GUINNESS ATKINSON FUNDS

Asia brief

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October 2015

Commentary and Review by Portfolio Manager Edmund Harriss & Analyst Mark Hammonds

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3rd Quarter Review for Asia Pacific Dividend Builder Fund

The third quarter saw equity markets sell off sharply, led lower by emerging markets. The Fund underperformed over the period but outperformed the market, as measure by the MSCI MSCI AC Pacific ex Japan Index.

The market's mood in the last three months was influenced by weakening Chinese economic data and the belief that an interest rate increase in the US was imminent. The change to China's currency regime (which prompted a 2.7% drop in the Yuan's exchange rate against the dollar) spooked investors who were already skittish. The immediate interpretation was that this represented devaluation, an active policy decision to weaken the currency which must therefore mean policymakers in China were beginning to panic.

Market action over the period has taken the form of dollar strength, a withdrawal of liquidity from emerging markets (resulting in pronounced currency weakness amongst the more indebted nations) and valuation compression in equity markets. The MSCI AC Pacific Index ended the quarter trading on an historic Price-to-Book multiple of 1.2x and a trailing Price-to-Earnings multiple of 10.7x. Looking over the past twenty years, these levels are crisis valuations.

Performance drivers

The focus of this Fund is companies that have demonstrated competitive advantages by generating a return on invested capital above the cost of capital over time. We look to invest in those companies which we believe can sustain those returns but where the market is valuing them on the basis that they won't.

This approach continued to work for the Fund during this particularly testing period. Out of the 36 holdings, 22 names outperformed and 14 underperformed. The top three performers (which rose during the period) included two Chinese names: AAC Technology, which makes smartphone components, and Shenzhou International, a textile and garment maker. The relative performance of the Fund was also supported by Taiwanese technology names including Asustek, Catcher Technology, Hon Hai and Taiwan Semiconductor. These businesses all benefit from ongoing consumer demand for high-end hand held devices, be they smartphones or tablets.

Looking at performance on a sector basis, consumer stocks, telecom services and information technology were the strongest contributors. The weakness was concentrated in banks and in energy. Chinese banks had a hard quarter, with China Merchants Bank, the best performer, down 17.24% and China Minsheng Bank, the weakest, down 29.71%. There were some earnings downgrades associated with these returns, but these were modest: the weakness was largely due to valuation compression on weak sentiment. Energy stocks CNOOC in China and PTT in Thailand were also down heavily as the oil price weakened further.

Portfolio changes

Clearly, market conditions caused us to review our holdings and ensure that the assumptions underpinning our original decision to buy still held. We maintain our view on China. Though facing challenges, it is not an economy in crisis; there is no danger of capital flight of the kind that has hit Brazil and Turkey, for example, and the central bank has ample scope to manage domestic liquidity conditions. We also hold on to the view that the market weakness we have seen does not reflect material changes to operating conditions. Our response has therefore been to rebalance into the weakness.

There have been two stock changes. At the start of the quarter Huabao International decided, after seven years, to omit its final dividend. The company justified this by highlighting the special dividend paid on top of its ordinary dividend at the interim stage and uncertain industry conditions ahead. We sold the position and purchased Aflac Inc, a US-listed health insurer that generates much of its business in Japan. The second stock change was triggered by the acquisition of iiNet, an internet service provider in Australia, by TPG Telecom. We purchased Largan Precision in its place, a manufacturer of high-end camera lenses.

Outlook

We maintain our focus on those companies whose prospects we believe are undervalued by the market. Our emphasis on cash-based returns on investment and on those companies that can offer a growing dividend stream on the back of those returns is an attractive combination, in our opinion. Slower growth in Asia is the reality and in part a function on slower trade growth (which the World Trade Organisation now expects to grow only 1.5% this year and 3% next year), that is in turn a reflection of a relatively weak global economy. In our view this has been more than priced in to Asian markets and our portfolio of companies that have demonstrated their ability to sustain profitability through difficult operating conditions in the past is trading at a discounted valuation to the overall market.

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Opinions expressed are subject to change, are not a guarantee and should not be considered investment advice.

The Fund invests in foreign securities which will involve greater volatility and political, economic and currency risks and differences in accounting methods. The Fund is non-diversified meaning its assets may be concentrated in fewer individual holdings than diversified funds. Therefore, the Fund is more exposed to individual stock volatility than diversified funds.

This information is authorized when preceded or accompanied by a prospectus for the Guinness Atkinson Funds. The prospectus contains more complete information, including investment objectives, risks, fees and expenses related to an ongoing investment in the Funds. Please read the prospectus carefully before investing.

Click Here for a list of Holdings for the Asia Pacific Dividend Builder Fund.

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MSCI AC Pacific ex Japan Index captures large and mid cap representation across 4 of 5 developed markets countries, excluding Japan, and 8 emerging markets countries in the Asia Pacific region.

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Price-to-Book Ratio (P/B) is used to compare a company's current market price to its book value.

Price-to-Earnings Ratio (P/E) is an equity valuation multiple. It is defined as market price per share divided by annual earnings per share.

Fund holdings and sector allocations are subject to change and are not a recommendation to buy or sell any security.