Guinness Best of China Fund

INVESTMENT COMMENTARY – June 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

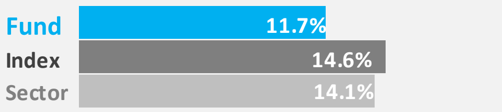
31.05.20

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

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

	1 year	3 years	From launch
Fund	8.3	11.3	64.0
Index	9.9	20.7	83.3
Sector	14.7	25.9	79.9

Annualised % total return from launch (GBP)



Risk analysis (annualised, weekly, from launch)

	Index	Sector	Fund
Alpha	0.0	-0.3	-2.5
Beta	1.0	1.0	1.0
Info ratio	0.0	-0.2	-0.4
Max drwdn	-17.8	-21.7	-25.7
Tracking err	0	5	6
Volatility	17.8	17.9	19.1
Sharpe ratio	0.6	0.5	0.4

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 2.0% (in USD, Z class) while the MSCI Golden Dragon Net Total Return Index also fell 2.0%.

- MSCI China fell 0.5% and MSCI Taiwan fell 2.5%. The Shenzhen Component Index fell 0.5% while the Shanghai Stock Exchange Composite Index fell 1.1%.

- In MSCI China, the strongest sectors were Consumer Discretionary (total return of +4.6%), Consumer Staples (+2.8%) and Health Care (+2.1%), while the weakest were Real Estate (-5.8%), Financials (-4.7%) and Materials (-4.4%).

- In Taiwan, the Information Technology Index, which makes up more than half of the Taiwanese index, fell 3.1%.

- In the Fund, positive contribution came from Haitian International (Industrials) and smartphone component manufacturers Elite Material, Novatek Microelectronics and Qualcomm. Consumer Discretionary names Alibaba, Zhejiang Supor and Haier Electronics were also positive contributors. On the other hand, we saw weakness in China Overseas Land & Investment, Hollysys Automation, China Lesso and Geely.

- Most of the Fund's underperformance this year can be attributed to its holdings in the Consumer Discretionary and Information Technology sectors. In the former, 1.2% of the 5.6% underperformance is attributable to Luk Fook, 0.9% from China Lilang and 0.7% from Li & Fung (which has been sold). In the Information Technology sector, 2.0% of the 5.6% underperformance is attributable to Tongda Group and 1.6% to AAC Technologies, both of which have been sold.

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Events in May

- An outbreak of COVID-19 cases emerged in north-east China, starting in Heilongjiang province, which shares a border with Russia. Cases spread to neighbouring Jilin province, with Shulan city locking down like Wuhan did in January. So far the outbreak seems to have been contained but serves as a reminder that coronavirus is likely here to stay until an effective vaccine can be developed.

- The Caixin Purchasing Managers Index, which is more geared towards private enterprises, increased from 49.4 in April to 50.7 in May, indicating an expansion in activity. The production sub-index rose to 54.0, its highest level in nine years, as activity makes up for the time lost in February and March. On the other hand, though the new export order sub-index improved to 41.7, this still indicates weak demand from abroad.

- MSCI Hong Kong fell 8.4%, with the Financials and Real Estate sectors, which are by far the largest parts of the local index, falling 8.2% and 13.6%. China is in the process of drafting laws which would ban subversion, separatism, terrorism and "activities of foreign forces" in Hong Kong. This development bypasses Hong Kong's Legislative Council, leading some to argue this violates the 'one country, two systems' principle.

- The move represents greater assertiveness by China. It may be a sign that China has lost confidence in Hong Kong's government or it could be a broader signal that China feels less constrained by its relationship with the US. The response so far by the US has been to begin the process of removing policy exemptions that give Hong Kong special treatment. This covers export controls, customs, financial transactions and immigration. For now, China may view this as a small price to pay for reasserting control over Hong Kong.

- Tensions between the US and China increased on multiple other fronts. The US tightened export controls on semiconductor exports to Huawei, and now explicit permission is required from the US government. The US Federal Retirement Thrift Investment Board, which manages more than $500bn in assets, postponed a plan to increase its allocation to Chinese shares after pressure from the White House. The US Senate approved a bill to force foreign companies to open their books to the Securities and Exchange Commission, increasing the likelihood Chinese companies delist from American bourses and list elsewhere. Netease and JD.com are on track to launch a secondary listing in Hong Kong, both following on from Alibaba last year.

Market Update

According to analysis by Goldman Sachs covering 90% of Chinese companies' market capitalisation, earnings of Chinese companies fell by 22% in the first quarter. Consumer Staples, as expected, grew earnings due to higher pork prices and good sales of Baijiu. Banks also grew earnings by 5%, but in the future we expect headwinds from rising non-performing loans and net interest margin compression. Internet stocks also outperformed, covering gaming, search and e-commerce. Due to the collapse in oil prices, Energy stocks faced significant losses; note the Fund has no exposure to the Energy sector.

Industrials, Consumer Discretionary and Information Technology saw earnings fall 66%, 59% and 47%. We expect second-quarter results to show a better picture as economic data indicate the recovery is continuing. As of May 26th, daily coal consumption of major electricity producers was 26% higher year-on-year. Traffic congestion within major cities is back to normal levels, though volume through subways remains a quarter below historical levels. Property sales volume is back to last year's levels.

During its annual National People's Congress meeting, the government dropped its GDP growth target due to the uncertainty arising from coronavirus. But it was noticeable that the government has a target of creating nine million jobs in urban areas and is targeting an urban unemployment rate of 6%. The government also made it clear it will not stimulate the economy like it did after the global financial crisis with broad monetary and infrastructure stimulus. Though the official budget deficit is forecast to be 3.6% of GDP, this does not include all sources of funding for the government, such as from special government bonds and off-budget items such as proceeds from land sales. Based on calculations by JP Morgan, China's augmented fiscal deficit will reach 15.1% of GDP in 2020, the highest since 2009. The Ministry of Finance is projecting an official on-budget deficit of 3.6% of GDP and estimates the official on-budget deficit will be RMB 3,760bn. The implied GDP growth target for 2020 is therefore 3.8% if we use last year's GDP deflator of 1.6%.

The PBoC has already committed RMB 1.8trn (assuming USDCNY 7.10, equivalent to $250bn) for a relending programme, with 42% of the total deployed as of June 4th. On June 2nd, the PBoC rolled out further measures to support small and medium-sized enterprises (SMEs). To help improve cash flows for SMEs, for loans due this year SMEs can defer payment of principal and interest until March 2021. This is in return for keeping employment stable.

SMEs account for 80% of total employment in China but only 4% of system loans, according to analysis by JP Morgan. The big five banks lend the majority of their funds to state owned enterprises (SOEs), meaning rural banks and city commercial banks are the main channel through which SMEs access credit. As of March 2020, inclusive finance (which includes SMEs and personal business loans with loans worth less than RMB 10m ($1.4m)) to total loans was only 5% for large banks. This compares to 7% for joint-stock banks, 10% for city commercial banks and 24% for rural financial institutions. Rural financial institutions and city commercial banks contributed to 52% of inclusive finance loans in the first quarter, highlighting their importance.

Due to their smaller size, information asymmetry and potentially riskier cash flows, lending to SMEs is viewed as riskier. This is reflected, for example, in the non-performing loan (NPL) ratio, which was 3.2% for SMEs compared to 1.9% for total loans. Additional incentives are therefore needed to encourage lending to smaller businesses. To help SMEs manage liquidity, the PBOC is now also setting up an additional relending facility worth RMB 400bn ($56bn) targeted towards micro SMEs. The underlying banks issue the loans and the PBOC will use the facility to purchase 40% of new loans, returning them to the underlying bank after a year. This will temporarily reduce the capital needs of these banks when lending to SMEs, making it more likely they will lend to SMEs. The big five banks also have a target of increasing inclusive finance by 40%, which implies an increase of RMB 1trn ($141bn).

Portfolio Update

Hollysys is a provider of automation and control technologies which targets industrial and railway customers. Revenue in the most recent quarter fell 35% year-on-year while net profit fell 50%. Lockdowns and a restriction on movement were obvious impediments which particularly impacted the higher-margin services business, which requires an on-site presence. It took until April for the labour return rate to reach 90%, since Beijing, where Hollysys is headquartered, only lowered its risk level at the end of April. Management expects that in the second half of this year, business should get a boost as China Railway restarts bidding activity, which has been relatively quiet for the past few quarters. Hollysys should get a further boost as China Railway has pledged to increase its railway investment target, which was already CNY 800bn / USD 112bn.

Autohome is China's largest online platform for buying and selling cars. Revenue in the first quarter fell 4%, with a 10% drop in advertisements and lead generations partly offset by an 85% rise in data revenue. 2020 is likely to be challenging if, as expected, car sales fall due to coronavirus which is likely to lead to reduced marketing budgets. There are, however, steps that Autohome can take to manage this headwind. More customers are buying Autohome's data products such as a "Smart Assistant" driven by AI which answers buyer's queries. Clients have consequently seen conversion rates increase by at least 20%. The weakness in the automobile market extended to Geely Automobile, who issued 600m new shares, raising $850m of funds.

Sino Biopharmaceutical's revenue and earnings were flat in the first quarter. Sales in the hepatitis franchise were down 24% as multiple products saw their prices cut as the government reins in healthcare costs. On the other hand, sales of oncology products rose 61%, surpassing hepatitis sales. Anlotinib, used to treat small cell lung cancer, is on its way to becoming a blockbuster drug for the company. Sino Biopharmaceutical also launched new oncology generics which are included in the government's centralised purchasing plan such as abiraterone (used to treat prostate cancer) and gefitinib (used to also treat non-small cell lung cancer).

Qualcomm reported better results than expected. Smartphone sales likely fell 21% and Qualcomm is expecting a further 30% fall in handset shipments in the next quarter. However, on a more positive note, average selling prices (ASPs) rose from $23 in the previous quarter to $32 in the most recent quarter. As 5G phones become more popular, Qualcomm should see a significant increase in sales as the market leader in its space. In China, 5G phones' market share has rapidly increased from 19% in the fourth quarter of 2019 to 40% in May, and we expect the rest of the world to follow this trend.

Baidu also fared better than expected. Though revenue fell 7% in the first quarter, with a 13% decline for the core business, this was offset by better cost control. The number of daily active users of the Baidu App rose in the quarter by 27 million users to 222m. More users are conducting their searches within the app, which means Baidu does not need to pay acquisition costs, helping margins. As hospitals drastically curtailed routine operations and procedures in the first two months of the year, revenue from this segment fell significantly and we expect a rebound as hospitals resume normal operations. Though the business has its challenges, we think the valuation is very undemanding based on a conservative sum of the parts approach.

Portfolio Switches

We are in the process of selling a position which will be revealed in next month's update when the sale is complete. In its place we bought JD.com, one of China's largest e-commerce websites. JD differs from Alibaba in that it has built its own logistics platform, so has more control over the quality of its service and the amount of inventory it holds. This means that during the worst of the lockdown, JD was better stocked than its peers and so was the only place online to buy certain goods. JD was initially known for selling electronics but has branched out into apparel and more recently groceries, and so has seen very strong demand this year. In the first quarter, JD's revenue grew 20% while overall online retail consumption fell 1%, highlighting its strong position. The company is seeing its highest demand by retailers in 17 years for the upcoming 618 Shopping Festival. The purchase of JD.com gives the Fund more exposure to e-commerce, which is likely to see even more adoption this year as coronavirus changes consumer habits.

Summary view & outlook

Recent changes we have made to the Fund are summarised below:

Out	
Name	**Sector**
Travelsky	Information Technology
Li & Fung	Consumer Discretionary
Tongda Group	Information Technology
AAC Technologies	Information Technology

In	
Name	**Sector**
Zhejiang Supor	Consumer Discretionary
JD.com	Consumer Discretionary

We are in the process of shifting the number of positions in the Fund to 30 concentrated positions. These changes mean the Fund's allocation to the Information Technology sector has fallen from 28% in December 2019 to 19% in May. The Fund's allocation to the Consumer Discretionary sector has increased from 19% in December 2019 to 22% in May. Debt/equity for the portfolio, excluding the three banks, is 45% i.e. the Fund is not highly geared. If we look at net debt/equity, which subtracts cash from debt, the figure is -17% 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 12.0x and BOC Hong Kong the least at 10.0x.

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*

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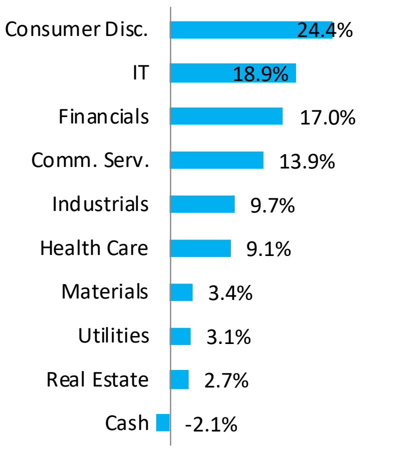
PORTFOLIO

31/05/2020

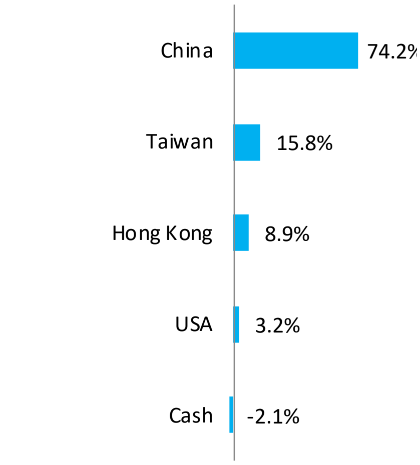
Fund top 10 holdings

Haitian International Hol	3.9%
Noah Holdings	3.8%
Baidu	3.6%
Haier Electronics	3.6%
China Merchants Bank	3.6%
Netease.com	3.6%
Novatek Microelectronics	3.5%
Autohome	3.5%
JD.com	3.5%
Ping An Insurance	3.4%
% of Fund in top 10	36.0%
Total number of stocks	32

Sector analysis



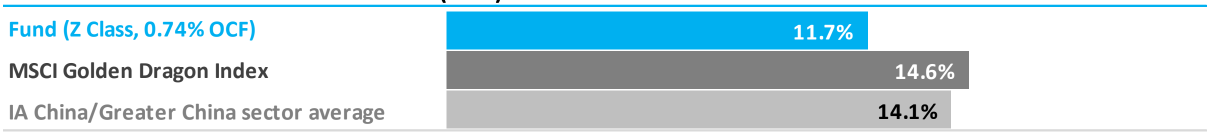
Geographic allocation



PERFORMANCE

31/05/2020

Annualised % total return from launch (GBP)



Discrete years % total return (GBP)	May '20	May '19	May '18	May '17	May '16
Fund (Z Class, 0.74% OCF)	8.3	-15.6	21.8	22.7	-
MSCI Golden Dragon Index	9.9	-7.7	19.0	46.5	-18.4
IA China/Greater China sector average	14.7	-11.6	24.2	44.2	-21.5

Cumulative % total return (GBP)	1 month	Year-to-date	1 year	3 years	5 years	From launch
Fund (Z Class, 0.74% OCF)	0.1	-6.5	8.3	11.3	-	64.0
MSCI Golden Dragon Index	-0.1	-1.6	9.9	20.7	44.2	83.3
IA China/Greater China sector average	1.0	2.1	14.7	25.9	42.5	79.9

RISK ANALYSIS

31/05/2020

Annualised, weekly, from launch on 15.12.15, in GBP	Index	Sector	Fund
Alpha	0.00	-0.34	-2.47
Beta	1.00	0.97	1.01
Information ratio	0.00	-0.17	-0.40
Maximum drawdown	-17.78	-21.67	-25.74
R squared	1.00	0.94	0.89
Sharpe ratio	0.60	0.54	0.41
Tracking error	0.00	4.58	6.29
Volatility	17.82	17.93	19.11

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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.