Guinness Atkinson

Asia Pacific Dividend Builder Fund

Managers Update – September 2016

Asian Markets

The region has continued to build on its outperformance of developed markets which began at the end of May and was sustained through the turbulence following the UK referendum. There are a number of possible explanations for this but we continue to argue that there is much further to go.

- First, there is a valuation gap that needs to correct. The Asian region is still trading at a 30% discount to developed markets which reflects conditions more akin to crisis. The region's economic stability make Asian markets look more attractive compared to more troubled regions including Europe.
- Second, perceptions about China's economic performance have settled in recent months. The currency has been stable and capital outflows have now slowed to a pace that matches the net inflows resulting from the trade surplus. This gives the central bank room to focus their efforts almost exclusively on managing domestic monetary conditions. Recent bank results show slower new non-performing loan formation and higher write-offs that point to a situation that is being addressed.
- Third, there is a cyclical recovery underway led by commodity prices and feeding into heavy industrial products such as steel and cement which is bringing producer price deflation to an end. China's industrial producers have seen their product prices fall for 4 ½ years and that's tough for companies which are weighed down by excess capacity and debt. An improvement in pricing coupled with the effects of operating leverage should see a pick-up in earnings' growth in the region as well as easing the debt-servicing burden in those sectors where risks are seen to be highest.

Our approach to macro analysis is focused on two areas. We want to form a view of the conditions that specifically impact upon our companies' ability to continue to generate the cash flow returns on invested capital that they have achieved in the past; and we want to know how these conditions will impact on stock valuations and specifically, on the discount rate used to value those cash flows. For the most part, operating conditions have not been especially challenging for the high-quality well-managed business in which we are invested. Monetary conditions have been accommodative, interest rates have been low and inflation benign. Slower trade growth has been a headwind certainly, but it has not derailed consumption or placed finances under strain.

The issue from the macro-perspective has been felt in Asia through investors' perceptions of higher risk, transmitted through the discount rate (the risk free interest rate on US treasuries plus an equity risk premium) that has manifested through depressed valuations. The risk free rate as measured by the 10 year US Treasury is at record lows but Asia has been priced, through an elevated equity risk premium, for a catastrophe that has not occurred. Indeed the prospects for disaster that seemed so imminent at the start of the year have receded steadily such that the region now looks relatively safer than other developing regions.

Conditions for investment are never perfect and by the time the stars align stocks have often fully reflected this, and more. At present, the world is less certain than ever and we believe that focusing on businesses that have proven their worth by creating wealth on a sustained basis is where we should invest. As long as investors remain fearful we perceive there are opportunities to buy into businesses whose stock prices imply a significant under-estimation of their prospects. Thus, in Asia we at Guinness Atkinson have a portfolio of thirty six businesses that have sustained a return on investment profile that is matched by only 1,900 listed companies in the world and yet trades on a 20% P/E discount to the region that is at a 30% discount to developed world markets even after recent outperformance.

Performance

Since the middle of the year the best performing markets as measured by the relevant MSCI country index have been New Zealand, China, Thailand, South Korea and Taiwan which have risen between 9% and 13% in the past two months. The pick-up in China, Chinese companies traded in Hong Kong and elsewhere, is probably the most notable since this is an area that has underperformed consistently for the past four years.

On a sector basis, technology has been the strongest and this reflects a sector preference also evident in other regions this year. The focus, in the absence of significant corporate investment, has been on consumer technology especially handheld devices and displays rather than personal computers which have been in decline. Materials, consumer discretionary and financials, especially banks, have been the other stronger performers.

In the portfolio, stocks' performances have largely reflected the geographic and sector results over the past two months. AAC Technologies, Largan Precision, Qualcomm (held due to its substantial revenues from China) have been our best performing technology names. BOC Hong Kong, our Chinese banks and Tisco Financial (a Thai finance company specializing in auto finance) have led the way in the financials space. However, performance has also been supported by strong returns from Australian retailer JB Hi-Fi, Taiwanese healthcare business St Shine Optical and from China/Hong Kong textile and apparel maker Pacific Textiles.

Out of thirty six holdings there were seven which fell over the period. The three weakest were Relo Holdings and KT&G Group, which fell 19% and 12% respectively but are still up 18% for the year, and Yangzijiang Shipbuilding whose margins remain under pressure. Of the remaining four stocks, DBS in Singapore gave back some its recent gains following a debt default by one of its customers, Swiber Holdings which we discussed last month, China Lilang, Catcher Technology and Novatek which were down between 1% and 4% over the period.

What we look for in our approach to stock selection and portfolio construction is a broad spread of performance contributions. We select what are our thirty-six best ideas and put them into an equally weighted portfolio, rebalancing from time to time recycling gains into laggards which has the added benefit of lowering stock-specific volatility and risk. In the last two months we can see performance has been closely linked to certain geographies and sectors but over the year to date it is spread across Australia, Taiwan, Thailand, Singapore, Korea, Japan and China and across seven sectors including banks, consumer (staples and discretionary), energy, healthcare, real estate, and technology.

Outlook

Last month we wrote that we expected the fund would under-perform the market amidst stronger conditions and that has been the case – but not by much. A distinctive characteristic of this fund has been its relative strength in down markets which, combined with good upside capture (85% in July and August), has kept the fund ahead of its benchmark. We believe that after a long period in the wilderness, Asia has a fair bit of catching up to do. Stock prices have shown reasonable strength since May and we believe that a recovery earnings could sustain that well into next year. For those who, quite reasonably, remain wary then we suggest that investing in the best quality businesses you can find that offer dividends supported by solid cash flows is a good first step into the region.

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 7/31/16

1	Largan Precision Co Ltd	3.42%
2	Pacific Textiles Holdings Ltd	3.10%
3	QUALCOMM Inc	3.08%
4	Link REIT/The	3.08%
5	Luk Fook Holdings International Ltd	3.04%
6	Belle Intl Hldgs Ltd	3.04%
7	Taiwan Semiconductor Manufacturing Co Ltd	2.95%
8	Hon Hai Precision Industry Co Ltd	2.94%
9	Li & Fung Ltd	2.92%
10	AAC Technologies Holdings Inc	2.92%

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

Equity risk premium also referred to as simply equity premium, is the excess return required by investors over a risk-free to compensate investors for taking on the relatively higher risk of equity investing.

Upside/downside capture ratios show you whether a given fund has outperformed--gained more or lost less than--a broad market benchmark during periods of market strength and weakness, and if so, by how much. Upside capture ratios for funds are calculated by taking the fund's monthly return during months when the benchmark had a positive return and dividing it by the benchmark return during that same month. Downside capture ratios are calculated by taking the fund's monthly return during the periods of negative benchmark performance and dividing it by the benchmark return.

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.