GUINNESS ATKINSON FUNDS

Asia brief

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Questions from the road

Where to invest

We have begun to promote the Asia Pacific Dividend Fund more widely in the past month and it has been well received – many have commented that its distinct process among Asian funds is a big attraction. We have started to see larger inflows; since the end of June, the Fund has grown from $2.4m to just under $16m.

We believe there is a lot of benefit to be gained by meeting our clients, and the discussions that we have with them are often highly thought-provoking. In this month's brief, we answer questions on two subjects that crop up regularly: China and interest rates.

China

How has the Fund fared with the recent volatility in Chinese stocks?

Investors in domestic Chinese stocks have had a wild ride over the past couple of months, and the recent fall of more than 30% in the Shanghai Composite Index has brought the market to the attention of all of those who invest in Asia. The large fall was preceded by an even larger run up over the past twelve months, as prices of domestic 'A' shares were bid up strongly, causing the index to more than double in value. Much of the bull market euphoria had been caused by retail investors (unlike western markets, the market is 80% dominated by retail investors, 20% by institutions) who saw the stock market as an opportunity to gamble. This tendency was exacerbated by the ready availability of leverage to retail investors – margin trading poured fuel on an already substantial fire.

Since the peak in June, the authorities have been fire-fighting in an effort to stem the falls that followed. The Peoples Bank of China (PBoC) announced a cut in interest rates, and further cuts in the level of reserves banks are required to hold to provide liquidity to the market. Further measures, such as restricting short-selling, suspending initial public offerings (IPOs) and preventing company insiders from selling their shares, were also introduced. So far these measures have had mixed success. The market has bounced a little from the lows reached in July, but it remains volatile.

The effect of these movements on the Fund has been felt, but not directly. We do not invest in the A-shares that have been the subject of this volatility; we invest in Hong Kong-listed Chinese companies (H-shares and Red Chips). These shares have at times come under selling pressure – during the period when there was a large number of A-share suspensions, many domestic Chinese investors sold H-shares instead in order to hedge their positions.

Why does the Fund have a large weighting to China? What is our long-term view on the country?

We do not make top-down allocations within the Fund. Our approach is bottom-up, and stocks are selected on the basis of their underlying fundamentals. While we consider the macroeconomic environment, this work feeds into our analysis of individual companies, rather than determining our allocation to a country or particular sector.

Our large weighting to China is therefore a function of our investment process, rather than a part of it. When we launched the Fund, we found that many of the value opportunities within our universe of quality companies were in (Hong Kong-listed) Chinese companies. This pattern was not unexpected, as China had been relatively unpopular for quite some time. The State Owned Enterprises (SOEs) and very heavy industrial companies, which represent a large proportion of the market, have been very out of favour as concern about slowing investment growth has severely dampened sentiment. However, we look at a different part of the market. Our focus is on quality companies that have generated persistently-high returns on invested capital and that aren't highly geared. Many of the Chinese companies in our universe had been tarred with the same brush applied to the less attractive SOEs. Thus we were able to pick up many of the quality companies at pretty cheap valuations. While many have been strong performers for the Fund since launch, we still find that the Chinese companies offer good value, and our portfolio, which has had very low stock turnover, continues to have a large weighting to China.

Our outlook for China for the next couple of years is generally favourable. While there are many challenges facing the authorities (including dealing with substantial amounts of debt incurred from investment and infrastructure spending, the ongoing liberalisation of financial markets, and the transition in the economy from investment and towards consumption) the Chinese have consistently demonstrated their willingness and ability to make significant structural changes in such a way that economic growth is not damaged. We expect growth to slow – it is a mathematical impossibility for the country to continue to grow at a high rate forever – but we expect the transition to be gradual.

Interest rates

How do we expect the Fund will react to the prospect of rising interest rates?

One concern expressed by investors generally is whether there is still value in dividend-paying stocks. As interest rates have remained at historic lows, held down by quantitative easing, the price of income-generating investments has been bid up. Bonds have been trading at historically high prices, and bond-like assets have been similarly bid up. This effect is particularly prevalent for asset classes linked to stable sources of income generation, such as infrastructure. So are dividend-paying stocks subject to the same pressure?

Our short answer is no, or at least not in the areas in which we are investing. We still see Asia as being one of the areas around the world where there are good opportunities to find value. Dividend yields, an indication of value, are more attractive than Western markets, and on a P/E basis the region trades at a significant discount to both US and world equities. As asset prices around the developed world have benefitted directly from quantitative easing-related buying, Asia has lagged the broad market, creating the opportunity we see today.

More fundamentally, the kind of companies we invest in are among those best placed to weather higher rates. Our focus on high return-on-capital companies means that they earn a positive spread of returns over the discount rate. This spread is important as it ensures that growth achieved by the company is accretive for shareholder value – it increases the company's intrinsic value. When interest rates increase, the discount rate at which a company's returns are discounted will increase, reducing the value of those returns. However, high return on capital companies will still earn well in excess of the discount rate – the large spread they enjoy acts as a cushion. Compare this with a company returning at the cost of capital. There is no room for the discount rate to increase before the company begins to earn a negative spread, meaning any growth achieved by the company is negative for shareholder value.

Since discount rates are notoriously difficult to estimate, we believe it is better to be approximately right, and to make an allowance for inaccuracy. By investing in companies with returns that significantly exceed the discount rate, the need for precision when estimating the discount rate is reduced. Even so, we still model the impact of changes in the discount rate – we can 'shock' the intrinsic value of the companies in our universe to see which are most sensitive to, say, a 1% increase in rates.

The other important part of our investment process is the elimination of companies that are highly geared from our universe. This criteria has two main advantages. First, a company that has only modest levels of gearing is likely to be better able to service the interest payments on its debt. Second, the valuation of its equity is less sensitive to changes in the value of its assets. Equity in highly-geared companies – particularly those that are in distress situations – can be especially volatile, so we avoid these types of companies.

Overall, it is this combination of high return and low gearing that means our portfolio should be well positioned for increasing rates. Indeed, for some of the companies in our portfolio, a rise in interest rates could even be beneficial. Aflac, a company introduced into the portfolio in July, has found that the volumes of life insurance business that it is able to write profitably have been suppressed because the bonds it uses to invest insurance premiums have not been available at sufficiently high yields. As yields pick up, we expect the company to increase the volumes it can write, while maintaining profitability.

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The Fund invests in foreign securities which will involve greater volatility and political, economic and currency risks and differences in accounting methods. The Fund is non-diversified meaning its assets may be concentrated in fewer individual holdings than diversified funds. Therefore, the Fund is more exposed to individual stock volatility than diversified funds.

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

Click for a list of current holdings for the Guinness Atkinson Asia Pacific Dividend Builder Fund.

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

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

Shanghai composite index is a stock market index of all stocks (A shares and B shares) that are traded at the Shanghai Stock Exchange.

Return on Invested Capital (ROIC) is a calculation used to assess a company's efficiency at allocating the capital under its control to profitable investments.

Dividend Yield is a dividend expressed as a percentage of a current share price

P/E ratio, is an equity valuation multiple. It is defined as market price per share divided by annual earnings per share.

Gearing is the level of a company's debt related to its equity capital, usually expressed in percentage form.

Return on capital is a financial measure that quantifies how well a company generates cash flow relative to the capital it has invested in its business.

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

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