Guinness Atkinson
China & Hong Kong Fund
Review of April 2019

Summary Review & Outlook

Fund & market

- In April, Chinese markets continued to rise with the Hang Seng Composite Index returning 2.10%.
- MSCI China (net return) returned 2.23% while Hong Kong returned 1.14%.
- In China, the strongest sectors were Communications Services, Information Technology and Financials while the weakest were Industrials and Energy.
- The leading contributors to Fund performance in April were stock specific, led by Qualcomm (modem and chip developer), Netease (online gaming and e-commerce) and Noah (wealth manager).

Events in April

- On the trade talks: Xi Jinping's speech at the recent Belt & Road Initiative forum dwelt on steps China will take on intellectual property, market opening, fair competition, effectively addressing and giving his seal of approval for the concessions required to get a deal done.
- Reports indicate Chinese policymakers are considering stimulating auto demand. Proposals include subsidizing replacement of older, dirtier vehicles with new electric vehicles (NEVs); incentivizing local governments to speed up the upgrade of their bus fleet with NEVs; removal of the vehicle tax for rural residents who replace their vehicles with an engine size below 1.6L.
- The National Development and Reform Commission is proposing to loosen hukou requirements to encourage mobility of workers. The hukou system links entitlement to services like education and healthcare to a particular area, meaning many migrants who move to larger cities are not entitled to these services. The new proposals call for cities with a population between one and three million people to lift all restrictions, while slightly larger cities are being pushed to gradually ease requirements. The aim is to encourage migration to these smaller cities rather than the larger tier one and two cities, some of which have become too large and are aiming to downsize.
- The Politburo met and stated that "efforts on structural deleveraging should be maintained" and "prudent monetary policy should be kept neither too tight nor too loose". This acts as a reminder that policymakers have a careful balancing act with managing growth while ensuring the financial risks in the system do not grow.
- Bloomberg began including Chinese government bonds and policy bank securities in its Bloomberg Barclays Global Aggregate Index.
- African Swine Fever (ASF) is likely to lead to China's pig population, which is the largest in the world, to fall by a third. The Ministry of Agriculture expects pork prices to rise by at least 70% yoy in the second half of the year and this is likely to put upward pressure on inflation.

Market Update

On the gradual opening of China's bond market, most comments have focused on the opportunity offered by a 'new' bond asset class that is deep and liquid as well as having a lower correlation to global benchmarks. (The same is true of Chinese A share equities.) This is certainly interesting for Global and EM bond managers, even though the addition of these bonds to the Bloomberg Barclays Global Aggregate Bond Index will not be complete until 2020. However, in our opinion it also speaks to growing confidence amongst Chinese financial policy makers.

Opening the government bond market is a big step that can have a significant impact on monetary policy management because of the introductions of portfolio flows which can often be far greater in bond markets than they are in equities. There are estimates that the combination of stock and bond market opening could generate portfolio flows of $200 billion a year on average. Even for a market of China's size such flows would be significant especially when we also remember that flows can move out as well as in. This suggests that the central bank, after years of maintaining barricades around the financial system, is now confident in its robustness. That is not to say that the risks have disappeared, but this is a step change that we believe has huge implications for how we should think about Asia over the next 10 years.

Portfolio Update

The resolution of the dispute between Qualcomm and Apple has received plenty of coverage and so we won't rehearse all of it here; but as holders of Qualcomm we have obviously taken a keen interest. The dramatic decision by Apple on the second day of the defining course case in this dispute, I think, allows us to draw some important conclusions:

- Qualcomm does indeed have a competitive advantage in chip design for mobile modems;
- Intel's withdrawal from that business shows it does not have a competitive edge in this market, despite confident assertions to the contrary only recently;
- 5G demands, with its high data volumes, require a high-quality solution that is not easily replicable;
- Apple's service revenues are not yet a substitute for handset sales - the risk of a delay to the new 5G handset presents too great a business risk to Apple.
- Apple is under intense competitive pressures. Samsung has been joined by Huawei in the top-end handset space and Apple's brand price premium is no longer secure as evidenced by falling device sales and the comparatively weak response to the recent XR model.

Qualcomm settled its dispute with Apple, with the two agreeing to a six-year licensing deal and Apple paying Qualcomm its dues which have been held back for the past two years. The share price subsequently increased by 50.5% in April. Intel immediately announced it would withdraw from the 5G modem business and this reaffirms our view that Qualcomm does indeed make the best modems. Apple is under pressure following the relative failure of the iPhone X – the risk of missing the next phone cycle is greater than the benefit (perhaps) of winning against Qualcomm.

China Merchants Bank reported solid results. The bank's deposit base is geared towards retail deposits and so is relatively low cost, allowing the net interest margin to increase. Pre-provisioning operating profit grew 13% while the non-performing loan coverage ratio rose to 363%. The bank is also making good use of its apps, with 59% of its wealth management products being sold through this channel.

New Oriental Education reported strong results. Student enrollments grew 40-45% while the hourly average selling price grew 5%. Margins rose due to better utilization of classrooms and cost control. A subsidiary, Koolearn, was listed on the Hong Kong Stock Exchange - it provides the online learning courses that New Oriental Education uses to complement its classroom-based teaching.

Anhui Conch Cement saw strong growth in earnings driven by both volume and margins. It is likely strong profit growth could continue as cement prices in key areas are higher compared to last year. There is some concern the government will start an anti-monopoly probe, but management seem comfortable with this risk, though there is a possibility further price increases become more moderated. Infrastructure and property construction should sustain the business in the near term.

Summary view & outlook

Our view on the prospects for the Fund is little changed. The sharp rally in Qualcomm has been a long time coming but based on our fundamental view of its competitive advantage, was not a shock. The outlook for China is also little changed. We inch closer to a trade deal but as we have seen from recent comments from President Trump, a deal cannot be taken as granted. There are plenty of signs that the slowdown in the domestic economy has now moderated. The dollar has been strong for a while and we do not expect it to move sharply higher given the interest rate outlook. In any case, Asia's sensitivity to this is not what is was: dollar debt as a proportion of the whole is well below Asian crisis levels and with most countries running current account surpluses and well-capitalized banking sectors, the region does not look vulnerable from this direction.

In the medium term, the China risk remains. High debt levels are an overhang but given the source of that debt funding is predominantly domestic we would have to look domestically for the source of a crisis. This could take the form of an economic slowdown brought about by a policy misstep, perhaps, combining with rapid monetary tightening in response to an inflationary or exogenous shock. There are no signs of these kinds of pressures in any of the data we are looking at.

Average earnings growth for the portfolio over the next two years is 10.7% per annum based on current consensus estimates. This is slightly lower than the 12.1% per annum forecast for MSCI Zhong Hua Index. 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. 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)

Performance

As of 4/30/2019	YTD	1 Year	3 Year	5 Year	10 Year
China & Hong Kong Fund (ICHKX)	**21.46%**	**-3.20%**	**17.00%**	**8.38%**	**8.94%**
Hang Seng Composite Index	**15.49%**	**-3.11%**	**14.87%**	**8.80%**	**10.05%**

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: 1.54%

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 4/30/19:

1.	Hollysys Automation Technologies Ltd	4.27%
2.	New Oriental Education & Technology Group Inc	3.96%
3.	QUALCOMM Inc	3.91%
4.	China Lesso Group Holdings Ltd	3.76%
5.	Autohome Inc	3.66%
6.	NetEase Inc - ADR	3.63%
7.	China Merchants Bank Co Ltd - H Shares	3.53%
8.	Anhui Conch Cement Co Ltd - H Shares	3.48%
9.	Yangzijiang Shipbuilding Holdings Ltd	3.44%
10.	Tencent Holdings Ltd	3.28%

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

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