Guinness Atkinson
Asia Pacific Dividend Builder Fund
Managers Update – August 2016

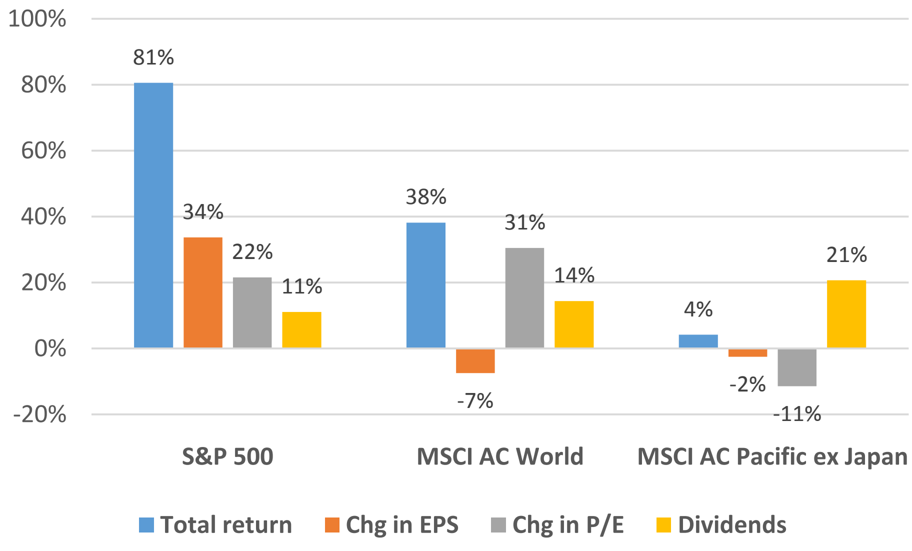
Asian Markets

July was a strong month for Asia with the MSCI AC Pacific Index up 5.6% in dollar terms. This month, as in June, emerging markets outperformed developed markets with Asia and Latin America leading the way but in Latin America this has been a function primarily of a recovery in their currencies while in Asia the returns have come from a multiple expansion.

We have argued for some time firstly, that Asia's macro-economic stability has been underestimated by investors resulting in depressed valuations that we believe are unwarranted; and secondly, that areas such as Latin America and Emerging Europe are economically skewed either to commodities or export manufacturing with little in reserve when, as has happened, commodity prices fell or consumer demand in key markets weakened. We argue further that the US market, far and away the best performing developed market over the past five years may not be as fundamentally well-supported as first appears.

This month we thought we would take a look at market returns over the past five years in just the same way as we evaluate the performance of the stocks in our portfolio, to gauge whether or not we are happy to hold them, by looking at the three components of shareholder returns – profits, price/earnings (P/E) multiple and dividends.

Figure 1. 5 year market returns (2010-2015) for US stocks, World and Asia Pacific equities as measured by the S&P 500 Index, MSCI AC World Index and MSCI AC Pacific ex Japan Index, disaggregated into profits, price/earnings multiple and dividends.



Sources: Bloomberg, Guinness Asset Management calculations. Compound returns 2010 – 2015 in US dollars.

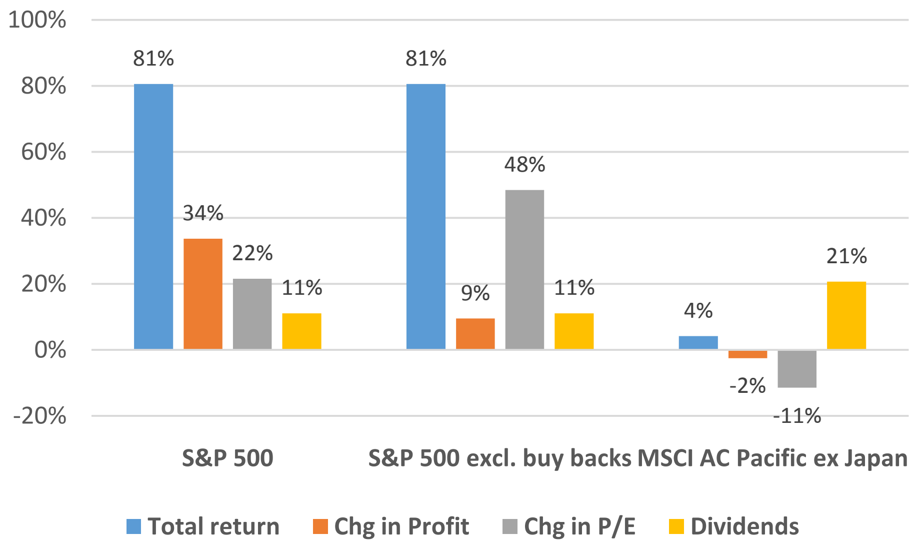
The blue bars show the total return over the five year period which are then broken down between the orange bars showing the return from growth in earnings per share (EPS), the gray bars show the return due to the expansion in the price/earnings ratio (P/E) of the markets and the yellow bars show the dividend contribution. By multiplying together the returns from the three components we arrive back at the blue bar, the total return.

The picture in the US looks solid: 34% comes from EPS growth, 11% from dividends and with those levels of contribution the 22% contribution from growth in the P/E looks eminently justifiable. The picture presented by the MSCI AC World Index, which includes developed and emerging markets, looks less reassuring. Profits as measured by EPS have declined although we have seen an increased contribution from the dividend. The story is one we know: profits in Europe are struggling for growth and in many emerging markets profits have fallen due to declining energy and commodity prices and due to economic weakness in Europe. The higher dividend contribution is welcome of course, but with profits down it has come at cost of a higher payout ratio (which was around 40% in 2011 and is pushing 60% today, according to Bloomberg).

Asia presents a different picture again. The total return from the region over the last five years has been next to nothing: 4.2%, or less than 1% a year. Profits have hardly changed, they are down 2.5% over the five year period, but the dividend contribution has been very strong. Dividends have contributed almost 21% to the total return and this has come about with only a modest increase in the payout ratio from 40% in 2011 to 43% today.The problem has been the 11% contraction in the market P/E. Indeed looking across the US, UK, Europe, Latin America, Emerging Europe and Asia the only area where we have seen a P/E contraction is in Asia Pacific.

China is one reason for the valuation contraction but so too might be the earnings' profile. The growth in EPS out of the US is very impressive and leaves the rest of the world looking very anaemic by comparison. But not all is as it seems. The US picture is heavily distorted by the share buyback phenomenon. This has always been part of the management canon and in the past has been closely linked to management incentive schemes which are often linked to EPS growth. In the last five years the effect has been dramatic.

Figure 2.5 year market returns disaggregated (2010-2015) for US stocks, US stocks excluding buybacks and Asia Pacific equities as measured by the S&P 500 Index and MSCI AC Pacific ex Japan Index.



Sources: Bloomberg, Guinness Asset Management calculations. Compound returns 2010 – 2015 in US dollars.

In this chart we show the original breakdown of US market returns as measured by the S&P 500 index but in the middle cluster, we measure the change in profit by net income rather than EPS and then the picture looks rather different. Company profits have grown not by 33.7% over the past five years but by 9.5% or to put another way by less than 2% per annum rather than 6%. The boost from 9.5% growth to 33.7% has come about by company managements buying back almost one in every five shares outstanding. Over the last five years they have spent $2.7 trillion doing it, instead of investing in productive assets as share prices continued to rise. If we adjust the breakdown of returns to assume no buy backs that expansion in the market multiple would have contributed 60% of the total return.

There are a number of observations we can make that flow from this. Firstly, it would seem that a significant proportion of the recent US market rise is attributable to financial engineering. The historic P/E of the market was 18.7 times 2015 earnings but if we exclude the effect of buybacks it was 22.9 times. That is expensive.

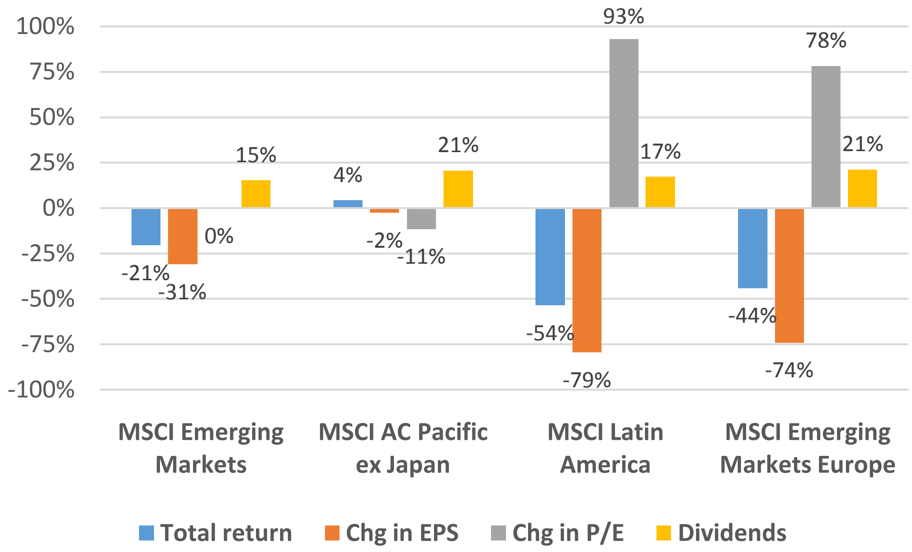
Secondly, when we consider that according to CNBC*, companies spent at total of $4.6 trillion in buybacks and dividends ($2.7 trillion on share buybacks and $1.9 trillion in dividends) while generating net profits of $4.6 trillion in we need to consider how sustainable that is. Companies need to invest to grow and this suggests that managements can see little in the way of investment opportunities; or perhaps they feel that buying back shares will deliver more rapid results in terms of share price increases. While running down cash balances and/or taking on debt can keep going for a while there will come a point when it stops. (Herbert Stein's law, "If something cannot keep going on forever, it will stop" applies here.)

*Data from S&P Dow Jones quoted on CNBC May 13 2016.
http://www.cnbc.com/2016/05/13/s-and-p-500-ompanies-are-planning-to-spend-600-billion-on-share-buybacks.html

Thirdly, in world where US profits have grown by only 1.8% per annum over five years while Asia's have fallen by only 0.5% per annum, then Asia's valuation contraction looks even less warranted, and more like an opportunity.

Finally, we should look at Asia Pacific in the context of broader emerging markets because that is how most investors look to allocate to it.

Figure 3.5 year market returns for Global Emerging Markets, Asia Pacific, Latin America and Emerging Europe equities as measured by MSCI Emerging Markets Index, MSCI AC Pacific ex Japan Index, MSCI Latin America Index and MSCI Emerging Markets Europe Index, disaggregated into profits, price/earnings multiple and dividends.



Sources: Bloomberg, Guinness Asset Management calculations. Compound returns 2010 – 2015 in US dollars.

The chart shows, I think, why it is so important to make an active distinction between emerging market regions. Asia is the largest component of the Emerging markets index and it is Asia's contraction in market multiple that offsets the multiple expansion in Latin America and Emerging Europe. The performance profile also illustrates the differences between the three regions. Asia has not suffered a collapse in profits or in currency (the combination of which explain the sharp profit declines in the other two). The earnings collapse in Latin America and Europe explains the significant multiple expansion – we believe prices are buoyed by the hope of recovery, not by profits and the dividend contribution is accompanied by a doubling in the payout ratios.

This final chart of the emerging markets paints a picture of excitement that perhaps we do not need just now and shows a very stable picture over the past five years of the Asian region which stands up to closer scrutiny against both developed market and emerging market comparisons. Over the next five years we think it likely that the region, which is still lightly held, will become a more significant part of stock portfolios. Low valuations, stable dividends and the world's second largest economy that continues to confound the bears with a crash that just won't come will combine, we believe, to deliver good returns over the coming years.

However, as investors we have to look for those returns and to avoid the excitement we saw in Figure 3. By looking for companies, not sectors or countries, with a long track record of operating cash flow excellence that are undervalued by the market we believe we can offer investors the best way in. We look at returns on investment in cash flow terms to steer us around clever accountants and financial engineers to identify those companies that can create value and grow cash flows for their re-investment needs, to underpin their stock valuations and to grow their dividends.

Performance

Over the past month the best performing sectors have been Information Technology, Consumer Discretionary and Financials. Laggards have been the traditionally more defensive Consumer Staples, Healthcare and Utilities sectors. When looking across geographies the performances have been more evenly spread but led by Hong Kong, Indonesia and Taiwan with New Zealand, the Philippines and Singapore being notable laggards.

At the stock level we have continued to see good performance from the likes of Largan Precision, AAC Technologies and JB Hi-Fi all of which have made regular appearances in our top ten holdings. However, it has been particularly encouraging to see Belle International as our second best performing stock after a long period of underperformance. We have been adding to this position over time and the recent report of a recovery in same store sales has lifted the stock by 25%. Also encouraging is to see the appearance of three Chinese banks among the outperformers over the month.

The weakest stock over the past month has been our Japanese stock, Relo Holdings which provides relocation services for company staff as well as a broader array of human resources benefits management. The stock has been our best performing holding and has given back 10% since the recent peak. We have, as part of rebalancing process, cut back the position periodically and so have taken the benefit of the recent run up. We continue to hold the position in spite of the strength as the company still continues to produce strong operating cash flows and has just again beaten consensus earnings' estimates for the last quarter.

Other corporate results that have come through include DBS Bank in Singapore. The share price has taken a knock following the bankruptcy of Swiber, an oil services company, to which the bank had loan exposure. We were aware of this when we purchased the position some 20% below the current price. The financial impact of the bad loan is limited and the share price move was more sentiment driven (i.e. concerns that DBS' underwriting skills are not all they should be) which we believe to be misplaced. The recent results from the bank show steady net interest margins and growth in non-interest income which has caused the price to move back up.

LPN Development in Thailand is a developer of condominiums in Bangkok. This company is still struggling for growth with current sales still looking sluggish. At the interim point they had achieved only 41% of the expected sales value for 2016 with some launches delayed into the second half. The company itself has a very strong balance sheet with cash on hand and so we have no concerns about their ability to sustain their dividend and to grow if the opportunity presents itself. It is the present elusiveness of growth opportunities that is at issue. For the present we expect that second half sales of completed projects will come through and it is the prospects for 2017 that are our focus. For the moment, the stock is cheap, the company's balance sheet is strong and management though cautious has a strong track record of high returns on investment so we are prepared to wait.

Outlook

The current strength we have seen in July and so far in August means that it is likely the fund will lag the overall market. This is consistent with the previously seen characteristics of the fund whereby it has tended to garner relative outperformance in weaker or tentatively rising markets. That said, we are confident in the stocks we hold and in their valuations. We think that Asia is going to gain more attention from international investors over the next twelve months as the region is still lightly held and has been neglected over the past five years. The Fund trades on a wide valuation discount to the region which itself is at a wider discount to world equities than it has been historically and thus we are very positive.

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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. 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. Investments in derivatives involve risks different from, and in certain cases, greater than the risks presented by traditional investments. Investments in smaller companies involve additional risks such as limited liquidity and greater volatility. Funds concentrated in a specific sector or geographic region may be subject to more volatility than a more diversified investment. Investments focused in a single geographic region may be exposed to greater risk than investments diversified among various geographies. Investments focused on the energy sector may be exposed to greater risk than an investments diversified among various sectors.

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 6/30/16

1	Relo Holdings Inc.	3.14%
2	St Shine Optical Co Ltd	3.08%
3	Largan Precision Co Ltd	3.07%
4	JB Hi-Fi Ltd	2.97%
5	Li & Fung Ltd	2.95%
6	Link REIT/The	2.92%
7	DBS Group Holdings	2.91%
8	Industrial & Commercial Bank of China Ltd-H Shares	2.89%
9	Catcher Technology Co Ltd	2.88%
10	Taiwan Semiconductor Manufacturing Co Ltd	2.86%

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

*Data from S&P Dow Jones quoted on CNBC May 13 2016.
http://www.cnbc.com/2016/05/13/s-and-p-500-ompanies-are-planning-to-spend-600-billion-on-share-buybacks.html

S&P 500 Indexis a market capitalization weighted index that monitors the performance of 500 stocks listed in the United States.

MSCI AC World Index is a free-float weighted index that includes both emerging and developed world markets.

MSCI AC Pacific Ex-Japan Index is a market capitalization weighted index that monitors the performance of stocks from the Pacific regions, excluding Japan.

MSCI Emerging Markets Index is a free float weighted index that captures large and mid-cap stocks from 17 countries.

MSCI Latin America Index is a free float weighted index that captures large and mid-cap stocks from 5 emerging markets in Latin America.

MSCI Emerging Markets Europe Index is a free float weighted index that captures large and mid-cap stocks from 6 emerging markets in Europe.

One cannot invest directly in an index.

Earnings per share (EPS) is calculated as the annualnet profit divided by the number of shares in issue.

Price-to-Earnings Ratio (P/E) is an equity valuation multiple. It is defined as market price per share divided by annual earnings per share.

Payout ratio measures the proportion of earnings paid out as a dividend. It is calculated by dividing the annual dividends per share by the annual earnings per share (DPS/EPS).

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