

Guinness Atkinson Inflation Managed Dividend (GAINX)

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By David Snowball, Publisher



Fund name Guinness Atkinson Inflation Managed Dividend (GAINX).

Objective and Strategy Guinness Atkinson Inflation Managed Dividend seeks consistent dividend growth at a rate greater than the rate of inflation by investing in a global portfolio of about **30 dividend paying stocks**. Stocks in the portfolio have survived four screens, one for business quality and three for valuation. They are:

1. They first identify dividend-paying companies that have provided an inflation-adjusted cash flow return on investment of at least 10% in each of the last 10 years. (That process reduces the potential field from 14,000 companies to about 400.) That's the "10 over 10" strategy that they refer to often.
2. They screen for companies with at least a moderate dividend yield, a history of rising dividends, low levels of debt and a low payout ratio.
3. They do rigorous fundamental analysis of each firm, including reflections on macro issues and the state of the company's business.
4. They invest in the **35 most attractively valued stocks** that survived those screens and weight each equally in the portfolio.

Active share is a measure of a portfolio's independence, the degree to which it differs from its benchmark. In general, for a fund with a large cap bias, a value above 70 is desirable. The most recent calculation (February 2014) places this fund's active share at 92.

Adviser Guinness Atkinson Asset Management. The firm started in 1993 as the US arm of Guinness Flight Global Asset Management and their first American funds were *Guinness Flight China and Hong Kong* (1994) and *Asia Focus* (1996). Guinness Flight was acquired by Investec, then Tim Guinness and Jim Atkinson acquired Investec's US funds business to form Guinness Atkinson. Their London-based sister company is Guinness Asset Management which runs European funds that parallel the U.S. ones. The U.S. operation has about \$375 million in assets under management and advises the eight GA funds.

Manager Ian Mortimer, Ph.D., C.F.A., and Matthew Page, C.F.A. Dr. Mortimer joined GA in 2006 and also co-manages the Global Innovators (IWIRX) fund. Prior to joining GA, he completed a doctorate in experimental physics at the University of Oxford. Mr. Page joined GA in 2005 after working for Goldman Sachs. He earned an M.A. from Oxford in 2004. The guys also co-manage European versions of their funds including the Dublin-based version of this one, called *Guinness Global Equity Income*.

Strategy capacity and closure About \$1 billion. The smallest stock the fund will invest in is about \$1 billion. With a compact, equal-weighted portfolio, having much more than \$1 billion in the strategy would impede their ability to invest in their smallest targeted names.

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Management’s stake in the fund It’s a little complicated. The managers, both residents of England, do not own shares of the American version of the fund but both do own shares of the European version. That provides the same portfolio, but a different legal structure and far better tax treatment. Matt avers “it’s most of my pension pot.” Corporately Guinness Atkinson has about \$180,000 invested in the fund and, separately, President Jim Atkinson appears to be the fund’s largest shareholder.

Opening date March 30, 2012. The European version of the fund is about a year older.

Minimum investment \$10,000, reduced to \$5,000 for IRAs. There are lower minimums at some brokerages. Schwab, for example, has the fund NTF for \$2500 for regular accounts and \$1000 for IRAs. Fidelity requires \$2500 for either sort of account.

Expense ratio 0.68% on assets of \$3 million (as of February 2014). That’s competitive with the ETFs in the same space and lower than the ETNs.

Comments There are, in general, two flavors of value investing: buy cigar butts on the cheap (wretched companies whose stocks more than discount their misery) or buy great companies at good prices. GAINX is firmly in the latter camp. Many investors share their enthusiasm for the sorts of great firms that Morningstar designates as having “wide moats.”

The question is: how can we best determine what qualifies as a “great company”? Most investors, Morningstar included, rely on a series of qualitative judgments about the quality of management, entry barriers, irreproducible niches and so on. Messrs. Mortimer and Page start with a simpler, more objective premise: great companies consistently produce great results. They believe the best measurement of “great results” is high and consistent cash flow return on investment (CFROI). In its simplest terms, CFROI asks “when a firm invests, say, a million dollars, how much additional cash flow does that investment create?” Crafty managers like cash flow calculations because they’re harder for firms to manipulate than are the many flavors of earnings. One proof of its validity is the fact that a firm’s own management will generally use CFROI—often called the internal rate of return—to determine whether a project, expansion or acquisition is worth undertaking. If you invest a million and get \$10,000 in cash flows the first year, your CFROI is 1%. At that rate, it would take the firm a century to recoup its investment.

The GAINX managers set a high and objective initial bar: firms must be paying a dividend and must have a CFROI greater than 10% in each of the past 10 years. Only about 3% of all publicly-traded companies clear that hurdle. Cyclical firms whose fortunes soar and dive disappear from the pool, as well as many utilities and telecomm firms whose “excess” returns get regulated away. More importantly, they screen out firms whose managements do not consistently and substantially add demonstrable value. That 3% are, by their standards, great companies.

One important signal that they’ve found a valid measure of a firm’s quality is the stability of the list. About 95% of the stocks that qualify this year will qualify next year as well, and about 80% will continue to qualify four years hence. This helps contribute to the fund’s very low turnover rate, 13%.

Because such firms tend to see their stocks bid up, the guys then apply a series of valuation and financial stability screens as well as fundamental analyses of the firm’s industry and challenges. In the end they select the 30-35 most attractively valued names in their pool. That value-consciousness led them to add defense contractors when they hit 10 year valuation lows in the midst of rumors of defense cutbacks and a tax preparation firm when the specter of tax simplification loomed. Overall, the portfolio sells at about a 9% discount to the MSCI World index despite holding higher-quality firms.

Their selection criteria strike us as distinctive, objective, rigorous and reasonable, giving them structural advantages over both passive products and the great majority of their active-managed peers. While no investment thrives in every market, this one has the hallmarks of an exceptional, long-term holding.

The fund underperformed in the first two months of 2014 for a surprising reason: volatility in the emerging markets. While the fund owns very few firms domiciled in the emerging markets, about 25% of the total revenues of all of their portfolios firms are generated in the emerging markets. That's a powerful source of long-term growth but also a palpable drag during short-term panics; in particular, the top holding took a huge hit in January because of the performance of their emerging markets investments.

Bottom Line The fund strives for two things: investments in great firms and a moderate, growing income stream that might help investors in a yield-starved world. Their selection criteria strike us as distinctive, objective, rigorous and reasonable, giving them structural advantages over both passive products and the great majority of their active-managed peers. While no investment thrives in every market, this one has the hallmarks of an exceptional, long-term holding. Investors worried about the fund's tiny U.S. asset base should take comfort from the fact that the strategy is actually around \$80 million when you account for the fund's Dublin-domiciled version.

Fund website Guinness Atkinson Inflation-Managed Dividend, <http://www.gafunds.com/our-funds/inflation-managed-dividend-fund/> Folks interested in the underlying strategy might want to read their white paper, **10 over 10 Investment Strategy**, <http://www.gafunds.com/10over10strategy>. The managers offered a **really nice portfolio update**, <http://www.gafunds.com/imdbrief2.14> in February 2014.

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The information provided herein represents the opinion of the author and is not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

Fund holdings and sector allocations are subject to change at any time, and should not be considered a recommendation to buy or sell any security.

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 and mid-cap companies, which will involve additional risks such as limited liquidity and greater volatility. Rising interest rates may negatively affect equity prices, inflation may affect markets differently than the Advisor expects, and the fund may be unable to provide reasonable protection against inflation.

The fund's gross expense ratio is 5.47%. The Advisor has contractually agreed to reduce its fees and/or pay Fund expenses (excluding Acquired Fund Fees and Expenses, interest, taxes, dividends on short positions and extraordinary expenses) in order to limit the Fund's Total Annual Operating Expenses to 0.68% through March 31, 2015.

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.

CFROI is a proprietary metric prepared by HOLT, a division of Credit Suisse. CRROI 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/ The term "income stream" used here is used synonymously with the word "dividends." The use of the word peers is meant to define all actively managed equity funds.