

## **Fund and Market**

- Following the consistent positive advances in Asian markets in 2017, we saw the return of more volatile conditions in 2018.
- The market moved in four clear phases in the first half of the year: a sharp rise in the so-called ‘melt-up’ in January, a swift drawdown in early February as volatility returned, choppy sideways trading from March to May, and a further sell-off in June as global trade tensions escalated.
- We believe the underlying earnings and dividend growth outlook for these companies in 2018 and 2019 to be positive, but ongoing macro concerns around trade in particular mean it is valuation multiples that have been most affected.
- We differ from other income funds by beginning not with the dividend but instead on the ability of companies to generate and sustain cash-based profits from which the dividend is a natural outcome. We therefore seek a total return outcome with income growth a meaningful element alongside profit and capital growth.
- Asia looks very attractive relative to developed markets, offering a combination of strong earnings growth and modest valuations. The Asia Pacific Dividend Builder Fund trades at a discount to the market (as measured by MSCI AC Pacific ex Japan Index), has double-digit earnings growth forecast, and yields more than the benchmark.
- Risks are ever-present: trade tensions, geopolitics, and normalizing interest rates are perhaps the most salient. However, for the long-term investor, the fundamental themes of manufacturing improvements, lifestyle upgrades and developing services industries are more pertinent – these are the themes that will drive long-term returns.

## **Events in 2018**

- Trade tensions dominated the news headlines for much of the first half of the year, with the announcement of steel and aluminum tariffs by the US. A temporary exemption to Canada and Mexico was granted on the grounds of renegotiating NAFTA provisions.
- Attention then turned squarely towards China. The strident views expressed by President Trump were initially met by China with a more conciliatory tone and dialogue ensued between both sides (leading the US Treasury Secretary at one point to declare that the trade war was “on hold”). But towards the end of the period, relations deteriorated as both parties’ views seemed some distance apart. The result was the announcement by the US of a 25% tariff to be applied to \$34bn of Chinese imports, with another \$16bn likely to follow. China retaliated by imposing tariffs of an equivalent size.
- China continued its deleveraging efforts to reduce excesses and vulnerabilities in the financial system.

- A historic summit was held in Singapore in June between President Trump and Kim Jong-Un which led to the signing of a joint statement committing to denuclearization of the Korean peninsula.
- The Malaysian election yielded a surprise result with the victory of Mahathir Mohamad, the 92-year-old former Prime Minister. He defeated Najib Razak who had become embroiled in the 1MDB scandal.
- Indonesia hiked interest rates several times after experiencing currency weakness and outflows.

### **Investment process summary**

We look for companies that have sustained competitive advantages over their peers which we measure using return on capital over a multi-year time horizon. We define our investment universe of around 300 companies as those that have achieved a return on capital that is persistently above the cost of capital over the past eight years.

Within our universe of 300 companies, we seek those where the market is undervaluing their future cash flows. Because the companies in the universe are both consistently profitable and typically have good opportunities to deploy capital, they are often able to reward shareholders with a dividend that grows over time.

By focusing on quality, value and dividends, we stand to benefit from three sources of total shareholder return: earnings growth, multiple re-rating and dividend income. For any given individual stock, the balance between these elements may vary, but we believe all three are important for overall returns.

We maintain a concentrated portfolio of 36 positions, all equally weighted. Our portfolio discipline ensures that if we want to buy another position, we first have to sell an existing holding. We rebalance the portfolio periodically, in order to benefit from market volatility.

### **Portfolio Positioning and Outlook**

Since hitting a high on January 26<sup>th</sup>, markets have been weaker and more volatile, but we are yet to see substantial negative revisions feeding through into corporate earnings estimates. In fact, earnings expectations remain robust, with solid growth currently forecast for 2018 and 2019. Thus, weakness is a result of multiple contraction – driven more by sentiment – rather than a direct result of deterioration in the underlying fundamentals.

Asia has looked attractive as a region both on an absolute basis and on a relative basis for some time, and the recent pullback, we think, represents a good buying opportunity. Asia trades at a 16% discount to developed markets on a price/earnings basis. This discount (based on forecast earnings) has been wider

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in the past, but because earnings growth has been a significant driver of the strong rise in Asian markets over the past couple of years, Asia remains attractive from a valuation point of view.

The portfolio is even more attractively valued, trading at a further 7% discount to the benchmark on forecast earnings. In aggregate, the portfolio trades on only 11.9x 2018 earnings and 10.8x 2019 earnings, implying 10% earnings growth.

As you would expect, given the fund's investment process, the average return on capital of the portfolio is substantially above the market average, and from an income perspective, the net yield of the portfolio is higher than both the benchmark and many other regions around the world. Furthermore, the companies in the portfolio have a good track record of growing their dividends – on average over the past five years they have grown them at more than 10% *per annum*. Last, balance sheets are strong, with the average net debt to equity ratio for non-financials at –12% (i.e. net cash).

If an individual company had these metrics, we doubt it would go unnoticed by investors for long (and the portfolio, of course, has the added benefit of offering diversification across sectors and geographies).

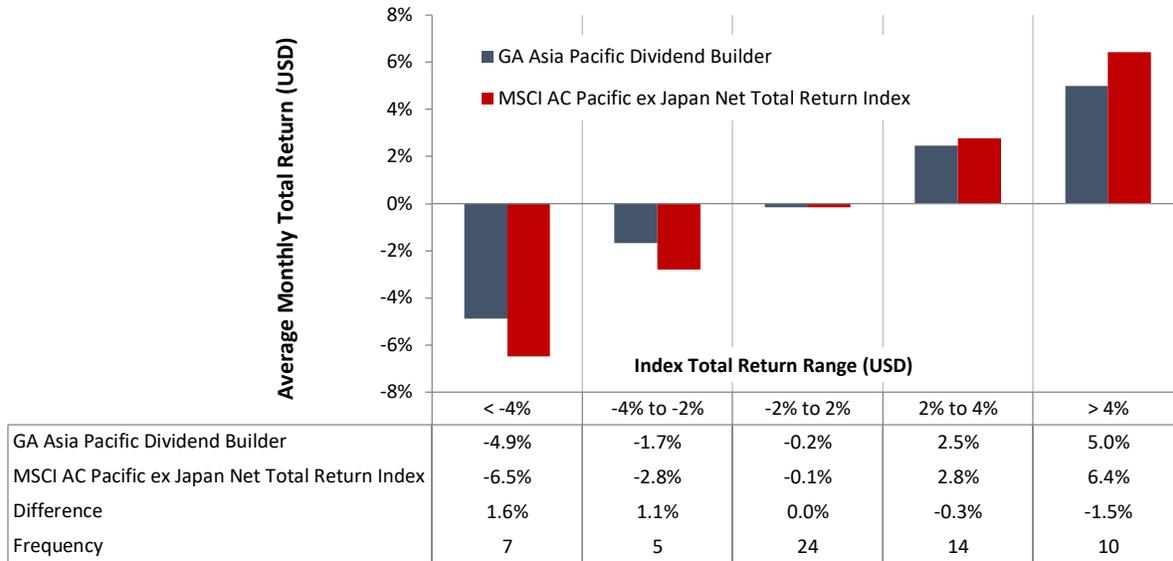
Investors in Asia have many risks to consider (of course, they are not alone in this respect). Conflicts over trade policies seem unlikely to be resolved in the near term (we write more about this below), the path of interest rate rises in the US could accelerate, and economic data, while robust, is not quite as strong as previously. But many of these factors are short-term in nature. We believe it is the more fundamental themes of manufacturing improvements, lifestyle upgrades and developing services industries that will drive Asia's growth (and shareholder returns) over the long term.

**We believe our focus on quality companies, defined by their cash flow-based returns on capital, will continue to provide a highly desirable combination of defensiveness and growth.**

## Performance

The chart below shows how the Fund has performed in weaker or strong market conditions over the five years to June 30, 2018. The tendency has been to capture most of the gains in strongly rising markets while offering greater downside protection in weaker conditions:

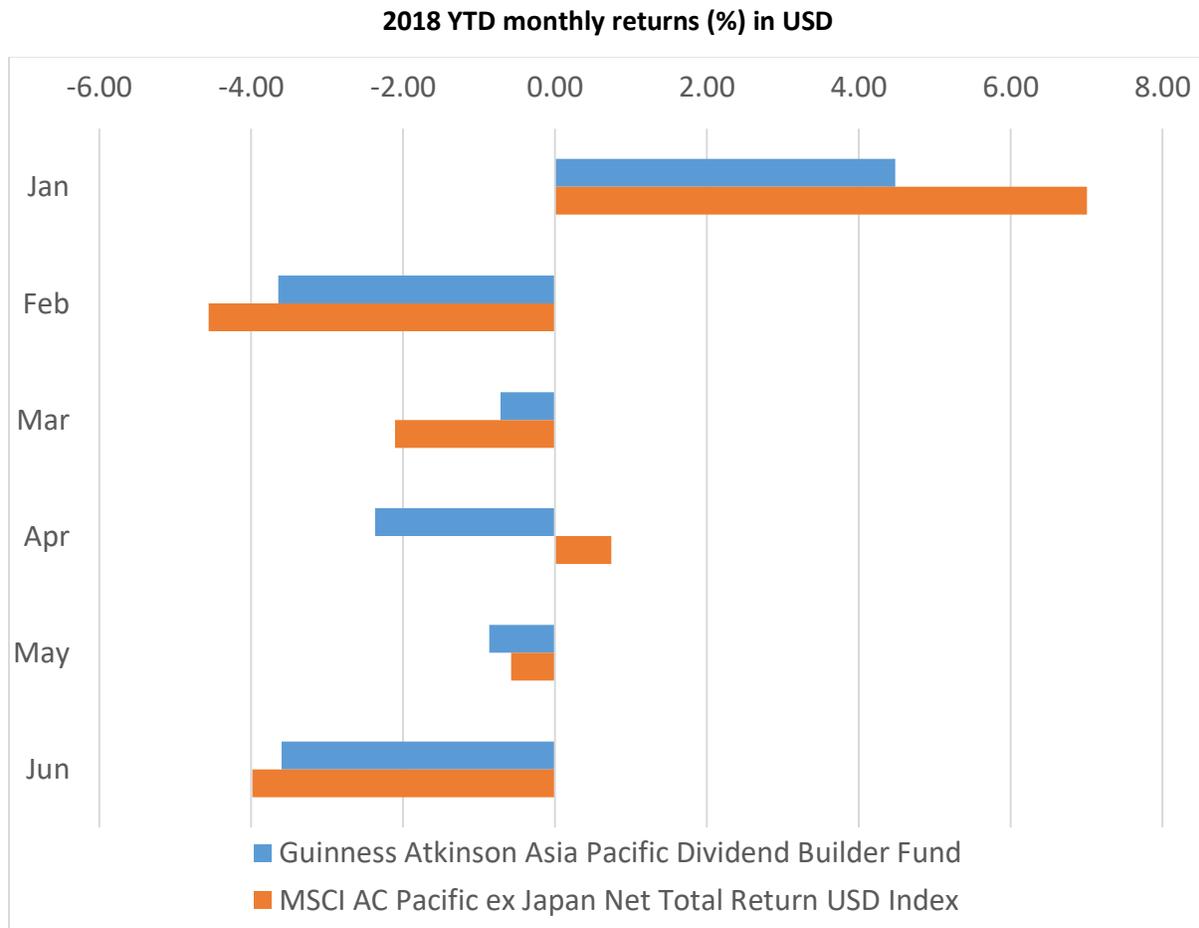
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Source: Bloomberg, Guinness Atkinson Asset Management

The fund underperformed in the first six months of the year, returning –6.75% versus the benchmark – 3.85% (MSCI AC Pacific ex Japan Net Total Return Index). The fund’s underperformance was attributable to some technology and China-related names and a few stock-specific factors.

To analyze the fund’s performance in detail, we first look at the monthly returns of the fund versus the benchmark, as the following chart shows, to assess whether the fund’s behavior is in line with expectations:



*Source: Bloomberg, Guinness Atkinson Asset Management*

Our two main periods of underperformance were in January, where we underperformed in a strong market environment, and April, where the fund fell in mildly positive markets. Both of these months merit further examination.

January saw the acceleration of the run-up in markets, following positive performance for most of 2017. While we would expect to underperform in such an environment, we would have liked the fund to have kept up a little better. Our lack of exposure to the Chinese internet companies (principally Tencent and Alibaba) hurt our relative performance. (We don't hold the Chinese internet companies, because they typically pay little or no dividends.) In contrast, we had good performance in January from our holdings in the Chinese banks as China's deleveraging and efforts to reform the financial sector gained credibility.

The markets peaked on January 26, before going into a sharp drawdown at the start of February. Our bigger periods of outperformance came in February and March when the fund provided downside protection by drawing down less than the market, as we would expect.

In April, our exposure to Information Technology harmed our relative performance. We hold several suppliers for smartphone manufactures in the portfolio, which were hit by a ‘perfect storm’ of three factors:

1. Concern over slowing iPhone sales
2. Weaker demand from Chinese manufacturers due to elevated inventory levels
3. General concerns over increased trade tensions between the US and Asia

We have since seen improvement in the first two areas: iPhone weakness was not as bad as people feared and Chinese demand looks likely to pick up. Trade tensions, while they have certainly intensified, we feel are less of a concern in this area because of the impracticality of deep upheaval within the technology supply chain (component production is unlikely to relocate to the US any time soon).

What is interesting is that we have seen this pattern before. There was similar weakness in technology names in April 2016, again primarily because of concern over iPhone sales slowing. But selling out would have been a mistake – the Information Technology sector performed very well on a relative basis for most of the rest of 2016 and 2017. The smartphone component manufacturers benefit from a trend of continuing upgrades in smartphone specifications. For example, in the case of Largan Precision, a camera lens manufacturer, the trend has been for Apple and others to add additional cameras to their phones, which feature increasingly sophisticated lenses (thus Largan benefits from both trends). That the market sometimes is more pessimistic on the sector as a whole is good for us, as we can top up our holdings. Meanwhile, the companies continue to generate strong returns on capital. At present, the Information Technology names are some of the most attractively valued stocks within the portfolio. The fund’s lack of exposure to Materials companies (which, being cyclical, don’t tend to feature heavily in our universe), also negatively affected our relative performance. Partially offsetting the underperformance in Information Technology, our Financials holdings (including the Chinese banks) and our Consumer Discretionary stocks performed well.

June was the second weakest month of the first six. The fund provided some downside protection in a falling market, but as not as much as we might have hoped. Markets were weaker as trade concerns intensified: the US confirmed a 25% tariff on \$34bn of Chinese imports, with a further \$16bn likely to follow; President Trump announced a review of automobile imports, questioning whether they were a threat to national security; further restrictions on Chinese overseas investment and use of intellectual property are to be investigated.

While trade tensions are undeniably unsettling to investors, they have not yet become a significant problem from an economic point of view (as the lack of substantial negative revisions to earnings demonstrates). What has disturbed sentiment the most is the threat of further tariffs on China – potentially affecting another \$200bn of imports (presumably accompanied by retaliatory measures by the

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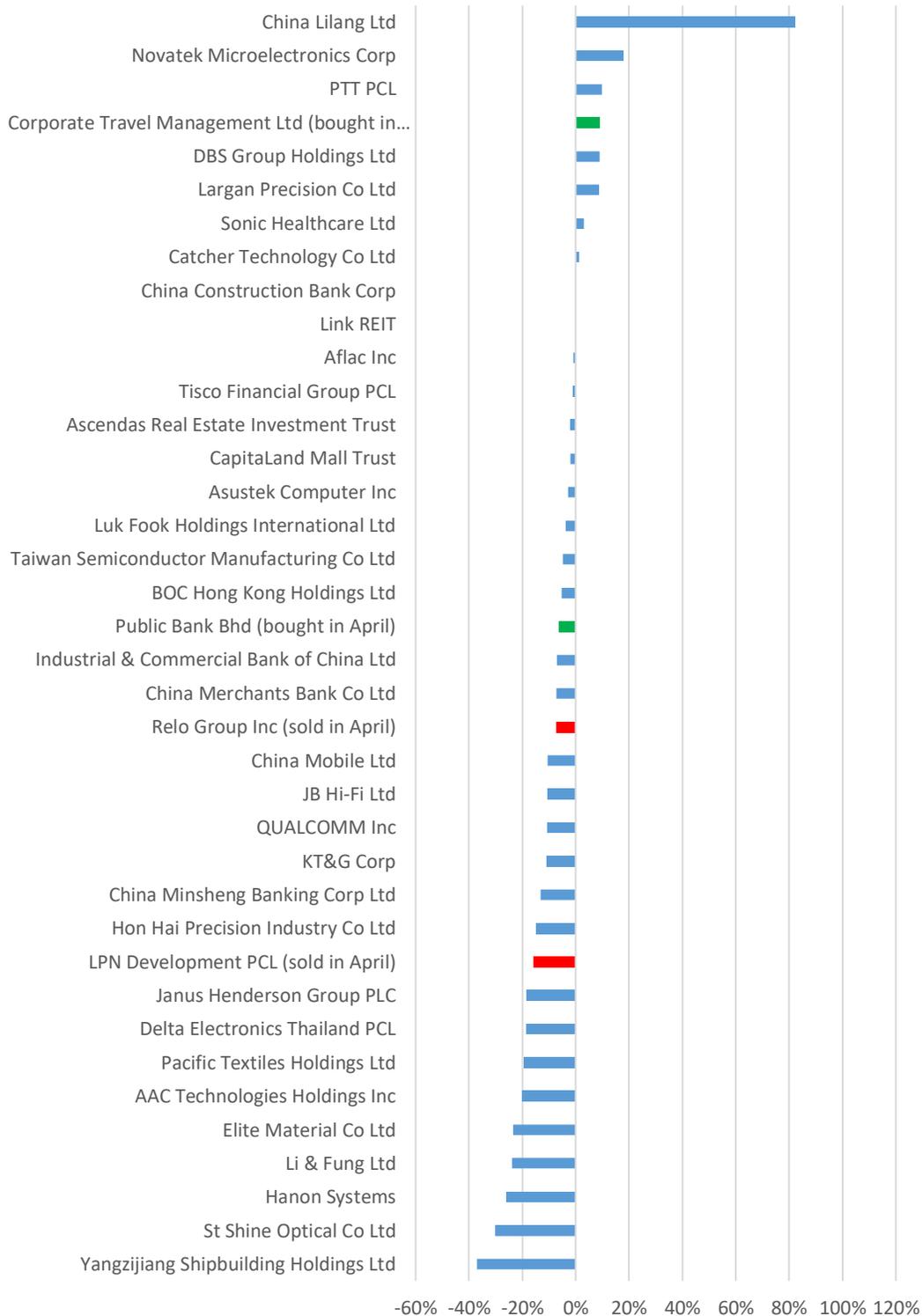


Chinese) – and a broadening of the conflict to involving the EU and other US trading partners. Our position is that a full-blown trade war is unlikely; we think a negotiated agreement is the probable outcome. We saw signs that the US and China are willing to strike a deal – the overturning of sanctions on ZTE, when the consequences of the ban were realized, being a prime example. However, we do not expect any immediate signs of progress, because President Trump still has to ‘act tough’ ahead of mid-term elections in autumn. We think behind-the-scenes negotiations are far more likely.

As this noise (which, again, in its current state is predicted to have a minimal effect on growth) rumbles on, we think it is wise to remember some of the long-term structural trends that have been taking place (and which prompted trade tensions to erupt in the first place). China has been transforming its economy, moving from simple product manufacturing into higher value-added and more technologically advanced manufacturing. In China and elsewhere in Asia, supply chains have become deeply embedded in the region, and many of the products that are produced – integrated circuits, electrical components, consumer electronics goods – are unlikely to be produced elsewhere. The broad long-term trends that have secured Asia’s development over the past 30 years are likely to continue.

The 36 names in the portfolio are our best ideas in the region and while we don’t expect them to move independently of one another, we want to avoid over-exposure to themes that could cause weakness in a significant section of the portfolio. So, when analyzing our performance, we want to ensure that it is not the direct result of thematic exposure, but rather that it comes from stock selection. The chart below shows the performance of individual stocks through the first half of the year:

Individual stock performance in 2018 (total return USD)



Holdings are subject to change.

Within the top five performers there is a mix of industries: retail, integrated circuit design, energy, travel services and banking. The companies are based in China, Taiwan, Thailand, Australia and Singapore.

Among the weaker names we have a similar mix of industries: shipbuilding, healthcare products, auto components, export services and product sourcing, and integrated circuit materials. Again, a variety of countries is represented: China, Taiwan, Korea and Hong Kong.

## Portfolio review

### Leaders



China Lilang was the stand-out performer over the first half of the year, returning more than 80% in USD terms. The company is a clothing retailer based in China and focused on casual menswear in the young adult segment. Lilang's main brand LILANZ has recovered after a difficult period in 2016, with same store sales accelerating over the second half of 2017 and continuing into 2018. The company also reported very strong year-on-year sales growth in both its fall and winter trade fairs.

Novatek Microelectronics is a designer of integrated circuits used primarily in flat-screen displays in a variety of applications including TVs, tablets, smartphones and cars. The company has recently benefited from greater adoption of its chips within TFT panels. Sales have begun to pick up and gross margins have also improved from a year ago. Novatek is projected to return to earnings growth this year.

PTT, the Thai oil and gas company (and our only Energy holding within the portfolio) performed well following a sustained recovery in the oil price. Brent crude rose from \$66.82/bl at the end of 2017 to \$78.60/bl at the end of June 2018. PTT's gas business sells part of its volume at oil-linked prices, but since the cost of its gas lags behind, the company benefits from an environment of rising oil prices. PTT also completed a stock split during the period. While this shouldn't affect the valuation of the company, it had no adverse effect on investor appetite for the stock.

Corporate Travel Management, one of the stocks added to the portfolio during the period, was among the better performers. For more details on the company, see comments below under 'Portfolio Changes'.

DBS bank in Singapore reported strong results for Q4 2017 in terms of loan growth and margins. Reinforcing the positive outlook was an increase in the dividend pay-out ratio and the announcement of a special dividend. DBS is a regional bank with operations in Singapore, HK/China and ASEAN. The

improvement in the oil price will also have helped to quell fears over DBS's exposure to smaller oil services companies in the region.

### Laggards



After returning more than 100% in USD terms last year, it is not surprising that Yangzijiang would give up some of the gains this year. The stock suffered in the first half after reporting lackluster results for the fourth quarter of 2017. Provisions on new orders resulting from foreign exchange movements and higher steel costs led to reduced gross margins. However, management reported good recent contract wins, and indicated that they will be discerning in selecting future contracts in the depressed pricing environment – something we like to hear.

After going through a pronounced cyclical downturn, conditions in the shipbuilding industry look set to improve. As older, lower-specification ships are scrapped, new orders are likely to come through. Tougher regulations to reduce emissions will also be a tailwind, accelerating the rate at which older vessels are scrapped. Yangzijiang's designs are well placed to benefit; the company has been focusing on advanced hull designs that are more fuel-efficient than those used previously. The stock is certainly one of the more volatile within our universe, and we have added to it at these lower levels to bring it back to neutral weight in the portfolio.

St. Shine has also been faced with higher costs, resulting in lower gross margin levels and prompting analysts to reduce their earnings expectations for the stock. Partly lower margins are a result of higher labor costs, but partly they are a result of depreciation as the company expands its capacity. St. Shine is forecast to achieve strong revenue growth in 2018 as a result of its new US direct-to-consumer customer, Hubble. The effect will be to decrease exposure to Japan, which currently accounts for more than half the company's revenues.

Hanon Systems was weak over the first half, giving back some of the gains achieved in 2017. The company, an automotive parts supplier specializing in thermal management systems, saw some softness in revenue from weaker sales by Hyundai and Kia in China. However, Hanon's efforts to diversify sources of revenue have helped to reduce the impact of China weakness and Hyundai Motor Group (which includes Kia) now

represents less than half of Hanon's sales. Hanon is attractively positioned with respect to electric vehicles – sales of parts for new energy vehicles rose to 7.5% of sales in the first quarter and account for 30% of the company's backlog. As emissions continue to be in focus in China and elsewhere, demand for Hanon's products – which are optimized for fuel efficiency – is likely to increase. We expect the company to recover over the second half of the year, as conditions in China appear to be improving. The stock trades on an attractive valuation and we are happy to continue to hold.

Li & Fung was another stock to give up some of its gains made over the latter part of 2017. The company has struggled from a weak environment for some of its main customers, US retailers, which have been closing stores to reduce their footprint and correspondingly reducing stock levels. Trade tensions have added an extra dimension of uncertainty, though there is scope for the company to benefit, since higher tariffs prompt businesses to make changes to their existing supply chains. For example, US customers may look to source goods outside China (but still within Asia) in order to avoid import tariffs. Li & Fung is taking steps to improve efficiency by investing in its digital sourcing platform. The company also paid a special dividend in the first half after selling its furniture, beauty and sweaters businesses where it sold goods as a principal. The divestment has the effect of simplifying the business and of strengthening the company's capital structure.

Elite Material suffered as a result of the tech sell-off in April, though the stock bounced in May after a broker upgrade. Following the recent weakness, the shares trade at very undemanding levels relative to peers and we have seen earnings estimates stabilize. A recovery in smartphone demand and increased adoption of the company's product should lead to a brighter performance for the stock in the second half.

## **Portfolio changes**

We made two changes to the portfolio during the first half. The first switch we made was to sell Relo Holdings in Japan and to buy Corporate Travel Management in Australia.

Relo, the one Japanese-listed stock in the portfolio, had been an excellent performer in the fund, but the yield contribution from the stock had fallen to a low level as the stock price had risen, accompanied by an increase in valuation multiples. While we thought the prospects for the company were good, we felt there were more attractive opportunities from an income and valuation perspective.

Corporate Travel Management (CTM) is an Australian company that provides travel management services for corporate clients in Australia, the US, Europe and Asia. In its most recent half-year results the company reported 15% growth in revenue and 32% growth in underlying EBITDA. The dividend was also increased 25%. We like the client proposition that CTM offers: reducing travel costs for its clients while making it easier to arrange and manage bookings. The founder and Managing Director owns a significant equity stake in the business. As with Relo, we expect a significant proportion of our total return as shareholders to come from continued earnings growth in the business, leading to growth in the income stream from dividends.

The second switch we made was to sell LPN Development in Thailand and to buy Public Bank in Malaysia.

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LPN Development had been a disappointing performer in recent times. The company, a Thai real estate developer centered around Bangkok, reported poor 2017 results, and had seen downgrades to 2018 earnings over a sustained period. LPN struggled with a build-up of inventory, a slower level of new project launches and a difficult market environment for condos. With doubts surrounding the company’s ability to adapt its strategy to circumstances we decided there were better opportunities elsewhere, and we sold the position.

In its place, we purchased Public Bank, a pure-play Malaysian bank exposed to improving consumer confidence in the country. The bank has generated good returns on equity since 1999, following the Asian crisis. Public Bank provides a modest dividend yield, but one that has been growing at a steady rate over the last six years, which we find attractive. Expectations of faster earnings growth, with positive revisions to estimates, were also supportive of our decision to buy.

**Performance**

The fund underperformed in the first six months of the year, returning -6.75% versus the benchmark - 3.70% (MSCI AC Pacific ex Japan Net Total Return Index). The fund’s underperformance was attributable to some technology and China-related names.

As of 6/30/2018	YTD	1 Year	3 Year	5 Year	10 Year
Asia Pacific Dividend Builder Fund (GAADX)	-6.75%	6.71%	6.32%	7.12%	4.40%
MSCI AC Pacific ex Japan Index	-3.70%	10.44%	7.89%	8.06%	6.10%

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

Expense Ratio: 1.12% (net); 3.48% (gross)

30-Day SEC Yield: Subsidized 3.08%, Unsubsidized 0.85%

*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*

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month end may be obtained by calling 800-915-6566 and/or visiting [www.gafunds.com](http://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 notes. Total returns reflect a fee waiver in effect and in the absence of this waiver, total returns would be lower.

**Edmund Harriss and Mark Hammonds** (portfolio managers)

**Sharukh Malik** (analyst)

*This material must be preceded or accompanied by a Prospectus. [Click here for the Prospectus.](#)*

**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 Net Total Return 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.

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.

Payout ratio refers to the proportion of company profits paid out to shareholders as a dividend.

The trade surplus is the difference between the value of a country's exports and imports. The current account surplus adds income and remittances to the trade surplus.

Net yield is the rate of return on an investment after subtracting all expenses.

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SEC Yield is a standard yield calculation developed by the U.S. Securities and Exchange Commission (SEC) that allows for fairer comparisons of bond funds. It is based on the most recent 30-day period covered by the fund's filings with the SEC. The yield figure reflects the dividends and interest earned during the period after the deduction of the fund's expenses.

Unsubsidized Yield represents what the yield would have been in the absence of temporary expense waivers or reimbursements.

Subsidized Yield represents the yield including temporary expense waivers and reimbursements.

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 06/30/18

1	Largan Precision Co Ltd	3.30%
2	Corporate Travel Management Ltd	3.18%
3	KT&G Corp	3.14%
4	CapitaMall Trust	3.02%
5	QUALCOMM Inc	3.00%
6	Asustek Computer Inc	2.99%
7	Ascendas Real Estate Investment Trust	2.98%
8	Sonic Healthcare Ltd	2.98%
9	Luk Fook Holdings International Ltd	2.92%
10	The Link REIT	2.91%

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

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