.4	18.4	-11.4	-8.5	18.2	35.8	21.7	8.5	-4.3	3.0
IA Asia Pacific ex Japan	6.3	19.4	-11.0	-8.1	17.5	35.1	20.4	7.3	-4.3	3.1

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 (Y class, 0.99% OCF)	1.4	3.5	12.9	10.3	-3.8	3.6	36.7	50.7	50.6	89.1
MSCI AC Pacific ex Japan Index	0.9	3.0	11.9	9.4	-4.3	3.0	37.6	51.8	31.9	65.7
IA Asia Pacific ex Japan	1.4	3.5	11.7	9.2	-4.3	3.1	35.5	49.4	32.1	65.8

Annualised % total return from launch

	USD	GBP
Fund (Y class, 0.99% OCF)	8.1%	12.8%
MSCI AC Pacific ex Japan Index	5.4%	10.0%
IA Asia Pacific ex Japan	5.4%	10.1%

Risk analysis - Annualised, weekly, from launch on 19.12.2013

31/03/2019	Index		Sector		Fund	
	USD	GBP	USD	GBP	USD	GBP
Alpha	0.0	0.0	0.6	1.2	3.7	4.1
Beta	1.0	1.0	0.9	0.9	0.8	0.9
Information ratio	0.0	0.0	0.0	0.0	0.5	0.5
Maximum drawdown	-29.3	-26.4	-26.7	-24.5	-24.3	-20.6
R squared	1.0	1.0	0.9	1.0	0.9	0.9
Sharpe ratio	0.1	0.4	0.1	0.5	0.4	0.7
Tracking error	0.0	0.0	3.6	3.6	5.8	5.8
Volatility	14.9	15.2	13.5	13.5	12.8	13.9

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Source: Financial Express, bid to bid, total return. 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 Asian 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.

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Risk

The Guinness Asian 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 Asian 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.