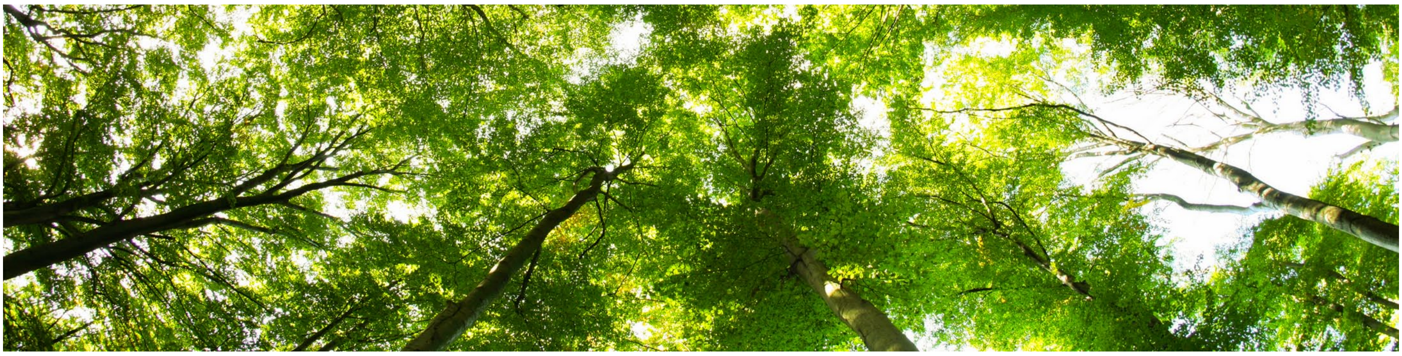

GUINNESS ATKINSON FUNDS

# Inflation Managed Dividends *brief*

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**Commentary and Review by co-portfolio managers Dr. Ian Mortimer, CFA and Matthew Page, CFA**

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## Manager's Review

*"The risk of paying too high a price for good quality stocks – while a real one – is not the chief hazard... Observation over many years has taught us that the chief losses to investors come from the purchase of low quality securities at times of favorable business conditions."* Benjamin Graham

Over the first four months of this year the market has been rewarding the kinds of companies that we consistently look for – high quality companies. Quality used as a description of a company appears to have quite a broad variety of meanings depending on who you speak to. Sometimes quality is simply used to describe large and old companies that have long histories with strong Western brands. Some might even argue that any company that pays a dividend is a quality company. Others would argue it is any company in traditionally defensive sectors such as consumer staples and pharmaceuticals which have low growth prospects and whose share prices have low volatility. Perhaps if you combine all those elements together you get the consensus idea of a quality company: a well known, large, old, low-growth, consumer staple company that pays a dividend, e.g. Coca Cola or Wal-Mart.

While we would agree that using our objective measure of quality (see our investment process white paper) many of the companies that fit the above description are quality companies, one needs to consider what it is about these types of companies that make them high quality. We believe a high quality company is not dependent on its market cap, where it is listed, what sector it is in, and whether it pays a dividend. We believe quality companies are those that can consistently create value at all points through a business cycle.

Based on our initial quality screening methodology we identify a broad universe of companies that are well diversified across sectors, size, geography, growth prospects, etc. Ultimately, what we are looking to find first and foremost is best-of-breed companies, irrespective of all other characteristics.
We then look to narrow this list down to a portfolio of 35 stocks that we find attractive on valuation, have a reasonable dividend yield and ability to grow the dividend over time. Our focus on quality therefore leads us to a portfolio that is unlikely to be a "high yield" portfolio relative to other portfolios one could construct, but is more focused on providing a reasonable level of dividend income today with growth in that dividend and the potential for capital appreciation over time.

A quality company that fits our definition, but maybe not others, is Aberdeen Asset Management. It is not a large cap (its market cap at the beginning of the year was $6.6 billion), it does not have particularly high brand recognition outside of professionals in the finance industry, it is in the financial sector not the consumer staples sector, it is listed in London but its true economic exposure is global, with an emphasis on emerging markets. It is not a particularly old company (established 1983) and revenue and profits have been growing quite quickly recently. If you asked 100 people on the street to name a quality company it is unlikely they would name Aberdeen Asset Management and more likely they would name something like Coca Cola.

The company has consistently generated high returns on capital for each of the last ten years and is therefore by our definition a quality company. Before we even consider the idiosyncrasies of any individual company, our analysis suggests that companies like this that achieve our quality definition are statistically highly likely to continue to achieve these high returns on capital in the near future.

The company recently reported a good set of results with revenues having grown 25%, and pre-tax profits up 52%, relative to the same period last year. The company also announced a 36% increase to the interim dividend.

Our process does also identify the large-cap blue chip companies and we have owned quite a number of them in the portfolio. However, we have been gradually reducing our exposure to these larger companies in recent months having sold Pepsico and Wal-Mart within the last 6 months largely on valuation grounds.

Clearly one might argue that we could have taken an approach of starting by looking for companies that offer a reasonable dividend yield and then attempt to identify which of these companies are of good quality and end up with the same portfolio of companies. However, if we were to have taken this approach we would have put ourselves at risk of being blinded by an attractive yield and trying to convince ourselves the company was of sufficient quality. This is a trap which is very easy to fall into, especially if you set your portfolio a target of achieving an absolute level of dividend yield. We prefer to be sure of the quality first and then take a thorough look under the hood to reach an understanding on whether the current valuation is likely to provide upside potential.

Quality is particularly important when investing in dividend paying companies, as it is this sustainable value creation that is critical for a company to have the ability to pay a dividend that can be grown and sustained into the future. One can also argue that with interest rates at all-time lows, quantitative easing providing liquidity, confidence improving, and commodity prices falling, the existing environment could be described as "favorable business conditions". In these conditions weak companies can superficially seem like quality companies, as their share prices rally with the rising tide.

With the strong demand for income that currently exists, companies that are trading on higher dividend yields are likely to be attractive to investors. However, the problem with targeting a specific absolute yield level is that as markets rally, you are forced into potentially more and more companies that are likely to be distressed. As valuations of equity markets rise and the force of mean reversion gets stronger, distressed companies are likely to be a painful place to be in any fall in equity markets.

A company with a high dividend yield normally signals one of two things. Either the company is distressed – suffering from competitive pressure, a weak balance sheet, poor customer demand, etc., or the company is simply out of favor – suffering from a low in the company's sentiment cycle, as the market is too focused on near-term transient issues. Distinguishing between the two is clearly critical.

We believe companies that pass our initial quality screening process are more likely to be out of favor than distressed. If we find an attractive opportunity to buy a company that offers a high yield and after thorough due diligence we feel comfortable that the company is more likely to be out of favor than distressed it would be tempting to add the stock to the portfolio with a high weighting, perhaps 5%, 7% or even 10% of the portfolio, in order to boost the yield of the portfolio. However, we have to realize that not all our decisions will work. Investing after all is a game of identifying probabilities that skew in your favor, not deterministic outcomes. Even then there are the unpredictable events, such as BP's Horizon oil spill, in which the only way to limit the threat to the portfolio is to limit the size of the position which we can own in a company. We want to limit the potential effect of us being wrong or unlucky and we therefore equally weight all our positions at 3%.

It is often temping when analyzing many stocks for possible inclusion in a portfolio to feel that your latest idea is your highest conviction, as the facts and thesis behind the investment are most clear in your mind. It is therefore again tempting to want to give the position a higher weighting in the portfolio and let other positions drift. However, with an equally weighted portfolio we don't spend time deciding how large the position should be; we either own it or we don't. Ultimately it will be up to the whim of the market to decide when a company's valuation might match our own valuation estimate, and this may take a considerable period of time. The stock idea that is most fresh in your mind does not necessarily correlate with a short time-period in which your valuation target might be met.

Our most recent stock purchase for the portfolio was Northrop Gruman. We think the company is out of favor rather than distressed due to concerns last December over the fiscal cliff. We think the valuation is incredibly attractive, ticking our three boxes of being cheap in absolute terms, cheap relative to the company's valuation history and cheap relative to its peers. It is trading on a high teen percentage pre-tax-profit to enterprise value (a metric we particularly like) and has recently announced it is going to repurchase 25% of its own stock.

It certainly feels like our highest conviction position right now, but we have applied the same scalable analysis to all our holdings before we purchase them, and like all of those that came before, we only allocated 3% of the portfolio to this company.

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

*This information is authorized for use when preceded or accompanied by a prospectus for the Guinness Atkinson Inflation Managed Dividend Fund. The prospectus contains more complete information, including investment objectives, risks, charges and expenses related to an ongoing investment in The Fund. Please read the prospectus carefully before investing.*

**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 companies, which will 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.**

Diversification does not assure a profit nor protext against loss in a declining market.

P/E is a valuation ratio of a company's current share price compared to its per-share earnings.

EV/EBITDA is a financial ratio that measures a company's return on investment that is normalized for differences between companies like capital structure, taxation and fixed asset accounting.

Free Cash Flow is a measure of financial performance calculated as operating cash flow minus capital expenditures.

For a list of current holdings, click here. Fund holdings and/or sector allocations are subject to change at any time and are not recommendations to buy or sell any security.

Enterprise Value (EV) is a measure of a company's value, often used as an alternative to straightforward market capitalization and is calculated as market cap plus debt, minority interest and preferred shares, minus total cash and cash equivalents.

Pre-tax profit is a company's earnings before tax as a percentage of total sales or revenues.

Pre-tax profit to Enterprise Value (EV) is calculated as EV/pre-tax profit

One cannot invest directly in an index.

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