Guinness Atkinson

**Asia Pacific Dividend Builder Fund**

Managers Monthly Update – January 2018

GUINNESS ATKINSON FUNDS

**Summary Review & Outlook**

**Fund & Market**

- The past month has seen Asian markets rise strongly with the MSCI AC Pacific ex Japan Index rise 6.99% in US dollar terms.
- These conditions do not suit this Fund's particular style and thus it lagged the market by 2.51%.
- The best performing sectors were China Energy, Korea and Singapore Industrials, China Technology and China Financials. Amongst countries, China was the standout winner rising over 12% in dollar terms followed by Thailand and Malaysia.
- We would not expect to outperform in these conditions and although the Fund has lagged in January, it is still in touch with broad market. On occasions of market weakness at the end of the month the Fund demonstrated defensive qualities as we would hope.
- In the month, all four of our Chinese banks were outperformers, beating the market by 7% or more in dollar terms. We also saw good contributions from Australian retailer JB Hi-Fi, Thai energy company PTT, Taiwan technology companies Novatek and Taiwan Semiconductor, and from Chinese shipbuilder Yangzijiang.
- The Malaysian ringgit, Thai baht and Chinese yuan were the nest performing currencies; the Korean won and Philippine peso were the weakest.
- The prices of Brent crude oil and Gold both rose 3%, which was in line with dollar weakness.
- Twenty two of the thirty-six stocks lagged the market mostly because they are lower beta names so less sensitive to market movements. There were a couple of stocks however that are facing headwinds. Luk Fook jewelry reported decelerating growth in same store sales in China and guided next year's growth at ~8% compared to earlier forecasts of ~14%, which disappointed the market. Li & Fung was weaker on macro concerns following a more aggressive trade stance from the US following the imposition of tariffs on Chinese-made solar panels and domestic appliances.

**Fund performance**

| as of 1/31/2018 | YTD | 1 YR | 3 YR | 5 YR | 10 YR |
|---|---|---|---|---|---|
| **Asia Pacific Dividend Builder Fund (GAADX)** | 4.48% | 36.82% | 13.69% | 9.11% | 5.90% |
| **MSCI AC Pacific ex Japan** | 6.99% | 39.05% | 12.72% | 8.60% | 6.88% |

All returns over 1 year annualized. *Source: Bloomberg, Guinness Atkinson Asset Management*

Expense Ratio: 1.11% (net)*; 3.14% (gross)

Guinness Atkinson

**Asia Pacific Dividend Builder Fund**

Managers Monthly Update – January 2018

*Performance data quoted represents past performance; past performance 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. Performance data current to the most recent month end may be obtained by calling 800-915-6566 and/or visiting www.gafunds.com. 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. Total returns reflect a fee waiver in effect and in the absence of this waiver, total returns would be lower.*

**Events in January**

- US bond yields rose and the dollar weakened. The US Government 10 Year yield rose from 2.5% to 2.7% and by Feb 2nd it reached 2.84%. At the same time the dollar weakened on trade-weighted basis by 3.2% (as measured by the DXY Dollar Index which is made up of EUR 57.6%, JPY 13.6%, GBP 11.9%, CAD 9.1%, SEK 4.2% and CHF 3.6%).
- The US announced punitive tariffs on Chinese-made solar panels and domestic appliances. This follows a generally more active stance on trade matters with respect to NAFTA. The Chinese response so far has been noticeably muted.
- In light of the weaker dollar the Chinese currency has been allowed to appreciate briskly against the dollar by 3.4%, to its strongest level since July 2015. On a trade weighted basis, the Chinese currency is effectively unchanged over the month.
- In the technology sector, the smartphone related companies are seeing share price pressure on weaker demand in both Chinese smartphone and iPhone X demand. Channel checks suggest that Apple is expecting more moderate demand and is thus scaling back orders for components. This is not new news and many of these stocks have been pricing this in since November.

**Outlook**

- Asian stock markets are well supported by earning's growth and macro-economic momentum supported by domestic activity (particularly in China, Singapore and Thailand) and by global growth which is looking brighter than it has for many years.
- We must expect that reported earnings growth will decelerate in coming months. This is a mathematical certainty as the comparisons will be made against a higher base.
- Valuations in Asia for the most part remain supportive, especially for those businesses with a profile of consistent profitability. We are cautious on those stocks in the cyclical sectors driven by macro-factors especially those exposed to industrial commodity prices, like the steel makers.
- We expect to see US interest rates move toward normalization and we are already seeing the bond market move more quickly. This may remove the need for the Federal Reserve to move faster but the effects will almost certainly be felt in the equity markets.
- The best defenses: focus, as we do, on those companies whose return on capital has been sustained above the cost of capital because less of their investment value will be eroded by a higher

discount rate; focus, as we do, on companies with only moderate debt levels with the ratio of debt to equity no greater than 1.

**Discussion**

**Asian earnings consensus forecasts** were upgraded a further 2.2% for 2018 and 2019 for the MSCI Asia Pacific ex Japan index. Chinese and Singaporean markets saw the biggest moves, up 3% and 2% respectively. Over the past twelve months amounts to a 16% upgrade to China estimates and 5% upgrade to Singapore. Downgrades to forecasts in January were for Taiwan, Philippines and India. Australian and Korea earnings estimates were unchanged for 2018 and up slightly for 2019.

We think that Asian markets will now be much more focused on the outlook for earnings. In the past eighteen months it is our opinion that market moves have been driven primarily by an excessively low valuation relative to both Asia's history and to developed markets. Reported earnings growth has been strong in the past year and this has provided support to the rally but now we think investors are looking ahead for reasons to continue to buy.

Upgrades to **China** have been significant as has China's equity market performance. We continue to remind readers that A share (Shanghai and Shenzhen) market performance is not the best guide to assessing China's economic well-being. Instead, these markets tend to be more responsive to short term liquidity conditions and this is especially true of the Shenzhen stock exchange. But China is doing well:

- Economic growth momentum is evident with overall growth of 6.9% in 2017 vs 6.7% in 2016.
- Rising commodity prices are a benefit for China because it allows materials producers to raise prices
- Pricing power for heavy industry and 16% growth in industrial profits improves the debt servicing capacity of the more heavily indebted sectors
- Higher debt servicing capacity has also been evident in slowing non-performing loan formation in the banking sector
- There is now evidence that intensified efforts at financial reform are proving effective and not destabilizing as some feared; credit growth has slowed this year and deleveraging in the banking sector is being enforced.
- Domestic confidence is higher as evidenced not only in retail sales and the real estate sector but also in the reduction in capital outflows which has been accompanied by renminbi strength against the dollar to 2015 levels.

**Singapore** upgrades are less significant to the world but are interesting nevertheless. The country is developed market and has been in the economic doldrums for a number of years. Production costs are higher there and so the goal has been to find a replacement for the electronic manufacturing segment that drove growth in the years before the financial crisis. Policy missteps, possibly the greatest being the controls on immigration, forced wage costs sharply higher and further eroded competitiveness. It also had an impact on the property market which eroded domestic confidence through a negative wealth effect.

The Singapore dollar declined against the US dollar from mid-2014 to the end of 2016 after strengthening fairly steadily over the previous 13 years.

However, conditions have begun to change for the better. The shift into healthcare (biotech and pharmaceuticals) is now paying off. Singapore's financial services, especially in asset management and wealth management have gained critical mass. Macro-economic data show a recovery in industrial production and non-oil exports. Consumer confidence which has been fragile is now showing signs of firming and the Singapore dollar strengthened 8.5% in 2017 and has risen a further 1% in January.

**Portfolio activity**

We have kept the portfolio composition unchanged in January but with flows into the Fund we have been able to effect rebalancing. Example beneficiaries of this have been Luk Fook, KT&G and Li & Fung. These stocks have all been underperformers this month as market attention has been elsewhere which represents a good opportunity to top up assuming we are correct in our two base assumptions which are firstly, these businesses are likely to sustain their 8%-or better cash flow return on investment (CFROI) and secondly, that the market undervalues that likely persistence.

**Luk Fook**, as we mentioned earlier, has underperformed because same store sales growth in its China jewelry stores has slowed by more than investors had expected. This growth slowdown has been in their sales of gem sets which are higher margin, but we regarded this as almost inevitable given the previous growth rate was unsustainable. The concern now is that with more growth coming from lower margin gold products we will see an overall reduction in profitability. However, it is our view that margin decline expectations have been overdone and second, if inflation becomes an issue we expect to see gold prices pick up which will benefit Luk Fook. We have already a 3% rise in the gold price this month and so we consider Luk Fook's share price drop to a be knee-jerk reaction and we are buyers.

**KT&G** is a Korean tobacco name we like that comes in and out of favor, but its profitability has been consistent. In recent months the share price was boosted by the launch of its "heat not burn" tobacco product but some are now saying this will still result in market share loss for KT&G, margin compression due to higher production costs and marketing expenses and that it will take longer to achieve scale economies. These views have contributed to the 16% drop in the share price since its mid-November peak. We take heart from recent management guidance of a faster national roll-out this year, from signs of faster consumer acceptance of the products and additionally from managements improved dividend policy which (let's not overstate it) is more shareholder friendly by ensuring a minimum 40% of profits will be paid out as dividends.

**Li & Fung** is a stock we have written about many times before. The company acts as a middle-man between manufacturers in Asia and retailers in the US and Europe. In recent years it's business has been squeezed by slower developed market demand and by the disintermediating effects of technology. Li & Fung therefore has to reinvent itself to some degree and re-focus on the service element of its business and to divest itself of direct production activity. Their aim is to provide a product design, sourcing, production and shipping service that will reduce the time between product concept and final delivery from around 40 weeks to 20. They are making good progress and the share price rallied last year. It fell back on President

Trump's imposition of tariffs on solar panels and white goods; investors worry whether broad trade relations are about to deteriorate. We believe not and that the share price weakness is an opportunity.

**Summary and conclusion**

The portfolio is trading on a price/earnings multiple basis, at a 10% discount to the market as measured by the MSCI AC Pacific ex Japan Index. This index is in turn trading at a wider discount to developed markets than its ten-year average. A combination of above average companies in our opinion, paying above average dividends and trading on a below-average valuation seems to us to be an attractive one.

**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 region, excluding Japan consisting of Australia, China, Hong Kong, Indonesia, Korea, Malaysia, New Zealand, Philippines, Singapore, Taiwan, and Thailand.

DXY is the US Dollar Index and indicates the general international value of the US Dollar. It does this by averaging the exchange rates between the USD and major world currencies. The Intercontinental Exchange Inc (ICE, which operates global commodity and financial products marketplaces) computes this by using the rates supplied by some 500 banks.

One 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.

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 01/31/18

| | | |
|---|---|---|
| 1 | JB Hi-Fi Ltd | 3.30% |
| 2 | China Construction Bank Corp - H Shares | 3.24% |
| 3 | St Shine Optical Co Ltd | 3.11% |
| 4 | China Merchants Bank Co Ltd - H Shares | 3.04% |
| 5 | PTT PCL /Foreign | 3.02% |
| 6 | DBS Group Holdings | 2.88% |
| 7 | Novatek Microelectronics Corp | 2.86% |
| 8 | Sonic Healthcare Ltd | 2.85% |
| 9 | Industrial & Commercial Bank of China Ltd - H Shares | 2.83% |
| 10 | China Mobile Ltd | 2.82% |

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

Distributed by Foreside Fund Services, LLC.