GUINNESS ATKINSON™
FUNDS
INVESTING IN HUMAN PROGRESS

REINVESTING DIVIDENDS:
A SIMPLE ALTERNATIVE TO ALTERNATIVES

by Jim Atkinson
Chief Executive Officer

INVESTMENT RESEARCH SERIES

INTRODUCTION

The financial markets have frustrated most investors over the past decade, plus. The S&P 500 has been more volatile than is comfortable for many investors, and so-called safe fixed income investments have offered paltry yields. Put that in context with a large segment of the population that is nearing or entering retirement, and it is no wonder why many investors are seeking alternative investments.

The phrase "alternative investment" can mean investments in less common asset classes, such as commodities, as well as approaches such as long/short or market neutral strategies. Most alternative investment strategies seek low-correlation with equities, and increasingly, many of them are steeped in complexity. The theory behind alternative investments is that traditional, long-only equity strategies have failed to provide sufficient returns for investors.

However, there is one time-tested, long-only strategy that may benefit from sideways or even downward trending markets that uses a straightforward and easily repeatable process. The simple alternative to alternative investing is likely right in front of your eyes, that is, traditional dividend investing. Specifically, investing in high quality companies and then reinvesting their dividends over time until it is time to begin collecting the income stream.

Historically, both stock and bond investing was much more focused on generating income. Much of the income orientation was lost during the bull market euphoria of the 1980s and 1990s. Those saving and investing for retirement are almost certainly seeking a singular objective of maximizing their retirement income. Yet, ironically, prior to the events of the most recent financial crisis, the most common path to that objective was to eschew income in favor of capital gains during the so-called "accumulation phase" with the plan of using those gains to invest in income generating securities at a later point near retirement, during the so-called "pay out phase."

More recently, of course, the plan has been to replace a large part of the equity risk inherent in growth stocks with alternatives in an effort to generate gains, often replacing that now well-known risk of equities with more opaque and less understood ones. Additionally, the task of translating capital appreciation into income producing securities remains. Might we suggest a more direct approach?

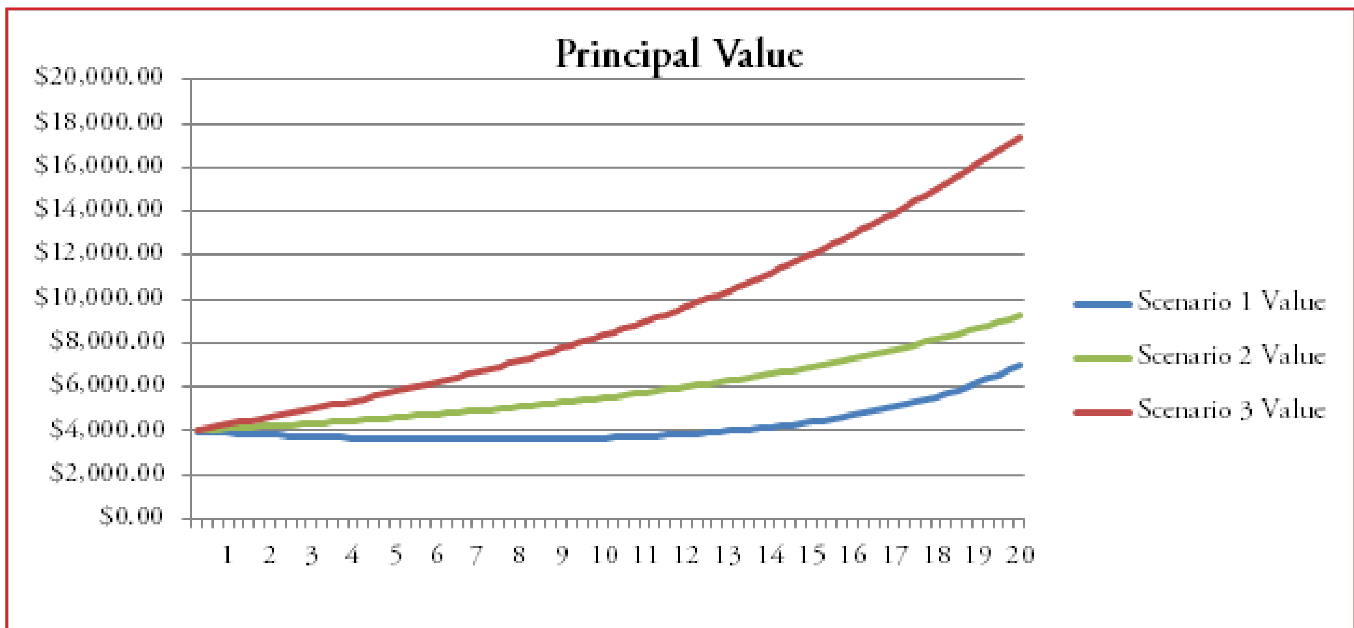
The dividend reinvestment strategy can benefit greatly from flat (good) or declining (better) markets. This is because the reinvested dividends accumulate more shares at lower prices. The strategy can benefit even more from a flat or declining market when systematic purchases are added to the mix. The key is understanding that downward price movements can actually be hugely beneficial for building a future income stream. Counter-intuitively, the decline in principal may actually be a meaningful benefit for income investors reinvesting their dividends who are thinking of income as their final outcome.

For illustrative purposes we'll use The Coca-Cola Company as an example and present three hypothetical scenarios which will demonstrate the benefit a declining market can have on a dividend strategy. As of October 18, 2012 the Coca-Cola Company pays a quarterly dividend of $0.255 per share which annualizes to a current yield of approximately 2.55%, assuming a starting price of $40 per share. Below we show three basic scenarios. In the first scenario we assume the price of the company declines by 5% per year for 20 years. In the second scenario we assume the price remains flat for 20 years while in the final scenario we assume the price appreciates by 5% per year for 20 years. In all scenarios we assume the dividend grows at a constant rate of 5% per annum and that the initial price is $40 per share. Note that this dividend growth rate is well below the last five year growth rate for The Coca-Cola Company's dividend of 10%. For all of the scenarios we assume a 100 share, $4,000, initial investment. At the end of the 20 years the value of our initial investment of $4,000 and the year 21 dividend stream can be seen for each scenario as follows:

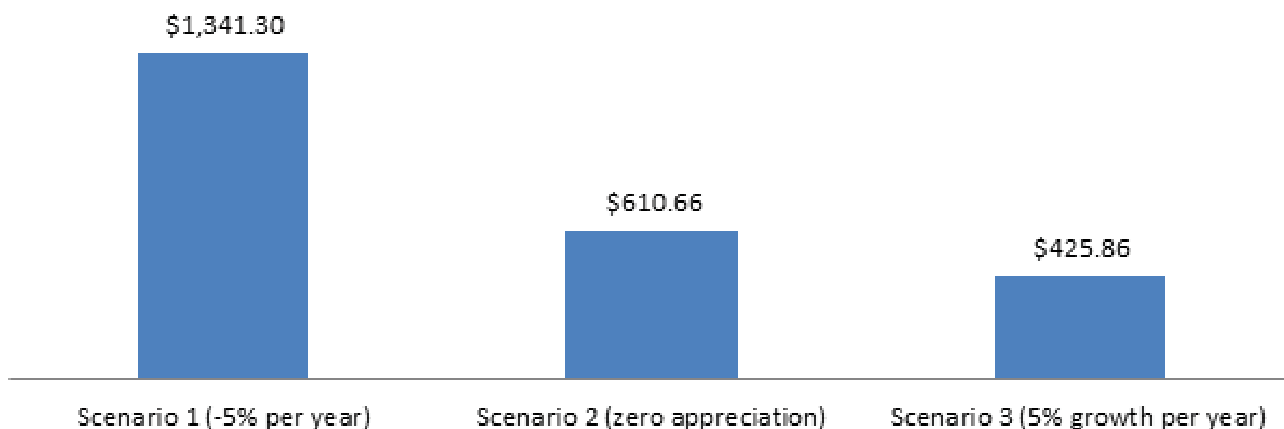
	Scenario 1 (annual decline of 5%)	Scenario 2 (zero appreciation)	Scenario 3 (annual appreciation of 5%)
Principal Value at End of Year 20	$6,967	$9,250	$17,379
Annual Income Year 21	$1,341	$610	$425

At first glance, scenario three—5% annual appreciation—is the obvious winning scenario, as the principal grows from $4,000 to $17,379 over 20 years. This principal value is nearly double the zero appreciation scenario and nearly 2.5 times the 5% decline scenario. However, the income from scenario 1, the 5% decline scenario, is more than three times greater than scenario 3. Importantly, scenario 1 finishes year 20 with a gain of nearly 40% over the starting value, despite the fact that the principal suffered an annual decline of 5% for 20 consecutive years.

The decline in principal may seem to be a negative, but it is actually a meaningful benefit for income investors reinvesting their dividends. This explains our tag line, "Think Income as Your Outcome."



The important point is that downward price movements can be hugely beneficial for investors that are seeking to build a future income stream. Counter-intuitively, the decline in principal may seem to be a negative, but it is actually a meaningful benefit for income investors reinvesting their dividends. This explains our tagline, "Think Income as Your Outcome."



While these scenarios are illustrative, Scenario 1 is highly unlikely, in that it is unreasonable to expect the dividend to grow at a rate of 5% per year while the principal declines at the rate of 5% per year. We would expect that over time the correlation between the stock price and the change in the dividend would be high. If Scenario 1 were to play out as we've modeled, the dividend yield at the end of year 20 would be 17.76%. Over short periods of time the dividend can grow while the stock declines or fails to appreciate. However, over the long-term such a pattern is unlikely to be sustained.

Of course, we don't actually know what The Coca-Cola Company's stock—or the stock market as a whole—will do over the next 20 years. If all goes well, The Coca-Cola Company will experience continued dividend growth and the stock will fluctuate, sometimes greatly. However, we think that over the long run, stock growth is likely to generally move in line with the growth rate of the dividend. Investors seeking to maximize their income over time will, or should have, a distinctly counter-intuitive view on where the stock price should go in the interim. Simply put, investors reinvesting their dividends or otherwise adding to their positions have an opportunity to do well in a weak or sideways market provided they:

1. Are prepared to invest over the long term so that the ebb and flow of the day-to-day fluctuations in their principal due to short term market movements can potentially work in their favor;
2. Recognize that a declining principal value has the potential to work in their favor;
3. Are able to identify and invest in high quality companies that can generate sustainable cash flow through a variety of market environments; and,
4. Are able to identify and invest in companies that maintain a disciplined approach to its dividend policy and that can continue to pay a dividend, even if its share price is falling.

These last two points are important and effectively mean that investors must have an investment methodology that is focused on company fundamentals and not only on the current dividend or dividend history. The dividend is the outcome, and it is predicated on a company's ability to consistently generate wealth.

While finding companies with such characteristics may seem daunting, we have identified a universe of approximately 400 stocks that have achieved 10% cash flow returns on investment (CFROI) every year for the last ten years, which of course includes the depths of the financial crisis of 2008, often referred to as "the ultimate stress test."

Investors' biggest worry today is that the stock market will decline or continue its volatile sideways pattern for a number of years. This is, in fact, the primary driver in the explosion of interest in retail alternative investment products. If in fact either fear is realized, a systematic dividend strategy represents a truly viable––and simple––alternative strategy.

Our advice to investors looking to build a sustainable stream of income for their retirement: Don't let a bad market ruin your life . . . embrace it.

Investors must have an investment methodology that is focused on company fundamentals and not simply focused on the current dividend or dividend history. The dividend is the outcome, and it is predicated on a company's ability to consistently generate wealth.

The Guinness Atkinson Inflation Managed Dividend Fund

The Guinness Atkinson Inflation Managed Dividend Fund invests in high quality companies on a global basis with the objective of providing a moderate level of current income and consistent dividend growth at a rate that exceeds inflation. Importantly this means that the companies in which the Fund invests need to be fundamentally sound and have, in the opinion of the managers, a strong likelihood of consistent dividend growth. To be selected for inclusion in the Fund a company has to meet a number of criteria, including a history of consistently superior results. Specifically, for at least 80% of the Fund's holdings, for consideration for inclusion, a company must have produced in each of the previous 10 years a cash flow return on investment of at least 10%. This 10 over 10 hurdle rate, which is calculated on a real basis, is actually a rare achievement. Of the 14,000 or so global stocks that we screen, typically, only approximately 400 or so companies will pass this test.

The Fund has a net expense ratio of 0.68% and a gross expense ratio of 0.92%. The fund is available as a no-transaction fee fund on most major platforms. The Advisor has agreed to keep the expense cap of 0.68% in place as least through March 31, 2015.

For more information visit www.gafunds.com/thinkincome or call 1.800.915.6565.

ABOUT THE CHIEF EXECUTIVE OFFICER

JIM ATKINSON
CEO & Chief Compliance Officer

Co-Founded Guinness Atkinson Asset Management in 2002.

From 1993 to 2000, Jim was the managing director of Guinness Flight Global Asset Management, Ltd. (which merged with Investec in 1998). Prior to 1993, he was a Sr. V.P. of Huntington Advisers, a mutual fund manager specializing in foreign currency money funds.

In addition, Jim has served as the president of Max Funds and as the Principal at a mutual fund marketing research and consultancy firm.

Jim graduated from the University of California, Los Angeles with a degree in History and emphasis in History of Science & Technology.

Mutual fund investing involves risk and loss of principal is possible. 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 Fund also invests in smaller companies, which will involve additional risks such as limited liquidity and greater volatility. The Fund may invest in derivatives which involves risks different from, and in certain cases, greater than the risks presented by traditional investments.

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.

Opinions expressed are those of Guinness Atkinson Funds, are subject to change, are not guaranteed and should not be considered investment advice.

Past performance is no guarantee of future results.

The S&P 500 is a market capitalization weighted index based on the 500 largest publicly traded American companies as determined by Standard & Poor's. You cannot invest directly in an index.

Cash Flow Return on Investment (CFROI*) is a valuation model that assumes the stock market sets prices on cash flow, not on corporate earnings. It is determined by dividing a company's gross cash flow by its gross investment.

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

As of 12/31/12, Guinness Atkinson Inflation Managed Dividend Fund had 2.47% of its total assets in The Coca-Cola Company.

*CFROI is a proprietary metric prepared by HOLT, a division of Credit Suisse. CFROI is a registered trademark of Credit Suisse AG or its affiliates in the United States and other countries. For more information on HOLT, a corporate performance and valuation advisory service of Credit Suisse, please visit their website at https://www.credit-suisse.com/investment_banking/holt/en/index.jsp

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