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

Summary Review and Outlook

Markets
- Asian markets accelerated in July, rising 5.0% (Source: Bloomberg) in the month (in USD)
- July was the second strongest month for Asian markets so far this year

Earnings
- Consensus forecasts currently expect Asia to grow earnings by 31% this year (Source: Bloomberg)
- Korea is forecast to grow earnings by 56%, driven in part by Samsung Electronics, which is forecast to have a very strong recovery in earnings (Source: Bloomberg)
- Earnings estimates have been revised up over the course of the year
- The combination of robust growth and positive revisions has led to the impressive rally Asia has experienced

Information Technology
- Information Technology remains the best performing sector in Asia this year and is also the top sector within global developed markets
- The China internet stocks—Tencent, Alibaba and Baidu—as well as Samsung Electronics have been significant contributors to the benchmark's (MSCI AC Pacific ex-Japan) returns
- While these companies do not meet the fund's criteria for inclusion, our holdings in Information Technology have been among the best performers in the portfolio

China
- China's financial markets have been undergoing a process of liberalization
- Inclusion of A-shares in the MSCI Emerging Markets Index will have a modest impact initially, but one that could grow meaningfully over time
- The introduction of the Bond Connect program, which has gone unnoticed by many, marks a significant step towards the opening of China's markets

Outlook
- Asia still trades at a sizeable discount to developed markets
- The portfolio – with its bias towards quality – trades at a further discount, and offers an attractive dividend yield
- Investors seem to have set aside their concerns recently, but risks remain, both for developed markets and also for Asia
- In an uncertain environment, we believe it is crucial to focus on quality. We invest in companies that have a track record of generating persistent returns on capital

Monthly review

Asian markets were very strong in the first half of the year, and that strength accelerated in July. The market gained 5.0% in the month (in USD), making it the second strongest month so far this year. (Source: Bloomberg)

Earnings

A significant driver of the returns in Asia this year has been an improved outlook for earnings. Consensus forecasts currently expect Asia (as reflected by the MSCI AC Pacific ex Japan Index) to grow its earnings by 31% this year and 9% next year. This performance should be seen in the context of a weak 2016, when earnings fell 13%. This recovery in earnings has been fairly broad-based, with many individual countries also forecast to grow earnings at an impressive rate. Korea, for example, is forecast to grow earnings by 56% (MSCI Korea Index). While Samsung Electronics, discussed below, accounts for a lot of this (the company is expected to grow earnings by 91% and represents more than 30% of the index when preferred shares are included), Korea excluding Samsung is still expected to offer some of the highest earnings growth in the region.

While analysts generally have a habit of starting the year with an optimistic growth forecast, then slowly reducing it over the course of the year, this year we have seen the opposite; earnings revisions have been positive.

It is this combination of robust growth and positive revisions that has led to the impressive rally this year.

Information Technology

The standout sector this year has been Information Technology, which, as the best performing sector within Asia, has risen 47.2%. This trend has also not been confined to the region – it has also been the best performing sector within global developed markets.

We have written about the sector already this year, during its positive run. Looking among Information Technology companies, some of the greatest contribution to the benchmark has come from the 'China internet' stocks: Tencent, Alibaba and Baidu. We don't own these names in the portfolio – their contribution to income is either insufficient or non-existent – but their sizeable weight in the benchmark has a strong influence over its returns.

Another company that has driven the benchmark returns has been Samsung Electronics. While there is plenty to admire about the company and its achievements, Samsung does not qualify for our investment universe as it has not achieved persistently high returns on capital. Some of the industries in which the company operates are highly capital-intensive, such as the manufacture of memory chips. Indeed, it has been a part of the company's strategy to make large capital investments with the aim of eventually dominating the supply of a particular product or component. A recent example of this is the announcement of 20 trillion won ($18bn) of investment in its Pyeongtaek semiconductor manufacturing facility.

Our investment process focusses heavily on the cash returns generated by Asian companies, and the capital investment required to generate them. The requirement for a company to have achieved persistently high returns on capital for eight consecutive years leads us to a universe of around 300 companies, with a number of those in the Information Technology sector.

Of our portfolio of 36 companies, nine are in the Information Technology sector, operating in a range of industries from consumer electronics manufacture and assembly to component manufacture and semiconductor design and fabrication. Several have been among the portfolio's top performers this year, including Catcher Technologies (+66.0%; smartphone casing), Largan Precision (+55.7%; smartphone camera lenses), Hon Hai (+55.3%; product assembly), and AAC (+50.2%; acoustic and vibration components). In contrast, the worst performing Information Technology stock has been Qualcomm (–16.8%; chip designer). Qualcomm's share price has struggled this year with the company's dispute with Apple, its customer, over royalties.

China

China is on a journey to liberalize its financial markets. While the ride is not always smooth, the direction of travel is clear. In recent months, two significant developments have advanced the liberalization of China's markets, though one seems to have escaped much attention.

In June, MSCI announced its decision to include Chinese A-shares in its Emerging Markets benchmark from next year. Initially, this will be implemented modestly; for the 222 companies that will be admitted, only 5% of the free float market cap will included and the resulting weight in the benchmark of the A-shares will only be about 0.7%. However, if the experience of Korea and Taiwan is anything to go by, this 'inclusion factor' could rise significantly over the coming years, leading to meaningful capital inflows. (We published a detailed discussion of the MSCI decision shortly after it was announced – please visit www.gafunds.com/resource-insight-center and download the bulletin China A shares into MSCI benchmarks or contact us directly.)

One of the key developments that allowed A-shares to be accepted by MSCI for inclusion has been the Stock Connect programs linking the Hong Kong and Shanghai and Shenzhen stock markets. The program has made domestic Chinese shares far more accessible to offshore investors (in addition to adding to demand for Hong Kong listed shares by onshore Chinese investors).

The development in July that many overlooked was the announcement and launch of a similar scheme for the fixed income market, the Bond Connect program. China has the world's third largest bond market, behind the US and Japan, but foreign ownership of domestic bonds has so far been very low. The Bond Connect will make it easier for foreigners to own bonds, while potentially being a key contributor of capital inflows. Again, if the experience of Korea and Taiwan is anything to go by, the opening up of domestic bond markets represents a significant milestone in financial market liberalisation.

The analogue of the MSCI emerging market indices for bonds are the JP Morgan EMBI indices. A decision to include Chinese onshore bonds within emerging market bond indices would again represent a very important step on China's ongoing journey.

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Portfolio

The best performing stocks in July were Yangzijiang Shipbuilding, which rose 20.7%, JB Hi-Fi, an Australian retailer of home consumer products, which rose 15.7%, and Largan Precision, a manufacturer of smartphone camera lenses, which rose 14.1%. Industrial and Commercial Bank of China and China Merchants Bank were also strong performers as they were less affected by the current deleveraging drive within the banking system.

Over the past few years the demand for new ships has fallen significantly as a result of oversupply in the shipping industry and extremely low shipping rates. However, orders for new ships seem to be picking up, and we are seeing demand particularly for new bulk carriers and tankers rather than LNG carriers. Industry data indicates that of the eight orders globally for bulk carriers in July, seven went to Yangzijiang. This is no accident and we maintain our view that Yangzijiang is a quality company. As we have said in the past, it is quite remarkable that in the cyclical shipbuilding industry, Yangzijiang has managed to generate a return on capital above its cost of capital throughout the cycle.

The weakest stock was Sonic Healthcare, a provider of medical diagnostics services in Australia, whose share price fell 4.3%. Other weaker performers were Catcher Technology, a Taiwanese company which manufacturers metal casings for smartphones, which fell 4.1%, and Qualcomm, which fell 3.7% as a result of its legal dispute with Apple.

Outlook

Back in June we noted that the MSCI AC Pacific ex. Japan Index was almost neck-and-neck with the S&P 500 Index from the end of the third quarter to the end of May. Now Asia is 4.5% ahead.

Despite the strong recent performance, Asia still trades at a sizeable discount to developed markets, and the portfolio – with its bias towards quality – trades at a further discount. Partly reflecting this, the portfolio companies offer an attractive dividend yield, diversified across multiple currencies.

As is often the case in a bull market, investors seem to have set aside their concerns, with measures such as the VIX index indicating a high degree of complacency. As the markets hit new highs, valuations in the US in particular look more and more stretched. But while we think Asian valuations are attractive, the region is not without its own risks and difficulties. In part, these represent known problems. We have written many times about the economic transition that China is going through: shifting away from investment towards consumption, restructuring industries with excess capacity and dealing with the build-up of bad debts in these sectors. But there are also problems that are harder to predict; geopolitical interventions, either locally or internationally, can rapidly change the outlook.

Given this uncertain environment, we think the best response is to focus on quality – companies with persistently strong track records. Such businesses have often thrived despite the economic challenges that were thrown at them in the past, and we hope they will continue to do so in future.

Edmund Harriss and **Mark Hammonds** (portfolio managers)
Sharukh Malik (analyst)

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 investments diversified among various sectors.

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 AC Asia ex Japan Index consists of the following 10 developed and emerging market country indexes: China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand.

Bond Connect is a new mutual market access scheme that will allow investors from Mainland China and overseas to trade in each other's bond markets through a market infrastructure linkage in Hong Kong, as announced by the People's Bank of China (PBC) and Hong Kong Monetary Authority (HKMA) on 16 May 2017

Stock Connect programs refer to Shanghai Connect and Shenzhen Connect.

Shanghai Connect is a securities trading and clearing links program developed by Hong Kong Exchanges and Clearing Limited (HKEX), Shanghai Stock Exchange (SSE) and China Securities Depository and Clearing Corporation Limited (ChinaClear), aiming to achieve a breakthrough in mutual market access between the Mainland and Hong Kong.

Shenzhen Connect was launched on 5 December 2016. Shenzhen Connect also applies similar program principles and design, aiming to achieve a breakthrough in mutual market access between the Mainland and Hong Kong

JP Morgan EMBI indices are a suite of indices that track bonds in emerging markets.

EMBI (Emerging Market Bond Index) is a benchmark index for measuring the total return performance of international government bonds issued by emerging market countries that are considered sovereign (issued in something other than local currency) and that meet specific liquidity and structural requirements.

VIX Index or CBOE Volatility Index is the Chicago Board Options Exchange (CBOE) Volatility Index, which is a measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

Opinions expressed are subject to change, are not a guarantee and should not be considered investment advice.

One cannot invest directly in an Index.

Past performance is not indicative of future results.

Top Fund Holdings as of 07/31/17

1	Largan Precision Co Ltd	3.25%
2	Yangzijiang Shipbuilding Holdings Ltd	2.98%
3	JB Hi-Fi Ltd	2.92%
4	Hon Hai Precision Industry Co Ltd	2.85%
5	The Link REIT	2.83%
6	Relo Holdings Inc	2.83%
7	Ascendas Real Estate Investment Trust	2.83%
8	Delta Electronics Thailand PCL /Foreign	2.80%
9	Catcher Technology Co Ltd	2.79%
10	Industrial & Commercial Bank of China Ltd - H Shares	2.79%

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