Guinness Asian Equity Income Fund

INVESTMENT COMMENTARY – July 2019

Launch date	**19.12.2013**
Team	**Edmund Harriss** (manager) **Mark Hammonds** (manager) **Sharukh Malik** (analyst)

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

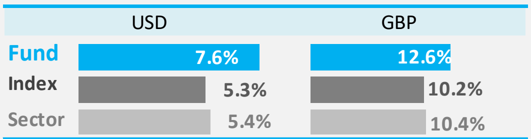
30/06/2019

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	12.1	12.2	1.5	5.3	49.6	92.3
Index	12.7	12.8	0.2	3.9	32.9	70.8
Sector	13.4	13.5	0.5	4.2	34.1	72.4

Annualised % total return from launch



Risk analysis (annualised, weekly, from launch)

	Index		**Sector**		**Fund**	
	USD	GBP	USD	GBP	USD	GBP
Alpha	0	0.0	0.7	1.3	3.3	3.7
Beta	1	1.0	0.9	0.9	0.8	0.9
Info ratio	0	0.0	0.1	0.1	0.4	0.4
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	15.0	13.6	13.5	12.8	13.9
Sharpe ratio	0.1	0.4	0.1	0.5	0.3	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.

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Fund & Market

- Markets rebounded in June following May's sharp sell-off, with Asian markets, developed and emerging markets all moving roughly in line.

- The Fund rose by more than market as measured by MSCI AC Pacific ex Japan NR Index in the first four months of the year before falling behind in May's sell-off. In June, the Fund closed the gap and at the time of writing (24 July) has moved back ahead over 2019.

- Given market conditions this year we are happy with how the Fund has behaved with the exception of performance in May: the correlation in stock movements in our North Asia exposure clearly tightened even though there is diversification in underlying revenue streams.

- We calculate that estimates of 2019 earnings for the MSCI AC Pacific ex Japan Index have dropped 10.9% this year; for the Fund, we calculate the drop to have been 3.8% over the same period.

- The key element in performance over the course of the year to date has been the expansion and contraction of the Price/Earnings (P/E) multiple: we calculate that over the first half, the P/E of the Index expanded 26.8% while that of the Fund expanded 16.5%.

- Leading sectors in the benchmark index in the first half were Consumer Discretionary, Real Estate and Materials, while laggards were Communication Services, Utilities, Healthcare, Energy and Industrials. Financials and Information Technology moved in line.

- Leading country performers, as measured by the MSCI Country indices, were Australia/New Zealand, Thailand and Hong Kong. Laggards were Malaysia, Korea, Indonesia and Taiwan. China, Singapore and the Philippines moved in line.

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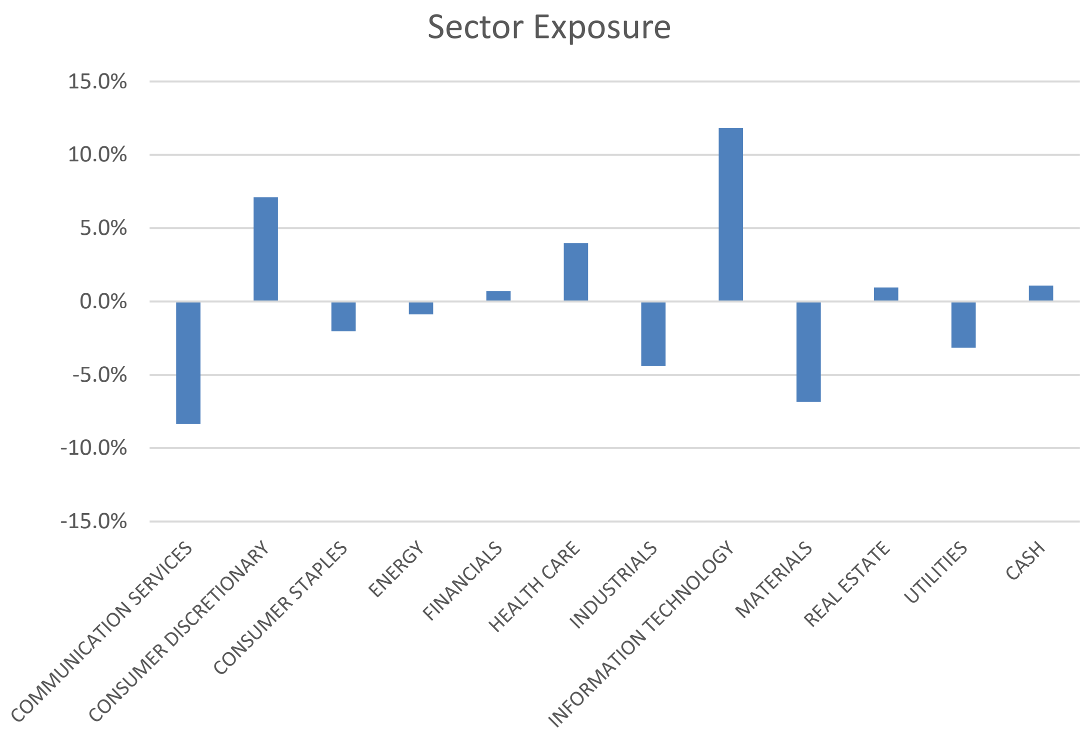
Events in 2019

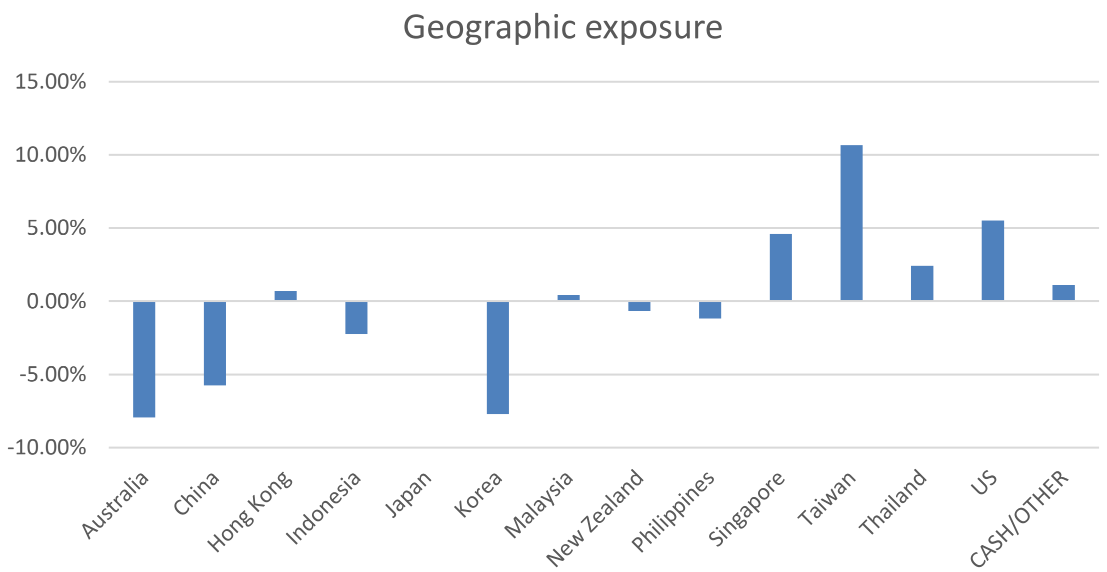
- Trade tensions reduced in January and then ratcheted back up again in early May before being raised further in late May by the blacklisting of Huawei Technologies.
- A fragile stabilisation between the two sides was achieved in June at the G20 summit but trust, even if there was little enough to begin with, has been damaged.
- The US Federal Reserve has decisively altered its position on the outlook for interest rates. Cuts, not increases, are now expected with the market divided on whether the next move will be a reduction of 0.25% or 0.5%.
- Modi won the election in India decisively; the Reserve Bank of India has begun to reduce interest rates; Indian economic growth decelerated in the first three months of 2019 to 5.8% year-on-year, the slowest rate in five years. Policy is now focused on this.
- Japan and South Korea are locked in their own trade dispute. Japan is limiting the transfer of key items related to the manufacture of semiconductors. The underlying cause appears to have been a Korean court ruling in relation to compensation for forced labour in the colonial period.
- Elections in Thailand and the coronation of the King have brought about a reduction in the risk premium for Thai equities making the market one the region's best performers this year. The new government will be in place by mid-July.
- In Indonesia the re-election of President Jokowi was affirmed by the Constitutional Court. Interest rates in Indonesia are expected to come down and plans are afoot to cut the corporate tax rate from 25% to 20%.
- Unrest has grown in Hong Kong in July as tensions between citizens and Beijing-backed government boiled over with an attempt to introduce an extradition law. The stock market has not yet been affected but Hong Kong's longer-term outlook points more firmly to China.

Portfolio positioning

Although the fund's benchmark, the MSCI AC Pacific ex Japan Index, plays no part in the construction of the portfolio, we think it might be helpful to show the position of the Fund relative to that of the Index on a sector and geographic basis.



The Fund is overweight in Consumer Discretionary, Health Care and Technology companies and is underweight Energy, Materials and Utilities which, either for cyclical or regulatory reasons, are unable to sustain our required minimum return on capital.



On a country basis, the Fund is most notably underweight in Australia, China and Korea and overweight in Singapore, Taiwan and Thailand. Our US position consists of Qualcomm (smartphone chips) and Aflac (health insurer).

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The split between emerging and developed markets remains very similar to that at the start of the year, accounting for 63% and 36% respectively (for reference, we count Korea and Taiwan as emerging markets; while the economies are developed the stock markets with their ID requirement for access and restricted currencies keep them in the emerging market category). In terms of market size, stocks below $1 billion market capitalisation account for 5% of the portfolio; $1 billion - $10 billion 53% and over $10 billion market capitalisation 41%. We have no illiquid or unlisted stocks in the portfolio. We use a conservative approach to assess portfolio liquidity: assuming a low-touch trading approach that would limit us to 25% of the daily trading volume and a requirement to liquidate the entire portfolio, we could sell 73% of the portfolio securities in a day and 93% within a week. If we were more active in seeking liquidity for the remaining four positions (China Lilang, Luk Fook, Pacific Textiles and St Shine Optical), the entire portfolio could be liquidated within 10 trading days.

Portfolio positioning is driven primarily by individual company considerations where we seek those businesses whose operations have sustained higher returns on capital and which, in our opinion, are likely to continue to do so but whose shares are priced as if they won't. We do not begin with a framework that leads us toward cyclical versus defensive or growth versus value or indeed to favour one country over another. These elements play a role when we consider the prospects for a particular business model and when we consider how we should value the current and expected future cash flows of the business.

The structural themes that attract investors to Asia include demographics and growing household wealth and disposable income which have arguably reached a critical mass in the region. The evidence that supports this assertion can be seen in spending patterns and the types and value of consumer products (cars, durables, fashion etc) that are now sold in the region as well as in macro-economic data which indicate lower volatility in economic growth and money supply metrics than ten or fifteen years ago. We seek to capture these themes by identifying good businesses, and through our portfolio construction, try to avoid excessive concentration in themes or product areas. This we do by considering revenue streams by geography, product area and customer group.

The largest exposures we have in headline terms are to China and Taiwan, followed by Hong Kong, Australia and Singapore. On a sector basis, the largest absolute exposures are to Information Technology, Financials and Consumer Discretionary, followed by Real Estate and Health Care. Much of our Information Technology exposure is to be found in Taiwan, where we are focused on hardware manufacturers and designers of processor and controller chips rather than in more cyclical areas such as memory or display panels. These are areas where Asian manufacturing skills have turned companies like Taiwan Semiconductor, Largan Precision and Novatek Microelectronics into world leaders. Our technology exposure also includes materials such as environmentally friendly coatings for printed circuit boards and super-efficient assemblers. These companies have operating facilities across the region and serve multiple customers and product areas; they are not simply China-based suppliers to Huawei, as stock price performances in May appeared to suggest.

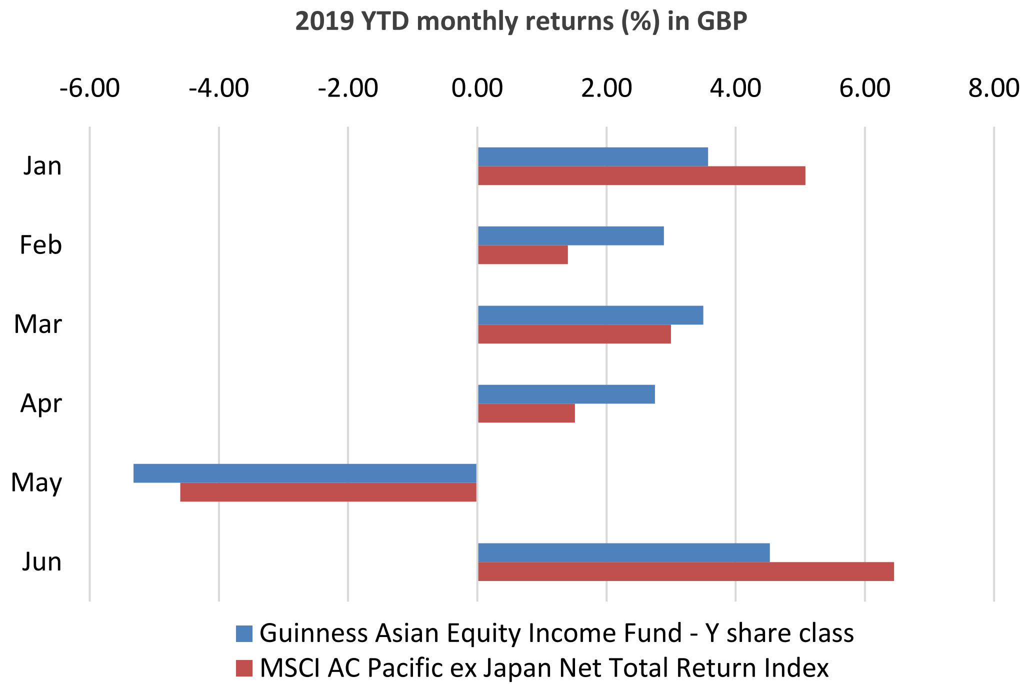
Consumer Discretionary exposure is to be found in Australia, China and Korea for the most part. These businesses include electrical retailers, travel services, autoparts, textile makers and fashion and jewellery retailers. While some are domestic businesses such as JB Hi-Fi and China Lilang, others offer regional and global services like Hanon Systems, Corporate Travel Services and Pacific Textiles. A similar story can be seen in our Financials exposure. We invest in commercial banks, finance companies, insurers and asset managers in China, Hong Kong, Malaysia, Singapore, Thailand as well as in Australia and in the US (through which we have exposure to Japan). Demographics is often cited as a reason to be interested in the region and so it is – for the younger populations in the likes of Indonesia and Vietnam but just as interestingly for ageing populations in China, Malaysia, Singapore and most obviously Japan. The needs of the two population profiles are different but both provide a backdrop for investment opportunities.

Real Estate exposure is concentrated in Singapore and Hong Kong. In the portfolio it takes the form of Real Estate Investment Trusts (REITs), which distribute 95% of their income. From an income perspective the dividends from these REITs remain attractive in a world of declining interest rates. We like the yield but we also like the ability of these companies to grow their dividends. In the case of the Singaporean REITs, Ascendas and CapitaLand Mall Trust, the growth drivers come from the refreshing and rebalancing of their portfolios through disposal and acquisition, their headroom to take on further debt up to a modest ceiling to fund expansion and their ability to improve rental yields through asset enhancement. In the case of Ascendas, industrial properties tied into logistics and central distribution sites reflects the changes underway in e-commerce. CapitaMall is exposed to bricks-and-mortar retail and so their advantage is their access to prime space and creation of retail destinations to serve luxury retail and spending. The Link REIT in Hong Kong has an increasingly interesting future. Its forays outside Hong Kong into Cantonese-speaking China have been successful. China's drive to create a greater Bay area linking Hong Kong and Macau with nine other mainland cities can only increase the possibilities afforded to this business.

Performance review

In the first quarter of the year, when markets were up strongly, the Fund (Y class) in GBP terms rose 10.3% versus the MSCI AC Pacific ex Japan NR Index which rose 9.4%. In the second quarter, when conditions were much choppier, the Fund rose 1.7% compared to the Index which rose 3.1%. For the first half the year, the Fund was up 12.2% and the Index rose 12.8%.

Given market conditions over the past six months, we are happy with where the Fund has ended up this year. However, we like to pay attention to how the Fund behaves in different market conditions and see where it conforms or deviates from our longer-term expectations. The chart below breaks down the performance of the Fund and its index into monthly returns.



Source: Bloomberg

The performance over five of the six months conformed with our expectations. Outperformance in February, March and April coincided with the results season, when the Fund tends to do well. In 2019, these company results followed a very weak period in stock markets in the last three months of 2018 when market fears reached a crescendo. Relief as much as positive expectations drove performance, in our opinion. The performance in May, when the Fund unperformed in weak market conditions, is the standout. We would normally expect to see a more defensive profile based upon a stronger earnings profile and diverse revenue streams.

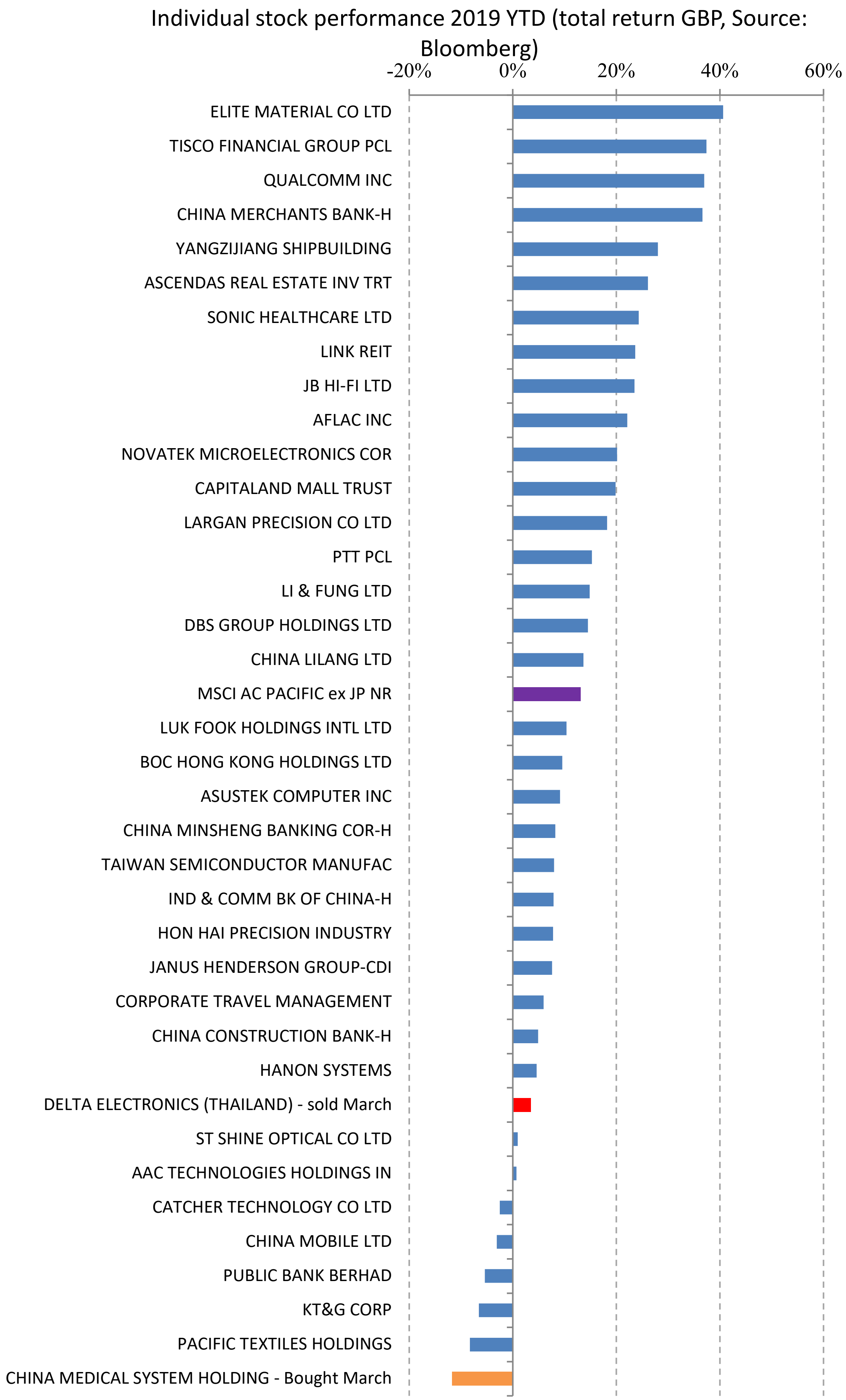
We have looked at the total returns of our stocks over the first six months of the year and at the contribution to returns from changes in the forward Price/Earnings valuation multiple and the imputed contribution from the combination of earnings and dividends. In the first four months of the year, revisions to consensus forecast earnings for the Fund's holdings were robust, down 3.8% compared to estimates for the market (as measured by our benchmark index) which fell 8.7%. In the portfolio we had three stocks which saw significant downgrades to forecasts (AAC Technologies, Catcher Technology and Li & Fung) and if we exclude those, 2019 earnings forecasts for the portfolio were unchanged. For the 17 stocks which drove the outperformance over the period, earnings estimates increased. This was sufficient to support the recovery in stock prices which was manifest in an expansion in the PE multiple from depressed levels at the end of 2018. There was a reasonable dispersion in stock performance between sectors and countries. Consumer Discretionary, Energy, Financials, Health Care, Information Technology and Real Estate were all represented among both leaders and laggards. The country representations were similarly diverse across the groups.

In May however, we saw a different pattern. The earnings profile of the portfolio barely changed, and performance was almost entirely explained by changes in the PE multiple, a measure of sentiment, which contracted 7.7% for the portfolio. The market PE multiple contracted less, by 5%, even though estimates of market earnings continued to drop. In the portfolio there was an evident concentration in behaviour amongst stocks in the technology sector and those with significant North Asia (read China) exposure. The ratcheting up in the trade dispute coupled with the blacklisting of Huawei prompted a sharp move by investors into non-China areas. In this liquidity shift, technology stock and stocks in North Asia tended to move together more closely. The fact that DBS in Singapore is a regional bank with substantial revenues from South and South East was outweighed in terms of sentiment by its Chinese banking business and was as weak as a pure Chinese bank or a Taiwan technology company exposed to Huawei smartphones.

In our analysis of this episode we do not believe that there is a concentration that we have missed. If earnings and dividends hold up and grow, then we would expect valuations to reflect that over time. We can accept that there will be periods when the market moves in a direction that we think is not justified by the fundamentals (i.e. the capacity and prospects for cash generation). The results season in the earlier part of the year justified to us that our faith in these businesses is not simply based on hope. We expect to see a solid results reason for our companies in coming months. (Taiwan Semiconductor has just reported solid mid-year results and added its comment that the demand outlook for the second half is "very, very strong".)

This analysis reminds us that stock behaviour at more extreme moments can be unfavourable to stock pickers and we shall continue to maintain vigilance on this aspect. The portfolio is expected, over time, to lag in strong markets and outperform when they are weak. In the short term, exceptions can occur, and it is important we have a view on the reasons for it when they do. We do not see the need for a radical shake-up of the portfolio, but we believe that spending some time thinking about and discussing this aspect of portfolio construction is important.

The chart below shows the performance of individual stocks through the first half of the year.


Individual stock performance 2019 YTD (total return GBP, Source: Bloomberg)
-20%
0%
20%
40%
60%
ELITE MATERIAL CO LTD
TISCO FINANCIAL GROUP PCL
QUALCOMM INC
CHINA MERCHANTS BANK-H
YANGZIJIANG SHIPBUILDING
ASCENDAS REAL ESTATE INV TRT
SONIC HEALTHCARE LTD
LINK REIT
JB HI-FI LTD
AFLAC INC
NOVATEK MICROELECTRONICS COR
CAPITALAND MALL TRUST
LARGAN PRECISION CO LTD
PTT PCL
LI & FUNG LTD
DBS GROUP HOLDINGS LTD
CHINA LILANG LTD
MSCI AC PACIFIC ex JP NR
LUK FOOK HOLDINGS INTL LTD
BOC HONG KONG HOLDINGS LTD
ASUSTEK COMPUTER INC
CHINA MINSHENG BANKING COR-H
TAIWAN SEMICONDUCTOR MANUFAC
IND & COMM BK OF CHINA-H
HON HAI PRECISION INDUSTRY
JANUS HENDERSON GROUP-CDI
CORPORATE TRAVEL MANAGEMENT
CHINA CONSTRUCTION BANK-H
HANON SYSTEMS
DELTA ELECTRONICS (THAILAND) - sold March
ST SHINE OPTICAL CO LTD
AAC TECHNOLOGIES HOLDINGS IN
CATCHER TECHNOLOGY CO LTD
CHINA MOBILE LTD
PUBLIC BANK BERHAD
KT&G CORP
PACIFIC TEXTILES HOLDINGS
CHINA MEDICAL SYSTEM HOLDING - Bought March

Leaders and Laggards

Amongst the leaders we particularly welcome the recovery in Elite Material, which we bought in August 2017. The company produces printed circuit boards used in smartphones, servers and the automotive sector and is the world's largest producer of halogen-free laminates, which are increasingly being adopted due to their environmentally friendly nature. From the latter part of 2017 and through 2018 the share price was weak on slowing sales but in 2019 the business has turned. Our equal weight and rebalancing process means we have added to the stock at lower levels; the position has outperformed the market by over 10% over the period since purchase.

The performances of Tisco Finance in Thailand, China Merchants Bank and Yangzijiang Shipbuilding have all been driven by better-than-expected results, with solid dividend growth from China Merchants Bank and accelerating dividend growth from the other two. Qualcomm's performance has been closely tied to the outcome of its dispute with Apple. This was suddenly resolved in Qualcomm's favour when Apple concluded that the risks to the launch of its next generation of smartphone were too great. In short, Apple's alternative chip supplier Intel was not able to match Qualcomm in the race to 5G-enabled handsets. The result was the immediate release of previously withheld royalty payments to Qualcomm and a jump in the share price.

Amongst the laggards our new purchase, China Medical Systems has been weighed by changes to the operating environment in China. We knew this was still a challenge and that the timing of resolution would be hard to judge, but it looks now that the skies are clearing. We have added on subsequent weakness and remain positive on the outlook. Pacific Textiles has seen its Vietnam operation achieve normal capacity utilisation after months of disruption. The business is generating cash and the dividend is generous with little need for extra capital expenditure. Growth from its main customer Uniqlo, however, remains elusive.

KT&G and Public Bank in Malaysia are low-growth but cash-generative businesses with solid local franchises. Their weaker performance in what have been strong markets overall is not a surprise. KT&G's outlook has improved with a turnaround in export sales, which dragged significantly last year. The next set of results should reflect that turnaround and the share price should get a lift. China Mobile has to contend with competition in its current business and a rising capital expenditure burden associated with 5G, which in China is fast becoming a political totem. As with Pacific Textiles, growth rather than cash generation is the issue and the 5G burden makes the prospects for improving returns more distant.

Portfolio changes

We made one change to the portfolio during the first half. The parent company of Delta Electronics (Thailand) made a tender offer for the shares it did not already own and we took up that offer. We replaced it with a position in China Medical Systems.

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 where alternative offerings are available resulting in substantial price cuts in certain cases. China Medical Systems has seen a significant drop in its share price that 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, respiratory distress down to onychomycosis (that's toenail fungus, for anyone interested). 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.

Outlook

Opinion in the market is divided on whether we are now at the end of the cycle or whether there is still further to go. The change in direction by the Federal Reserve appears to suggest that they are concerned, and the recent moves by the European Central Bank have only added to that. Monetary easing is the order of the day, with several central banks in the emerging markets cutting interest rates to stay in front of the Federal Reserve.

Investment and consumer demand in Asia are weaker than they were but have certainly not collapsed. China has been reluctant to move aggressively to stimulate the domestic economy and the moves they have made show some signs of effectiveness. This reluctance reflects their ongoing wish to tackle debt, for which we think they should be applauded. The unrest in Hong Kong is a matter of concern. China has been careful not to be seen to crack down in Hong Kong, but the recent siege of the China Liaison office in marks a switch away from protests against the Hong Kong government and toward a more direct challenge to China.

Chinese leaders are about to head off for the summer retreat and significant policy moves are unlikely (but not impossible) until September. Renewed face-to-face trade talks with the US will happen before then, but little concrete is expected given China's demands that the recent tariff increases and the blacklisting of Huawei be lifted.

We think that in this increasingly uncertain environment there are doubts as to whether growth can continue or if the value approach (based upon lower Price/Earnings multiples) is broken due to changing business models. In this context we believe an equity position in good businesses with sustained and growing dividend streams over the long term, whether in Asian, European or Global companies, cannot be a bad thing.

Edmund Harriss
Mark Hammonds (portfolio managers)
Sharukh Malik (analyst)

Data sources

Fund performance: *Financial Express, total return*

Index and stock data: *Bloomberg*

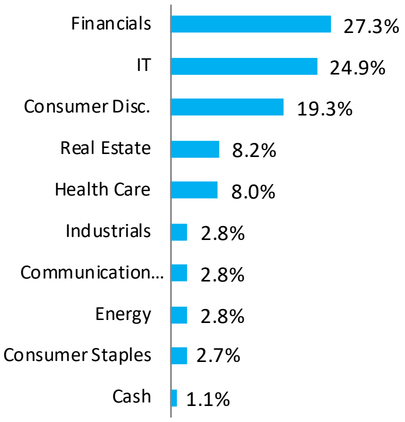
PORTFOLIO

30/06/2019

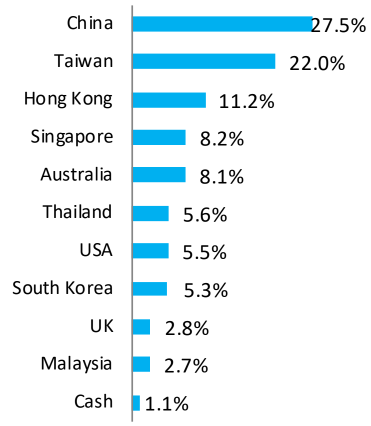
Fund top 10 holdings

Li & Fung	3.1%
Catcher Technology	2.9%
Corporate Travel Management	2.9%
Novatek Microelectronics	2.9%
Qualcomm	2.8%
Yangzijiang Shipbuilding	2.8%
Janus Henderson	2.8%
Capitamall Trust	2.8%
Largan Precision	2.8%
ICBC	2.8%
% of Fund in top 10	28.7%
Total number of stocks in Fund	36

Sector analysis



Geographic allocation



PERFORMANCE

30/06/2019

Discrete years % total return

	Jun '15		Jun '16		Jun '17		Jun '18		Jun '19	
	USD	GBP	USD	GBP	USD	GBP	USD	GBP	USD	GBP
Fund (Y class, 0.99% OCF)	12.5	22.3	-8.0	8.2	22.3	25.7	6.7	5.0	1.5	5.3
MSCI AC Pacific ex Japan Index	-1.0	7.6	-10.5	5.2	25.6	29.3	9.9	8.1	0.2	3.9
IA Asia Pacific ex Japan	-0.2	8.5	-10.4	5.3	25.1	28.8	9.2	7.5	0.5	4.2

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)	5.6	4.5	12.1	12.2	1.5	5.3	32.4	39.0	49.6	92.3
MSCI AC Pacific ex Japan Index	7.0	6.0	12.7	12.8	0.2	3.9	38.3	45.3	32.9	70.8
IA Asia Pacific ex Japan	6.5	5.4	13.4	13.5	0.5	4.2	37.3	44.2	34.1	72.4

Annualised % total return from launch

	USD	GBP
Fund (Y class, 0.99% OCF)	7.6%	12.6%
MSCI AC Pacific ex Japan Index	5.3%	10.2%
IA Asia Pacific ex Japan	5.4%	10.4%

Risk analysis - Annualised, weekly, from launch on 19.12.2013

30/06/2019

	Index		Sector		Fund	
	USD	GBP	USD	GBP	USD	GBP
Alpha	0.0	0.0	0.7	1.3	3.3	3.7
Beta	1.0	1.0	0.9	0.9	0.8	0.9
Information ratio	0.0	0.0	0.1	0.1	0.4	0.4
Maximum drawdown	-29.3	-26.4	-26.7	-24.5	-24.3	-20.6
R squared	1.0	1.0	1.0	1.0	0.9	0.9
Sharpe ratio	0.1	0.4	0.1	0.5	0.3	0.7
Tracking error	0.0	0.0	3.6	3.6	5.8	5.8
Volatility	14.9	15.0	13.6	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

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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.

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Singapore

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Telephone calls will be recorded and monitored.