Guinness Atkinson

China & Hong Kong Fund

Managers' Update - September 2021

GUINNESS ATKINSON FUNDS

Summary Review & Outlook

Market

- In August, MSCI China was flat and MSCI Hong Kong fell 0.7%. The CSI 300 Index rose 0.1%.
- In August, MSCI China Value rose 0.3% while MSCI China Growth fell 0.3%.
- In China, the strongest sectors were Energy (total return of +11.5%), Materials (+9.4%) and Industrials (+5.5%) while the weakest were Health Care (-6.4%), Consumer Discretionary (-1.6%) and Communication Services (-1.3%).
- In Hong Kong, the Real Estate and Financials indices fell 4.1% and 0.9% respectively.
- In the Fund, strong performers were Xinyi Solar, Nari Technology, JD.com, Haier Smart Home and China Overseas Land. Weaker stocks were Fuling Zhacai, Shengyi Tech, Alibaba and Ping An.

Market Overview

The government has been talking up its focus on "common prosperity". The term has been used in the past, with it being mentioned by Mao Zedong and Deng Xiaoping. Under Deng, the focus was on allowing some to prosper before others through free markets, which would eventually allow the achievement of common prosperity for all. In the past year, the government made common prosperity an objective, after deeming that the problem of extreme poverty had been solved. That being said, there is no precise definition of what it actually means. Given what we have read, we regard common prosperity as a term with multiple aims. The primary aim is to reduce income and wealth inequality. Notes released after Party meetings indicate that the Party wants more chances for wealth generation. They aim to make the middle class bigger but also mention the need to "adjust excessive incomes and prohibit illicit income to promote social fairness and justice". We interpret this as a continued focus on economic growth, but with an evolved taxation system to redistribute income. Other goals include:

- A more inclusive and fair education system.
- A system which allows more people to become wealthy.
- Improving elderly care and medical security.
- Protecting property and intellectual property rights.
- Improving incomes in rural areas.

The Party has also given statements indicating what common prosperity does not mean – an official said it does not mean "killing the rich to help the poor", while another stressed that the phrase does not translate to egalitarianism.

In Zhejiang province, where Xi Jinping was Party Secretary between 2002 and 2007, the local government has established a common prosperity pilot zone. The pilot aims to double household income within 10 years, which will require economic growth if the target is to be met. In the press release, there is more focus on how to achieve growth rather than on taxes and redistribution of income.

In terms of the impact on portfolio management, we interpret common prosperity as investing in stocks which:

- Do not have a negative impact on wider society.
- Do not make it harder for the low- and middle-income consumers to grow their incomes and welfare over time.
- Align with the state's view of what is needed to drive economic growth in the next decade. Our focus on structural growth themes means we are well placed for this. Areas of exposure include Sustainability, Manufacturing Upgrades, Cloud Computing & Artificial Intelligence and Healthcare.

Motivation

We believe there are several motivations behind the government's focus on common prosperity:

- To reduce widening income and wealth inequality. One measure to calculate income inequality is the Gini Coefficient. A value of zero means an equal society (where all incomes are the same) while a value of 100 means maximum inequality (e.g. one person has all the income). Based on data from the World Bank, the Gini coefficient for China is 39 compared to 41 for the US and 35 for the UK. Given that China is a socialist country, this is a surprising result. For context, the Gini coefficients are 28 for Norway, 30 for Sweden and 28 for Denmark.
- To improve poor corporate behavior, which might help profits to shareholders while in some cases, is also detrimental to wider society – see the next section for examples.
- To check the power of large companies, especially in the tech space. In November 2020, Jack Ma essentially criticized the government's approach to financing directly to their faces. Following the speech, which was not received well by the government, there was a notable increase in government regulation in the tech space. Given the amount of data these online tech companies possess, as well as the fact some operate social media platforms, they arguably present a potential threat to the Party's rule over China.

Actions

Over the past few months, various industries have faced regulatory actions. We think many of these moves do have understandable rationale:

- Online platforms such as Alibaba were barred from restricting merchants to exclusivity deals, where the merchant can only sell on one platform. This practice was to the clear detriment of the seller as well as consumers, who faced less choice.
- Food delivery drivers to be paid the minimum wage and to be offered access to insurance.
- Chinese courts ruled that the "996" practice (working from 9am to 9pm, 6 days a week), which is popular in tech companies, is illegal. The practice has long been criticized and this intensified this year after two employees of Pinduoduo died in separate incidents, which were potentially linked to arduous working hours.
- People under the age of 18 to be restricted to only three hours of gaming on weekends. While we think this is too restrictive, the move does have some rationale. Hundreds of millions of people in China have some form of visual impairment, which may be linked to excessive screen use.

Additionally, in 2019 the World Health Organisation (WHO) formally classed gaming disorders as a behavioral disease.

- The government is intending for much of the for-profit education sector to turn non-profit. The government is concerned that the gap between richer and poorer students could further increase, given the popularity of after school tuition services in middle class families. Additionally, expensive tuition is likely to discourage families from having more children, which makes it much harder for China to increase its birth rate. The government's action marked a repeat of what has occurred in Korea.
- The *People's Daily* called for greater supervision of the online healthcare sector. In particular, it called for better supervision and standards in the prescription of medicines. In some cases, online platforms distributed medicines before they were actually prescribed.
- The Personal Information Protection Law (PIPL) was passed and becomes effective in November. Where algorithms decide which adverts and information are shown to users, users will have the option for their personal data to be ignored by the algorithm. The law also sets out a framework outlining why and how personal data can be used, much like Europe's GDPR. Companies can be fined up to 5% of their revenue if they violate the law.

However, there are some actions which have less to do with improving market failures or reducing inequality, and more to do with maintaining power. Data is the recurring theme in these cases, which can be used as a justification for more state involvement. For example, concerns over data security were used to justify the removal of Didi's app from app stores. The official justification was the government was concerned over potentially sensitive data flowing between domestic and foreign entities, though we question how much data genuinely left the country in this case. Nonetheless, data security concerns have forced multinationals such as Apple and Tesla to keep most of their data within China. More broadly, the issue of data is relevant in the case of surveillance, facial recognition, the digital renminbi and the evolving social security system.

<u>Company Responses</u>

In response to the new regulations, we have seen several companies allocate funds towards common prosperity initiatives. Both Alibaba and Tencent have pledged $15.5bn, while the founders of companies including Bytedance, Pinduoduo and Xiaomi have followed. While some of the headlines in Western reports suggest these are donations with no economic value, we do not think it so clear cut. We have the suspicion that some of these investments are being marketed as aligned with common prosperity, but are normal commercial investments that would have been made anyway at some point in the future. For example, Alibaba's $15.5bn investment aims to deliver on 10 key initiatives by 2025, focusing on "technology innovation, economic development, high-quality employment creation, care for vulnerable groups, and establishing a common prosperity development fund." Some of Alibaba's funds will be used to:

- "Support small and medium-sized enterprises to expand into new overseas markets" – Alibaba can do this through its platform AliExpress, for example.
- "Improve the welfare of gig economy workers" – Alibaba operates Ele.me, its food delivery service. This initiative may just mean Alibaba will pay its drivers more or will pay for some of their insurance.
- "Enhance healthcare capability in less developed areas" – Alibaba operates Alibaba Health Information Technology, one of the largest online healthcare platforms in China.

Similarly, Tencent will invest $15.5bn with a focus on:

- Innovation in the educational sector – Tencent Education offers classes used by more than 100 million students.
- "Public welfare digitisation" – Tencent Meeting has more than 100m registered users.
- Medical assistance – Tencent backs WeDoctor, an online health platform which gives patients access to doctors, hospitals, pharmacies and insurers.
- Rural economic efficiency – Tencent's AI applications could be relevant here, as it has trialled its AI solutions to help improve agricultural yields.

These investments fit in line with the government's objectives of common prosperity, which means these companies could be less likely to face regulatory action. No doubt, a portion of the capital invested can be thought of as a social contribution with little expected return. But some of these investments may have eventually been made anyway – the current focus on common prosperity means they are being frontloaded. These investments do have commercial appeal but are currently being marketed as investments in common prosperity. It would not surprise us if some of the investments discussed end up earning a return on capital well above the cost of capital.

Company Results

Xinyi Solar reported interim results where revenue increased 75% and net income increased 118%. Results were driven by both higher volume and higher blended average selling prices (ASPs). New production lines are helping the company cope with strong demand. While spot prices for solar glass have been falling since April, the company's blended gross margin only fell by two percentage points compared to the second half of 2020, supported by the more stable solar farm business.

Nari Technology's first half revenue and net income grew 22% and 34% respectively. Orders for the company's main product, power communications equipment, were robust. Management expect 15-20% growth a year for this segment over the next few years. Sales related to the buildout of Ultra High Voltage lines grew 90% year as more lines were completed. Encouragingly the company is diversifying its customer base, as revenue from non-grid customers grew 28%.

JD.com reported second quarter revenue growth of 26%. Despite the regulatory headwinds and weaker than expected macro data, sales have remained resilient, and management expect retail sales growth of

20-25% in the third quarter. As the company is expanding its non-retail business, costs are increasing at a faster rate than sales. That being said, we are seeing signs the company is being sensible. For example, JD is refining its roll out of community group purchases (CGP) and is now targeting particular areas rather than the whole country - this should lower the impact on margins. Given the regulatory changes affecting the sector, the company highlights it already fully covers social security insurance for its delivery workers, so unlike some of its peers, will not face higher costs from new regulations.

China Overseas Land & Investment (COLI) reported 1H of 2021 results with core net profit (excluding the effects of investment property revaluation and foreign exchange) up 2%, in line with expectations. The Chinese real estate sector can be a worrying sector, but COLI is easily the best positioned in our view. It has the lowest debt ratios of its peers (debt to equity 67%, net debt to equity 33%) and its investment grade credit rating, also the best in the sector, gives it access to the lowest cost of funding at 3.6%. COLI's business is property development with 40% of its landbank in Tier 1 cities (Beijing, Shanghai, Hong Kong etc) and in urban renewal projects. The stock offers a combination of strong balance sheet, good market position, and a stabilizing margin trend that suggests earnings growth is likely to track sales growth more closely. We believe the company has a strong enough balance sheet to weather weakness in the property market. But more importantly, if the property market is to become volatile because of problems with Evergrande, COLI has the ability to acquire good quality assets trading at depressed prices.

Fuling Zhacai reported first half revenue growth of 13% but earnings contraction of 17%. Fuling Zhacai was able to increase its gross margin despite higher raw material costs, a sign of the business's strong pricing power. Earnings fell because promotion expenses increased, as the company is trying to target more customers. We see these marketing expenses as an investment to generate future earnings growth, and so are comfortable with the stock despite the fall in earnings.

Ping An Insurance Group reported interim results for 1H2021 that were better than forecast with net book value and operating profit above expectation. The dividend was increased by 5%. The value of new business in the life insurance segment dropped significantly as a result of declining first year premiums and lower margins. This is consistent with Ping An's drive to reduce the number of sales agents but to increase productivity, which remained unchanged on last year but with an 11% lower headcount. This lies behind the improvement at the operating profit level. Property & Casualty however, was a highlight with credit and guarantee insurance leading the way resulting in a Combined ratio (costs and expenses divided by revenues earned) falling to 95.9%, thereby increasing profits. Another strong contribution from Ping An Bank and the announcement of a share buyback made for a good set of results.

Stock Switches

In June we sold New Oriental Education and in July we sold Yuhong. In response, in August we bought AIA and Shengyi Technology.

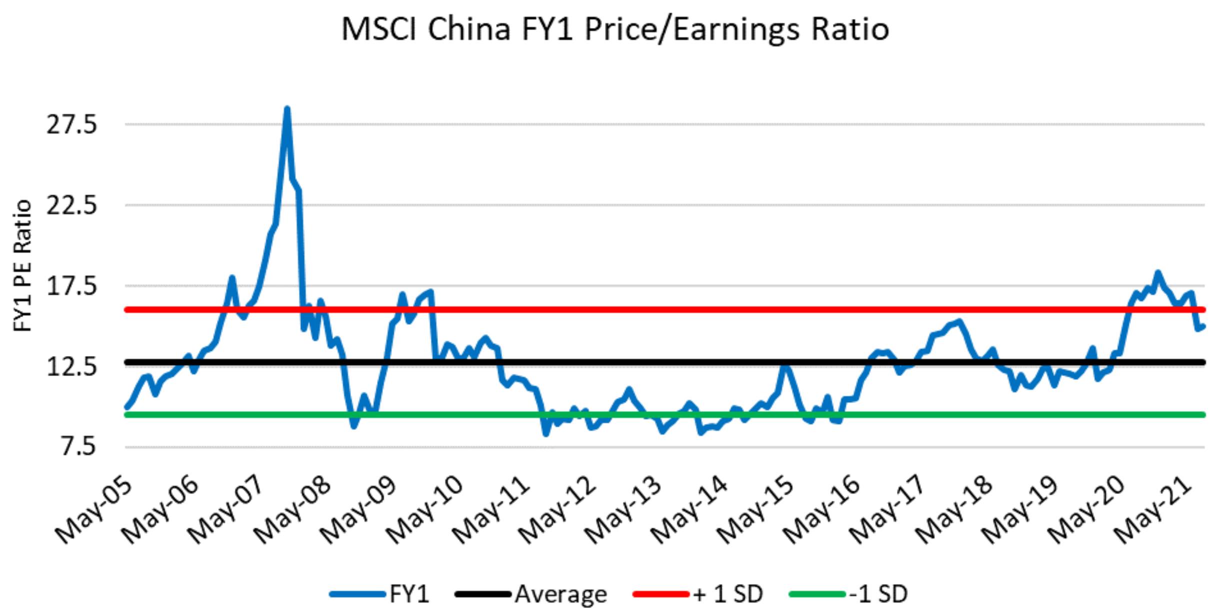
AIA gives the fund exposure to growing demand for life and health insurance. It is headquartered in Hong Kong and derived more than 50% of its revenue from the China region. AIA also has exposure to Southeast Asia, namely Thailand, Malaysia and Singapore. However, much of the future earnings growth is likely to come from mainland China. AIA is targeting the rising middle class in the country and we believe there is a lot of room for the company to grow from a relatively low base. AIA targets the premium end of the market, using its highly trained workforce which is viewed as giving some of the best service in the industry. This is backed up by AIA's very low turnover rate amongst its staff, relative to its competitors.

Shengyi Technology makes copper clad laminates (CCLs), which are the main base material for printed circuit boards (PCBs). It benefits from multiple trends which point to greater demand for CCLs and PCBs: growing popularity of 5G compatible devices, growing demand for servers and cloud services as well as localization towards Chinese suppliers in the Chinese market. Shengyi is quickly moving up the value chain, supporting a gradual rise in margins over time.

Outlook

Valuations have come down from the peak earlier this year and relative to its longer-term average, the Chinese market is not cheap, as seen below. However, this long-term average does include a long period after the financial crisis, where China was in a bear market and was trading below 10x. During this period, producer price inflation was negative and the property market was in a relative slump. We do not think that these conditions are about to repeat. This depressed period for the index also did not include the highly rated technology stocks which began to dominate the market from 2017 onwards.

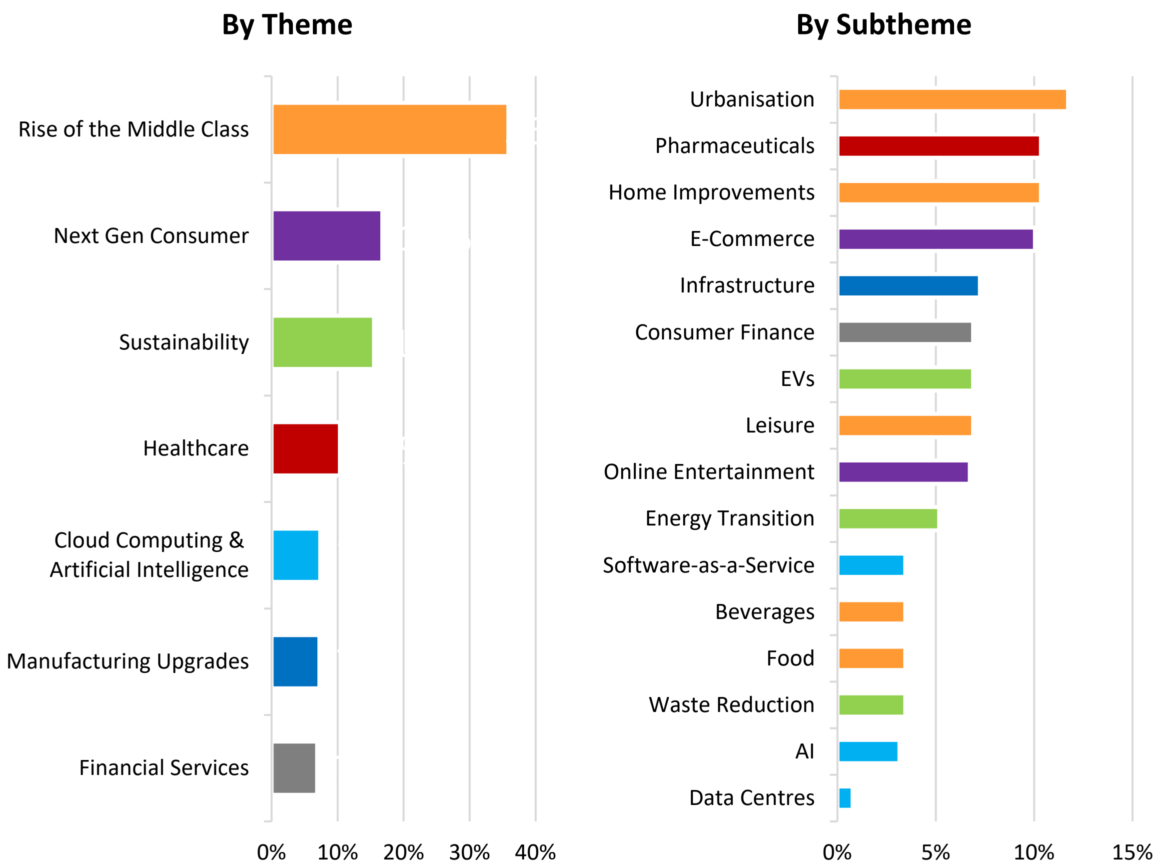
Looking at China since 2013, much of the multiple compression this year has come from Privately Owned Enterprises (POEs) rather than State Owned Enterprises (SOEs). Multiples for POEs are now in line with their eight-year average, while the multiple for SOEs remain cheap (reflecting the lower efficiency for these businesses). We think that overall, multiples in China are now reasonable. Downward earnings revisions are currently greatest for the offshore Internet stocks, where estimates for 2021 and 2022 have been cut by 27%. Private businesses more generally also seeing downward revisions of 13%, as earnings expectations became too bullish after China had a good run in 2020, and the economy is now slowing down as stimulus is being gradually wound down. On the other hand, state owned enterprises are seeing positive earnings revisions of 9%.



Data as of 08/31/21. (Source – Bloomberg, Guinness Asset Management calculations)

It is of course impossible to say how much more the market can fall. But at these prices, China certainly is an attractive proposition. What is more interesting is that there are many good ideas apart from online tech companies which have been driving recent weakness. For example, based on consensus earnings expectations, the two-year earnings growth rate for Tencent and Alibaba is now 4% and 8% respectively. This means they are expected to be among the slower growth companies in the fund. Areas such as sustainable energy, import substitution, and China's move up the manufacturing chain are worth considering – many of the companies in these industries do not conflict with the recent focus on common prosperity.

For example, in the China & Hong Kong Fund, where online tech companies are less than 20% of the fund, we are being asked to pay 15x on 2021 earnings for expected ~14% earnings growth a year, for the next two years. There is so much more than just online tech if one is interested in the growth opportunities in China. The themes and subthemes in the fund reflect this:



As of 06/30/21.

Below we briefly outline some of the Hong-Kong listed stocks in the Fund which we think are interesting:

- **Manufacturing Upgrades** – Geely. We think Geely is one of China's best run car companies and is well placed to deal with the changes in the industry. The company benefits from cooperation with Volvo, which its parent company owns, where the two use the same design system to save costs. The parent company also owns a stake in Daimler and the two are working together to build new engines for hybrid vehicles. Geely's new EV brand *Zeekr* just raised $500m in funding, valuing it at $9bn. Geely has also set up a joint venture with Baidu, which is China's most advanced companies in the autonomous driving field.
- **Healthcare** – CSPC Pharmaceutical. An aging population means demand for pharmaceutical products is expected to increase – in 2020, 19% of the population was over 60 years old vs only 7% in 2000. CSPC gives exposure to the cardiovascular and oncology fields. The company is increasing its R&D spend to increase exposure to the innovative segment of the market, where pricing power is stronger.

- **Rise of the Middle Class** - Haier Smart Home. Haier is one of China's largest manufacturers of household appliances, covering fridges, washing machines, TVs etc. Haier owns several brands to target different parts of the market, in order to take advantage of consumption upgrades. For example, its premium brand, *Casarte*, grew sales 74% in 1H21.

Edmund Harriss (portfolio manager)

Sharukh Malik (portfolio manager)

Performance

In August, the Guinness Atkinson China & Hong Kong Fund rose 0.44% while the Hang Seng Composite Index rose 0.69% and the MSCI China Net Total Return (NTR) Index was flat.

In the regulatory led sell-off, the Fund outperformed due to its underweight in the large online tech stocks which are a large part of the index. In the sell-off (07/31/21 – 08/20/21), the Fund outperformed the Hang Seng Composite Index by 1.61% and the MSCI China NTR Index by 4.28%. As the tech stocks rebounded, the Fund gave back its relative gains.

As of 08/31/2021	YTD	1 Year	3 Year	5 Year	10 Year
China & Hong Kong Fund (ICHKX)	-2.55%	10.64%	8.65%	10.84%	5.29%
Hang Seng Composite Index TR	-4.65%	5.54%	5.43%	8.59%	6.80%
MSCI China Net Total Return Index	-12.26%	-5.10%	7.27%	10.80%	7.24%

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

Expense Ratio: 1.60%

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.

As of 06/30/2021	YTD	1 Year	3 Year	5 Year	10 Year
China & Hong Kong Fund (ICHKX)	4.40%	32.00%	8.50%	14.76%	4.74%
Hang Seng Composite Index TR	6.33%	29.76%	7.84%	13.24%	6.95%
MSCI China Net Total Return Index	1.83%	27.39%	10.34%	16.58%	7.70%

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

Expense Ratio: 1.60%

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.

The Shanghai Shenzhen CSI 300 Index is a market capitalization-weighted stock market index designed to replicate the performance of the top 300 A-share stocks traded in the Shanghai and Shenzhen stock exchanges.

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.

MSCI China Value Index captures large and mid cap Chinese securities exhibiting overall value style characteristics. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price, and dividend yield.

MSCI China Growth Index captures large and mid cap securities exhibiting overall growth style characteristics across the Chinese equity markets.

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

The Gini coefficient or Gini index is a measure of the distribution of income across a population.

Price-Earnings (P/E) ratio is a valuation ratio of a company's current share price compared to its per-share earnings. Forward earnings differ from trailing earnings, which is the figure quoted more often, as they are a projection and not a fact.

The General Data Protection Regulation (GDPR) is a privacy and security law drafted and passed by the European Union (EU). It imposes obligations onto organizations anywhere, so long as they target or collect data related to people in the EU.

A privately owned company (POE) in China is a company that is majority owned by the government.

A state-owned enterprise (SOE) is a legal entity that is created by a government in order to partake in commercial activities on the government's behalf.

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 08/31/2021:

1.	Xinyi Solar Holdings Ltd	5.33%
2.	NARI Technology Co Ltd	4.83%
3.	China Resources Gas Group Ltd	4.47%
4.	China Merchants Bank Co Ltd - H Shares ADR	4.00%
5.	CSPC Pharmaceutical Group Ltd	3.85%
6.	Venustech Group Inc	3.83%
7.	Autohome Inc	3.80%
8.	JD.com Inc	3.77%
9.	NetEase Inc	3.76%
10.	China Lesso Group Holdings Ltd	3.67%

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

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