Guinness Asian Equity Income Fund

INVESTMENT COMMENTARY – April 2020

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

31/03/2020

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

	2017		2018		2019	
	USD	GBP	USD	GBP	USD	GBP
Fund	36.5	24.6	-15.5	-10.3	19.0	14.4
Index	37.3	25.4	-14.5	-9.2	20.3	15.7
Sector	37.2	25.3	-15.1	-9.8	20.4	15.8

	YTD		1 year		From launch	
	USD	GBP	USD	GBP	USD	GBP
Fund	-25.8	-20.7	-21.7	-17.7	17.9	55.6
Index	-19.7	-14.3	-13.7	-9.3	13.8	50.2
Sector	-21.7	-16.4	-15.6	-11.3	11.5	47.1

Annualised % total return from launch

	USD	GBP
Fund	2.7%	7.3%
Index	2.1%	6.7%
Sector	1.7%	6.3%

Risk analysis (annualised, weekly, from launch)

	Index		Sector		Fund	
	USD	GBP	USD	GBP	USD	GBP
Alpha	0	0.0	-0.1	0.5	1.0	1.5
Beta	1	1.0	0.9	0.9	0.9	0.9
Info ratio	0	0.0	0.0	0.0	0.1	0.1
Max drwdn	-29.3	-26.4	-28.8	-24.5	-33.2	-24.8
Tracking err	0	0.0	3.5	3.5	5.7	5.7
Volatility	16.2	15.4	15.2	14.0	14.8	14.6
Sharpe ratio	0.0	0.2	0.0	0.2	0.0	0.3

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Source: Financial Express, Y class 0.99%, bid to bid, total return.

Fund & Market

- Asian markets fell sharply in March as the coronavirus spread around the world. For the month, the MSCI Pacific ex Japan Net Total Return Index fell 13.00% (all figures in USD unless stated otherwise). Since then (to 20 April) the market has risen 6.89%.

- During the month the best-performing sectors were Communication Services, Health Care and Consumer Staples; the weakest were Energy, Real Estate and Financials. This was also the case over the quarter.

- China has been the notable outperformer over the past month and over the first quarter. The weakest countries have been Indonesia, Thailand, Australia, India and Singapore.

- Chinese stocks in Utilities, banks, insurance, communication services, Health Care and Consumer Discretionary have worked best. These have been joined by technology names such as Elite Material and Novatek Microelectronics along with Ascendas REIT in Singapore and Public Bank in Malaysia.

- Weak names in the month, and over the quarter, include Corporate Travel, Tisco Finance, JB Hi-Fi, Janus Henderson, Tech Mahindra and DBS.

Events in March

- The coronavirus continued to spread across the world. Italy and Spain were particularly badly affected by the health crisis.

- Major lockdowns were announced in multiple countries, bringing widespread severe economic disruption.

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- The Fed cut interest rates by 100 basis points to zero (at the lower end of the range) on 15 March (a Sunday). A range of supportive measures were introduced, including $700bn additional asset purchases and dollar swap lines with foreign central banks.

- Further policy measures were announced by the Fed on 23 March, which included a pledge to buy corporate bonds for the first time. The package removed the existing cap on asset purchases.

- Congress approved a $2tn package to support the economy, with a combination of spending, business lending and loan guarantees.

- By the end of the month, the US surpassed China as the country with the largest number of confirmed coronavirus cases.

- The oil price fell dramatically after a breakdown in relations between Saudi Arabia and Russia, and a failure to agree production cuts. The WTI oil price benchmark declined 54%.

- Public finances came under pressure and there was weakening asset quality in the banking sector.

A macro view

Almost 90% of the world's GDP has been impacted by the pandemic; 16% of GDP (i.e. China) is in the process of lifting restrictions. The manner and speed with which households and economies open up will be key to evaluating recovery prospects. Today, it is too early to do so with any kind of certainty and so we rely on scenario analysis which of course produces an enormous range of results.

A recent scenario, offered by independent research house Oxford Economics, presents the following outlook: The world economy is expected to contract by 2.8% in 2020, with advanced economies contracting by 4.5% and emerging markets by 1.1%. This is expected to be followed by a rebound in 2021 with world growth of 5.9%, with advanced economies growing 6.2% (led by the US) and emerging markets growing 7.2% (led by China and India). Oxford Economics expects the third quarter of this year to mark the start of the recovery. Critical to these assumptions, however, is the speed with which the world can ease up on the lockdowns; but just as important is the size and structure of the spending response to support and then stimulate economic activity. In the longer term it is the level of activity achieved rather than the percentage change that will matter more to us.

We think that from a macro perspective, and with caveats, there are encouraging signs from Asia, which of course is further through the pandemic. Restrictions in China, Korea, Taiwan and Hong Kong are being lifted. New cases are being identified but at much lower levels. High-frequency data from the world's largest manufacturing economy are pointing north, especially in March. According to government data the work resumption rate in large industrial companies is back to 98.6% as at March 28th, while that for smaller enterprises is up from 33% at the end of February to 80% as at April 10th. This was supported by monthly data that showed sequential (i.e. compared to the prior month) recovery in industrial production, retail sales and property sales. Compared to the same period last year, activity levels are lower, but at this stage we can identify moderating pressure.

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There have been government responses throughout the region to provide economic support with interest rate cuts, expansion of credit, and fiscal responses including tax cuts and government spending. The situation is helped by the relatively strong financial position of governments and banking sectors. Indeed, globally the banking sector is much better capitalised and balance sheets are a lot cleaner going into this crisis than in the run-up to 2008.

The feedback from companies has been cautious, as one would expect. Those reporting full-year results cited uncertainty in various aspects of their businesses. The quarterly results season just beginning now is perhaps more informative. For example, we saw Taiwan Semiconductor presenting a positive view for its business, driven by demand for chips from telecom handsets and high-performance computing. The company has warned that slowing handset demand will drag on revenues in the second half, but the market was most impressed by its commitment to maintain its US$16 billion capital expenditure plan this year. China Mobile saw a slight drop in revenue for the first quarter due to a drop in handset sales; revenues from telecom services, which make up the bulk of the business however, grew. The loss of 4m subscribers should be seen against a total subscriber base of 946 million at the end of March.

Fund view

Financial health

Our focus on Quality businesses rests upon two pillars: superior operating performance (as measured by returns on capital) that rests upon a solid financial platform (i.e. a strong balance sheet). At a time when operations have been severely disrupted for a period with an uncertain duration, the focus needs to be on the resilience of those financial platforms. Those with strong balance sheets are the ones best placed to turn their operating advantages into cash flows. Capital-intensive businesses are potentially vulnerable.

Our balance sheet analysis has therefore focused on structure and liquidity which we can consider in terms of the following categories: Liquid assets, Working capital structure, Operating assets and Sources of Funding. Taking each of these in turn we have considered the following:

Liquid assets: Cash component, the identity of Cash Equivalents and Short-Term investments together with any pledges or guarantees to support loans to subsidiaries or associates that might exist.

Working capital structure: Related to liquidity, we consider how quickly Accounts Receivables (i.e. sales made but not yet paid for) are converted into cash, how much money is tied up in inventory and finished goods and finally Accounts Payable, the amounts due to suppliers and how soon they must be paid.

Operating assets: This consists of the Property, Plant and Equipment. Does the company own these assets, or does it lease (rent) them? How quickly do they need replacing and how expensive is it to do so?

Sources of Funding: This means a consideration of the proportions funded by the company's own resources (equity) and the proportion of external funding (i.e. debt). The size and maturity structure of external funding is critical in times of stress. Interest must still be paid on borrowing and if the maturity

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structure is wrong a company can find itself with a substantial proportion of debt falling due at a time when it is hardest to refinance.

A capital-intensive business, therefore, is one which has a sizeable proportion of its assets tied up in equipment and working capital; in a time of economic stress, when activity is low then these businesses can quickly run into trouble. Airlines are a perfect example of what can go wrong. Taiwan Semiconductor is another capital-intensive business, but for that company it all seems to be going right; the reason is that its superior production technology delivers high-quality chips that command higher prices at far lower costs than their peers can achieve. This generates sufficient cash for the company to afford $10 billion of capital expenditure in any year to keep them ahead without recourse to significant debt funding. At the last balance sheet date, the cash held on the balance sheet is 2.8x the size of the company's borrowings. Its debt is primarily short-term debt to fund working capital requirements through the year while the cash is there to fund the capital expenditure and the dividend.

The analysis of the portfolio is split between the non-bank portion 81% and the bank portion 19%. The non-bank portion has total debt to equity of 36%, so 63% of our companies' operations are funded with their own resources. When we take account of cash, we can see the overall portfolio is net cash, which is to say that the aggregate cash balances are greater than the amounts borrowed. We are most concerned with the position for the next twelve months, after (and likely well before) which business activity will resume.

In terms of interest coverage, we compare operating income (defined as revenues less operating costs but before interest costs, depreciation charges and tax) to interest expense. The lowest coverage is Hon Hai Precision, whose interest costs are 2.7x covered by operating income. The next lowest are the two Singapore real estate investment trusts (REITs) with 4x and 5x coverage. In the rest of the portfolio, interest expenses are over 10x covered.

Refinancing risk is the next consideration. We looked at near-term financial obligations by combining short-term borrowing, the amount of long-term debt falling due in the next twelve months and lease expenses, and looking at what would happen if there was no access of any kind to further financing. All but five stocks can cover this fully with cash on hand. The five stocks that could not are three REITs (Ascendas REIT, CapitaLand Mall Trust and The Link REIT), Sonic Healthcare and Luk Fook. The maximum exposure at 6% of equity is with Ascendas REIT. The other four have exposures that are less than 2% of equity.

In the bank portion of the portfolio we primarily consider the capital base and the degree to which it is geared by measuring assets to equity. The banks in our portfolio have equity leverage of 8-12 times, which is to say the assets on the balance sheet which consist of loans, bonds or other interest earning instruments are 8-12 times the size of the equity base. This is rather lower than the 15-20 times leverage that is common amongst developed market financial institutions. In the years following the Asian financial crisis, bank leverage in the region came down and capital bases increased, which meant that they were largely unscathed in the global financial crisis 10 years on. Further financial reforms, especially in China, saw a reduction in shadow banking activity, with more brought onto the balance sheet and more capital set aside to support it.

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Operations and Dividends

Earnings estimates for this year are a moving target. Much will depend on the ability and willingness of consumers to begin to return to normal. A significant proportion of the portfolio might be described as economically sensitive. We have exposure to consumer electronics through technology manufacturing, to consumer discretionary segments like clothing, home appliances as well as insurance. There is also exposure to commercial lending and finance businesses which are linked to economic activity. A difficulty at the moment is that the nature of this event can be seen to have first, second and third-order effects. As the market tries to get to grips with this, we have seen share prices move wildly across the board.

On our side are businesses with core strengths to weather the storm and competitive advantages and market positions which should enable them once again to grow cash flows and dividends once activity resumes. So, operating performance in cash flow terms and the resultant dividends are likely to continue to be the most important long-term determinants of performance.

We are confident in the strength of our companies' financial platforms and we have not changed our views on the operating skills, strengths in production and distribution and their overall competitive advantages in normal conditions. We expect our companies to have the ability and willingness to pay dividends but expect this to be tested in the coming year. Companies in Asian and emerging markets tend to have dividend policies that are calculated as a proportion of earnings, otherwise known as a pay-out ratio. In developed markets a progressive dividend policy, where the company seeks to increase (or at least maintain) the dividend per share from year to year is more common. We hold some such in the portfolio, such as Aflac, Janus Henderson and Sonic Healthcare, but for the most part the companies operate a pay-out ratio policy.

When we assess dividends paid by our companies, therefore, we are very often looking for stability in the pay-out ratio. This means, however, that in a year when earnings drop, dividends are likely to fall too. Consensus estimates for company earnings in 2020 have of course been coming down. The latest estimate for our portfolio companies is for a decline of 8.6% in 2020 followed by a 9.7% recovery in 2021. But it is important to remember this is still a moving target.

We have looked back to the Financial Crisis and its aftermath from 2007-10 to see how dividends from the companies we hold in the portfolio today fared back then. The situation was driven by different dynamics and so should not be seen as a template for what happens next, but it can tell us a little about how the management groups of these companies reacted in a period of high uncertainty and economic disruption.

Figure 1 shows the change in dividends per share in 2008 for 33 of the 36 companies we hold (the remaining three did not report dividends in 2007) and compares them to the 2008 dividend performance of companies that presently constitute the S&P Pan Asia Dividend Aristocrats Index and the MSCI Asia Pacific ex Japan Index.

Figure 2 shows the average annual growth rate of dividends from these same groups over the 2007-10 period.

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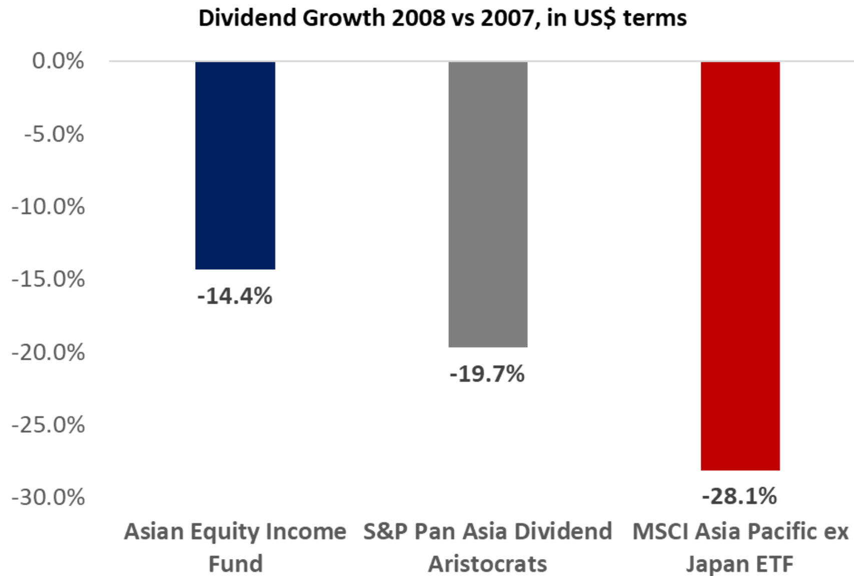
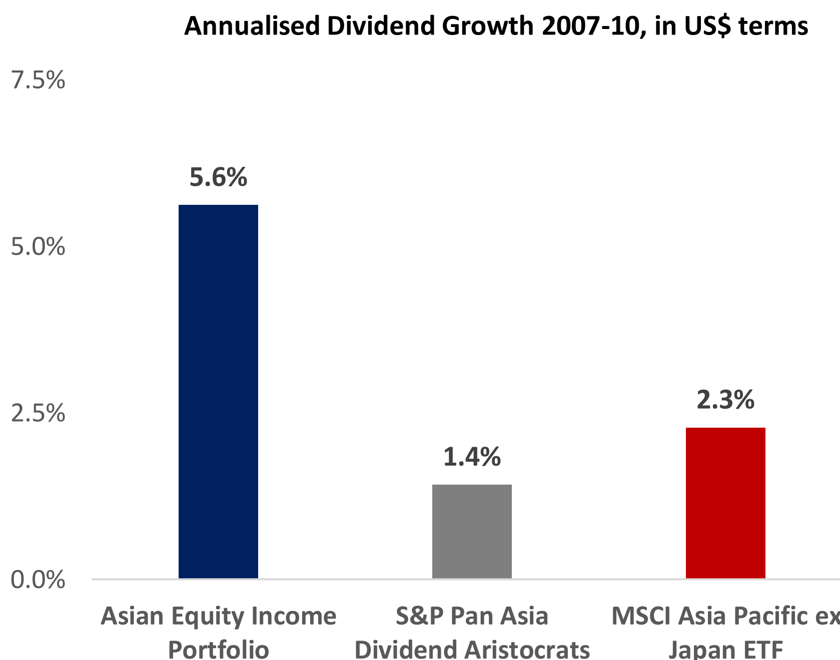


[**Figure 1**. *Sources: Bloomberg, Company data and Guinness Asset Management calculations. Figures are based on dividends per share reported 2007 and 2008, in US$ terms, by the companies held in the portfolios as at 31 March 2020. For Guinness Asian Equity Income, 33 of the 36 companies held reported dividends in the period; for S&P Pan Asia Dividend Aristocrats 91 out of 100 companies reported and for MSCI Asia Pacific ex Japan Index, for which we use the Lyxor ETF (AEJ FP) as a proxy, 748 companies out of 1,236 reported.*]



[**Figure 2.** *Sources: Bloomberg, Company data and Guinness Asset Management calculations. Figures are based on dividends per share reported between 2007 and 2010, in US$ terms, by the companies held in the portfolios as at 31 March 2020. For Guinness Asian Equity Income, 33 of the 36 companies held reported dividends in the period; for S&P Pan Asia Dividend Aristocrats 91 out of 100 companies reported and for MSCI Asia Pacific ex Japan Index, for which we use the Lyxor ETF (AEJ FP) as a proxy, 748 companies out of 1,236 reported.*]

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As at the end of March, 22 out of our 36 companies had reported full-year results and overall dividend growth was running at 2.3% in US dollar terms compared to the same period last year. This calculation takes into account that one of the companies in the portfolio, AAC Technologies, omitted its final dividend.

Portfolio update

Outperforming names in the portfolio during the month and quarter have been concentrated among the Chinese stocks. China Construction Bank, China Merchants Bank, Ping An (in Financials), China Mobile (in Communication Services) and China Resources Gas (in Utilities) have worked well for us. Alongside these were Catcher Technology and Taiwan Semiconductor Manufacturing. The rest were underperformers over the period.

The weakest stock in the portfolio has been Corporate Travel Management, for which business has dried up. Its balance sheet, however, is strong and it is differentiated from other travel companies by its business model. Being in the corporate business, rather than leisure, it does not block-book tours which sit on the balance sheet before being sold on. The company operates on a pass-through basis, receiving payments and passing onto airlines on a 30-day cycle while taking fees along the way. This means the balance sheet is light, debt is small and because the core business asset is a technology platform, the cost base is variable. The company has access to ample credit lines should it need them to cover its fixed costs for an extended period.

The rest of the portfolio includes Staples, Discretionary, Health Care, Real Estate, insurance, asset management and technology services across the rest of Asia, designed to give us exposure to the structural trends that existed before this crisis and which remain in place. Since the end of the quarter we have seen a broadening in the number and types of names that are outperforming and while we are not necessarily happy with share price action over the quarter, we remain confident in the operating strengths of the businesses themselves. If, as they say, the proof of the pudding is in the eating, then we believe the proof of these companies will be in the dividends they pay.

Over the quarter we have made two changes to the portfolio, both driven by new ideas that we have been watching while waiting for an attractive entry point. The first is Zhejiang Supor, a China A-share company which makes kitchen equipment (its French parent SEB owns Tefal) and the second is Shenzhou International, a textile company supplying companies such as Nike, Adidas and Ralph Lauren. We sold Li & Fung to make way for one of these names. The second company, sold more recently, will be discussed next month. For a while we were at 37 names and the delay in the second sale was a matter of timing – the volatile conditions that suited the purchase did not equally suit the sale. The portfolio is now back at 36 positions.

Outlook

We continue to try and ground our view of prospects for the portfolio on the separate pillars of basic financial strength, operational cash flows, dividend streams and valuation. As you may judge going through that list, the level of uncertainty rises at each step. However, we take a longer-term view when building the investment case for each position. This means that even in a time of significant disruption

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we are confident that the businesses are not at risk. Some may resume more slowly than others, but all have fundamental financial and operational strengths, in our view.

The valuation question is more difficult, especially if it is considered in terms of multiples of earnings over the next couple of years. But our core approach is different. We think about the cash flows these companies are capable of generating over time and what these cash flows are worth in today's money. In this context, a disruption over the next year to two years does not have such a great impact on valuation assumptions and helps us to separate out the intense noise of current market volatility from the fundamental long-term assessment of value. This has been our approach since the Fund was launched and we shall stick to it.

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

Data sources

Fund performance: *Financial Express, total return*

Index and stock data: *Bloomberg*

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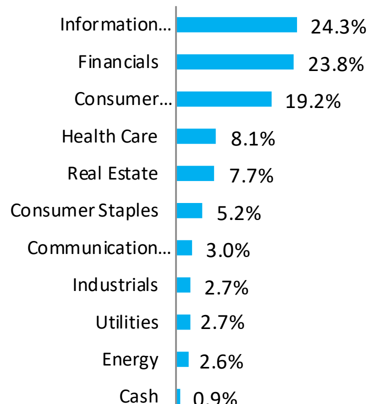
PORTFOLIO

31/03/2020

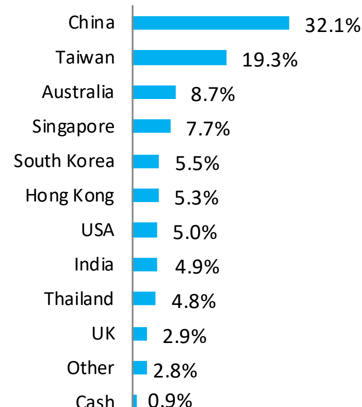
Fund top 10 holdings

JB Hi-fi	3.2%
Elite Material	3.0%
China Mobile	3.0%
Janus Henderson	2.9%
Taiwan Semiconductor	2.9%
Sonic Healthcare	2.9%
Public Bank Bhd	2.8%
China Merchants Bank	2.8%
Novatek Microelectronics	2.8%
KT&G Corporation	2.8%
% of Fund in top 10	29.1%
Total number of stocks in Fund	37

Sector analysis



Geographic allocation



PERFORMANCE

31/03/2020

Discrete years % total return

	Mar '20		Mar '19		Mar '18		Mar '17		Mar '16	
	USD	GBP	USD	GBP	USD	GBP	USD	GBP	USD	GBP
Fund (Y class, 0.99% OCF)	-21.7	-17.7	-3.8	3.6	20.8	7.6	17.6	35.2	-5.6	-2.5
MSCI AC Pacific ex Japan Index	-13.7	-9.3	-4.3	3.0	21.7	8.5	18.2	35.8	-11.4	-8.5
IA Asia Pacific ex Japan	-15.6	-11.3	-4.3	3.1	20.4	7.3	17.5	35.1	-11.0	-8.1

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)	-15.7	-13.2	-25.8	-20.7	-21.7	-17.7	-9.0	-8.3	17.9	55.6
MSCI AC Pacific ex Japan Index	-13.0	-10.4	-19.7	-14.3	-13.7	-9.3	0.5	1.4	13.8	50.2
IA Asia Pacific ex Japan	-14.2	-11.6	-21.7	-16.4	-15.6	-11.3	-2.7	-1.9	11.5	47.1

Annualised % total return from launch

	USD	GBP
Fund (Y class, 0.99% OCF)	2.7%	7.3%
MSCI AC Pacific ex Japan Index	2.1%	6.7%
IA Asia Pacific ex Japan	1.7%	6.3%

Risk analysis - Annualised, weekly, from launch on 19.12.2013

31/03/2020

	Index		Sector		Fund	
	USD	GBP	USD	GBP	USD	GBP
Alpha	0.0	0.0	-0.1	0.5	1.0	1.5
Beta	1.0	1.0	0.9	0.9	0.9	0.9
Information ratio	0.0	0.0	0.0	0.0	0.1	0.1
Maximum drawdown	-29.3	-26.4	-28.8	-24.5	-33.2	-24.8
R squared	1.0	1.0	1.0	1.0	0.9	0.9
Sharpe ratio	0.0	0.2	0.0	0.2	0.0	0.3
Tracking error	0.0	0.0	3.5	3.5	5.7	5.7
Volatility	16.2	15.4	15.2	14.0	14.8	14.6

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Source: Financial Express, bid to bid, total return (Y Class, 0.99% OCF). Fund launch date: 19.12.2013. Fund returns are for share classes with a current Ongoing Charges Figure (OCF) stated above; returns for share classes with a different OCF will vary accordingly.

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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, 18 Smith Square, London SW1P 3HZ.

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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
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Telephone calls will be recorded and monitored.