

## Summary Review & Outlook

### Fund & market

- MSCI Hong Kong Index (net total return of +5.85%) was the strongest market, compared to MSCI China Index which rose 3.45%.
- The gains in Hong Kong were driven by the Financials (total return of +10.56%) and Consumer Discretionary (+6.42%) sectors. AIA Group, which makes up ~20% of the index in Hong Kong, was strong following approval regulatory approval to start work on expanding to Tianjin and Shijiazhaung. MGM China and Galaxy reported earnings which beat expectation.
- In China, the strongest sectors were Information Technology (+14.06%) and Consumer Discretionary (+8.57%).

### Events in February

- The Chinese New Year festival started on February 5<sup>th</sup>. Note the timing of the New Year can affect economic activity leading to the event as well as after, so it is important to interpret economic data appropriately.
- Talks between China and the US seem to be progressing well. Robert Lighthizer and Steve Mnuchin went to Beijing to continue negotiations which was followed by Liu He travelling to Washington DC. It was here that Donald Trump postponed the increase in tariffs that were due to come into effect in March. Larry Kudlow said they were “making great headway on nontariff barriers” and “we have mechanisms with regard to enforcement, which, is – I think – unparalleled”. Lighthizer said that as part of the enforcement of any deal, the Chinese are willing to meet regularly to address US complaints, with monthly meetings between lower level officials and semi annual exchanges between ministers. If the US were not happy with the arrangements, they would be able to act “proportionally but unilaterally”.
- Lighthizer, however, cautions that he is looking for “significant structural changes” in China’s economy, in terms of the treatment of intellectual property and technology transfer, which suggests the Chinese will have to offer more than greater purchases of agricultural goods to cut the bilateral trade deficit.
- Credit growth, as measured by total social financing (standard measure used in China that incorporates all forms of credit), came in higher than expected for January, at 10.4% compared to 9.8% in December. Delving deeper into the data, trust loans grew for the first time since February 2018, indicating the contraction in the shadow banking system may be over, for now. Given the weak economic data, policymakers are focusing on supporting growth but the challenge will be in ensuring credit is not used for speculative purposes.
- Not so much of an event but cracks are appearing in the previously unified position against Huawei. 5G technology is coming and Huawei’s equipment is regarded equivalent (or better) to that of Nokia and Ericsson and undoubtedly cheaper. Germany and the UK seem to be taking more of a measured approach compared to the US.

### Market Update

MSCI announced it would increase the inclusion factor for China A shares from 5% to 20%, which means 20% of the relevant A shares' free float adjusted market capitalization will be represented. This will happen in three steps, concluding in November 2019. Whereas the inclusion of A shares in 2018 solely focused on large cap shares, the coming changes will also include mid cap and some ChiNext shares (which represent smaller, more innovative companies). This represents another step in China's integration with global financial markets. On a pro-forma basis, A shares' weight in the following indices would be:

	China A shares weight (current)	China A shares weight (Nov-19)
MSCI China	2.5%	10.4%
MSCI Asia ex. Japan	0.9%	4.0%
MSCI EM	0.8%	3.3%
MSCI AC World	0.1%	0.4%

*Source: MSCI*

If we include Chinese shares (A shares and Chinese shares listed in Hong Kong and the US), China's weight in the following indices would evolve as follows:

	China shares weight (current)	China shares weight (Nov-19)
MSCI Asia ex. Japan	35.9%	38.0%
MSCI EM	30.9%	31.9%
MSCI AC World	3.7%	4.0%

*Source: MSCI*

The direction of travel is clear and investors will have to pay more attention to Chinese shares in their allocations. For the inclusion factor to increase even further, there are some operational issues that need to be resolved to satisfy institutional investors. Currently, A shares have a settlement cycle of 0-1 days which presents an operational problem. Once this issue is resolved, we expect the inclusion factor to increase.

We must also remember the Bond Connect which allows foreigners to buy onshore bonds. Foreign ownership of Chinese government debt, as a percentage of total government debt, is smaller in China than Thailand, Brazil, Turkey, Colombia, Poland and Mexico. One reason for this is because Chinese government bonds were historically not included in the main bond indices. However, from April 2019 onwards, Bloomberg will be adding renminbi government debt into the Bloomberg Barclays Global Aggregate index. The process will be implemented over 20 months and when fully accounted for, Chinese bonds will represent the fourth largest currency in the index. According to HSBC, this could result in \$150bn of inflows into China's bond market. If FTSE Russel and JP Morgan did the same, close to another

\$300bn could follow. Note the equity and bond flows should also lead to demand for the renminbi increasing, putting pressure on the currency to appreciate in the long term.

#### **Portfolio Update**

After a weak January, Autohome was the strongest stock in the portfolio. In January the company increased prices for lead generation by at least 20%, with reports indicating some clients stopped dealing with Autohome as a result. During its earnings call covering fourth quarter results, management confirmed the reported clients were still working with Autohome. The company reported strong results for the quarter, with revenue growing 25% and operating income growing 49%. More importantly, it is still expecting revenues to grow in line with recent quarters even though the automobile market is weak. In January, retail sales of automobiles in China fell 4% while wholesale prices fell 17%. Dealers are responding to the weak market by reducing spending on sales channels with a low return on investment. This should help Autohome, as it is the dominant platform online. One estimate puts dealers allocate 40-50% of the marketing budget online, with Autohome and Bitauto capturing half of this. Autohome is a critical platform in China and cannot be ignored – it is big enough to benefit from the “network effect”. The business is also growing its exposure to the used car segment through its investment in the Tiantian Paiche platform. A newer part of the business, the commission earned through loans and insurance in conjunction with parent company Ping An, is notably growing quickly.

Pacific Textiles announced it had completed building its piping network and tanks in its factory in Vietnam, in order to meet the latest environmental requirements. Management are expecting the production level of the factory to reach 80-90% of capacity by April, a significant increase from the 40% level in November. The rise in utilization should boost operating margins considerably and help Pacific Textiles diversify its customer base.

Netease reported results which broadly met expectations. Gaming revenue grew with mobile driving growth. Following the release of expansion packs for older titles, PC gaming grew by more than expected. Since gaming approvals resumed at the end of December, Netease has had one approved and has many waiting to be approved. Throughout 2019, as more games are approved, we expect Netease’s revenue growth from this segment to accelerate. The e-commerce business continues to grow but is still operating at a loss. We are willing to give Netease time to grow this business – at a market share of 25%, it is now the second largest firm in China’s e-commerce market for imported goods, only behind Alibaba’s Tmall with a market share of 37%. We note reports that Amazon and Netease are considering merging their e-commerce businesses in China. If this were to go through, the benefit of economies of scale should help the combined business become more competitive against Tmall.

Baidu reported growing revenues but operating income fell due to higher spending on marketing. Baidu now has various apps and is spending more to attract users e.g. it was the exclusive sponsor for CCTV’s New Year Gala red packet campaign, where users could send a digital gift with an associated monetary value, but only on Baidu’s apps. Some estimate the sponsorship will cost between RMB1,000m and RMB1,900m (equivalent to between \$149m and \$284m assuming USDCNY is 6.70). This may seem steep,

but note the Gala is viewed by hundreds of millions of people - reports indicate Baidu gained 300m users overnight.

In the smartphone supply chain, two of the Fund's companies, AAC Technologies and Tongda, put out profit warnings. It is well known that the smartphone market in China is currently weak and this is feeding through to suppliers. That being said, we are looking further out to the future and we believe the market is undervaluing the returns these sorts of businesses are likely to generate. AAC should benefit from selling more advanced acoustics and haptics components as phones are upgraded. Tongda should benefit from being an early mover into glass/ceramic casings (plastic casings which look like metal) as well as its continued partnership with Apple to supply waterproof components. If prices were to fall further from what we believe are depressed valuations, we will continue to add to these positions to take advantage of this pricing anomaly.

Summary view & outlook

We expect the fund's focus on companies persistently earning a return on capital well above the cost of capital to do well in the long term. The fund now trades on a price to earnings multiple of 10.1x, based on estimated 2019 earnings, while the fund's discount to the MSCI Zhong Hua Index is 22%. Our confidence in the future is based upon sustained profitability over many years covering the post financial crisis stimulus, numerous housing cycles, the four-year period of falling producer prices 2011-15, the mainland stock market bubble and the current slowdown.

**Performance**

As of 2/28/2019	YTD	1 Year	3 Year	5 Year	10 Year
<b>China &amp; Hong Kong Fund (ICHKX)</b>	<b>13.21%</b>	<b>-11.76%</b>	<b>17.41%</b>	<b>5.91%</b>	<b>10.94%</b>
<b>Hang Seng Composite Index</b>	<b>11.46%</b>	<b>-7.26%</b>	<b>17.62%</b>	<b>7.34%</b>	<b>11.46%</b>

As of 12/31/2018	YTD	1 Year	3 Year	5 Year	10 Year
China & Hong Kong Fund (ICHKX)	-20.21%	-20.21%	6.93%	2.07%	8.08%
Hang Seng Composite Index	-14.15%	-14.15%	7.76%	4.43%	9.02%

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

Expense Ratio: 1.64%

*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 shown is current to the most recent month and quarter end. To obtain performance as of the most recent month end, please visit [www.gafunds.com](http://www.gafunds.com) or call 1-800-915-6565. Total returns reflect a fee waiver in effect and in the absence of this waiver, the total returns would be lower. 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.*

From April to December 2018, the Hang Seng Composite Price Return Index was used instead of the Hang Seng Composite Index Total Return. The Hang Seng Composite Index Total Return includes reinvested dividends but reflects no deduction for fees, expenses, and taxes.

***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](http://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 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.**

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.

The MSCI Zhong Hua Index is a composite index that comprises the MSCI China and MSCI Hong Kong Index. The index captures large and mid cap representation across all China securities (B shares, H shares, Red Chips, PChips and foreign listed shares) as well as Hong Kong securities.

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

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 2/28/19:

1.	Ping An Insurance Group Co of China Ltd - H Shares	3.97%
2.	Hollysys Automation Technologies Ltd	3.97%
3.	Sino Biopharmaceutical Ltd	3.66%
4.	Noah Holdings Ltd	3.65%
5.	New Oriental Education & Technology Group Inc	3.62%
6.	Anhui Conch Cement Co Ltd - H Shares	3.48%
7.	China Merchants Bank Co Ltd - H Shares	3.47%
8.	Yangzijiang Shipbuilding Holdings Ltd	3.35%
9.	Haier Electronics Group Co Ltd	3.28%
10.	CNOOC Ltd	3.20%

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

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