Guinness Atkinson
Asia Pacific Dividend Builder Fund
Managers Quarterly Update – October 2016

Over the past five years developed markets, and the US in particular has been the place to be. Developed markets, as measured by the MSCI World Index have delivered a total return of 78.56% in the five years to September 30 2016 and the US, measured by the S&P 500 Index, has delivered a whopping 113.20% or 16.33% per annum for the same period. Emerging markets by contrast, as measured by the MSCI Emerging Markets Index, have returned 18.06% over the same period or a sorry-looking 3.37% per annum. Will this continue? Will the US deliver another 16% per annum for the next five years? That seems unlikely. Market leadership has changed this year and we think investors now need to look a little deeper and get behind the headlines.

In 2016, emerging markets have risen 16.25% compared to developed markets which are up 6.04% and the US up 7.82%. The Asian component is up 13.17% while emerging markets ex-Asia are up 24.27%. What are we to make of this? If we want to invest in this area for the next three to five years we need to be confident that there is a real story here and that we're not about to be sucked into a market bounce, another false dawn.

We would argue that many of the economies of the ex-Asia component of emerging markets are as uncertain and volatile as they have ever been. Looking at Brazil and Russia, the two main stock markets in this group, the strength was in the first half of the year and was driven by the recovery in commodity prices from the beginning of March and recovery in the Brazilian Real and the Russian ruble against the dollar on the back of that, both from depressed levels. It is also worth pointing out that these two specific and linked moves in commodities and currencies occurred once it became clear that the China's imminent economic and currency collapse was not so imminent after all.

Since the middle of the year emerging markets ex Asia have been more subdued rising 5.62%; leadership has been taken up by Asia which is up 10.62% and the best market was…China. China has had its best quarter since 2009 with the MSCI China Index up 13.97. Should we be surprised? Not really. We have been arguing, in the face of relentless negative press coverage, that China's economic challenges are significant but not overwhelming. The music reached a crescendo this year with warnings that a stock market crash presaged an economic collapse – it did not happen; that capital was flying out of the country which presaged a currency collapse – it did not happen; that overbuilding and unsold apartments presaged a property collapse – it did not happen.

Now the focus is on debt: the bad loans in the banking system, rising debt to gross domestic product (GDP) and the warnings that China's economy is about to collapse. Debt is rising but China's economy isn't collapsing. It appears to be growing at over 6%,running a trade and current account surplus of almost $600 billion (5.7% of 2015 GDP) and still just about getting by after all that capital flight with $3.2 trillion of foreign exchange reserves. [1] China and Asia have been priced for a crisis that has not happened. In the last quarter Asian markets have moved higher and while the first move was the result of cheap valuations and improving sentiment we are now seeing economic data and earnings numbers moving in support.

Asian economic review

- China

[1] Source: China National Bureau of Statistics.

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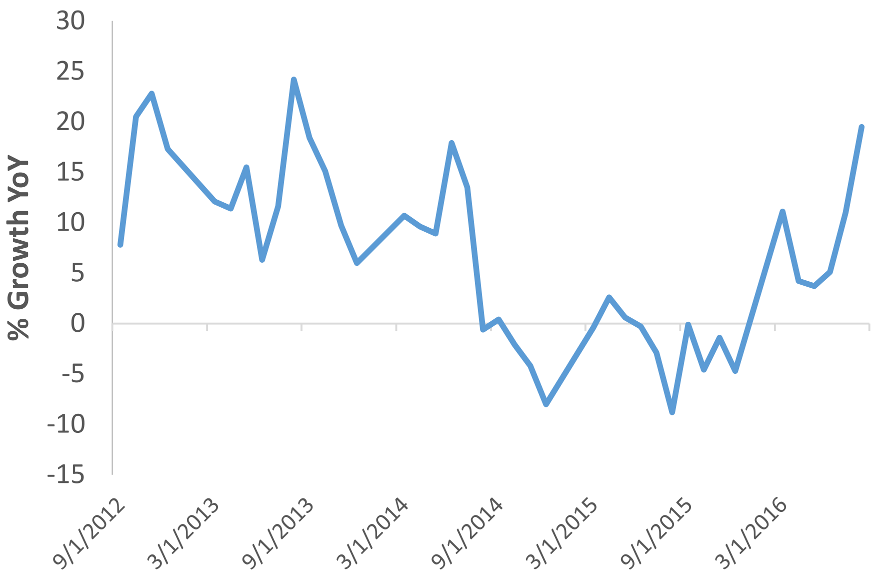
We believe The most important development has been the recovery in Chinese **Producer Price Inflation** (a measure of the prices companies charge for intermediate goods, as opposed to Consumer Price Inflation measuring the prices paid by consumers for finished goods). Producer prices have been falling in China over four years, declining at a rate of 5.9% per annum by the end of 2015. In 2016, that rate of decline has eased with prices now down 0.8% in August compared to the same time last year. We expect to see prices rises come through before the year is out. This is important because it means that industrial profits should pick up, that operationally geared business in particular will see improved conditions and that the more heavily indebted companies will see their debt burdens ease, cash flows strengthen and an improvement in their debt servicing capacity.

China's **industrial profits** have indeed picked up with the latest reading in August showing a 19.5% rise compared to August last year.

Chart 1: China Enterprises Industrial Total Profits % Year over Year (YoY)



Source: China National Bureau of Statistics as of August 2016.

Much of this growth is related to the oil and commodities sector but in spite of higher commodity prices the profits of light industry and machinery have also held up. The next question is whether this recovery will lead to renewed growth in industrial investment, one of the major factors behind China's slowing GDP growth. For the present, excess capacity in the heavy industrial sectors makes an investment rebound less likely but it makes a stabilization in investment more probable and is another step toward stabilizing GDP growth.

China **trade** figures have also delivered a positive surprise in the last quarter. Exports grew in August by 3.2% compared to July (although down year on year) but even more importantly so too did imports. In the import numbers commodities certainly played their part rising 8% compared to July but it was the jump in imported products for the processing trade i.e. technology components for assembly and onward export which rose over 12% month on month that was most notable. We have noted before that China's fundamental economic strength lies in its success in evolving its manufacturing economy from lower-end toward higher value-added products. The increasing local content in Chinese exports means that more value-add is being created in China which supports the long term goal of boosting the consumer sector in China through higher wages and consumer spending.

The **renminbi** has been stable during the quarter. This is dismissed by many as the product of government manipulation and intervention. The story that many have missed is that in the last few months *the government has not needed to intervene*. Downward pressure on the currency has eased not only because the US dollar has been comparatively stable (the US Dollar Index began the quarter at 96.1 and ended it at 95.5) but also because capital outflows have slowed significantly. **Capital flows** from China have been seriously, perhaps wilfully, misunderstood. Capital inflows in 2013-14 which drove China's **foreign exchange reserves** from \$3.2 trillion to just under \$4 trillion were the product both of a rising trade surplus but also currency speculation.[2] While the renminbi was strengthening steadily against the dollar Chinese companies borrowed dollars knowing they could repay in three years with a stronger renminbi. When the currency stopped appreciating companies repaid the dollar debt, resulting in capital outflows, bringing foreign exchange reserves back down to \$3.2 trillion. Looking at the breakdown of China's balance of payments, it is evident that this process has now played out and flows linked to foreign borrowings are now inflows not outflows.

China **bank debt** growth has slowed in recent years. In the heady days of 2005-10 credit was growing at over 25% year on year (and that does not include the 2009 response to the global financial crisis). This year it has slowed to around 10% (4% in 2013, 7% in 2014 and 9% in 2015)[3] and actually contracted in the last 3 months but with economic growth slowing the debt to GDP ratio is still climbing. We have argued before how little value can be attached to this ratio – in 2001, just before Argentina defaulted it had a government debt to GDP ratio of ~60%.[4] Those using that metric as a warning signal would not have seen it coming. Most did not. Instead we need to look in more detail: who are the borrowers, who are the lenders, how are lenders funded and what capacity is there to service the debt? We can also look to distinguish between new debt and legacy debt. And since the call that China is about to experience a debt crisis is a significant one with global economic implications, the question of Chinese debt merits a more detailed consideration than that offered in the newspaper columns.

Most of China's debt has been extended through the banking channel specifically the two policy banks, China Development Bank and Export Import Bank of China, and the four major state owned commercial banks. These are primarily owned by the government and are primarily funded by government and/or domestic depositors. China is sovereign over its banking sector – there is no dependence on external funding, there are no EU-type rules governing the provision of support and the government has the ability to control private capital flows. There has been much debate about the level of non-performing loans in the banking system. The most pessimistic estimates suggest it could be as much at 25%-30% of GDP, and these assume nothing for recovery rates. But China has deep pockets. If it came to it, the Chinese government could bail out the lot and take its government debt to GDP ratio from 50% currently to 80%. That's high (the US is 75% and the UK is 90%) but not intolerable; and China's economy is still growing faster than the US, UK and EU. A nice contrast was recently drawn by Capital Economics with the situation in Italy where non-performing loans are running at 20%, the Italian government is circumscribed by EU rules forbidding intervention (though the Germans are said to be

[2] Source: China State Administration for Foreign Exchange.
[3] Source: People's Bank of China.
[4] Source: Kiguel, M. Argentina's 2001 Economic and Financial Crisis: Lessons for Europe.

considering flouting those for Deutsche Bank), government debt to GDP is 133% and the economy is stagnating. Now that's a problem.

New debt formation is now the focus but the purposes and direction of lending are key. China cannot simply pull the plug on credit provision while the economy is still undergoing capacity cuts and deleveraging in the legacy sectors that drove growth over the last 30 years. Fundamentally this whole process is a ten year programme (and perhaps longer) rather than the 3 years that some call for. The redirection and re-training of labour and the social and political consequences of economic transformation make it wholly impractical and unrealistic to expect it to move faster. The economy needs support to generate 'good' growth and to manage the slowdown in 'bad' growth.

Policy driven economic support comes in two broad forms. Firstly financial support is delivered through the lowering of market interest rates through open market operations that have brought the Chinese government bond yields across all maturities down by 1% over the past year and through debt restructuring, for example swapping some local government bank debt into municipal bonds. Improving the transmission mechanisms for lower rates through the economy and lowering the debt burden have been crucial but less immediately visible changes. Secondly, government spending in infrastructure has prioritised useful areas including water conservation/flood prevention, rural electricity transmission networks and telecom and internet infrastructure. Interestingly, the government is also seeking to promote public-private partnerships in some of these projects. Railway spending planned for the next five years is lower than for the last five but is still substantial and is expected to come to over $400 billion for another 23,000 km (14,375 miles) of new lines.

We think This has implications for how investors should look at China in coming years. Rather than 'Buy China' for a China boom, investors may need to consider taking an active approach looking for the businesses that will thrive in an evolving economy, that are not dependent on policy-driven economic growth.

- Rest of Asia

In north Asia both **Korea** and **Taiwan** are more dependent on external demand for growth while domestic activity remains sluggish. **Exports for both Korea and Taiwan** are below 2015 levels in line with overall sluggishness in global trade but for both the declines have been becoming less severe and reaching positive year on year growth in June. **Interest rates in Korea** have been coming down since 2012 from 3.5% to 1.5% at the start of the year. In 2016 the central bank has been in watch mode and cut once more to 1.25% in June. **Taiwan interest rates** have also come down by 1% over the past 12 months with cuts amounting to 0.25% this year. Boosts in the technology sector and industrial production have still not been enough to address stagnant wages and falling property prices. But recent strength lead the central bank adopt a wait and see approach for now.

In south-east Asia, **Thailand's** growth has been driven in recent months by stronger tourism growth and improving external demand coming through from China and from Europe. A bounce in exports to 6.5% year on year in August has reduced pressure on the central bank to support growth. The policy interest rate has remained at 1.5% all year and looks unlikely to change soon. The government is expected to embark on fiscal spending supporting both infrastructure spending and consumption ahead of the elections next year. A strong Thai Baht remains an issue but the central bank has favoured intervention preferring to hold back the option to cut the interest rates in order to support growth if necessary next year.

Malaysia has seen an improvement in economic growth as the impact of earlier shocks such as the introduction of a goods and sales tax, have faded. A recovery in oil prices also helped. Investment growth has picked up (both public and private) in consequence of large infrastructure projects now underway: one is the second Mass Rapid Transit rail line running for 52 km/32.5 miles (13.5 km/8.5 miles underground) through densely populated areas to Putrajaya with 37 stations (11 underground). **Singapore** remains mired in slow growth and higher wage costs that impact upon competitiveness. Singapore's ongoing focus on controlling immigration and foreign labour is particularly to blame for its travails. Industrial production weakness is evident across the board in biomedical, transport and precision engineering segments as well as in general manufacturing. Lower interest rates seem likely and pressure on the Singapore dollar is expected to continue.

Markets

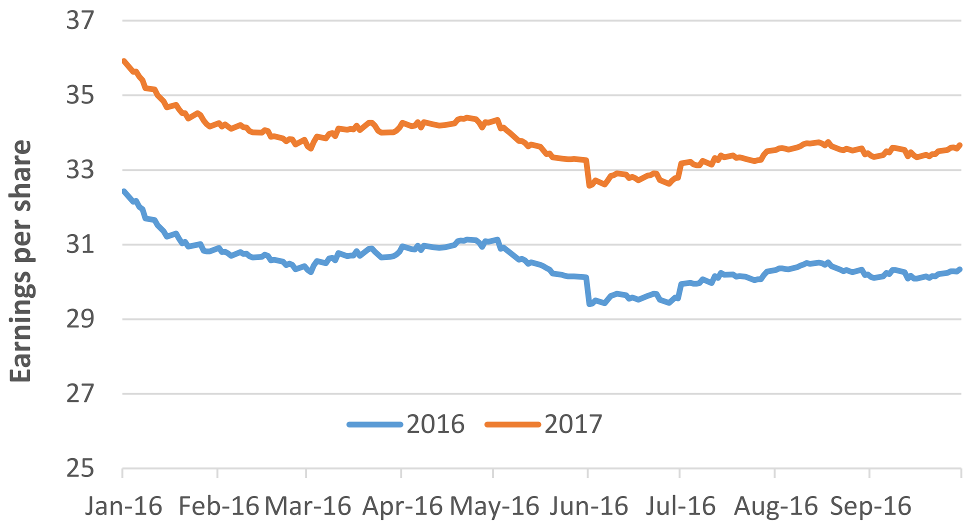
In the third quarter stock markets in the Asia Pacific region (including Australia) excluding Japan as measured by MSCI AC Pacific ex Japan Index rose 10.22% which put it on a forward Price to Earnings multiple of 14.4 times consensus estimated earnings for 2016. The best performing markets as measured by their respective MSCI country indices in US dollar terms were China +13.97%, New Zealand +13.57% Taiwan +12.34%, Hong Kong +11.94% and Korea +11.22%. The weakest markets were Philippines -4.62%, Malaysia -2.32%, Singapore +0.10% and India +5.89%. For completeness, Japan rose 9.10% in the quarter given a 2% lift in dollar terms by a stronger Yen.

Asian currencies have been steady over the quarter. The Korean Won was the strongest, up 4.6% against the dollar followed by the Taiwanese dollar up 2.9% and the Thai Baht up 1.5%. The Chinese renminbi was almost unchanged, down -0.3%, while weakness was evident in Malaysia and Philippines with the Ringgit and Peso both down 2.7%. In aggregate, on a weighted average basis Asian currencies were 0.7% up in the quarter.

By sector, markets were led by Information Technology +18.41% and Materials +14.34% followed by Consumer Discretionary +11.11%. Among the laggards were Utilities +2.74%, Telecommunication Services +2.80%, Health Care +3.39%, Industrials +5.18% and Energy +5.40%. The strength in the Information Technology sector explains the strength evident in Taiwan and, to some extent, Korea and has been a notable theme for much of the year in both emerging markets and in the US, but less so in Europe. Handheld devices still dominate but it is also apparent that after 18 months in the doldrums Notebook PC sales are picking up once again.

Earnings forecast revisions are an important short term gauge of market sentiment but need to be treated with caution over the longer term.

Chart 2: Estimated earnings for MSCI AC Pacific ex Japan Index over the course of 2016



Source: Bloomberg

Analysts tend to be over-optimistic in their estimates and the subsequent twelve months are often spent paring them back. We see this across all markets. In the case of Asia Pacific we see 2016 estimates are 14% lower than they were a year ago while 2017 estimates have come down 13.3% (Source: IBES & JP Morgan). In the last quarter however these downward revisions have moderated with 2016 estimates down 0.1% and 2017 estimates 0.4% higher. Thailand and Korea have seen the most significant upward revisions, over 3% in each case to 2016 estimates. China is the weakest down 3%-3.5% in the past quarter for 2016 and 2017 but this still a significant moderation to the pace of downgrades which, unsurprisingly are dominated by the large cap state-owned enterprises in the over-capacity sectors.

Fund performance and activity

In the third quarter the Fund rose 9.00% in USD terms compared to the benchmark which rose 10.22%. In the year to date, the fund rose 16.18% and is 2.99% ahead of the benchmark.

as of 9/30/16	3Q16	YTD	1 YR	3 YR	5 YR	10 YR
Asia Pacific Dividend Builder Fund	9.00%	16.18%	16.82%	6.04%	9.36%	6.17%
MSCI AC Pacific ex Japan	10.22%	13.19%	19.84%	2.41%	7.53%	6.64%

All returns over 1 year annualized. *Source: Bloomberg, Guinness Atkinson Asset Management*
Expense Ratio: 1.10% (net)*; 3.87% (gross)

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/GIF_performance or call (800) 915-6566.

Performance data does not reflect the 2% redemption fee for shares held less than 30 days 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 1.10% through June 30, 2017. To the extent that the Advisor waives its fees and/or absorbs expenses to satisfy this cap, it may seek repayment of a portion or all of such amounts at any time within three fiscal years after the fiscal year in which such amounts were waives or absorbed, subject to the 1.10% expense cap.

Amongst the top ten performers in the portfolio over the quarter five were in the Information Technology sector led by Largan Precision and Qualcomm (which generates over 50% of its revenues from the region). However in that group were two Chinese banks, China Merchants and China Minsheng who are both beneficiaries of brighter conditions in China. JB Hi-Fi was the third best performer over the period following a successful rights issue to fund their acquisition of home goods store The Good Guys in Australia. There was also good news from Belle International, a footwear designer and retailer in China whose stock price has suffered in the wake of tougher trading conditions. We have been adding to the position during the weakness and performance has now turned and been sustained through the last quarter and the last month as margins and same store sales growth has stabilized.

Amongst the bottom five performers over the quarter, three of the weakest were Yangzijiang Shipping, China Lilang and LPN Development. Yangzijiang was the weakest as shipping orders continue to decline but with its quality production and low debt the company will benefit when the cycle turns. China Lilang had a weak quarter following poor results at its lower level brand, L2 although the main higher margin brand is still performing well.. A designer of men's fashion, the L2 brand has struggled and the company is in the process of closing poor performing stores. LPN Development in Bangkok has seen land prices in its core area run up and this is hitting margins. The company is reluctant buy more land in this area and is presently considering whether or not to begin new developments on the other side of the city; the decision hinges on railway investment and the likely impact on property in surrounding districts. The last two were Relo Holdings in Japan and KT&G in Korea. Both stocks have performed well in 2016 and gave back some of that performance during the quarter.

Other than some modest rebalancing there has been little fund activity and no changes have been made to the portfolio.

Outlook

The Asian region, and China in particular, is one whose stock markets have been priced for a crisis that has not occurred. As we have said many times, we only need for things *not* to go catastrophically wrong and there is value. We think Every article that drums up fears of debt crisis quoting World Bank, IMF or BIS officials all contain the same message – at the current size (even after all the growth in debt) no debt crisis is imminent. They say that *left unchecked* the risk of such a crisis grows - this is not the economic equivalent of discovering fire, but is a statement of the obvious recognised by investors, bankers, company management and policy makers alike. But China is checking this but at a slower pace than many economists would like (though their record in such circumstances is hardly unblemished) in recognition of the political, economic and social realities of implementation.

We expect to see economic and market data in Asia continue to improve in coming months which are likely to be supportive of share prices into 2017. The picture is not one where all the lights are green, but one where many of the red lights are changing to amber. World trade growth is still weak but EU demand has not been impacted as severely by Brexit as was expected, prompting upgrades. The weaker Chinese currency, once the lagged effect kicks in, is likely to boost China's share of world export trade in 2017 and could provide support to GDP growth through a net exports contribution, even as heavy domestic industry continues to slow. So Chinese growth and investment is not about to take off but is less, rather than more, likely to take a tumble. Elsewhere in Asia we expect to see better trade growth support Korea and Taiwan and we expect to see domestic spending in Indonesia, Malaysia and Thailand in areas such as infrastructure to support growth. We believe All these areas lead sentiment toward upgrades rather than downgrades.

While Asian growth has factors that are becoming more supportive the region is always vulnerable to the dollar and the interest rate cycle. Asian policymakers have been using a mix of interest rate cuts, fiscal support and liquidity operations to support their economies over the past 2-3 years. A rise in US interest rates is clearly coming – November, December, next year some time, who knows? – but it will happen. However, a rapid ratcheting up of interest rates is not on the cards and we do not believe that monetary easing in the region is about to come to an abrupt halt. Bond yields in the US, UK and Europe are still abnormally low and as we have seen 'tentative' does not go far enough to describe the moves so far to normalize them.

In such a world where all of us have been and will probably continue to be blind-sided by events, we believe the best approach is to invest from the bottom up: find a good business, that has demonstrated over a long period its ability to generate returns on investment above the cost of capital in cash flow terms, that is undervalued by the market and invest in that. Then, when the world pivots once again, you know what it is you've bought and maybe that will give you a terrific opportunity to buy more.

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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 9/30/16

1	Largan Precision Co Ltd	3.29%
2	CNY Minsheng Banking - H Shares	3.23%
3	JB Hi-Fi Ltd	3.20%
4	Delta Electronics Thailand PCL /Foreign	3.14%
5	Link REIT/The	3.10%
6	Catcher Technology Co Ltd	3.10%
7	Li & Fung Ltd	3.07%
8	QUALCOMM Inc	3.06%
9	China Merchants Bank Co Ltd - H Shares	3.03%
10	KT&G Corp	3.02%

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

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

MSCI World Index is a free-float weighted index that includes 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 Emerging Markets ex Asia Index is a free float weighted index that captures large and mid-cap stocks from emerging markets excluding the Asia region.

MSCI EM Asia Europe Index is a free float weighted index that captures large and mid-cap stocks from 8 emerging markets in Asia.

One cannot invest directly in an index.

Earnings per share (EPS) is calculated as the annual net 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.

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