GUINNESS ATKINSON FUNDS

Asia brief


Edmund Harriss


Mark Hammonds

April 2015

Commentary and Review by Portfolio Manager Edmund Harriss & Analyst Mark Hammonds

Subscribe to other Guinness Atkinson E-mail services

View Archive Briefs

The case for Asian emerging markets

One of the questions we are often asked by investors is, why should I invest in emerging markets? While we invest in both developed and emerging markets, it is often the latter that interest people more because of higher growth expectations, albeit with greater perceived risk. We believe that emerging markets in Asia currently offer more attractive opportunities for investment, and accordingly, the portfolio is weighted 64% to emerging countries versus 36% to developed markets.

The natural follow-up question from an investor is, why Asian emerging markets? Our contention is that Asian emerging markets offer a more diversified investment opportunity than emerging markets elsewhere. In this month's brief we explore some of the reasons why we hold this view.

Boom and bust

The B(razil)R(ussia)I(ndia)C(hina) economies have been a popular investment concept in recent years, but the economies of two of the BRICs, Brazil and Russia, have been reliant on commodities especially oil & gas and iron ore. This dependency was to their advantage as prices rose especially during the China investment boom, but as the boom has stalled, falling commodity prices has left their economies cruelly exposed. Their currencies have weakened and both are struggling with recession and high inflation. Both notably failed to broaden and deepen their wider industrial bases in the good times.

The contrast with Asia is significant.

There are countries in Asia Pacific that are also significant commodity producers: oil, gas, iron ore, copper, nickel, tin, rubber and crude palm oil are all produced in the region. Thailand and Malaysia for example do have greater reliance on oil and gas. One of the companies in our portfolio, PTT, is engaged in the production and processing of natural gas in Thailand whose major customers are electricity generators which generate 75% of the country's electricity from natural gas. However, rather than relying on revenues from commodities, whose prices they cannot control, Asia's key strength is its development as a global manufacturing hub that has become increasingly integrated over time.

The success of this process may be seen in the resilience of the region to the global financial crisis. We also see that the benefits of falling commodity prices have greatly outweighed the negative effects. Fuel costs have fallen to the benefit of end consumers and the governments that subsidised them, corporate margins have risen and inflation pressures dampened. The diversity and complexity of Asian manufacturing is increasingly becoming the region's growth driver, and the wealth creation associated with it underpins the rise of the Asian consumer sector.

"Knitting" for the West"

China's manufacturing industry is a prime example of this trend. China has developed at an extraordinary pace over the past few decades, and in the early stages much of this growth has been driven by basic labour-intensive manufacturing as the country cashed in on the 'demographic dividend'. Textile manufacturing has long been a China speciality, but the abundance of cheap labor has diminished so wages have begun to rise. This has had the benefit of increasing levels of disposable incomes but it has created a challenge for companies in the textile sector whose costs have been pushed higher. The response has been emblematic for China Inc. Lower-end companies have moved out and relocated to Bangladesh, Cambodia, Laos and Vietnam. Those that stayed have moved into more sophisticated textile products and invested in greater automation and production efficiency.

There are two textiles companies in the portfolio, Pacific Textiles and Shenzhou International. They manufacture sophisticated mixed types of fabrics and customized textiles offering dyeing, printing and finishing services. The fabrics are used in a wide range of garments, including men's and women's clothing, sportswear, swimwear and underwear for clients including Uniqlo, Nike, GAP, Marks & Spencer and Victoria's Secret.

The ability to produce higher quality materials efficiently and in volume for demanding clients has enabled Pacific Textile and Shenzhou to maintain margins well above the sector average that should provide sufficient cash flows to sustain investment and dividend growth.

A boost to consumerism

Growth in manufacturing in Asia has led to consumption – typically regarded as a more stable source of growth – occupying a greater share of the economy. Much of China's recent economic policy has been to manage the transition from investment-led growth to growth driven by consumption. Reflecting its increasing importance, there is a greater weighting in the portfolio to consumer sectors: 60% versus 39% for other sectors.

China Lilang, is exposed to increasing demand in China for consumer fashion. Lilang is a designer and retailer of men's clothing, sold from over 3,000 outlets across China. Lilang has two brands: LILANZ, a higher-end brand targeting more affluent customers, and L2, targeting men aged 20-35 years. Lilang designs its own clothes and has a mixture of Chinese and European design teams. The company's formula has been very popular, and it has maintained high returns on investment since 2006 while being able to expand. Shareholders have also benefited from the company's success as management has been able to pay out over 65% of earnings as dividends.

Taiwanese Technology

Taiwan has also centred its economic development on production, gaining a particular expertise in consumer electronics, both components, and finished goods. While technology is an industry susceptible to rapid change and short product life-cycles, some companies have achieved impressive track records. We also see Taiwan as a place with attractive investment opportunities, and it has a relatively high weighting in the portfolio of 16%.

Catcher Technology manufactures the high-quality casing used on the iPhone 6. While being an extremely significant source of demand in its own right, the iPhone 6 is also influencing the competition. The new Samsung S6 has been launched recently with a high-quality metal finish, replacing the plastic cases used on previous models. Metal cases, such as that used on the iPhone 6 are produced to exacting specifications using CNC (Computer Numerical Control) machines. Not only must producers be able to meet the high standards of end customers like Apple, they must also be able to maintain standards while producing in high volumes.

Taiwanese technology manufacturer Asustek Computer has developed from pure manufacturer to become a consumer brand (ASUS) in its own right. The company started in 1989 as a computer component manufacturer specializing in motherboards noted for their stability and reliability. Asustek has since gone on to become the world's number five maker of notebook PCs, and the company also manufactures tablets, PC components and peripherals under the ASUS brand. Asustek is producing attractively-designed products that can compete effectively with Western manufacturers. As a result, ASUS is becoming more widely recognised as a consumer brand outside of Asia, echoing a trend we see across the region.

Overlooked opportunities

The Asian region has matured substantially over the past 20 years. Economic growth has slowed from the breakneck pace of the 1990s and companies have learned to be more discerning in their investment decisions. The result of more disciplined capital allocation and management has been improved returns on investment and stronger cash flows. A dividend-paying culture has become more widely established, although Japan and South Korea have yet to embrace this fully.

Asia has undeniably developed as a global manufacturing hub, and the region's consumer sector is expanding at a rapid rate. We think that the diversification that these industries provide sets Asia apart from other emerging markets that are more dependent on commodities. We acknowledge that many of the companies in Asia are not yet household names, but this does not preclude them from being good investments. The companies in our universe have achieved persistently high returns on capital, with track records that rival their more well-known counterparts in developed markets. In fact, it is precisely the lack of familiarity that investors have with some of these companies, in addition to fears about emerging markets in general, that may create the attractive investment opportunities we believe the region offers.

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. Non-diversified funds concentrate assets in fewer holdings than diversified funds. Therefore, nondiversified funds are more exposed to individual stock volatility than diversified funds. Investments in smaller companies 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. 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.

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

Click for a list of current holdings for the Guinness Atkinson Asia Focus Fund.

Click for a list of current holdings for the Guinness Atkinson Asia Pacific Dividend Builder Fund.

Click for a list of current holdings for the Guinness Atkinson China Hong Kong Fund.

Click for a list of current holdings for the Guinness Atkinson Renminbi Yuan & Bond Fund.

Diversification does not assure a profit or protect against loss in a declining market.

Opinions expressed are subject to change, are not guaranteed and should not be considered investment advice.

Return on Investment (ROI) is a performance measure used to evaluate the efficiency of an investment or to compare the efficiency of a number of different investments.

This information is authorized when preceded or accompanied by a prospectus for the Guinness Atkinson Funds. The prospectus contains more complete information, including investment objectives, risks, fees and expenses related to ano ongoing investment in the Funds. Please read the prospectus carefully before investing.

Distributed by Quasar Distributors, LLC.