- For the moment markets are looking toward domestic US policy enactments that are likely to generate growth.
- Life has clearly become more complicated outside the US as the President seeks to redefine the world via Twitter and is none too bothered about sugar-coating it. The speed of policy evolution and delivery, rather than the manner of it, is the challenge.
- The best approach we can think of is to put money behind good quality businesses that have demonstrated their strength by generating a return on capital that has been higher than the cost of that capital for many years and therefore is likely, we believe, to go on doing so.
- Asia trades at a 27% discount on a price/earnings ratio basis to developed markets and our portfolio trades at a 14% discount to Asia.
- Our two fundamental questions continue to guide us in our decision to invest in a company and at what price:
    - "Will the returns on investment of the past carry on into the future?" and
    - "What discount will we apply to value those returns?"

**Markets**

The performance of Asia and of emerging markets more broadly has been much stronger than developed markets this year, but they had been relatively weaker in December. Looking at the last two months together, world markets, developed and emerging have moved roughly in line, up between 4% and 5% in dollar terms. The performance of markets suggests they are looking at a different set of issues from the news media. The story is all about President Trump and while the news media focuses on his enactment of US immigration policies and foreign relations, markets appear to be looking forward to the enactment of domestic economic policies designed to stimulate US growth.

There are two macro areas that will occupy markets this year and with which we in Asia will also have to contend (over and above issues in China, North and South Korea, Thailand etc.…):

1. US policy

We expect that US domestic needs will now be placed above foreign policy priorities especially with respect to trade. President Trump has complained about 'unfair' trade practices relating to almost all trade agreements and individually against China, Mexico, Japan and Germany. Trump says it's time to "stop being taken advantage of" but in fact it's the result of a conscious fundamental policy decision. For forty years, since the Nixon era, trade has been a tool of US foreign policy: by opening its own markets to outsiders while accepting more restricted access for its own companies in return, the US has acquired greater geopolitical clout because foreign economies now benefit so greatly from that US market access. The cost has been born by American workers although benefits have accrued to US consumers. Even twenty years ago workers and consumers could be considered one and the same but in fact they have splintered between those of the old industrial production sectors that have lost out and those of the New Economy that have gained. But whether it was policy choice or basic unfairness, Trump is set on reversing the tide.

One immediate concerns for Asia, and anyone else exporting into the US, is the possible implementation of a border adjustment tax. This would mean that only costs incurred in the US are deductible for the tax calculation on profit as opposed to the prior arrangement in which costs incurred overseas were also recognised. This will clearly hurt margins for US distributors and the burden will be shared with overseas suppliers. This is not a done deal and lobbying is underway but something along these lines looks likely. Such a move might be preferable to a selective imposition of tariffs. It would affect all countries' competitiveness versus the US but not against each other putting the EU, China and rest of Asia on an equal footing. A second issue is the Administration's attitude toward China. Peter Navarro is a professor of economics and public policy who has been appointed as the head of the President's new US Trade council. He has published a number of books including one titled *Death by China* which gives some sense of his views. He also recently described the euro as 'an implicit deutschemark' suggesting Germany is behind its weakness to extract a trade advantage.

Our view: It seems clear that Trump is intent on changing the basis on which the US conducts its trade and is also driven by a need to increase tax revenues from this source in order to fund tax breaks he wishes to introduce domestically to generate growth. However, it is also true that the global supply chain has developed rapidly and is based upon more than just low cost labour. Technology, logistics, communications, know-how and capital have all combined to make a highly competitive package. Trump wants to move quickly but he is not seeking to adapt to the new world but to turn back the clock to America of the 1950s and 1960s. We don't think it will work.

Our response therefore is focus on companies whose production skills, product development, capital allocation and customer relations put them at the forefront of either the global supply chain or their domestic markets. Trade growth in any case has been slowing and the US market, though still important is not the growth driver it once was. The wealth of the emerging world is increasing and new markets are opening up. From China's standpoint specifically, it could also serve to speed up their own economic transition to develop domestic consumption. We need to focus on the ability of our companies to continue to generate the cash flow based returns they achieved in the past and we also need to be conservative when applying a discount rate to value those returns.

2. Europe

Europe is under increasing political and financial strain, conditions that are not conducive to problem solving. The UK has voted to leave the European Union and although the UK government lost its case in the Supreme Court that requires the matter to be put to a vote in Parliament, it has just received an overwhelming parliamentary endorsement. Therefore the UK will move toward its exit. At the same time elections in France, the Netherlands and Germany are coming up this year with similar issues that dominated the UK referendum and the US election holding sway.

Debt issues in the Eurozone have not received much attention lately but Italy narrowly averted a banking crisis over Christmas, but the fundamental problems remain in the Italian banking system. Greece is also about to come back into focus with another debt payment coming due later this month. Greek bond yields have started to climb again, with the 10 year government bond yield at 7.36%, 1% higher than at the beginning of December 2016. To be sure, they are nowhere near the 30% level of March 2012 but it is a reminder that this is (another) problem deferred, not solved.

Our response, as before is to focus on the companies in which we invest rather than try to make a macro-based decision. Our two fundamental questions "Will the returns on investment of the past carry on into the future?" and "What discount rate should we apply to value those returns?" continue to guide us in our assessment of whether we want to invest in a company and how much we should we pay for its shares.

**Company news**

In keeping with our stock specific approach the best performing stocks over the past month have been technology companies Largan Precision and Catcher Technology from Taiwan; AAC Technologies from China; Hong Kong jewellery retailer Luk Fook; three banks in Hong Kong, Singapore and China; PTT, an energy company in Thailand and Belle International a China footwear designer and retailer.

Underperforming positions included Hanon Systems (Korean auto-parts), Henderson Group (asset management), China Construction Bank, Li & Fung (a Hong Kong-based factory agent), and St Shine Optical (a Taiwanese maker of contact lenses). The outstanding laggard however was Qualcomm which fell 18% in the month and we topped up the position. This followed news of a law suit brought against it by Apple complaining about unreasonable business practices. Qualcomm's model is to levy a charge on any device that incorporates its technology, based on the overall price of the device. Apple's point is that its devices contain features unrelated to Qualcomm technology that allow it to charge a premium price which it must then share with Qualcomm. Lawsuits in this sector are frequent and the sums sought are generally substantial but we believe the share price drop was overdone.

Companies that reported this month include Ascendas REIT and CapitaMall Trust in Singapore, Largan Precision and TSMC in Taiwan, KT&G in Korea, Tisco in Thailand and Aflac in the US. Ascendas reported its third quarter results which were ahead of expectations while CapitaMall full year results were flat. Both are potentially vulnerable to higher US interest rates but they both offer the prospect of dividend growth and all their financing needs are covered. Largan's results were solid rather spectacular but management's outlook points toward sustained earnings growth over the next 2 years with new dual camera smartphones and the settlement of its own lawsuit (as we said, these are frequent in this sector) should allow it to cut into the single lens compact camera module market (think car cameras after smartphones). Taiwan Semiconductor (TSMC) offered no surprises and was a market performer during the month.

KT&G posted strong results, as expected, but some analysts had hoped there would be a (positive) change to the dividend policy. As it was the company kept to its long term policy and stock has fallen back – we do not think sticking to the policy is a problem and therefore we remain buyers on the weakness. In Thailand, Tisco Financial reported results that while slightly below expectations for net profit were strong at the operating level. The reason the bottom line was weaker was to increase their provision coverage of non-performing loans. Building bad debt provisions when time are good is something we like. A lot. Thailand was the epicentre of the Asian financial crisis in 1998 and to see a Thai finance company (whose consumer lending is inherently riskier) exercising prudent provisioning policies through the cycle is what will support cash flow returns and dividends over time, in our view. Finally Aflac, which generates over 50% of its revenue from Japan, reported results that for the fourth quarter of 2016 missed forecasts. The stock was a significant outperformer in 2016 but has experienced weak sales in the last two months. This is the product of higher staff turnover in the US business since Aflac linked compensation more closely to new sales. Aflac believes the coming year will still be good and this is based upon stabilisation in the US but its operations in Japan are the main driver.

**Outlook**

The portfolio as it stands today is trading on a price/earnings valuation discount of 14% to Asia which in its turn is at a 27% discount to developed markets. All of these companies are high quality businesses as we define the term (high and sustained return on invested capital) that we believe are well positioned to cope with greater global uncertainty.

While it is reasonable to be concerned about the world at large we still believe it is more useful and worthwhile to worry about our companies. Can they continue to generate the superior returns on investment that they achieved in the past? How will policy changes and new international relationships impact upon that ability? How will we value the shares of these companies in the light of possible changes to interest rates, inflation expectations or tax changes? By thinking about our investments in this way we think we can find good quality businesses at the right price. And we think that's what we have.

Edmund Harriss (portfolio manager)
Mark Hammonds & Sharukh Malik (analysts)

Guinness Atkinson
**Asia Pacific Dividend Builder Fund**
Managers Monthly Update – February 2017

*The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory and summary prospectus contains this and other important information about the investment company, and it may be obtained by calling 800-915-6566 or visiting gafunds.com. Read it carefully before investing.*

**Investments in foreign securities involve greater volatility, political, economic and currency risks and differences in accounting methods. These risks are greater for emerging markets countries. Non-diversified funds concentrate assets in fewer holdings than diversified funds. Therefore, non-diversified funds are more exposed to individual stock volatility than diversified funds. Investments in debt securities typically decrease in value when interest rates rise, which can be greater for longer-term debt securities. Investments in derivatives involve risks different from, and in certain cases, greater than the risks presented by traditional investments. Investments in smaller companies involve additional risks such as limited liquidity and greater volatility. Funds concentrated in a specific sector or geographic region may be subject to more volatility than a more diversified investment. Investments focused in a single geographic region may be exposed to greater risk than investments diversified among various geographies. Investments focused on the energy sector may be exposed to greater risk than an investments diversified among various sectors.**

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

MSCI AC Pacific Ex-Japan Index is a market capitalization weighted index that monitors the performance of stocks from the Pacific regions, excluding Japan. (You cannot invest directly in an Index.)

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

Discount rate is the theoretical or observed interest rate used in computations of present value, at which people discount future cash flows to derive a value in today's money.

Past performance is not indicative of future results.

Top Fund Holdings as of 01/31/17

| | | |
|---|---|---|
| 1 | DBS Group Holdings | 3.00% |
| 2 | Largan Precision Co Ltd | 3.00% |
| 3 | PTT PCL /Foreign | 2.99% |
| 4 | AAC Technologies Hld | 2.97% |
| 5 | Catcher Technology | 2.97% |
| 6 | China Mobile HK Ltd | 2.93% |
| 7 | BOC Hong Kong Ltd | 2.93% |
| 8 | China Merchants Bank H Shares | 2.91% |
| 9 | St. Shine Optical Co | 2.90% |
| 10 | Delta Electronics/ Foreign | 2.90% |

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

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