Guinness Atkinson

Asia Pacific Dividend Builder Fund

Managers Monthly Update – June 2017

GUINNESS ATKINSON FUNDS

Summary Review & Outlook

Fund & Market

- The Fund invests in good quality companies, defined by their cash flow returns on capital that have been sustained over many years and whose stock prices, in our opinion, under-value the likely persistence of those returns.
- With this approach, we expect the Fund performance to capture most but not all, of the rise in strong market conditions and provide greater downside protection in weak markets. In May, and for the year to date, the Fund's performance has been ahead of expectations.
- Asian markets, as measured by MSCI Pacific ex Japan rose 2.81% in May in dollar terms, ahead of the S&P 500 Index which rose 1.41% but behind Europe and the UK whose markets were over 4% higher. In the year so far, Asia (up 17.52%) and Europe up (18.92%) have been the strongest areas.

Events in May

- Chinese policy makers have re-focused on financial deleveraging in banks and non-bank financial institutions by increasing domestic money market rates through open market operations and more onerous requirements from the banking regulator.
- Risks in the Korean peninsula have diminished. South Korea impeached President Park and her replacement has been widely welcomed. There has also been an improvement in relations between China, South Korea and the US over North Korea. While perhaps not a 'meeting of minds' there is evidence of a more co-ordinated response.
- Technology is a stand-out sector in Asia driven by renewed product advances in smartphones and a cyclical rise in component prices – memory chips and OLED display technology being two key areas.
- Economic growth and pricing power in the region have been better than expected prompting analysts to upgrade their profit forecasts.
- Regional currencies have strengthened especially the Korean won, Taiwanese dollar, the Thai baht and most recently, the Chinese renminbi.

Outlook & Risks

- Asian markets as measured by MSCI Pacific ex Japan are still trading at a 28% discount to developed markets, as measured by the MSCI World Index, on an historic Price/Earnings (P/E) multiple basis.
- The Fund is trading at an 8% discount to Asia on a P/E basis while offering a similar forecast earnings growth profile.
- The consensus of analysts' estimates puts profit growth at 8% for the next two years which, although lower than developed markets growth estimates, is still both better than prior years and is made more attractive by the lower valuations, in our opinion.
- A key risk to market expectations, but one of which we are well aware, is of slower Chinese growth in coming months. Efforts to rebalance the economy and tackle leverage <u>will</u> exert a drag on growth and China is <u>committed</u> to tackling these issues.
- Slower Chinese growth is likely to be felt in weaker commodities prices, heavy industry and construction – all sectors that require volume growth to make a profit.

We try to mitigate ongoing macro uncertainties by focusing investment in those companies that have achieved profitability without requiring favorable policy or cyclical support.

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Discussion

- China

China remains a concern to many but we continue to argue that we think those concerns are excessive. The focus is on the accumulation of debt in China and a fear that this will precipitate financial crisis. There is another group who see stronger growth in China over the last six to nine months and are betting on a cyclical recovery and thus increasing their exposure to the heavy industrial and materials sectors that have been beaten down in the past few years.

Our view is that China offers some great investment opportunities among good companies whose valuations have been depressed by bearish macro views. But we caution against buying into companies that are beneficiaries of a perceived cyclical recovery because there are other forces at work. China is in the process of tackling its debt and excess capacity issues but these efforts exert a drag on growth. A stronger cyclical recovery provides more headroom to intensify these efforts and hence, growth momentum is likely to slow. In short, focusing on the good Chinese businesses that supply those goods and services that consumers want to buy, as opposed to those which were once used to drive economic growth is the right strategy, in our opinion.

- Technology

Technology innovation in Asia is focused primarily on production rather than original design, and Asian companies are very good at production, in large volumes and to a high standard. Most smartphones, tablets and PCs are assembled here and the chips, screens and components are made here.

There are two big stories in the Asian tech sector that are driving stock prices at present. One is the smartphone 'super-cycle' which is being driven by Apple; the other is rising component prices across memory, screens and even the casings. If we look at smartphones first, the anticipated introduction of the new iPhone is significant because of the range of product advances and new features has a major impact across the supply chain. OLED screens, glass cases, dual high definition cameras, faster processing, more memory – all these advances support average selling prices for the companies that supply. Volume estimates for shipments of the new device come in around 210m for 2017, 250m in 2018 and 270m in 2019. And the features adopted here will likely be adopted by the likes of Samsung and the Chinese makers in due course.

Moving on to component prices the biggest areas are memory chips and OLED screens. Memory capacity has tightened in recent years and this has collided with a significant increase in demand from the smartphone sector and a stabilization in demand from PCs and tablets. In the world of displays OLED technology has arrived sooner than was expected. Theses screens are higher definition and, because they do not require backlighting, they are lighter and more flexible. Smartphone casings have also been given a new lease of life with the introduction of glass (to allow for wireless charging). The frames required to hold the overall casing together has a higher selling price associated with it and this has been a key reason for the performance of Catcher Technology, which is held in the portfolio.

For the present, momentum in the technology sector looks likely to continue for a while yet. We need to be aware however, that rising component prices are likely eventually to lead either to compressed margins for suppliers or, if passed on to end customers, lower final demand.

- Earnings and valuations

The Asian region, as measured by the MSCI Pacific ex Japan Index is still trading on a 28% discount to developed markets on a P/E basis. We believe this discount is too wide (and our Fund with its quality businesses is cheaper still) and is based on views that are 15 years out of date. Firstly, we believe investors still view the regional economies as overly dependent upon external demand for commodities and exported goods and have failed to take account of the considerable influence now wielded by consumers. The economic cycle is demonstrably less volatile as a consequence. Secondly, the perception that companies in the region either poorly managed or too dependent upon outside factors or both persists, but we can point to a significant subset of some 500 companies whose profitability and returns on investment have improved and been sustained since the Asian economic crisis of 20 years ago.

The fundamental investment arguments of better companies in a more diversified operating environment is given added weight by the improvement in earnings expectations for the next two years. From 2010 to 2015 Asian markets were effectively side-lined by the bull market in the US. This was reasonable given the lack of earnings growth over the period of 0.5% per annum on average, but this also led to valuation compression. Consensus estimates reported by Bloomberg point to profits growth of 14% this year and 8% in 2018 and 2019. The PE multiples of 13.8x estimated 2017 profits and 12.7x 2018 in our opinion make the region look more attractive, not less.

Portfolio

The portfolio is made up of 36 stocks which we believe are undervalued by the market relative to the likely persistence of returns on invested capital that the underlying companies can generate. The equally weighted portfolio is thus a ‘best ideas’ portfolio.

The best performing stocks were Hanon Systems of Korea engaged in climate control systems for conventional and electric vehicle engines which rose 24%; Relo Group of Japan which provides relocation services for Japanese executives; China Merchants Bank which is private not state-owned and is the most retail-focused of China’s banks rose 15%; Yangzijiang Shipbuilding whose recent results and new orders came in ahead of expectations; and Belle International, a Chinese designer and retailer of footwear that is in process of being acquired also rose 15%.

The weakest stock by far was AAC Technologies which fell 27% before being suspended following the issue of a report by a short-seller, Gotham, who alleged the company was engaged in dubious accounting practices. The report was, in our opinion, deeply flawed and following the month-end AAC produced a report of investigations conducted by an independent party that laid these allegations to rest fairly comprehensively. The stock has re-commenced trading and made back most of the losses; and Gotham’s reputation has taken a dent.

Other weak performers during the month were LPN Development, a Thai property developer; Luk Fook Holdings, a jewelry retailer in Hong Kong and China; JB Hi-Fi of Australia, a discount retailer of electrical goods fell 7% following news that Amazon is about to increase its Australian presence; and Largan Precision of Taiwan, a maker of camera lenses for smartphones fell 5%.

Outlook

Asia has had a very strong start this year with the MSCI Pacific ex Japan and over 8% better than the S&P 500 Index but if we look back to end of the third quarter 2016 and include Asia's fall in the last 3 months of the year, then the two are almost exactly in line up around 12%. We have therefore seen a bounce and a recovery but that does not mean we are done. Asia's valuation discount remains, earnings upgrades are evident and Asian currencies are tending to strengthen still. In the last few weeks that currency strength has also included China's renminbi.

Our belief is that many investors remain underweight to Asia and with valuations in the US market looking stretched we think there are strong arguments for looking at these markets. The macro uncertainties and unfamiliarity with the countries and companies can be offset by focusing on what you buy rather than where you buy. So at the risk of repetition, our focus is on companies that can already show a long track record of strong financial discipline and performance and identifying those whose current market price undervalues those qualities and persistence.

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

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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 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. The MSCI AC Asia ex Japan Index consists of the following 10 developed and emerging market country indexes: China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand. 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.

Past performance is not indicative of future results.

Top Fund Holdings as of 05/31/17

1	China Merchants Bank Co Ltd - H Shares	3.24%
2	Relo Holdings Inc	3.11%
3	CNY Minsheng Banking - H Shares	3.00%
4	Largan Precision Co Ltd	2.98%
5	The Link REIT	2.98%
6	BOC Hong Kong Holdings Ltd	2.90%
7	Ascendas Real Estate Investment Trust	2.87%

8	Hanon Systems	2.87%
9	Janus Henderson Group PLC	2.87%
10	CapitaMall Trust	2.86%

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

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