Guinness Atkinson

China & Hong Kong Fund

Review of April 2020

Summary Review & Outlook

Fund & market

- In April, MSCI China rose 6.6% while MSCI Hong Kong rose 7.3%. The Shenzhen Component Index rose 8.0% while the Shanghai Stock Exchange Composite Index rose 4.3%.
- In MSCI China, the strongest sectors were Health Care (total return of +14.1%), Materials (+8.9%) and Communication Services (+8.6%) while the weakest were Financials (+2.5%), Energy (+2.6%) and Real Estate (+4.7%).
- In Hong Kong, the Financials and Real Estate sectors, which are by far the largest parts of the local index, rose 4.2% and 7.7%.

Events in April

- Life is gradually returning back to normal in China and an important milestone was reached when the lockdown in Wuhan was ended. But there was a reminder that a second wave of COVID-19 cases is a possibility as there was a spike of cases in Harbin, the capital of Heilongjiang province in the north east. The province has banned non-locals from entering the region and so far, it seems the outbreak has been contained.
- China's GDP fell 6.8% in the first quarter due to the effects of lockdown from COVID-19. That being said, there are clear signs of recovery in the economy. Industrial production increased 37% month-on-month in March. Retail sales surged 84% month-on-month in March but were still down 16% year-on-year.
- The official unemployment rate, based on surveys by the National Bureau of Statistics (NBS), increased from 5.3% in January to 5.9% in March. However, this rate likely understates the true level of unemployment. Migrant workers who were fired and then returned to their home provinces are not included in the survey. Additionally, some state-owned enterprises (SOEs) have not fired workers but have instead reduced workers' wages and hours. According to the NBS, in March 18.3% of urban workers were still employed but did not actually work.
- The one-year loan prime rate (LPR), used increasingly to price loans, was lowered by 0.2% to 3.85%. The five-year rate was lowered by 0.1% to 4.65%.
- Over the past few years, the government has tried to channel more credit to small and medium enterprises (SMEs), and the fallout from coronavirus has made this task more difficult. So far this year, SOEs have been attracting nearly all funds in the bond markets and from banks. To this end, the Ministry of Finance (MOF) now requires local government backed lending facilities to aim for 80% exposure towards SMEs.
- In Beijing, the household income threshold to be eligible for housing rent subsidy was lowered from CNY 4,200 a month to CNY 2,400 a month.
- Local governments are loosening measures that were put in place over the past few years to cool down the property market. In Lanzhou, the capital of Gansu province, the down-payment rate for commercial real estate was lowered from 70% to 50%, which is about average for China.

- The Chinese government will push infrastructure to stimulate growth. While this will include traditional investments into roads, bridges and railways, the government has specified a list of what it considers "new infrastructure." This includes 5G base stations, data centers, ultra-high voltage networks, artificial Intelligence and the industrial Internet of Things (IoT)
- Special bonds can now account for 25% of funding for these infrastructure investments, up from 20%.
- In Hong Kong, no new local cases of coronavirus have been reported since mid-April. Most public services were resumed on May 4th.
- The government's stimulus measured announced on April 8th are worth ~4.8% of GDP and include wage subsidies and financing guarantees for SMEs. This was needed given first quarter GDP fell 8.9%.
- In Taiwan, total coronavirus cases are 440, with only six deaths. However, the economy is highly dependent on foreign demand and so in April the Purchasing Managers Index fell to 42.2.

Market Update

According to calculations by Goldman Sachs, aggregate demand in China is tracking at 81% of 2019 demand, as of April 24th. On the positive side, we see the property and construction markets picking up. In the consumer discretionary market, a noticeable improvement is seen in the auto, restaurant and sportwear markets. On the other hand, weakness is clear in the travel, gaming and box office sectors. In the first three days of the Golden Week holiday at the beginning of May, there were 85m domestic tourists spending CNY 35.1bn. This marks a 42% year-on-year decline in tourists and a 60% decline in spending. Though this is clearly weak, this is an improvement compared to the 61% decline in tourists and 81% decline in spending in the Qingming holiday at the beginning of April.

Measure (as % of last year)	March 27th	April 24th
Utilization hours of excavators	75%	90%
Property sales	67%	85%
Auto sales (mass market)	60%	93%
Selected restaurant sales	58%	74%
Selected sportwear sales	61%	73%

Data covers the seven days preceding each date. (Source – Goldman Sachs)

Portfolio Update

Supor's revenue fell 35% yoy while earnings per share (EPS) fell 40%. The company faced a supply shortage until the middle of March and so was unable to make shipments even though online demand was growing. The long-term story remains the same - in the overall consumer appliances industry, small appliances have market share of 19% in China versus 29% in Japan and 37% in Korea. While 93% of consumers have a rice cooker and 84% have a kettle, only 35% have a slow cooker and 13% have a food processor. There is much room for the cookware and small appliances industry to grow, and Supor should be able to take advantage of this opportunity.

New Oriental Education, a provider of tuition services, reported revenue that grew 16% and EPS that grew 40%. This dropout rates for the company's courses have improved from the spike in February as classed moved out of physical platforms to New Oriental's online platform. Promotions for summer courses are starting and management are sticking to last year's strategy, which is to charge higher prices and focus on converting students to become full time customers. This means New Oriental will charge about twice what it did last year, and four to 10 times what it charged in 2018. The company is one of the most well-known tuition companies in China which allows it to charge premium prices. Management is guiding revenue to be flat which marks a deceleration in topline growth, but we think this is entirely understandable in the circumstances we are in. The balance sheet is strong enough to weather a slowdown in growth while many smaller peers are unlikely to survive a period of weakness. We think there is a strong chance that New Oriental increases its market share as a result.

China Merchants bank had a strong set of results which beat expectations. It achieved 11% pre-provision operating profit growth in first quarter though a deterioration in asset quality is expected in the second quarter. China Construction Bank also had good results, with pre-provisioning operating profit up 6%. The net interest margin is expected to fall over the coming quarters.

Portfolio Switches

We sold AAC Technologies after it announced a negative profit warning. The returns of the business have been falling for some time and the decline in profit in the first quarter was unexpectedly high.

We are now in the process of moving the fund from 33 positions to 30 positions. There are few alternative companies in the offshore market that 1) meet our quality threshold of achieving an 8% return on capital over eight years, and 2) offer attractive valuations over the medium term. The onshore universe offers more than 100 new companies and is one we are looking to increase our exposure to. However, there are risks in the market that we must manage. One such risk that is increasingly becoming apparent is the popularity of pledged shares by main shareholders. If these main shareholders come into difficulty, these pledged shares can be sold by debtors which would have all sorts of implications for share prices and management of these companies. As a result of the lack of compelling alternative ideas in the universe, we would rather increase exposure to the existing positions in the fund which we consider to be best in class.

Summary view & outlook

We believe we own a set of companies that can navigate the upcoming slowdown in the global economy. Debt/equity for the portfolio, excluding the three banks, is 42% i.e. the Fund is not highly geared. If we look at net debt/equity, which subtracts cash from debt, the figure is -14% i.e. our companies could in theory pay back all of their debt with cash. We measure bank leverage by comparing total assets to total equity. We would consider assets that are 20x the size of equity to be the maximum we would accept for a bank and for an emerging markets bank with their more highly concentrated loan books we think we should be looking at 12-13x. China Merchants Bank is the most leveraged at 12.0x and BOC Hong Kong the least at 10.0x.

Edmund Harriss (portfolio manager)

Performance

As of 4/30/2020	YTD	1 Year	3 Year	5 Year	10 Year
China & Hong Kong Fund (ICHKX)	-12.43%	-6.27%	5.28%	1.55%	2.21%
Hang Seng Composite Index TR	-9.32%	-9.42%	4.20%	0.46%	4.79%

As of 3/31/2020	YTD	1 Year	3 Year	5 Year	10 Year
China & Hong Kong Fund (ICHKX)	-18.73%	-9.51%	2.89%	2.64%	1.40%
Hang Seng Composite Index TR	-14.17%	-12.47%	2.89%	2.24%	4.15%

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

Expense Ratio: 1.69%

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. 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.*

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. The China and/or Hong Kong stock markets in which the Fund invests may experience periods of volatility and instability. These fluctuations may cause a security to be worth less than it was at the time of purchase. Market risk applies to individual securities, a particular sector or the entire economy. China and/or Hong Kong stocks may fall out of favor with investors, the value of Chinese currencies may decline relative to the U.S. dollar and/or China or Hong Kong stock markets may decline generally. The Fund invests in invest in small-cap or mid-cap, which involve additional risks such as limited liquidity and greater volatility, than investments in larger companies.

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.

MSCI China Index captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). With 703 constituents, the index covers about 85% of this China equity universe.

MSCI Hong Kong Index is a capital weighted stock index designed to measure the performance of the large and mid cap segments of the Hong Kong market. It has 48 constituents and covers approximately 85% of the free float-adjusted market capitalization of Hong Kong equity stocks.

Shanghai Composite Index, also known as SSE Index, is a stock market index of all stocks that are traded at the Shanghai Stock Exchange.

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 4/30/2020:

1.	Tencent Holdings Ltd	4.21%
2.	Anhui Conch Cement Co Ltd - H Shares	3.97%
3.	Alibaba Group Holding Ltd	3.91%
4.	Noah Holdings Ltd	3.87%
5.	NetEase Inc - ADR	3.86%
6.	Sino Biopharmaceutical Ltd	3.65%
7.	New Oriental Education & Technology Group Inc	3.53%
8.	Geely Automobile Holdings Ltd	3.52%
9.	China Lesso Group Holdings Ltd	3.48%
10.	China Merchants Bank Co Ltd - H Shares	3.44%

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

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