Guinness Atkinson
China & Hong Kong Fund
Review of H1 2018

Review of H1 2018 & Outlook

Fund & Market

- Following the consistent positive advances in Asian markets in 2017, we saw the return of more volatile conditions in 2018.
- The market moved in four clear phases in the first half of the year: a sharp rise in the so-called 'melt-up' in January, a swift drawdown in early February as volatility returned, choppy sideways trading from March to May, and a further sell-off in June as global trade tensions escalated.
- We believe the underlying earnings growth outlook for our companies in 2018 and 2019 to be positive but ongoing macro-concerns, around trade in particular, have compressed valuation multiples.
- China looks very attractive relative to developed markets, offering a combination of strong earnings growth and modest valuations. The portfolio trades at a discount to the market (as measured by the Hang Seng Composite Index), has double-digit earnings growth forecast and is more diversified than the index.
- Risks are ever-present: trade tensions, geopolitics, and normalizing interest rates are perhaps the most salient. However, for the long-term investor, the fundamental themes of manufacturing improvements, lifestyle upgrades and developing services industries are more pertinent – these are the themes that will drive long term returns.

Events in 2018

- Trade tensions dominated the news headlines for much of the first half of the year, with the announcement of steel and aluminum tariffs by the US. A temporary exemption to Canada and Mexico was granted on the grounds of renegotiating NAFTA provisions.
- Attention then turned squarely towards China. The strident views expressed by President Trump were initially met with a more conciliatory tone by China, and dialogue ensued between both sides (leading the US Treasury Secretary at one point to declare that the trade war was "on hold"). But towards the end of the period relations deteriorated as both parties' views seemed some distance apart. The result was the announcement by the US of a 25% tariff to be applied to $34bn of Chinese imports, with another $16bn likely to follow. China retaliated by imposing tariffs of an equivalent size. The US is now planning to put tariffs on $200bn of Chinese imports.
- In July, China cut tariffs on imported vehicles from as high as 25% to 15%. Tariffs on a range of consumer goods were also reduced. For example, tariffs on clothes and shoes fell from 15.9% to 7.1% while tariffs on washing machines and refrigerators fell from 20.5% to 8%.
- China continued its deleveraging efforts to reduce excesses and vulnerabilities in the financial system.
- MSCI began including Chinese A shares in some of its indices, including the Emerging Markets index. As of the end of May, Chinese A shares were capped at 2.5% of their free float adjusted market capitalization, which will rise to 5.0% later in the year.

Investment process summary

80% of the fund is invested in quality companies which we measure using return on capital over a multi-year time horizon. These companies have persistently generated a high cash return on capital over the past eight years. We look for companies that have the ability to grow their earnings over time while doing so efficiently through a high return on capital.

The fund holds 32 positions which are equally weighted. In addition, the fund holds one legacy holding which makes up a small part of the portfolio. Our portfolio discipline ensures that if we want to buy another position we first have to sell an existing holding. We rebalance the portfolio periodically in order to benefit from market volatility.

The equally weighted nature of the portfolio makes it very different to both the index and other China funds. The Hang Seng Composite Index is skewed towards a few large companies – Tencent (weight of 10.41%), HSBC (9.51%), AIA (5.25%) and China Construction Bank (4.42%). Most China funds have close to 10% in both Tencent and Alibaba which presents significant downside risk if one of these companies were to suffer an unexpected shock. To put things into context these concentrations are significantly larger than in other markets. For example, as of the end of June the largest company in MSCI USA was Apple with a 3.9% weight. In MSCI Europe the largest company was Nestle with a 2.7% weight. The concentration risk in China is materially higher than in developed markets and so the need to sensibly diversify is key. We acknowledge that Tencent and Alibaba (not held because it does yet have the persistent returns we require) are highly cash generative companies but there are risks present with holding 10% in each company. For example, what are the implications if the Party believes these tech conglomerates have become too big and need to be reined in?

The equally weighted nature of the fund means each position has a neutral weight of just over 3.0%. Each position is large enough to meaningfully contribute to the fund but not large enough to hurt the fund on the downside.

Portfolio positioning and Outlook

Since hitting a high on January 26th, markets have been weaker and more volatile, but we are yet to see substantial negative revisions feeding through into corporate earnings estimates. In fact, earnings expectations remain robust, with solid growth currently forecast for 2018 and 2019. Thus, weakness is a result of multiple contraction—driven more by sentiment— rather than a direct result of deterioration in the underlying fundamentals.

China has looked attractive as a region, both on an absolute basis and on a relative basis, for some time, and the recent pullback, we think, represents a good buying opportunity. The MSCI China Index trades at a 16% discount to the MSCI World Index on a price/earnings basis. This discount (based on forecast earnings) has been wider in the past, but because earnings growth has been a significant driver of the strong rise in China over the past couple of years, it remains attractive from a valuation point of view.

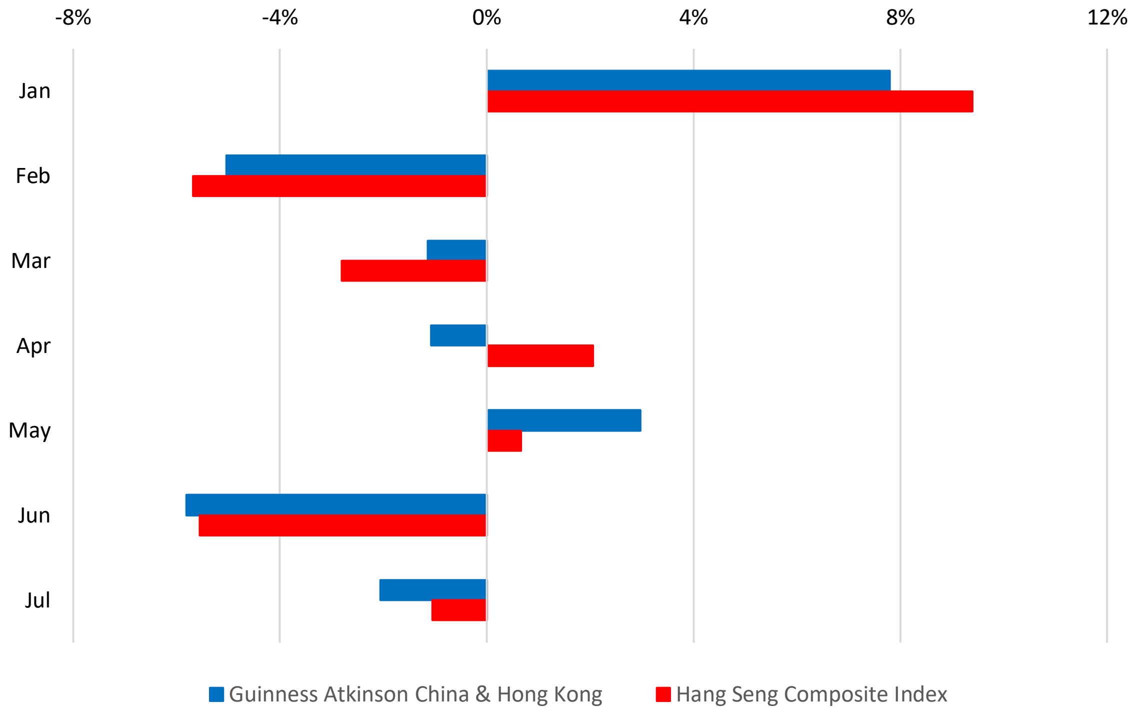
If an individual company had these metrics we think it would be unlikely for it to go unnoticed by investors for long. (The portfolio, of course, has the added benefit of offering diversification across sectors.)

Investors in China have many risks to consider (of course, they are not alone in this respect). Conflicts over trade policies seem unlikely to be resolved in the near term (we write more about this below), the path of interest rate rises in the US could accelerate, and economic data, while robust, is not quite as strong as before. But many of these factors are short term in nature. We believe it is the more fundamental themes of manufacturing improvements, lifestyle upgrades and developing services industries that will drive China's growth (and shareholder returns) over the long term.

Performance review

The chart below shows how the Fund has performed this year. The fund underperformed in the first six months of the year, returning –2.90% versus the benchmark –2.71%. To analyze the fund's performance in detail, we first look at the monthly returns of the fund versus the benchmark, as the following chart shows, to assess whether the fund's behavior is in line with expectations:

2018 YTD monthly returns (%) in USD



Source: Bloomberg, Guinness Atkinson Asset Management

The two main periods of underperformance came in January and April. In January we saw the acceleration of the run-up in markets, following positive performance for most of 2017. Markets were very strong, with the index rising 9.39% in a single month. In China the best performing sectors in the MSCI sectors were financials (total return of +18.2%), real estate (+17.1%) and energy (+14.1%). These are all sectors to which the fund has relatively lower exposure. There are few real estate companies which earn a high enough return on assets and are appropriately geared. There are also few energy companies which have maintained the consistent returns we are looking for.

Individually, weaker stocks were Tongda (manufacturer of metal casings for smartphones), China Medical System (contract sales organization in the pharmaceutical industry), Netease (gaming developer) and AAC Technologies (manufacturer of speakers and haptics in smartphones). Given that the operating conditions for these companies did not suddenly change in January, we were not concerned by the underperformance of their share prices.

The markets peaked on January 26th before going into a sharp draw down at the start of February. The fund outperformed in February, with AAC Technologies and Tongda (laggards in January) as the two strongest stocks.

In April several suppliers for smartphone manufactures in the portfolio were hit by a 'perfect storm' of three factors:

1. Concern over slowing iPhone sales
2. Weaker demand from Chinese manufacturers due to elevated inventory levels
3. General concerns over increased trade tensions between the US and Asia

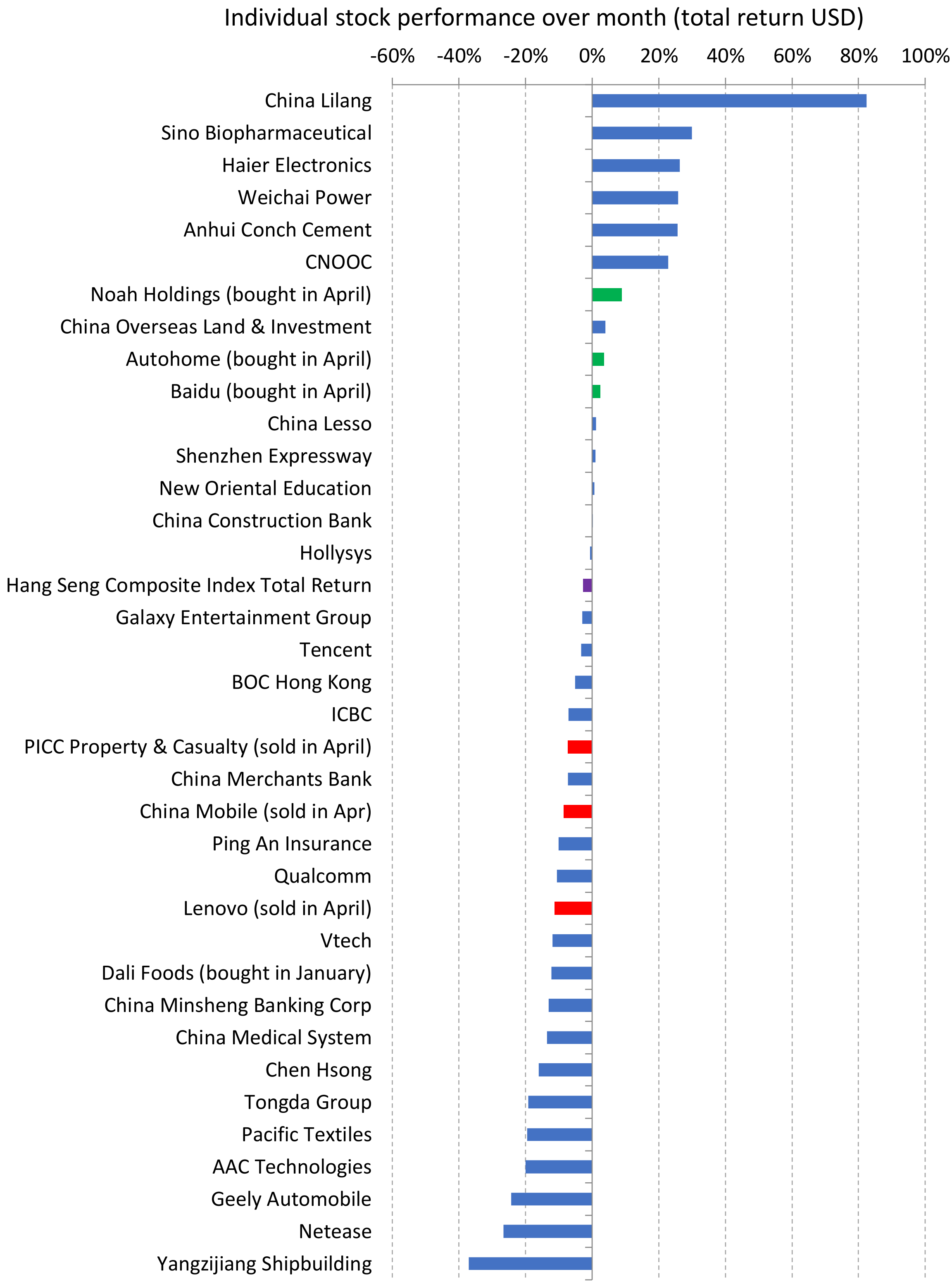
We have since seen improvement in the first two areas: iPhone weakness was not as bad as people feared and Chinese demand looks likely to pick up. Trade tensions, while they have certainly intensified, we feel are less of a concern in this area because of the impracticality of deep upheaval within the technology supply-chain (component production is unlikely to relocate to the US any time soon).

What is interesting is that we have seen this pattern before: we saw similar weakness in technology names in April 2016, again primarily because of concern over iPhone sales slowing. But selling out would have been a mistake – the Information Technology sector performed very well on a relative basis for most of the rest of 2016 and 2017. The smartphone component manufacturers benefit from a trend of continuing upgrades in smartphone specifications. That the market sometimes is more pessimistic on the sector as a whole is good for us, as we can top up our holdings. Meanwhile, the companies continue to generate strong returns on capital. At present, the information technology names are some of the most attractively valued stocks within the portfolio.

In June, trade concerns intensified: the US confirmed a 25% tariff on $34bn of Chinese imports, with a further $16bn likely to follow; President Trump announced a review of automobile imports, questioning whether they were a threat to national security; further restrictions on Chinese overseas investment and use of intellectual property are to be investigated. While trade tensions are undeniably unsettling to investors, they have not yet become a significant problem from an economic point of view (as the lack of substantial negative revisions to earnings demonstrates). What has disturbed sentiment the most is the threat of further tariffs on China—potentially affecting another $200bn of imports (presumably accompanied by retaliatory measures by the Chinese)—and a broadening of the conflict to involving the EU and other US trading partners. Our position is that a full-blown trade war is unlikely – we think a negotiated agreement is the probable outcome. We saw signs that the US and China are willing to strike a deal: the overturning of sanctions on ZTE, when the consequences of the ban were realized, being a prime example. However, we do not expect any immediate signs of progress – President Trump still has to 'act tough' ahead of mid-term elections in the autumn. We think behind-the-scenes negotiations are far more likely.

As this noise (which again in its current state is predicted to have a minimal effect on growth) rumbles on, we think it is wise to remember some of the long-term structural trends that have been taking place (and which prompted trade tensions to erupt in the first place). China has been transforming its economy, moving from simple product manufacturing into higher value-added and more technologically advanced manufacturing. In China and elsewhere in Asia, supply chains have become deeply embedded in the region, and many of the products that are produced – integrated circuits, electrical components, consumer electronics goods – are unlikely to be produced elsewhere. The broad long-term trends that have secured Asia's development over the past 30 years are likely to continue.

The 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 could cause weakness in a significant section of the portfolio. So, when analyzing our performance, we want to ensure that it is not the direct result of thematic exposure, but rather that it comes from stock selection. The chart below shows the performance of individual stocks through the first half of the year:



Source: Bloomberg, Guinness Atkinson Asset Management

In the top five performers, there are a mix of industries: retail, healthcare, consumer appliances, cement and integrated circuit design. Among the weaker names we also have a mix of industries: shipbuilding, contact lenses, mobile games, automobiles and product sourcing.

Portfolio review

Leaders

LILANZ 利郎

China Lilang was the standout performer over the first half of the year, returning more than 80% in GBP terms. The company is a clothing retailer, based in China, focused on casual menswear in the young adult segment. Lilang's main brand, LILANZ, has recovered after a difficult period in 2016, with same store sales accelerating over the second half of 2017 and continuing into 2018. The company also reported very strong year-on-year sales growth in both its fall and winter trade fairs.

中國生物製藥有限公司
SINO BIOPHARMACEUTICAL LIMITED

Sino Biopharmaceutical specializes in generic drugs with a particular focus on hepatitis and cardio-vascular products. For 2016 and much of 2017, the market was worried that the company's core, its hepatitis franchise, was going to face more competition from a new and cheap product. The reality was different as Sino Biopharm received approval for a generic version of the new drug which is priced very competitively. Additionally, the company received approval for a new product to treat non-small cell lung cancer. The product has the potential to become a blockbuster drug.

Haier

Haier Electronics sells washing machines and water heaters, operates stores selling Haier and 3rd party branded goods, and provides logistics services for online deliveries. There are multiple reasons to like the business. In China many households still use older, cheaper top loaded washing machines which may be replaced as household incomes rise. A subsidiary, Goodaymart Logistics, is the primary logistics service provider for large home appliances merchants on Tmall.com. The logistics industry is notoriously competitive in China and so it is good to see the logistics business is profitable.

Weichai Power manufactures engines used in heavy duty trucks. Its first quarter results were much better than expected with strong sales growth and an improvement in margins. Heavy duty truck sales have been coming in stronger than expected because of solid construction levels and recurring replacement demand. That being said, however, we expect sales to have peaked. 2017 was an exceptionally strong year and will be tough to beat. Due to changes in environmental regulations, orders were bought forward in the first half of the year and so it is likely sales growth will come down in the second half of the year.

Anhui Conch is a large cement producer with significant market share. Over the past few years the industry has been very disciplined when increasing capacity, preferring to maintain margins over growth. As a result, gross profit per ton is above average and is likely to remain so for the foreseeable future. Anhui Conch is not the most exciting business but has the characteristics we are looking for: 1) consistent cash return on investment above the likely cost of capital, 2) the potential for earnings growth and 3) is in our opinion, undervalued.

Laggards

After returning more than 80% in GBP terms last year, it is not surprising that Yangzijiang would give up some of the gains this year. The stock suffered in the first half after reporting lackluster results for the fourth quarter of 2017. Provisions on new orders resulting from foreign exchange movements and higher steel costs led to reduced gross margins. However, management reported good recent contract wins, and indicated that they will be discerning in selecting future contracts in the depressed pricing environment – something we like to hear.

After going through a pronounced cyclical downturn, conditions in the shipbuilding industry look set to improve. As older, lower spec ships are scrapped, new orders are likely to come through. Tougher regulations from an environmental perspective to reduce emissions will also be a tailwind, accelerating the rate at which older vessels are scrapped. Yangzijiang's designs are well placed to benefit – the company has been focusing on advanced hull designs that are more fuel efficient than those used previously. The stock is certainly one of the more volatile within our universe, and we have added to it at these lower levels, to bring the stock back to neutral weight in the portfolio.

Netease develops games for mobile and PCs and is the second largest developer in China. The start to the year has been tough with revenues from a major game, *Onmyoji*, falling sharply. While Netease has released battle-royale style games that have done well, they have not become popular enough to offset weakness in more established games. Additionally, the company has expanded into cross border e-commerce through *Yanxuan* and *Kaola*. *Yanxuan* sells unbranded versions of mass market and luxury goods while *Kaola* sells a range of high quality international goods. Both websites are doing well and though are loss making for now, have the potential to become very cash generative given the size of the e-commerce market in China. Netease continues to generate an overall cash return on investment that is well above the likely cost of capital and we have been adding to the position through its recent weakness.

Geely is an automobile manufacturer specializing in sedans and SUVs. Geely was the best performer in the fund in 2016 and 2017, returning 621.2% over the two years. The automobile market in China is still growing but the growth rate has slowed down from a peak of more than 50% growth in December 2017 to just above 20% growth in June 2018. That being said Geely's retail sales are growing much faster than the industry. For the first six months of the year Geely announced it is expecting net profit to increase by around 50% and so we see the recent weakness as a great opportunity to be adding to the position.

AAC is a manufacturer known for its speaker boxes and haptics used in smartphones. For more than 15 years the company has maintained a cash return on investment of at least 15% which is very impressive. These components are likely to be upgraded every few years and so are very cash generative for AAC. However, the share price has been weak recently given 1) the slowdown in the Chinese smartphone market and 2) lower margins as a result of expansion into new segments. AAC is expanding into the production of lenses used in smartphones. The company claims its proprietary technology allows it to produce glass lenses, an industry others have found it hard to break into because of patents held by competitors. At the same time the company is investing in a new casings business. Many smartphones now have shifted from using a metal case to using a metal frame and a glass pane on the back. Fixed costs as a result of these new investments have led to lower margins which are expected to persist for the next few quarters.

PACIFIC TEXTILES HOLDINGS LIMITED
互太紡織控股有限公司

Pacific Textiles (PT) is a clothing manufacturer supplying companies such as Uniqlo, Anta Sports and Calvin Klein. It is one of our holdings which is more of a value play given the difficulty the business has had in growing earnings. Like many of its competitors, labor costs in China are rising and to remain competitive, many manufacturers are shifting production to lower cost countries like Bangladesh and Vietnam. PT started constructing a factory in China in 2014 which commenced production in 2015. However, last year a dispute arose where local villagers were blocking the entrance to the factory. These villagers were not happy with the compensation they received in exchange for their land being used to construct the industrial park where PT's factory is located. The dispute eventually lasted for five months which meant PT was stuck with a factory which incurred fixed costs but created no revenue. Though the impact to earnings was significant, we see this as a one-off cost. PT's recurring earnings remain solid and we do see a path for earnings growth, something the company has struggled with over the past few years. Anta Sports is a new customer which is growing rapidly. Uniqlo's sales outside of Japan continue to well, especially in China.

Portfolio changes

达利集团
DALI GROUP

In January we initiated a new position in Dali Foods. It is a relatively newer business, having listed in 2015. It is a food and beverage company with products including breads, chips, biscuits and herbal teas. The company's strategy so far has been to sell similar but cheaper products than market leaders. Dali targets lower tier cities where consumption is rapidly increasing and where this strategy is most effective. Dali recently launched a new soymilk brand which is geared towards the premium end of the market. It is marketed as a healthy product with superior protein and bean content versus competitors and so far, is doing very well. Dali also sells energy drinks and its brand, Hi-Tiger, has the second largest market share after Redbull.

Three switches were made in April. For some time, we had been keeping an eye on companies in the fund which were struggling to grow their earnings. The fund aims to invest in companies which can grow their earnings and we saw the opportunity to switch into companies which can better serve this aim.

Lenovo 汽车之家 autohome.com.cn

The first switch was to sell Lenovo for Autohome. Lenovo had been in the portfolio since launch and had disappointed. Despite a seemingly low valuation we decided a recovery was unlikely. Its PC business remains very cash generative though it is facing more competition and recently lost its number one spot to HP. The underperforming areas have been the smartphone and data center segments. It is very hard to generate persistent profits in smartphones and we had little confidence that Lenovo could turn losses in its smartphone segment to a profit, let alone a persistent profit. The data center business may possibly be turning around but it is still ultimately generating a loss.

Autohome is an automotive classified advertising business which has a dominant market share in China. On average 10.1 million people used its app daily in the first quarter of 2018. Its revenue comes from adverts and from the fees it charges to dealers to list on the website. It benefits from the network effect as it is now the go to destination to buy and sell cars online. The business also benefits from its controlling shareholder, Ping An Insurance, who have the ability to sell car insurance on every transaction. Autohome has persistently generated a cash return on investment above 20% since it listed which is amongst the highest in our quality universe.

The second switch was to sell China Mobile for Baidu. The cash return on investment on China Mobile has been below 8% for several years now. While this does not necessarily mean we have to sell the stock, we think the fact the returns of the business have dipped is an indication of the type of business China Mobile has become. It is now essentially a utility company, and earnings are likely to grow at a lackluster pace.

Baidu's search engine is dominant in China with a market share of over 75%. In the past, Baidu has been guilty of unsuccessfully throwing money at new businesses without realizing a positive return. As a result, its cash return on investment has fallen from 30% in the 2007-2012 period to 12% in 2017. But we believe the business is a better allocator of capital today than it was in the past. For example, it recently sold its share in its food delivery business, "Ele.me". Food delivery is a rapidly growing industry in China but at the moment competition is fierce as incumbents try to win market share. We have seen instances where companies are discounting so much one can order dinner for only 1RMB, or £0.12. It is unsurprising that profits are non-existent in this sector, so we view the exit as a positive move. Baidu's investments in artificial intelligence could also prove to be lucrative. It's operating system, DuerOS (think Amazon's Alexa or Google's Assistant) is being developed so it can be used on any hardware from any manufacturer. Over the next decade, as consumer electronics become more connected, Baidu's OS could become an integral part of each household in the same way its search function became an integral part of everyday life. Baidu's autonomous vehicle network, Apollo, is in development and in our view is being backed by the government. Though it is still very early days the Apollo network could become a key part of China's digital infrastructure in the future.

The third switch was to sell PICC for Noah. PICC is an insurer which has a very high return on equity relative to our quality universe. The problem is that the property and casualty insurance industry is becoming more competitive and we question whether the business can maintain its returns over the next few years. The insurance regulator further added to our concerns when it increased the maximum discount insurers are allowed to offer in several regions, potentially leading to lower margins for the business. Noah is a wealth and asset manager targeting high network individuals. It distributes onshore and offshore products across China. As Chinese financial markets mature, investors are becoming more accustomed to the idea of diversified asset allocation. So, in addition to equity offerings, Noah also gives investors access to fixed income, private equity and fund-of-funds products denominated in RMB and USD. The recent improvement in rules around the asset management industry, which brings it closer to global standards, should serve Noah well as it already positions and operates itself as a sophisticated asset manager.

Performance

The fund underperformed in the first six months of the year, returning -2.90% versus the benchmark -2.71% (Hang Seng Composite Total Return Index). The fund's under-performance mainly came in January where markets were extremely strong, rising nearly 10% in a single month.

As of 6/30/2018	YTD	1 Year	3 Year	5 Year	10 Year
China & Hong Kong Fund (ICHKX)	-2.90%	16.82%	7.56%	9.94%	4.28%
Hang Seng Composite Index	-4.32%	12.18%	2.68%	6.58%	2.43%

All returns over 1 year annualized. *Source: Bloomberg, Guinness Atkinson Asset Management.*

Expense Ratio: 1.64%

Edmund Harriss and Mark Hammonds (portfolio managers)

Sharukh Malik (analyst)

Guinness Atkinson
China & Hong Kong Fund
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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.

One cannot invest directly in an Index.

Hang Seng Composite Total Return Index is a market capitalization weighted index that monitors the performance of stocks listed in Hong Kong.

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

Payout ratio refers to the proportion of company profits paid out to shareholders as a dividend.

The trade surplus is the difference between the value of a country's exports and imports. The current account surplus adds income and remittances to the trade surplus.

Opinions expressed are subject to change, are not a guarantee and should not be considered investment advice. Past performance is not indicative of future results.

Top Fund Holdings as of 06/30/18

1.	CNOOC Ltd	3.84%
2.	New Oriental Education & Technology Group Inc	3.62%
3.	Lilang China Co	3.53%
4.	Noah Holdings Ltd	3.44%
5.	China Construction Bank Cor	3.38%
6.	Autohome Inc	3.33%
7.	Baidu Inc	3.27%
8.	Haier Electronics Group Co Ltd	3.26%
9.	Weichai Power Co Ltd	3.25%
10.	Sino Biopharmaceutical Ltd	3.22%

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