Guinness Atkinson

# Asia Pacific Dividend Builder Fund

Managers Monthly Update – July 2017

GUINNESS ATKINSON FUNDS

**Review of the first half of 2017 & Outlook**

**Fund & Market**

- We believe in concentrating our attention on good companies that we think, when undervalued, make for good investments. We try to understand our companies in the context of the world in which they operate rather than try to formulate a shape of the world and find investments to fit.
- This year the Fund has captured 97% of the gains in the MSCI AC Pacific ex Japan Index which has risen 20.05%, and has done better than the S&P 500, as well as Europe, Japan and Emerging Markets as measured by their respective MSCI indices.
- We believe that Asia has further to go supported by stronger than expected economic growth, rising consensus profits estimates and valuations which are still at a significant discount to developed markets. We think this contrasts with a US stock market that appears to us to be expensive and which we believe is pricing in expectations reduced corporate taxes and increases in domestic investment, that appear to be further away or even receding.

**Events in 2017**

- From an Asia standpoint, the good news was that bad stuff did not happen. President Trump did not slap trade tariffs on China or brand China a currency manipulator.
- A new South Korean President was elected in May following the impeachment of President Park. Improved relations between South Korea and China have followed.
- China's economy grew 6.9% in the first quarter[1] and may be followed by 6.7% growth in the second quarter of 2017. This would be much more positive than people were expecting last year and has probably been a significant driver of commodity prices (ex-oil).
- European elections saw both the Dutch and French firmly reject the anti-immigration/anti-EU parties. German elections in September appear to us to favour the incumbent, Angela Merkel. This we think has helped reduce fears of EU instability. The British meanwhile, continue to make a mess of it – the election failed to deliver a thumping majority and went the other way weakening the Brexit negotiating position which was not strong to begin with. This is a British problem and has no wider material impact.
- Asian regional currencies have strengthened 3.3% this year on a weighted average basis (4% if we exclude the Japanese yen and the Chinese renminbi) especially the Korean won, Taiwanese dollar, the Thai baht and most recently, the renminbi[2].

**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 10% discount to Asia on a P/E basis while offering a similar forecast earnings growth profile.
- Efforts by Japan to kick-start its economy show no signs of being effective.

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[1] Source: China National Bureau of Statistics

[2] Source Bloomberg and Guinness Atkinson calculations. Weights are calculated using 2013 Gross Domestic Product figures in dollars for each country.

- India's top-down reform story that has attracted high levels of interest is countered from the bottom up by slower economic growth, bad debt issues in the state banking sector and the biggest downgrades to profit forecasts in the region.
- A key risk to market expectations, but one of which we are aware, is of slower Chinese growth ahead. Economic rebalancing and leverage reduction will slow growth but China is committed.
- Technology has been strong and we think the smartphone sector has further to run. But we are aware that the higher component prices that benefit Asian technology manufacturers and suppliers will eventually have an impact on end demand if higher prices are passed on.

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

**Fund performance**

| as of 6/30/17 | YTD | 1 YR | 3 YR | 5 YR | 10 YR |
|---|---|---|---|---|---|
| **Asia Pacific Dividend Builder Fund** | 19.46% | 21.95% | 8.14% | 8.97% | 3.87% |
| **MSCI AC Pacific ex Japan** | 20.05% | 26.27% | 4.23% | 8.05% | 4.69% |

All returns over 1 year annualized. *Source: Bloomberg, Guinness Atkinson Asset Management*
Expense Ratio: 1.11% (net)*; 3.14% (gross)

*Performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the Fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by calling 800-915-6566 and/or visiting www.gafunds.com. Performance data does not reflect the 2% redemption fee for shares held less than 30 days and, if deducted the fee would reduce the performance noted. Total returns reflect a fee waiver in effect and in the absence of this waiver, total returns would be lower.*

* The Advisor has contractually agreed to reduce its fees and/or pay Fund expenses (excluding Acquired Fund Fees and Expenses, interest, taxes, dividends on short positions and extraordinary expenses) to limit the Fund's Total Annual Operating Expenses to 1.10% through June 30, 2018. To the extent that the Advisor waives its fees and/or absorbs expenses to satisfy this cap, it may seek repayment of a portion or all such amounts at any time within three fiscal years after the fiscal year in which such amounts were waived or absorbed, subject to the 1.10% expense cap.

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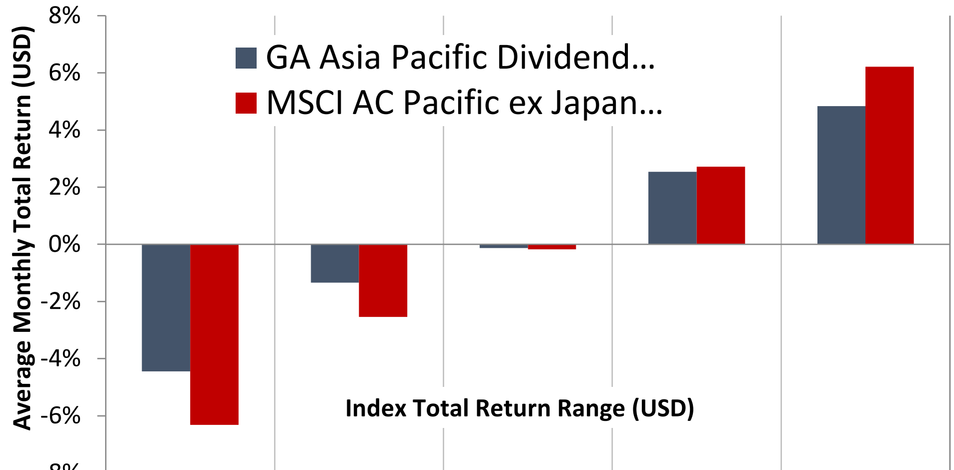
**Discussion**

- Performance

We have positioned the Fund in those companies which we believe to be the best quality in the market and we define that quality in terms of their ability to convert competitive advantages into financial returns on capital that have been greater than the cost of that capital. We require these companies to have achieved this on a sustained basis for at least eight consecutive years. We think this is long enough to make it probable that these advantages and the accompanying returns on capital will be persist making us more confident in judging whether the market is under-pricing the stock. The portfolio consists of 36 such names which are equally weighted.

The chart below shows how the Fund has performed in weaker or strong market conditions in the five years to June 30 2017. The tendency has been to capture most of the gains in strongly rising markets while offering greater downside protection in weaker conditions:




| | < -4% | -4% to -2% | -2% to 2% | 2% to 4% | > 4% |
|---|---|---|---|---|---|
| GA Asia Pacific Dividend Builder | -4.45% | -1.34% | -0.13% | 2.54% | 4.83% |
| MSCI AC Pacific ex Japan Index | -6.32% | -2.54% | -0.17% | 2.72% | 6.21% |
| Difference | 1.87% | 1.20% | 0.04% | -0.18% | -1.38% |
| Frequency | 8 | 3 | 23 | 16 | 10 |

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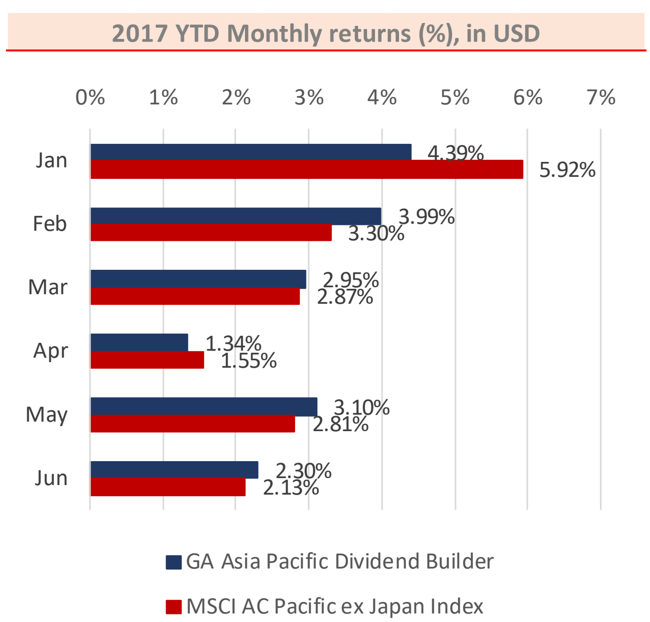
In the first half of 2017 the Fund has performed well rising 19.46% capturing 97% of the gains in the MSCI AC Pacific ex Japan Index. Over one year the Fund is up 21.95% compared to the index which rose 26.27%. This is in line with what we would expect. Over the last three years, which include periods of market weakness most notably in 2015 and early 2016, the performance is very strong with the Fund producing an annualized performance of 8.14% compared to 4.23% for the market. We believe the key to producing performance growth over time is the preservation of prior gains when markets are weak.

Monthly performance in 2017

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A review of the Fund's performance month by month is helpful to us when considering whether the behavior is in line with expectations. The 36 names in the portfolio are our best ideas in the region and while we don't expect them to move independently of one another we want to avoid over-exposure to themes that once exhausted could cause an entire section of the portfolio to roll over.

This year for example, technology has been the best performing sector component of the MSCI AC Pacific ex Japan Index, up 38%, and its strength relative to the market has continued almost continuously this year. Closer examination shows that it is the smartphone and memory segments that are doing best.

The smartphone sector was regarded as having reached saturation and a broad sell-off in the sector in April 2016 expressed those concerns. However, the new designs coming through from Apple, and to a lesser extent Samsung, have changed the picture. Whether it is the new casings to enable wireless charging, display technology that is both more flexible and consumes less power, to improvements in camera technology, processors and command functions – there is something for almost everyone in the supply chain. There is a view that we are in a smartphone 'super-cycle'. Related to this has been a recovery in memory pricing for both DRAM and Flash memory. Both are used in handheld devices and Flash memory is increasingly being incorporated into personal computers. Toshiba in Japan (not held in the portfolio) is in all sorts of trouble and last year put its memory business up for sale. As memory prices have picked up multiple bidders have appeared.

From the Fund's perspective, we want to be comfortable that the stronger than expected performance is not purely a thematic event but comes from our stock selection.

The chart below shows the performance of all the stocks in the portfolio through the first half of the year.

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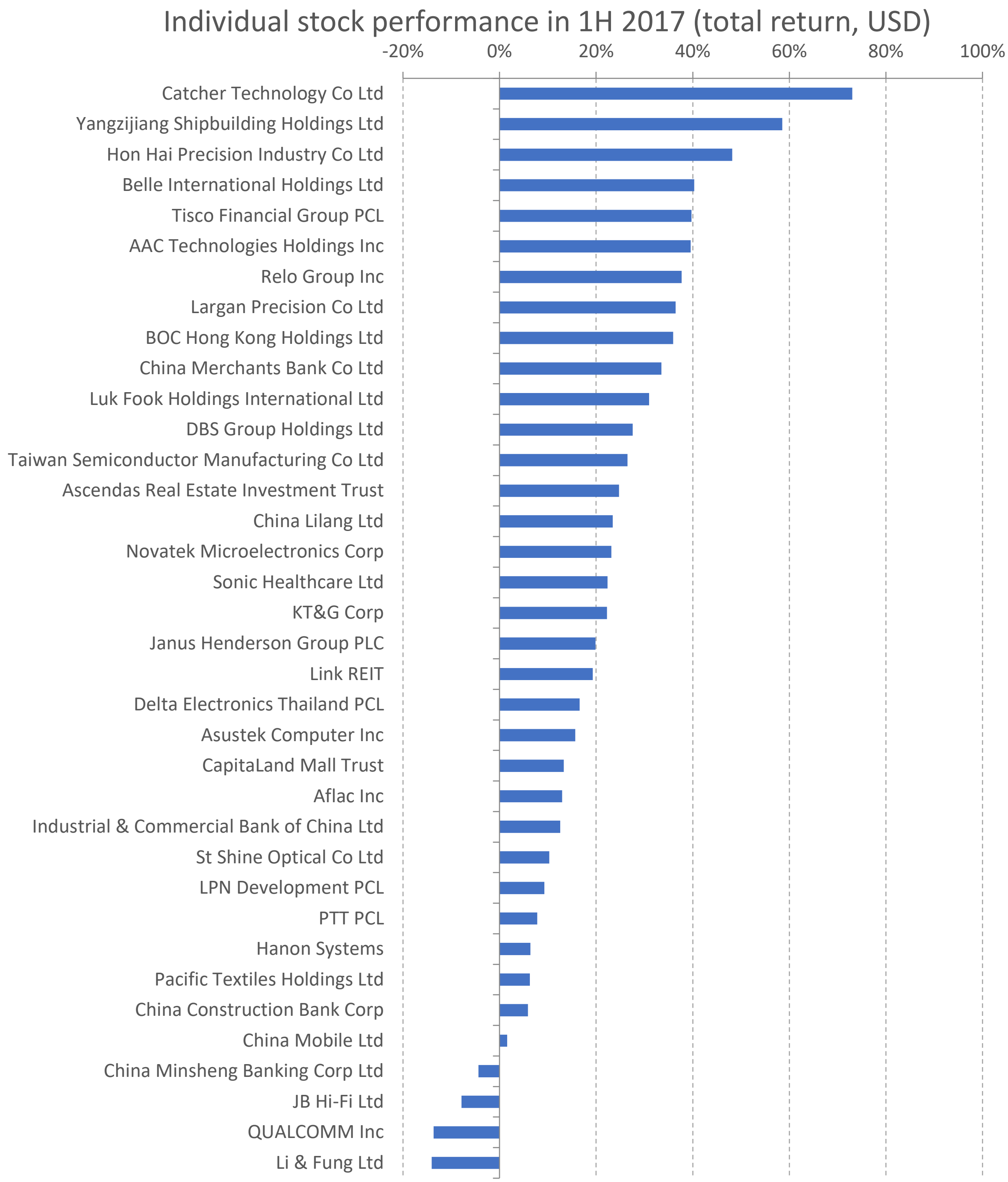


Holdings are subject to change at any time. The mention of any individual securities should neither constitute nor be construed as a recommendation to buy or sell such securities and the information provided regarding such individual securities is not a sufficient basis upon which to make an investment decision. The performance of the securities below is not intended to represent the performance of the fund. **Past performance is no guarantee of future results.**

A review of the monthly performance reveals the Fund outperformed in four of the six months in conditions that would normally lead us to expect a moderate lag. The possible concern, as discussed above is that we might have too high an exposure to a sector or theme that could then have a significant impact if sentiment toward those areas were to turn. However, when we look at the individual stock performances we can see there is a wider spread. In the top 5 performers, there are two technology names but also a Chinese shipbuilder, a Chinese clothing retailer and Thai consumer finance company. The top 10 stocks also include a Chinese bank, a Hong Kong bank and Japanese real estate services company and jewellery retailer. Amongst the weakest names we have a Hong Kong manufacturing agency, a technology company and Australian discount electrical retailer, a Chinese bank and a telecom services company.

**Leaders**

Catcher Technology is a manufacturer of smartphone casings and is most exposed to Apple. The stock did not perform well last year as concerns grew that both volumes and pricing of metal casings were coming under pressure. News that Apple was considering glass rather than metal for its next generation iPhone added to the gloom. The reality turned out to be a little different. Although Catcher does not make glass casings, the frame required to hold the glass are tricky to make and Catcher has both a good track record in its ability to produce in volume, to the high standard required, in timely fashion and it has a strong relationship with its customers. The frames are expected to sell for higher price than the previous all-metal casings and the volumes required have been revised higher as expectations have grown for the new iPhone. Stronger than expected 2016 results reported this year together with upgraded forecasts have made Catcher our best performer this year.

Yangzijiang Shipbuilding has a different story. Shipbuilding has been out of favour for a number of years as global growth, and trade growth in particular, has slowed. This has driven down shipping rates for both container and bulk transportation with a decline in orders for new ships the inevitable knock-on effect. However, Yangzijiang has maintained returns on invested capital at levels above the cost of capital for over ten years. The company has low debt and it has scale. The company is also active in incorporating newer technology (for example in the design of the hull) to make a more efficient vessel. While their new orders have declined in number and with lower associated margins, they have still held up better than the rest. The valuation of the company had been driven down to low levels in line with the sector but when 2016 results came in 'not-as-bad-as expected' the stock bounced. A recent recovery in shipping rates and orders evident in the Korean shipyards as well, the stock price recovery continued making it our second-best performer.

Hon Hai Precision is another technology company. Their trading name is Foxconn and they are a major producer for Apple, but there is also much more to this company. At present the stock price is being driven by expectations surrounding Apple and for Hon Hai, the big earnings driver is expected to be the new OLED iPhone model. OLED stands for Organic Light Emitting Diode which is used for displays and consumes significantly less power which helps to support longer battery life. This model will have the glass case which supports wireless charging. However, Hon Hai's activities spread much further. They acquired Sharp in 2016 and are still in the hunt for Toshiba's flash memory business. The company is involved in products ranging from Internet of Things to Artificial Intelligence. The company has recently expressed a commitment to shareholder to focus on cash based returns on investment and to increase the proportion of profits distributed as dividends.

The last two names in the top 5 performers are Belle International and Tisco Financial Group. Belle is a Chinese designer and retailer of women's shoes and has recently expanded into sports shoes. The business has been struggling, like most retailers, with the rise in online shopping which has had the effect of depressing margins in the core business although its sports segment is growing well. The brand is well known in China and Belle has almost 4,000 outlets across 150 cities. This has made it an attractive acquisition target and earlier this year Hillhouse and CDH Investments have agreed to acquire the business for $6.8 billion. Tisco Financial Group does the bulk of its business in the hire-purchase segment of consumer finance with a focus on cars and motorcycles. The business is not perceived as glamorous or high quality in the traditional sense but from an investment perspective it is one of the best at what it does and its financial profile reflects that. The recent acquisition of Standard Chartered Bank's consumer loan book has added extra growth momentum. Tisco's results were very positive not only in growth and profits but also in asset quality with lower credit costs and prudent provisioning combining to provide strong non-performing loan coverage of 164% at the end of the first quarter of 2017.

**Laggards**

LI & FUNG QUALCOMM JB HI-FI 中国民生银行 CHINA MINSHENG BANK

Li & Fung continues to test us. The company is a manufacturing agent operating between US and European retailers on the one hand and factories in developing markets including China on the other. They operate on slender margins so require volume growth which is proving elusive. The challenges they face reflect those of the wider retail sector: high promotional activities, reduced inventories, weaker consumer demand and retail bankruptcies. Opportunities exist in making the shift with their customers to online channels, e-commerce platforms and private label. Li & Fung is an efficient business with high cash and low levels of debt; growth is the problem. A new three-year plan for 2017-19 aims to focus on the supply chain: speed of production from pre-order to delivery for an average retailer according to Li & Fung takes 40 weeks and they aim to cut this to 21 weeks. They seek to create a digital platform to provide visibility for the customer at each stage (end to end) and the tools for customers to manage the process. In short, there are substantial additions they need to make to the supply chain management services they provide to secure their relevance as a business.

Qualcomm's business is well-known. The technology it provides and has designed is essential to the operation of a cell phone and herein lies the problem. Qualcomm's business model is based upon its 'indispensable' technology and it requires royalty payments for the use of its patents, based on the selling price of the device that uses them. This model is now being challenged by Apple which argues that its devices are now far more than just cell phones and that Qualcomm is riding unfairly on the premium prices being charged by Apple for additional features with which Qualcomm has had no involvement. The legal challenges to Qualcomm's pricing model and the suspension of payments by Apple's suppliers, at Apple's direction, have had a negative impact on the stock price.

JB Hi-Fi in Australia is a discount retailer of electrical goods. It was the third best performer in the portfolio in 2016 which goes some way to explain the relative weakness this year. However, there have also been developments in the Australian market with the expected arrival of Amazon which of course, could disrupt this segment. There is an expectation from some that Amazon could undercut the local retailers by up to 15%. JB HiFi's major domestic competitor Harvey Norman is said to be cutting prices by 10%. However, this market is already competitive. The three main discount electrical retailers hold 58% market share between them and already offer some keen pricing so Amazon is not necessarily going to find the massive 'price-busting' opportunity they expect. So, intensifying competition rather than a disappearing market is what we might expect to see.

The two remaining laggards among the bottom 5 this year are China Minsheng Banking and China Mobile. China Minsheng is a private rather than a state-owned bank which is more affected by the deleveraging underway in China than its peer China Merchants Bank (which we also hold and is one of our top 10 performers this year). As a mid-sized bank, it lacks the deposit franchise of its state-owned competitors which forces it to seek funding from the wholesale market. The focus of its lending is corporate into mid-sized entities. The risks it faces are higher funding costs, lower loan rates as competition picks up and the possibility it will need to set aside more capital against so-called 'non-standard assets'. The issue is one of competition rather than stability. China Mobile has nothing wrong with it beyond the fact it is large and not growing very fast. The telecom landscape in China is stable from a regulatory perspective but is competitive. Recent results from the company showed good key performance indicators with new customer additions for fixed line broadband and on the mobile side. There is regulatory pressure to cut roaming fees which exerts some downward pressure on profits but not significantly. Further improvements in capital management would unlock further value but even without that the stock looks attractively valued, just out of favour right now.

**Outlook**

We continue to believe that Asia looks attractive, along with Europe, compared to the US. US markets have remained buoyant but expectations of imminent changes to corporate taxes in America or for a rise in domestic infrastructure investment look more distant with a president who seems more engaged in defending his personal brand and tangling with journalists and TV presenters. We think that investors should be considering diversifying after a strong 8-year run and Asia, on a 28% discount to developed markets, is one area to look. Quality, Value, Dividends all seem to us to look attractive in the region.

We think that focusing on good quality companies that have already achieved a financial track record in terms of returns on invested capital that have only been achieved by a minority of companies, worldwide goes some way to mitigating the risks of investing overseas. Our disciplined approach of keeping to 36 dividend paying names that appear to us to be undervalued relative to the returns on investment we believe they can continue to generate we think is a sensible approach. The portfolio trades at a valuation discount to Asia because we think that investors have not yet appreciated that there are quality companies out there trading in different parts of the world and have been neglected.

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.

MSCI Europe and MSCI Japan Indexes are market capitalization weighted indexes that monitor the performance of stocks in Europe and Japan.

One 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.

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Top Fund Holdings as of 06/30/17

| | | |
|---|---|---|
| 1 | AAC Technologies | 3.20% |
| 2 | Catcher Technology | 3.06% |
| 3 | Largan Precision Co | 2.99% |
| 4 | Hon Hai Precision Industry | 2.96% |
| 5 | KT&G Corp | 2.88% |
| 6 | Sonic Healthcare | 2.87% |
| 7 | St Shine optical | 2.86% |
| 8 | China Lilang | 2.84% |
| 9 | CapitalandMall Trust | 2.84% |
| 10 | Industrial & Commercial Bk of China - H | 2.84% |