# Guinness Best of China Fund

## INVESTMENT COMMENTARY – April 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.

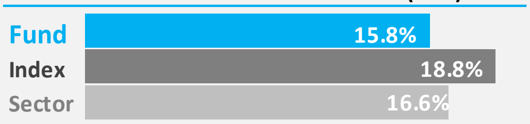
### Performance

31.03.19

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

| | 1 year | 3 years | From launch |
|---|---|---|---|
| **Fund** | -4.2 | 58.1 | 62.0 |
| **Index** | 3.7 | 65.7 | 76.6 |
| **Sector** | 0.9 | 63.5 | 65.8 |

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




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

| | Index | Sector | Fund |
|---|---|---|---|
| **Alpha** | 0.0 | -1.8 | -2.1 |
| **Beta** | 1.0 | 1.0 | 1.0 |
| **Info ratio** | 0.0 | -0.5 | -0.4 |
| **Max drwdn** | -17.8 | -21.7 | -25.7 |
| **Tracking err** | 0 | 5 | 6 |
| **Volatility** | 18.2 | 18.4 | 18.9 |
| **Sharpe ratio** | 0.8 | 0.7 | 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 the first quarter, the Best of China Fund rose 16.4% (in GBP, Z class) while the MSCI Golden Dragon Net Total Return Index rose 12.8%.

- In March, the Fund rose 5.6% outperforming the benchmark by 1.3%. China (with a net total return of +4.6% for MSCI China Index) was the strongest market compared to 4.4% for Taiwan and 3.5% for Hong Kong.

- The leading contributors to Fund performance in the quarter were Consumer Discretionary stocks China Lilang, New Oriental Education and Haier Electronics; IT names Novatek Microelectronics, Elite Material, Hollysys Automation and Vtech; Financial stocks China Merchants Bank and Ping An Insurance and Industrial stocks including China Lesso, Yangzijiang Shipbuilding and Haitian International.

## Events in March

- The government has set its growth target for the economy at 6.0-6.5%, lower than the target of ‘about 6.5%’ for 2018. The VAT rate for the manufacturing sector was cut from 16% to 13% and from 10% to 9% for the construction and transportation sectors.

- The government’s focus is on stabilising growth. The Caixin Purchasing Managers Index (PMI), which focuses on private rather than state enterprises, came in at 50.5 for March, indicating expansion for the first time since November 2018. The government is aiming for credit to grow in line with nominal GDP growth and while this year will not see a splurge in credit like we saw after the Financial Crisis, the impact of monetary policy will still be important.

- Looser fiscal policy to support growth is a new tool. In addition to cuts in VAT, the government has already raised the monthly personal allowance for income tax and increased the number of items eligible for tax deductions e.g. rent, education and healthcare.

- The Stock Exchange of Hong Kong and MSCI announced it would launch futures for the 421 A-shares that will be included in the MSCI Emerging Markets Index by September this year. This development will act as a challenge to the Singapore Exchange, which dominates trading on derivatives of the A share market.

- Trade talks between the US and China have continued with meetings in both Beijing and Washington. A deal does not look imminent since sticking points remain over intellectual property protections, state support for industry and enforcement of any agreement. Importantly, however, both sides are working toward a conclusion, and as long as that continues we do not expect to see an escalation of tensions.

- Italy formally endorsed China's Belt and Road Initiative, becoming the first G7 country to do so. Italy's GDP is expected to be flat this year and the prospect of greater trade with China, as well as greater investment, is appealing, but this has not been welcomed elsewhere in Europe. In a paper the European Commission called China a 'systemic rival' and its attitude towards China is hardening.

- China is also showing its political weight in other countries. Following the arrest of Meng Wanzhou, Huawei's CFO, in Canada, China has blocked shipments of canola oil from Canada's largest domestic exporter. Following Australia's decision to ban Huawei from its infrastructure for 5G, China has restricted its imports of coking coal. In 2018, more than 20% of Australia's coking coal exports went to China.

- Regulators gave approval to Chubb, a Swiss insurance provider, to take control of its domestic joint venture in China. Nomura and JP Morgan were also given approval to set up majority-owned brokerages.

## Market Update

A new securities market, the Science Technology Innovation Board (STIB), is to be launched with the aim of making it easier for private companies in innovative sectors to raise capital. It will reside in Shanghai and will differ from the existing Chinext board in Shenzhen in several ways. It is likely the STIB will act as a testing board for new rules which if deemed successful may be rolled out to the main exchanges:

- The system will be registration-based, not approval-based, which existing bourses use. Approval-based systems take much longer to complete – on average, the process is six months compared to two to three months in registration-based systems like in Hong Kong and the US.

- A quirk with current listings on the mainland is that domestic IPOs cannot be valued at more than 23x on a price/earnings ratio, using trailing earnings. Often this means a new issue will rapidly shoot up to what the market "thinks" it is worth. In the STIB system this cap will be removed.

- Daily price limits will be widened from the existing 10% to 20% after the first five days trading.

- Dual class structures will be permitted, presumably to encourage unicorns to list in China rather than in the US or Hong Kong.

- There is a stronger focus on corporate governance. Explicit rules cover information disclosure (a major problem in China) and disciplinary actions when rules are not followed.

## Portfolio Update

Most of the portfolio's companies reported earnings in March. China Lilang, which sells men's casualwear, reported strong profit growth. It launched a new smart casual collection targeting the younger end of its target demographic of 20-45-year-olds. The range is to be rolled out into the wealthier Tier 1 and Tier 2 cities in China, alongside the core range; while at the same time the core range is to expand into the so-called Tier 3 and Tier 4 cities. The new range is being distributed on a consignment rather than wholesale basis, meaning that distributors do not have to buy stock first but can place orders as they need and return unsold stock. This is sensible since it lowers the risk to distributors of the new range and limits the potential for inventory build-up.

China Lesso produces plastic pipes, pipe fittings and building materials. It also reported good results, showing it is no longer solely dependent on the property market. Management cited greater demand for pipes from the country's on-going shift from coal to gas. Efforts to tackle water pollution are also positive for the business as projects covering river treatment, soil restoration and water purifiers were cited. Lesso acquired a majority stake in Jiangsu Yongbao, which deals in the treatment of hazardous waste, wastewater and exhaust fumes. The stock has been cheap for some time, but Lesso's growth over the past eight years has been good. Revenue has grown 12% per annum, operating profit 10% and net income 8% per annum.

Elite Material has had a strong recovery this year as it is becoming more likely it will re-enter the iPhone supply chain. It produces copper-clad laminates used for printed circuit boards and specialises in halogen-free laminates which are environmentally friendly. Its Korean customers are likely to increase adoption of the newest laminate while the Chinese are expected to follow later this year.

On the other hand, weaker results were reported by Haitian International, Tongda and AAC Technologies. Haitian manufactures plastic injection moulding machines, which are subject to tariffs in the US. Despite this headwind, operating income only fell 3%. Sales of the company's main series fell, but this was mitigated by the fact that more customers are instead buying the company's electric machines. Haitian saw greater demand from Europe and emerging markets including Brazil and Russia. It has also just launched the latest generation of its products targeting the mid-to-high end of the market. The stock has outperformed this year as US-China trade discussion have progressed.

Two of our holdings in the smartphone supply chain, Tongda and AAC Technologies, updated the market. Tongda's traditional business is metal casings for smartphones in the low-to-mid section of the market. Customers here are moving away from metal and towards cheaper plastic casings which look like glass ('glasstic'). At the moment the margins on the glasstic casings are much lower than on metal casings, so profits fell in 2018, though management believe margins are expected to recover as production ramps up. We are willing to give the business time to recover as Samsung is a new client and should drive volume growth. We will be watching margins carefully during the next trading update.

AAC Technologies is going through a tough patch after releasing a profit warning at the end of February. It is facing more intense competition than we expected in the acoustics and haptics segments. The weakness in the smartphone market is causing pricing pressure down the supply chain and AAC is not immune to this. We continue to hold because we think that AAC is well positioned for the replacement cycle. As consumers buy newer phones, they will be buying products with more advanced speakers, in which AAC is strong.

## Summary view & outlook

Recent noises from China point to a more stable domestic economic environment in response to the various support measures that have been enacted since September as slower growth became more evident. The export side still looks weak, as most recently indicated by the new export orders component of the Purchasing Managers Index reported for March. It seems likely, therefore, that domestic policy will remain supportive. The programme of debt reduction continues but is being pursued less aggressively in favour of stabilising growth. This is in line with what we have said in the past – that debt reduction will take many years and the pace will fluctuate in response to economic conditions. De-leveraging places a drag on growth, so when conditions are favourable there is room for greater intensity; at a time of slower growth and trade uncertainty we would expect the pace to slow.

The portfolio has a strong China domestic bias. Average earnings growth for the next two years is 10.5% per annum based on current consensus estimates. This is better than the 7.5% per annum forecast for the market (as measured by the benchmark MSCI Golden Dragon Index). This is made more attractive still when we consider valuations. The fund's price-earnings multiple of 11.4x 2019 and 10.1x 2020 estimated earnings puts it at a 15% discount to the market at the end of quarter. We have all seen the improvement in the Chinese outlook this year, with global markets responding very positively. We believe that there remain plenty of uncertainties and that our focus on higher-quality companies, evidenced by their ability to sustain profitability over time, is fully justified.

**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*

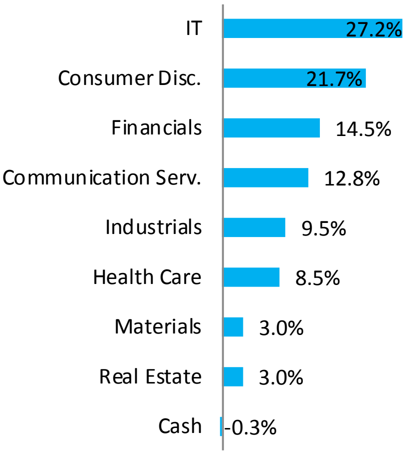
## PORTFOLIO

31/03/2019

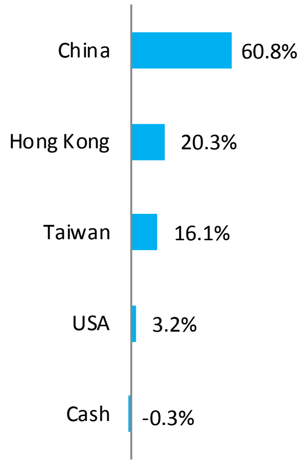
### Fund top 10 holdings

| | |
|---|---|
| Autohome | 4.0% |
| China Lilang | 3.6% |
| Elite Material | 3.6% |
| Novatek Microelectronics | 3.5% |
| China Lesso Group | 3.4% |
| Luk Fook Holdings | 3.3% |
| Ping An Insurance | 3.2% |
| Qualcomm | 3.2% |
| Sino Biopharmaceutical | 3.2% |
| Geely Automobile Holding | 3.2% |
| % of Fund in top 10 | 34.3% |
| Total number of stocks | 33 |

### Sector analysis



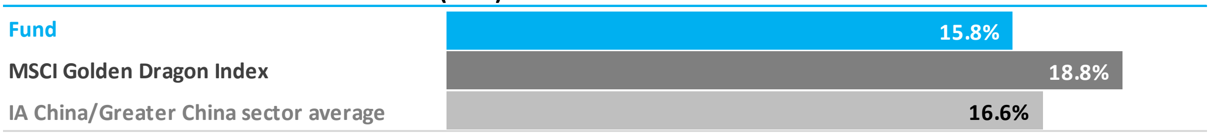

### Geographic allocation




## PERFORMANCE

31/03/2019

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




| Discrete years % total return (GBP) | Mar '15 | Mar '16 | Mar '17 | Mar '18 | Mar '19 |
|---|---|---|---|---|---|
| **Fund** | - | - | 42.7 | 15.6 | -4.2 |
| MSCI Golden Dragon Index | 33.2 | -10.9 | 37.7 | 16.0 | 3.7 |
| IA China/Greater China sector average | 28.5 | -11.5 | 36.0 | 19.1 | 0.9 |

| Cumulative % total return (GBP) | 1 month | Year-to-date | 1 year | 3 years | 5 years | From launch |
|---|---|---|---|---|---|---|
| **Fund** | 5.63 | 16.40 | -4.18 | 58.11 | - | 62.04 |
| MSCI Golden Dragon Index | 4.31 | 12.77 | 3.70 | 65.69 | 96.56 | 76.55 |
| IA China/Greater China sector average | 4.50 | 15.00 | 0.94 | 63.50 | 86.07 | 65.84 |

## RISK ANALYSIS

31/03/2019

| Annualised, weekly, from launch on 15.12.15, in GBP | Index | Sector | Fund |
|---|---|---|---|
| Alpha | 0.00 | -1.78 | -2.06 |
| Beta | 1.00 | 0.98 | 0.98 |
| Information ratio | 0.00 | -0.48 | -0.42 |
| Maximum drawdown | -17.78 | -21.67 | -25.74 |
| R squared | 1.00 | 0.94 | 0.90 |
| Sharpe ratio | 0.80 | 0.65 | 0.62 |
| Tracking error | 0.00 | 4.62 | 6.01 |
| Volatility | 18.24 | 18.42 | 18.85 |

**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.