Guinness Atkinson

Asia Pacific Dividend Builder Fund

Review of February 2020

Fund and Market

- The Fund has fallen by more than the market in February – but while share prices of portfolio companies have fallen, their forecast earnings for 2020 and 2021 have held up well.
- Consensus earnings estimates for the portfolio are for average annual earnings growth over the 2019-21 period of 5.3%, down from a 6.3% growth rate estimated at the beginning of the year. The reduction is the result of a cut to 2019 estimated growth from 3.4% to 2.1% and in 2020 from 6.6% to 4.6%. Estimated growth for 2021 of 9% remains unchanged.
- Share price weakness in the portfolio was spread across geographies and sectors. Anything involved in consumer manufacturing and distribution of physical goods as well as those exposed to consumer finance saw share prices fall.
- That said, there were stocks that outperformed, including our Hong Kong and Chinese banks and our shipbuilding companies, and half of our technology manufacturing names did better than the MSCI AC Pacific ex Japan index.
- It is hard to generalize about stock performance beyond saying that much market action has been driven by fear. The companies in the portfolio have low debt and ample cash on hand to deal with current business disruption. They have inherent product, customer and management strength to reassure on long-term profitability and dividend streams. This leads us to believe that recent portfolio declines, while painful today, are likely to reverse sooner rather than later.

Events in February

- The rate of new virus cases decelerated in China but accelerated in the rest of the world. In absolute terms, the bulk of the cases are in China and the majority of deaths are among those with pre-existing medical conditions.
- The virus outbreak in Italy showed what might happen, and therefore market focus has been on the possible extent and duration of containment measures in assessing likely economic damage.
- Economic data from China have reflected the economic shutdown after the Chinese New Year holidays.
- Finance ministers from the G20 met in Riyadh. The International Monetary Fund (IMF) downgraded forecast Chinese economic growth to 5.4% implying a 0.1% hit to global GDP. The median consensus forecast for 2020 GDP growth is now 2.9% versus 3.1% in January.
- Malaysia's Prime Minister resigned. The reasons are murky, but it is likely the result of a power struggle that seeks to exclude Anwar Ibrahim from the succeeding to the office.
- India removed foreign investment limits of certain sovereign bonds as it seeks inclusion in global bond indices. This is relevant given India's deteriorating public finances and weakening asset quality in the banking sector.

Market Update

The public news flow on the Coronavirus as governments seeks to show they are "doing something" and news outlets compete for attention has created a climate of fear which finally took hold in financial markets in February. There is great enthusiasm for creating and lingering over worst-case scenarios. However, it is also evident by a look at the data, rather than the myriad opinions of what might be, that the spread is coming under control. In China the rate of new infections continues to slow and is now at a daily rate of 0.1%. Net of recoveries, infections were down 37% week-on-week. China appears to have passed the high-water mark.

In Korea, as of March 4th, the daily growth in infections has slowed from 35% five days ago to 15% over the past three days and was up 11%. Korea has been one of the best at releasing data (twice a day) on testing and infections. Korea's Center for Disease Control and Prevention reported last week that the virus barely mutates and shows the same behavior when transmitting form one person to another. The journal *Scientist* also published an article saying the genetic sequences among patients around the world are similar and that any mutations are likely of little consequence.

Why is this important? It means that the virus is likely to behave similarly worldwide, so studies of the spread, risks and treatments will be similar. It means also that potential vaccines should be widely effective. A key concern has been the potential for mutation and that the virus will be unstoppable. This fear is not supported by evidence.

From an investment standpoint, this aligns with comments from the Governor of the Bank of England, who described this as a significant economic shock but ultimately temporary. Economic shocks such as the financial crisis of 2008 or the oil price shock in the 1970s had long-term structural implications. Unless this leads to a global economic shutdown for an extended period, which would then have financial solvency implications, we expect this to manifest in economic terms with a significant curtailment of economic growth in the first quarter followed by a sharp rebound in activity in the second quarter. JP Morgan now expects China's economy to contract this quarter compared to the final quarter of 2019, followed by a significant rebound.

How does this happen? We expect it to be driven by a combination of manufacturing output accelerating with first quarter output pushed into the second with increased work shifts. We expect to see incentives to boost consumption and efforts to reinvigorate the real estate and construction market. China's growth rate for 2020 may end up closer to 5% (some forecasts say less, though we probably won't see a published figure of less than 5%) but there is no doubt there will be maximum effort made to restart activity.

The path of equity markets will follow shifts in expectations. A "V" shaped recovery profile is predicated on a synchronized pattern of disruption and resumption of growth. The return to work in Asia is happening but perhaps more slowly than was expected in early February. Nevertheless, Hon Hai Precision, which is the largest assembler of iPhones, has stated that its operations will be in full production by the end of March. The new challenge is the impact of the spread in the rest of the world and efforts to contain it. This may lead to a "W" shaped recovery in stock markets as expectations are adjusted.

The sharp falls we have seen in share prices around the world have been some of the steepest 10% drops from a market peak ever. This perhaps has more to do with run-up in markets over recent months in which earnings revisions have played almost no part. This has been a period of valuation expansion on growth expectations, followed by compression.

Portfolio Update

To be sure, there have been earnings downgrades in Asia; the consensus has cut 2020 profit estimates for the market, as measured by MSCI Asia Pacific ex Japan Index, by 2.9% and 2021 estimates by 2.4% in past month. Over the same period, earnings for the portfolio have been revised down 2.2% for 2020 and 1.9% for 2021. Out of the 36 names in the portfolio, ten have had their 2020 earnings forecasts cut by more than the market, nine have changed by less than 1%, and four have seen their forecasts raised. The remaining 11 have seen cuts to forecasts by more than 1% but all still better than the market.

Among the weakest ten stocks in February we can see that six of them (Corporate Travel, Sonic Healthcare, CapitaLand Mall Trust, KT&G, PTT and Public Bank) saw earnings downgrades of 4% or more. Of the remaining four, Janus Henderson and Luk Fook saw earnings upgrades while forecasts for Godrej Consumer Products and Aflac moved down by 0.5% and 0.1% respectively. This group of ten stocks fell between 11% and 24% in February, with only Corporate Travel moving in line with earnings forecasts. Since earnings expectations have not moved to anything like the same extent as stock prices, we are left with valuation compression as the primary driver. This then leads us to consider whether underperformance over the month was attributable to overvaluation. Have we been buying into and paying up for growth or do we think the price moves are knee-jerk reactions and overdone?

In the case of Corporate Travel, whose profit forecasts were cut by 26% and 16% for 2020 and 2021, we must recognize this as the most vulnerable company in the portfolio to a shock of this nature. Our thesis for the investment depends upon the notion that business travel will resume and that the business model remains sound in the long term. We think the share price reflects the impact for the current year but undervalues the business over our rolling three-year horizon.

We look at valuations in the first instance on a long-term cash flow basis. We consider the value of the cash flows that come from existing asset plus the value of those generated by from a long-term and sustainable rate of reinvestment of profits, which in turn is considered in light of the cash available to reinvest and that required to match the dividend pay-out policy. The degree to which the share price is above or below this valuation indicates how much, if anything, we are paying for growth. We think that the portfolio overall is in line with base valuation level; in other words, at the portfolio level we do not think we are paying anything for growth.

At the individual stock level, there is more of a spread. One of our valuation warning flags is triggered when the growth element of the valuation exceeds 40% of the total. The only stock that exceeds this is Godrej Consumer Products, which trades expensively, as does the rest of the Indian Consumer Staples sector. We have accepted this for Godrej, having considered it in the light of the sector valuation history, its own history and the return on capital profile of the business. It is the only one that exceeds this level. The next most expensive on this metric are Largan Precision, Sonic Healthcare, St Shine Optical and Corporate Travel for whom 30%-40% of the valuation is attributable to growth. All these businesses are characterized by a high and stable return on capital historic profile. In the case of Corporate Travel, the share price move is linked, we believe, to the short-term outlook, and the long-term growth expectation is little changed.

In light of the economic disruption we are seeing, we have also reviewed the balance sheet strength of our companies. At the portfolio level, excluding our six banks, total debt to equity is at 38.3% and on a net debt basis the portfolio is 3% net cash. When looking at individual companies on a net debt basis, the most highly indebted is Qualcomm, at 74.8% following its substantial return of cash to shareholders after its planned acquisition of NXP failed to gain regulatory clearance. The debt level has dropped quickly since then. The next two most indebted are Ascendas REIT and CapitaLand Mall Trust at 63% and 43% respectively. After that, the gearing ratios in the portfolio come down quickly. We measure bank leverage by comparing total assets to total equity. We would consider assets that are 20x the size of equity to be the maximum we would want to accept for a bank and for an emerging markets bank with their more highly concentrated loan books we think we should be looking at 12-13x. China Merchants Bank is the most leveraged at 13.2x and Tisco Financial the least at 7.9x.

Eleven companies reported annual results for the year ending December 2019. DBS and Hanon Systems were ahead of consensus expectations while PTT, KT&G and Yangzijiang Shipbuilding were behind. The rest were in line with expectations. In terms of dividend growth, the strongest were Novatek Microelectronics +25%, Ping An Insurance +19% (+7% if we include last year's special dividend), Largan Precision +18%, KT&G +10% and JB Hi Fi +9%. Public Bank, Aflac, Sonic Healthcare and DBS follow a progressive dividend policy, growing 2.5%-5% a year in recent years, and 2019 has been consistent with that. PTT, Janus Henderson and Corporate Travel dividends were unchanged. There were no dividend cuts.

Outlook

The following comments may well be overtaken by events, but at present we are looking for China and Asia to begin a return to work. Hon Hai Precision targets full production by the end of March. Restrictions on movement are being lifted in measured fashion and policy efforts are directed toward macro-economic support. There is clearly some reluctance in China to deploy a massive stimulus package as we saw in 2009, the legacy of which is still with us. We see the greatest focus needs to be on the provision of liquidity and fiscal flexibility to allow companies to manage their working capital.

The recent US interest rate cut of 0.5% has divided opinion. In our view, while attention-grabbing, it does not really address the problems businesses will face if economic disruption is extended. The issue will be one of access to credit rather than the pricing of it, in our opinion. While it seems to us the high-water mark has passed in Asia, the unknowable piece is the extent of the spread in the rest of the world, the measures taken to contain it and the resultant impact on demand. Earnings estimates are likely to come down further, not only in Asia but also in developed markets as the extent of the impact becomes clear. However, we proceed on the basis that this is a significant but ultimately temporary economic shock.

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Performance

as of 2/29/20	1 YR	3 YR	5 YR	10 YR
Asia Pacific Dividend Builder Fund	-6.10%	3.29%	3.91%	5.94%
MSCI AC Pacific ex Japan NR	0.06%	5.90%	3.86%	5.72%

as of 12/31/19	1 YR	3 YR	5 YR	10 YR
Asia Pacific Dividend Builder Fund	20.33%	11.19%	7.37%	7.18%
MSCI AC Pacific ex Japan NR	20.30%	12.07%	6.45%	6.01%

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

Expense Ratio: 1.12% (net); 3.27% (gross)*

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 current to the most recent month end may be obtained by calling 800-915-6566 and/or visiting www.gafunds.com. 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. Total returns reflect a fee waiver in effect and in the absence of this waiver, total returns would be lower.

**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 1.10% through June 30, 2020. To the extent that the Advisor absorbs expenses to satisfy this cap, it may recoup a portion or all of such amounts absorbed at any time within three fiscal years after the fiscal year in which such amounts were absorbed, subject to the expense cap in place at the time recoupment is sought, which cannot exceed the expense cap at the time of the waiver. The expense limitation agreement may be terminated by the Board of the Fund at any time without penalty upon 60 days' notice.*

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 Asia Pacific stock markets may experience periods of volatility and instability. Some domestic China "A" Shares are available through the Hong Kong Stock Connect or Shenzhen Stock Connect, which may be subject to risks of trading suspensions,

quota limitations and additional risk. The Fund may invest in small-cap or mid-cap companies, which involves additional risks such as limited liquidity and greater volatility, than in larger companies.

MSCI AC Pacific Ex-Japan Net Total Return 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.

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 2/29/2020:

1.	BOC Hong Kong Holdings Ltd	3.20%
2.	Tisco Financial Group PCL/Foreign	3.14%
3.	St Shine Optical Co Ltd	3.12%
4.	Largan Precision Co Ltd	3.04%
5.	Public Bank Bhd	3.00%
6.	Taiwan Semiconductor Manufacturing Co Ltd	2.99%
7.	China Merchants Bank Co Ltd - H Shares	2.99%
8.	Hon Hai Precision Industry Co Ltd	2.99%
9.	Ping An Insurance Group Co of China Ltd - H Shares	2.98%
10.	DBS Group Holdings	2.97%

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

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