Guinness Atkinson
Asia Pacific Dividend Builder Fund
Managers Monthly Update – November 2016

GUINNESS ATKINSON FUNDS

Markets

We think the best and most significant news from the region has come from China with producer price deflation now ended. The return of pricing power, in part due to rising commodity prices, helps ease the capacity and debt burdens of the heavy industrial sector. Industrial profits have picked up and cash flows along with them which serves to strengthen debt servicing capacity. We can see this easing of the debt burden through reports from the banks which show a moderation in the pace of non-performing loan formation. To be clear debt and capacity issues remain and will be with us for a while yet but as we have argued consistently, conditions in China are pointing toward improvement and are a far cry from the extreme pessimism at the start of the year.

The most recent Chinese economic data show rising Purchasing managers indices that indicate rising industrial activity and confidence with a marked pickup in new orders. This same data series also indicates weaker demand from the export side. This too is a consistent story across the region. External demand, from the rest of the world, remains fragile both from the US and from Europe with the result that export numbers from China, South Korea, Taiwan, Thailand, Singapore and Malaysia are all weak. Our investment focus therefore, has to on domestic activity and on those exporters with specific competitive advantages and specialist products rather than those producing lower-value mass-market goods.

The death of the King of Thailand in October following a long illness put the country into mourning. King Bhumibol Adulyadej reigned for 70 years and was revered. His successor does not enjoy the same level of respect and in a country that has seen more than its fair share of political turbulence uncertainty has risen. However, for the present it looks as though the succession will proceed. The government (which took control following a coup) is stable and although the elections which were carded for 2017 might not now happen until 2018 the country, its businesses and its financial sector are operating uninterrupted. The stock market which fell 5% immediately following the news has recovered all its losses and indeed outperformed the region, as measured by the MSCI AC Pacific ex Japan Index in October.

South Korea has also had a difficult month with its president caught up in a political scandal and its leading company, Samsung Electronics, forced to recall and to cancel production of its new Galaxy Note 7 smartphone. The political scandal is unusual in that it concerns the heavy influence exerted by a close friend a close friend of President Park ranging from the way she dresses, to the content of speeches to the formulation of government policy as well as allegations of undue pressure placed on companies to donate substantial funds to foundations controlled by Choi in return for her political influence. The nature of this relationship has come as shock to Korean society pushing the President's approval ratings to single digits. The concern therefore is what she might do to court popularity and potential targets could be China, Japan or North Korea. This is primarily a domestic issue at present and we do not see it as long-lasting (elections are no more than a year away) but it is another factor to consider.

Our overall view on the region nevertheless remains upbeat. Markets have rallied since the middle of the year primarily on the back of low valuations and recognition that earlier fears were overdone. The next stage of the rally depends on earnings growth and upward revisions to profit forecasts. We are encouraged to see early signs that this is coming through. Drivers are likely to be primarily domestic while demand for exports overall is expected to remain weak. There are few inflationary pressures to speak of within the region to cause central banks to tighten policy and most countries that intend to increase spending on infrastructure or pursue other means to boost consumption have the funds to do so.

One inflation point that is worth bearing in mind however, is that the end of producer price deflation in China signals a weakening of the deflationary force that China has exerted globally. When added to the fact that energy prices have stabilised and base effects will soon wear off, we may see a more marked increase in inflation than is currently priced in. How much more inflationary pressure might be expected as a result of the new US President's spending plans has yet to be seen. This may not lead to significantly faster interest rate increases in the US, since Mrs Yellen has already signalled her willingness to tolerate higher inflation for longer, but financial conditions may tighten nonetheless through rising bond yields and a stronger dollar (on the back of rising interest rate expectations).

Performance

In the month of October, Asian equities fell, along with global equities. The benchmark for the fund, the MSCI AC Pacific ex. Japan Index fell 1.8% in US dollar terms, and the MSCI World Index fell 1.9%.

The only market in the region that posted a positive return—other than Japan—was Taiwan, which rose 1.4%, as measured by its MSCI country index. Performance was weakest in New Zealand, Singapore and Korea – New Zealand and Korea were two of the stronger performers in the third quarter, so it is unsurprising that some of their gains were surrendered.

On a sector basis, Materials and Energy were the only sectors to post positive performance, rising 1.7% and 0.4% respectively in October. Because of our focus on companies that have demonstrated persistent returns on capital, the fund currently has no exposure to Materials and limited exposure to Energy. Healthcare, Real Estate and Consumer Staples were the weakest sectors, with Healthcare falling 6.8%.

The best performer in the portfolio was Luk Fook Holdings, a jewellery retailer operating in China, Hong Kong and Macau. The company reported a moderate recovery in sales in September and October, adding to hopes that earnings would start to improve. Other strong performers were Hon Hai Precision, an outsourced manufacturer and assembler of consumer electronics for Apple and others, and Novatek Microelectronics, a manufacturer of chipsets used in flat-panel displays.

Weaker performers in the portfolio included KT&G, a Korean tobacco company and Belle International, a retailer of footwear in China. Both of our healthcare holdings – St Shine Optical and Sonic Healthcare – also struggled.

As we have written before, our focus within the fund is very much on individual stock selection. We pick our thirty-six best ideas and put them into an equally weighted portfolio. We typically view periods of short-term weakness in individual stock prices as an opportunity to rebalance the portfolio, recycling gains back into laggards.

Outlook

Our outlook for the region and for our approach to investing in it remains upbeat on the basis of attractive valuations and the rising prospects for profits growth. While the fund invests in quality companies, it trades on an aggregate valuation that is a substantial discount to the market, which is in turn at a discount to world equities. These attractive valuations underscore the investment opportunity that we think exists in Asia currently. We think The portfolio also offers an attractive source of potential income.

It is clear however that not every part of the market is that optimistic. Global markets appear to reflect increasing levels of uncertainty, both political and economic, with the VIX volatility index picking up in recent days. We believe that the merits of investing in quality companies at attractive valuations are clear. We are happy to hold our portfolio companies through any down cycle (they have already demonstrated the ability to generate strong returns on capital in the 2008-09 down cycle), and we will continue to rebalance the portfolio in response to market volatility, seeking to add to positions where opportunities to do so are presented. We also believe that our focus on value minimises potential valuation risk – something that could be very valuable, should markets undergo a correction.

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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 October 31, 2016

1	Hon Hai Precision Industry Co Ltd	3.27%
2	Largan Precision Industry Co Ltd	3.25%
3	Luk Fook Holdings International Ltd	3.22%
4	Taiwan Semiconductor Manufacturing Co Ltd	3.03%
5	PTT PCL /Foreign	2.97%
6	China Construction Bank – H Shares	2.95%
7	Relo Holdings Inc	2.95%
8	Asustek Computer Inc	2.89%
9	Novatek Microelectronics Corp	2.78%
10	LPN Development PCL /Foreign - NVDR	2.76%

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

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.

The MSCI Taiwan Index is designed to measure the performance of the large and mid cap segments of the Taiwan market. With 90 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Taiwan.

The VIX, or volatility Index, shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. This volatility is meant to be forward looking, and is a widely used measure of market risk, often referred to as the "investor fear gauge."

The Producer Price Index measures the average change in selling prices received by producers of goods and services. Producer price deflation indicates a decline in these prices.

One cannot invest directly in an index.