

Guinness Atkinson
Asia Pacific Dividend Builder Fund
Managers Monthly Update – December 2017



Fund & Market

- The Fund performed well again in November, ending 2.45% ahead of the MSCI AC Pacific ex Japan Index which rose 0.79% (All returns are total returns in USD).
- Year to date, Asia remains ahead of the US, Europe, Global Emerging Markets, and Global Developed Markets. (MSCI AC Pacific ex Japan: +33.67%, S&P 500: +20.49%, MSCI Europe: +23.92%, MSCI Emerging Markets: +32.88%, MSCI World: +21.42%.)
- The best performing sectors in November in Asia were Health Care, Consumer Staples and Financials. The worst performing sectors were Industrials, Information Technology and Utilities. On a country basis, Singapore and Hong Kong were strong; Taiwan and Indonesia lagged.
- For the year to date, the best performing sectors are Information Technology (+63.62%), Healthcare (+43.74%) and Real Estate (+34.92%). The worst performing sectors are Telecom Services (+7.28%), Utilities (+17.14%) and Industrials (+19.41%). China, Korea and Singapore have been the better performing countries, while New Zealand, Indonesia and Australia have lagged.
- Technology stocks sold off towards the end of the month as investors in both Asia and the US took profits and moved into other sectors. As highlighted above, technology has been the stand-out best performing sector this year, and we were not surprised to see a degree of price correction. We find many companies with the characteristics we look for—returns on capital persistently above the cost of capital, reasonable valuations and an attractive dividend capable of growing over the long term—in the information technology sector.

Events in November

- China's Ministry of Finance announced significant cuts to import taxes on consumer goods. Reductions will be applied to 187 product categories from the start of December.¹ The tax reductions should benefit both consumers and multinational consumer goods companies, particularly those manufacturing products where quality and product safety are treated with high importance, such as infant milk formula.
- Shortly after President Trump's visit to China, the country announced further measures to liberalize its financial sector. The limits on foreign ownership of companies operating in the banking, securities, asset management and insurance industries will be eased. Though the changes will take place over several years, they are an important step in China's ongoing liberalization of its markets, and they should promote greater competition among domestic companies.
- Also in China, the financial regulators jointly issued a consultation paper on the asset management business, covering Wealth Management Products and Asset Management Plans. The new regulations should be beneficial for the long-term health of the Chinese banking sector, and follow other regulatory announcements earlier in the year.
- The Australian government agreed to hold a Royal Commission of Inquiry into the financial services sector, following political pressure to investigate the sector from opposition parties. The government introduced the inquiry after several scandals that have undermined public confidence

¹ <https://www.bloomberg.com/amp/news/articles/2017-11-24/china-to-slash-import-tariffs-on-consumer-products-from-december>

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in the banks. The reaction from the market was negative, and Australian banks underperformed during the month.

Outlook

- Earnings in 2017 for Asian companies look set to be much improved over those in 2016. Stronger global growth and recovering commodity prices over the past two years have translated into higher profits and improved cashflows.
- Asian stock market valuations have re-rated during 2017, but the strength in Asian markets has primarily been led by earnings growth. The region still trades at an attractive level – both, we believe, on an absolute basis and relative to developed markets.
- The path of interest rate rises in the US remains closely watched. We believe the path of slow and steady increases is most likely at this point, with the FED unwilling to jeopardize a modest economic recovery.

Portfolio

Three stocks significantly outperformed during November: Qualcomm rose 31.14%, St Shine was up 18.45% and KT&G rose 18.44%.

Qualcomm

For Qualcomm's share price, it has been a volatile year. The stock started 2017 with a sharp sell-off following the company's legal dispute with Apple over royalty payments. But earlier last month, the stock staged a dramatic recovery, after rumors that the company was the subject of a takeover bid sent the price up as much as 13 percent in a single day.

The bid—which was confirmed shortly afterwards—from Broadcom, offered \$70 to Qualcomm shareholders – \$60 in cash and \$10 in stock. Including \$25bn of net debt, the bid valued Qualcomm at \$130bn, giving the combined company a market value of over \$200bn. The deal would be the largest ever public tech deal—surpassing the \$67bn acquisition of EMC by Dell in October 2015—and would create the world's third-largest semiconductor company.

Broadcom is a chip designer, specializing in networking and communication. The company's consumer products include WiFi and Bluetooth chips. Broadcom recently announced that it was changing domicile and moving its headquarters from Singapore to the US – the decision was originally interpreted as an effort to help its proposed (separate) \$5.5bn takeover of Brocade to proceed, but should be seen in a new light after the Qualcomm bid. Broadcom is run by Hock Tan and has a history of M&A – the name itself was retained after Avago's acquisition of Broadcom, which completed in 2017.

The new proposed deal comes at a time of flux for Qualcomm, with the company's share price significantly weakened by the Apple dispute.

The heart of Qualcomm's legal disagreement with Apple has been the licensing fees Qualcomm demands for using their intellectual property in smartphone modems. The fees are based on a percentage of the

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overall product price, and smartphones have become more sophisticated—and more expensive—the fees based on overall device price have increased. Apple’s complaint is that Qualcomm is abusing its position and unfairly charging too much. The smartphone manufacturers argue that the modem represents an increasingly less significant portion of the overall product; Qualcomm retorts that the modem is nevertheless an essential component of the device.

January represented a turning point in the dispute. Apple instructed its contract manufacturers, who were responsible for making the royalty payments, to suspend payments to Qualcomm. As the tensions have stacked up, the uncertainty has weighed on the company’s share price. More recently, news reports were circulated that Apple was planning to reduce its reliance on the Qualcomm’s products, potentially developing its own in-house alternatives.

Despite the negative headlines, we believe there is the potential for the dispute with Apple to be resolved. While we were surprised by the ferocity at which Apple has escalated the matter, Apple is known for playing hard-ball with their suppliers. Also, there is precedent for these kinds of conflicts to be resolved. In 2015, following the resolution of a dispute with the Chinese regulator (Qualcomm settled by agreeing to pay a \$975m fine), many of the local smartphone manufacturers withheld royalty payments, until new commercial agreements had been reached. Eventually the disputes were solved, and new terms were signed with the manufacturers. Catch-up payments allowed Qualcomm to recoup some of the payments that had been previously withheld. We think Qualcomm is well-placed to renegotiate a licensing agreement that is acceptable to Apple.

There is even the suggestion that it is in Apple’s interests to negotiate with Qualcomm. The dispute has left the company vulnerable to takeover, and the proposed acquisition would create a supplier with significant market heft and pricing power. As the New York Times points out: “Broadcom’s chief executive, Hock Tan, is said to be open to renegotiating the Qualcomm contract should his company prevail,” but Apple is unlikely to want a supplier with such leverage. (Broadcom is already a significant supplier for Apple.) This threat could be enough to make Apple swiftly return to the negotiating table.

Prior to the bid, we thought that Qualcomm’s shares represented good value. Analyst earnings estimates appeared to reflect Apple withholding royalty payments, with little or no contribution expected from their major customer. Essentially, the bad news had already been ‘baked into’ the share price.

As expected, Qualcomm’s board rejected the bid, saying that it “dramatically undervalues” the company. The bid has since gone hostile, with Broadcom proposing to replace all 11 of Qualcomm’s directors as part of a proxy battle.

A deal between Broadcom and Qualcomm might also encounter regulatory stumbling blocks – a fact that Qualcomm made clear in their rejection. Broadcom does earn revenue from similar areas to Qualcomm and NXP, such as wired infrastructure, and there is potentially a high degree of overlap in some more narrow areas.

Setting aside the recent bid, the company still has an exciting future ahead of it. Qualcomm’s current products are technically superior to rivals. In the new iPhone 8 and 8 Plus, Apple has used both Qualcomm and Intel chips, but it has had to restrict the Qualcomm chip to ensure that there is not a performance

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difference between two versions in what should be a homogenous product. The Qualcomm chips are compatible with gigabit LTE technologies, but the restrictions mean that iPhones are slower than some Android handsets.

The industry is also about to undergo is the roll-out of 5G. Qualcomm has been working on this technology for many years, and holds numerous patents related to 5G technology. The introduction of the technology will involve upgrading equipment in existing mobile telephone infrastructure (phone masts etc.), but also another round of handset upgrades (yes, you will have to buy another new phone). This upgrade cycle may also be dramatic than the previous 4G roll-out – China, for example, implemented 4G slower than Western countries, but that won't necessarily be the case this time around.

Qualcomm is already trying to close a deal of its own. In October 2016, it agreed to buy NXP Semiconductors, based in Amsterdam, for \$38bn. NXP developed near field communication (NFC) technology with Sony, which is now used in mobile payments. The company is also a market leader in automotive chips, including automotive networking, and technology used in 'Internet of Things' devices. These areas are both exciting in their own right – cars are expected to have ever-increasing 'silicon content', and more-and-more devices are expected to feature internet connectivity – but they are particularly so for Qualcomm as they allow it to extend its networking technology outside of smartphone handsets. The deal has been held up by antitrust investigations in Europe, but is expected to go through by early next year.

Qualcomm has many of the characteristics we look for in a company. Its returns on investment, measured in cashflow terms, have significantly exceeded the cost of capital, and those high returns have persisted over many years. The company's attractive business model (so attractive that it has triggered the ire of one of its key customers) has led to persistent cash generation – earning high profit margins, with low capital investment.

Despite its relatively modest physical capital base, Qualcomm has demonstrated an ability to invest in R&D, as the company's patents and their position at the heart of connectivity standards shows. Qualcomm has proven that it can innovate in order to maintain its competitive position as technology evolves.

But it is not enough to be a good company, we have to believe that the investment case stacks up too. Qualcomm offers an attractive valuation – multiples look reasonable, and there are plenty of factors that could offer upside to current earnings estimates. Despite growth slowing recently, we believe there are many reasons—both cyclical and structural—to be optimistic about it returning.

We think the bid from Broadcom does undervalue the company, and in that sense, is opportunistic. However, there are multiple ways that the situation could play out. Now that the bid has gone hostile, we are likely to see significant developments in the near future.

Other stocks

KT&G had a strong month as the company unveiled its new 'Lil' product to the market. The Lil is KT&G's heat-not-burn product, which as the name suggests, heats tobacco to a lower temperature than a normal cigarette. The product and refills will be sold at a competitive price to rivals' offerings. K&G are initially launching the product for sale at stores in Seoul and online.

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St Shine Optical is a stock we have written about as optimism around the company has ebbed and flowed over the past three years. The company is enjoying another upswing and the share price has now pushed through the high in 2014. Recent results came in 9% ahead of consensus estimates reflecting the reacceleration in sales growth, which the company reports monthly. Expansion into the US market is the recent positive development driving St Shine's share price. A new on-line client was added in 2016 and now accounts for 85% of US sales. The belief is that sales in this channel could be more stable than those from Bausch & Lomb in China. Even more encouragingly, the gross profit margin for US sales has now increased to match that of Chinese sales. Margin expansion, increased production capacity as well as new sales areas are combining to make for a strong story.

The weakest performers in the month were: Li & Fung, which fell 12.57%, Hon Hai Precision which fell 10.41% and Largan Precision which fell 9.75%. Li & Fung has been a disappointing performer for the year overall, though the company has recently begun to show improving operating results. The sell-off in November gave up some of the gains made in past months, but earnings expectations remain relatively unchanged. Hon Hai and Largan, two information technology companies, both suffered in a month where tech was the second-worst performing sector. However, IT remains the best performing sector year to date, and shares in both companies have returned more than 30% this year.

Edmund Harriss and **Mark Hammonds** (portfolio managers)
Sharukh Malik (analyst)

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. Non-diversified funds concentrate assets in fewer holdings than diversified funds. Therefore, non-diversified funds are more exposed to individual stock volatility than diversified funds. Investments in debt securities typically decrease in value when interest rates rise, which can be greater for longer-term debt securities. Investments in derivatives involve risks different from, and in certain cases, greater than the risks presented by traditional investments. Investments in smaller companies involve additional risks such as limited liquidity and greater volatility. 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. Investments focused on the energy sector may be exposed to greater risk than investments diversified among various sectors.

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MSCI AC Pacific Ex-Japan Index is a market capitalization weighted index that monitors the performance of stocks from the Pacific region, excluding Japan consisting of Australia, China, Hong Kong, Indonesia, Korea, Malaysia, New Zealand, Philippines, Singapore, Taiwan, and Thailand.

One cannot invest directly in an Index.

Price/Earnings Ratio (P/E) is an equity valuation multiple. It is defined as market price per share divided by annual earnings per share.

Economic complexity is a measure of the production characteristics of large economic systems, usually whole countries. The goal is to explain an economic system as a whole rather than the sum of its parts; to explain the knowledge accumulated in a country's population (the networks that people form), and that is expressed in the country's industrial composition. To achieve this goal, the measure combines metrics of the diversity of countries and the ubiquity of products to create measures of the relative complexity of a country's exports.

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 11/30/17

1	St Shine Optical Co Ltd	3.16%
2	Relo Holdings Inc	3.13%
3	QUALCOMM Inc	3.04%
4	Luk Fook Holdings International Ltd	3.01%
5	KT&G Corp	3.00%
6	Hanon Systems	2.97%
7	LPN Development PCL /Foreign - NVDR	2.92%
8	DBS Group Holdings	2.89%
9	BOC Hong Kong Holdings Ltd	2.88%
10	Aflac Inc	2.84%

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

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