Guinness Best of China Fund

INVESTMENT COMMENTARY – March 2020

Launch date	**15.12.15**
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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

29.02.2020

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

	2017	2018	2019
Fund	38.2	-20.3	26.0
Index	31.3	-9.5	19.0
Sector	35.9	-14.2	22.2

	1 year	3 years	From launch
Fund	8.4	18.4	66.2
Index	8.8	27.7	84.1
Sector	9.8	29.4	74.2

Annualised % total return from launch (GBP)

Risk analysis (annualised, weekly, from launch)

	Index	Sector	Fund
Alpha	0.0	-1.3	-2.4
Beta	1.0	1.0	1.0
Info ratio	0.0	-0.4	-0.4
Max drwdn	-17.8	-21.7	-25.7
Tracking err	0	5	6
Volatility	18.0	18.2	19.2
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 February, the Best of China Fund rose 1.5% (in GBP, Z class) while the MSCI Golden Dragon Net Total Return Index rose 3.2%.
- Consensus earnings estimates for the portfolio are for average annual earnings growth over the 2019-21 period of 8.2%, down from an 8.9% growth rate estimated at the beginning of the year. The reduction is the result of a cut to 2019 estimated growth from 3.5% to 2.7% and to 2020 from 11.0% to 9.1%.
- MSCI China rose 4.4%%, MSCI Taiwan rose 1.5% while MSCI Hong Kong rose 2.0%. The Shenzhen Component Index rose 4.3% while the Shanghai Stock Exchange Composite Index fell 1.8%.
- In MSCI China, the strongest sectors were Health Care (total return of +9.1%), Materials (+8.6%) and Information Technology (+7.8%) while the weakest were Energy (-7.8%), Utilities (-3.2%) and Financials (+3.5%).
- In Taiwan, the Information Technology Index, which makes up more than half of the Taiwanese index, fell 10.3%.
- In Hong Kong, the Financials and Real Estate sectors, which are by far the largest parts of the local index, were up 2.5% and 1.4% respectively.

Events in February

- Based on the data coming out of China, the spread of coronavirus there seems to be under control. As of March 4th, there have been 80,270 cases in China with 2,981 deaths. What is less mentioned is that there have been 49,928 recoveries. The number of daily new cases has dropped to the low hundreds. As people get back to work, we will be watching whether there is a spike in cases.

- Though there are valid concerns over the quality of data, it does seem economic activity is slowly recovering. Coal consumption, traffic congestion and daily property sales began gradually recovering in the second half of February, though all are well below normal levels.

- A Joint Mission from the World Health Organisation (WHO) visited China and noted several developments which suggest the situation is improving e.g. fever clinics are reporting “we used to have a line out of the door, and now we see a case once per hour” while physicians report they now have empty beds to treat patients.

- However, coronavirus is now spreading outside of China with cases clustered in South Korea, Iran and Italy. The OECD lowered its global growth forecast from 2.9% to 2.4%, and it is likely global demand for Chinese exports will be weak in the foreseeable future.

- The Chinese government is now trying to restart the economy with a combination of fiscal and monetary policy. Many small and medium enterprises (SMEs) are facing liquidity pressure and so the PBOC allocated CNY 300bn in refinancing funds. The quota was raised to CNY 500bn at the end of the month and the refinancing rate was also lowered by 0.25% to 2.5%. The PBOC cut the one year loan prime rate by 0.1% to 4.05%. Qualified small and medium enterprises (SMEs) with principal or interest due in the first six months of the year can potentially delay their repayments.

- Fiscal policy has also been loosened. Toll fees have been temporarily waived for all vehicles. Gas and electricity prices have been temporarily cut. Employer contributions were waived from February to June for pensions and unemployment schemes in Hubei. This also extends to SMEs in other regions, while larger companies will see their contributions halved.

- To stimulate the housing market, the central government announced the system of issuing corporate bonds would move from an approval-based system to a registration-based system, allowing companies to issue debt more easily. The 40% cap on outstanding corporate bonds to net asset ratio was lifted, allowing property developers to issue more corporate bonds to repay existing debt.

- Numerous local governments put out additional policies including subsidies on home purchases, loosening pre-sale requirements and increasing the length of time payments developers can defer their payments for.

- The local government in Guangzhou is planning on subsidising purchases of New Energy Vehicles (NEVs) by CNY 10,000 per vehicle and purchases of vehicles that meet new “National VI” emission standards by CNY 3,000 per vehicle. It would not surprise us if this is replicated in other provinces.

Market Update

The public news flow on the Coronavirus as governments seeks to show they are 'doing something' and news outlets compete for attention has created a climate of fear which finally took hold in financial markets in February. There is great enthusiasm for creating and lingering over worst case scenarios. However, it is also evident by a look at the data, rather than the myriad opinions of what might be, that the spread is coming under control. In China the rate of new infections continues to slow and is now at a daily rate of 0.1%. Net of recoveries, infections were down 37% week on week. China appears to have passed the high water mark.

In Korea, as of 4th March the daily growth in infections has slowed from 35% 5 days ago to 15% over the past three days, and was 11% today. Korea has been one of the best at releasing data (twice a day) on testing and infections. Korea's Centre for Disease Control and Prevention reported last week that the virus barely mutates and shows the same behaviour when transmitting form one person to another. The journal Scientist also published an article saying the genetic sequences among patients around the world are similar and that any mutations are likely of little consequence.

Why is this important? Because it means that the virus is likely to behave similarly worldwide so studies of the spread, risks and treatments will be similar. It means also that potential vaccines should be widely effective. A key concern has been the potential for mutation and this will be unstoppable. This fear is not supported by evidence.

From an investment standpoint this aligns with comments from the Governor of the Bank of England who described this as a significant economic shock, but ultimately temporary. Economic shocks such as the financial crisis of 2008 or the oil price shock in the 1970s had long term structural implications. Unless this leads to a global economic shutdown for an extended period, which would then have financial solvency implications, we expect this to manifest in economic terms with a significant curtailment of economic growth in the first quarter followed by a rebound later in the year.

How does this happen? We expect this to be driven by a combination of manufacturing output to accelerate with first quarter output pushed into the second with increased work shifts. We expect to see incentives to boost consumption and efforts to reinvigorate the real estate and construction market. China's growth rate for 2020 may end up closer to 5% (some forecasts say less, though we probably won't see a published figure of less than 5%) but there is no doubt there will be maximum effort made to restart activity.

The path of equity markets will follow shifts in expectations. The return to work in Asia is happening but perhaps more slowly than was expected in early February. Nevertheless, Hon Hai Precision which is the largest assembler of iPhones has stated that it expects its operations to be in full production by the end of March. The new challenge is the impact of the spread in the rest of the world and efforts to contain it. This may lead to a 'W' shaped recovery in stock markets as expectations are adjusted.

The sharp falls we have seen in share prices around the world have been some of the steepest 10% drops from a market peak, ever. It is worth noting, however, that in February Chinese markets held up relatively well. While the MSCI World Index fell 8.5% in February, MSCI China rose 1.0%. In the first two months of the year, MSCI World fell 9.0% while MSCI China fell by 3.9%. This perhaps has more to do with run up in markets over recent months in which earnings revisions played almost no part.

Portfolio Update

We are cautious into reading too much into consensus earnings estimates because analysts can be slow to revise their expectations. Additionally the spread of coronavirus abroad is developing quickly and so analyst estimates may currently be too optimistic. That being said we do still find it useful to break down our stocks' total return into the contribution by earnings estimates and price multiples.

In the first two months of the year, the average reduction in 2020 earnings estimates for the companies in the Fund was 0.8%. The average reduction in price multiple was 9.8%. This can be interpreted in many ways. This could mean that the market is pricing in a reduction in earnings that analysts have not yet factored in, or that analysts are simply too optimistic right now. Or, on the other hand, that the market is being too pessimistic on valuations. This will become clearer as coronavirus develops.

Two thirds of the portfolio's underperformance in February can be explained by weak performance from its component suppliers: Tongda Group, Novatek, AAC Technologies and Qualcomm. Even if companies have resumed production, not all workers have come back and so factories are running at less than normal levels. This prompted Apple to warn sales will be weaker than expected in the first quarter given the supply bottlenecks, and because most of its stores in China were shut for an extended period of time (though 29 of its 42 retail stores in China have since re-opened). Nevertheless Hon Hai Precision, which is the largest assembler of iPhones, has stated that it expects operations will be in full production by the end of March. Given the spread of coronavirus, the outlook for demand and earnings it uncertain and this may be why some of these component suppliers saw their price multiples fall sharply in February.

The biggest reduction in earnings estimates were to Li & Fung and Noah. Li & Fung saw earnings estimates cut for various reasons. Trade tensions in the second half of 2019 likely lowered profit. Higher interest costs as a result of more borrowing also likely to cut into earnings. Noah is a wealth and asset manager. Though it does have an online presence, most of its revenue is derived from offline sales where clients meet Noah in person to discuss their investment decisions. We do not think many meetings are going to go ahead, at least in the short-term. Additionally, many of Noah's clients are high net worth individuals who themselves may be facing liquidity or cash flow issues because of the slowdown of the economy.

The government's drive to restart the economy may have effects on some of our holdings, such as China Resources Gas (CRG). At the beginning of the month, the local government in Zhejiang announced a 10% reduction in industrial gas tariffs, lasting three months. This was offset by a 5% cut in the city-gate price, which is the input cost, thus lowering the hit to margins. 3-4% of CRG's revenue comes from Zhejiang Province, not all of which is to industrial customers. To judge the importance of industrial customers to CRG, the best we can do is to look at the overall business. In 2018 sales by volume to the industrial sector accounted for 32% of CRG's total volume and if we apply that same rate to Zhejiang, it is likely 1.0%-1.3% of overall revenue will be affected by the lower tariff in the province. Hubei Province followed by also announcing a 10% cut to industrial gas tariffs lasting for six months - CRG's exposure to Hubei is approximately 5%. CRG think the impact to prices will be less than implied as they normally discount prices to industrial customers anyway because of the high volumes they bring, meaning prices are normally already below the official tariff. At the end of the month, the National Development and Reform Commission (NDRC) bought forward the date the gas industry is regarded as in the off-peak season, effectively cutting gas prices in industries that follow government-led pricing, such as the agriculture industry. Where prices are negotiated with customers, the NDRC encouraged prices to be cut but did not specify by how much.

Portfolio Switches

We sold our holding in TravelSky. TravelSky supplies data for China's aviation industry. Its services include real-time flight reservation information and ticket prices, inventory control and airport passenger processing. The number of people travelling in China has fallen significantly and TravelSky's earnings are likely to decline as a result. We felt the fall in the share price did not reflect this and so sold the position.

Summary view & outlook

The following comments may well be overtaken by events but at present we are looking for China and Asia to begin a return to work. Restrictions on movement are being lifted in measured fashion and policy efforts are directed toward macro-economic support. There is clearly some reluctance in China to deploy a massive stimulus package as we saw in 2009, the legacy of which is still with us. We see the greatest focus needs to be on the provision of liquidity and fiscal flexibility to allow companies to manage their working capital. Debt/equity for the portfolio, excluding the three banks, is 44% i.e. the Fund is not highly geared. If we look at net debt/equity, which subtracts cash from debt, the figure is -13% i.e. our companies could in theory pay back all of their debt with cash. We measure bank leverage by comparing total assets to total equity. We would consider assets that are 20x the size of equity to be the maximum we would accept for a bank and for an emerging markets bank with their more highly concentrated loan books we think we should be looking at 12-13x. China Merchants Bank is the most leveraged at 12.1x and BOC Hong Kong the least at 10.1x.

The recent US interest rate cut of 0.5% has divided opinion. In our view, while attention grabbing, it does not really address the problems businesses will face if economic disruption is extended. The issue will be one of access to credit rather than the pricing of it, in our opinion. While it seems to us the high-water mark has passed in Asia, the unknowable piece is the extent of the spread in the rest of the world, the measures taken to contain it and the resultant impact on demand. We proceed on the basis that this is a significant but ultimately temporary economic shock.

Edmund Harriss (portfolio manager)
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Data sources

Fund performance: *Financial Express, total return 0.74% OCF in GBP*

Index and stock data: *Bloomberg*

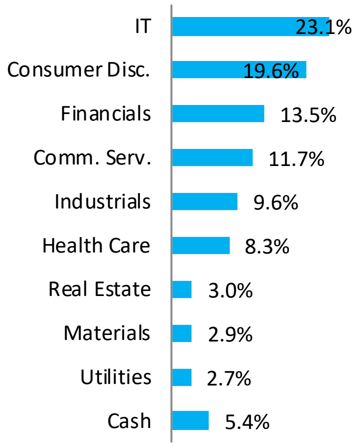
PORTFOLIO

29/02/2020

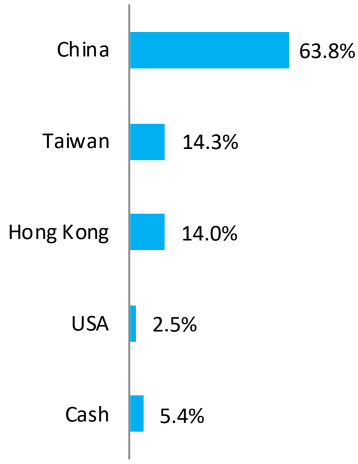
Fund top 10 holdings

China Lesso Group	4.0%
Geely Automobile Holdin	3.2%
Tencent Holdings	3.1%
Tongda Group Holdings	3.1%
Hollysys Automation Tech	3.1%
Alibaba Group	3.1%
Catcher Technology	3.0%
AAC Technologies	3.0%
Autohome	3.0%
Elite Material	3.0%
% of Fund in top 10	31.7%
Total number of stocks	33

Sector analysis



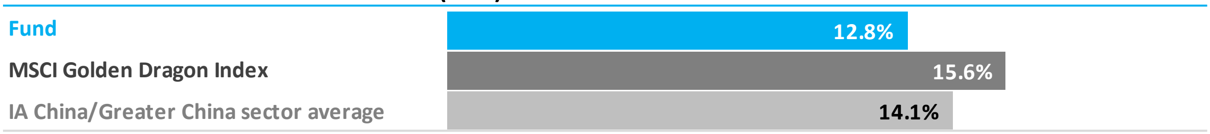
Geographic allocation



PERFORMANCE

29/02/2020

Annualised % total return from launch (GBP)



Discrete years % total return (GBP)	Jan '16	Jan '17	Jan '18	Jan '19	Jan '20
Fund	-	22.7	25.4	-12.8	8.4
MSCI Golden Dragon Index	-12.4	45.0	22.9	-4.5	8.8
IA China/Greater China sector average	-11.2	41.1	27.6	-7.7	9.8

Cumulative % total return (GBP)	1 month	Year-to-date	1 year	3 years	5 years	From launch
Fund	1.5	-5.2	8.4	18.4	-	66.2
MSCI Golden Dragon Index	3.2	-1.2	8.8	27.7	62.1	84.1
IA China/Greater China sector average	2.7	-1.1	9.8	29.4	62.0	74.2

RISK ANALYSIS

31/01/2020

Annualised, weekly, from launch on 15.12.15, in GBP	Index	Sector	Fund
Alpha	0.00	-1.25	-2.40
Beta	1.00	0.98	1.01
Information ratio	0.00	-0.36	-0.40
Maximum drawdown	-17.78	-21.67	-25.74
R squared	1.00	0.94	0.90
Sharpe ratio	0.65	0.54	0.46
Tracking error	0.00	4.56	6.05
Volatility	18.01	18.16	19.21

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, 18 Smith Square, London SW1P 3HZ.

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

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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.