Guinness Atkinson
Asia Pacific Dividend Builder Fund
Managers Monthly Update – March 2017

Markets

Market strength in Asia has been attributed to the ongoing rebound in the domestic Chinese economy; to the recovery in commodity and materials prices (partly related to China); to a moderation in the strength of the dollar; and to an easing of some of the concerns surrounding future US trade policies. Market expectations for stronger US domestic growth are also rising which leads us toward a further increase in US interest rates.

The macro-economic environment remains just as uncertain as it was 6, 12 and 18 months ago: global debt levels are elevated as are political risks and it is possible that in such an environment any signs of renewed growth are warmly greeted not least because this eases the repayment burden of heavily indebted nations. This is especially true in China whose high corporate debt level has been widely reported. The recovery in profitability in the heavy industrial sector (where much of debt and excess capacity problems are to be found) and a return of pricing power—reflected in the producer prices index, which has gone from roughly 6% *de*flation at the end of 2015 to nearly 7% *in*flation currently—means debt servicing capacity is increased rather than lowered. We have seen a slower pace of non-performing loan formation in the banking sector and furthermore, analyst estimates of 'hidden' non-performing loans in China which were being touted at 15%-20% last year are now being scaled back by 5%-7% (Credit Suisse estimates, Feb 23 2017).

Another development that has not garnered much attention was news that China increased interest rates just after Chinese New Year. This was not a move in benchmark deposit/lending rates, which in any case have become less important since deregulation, but was a rise in short term money market rates. China's management of money market operations has shifted much further to toward market-based tools than many realise. Liquidity in the financial system is managed by the PBoC on a daily basis through the provision of a Standby Liquidity Facility and Open Market Operations using short term instruments known as Repurchase Agreements (Repos). In this they are using similar tools to central banks in developed markets.

The supply and pricing of liquidity in the financial system is managed using these tools with the most active being those with maturities ranging from 1 day through to 1 month. The cost of money day-to-day lies within an interest rate corridor with the higher rate being that associated with the Standby Liquidity Facility and the lower rate associated with the repo rate of similar maturity. This market-based system allows the central bank to transmit its desired level of interest rates into the market. The rates on the corridor have moved 0.1% higher this month. This increases banks' funding costs and appears to have been a market-based solution to tackling a nascent bubble in China domestic bond markets which has largely been driven by bank buying.

This may seem rather uninteresting at first glance but it is axiomatic of the way China's economic system is evolving. At the heart of China's investment boom/excess capacity/debt problem has been the poor capital allocation, capital pricing and lending practices by the banks. A move to a market-based system has to happen before this can be resolved – everyone has been calling for it; China's apparently slow response has been given as a reason not to invest there and yet, here it is. The problem of China's financial plumbing is being addressed.

The response is one of several instances of where gradual steps have been taken to resolve problems that have built up over time. Last year, cooling measures were introduced to tackle a overheating housing market, which had seen prices in 'tier one' cities (Beijing, Shanghai, Guangzhou and Shenzhen) boom. The measures, including restrictions on second home purchases and requiring borrowers to put greater deposits down, appear to have had an impact: the worst of the excesses have been kerbed and inventories have begun to reduce.

We are not suggesting that all has been resolved in the country but we do argue that a blanket decision not to invest in anything Chinese is both dogmatic and short-sighted.

Company news

In the past month, and for the year to date we have seen good performances coming from Chinese retailers Belle International (women's shoes) and China Lilang (menswear) following evidence of stronger consumer sentiment during and after Chinese New Year. Technology names have also been strong. Smartphone suppliers like Largan Precision, AAC Technology and Catcher Technology have done well but so too have Delta Electronics Thailand (power supply systems) and Novatek (display chip designer). The latter two both reported results that were better than expected.

Banking stocks have also had a good run this year. Chinese banks have been lifted for the reasons discussed above but so too have the likes of DBS in Singapore, BOC Hong Kong in Hong Kong and Tisco Financial in Thailand. In the first two cases this is related to rising interest rate expectations which, it is hoped, will feed through into widening interest spreads and hence profitability. In the case of Tisco, the rise is specific to them and relates to stronger growth in their consumer lending business following the acquisition of the consumer loan book from Standard Chartered Bank as well as strong recent results.

On the weaker side we have St Shine Optical and LPN Development in Thailand. St Shine's biggest client, in Japan, has seen competition heat up with the arrival of a local new entrant in the contact lens market whose products are produced by another Taiwanese lens maker but who has come in with a substantial market push including celebrity endorsements. This, we think, is likely to be a transitory issue and the more important issue for St Shine is currency exposure with recent Yen weakness against the dollar having an impact on product pricing. In St Shine's case we need to watch the exchange rates of both the Yen and the Taiwanese dollar against the US dollar. This however, is not new territory and St Shine is also building up new customers in China but we think that growth from this area is unlikely to become visible until later in 2017.

LPN Development is a builder of lower priced apartments in and around Bangkok and has recently experienced slower sales growth as well as having a lower backlog of future developments. Management is known to be conservative which partly accounts for the good and steady return on capital profile but they do now need to increase the number of projects coming through. At its recent results meeting, management targeted 135% pre-sales growth which we believe is achievable and should set them up for stronger revenue growth (revenue is recognised on delivery of the apartments, not their pre-sale) in 2017/18. The company has shifted its focus further into town with mid- to higher-end apartments and smaller overall project sizes to increase throughput.

Outlook

The portfolio as it stands today is trading on a price/earnings valuation discount of 13% to Asia (MSCI AC Pacific Ex-Japan Index, the fund's benchmark) which in its turn is at a 30% discount to developed markets (the MSCI World Index). All of these companies are high quality businesses as we define the term (historically high and sustained return on invested capital) that we believe are well positioned to cope with greater global uncertainty.

While it is reasonable to be concerned about the world at large we still believe it is more useful and worthwhile to worry about our companies. Can they continue to generate the superior returns on investment that they achieved in the past? How will policy changes and new international relationships impact upon that ability? How will we value the shares of these companies in the light of possible changes to interest rates, inflation expectations or tax changes? By asking these questions and thinking about our investments in this way we think we can find good quality businesses at the right price. And we think that's exactly what we have.

Edmund Harriss (portfolio manager)
Mark Hammonds & Sharukh Malik (analysts)

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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.

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.

You cannot invest directly in an Index.

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

Past performance is not indicative of future results.

Top Fund Holdings as of 02/28/17

1	Belle Intl Hldgs Ltd	2.92%
2	Tisco Financial Group PCL/Foreign	2.88%
3	Relo Holdings Inc	2.87%
4	Hanon Systems	2.87%
5	Aflac Inc	2.87%
6	Lilang China Co	2.85%
7	KT&G Corp	2.85%
8	Delta Electronics Thailand PCL /Foreign	2.84%
9	Yangzijiang Shipbuilding Holdings Ltd	2.83%
10	Ascendas Real Estate Investment Trust	2.82%

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

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