



**GUINNESS
ATKINSON**
F U N D S

Inflation Managed Dividends *brief*



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**Commentary and Review by co-portfolio managers
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Manager's Review

The year started strongly for global equities, as many of the concerns around the US “fiscal cliff” were put to bed, and attention turned to improving economic data in the US, Japanese “QE” and further concerns of slower growth in China. In the US the number of new housing starts has headed back towards historic trend levels, house prices have started to appreciate again, consumer confidence has improved, while unemployment continued to fall. We saw a period of relative calm in Europe compared to what we have been used to over the previous two years, with yields on Spanish and Italian 10 year government bonds averaging well below 5%. Further central bank quantitative easing came from Japan, providing more support to income producing assets and a strong rally in the Nikkei Index. The market peaked on May 22nd after Ben Bernanke told Congress that the Fed could start to scale back quantitative easing should the economy shows signs of continued and sustainable improvement. Markets continued to decline in June over the anticipation of the withdrawal of US support to asset prices with Emerging Market equities and high yielding equities being hit hardest.

Performance of our holdings

In terms of performance attribution, our allocation to Industrials was the largest contributor to performance relative to the benchmark. Stock selection dominated this outperformance with Meggitt and Northrop Grumman performing particularly well. This was narrowly followed by our overweight position in the Consumer Staples sector. We did not own any companies in the Materials or Utilities sectors.

Our focus on companies that could generate high return on capital, offer value, and grow their dividend, as opposed to companies that offer a high dividend yield, meant that we weathered much of the volatility of the period well, outperforming the benchmark in the rally from 12/31/12 to 5/22/13 and holding onto this by also outperforming during the correction from May 22nd to the end of June (6/30/13).

The three best performing stocks in the first six months were H&R Block (+51.55% Total Return), Microsoft (+31.29%) and Meggitt (+28.94%).

The three worst performing stocks were ENI (-12.90%), China Mobile (-8.32%) and Imperial Tobacco (-6.27%).

Portfolio Performance

After five out of five months of positive performance in 2013, in June the MSCI World Index declined 2.42%. The fund performed robustly over the first half of 2013 in what proved to be another fairly choppy period of swinging expectations. The fund was up 13.16% in the first 6 months of the year, outperforming the benchmark MSCI World index by 4.34%.

As of 6/30/13	YTD	1 YR	Since Inception (3/30/12)
Inflation Managed Dividend Fund*	13.16%	21.29%	14.67%
MSCI World Index	8.82%	19.41%	13.65%

*The expense ratio is 7.05% (gross), 0.68% (net).

Performance data quoted represent past performance and 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. For most recent month-end and quarter-end performance, visit http://www.gafunds.com/IMD_performance or call (800) 915-6566. The Fund imposes a 2% redemption fee on shares held for less than 30 days. Performance data does not reflect the redemption fee and, if deducted, the fee would reduce the performance noted.

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 0.68% through March 31, 2015.

Buys and Sells

We sold two of our winners in March as we thought the valuations on Wal-Mart and VF Corp were starting to look quite full, while at the same time the dividend growth of these companies was being outpaced by share price appreciation. Consequently, the dividend yield of these two companies was by now considerably below where it was when we initiated our original positions, and we could find better valuation and yield elsewhere. We bought Northrop Grumman and BAE systems in their place which looked unloved and cheap. Concerns about the US fiscal cliff had pushed Northrop Grumman to historic low valuations, as well as being cheap relative to the company’s peers and in absolute terms. Both companies offered a likely possibility of improved yield at the portfolio level.

As we try to keep our turnover low that sometimes means we will keep positions in the portfolio that might be starting to look quite fully valued. It is always a balancing act between selling a company because you believe the valuation is starting to look rich, while at the same time trying to make as few changes to the portfolio as possible. Some investors we speak to are concerned that a number of consumer staples companies are looking fully valued. We would agree.

While Consumer Staples remains our largest sector weighting, we have been reducing our exposure to the sector during the last 12 months, as we have felt that valuations of some companies are starting to look fairly full and we could find better value elsewhere. For example, we sold Wal-Mart in March and Pepsico in October last year. A few of the large cap global consumer staple companies that we own have seen some small declines in analysts’ earnings expectations for 2013, however, year on year earnings growth of high single digit percentage rates continue to look healthy and achievable. We continue to think that many of these positions remain an attractive part of the portfolio.

Portfolio Breakdown

We continue to have our largest sector weighting to the Consumer Staples sector at 25.0%, followed by Industrials and Financials at 17.4% and 16.3%, respectively. We continue not to own any utility or materials stocks, as our initial screen of looking for companies with a history of consistently generating high return on capital over a business cycle excludes the vast majority of companies in these sectors. Regulated industries like Utilities are normally not allowed to earn such high returns on capital for a prolonged period of time because of their state-mandated monopolistic or oligopolistic competitive advantage. Companies in the Materials sector tend not to make it through our screen due to the fact that they lack any significant pricing power over underlying commodity prices, making returns on capital fairly volatile. Both of these sectors make up a relatively small proportion of the MSCI World index, and we feel very comfortable owning more high return on capital companies at the expense of these sectors, despite the fact that these sectors have traditionally been a strong source of high yielding stocks.

Many of the companies in the sector often have a significant exposure to emerging markets (e.g. Coca Cola and Unilever), and in our opinion, have offered an attractive way to get exposure to emerging markets considering the value these companies

Top 10 Sectors (as of 6/30/13)	
Consumer Staples	25.0%
Industrials	17.4%
Financials	16.7%
Health care	14.1%
Energy	7.0%
Consumer Discretionary	6.2%
Telecommunication Services	4.7%
Information Technology	5.5%
Materials	0.0%
Utilities	0.0%

have offered and their ability to capitalize on the falling cost of debt. Emerging market companies that generate high return on capital have looked relatively expensive to us over the last 3 years. As western listed consumer staple companies have performed so well, the value on a relative basis to locally listed companies is potentially reducing, but we do not currently see many compelling opportunities in emerging markets.

Another attractive attribute that these have over locally listed emerging markets stocks is low volatility in the share price, given the relatively predictable earnings stream. In the current environment of untested central bank policies we find it a particularly attractive attribute.

Ultimately, we must maintain a disciplined search for value above all else, which will likely mean further reducing our exposure to consumer staples over the second half of the year. If emerging markets continue to be hurt by concerns over the threat of the fed tapering quantitative easing, then potentially more compelling opportunities could arise.

With equity markets having performed well over the last 18 months, we are more cautious than ever on companies that are trading on high dividend yields of say 5-6%+. High dividend yield can be a fantastic buy signal when markets are trading on low valuation multiples, such as in 2009, but can be painful when markets are trading on moderate to high multiples. With the strong demand for income that currently exists, we think valuations on high yield stocks have been driven to valuation multiples that are not taking into account the potential weakness of their business model in an environment where cheap easy credit is taken away.

Simply focusing on companies that have grown their dividend each year is also insufficient, in our minds. Kmart's dividend increased every year from 1978 to 1994 until it was cut in 1995, and by 2002, in the wake of the tech bubble, the company had filed for bankruptcy. Wal-Mart, on the other hand, has increased its dividend every year from 1978 and continues to do so. The key difference that stands out between the two companies was their return on capital. In 1995 Kmart had a 5 year average return on equity of 7%, which is likely to have been below their cost of capital, if we assume it was 9%. Wal-Mart, on the other hand, had a 5 year return on equity of 25% which would have been well in excess of the company's cost of capital. Indeed, Wal-Mart's return on capital continues to be maintained at a similar level today averaging 23% over the last 5 years.

So, while someone who had invested in Kmart in 1980 would have lost everything by 2002, when Kmart filed for bankruptcy, an investor in Wal-Mart over the same period (1980-2002) would have generated a total return of 29,098%.

While this is a fairly startling example, it makes complete sense that a company that doesn't generate a return on capital higher than its cost of capital cannot pay a sustainable dividend for a prolonged period of time. It may be able to pay a dividend for a number of years, by selling assets, taking on debt, extending the time within which it will pay suppliers, depleting its cash reserves, etc., but there is only so long this can last before the company's issues will come to light.

In our minds, a high return on capital for a prolonged period of time must be our starting point when looking for companies that can afford to pay a sustainable dividend. Companies that have generated consistently high returns on capital over a business cycle are very likely to remain good companies into the future. As long as we ensure that we apply a consistent value discipline to selecting the companies to hold in the portfolio, then we believe we have a good chance of continuing to outperform the market while aiming to provide investors with the income they are seeking.

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.

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.

The MSCI World Index (MXWO) is a capitalization weighted index that monitors the performance of stocks from around the world.

Nikkei Index is the leading and most-respected index of Japanese stocks and is a price-weighted index comprised of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange.

One cannot invest directly in an index.

Return on equity (ROE) is the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Cash flow is a revenue or expense stream that changes a cash account over a given period.

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