GUINNESS ATKINSON™ FUNDS

INVESTING IN HUMAN PROGRESS

A REVOLUTIONARY IDEA: RENMINBI IN EVERY WALLET

by Edmund Harriss
Portfolio Manager

INVESTMENT RESEARCH SERIES

A Revolutionary Idea

The 20th Century was a revolutionary one for China, and for most, the obvious was the Chariman Mao led Communist revolution. In truth, the economic reforms adopted by Deng Xio Peng in the late 1970s were, in many ways, more revolutionary and paved the way for China to become the world's largest economy. Just as it was unimaginable in 1979 to envision that China would become the world's number two economy with a clear trajectory to number one, it is for many unimaginable to think that the renminbi may rival, or one day possibly surpass, the US dollar as the world's reserve currency. While it may seem revolutionary at the moment, we believe that over time it will become common practice to hold assets—including cash—denominated in the renminbi.

IMPORTANCE OF THE RENMINBI

China ranks second in the world by output and ranks first for trade in goods and in foreign exchange reserves. The country's economic output in 2012 is estimated to have been $8.23 trillion, accounting for 11.5% of the world's total; its trade in merchandise goods during 2012 reached $3.87 trillion, accounting for 10.3% of the world's total and placing it ahead of the United States. China's financial importance internationally can also be measured by its foreign exchange reserves. At the end of September 2012, foreign exchange reserves held by the world's central banks totalled $10.78 trillion of which 30% ($3.29 trillion) were held by China. Not surprisingly, 60% of China's foreign reserves are comprised of US government securities.[1] However, in contrast to its size, the renminbi accounts for less than 1% of foreign exchange transactions. Policymakers, bankers, companies and investors should all care about the renminbi. It is not tenable, practical or even likely that a country with China's economic clout would persist with an arrangement that effectively outsources financial transactions through a currency that is not their own.

China has set its sights on internationalizing its currency with the development of an offshore market, which should ultimately lead to access to China's domestic financial markets and currency convertibility:

"For the central bank, the next movement related to the yuan [renminbi] is going to be the reform of convertibility…We are going to realize it, we are moving in this direction."
- PBOC governor Zhou Xiaochuan, November 2012.

[1] WSJ February 27, 2013, Ben Steil, director of international economics at the Council on Foreign Relations

China has taken the first big step toward currency convertibility using its $3.8 trillion of trade-related flows. Since 2010 Chinese companies engaged in the purchase or sale of goods overseas have been permitted to settle their bills in renminbi. The immediate result was a surge in the renminbi deposit pool in Hong Kong which grew 6.7 times between June 2010 and December 2012 to RMB603 billion ($96 billion).

Renminbi, raised offshore is being brought back into China either in the course of trade, or to fund business expansion or for the purposes of financial investment into bonds and equities in China. During 2012 the growth of the offshore renminbi deposit pool slowed but the level of cross-border money flows rose sharply. In the course of the year RMB260 billion ($41 billion), equivalent to 45% of renminbi deposits in Hong Kong moved out either overseas or back into China for corporate or portfolio investment.

China Currency Decoded

Renminbi (RMB) is the official currency of China.
Yuan is the unit of currency.
CNY is the international currency code for the renminbi.
CNH is the currency code for renminbi traded outside China in the offshore market.

The development of the offshore renminbi market and currency convertibility is important to China for a variety of reasons, not the least of which is to protect against holding too many US dollars. As Zho Xiaochuan, Governor at the People's Bank of China put it in late 2010, "(US monetary policy) may be optimal for the US alone…it is not necessarily optimal for the world. There is a conflict between the US dollar's domestic role and its international settlement role."[2] It is quite understandable that China may not want to continue to grow their stockpile of US dollar denominated assets, particularly given that the US is in the enviable position of being able to print dollars to meet its needs.

China still sees a world where the dollar remains the pre-eminent world currency. The head of the Chinese central bank's Research Institute wrote in 2013:

"For the foreseeable future, we can speak of the global currency system as a framework of '1+4'. The dollar will continue to be the super reserve currency, supplemented by four smaller reserve currencies: the euro and the British pound in Europe, and the Japanese yen and the Chinese renminbi in Asia".

[2] WSJ February 27, 2013

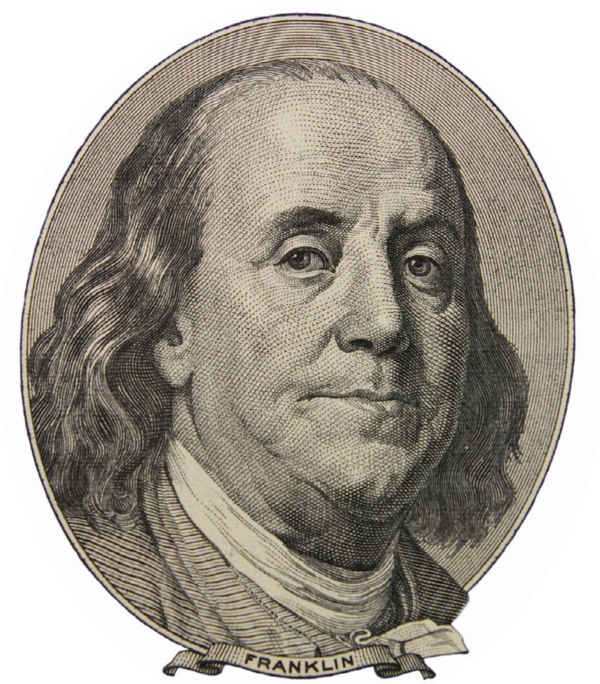
THE TALE OF TWO CURRENCIES

US dollar based investors should consider the relative merits of the renminbi and the US dollar. A country's currency is often likened to "stock" of a country. While an imperfect analogy, countries, like companies, have growth rates, debt levels, deficits and the like. If we were to compare China to the US on this basis we might look at the following:

	China	US
Personal Savings Rate	54.3%	3.9%
Budget Surplus/(Deficit)	(1.6%)	(6.7%)
GDP Growth Rate	7.8%	2.2%
Trade Surplus/(Deficit)	$231.6 bn	($539.5 bn)
Foreign Reserves	$3.311 bn	

Source: IMF World Economic Outlook 2013; US Department of Commerce, Bureau of Analysis; China National Bureau of Statistics

Naturally, this simple comparison doesn't tell the whole story. With the US enjoying status as the world's largest economy and with its currency being the world reserve currency, the US dollar has built in support that provides the US with flexibility that no other country enjoys. In particular, despite the recent record levels of bond purchases by the US Treasury, the dollar has been generally appreciating against many major world currencies (although it has depreciated in recent years against the renmimbi). These country fundamentals matter in the long run; should the US continue to create unprecedented amounts of fiat dollars, run large and growing trade and budget deficits and in general live well beyond its means, the position as sole world reserve country will be challenged.



The Offshore Renminbi Investment Market

Direct access to renminbi cash and bank accounts for non-Chinese residents is available to corporations and investment funds. While the onshore renminbi (CNY) and the offshore renminbi (CNH) are the same currency, the rates of exchange against the dollar are different.

- The CNY trades within a permitted range of 1% above and below a central parity rate that is published each day. When we see news that China has allowed its currency to strengthen or weaken it reflects a change to the central parity rate. The CNY is underpinned by China's monetary base.
- The CNH can trade wherever the market takes it according to prevailing supply and demand conditions. The CNH is underpinned by amount of renminbi held offshore.

Buyers and sellers of renminbi outside China who user renminbi for trade settlement purposes may trade at either the CNY rate of exchange or at the CNH rate. Those trading renminbi for any other purpose including investment must use the CNH exchange rate. Changes in domestic Chinese fund flows and sentiment can move the CNY rate above or below the central parity; changes in foreign flows and sentiment can move the CNH rate above and below the CNY rate. In practice, the ability of Chinese importers and exporters to use either exchange rate keeps the two very close.

For renminbi investors the investment options are primarily cash deposits and fixed income instruments such as certificates of deposits, notes and bonds.

Certificates of deposit (CD)

Banks issue certificates of deposit to secure the funding required for carrying on commercial lending. In 2012 they raised RMB153.66 billion ($24 billion) of which 90% were for maturities of less than one year. This replaced and exceeded RMB102 billion ($16 billion) that matured in the same year. The most active issuers have been Chinese banks although foreign banks in Hong Kong also participate.

This level of issuance indicates the substantial growth in renminbi lending, especially when we consider that in 2010 issuance was only RMB5.69 billion ($0.85 billion). As banks' renmninbi businesses have grown so too has competition for funding pushing up the interest rate offered as high as 3.3% for one year although this has recently pulled back below 3%.

Bonds and Medium Term Notes

The offshore bond market has renminbi denominated bonds outstanding worth almost $42 billion compared to $23 billion at the end of 2011 and $5.8 billion in 2010. The market is characterized by short maturity, with 77% of issues with less than three years' maturity. Chinese issuers dominate accounting for 73% of the market, but 2012 saw overseas issuers increasing share to 27% and the market now has issuers from over 20 countries across fifteen sectors, plus the Chinese government. 60% of the market carries a credit rating, and 56% of issues are investment grade.

The average yield for the bond market, as measured by HSBC Offshore (CNH) Renminbi Bond Index was 3.83% at the end of 2012, and the market's duration was 2.58 years.

FROM RARE TO MAINSTREAM

In a little over two years the offshore renminbi market activities have expanded from Hong Kong to Singapore, Taiwan, London and New York. The range of activities has expanded from simple trade settlement to:

- Foreign exchange trading in spot & forward
- Currency swaps
- Trade settlement
- Commercial lending
- Bond issuance
- Portfolio investment

Approximately $5-6bn of renminbi foreign exchange transactions in the spot and forward market take place every day in Hong Kong, Singapore, London and New York. The bulk of these transactions are related to China's trade of which around 10% of the total ($380 billion out of $3.8 trillion) has been settled in renminbi. The increasing activity is due to practical operational reasons. It is easier for companies to move trade monies in and out of China in renminbi; the agreement of trade invoices at spot renminbi values reduces the need for hedging. And mainland Chinese companies are increasingly offering discounts to trade partners willing to settle in local currency.

Commercial banking activities are growing not only in Hong Kong but also elsewhere in Asia and in London. European companies have markedly increased their renminbi activity and according to SWIFT, the largest share of offshore payments outside China and Hong Kong is handled by Britain at 28% of the total. (SWIFT is a financial messaging system with the actual payments made via Fedwire or CHIPS.) Consistent with that, renminbi foreign exchange trading in London grew 150% in the year to June 2012 to average daily volume worth $1.7 billion.

Further growth of renminbi activity in the world's latest foreign exchange market will be lifted by the Bank of England's statement that it is ready "in principle" to establish a currency swap line with China's central bank. A central bank swap line is an agreement by a central bank to provide the other side with liquidity, in this case in renminbi to London and in British pounds to China. This would make Britain the first developed nation to establish a swap line with China and would be placed alongside existing agreements for the dollar, euro and yen.

Renminbi denominated bank lending for the most part is related to trade finance and for maturities up to a year. In a new development cross-border commercial lending is being trialed. Mainland Chinese companies with business interests in Qianhai, near Shenzhen just over the border from Hong Kong, are permitted to borrow renminbi from Hong Kong-based institutions and bring the money back into China. The move is significant, not only for the ability Chinese companies to source bank loans outside China but also because the interest rate is entirely market determined.

Renminbi foreign exchange trading in London grew 150% in one year to June 2012 to an average daily volume worth $1.7 billion.

Just as China made a rapid economic shift from communism to capitalism, it is making a rapid shift from having a closed and managed currency to a freely traded global currency. While there is much progress to be made, it is clear China has made significant progress in just three years. It is still in its early days, and investors moving into the renminbi now are clearly early adopters.

WHY HOLD RENMINBI?

The financial policies in the aftermath of the global financial crisis present investors with a challenge. The financial stimulus program in the US has substantially increased the money supply and driven the yields on America's sovereign debt to record lows. The yields on corporate debt have followed suit and this has dramatically altered the risk/reward profile of these investments. One of the major risks is that the bond purchase program by the Fed has pushed yields well below their 'natural' level and that merely a slowing of the policy, never mind stopping or reversing it, could result in significant shift higher. Any move would be significant given how low yields are today.

Inflation Risk

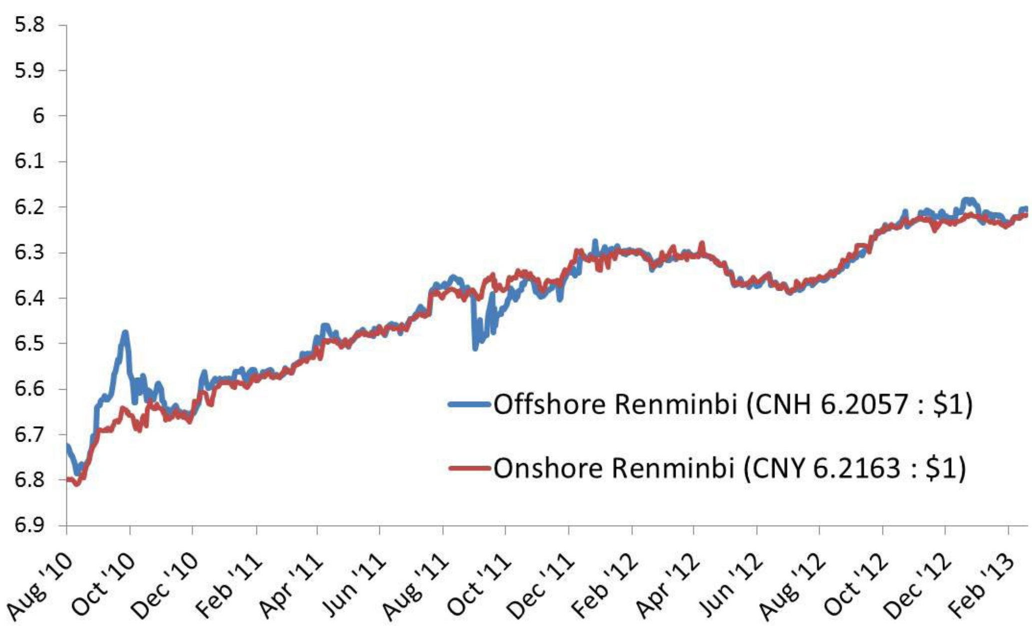
The other risk that is now being discussed more is the prospect of rising inflation and its corollary, a weaker dollar. At present capacity, the US economy is not tight, but when employment does recover, the inflation risks posed by an excess of money in the system could call for prompt action, and we think financial markets are not likely prepared for this. It is in anticipation of this that we read of a "Great Rotation" out of bonds into stocks, although stocks as financial assets have also benefitted from these easy monetary conditions.

Growth Transformation

China's economy and currency offers a different prospect, in our opinion. Economic growth is likely to be slower over the next ten years than over the past ten but this is expected to be in the range 7%-8% rather than the 9%-11%. Such a slowdown has to be expected; as China's infrastructure and industrial base has expanded so the incremental gains must subside. China's future now lies in service industries, higher value-added production and more consumption. The success of this depends on an ability to overcome administrative, institutional and societal obstacles. But success will bring not only slower growth but higher prosperity.

The size of China's domestic economy and the resources at its disposal means that China is more than just a manufacturer of goods for export. The currency and asset denominated in it offer investors some diversification.

Onshore and Offshore Renminbi Exchange Rate vs. USD
Source: Bloomberg



Undervalued Yuan

China has been accused by many, including the current and previous administrations, of keeping the renminbi yuan artificially low in an effort to provide an edge for its export driven economy. China's desire for an undervalued currency is mitigated as the economy transitions towards an emphasis on domestic consumption. Further, a stronger renminbi helps contain inflationary pressure within China.

This undervaluation of the renminbi compared to the currencies of its major trading partners has been a source of friction for many years as China's trade surplus grew. Since 2005, when China unpegged it currency from the dollar the renminbi has strengthened 33%. Yet with its economic growth profile, rising standards of living and continued current account surpluses the renminbi still appears undervalued even though the moderation of trade surpluses in recent years has lowered the political temperature.

There are many methods of assessing a currency's under- or over- valuation. Economic models used by the International Monetary Fund (IMF) include Effective Real Exchange Rate, External Sustainability and Macro-economic Balance models all of which provide very different answers and are subject to significant uncertainties of measurement, economic linkages and most relevantly, structural change. And China has undergone huge structural change and continues to do so. In 2012 the IMF described the currency as "moderately" undervalued from "significantly", without giving a value, following a change to its forecast for China's surpluses.

We take a view on China's currency based on Purchasing Power Parity (PPP), a method that seeks to value currencies against the dollar having adjusted for local spending power. On this basis, with rising income per head and improving standards of living the renminbi is still cheap. And to prevent Chinese surpluses rising once again, which presents its own set of problems, the renminbi will need to keep strengthening.

For US investors, with the dollar facing potential headwinds from debt and the possibility of both inflation and dollar weakness as a result of Quantitative Easing, the renminbi offers an intriguing alternative.

WHAT'S IN YOUR WALLET?

While a currency revolution is not necessarily at hand, it is not a radical idea to think that the renminbi could possibly at some point in the foreseeable future, rise in stature to match China's economic position as the number two…and perhaps soon to be number one…global economy. At that point, the owning of the renminbi will be less than revolutionary.

Guinness Atkinson Renminbi Yuan & Bond Fund (GARBX)

This Fund is designed to offer a simple solution and easy access to the renminbi cash and bond markets. The Fund buys renminbi in the offshore spot market which is held in a bank account. The renminbi cash is then invested into a range of bonds and certificates of deposit with an emphasis on keeping credit risk low.

The aims of the Fund are:

- to provide US investors with exposure to the renminbi,
- to provide some diversification from the dollar,
- to provide an attractive yield combined with the possibility of currency appreciation and
- to minimize risk.

To this end we keep our investment strategy as simple as we can. We buy renminbi cash directly; we do not use synthetic products, such as non-deliverable forward contracts. We prefer to invest in investment grade instruments primarily, although as China specialists we are willing to invest in unrated names where we know the business. Unrated names account for less than 15% of the portfolio.

We have so far seen a relatively low volatility of both the Fund and the renminbi currency and bond market. Since the end of June 2011 when the Fund was launched, the standard deviation, as of 12/31/12, of the Fund was 2.63% and the bond market was 3.27% (based on the standard deviation of weekly changes in the CNH exchange rate and the HSBC Offshore (CNH) Renminbi Bond Index).

ABOUT THE FUND MANAGER

EDMUND HARRISS
Portfolio Manager

Joined Guinness Atkinson Asset Management in 2003 and also serves as investment director and board member.

Edmund spent time living in Hong Kong while managing the Guinness Atkinson China & Hong Kong Fund, giving him a unique, first-hand experience of investing in the region.

Edmund graduated from Christ Church, University of Oxford, with a Masters degree in Management Studies and has a Bachelors degree in History from the University of York.

He is also an Associate of the Society of Investment Professionals.

This information is authorized for use 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 an ongoing investment in the Funds. Please read the prospectus carefully before investing.

Performance data quoted represents past performance and does not guarantee future results. Index performance is not illustrative of Guinness Atkinson fund performance and an investment cannot be made in an index. For Guinness Atkinson Fund performance, visit gafunds.com.

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, 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. The Fund may invest in derivatives which involves risks different from, and in certain cases, greater than the risks presented by traditional investments. Investments focused in a single geographic region may be exposed to greater risk than investments diversified among various geographies.

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

Standard Deviation is applied to the annual rate of return of an investment to measure the investment's volatility. Standard deviation is also known as historical volatility and is used by investors as a gauge for the amount of expected volatility.

The HSBC Offshore Renminbi Bond Index (CNH Index) tracks total return performance of renminbi-denominated and renminbi-settled bonds and certificates of deposit issued outside the People's Republic of China

One cannot invest directly in an index.

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