Guinness Best of China Fund

INVESTMENT COMMENTARY – June 2019

Launch date	**15.12.15**
Team	**Edmund Harriss** (manager) **Mark Hammonds** (analyst) **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.

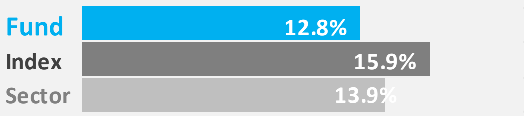
The Fund is managed for capital growth and invests in profitable companies generating persistently high return on capital over the business cycle.

Performance 31.05.19

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

	1 year	3 years	From launch
Fund	-15.6	54.6	51.5
Index	-7.7	60.8	66.8
Sector	-11.6	58.3	56.9

Annualised % total return from launch (GBP)



Risk analysis (annualised, weekly, from launch)

	Index	Sector	Fund
Alpha	0.0	-1.7	-2.4
Beta	1.0	1.0	1.0
Info ratio	0.0	-0.5	-0.5
Max drwdn	-17.8	-21.7	-25.7
Tracking err	0	5	6
Volatility	18.2	18.4	19.0
Sharpe ratio	0.7	0.5	0.5

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 May, the Best of China Fund fell 10.2% (in GBP, Z class) while the MSCI Golden Dragon Net Total Return Index fell 7.7%. For the year to date the Fund is up 8.8%, ahead of the benchmark which is up by 6.5%.
- MSCI Hong Kong (net total return of -3.6%) held up relatively better than Taiwan (-4.8%) and China (-10.2%).
- In China, the strongest sectors were Utilities and Consumer Staples while the weakest were Consumer Discretionary, Information Technology and Communication Services.
- The Fund's Health Care holdings positively contributed to performance. Underperformance was a combination of stock specific factors from Baidu and Noah, while the fund's Information Technology holdings sold off following Huawei's blacklisting by the US.

Events in May

- Trade talks between the US and China broke down, followed by the US' decision to raise tariffs on $200bn of Chinese goods up from 10% to 25%. The US is now planning on imposing tariffs on the remaining imports from China.
- China retaliated by raising the tariffs on $60bn of American imports from 5-10% to 5-25%. Trump and Xi are expected to next meet at the G20 meeting in June.
- The US put Huawei on an Entity List, meaning US businesses have to obtain permission to sell to Huawei. Approvals are rarely granted, so this move effectively means US companies are banned from selling to Huawei.

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- China followed by creating an "Unreliable Entity List" which will target foreign firms which do not "comply with market rules, violate the spirit of contract, block or cut supplies to Chinese firms for non-commercial purposes".

- Industrial data showed a mixed picture. The official Purchasing Manufacturing Index (PMI), which is more geared towards state owned enterprises, fell to 49.4 in May. The Caixin PMI, which is more geared towards private firms, was flat at 50.2 in May.

- Retail sales growth decelerated from 8.7% in March to 7.2% in April. Car sales fell 14.6% in April.

- Support for the economy continues. The PBoC cut the required reserve ratio for small and medium sized banks, aimed at increasing loans targeted towards small and medium enterprises. Total credit growth fell slightly, from 10.7% in March to 10.4% in April.

Market Update

The China Banking and Insurance Regulatory Commission (CBIRC) took control over Baoshang Bank, a city commercial bank which is unlisted. This was due to unspecified serious credit risks within Baoshang, whose assets are worth 0.3% of China's total banking assets. China Construction Bank will run daily banking operations for 12 months but this is not a takeover. Deposit insurance covers retail deposits worth up to RMB0.5m, while in this case corporate deposits and interbank liabilities below RMB50m will also be protected. According to Caixin, unprotected corporate deposits and interbank liabilities (i.e. that above RMB50m) may have to take a haircut of 20% and 30% respectively. Given Baoshang's small size and the regulator's decisiveness, it is very unlikely this incident will impact the rest of the banking sector. The bank exhibits characteristics that we want to avoid. As of its latest financials, last published in 2017, wholesale funding's contribution to the balance sheet was 53%. The average asset growth rate between 2013 and 2017 was 26% while deposits only grew 12%, leaving the bank dependent on more expensive wholesale markets. The Chinese banks we do own in the Fund rely much more on stable deposits rather than wholesale funding. China Construction Bank and China Merchants Bank's total deposits accounted for 75% and 66%, respectively, of total funding in 2018.

The US' move to put Huawei on its Entity List will affect some of the seven smartphone component suppliers we own. None of our Asian component manufacturers use US technologies, materials and applications that exceed the 25% limit needed to be affected by the Entity List. But all (with the exception of Catcher) will be affected by a reduction in orders from Huawei which is very likely if consumers buy fewer Huawei phones. We do, however, think that consumers who were going to purchase a Huawei will now purchase another brand. A component supplier who has diversified revenue exposure should be unaffected in the medium term, though in the short term there could be volatility if orders from Huawei decline rapidly and others take time to pick up. Of our five Asian holdings, exposure to Huawei ranges from 5-15% and we stress that none are a pure play on Huawei's growth. Qualcomm is the only of our holdings which is US domiciled – it derives more than 50% of its revenue from China and so is eligible for the Fund. It is affected by the Entity List and reports indicate it has stopped shipments to Huawei, which accounts for ~2.6% of revenue. Qualcomm is also owed royalties from Huawei and in the midst of the trade dispute, payment of those must be in doubt.

Portfolio Update

Sino Biopharmaceutical reported continued growth which was impressive in a rapidly changing regulatory environment. The government's central procurement scheme aims to cut prices for drugs in 11 major cities but Sino Biopharm is coping well with revenue and net profit growth of 33% and 11% in the first quarter. New products contributed to 18% of sales and this is expected to rise, which should help the business cope with price cuts to older products.

Noah's wealth management business grew earnings slightly. On the one hand its number of active clients grew 49% to 8,000 and total transaction value (TTV) for fixed income products grew 67%. However, TTV for private equity fell 79% as the domestic market remained very sluggish. Revenue from performance based fees fell significantly as public equity products did not pass their high water marks. The asset management business also suffered from the same problem. On a more positive note, Noah is rapidly growing its overseas business, meaning this segment grew revenue 39% compared to the domestic business whose revenue fell slightly.

Baidu has been spending a lot on content and traffic acquisition costs to build scale for iQiyi (the Chinese Netflix) and its newer apps, such as Baijiahao (a newsfeed app). This was fine in the past as the core business of advertising was highly cash generative, supporting these growing businesses. However during the first quarter the ad business unexpectedly slowed down. Management believe advertising inventory in the market increased towards the end of the first quarter, lowering prices e.g. Tencent's Wechat Moments and Mini Programs have been adding performance-based advertising inventory. Management also believe some peers are bidding on negative margins and so Baidu is taking a cautious view, arguing the advertising market will be more challenging in 2019 and revenue could fall in the second quarter. The share price fell sharply but we feel that part of the slowdown is due to the changes Baidu is making to its business. For example, Baidu is creating standard data fields for its healthcare ads so that it can better present information e.g. "If you look at in the online travel industry, if you try to find information about a particular hotel, you typically do not go to … the website of a hotel's official website. You actually find structured data about the users' comments and their price and all sorts of things that Ctrip has on the Ctrip website". Due to this new format of ads, advertisers are judging conversion rates and so are holding back on their marketing spend on Baidu's platform. The changes Baidu is making should be positive in the long term but could slow growth in the short-term. We felt the reaction was overdone and added to the position.

VTech's results disappointed. The telecommunications business encompasses residential and commercial phones. The residential segment is undergoing long-term decline as home phones are becoming redundant, but it seems VTech is also losing market share here, leading to a greater decline than we would otherwise expect. Gross margins were weak for the full year driven by tight supply of certain components and higher direct labour costs and manufacturing overheads, though these pressures are expected to fall over the next year. Sales of toys in Europe recovered after a weak first half, as expected. Revenue from the Asia Pacific region grew 26% for the full year and 41% for the interim period, driven by rapid growth in the Contract Manufacturing Services segment. Here VTech acquired a factory in Malaysia producing professional audio equipment, to insulate this particular product from the effects of tariffs.

Summary view & outlook

The portfolio has a strong China domestic bias. Average earnings growth for the next two years is 12.6% per annum based on current consensus estimates. This is close to the 12.9% 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 10.0x 2019 and 8.9x 2020 estimated earnings put it at a 21% discount to the market. We believe 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*

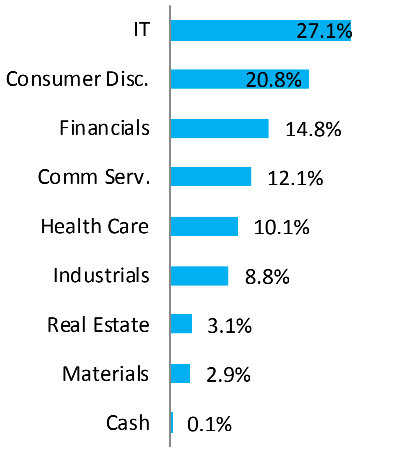
PORTFOLIO

31/05/2019

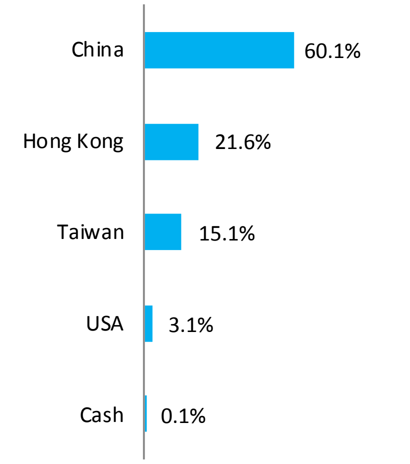
Fund top 10 holdings

Sino Biopharmaceutical	3.6%
Hollysys Automation Tech	3.5%
China Medical System	3.5%
China Lesso Group	3.4%
Autohome	3.3%
Netease.com	3.3%
Ping An Insurance	3.2%
Li & Fung	3.2%
Taiwan Semiconductor	3.2%
Luk Fook Holdings	3.1%
% of Fund in top 10	33.3%
Total number of stocks	33

Sector analysis



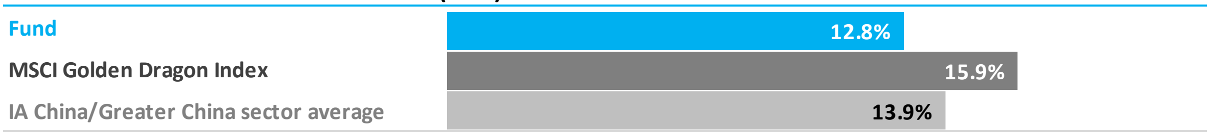
Geographic allocation



PERFORMANCE

31/05/2019

Annualised % total return from launch (GBP)



Discrete years % total return (GBP)	May '15	May '16	May '17	May '18	May '19
Fund	-	-	50.4	21.8	-15.6
MSCI Golden Dragon Index	36.5	-18.4	46.5	19.0	-7.7
IA China/Greater China sector average	41.1	-21.5	44.2	24.2	-11.6

Cumulative % total return (GBP)	1 month	Year-to-date	1 year	3 years	5 years	From launch
Fund	-10.18	8.79	-15.61	54.55	-	51.45
MSCI Golden Dragon Index	-7.69	6.52	-7.74	60.78	78.97	66.76
IA China/Greater China sector average	-7.65	8.83	-11.63	58.31	75.28	56.94

RISK ANALYSIS

31/05/2019

Annualised, weekly, from launch on 15.12.15, in GBP	Index	Sector	Fund
Alpha	0.00	-1.72	-2.43
Beta	1.00	0.98	0.99
Information ratio	0.00	-0.45	-0.45
Maximum drawdown	-17.78	-21.67	-25.74
R squared	1.00	0.94	0.90
Sharpe ratio	0.65	0.51	0.46
Tracking error	0.00	4.56	6.04
Volatility	18.15	18.38	18.97

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.