Guinness Atkinson
China & Hong Kong Fund
Review of March 2019

Summary Review & Outlook

Fund & market

- The leading contributors to Fund performance in the quarter were Consumer Discretionary stocks China Lilang, New Oriental Education and Haier Electronics; IT names Hollysys Automation and Vtech; Financial stocks China Merchants Bank and Ping An Insurance as well as Industrial stocks including Weichai Power, China Lesso and Yangzijiang Shipbuilding.

Events in March

- The government sets its growth target for the economy at 6.0-6.5%, lower than the target of 'about 6.5%' for 2018. The VAT rate for the manufacturing sector was cut from 16% to 13%, while it was cut from 10% to 9% for the construction and transportation sectors.
- The government's focus is on stabilizing growth. The Caixin Purchasing Managers Index (PMI) which focuses on private rather than state enterprises, came in at 50.5 for March, indicating expansion for the first time since November 2018. The government is aiming for credit to grow in line with nominal GDP growth and while this year will not see a splurge in credit like we saw after the financial crisis, the impact of monetary policy will still be important.
- Looser fiscal policy to support growth is a new tool. In addition to cuts in VAT, the government has already raised the monthly personal allowance for income tax and increased the number of items eligible for tax deductions e.g. rent, education and healthcare.
- The Stock Exchange of Hong Kong and MSCI announced they would launch futures for the A shares in the MSCI Emerging Markets Index. These futures will cover the 421 stocks that will be included by September this year. This development will act as a challenge to the Singapore Exchange which dominates trading on derivatives of the A share market.
- Trade talks between the US and China have continued with meetings in both Beijing and Washington. A deal does not look imminent with sticking points being intellectual property protections, state support for industry and enforcement of any agreement. Importantly however, both sides are working toward a conclusion and as long as that continues, we do not expect to see an escalation of tensions.
- Italy formally endorsed China's Belt and Road Initiative, becoming the first G7 country to do so. Italy's GDP is expected to be flat this year and the prospect of greater trade with China, as well as greater investment, is appealing. But this has not been welcomed elsewhere in Europe. In a paper, the European Commission called China a 'systematic rival' and its attitude towards China is hardening.
- China is also flexing its political weight in other countries. Following the arrest of Meng Wanzhou, Huawei's CFO, in Canada, China has blocked shipments of canola oil from Canada's largest domestic exporter. Following Australia's decision to ban Huawei from its infrastructure for 5G, China has restricted its imports of coking coal. In 2018, more than 20% of Australia's coking coal exports went to China so this is big news.
- Regulators gave approval to Chubb, a Swiss insurance provider, to take control of its domestic joint venture in China. Nomura and JP Morgan were also given approval to set up majority owned brokerages.

Market Update

A new securities market, the Science Technology Innovation Board (STIB), is to be launched which aims to make it easier for private companies in innovative sectors to raise capital. It will reside in Shanghai and will be different to the existing Chinext board in Shenzhen in several ways. It is likely the STIB will act as a testing board for new rules and if they are deemed to be a success, may be rolled out to the main exchanges. Some of these new regulations are expected to include:

- The system will be registration based, not approval based which existing bourses use. Approval based systems take much longer to complete – on average, the process is six months compared to two to three months in registration-based systems like in Hong Kong and the US.
- A quirk with current listings on the mainland is that domestic IPOs cannot be valued at more than 23x on a price/earnings ratio, using trailing earnings. Often this means a new issue will rapidly shoot up to what the market "thinks" it is worth. In the STIB system this cap will be removed.
- Daily price limits will be widened from the existing 10% to 20%, after the first five days trading.
- Dual class structures will be permitted, presumably to encourage unicorns to list in China rather than in the US or Hong Kong.
- There is a stronger focus on corporate governance. Explicit rules cover information disclosure (a major problem in China) and disciplinary actions when rules are not followed.

Portfolio Update

Most of the portfolio's companies reported earnings in March. China Lilang, which sells men's casualwear, reported strong profit growth. It launched a new smart casual collection targeting the younger range of its 20-45 year old target demographic. The range is to be rolled out into the wealthier, Tier 1 and Tier 2, cities in China, alongside the core range; while at the same time the core range is to expand into the so-called Tier 3 and Tier 4 cities. The new range is being distributed on a consignment rather than wholesale basis, meaning that distributors do not have to buy stock first but can place orders as they need and can return unsold stock. This is sensible since it lowers the risk to distributors of the new range and limits the potential for inventory build-up.

China Lesso produces plastic pipes, pipe fittings and building materials. It also reported good results, showing it is no longer solely dependent on the property market. Management cited greater demand for pipes from the country's ongoing shift away from coal and towards gas. Efforts to tackle water pollution are also positive for the business as projects covering river treatment, soil restoration and water purifiers were cited. Lesso acquired a majority stake in Jiangsu Yongbao which deals in the treatment of hazardous waste, wastewater and exhaust fumes. The stock has been cheap for some time but Lesso's growth over the past eight years has been good. Revenue has grown 12% per annum, operating profit has grown 10% per annum (p.a.) and net income has grown 8% p.a.

Two of our holdings in the smartphone supply chain, Tongda and AAC Technologies, updated the market. Tongda's traditional business is metal casings for smartphones in the low-to-mid end of the market. Customers here are moving away from metal and towards cheaper plastic casings which look like glass (‘glasstic’). At the moment the margins on the glasstic casings are much lower than on metal casings, so profits fell in 2018, though management believe margins are expected to recover as production ramps up. We are willing to give the business time to recover as Samsung is a new client and should drive volume growth. We will be watching margins carefully during the next trading update.

AAC Technologies is going through a tough patch as at the end of February it released a profit warning. It is facing more intense competition than we expected in the acoustics and haptics segments. The weakness in the smartphone market is causing pricing pressure down the supply chain and AAC is not immune to this. We continue to hold because we think that AAC is well positioned for the replacement cycle. As consumers buy newer phones, they will be buying products with more advanced speakers where AAC is well positioned.

Summary view & outlook

Recent noises from China point to a more stable domestic economic environment in response to the various support measures that have been put in place since September last year as slower growth became more evident. The export side still looks weak as most recently indicated by the new export orders component of the Purchasing Managers Index reported for March. It seems likely therefore that domestic policy will remain supportive. The program of debt reduction continues but is being pursued less aggressively in favor of stabilizing growth. This is in line with what we have said in the past, that debt reduction will take many years and the pace will fluctuate in response to economic conditions. De-leveraging places a drag on growth and so when conditions are favorable there is room for greater intensity; at a time of slower growth and trade uncertainty we would expect the pace to slow.

Average earnings growth for the portfolio over the next two years is 8.9% per annum based on current consensus estimates. This is better than the 7.2% per annum forecast for MSCI Zhong Hua Index. This is made more attractive still when we consider valuations. The fund’s price earnings multiple of 10.2x 2019 and 9.2x 2020 estimated earnings put it at a 21% discount to the MSCI Zhong Hua Index, as at the end of quarter. We have all seen the improvement in the Chinese outlook this year with global markets responding very positively. We believe that there remain plenty of uncertainties out there and that our focus on higher quality companies, evidenced by their ability to sustain profitability over time, is fully justified.

Edmund Harriss (portfolio manager)

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Performance

As of 3/31/2019	YTD	1 Year	3 Year	5 Year	10 Year
China & Hong Kong Fund (ICHKX)	**16.75%**	**-7.95%**	**14.76%**	**6.90%**	**10.12%**
Hang Seng Composite Index	**13.11%**	**-3.15%**	**14.45%**	**8.17%**	**10.81%**

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 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. 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 3/31/19:

1.	Ping An Insurance Group Co of China Ltd - H Shares	4.13%
2.	New Oriental Education & Technology Group Inc	3.87%
3.	Sino Biopharmaceutical Ltd	3.77%
4.	Hollysys Automation Technologies Ltd	3.65%
5.	Anhui Conch Cement Co Ltd - H Shares	3.63%
6.	China Merchants Bank Co Ltd - H Shares	3.60%
7.	China Lesso Group Holdings Ltd	3.57%
8.	Weichai Power Co Ltd - H Shares	3.49%
9.	Autohome Inc	3.45%
10.	Yangzijiang Shipbuilding Holdings Ltd	3.42%

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