Guinness Atkinson

China & Hong Kong Fund

September 2018

GUINNESS ATKINSON FUNDS

Summary Review & Outlook

Fund & market

- The US introduced 25% tariffs on $16bn worth of imports from China, with China retaliating in kind with its own tariffs. In September the US imposed a 10% tariff on $200bn of imports from China.
- The Hang Seng Composite Index fell 3.00% in August while the Fund fell 5.07%.
- AAC has struggled this year, but we attribute a large part of the underperformance to expectations getting too far ahead of themselves. Results in the second quarter disappointed after the company faced foreign exchange headwinds and an adverse product mix. We expect the company's results to improve in the second half of 2018 on increased adoption of the company's products by Android manufacturers and as a result of the new iPhone launches.
- On the other hand, Ping An reported good results.
- MSCI Hong Kong and China were weak, falling 1.0% and 2.5%.
- In China, the weakest sectors were utilities, consumer staples and information technology which fell 7.8%, 6.3% and 5.1% respectively. On the other hand, the strongest sectors were telecommunications, energy and real estate. The fund has no exposure to the first two sectors and has one holding in real estate.

Outlook

- Chinese markets still offer attractive earnings growth compared to developed markets, while trading at reasonable valuations.
- The imposition of additional trade tariffs seems probable and their effects are likely to become evident from 2019. (President Trump has recently upped the ante by suggesting tariffs be imposed on all Chinese goods imported into the US).
- We believe our core focus on good companies with demonstrably stable businesses is a sustainable long-term approach. We continue to focus on macro-environment but only insofar as it impacts upon our businesses.
- We think the best long-term stories are to be found in the consumer, financial, health care and technology sectors and among certain industrial companies.
- At a time of uncertainty, we think that holding quality companies that have achieved consistently higher cash returns on capital is a sensible approach.

Why invest in China?

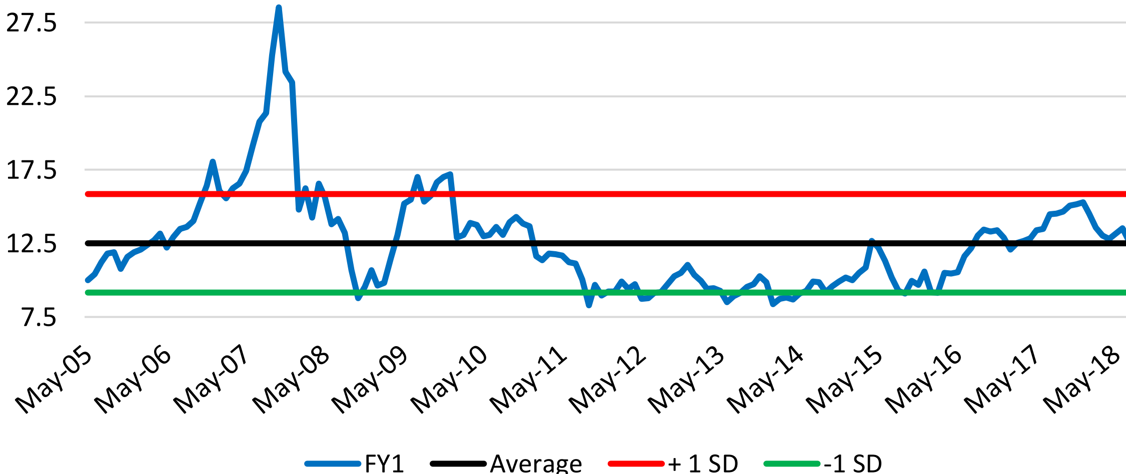
We do not think investors pay enough attention to Chinese companies. We often hear the argument that there are very few worthy companies in the country to invest in. Or that Chinese companies are low "quality" (where we note quality is never defined). While it is certainly true there are many examples of Chinese companies that are poorly run and inefficient, it does not follow that this applies to all Chinese companies. Ten years ago, it is true that there were few good quality Chinese companies to invest in.

However, we argue that today there are many good quality Chinese companies which, if were listed in developed markets, one would be comfortable buying.

We define **quality companies as those that generate a persistently high cash return on invested capital** – we use 8% as a minimum threshold. The majority of the fund is invested in companies that have achieved return on capital over eight years, as it is this persistence which is a good predictor of whether a company continues to achieve a high return on capital. Out of 19,302 companies worldwide only 2,235 companies (12%) meet our quality criteria.

The fund invests in companies listed in Hong Kong and in companies which derive more than 50% of their revenues from the China region. The view that there are few quality Chinese companies to invest in may have been true more than a decade ago but is now outdated. In 2005, only 24 Chinese and companies met our quality criteria. Today, 82 Chinese companies pass our quality test. After excluding companies with a market capitalization of less than $500m and those with too much leverage on their balance sheets, we are left with 67 quality companies in the Greater China area. These companies are part of a select few with the characteristics we look for.

We have established that quality Chinese companies can be found. What about valuations? We start off by looking at the valuation of MSCI China which, on a forward-looking price/earnings basis, is now trading at about its historic average. Fears over a slowdown in economic growth and a potential trade war are weighing on valuations. But earnings are still expected to grow strongly with a consensus growth forecast for 19% in 2018 and 16% in 2019.



Source: MSCI, Bloomberg, Guinness Atkinson calculations

The overall valuation of MSCI China Index needs to be considered in the light of its construction. The index is dominated by Tencent and Alibaba whose weights are 15.4% and 12.6%. To put things into context these concentrations are significantly larger than in other markets; for example, as of the end of June the largest company in MSCI USA was Apple with a 3.9% weight. In MSCI Europe the largest company was Nestle with a 2.7% weight. In addition to the company specific risk within the benchmark, the valuation of the China index is significantly impacted by Tencent and Alibaba. MSCI China trades at around 12.3x on 2018 earnings and 10.6x on 2019 earnings. As the table below shows, Tencent and Alibaba trade at valuations much higher. If we strip these two companies, the valuation of the region becomes much more compelling, trading on 9.8x on 2018 earnings and 8.6x on 2019 earnings.

Name	2018 PE	2019 PE
MSCI China	12.3	10.6
Tencent	34.4	26.8
Alibaba	33.0	23.8
MSCI China ex Tencent & Alibaba	9.8	8.6

Forecasting is inherently limited and cannot be relied upon.

Company updates

Tongda Group, which produces casings for smartphones, fell 24.4% in August. The company put out solid first half results with adjusted operating profits growing 6% (adjusting for write offs last year so we can compare on a like-for-like basis). In the current environment in the smartphone industry, where smartphone shipments in the second quarter fell 5.9% year-on-year, we think Tongda's results are respectable. The market may be worried that Tongda's margins are falling and will remain lower than their historical level. This is because Tongda is producing more plastic-like casings for its major client Xiaomi which have a lower average selling price than the company's traditional metal casings. Management argue that in the initial ramp up for these newer plastic casings, the margin will be lower, but as production increases the company will benefit from economies of scale and the margins will end up higher than that of metal casings. We believe the share price of Tongda does not currently reflect the efficiency and quality of the business. The business has returned a 10% return on capital since 2010 and is likely to do so this year. But the stock now trades at 4.7x FY18 earnings which is more than one standard deviation below its average, and this is now approaching two standard deviations. Relative to its peers it is one of the cheapest stocks in the smartphone supply chain.

Netease's share price has been weak. Myopia, or near-sightedness, is a common problem in China and is attributed to some degree to online games. Several government departments issued rules to tackle the problem. This includes a cap on the number of online games, an attempt to introduce an age-based reminder system and a cap on gaming time for children. This news weighed heavily on game developers with exposure to China. On the other hand, more reports are coming out indicating the government will

soon begin approving monetization of games. As a reminder, in China a game needs one approval to launch and another to monetize the game. This system has been in limbo for several months due to internal government restructuring and it has not been possible to monetize newly launched "*battle royal*" style games across the industry. The resumption of approvals should provide a boost to sentiment around the company. China is the largest gaming market in the world. Tencent (held in the fund) controls more than half of the mobile gaming market while Netease is second with a 15% share of the market, more than the next seven largest companies combined.

Ping An, an insurance conglomerate, reported strong results, with most key metrics coming in ahead of consensus. Though there is much room for the insurance industry in China to grow, competition is intensifying, and we cannot assume the returns that the industry generated in the past will be the same as will be generated in the future. This is one of the main reasons we sold PICC P&C earlier this year, a company whose efficiency has decreased over the past three years. On the other hand, Ping An has maintained its return on equity and is likely to do so this year. We believe its use of technology in aiding its strong distribution capacity means the company has a high chance of maintaining its return on capital in the future.

Summary view & outlook

We expect the fund's focus on companies persistently earning a return on capital well above the cost of capital to do well in the long term. The fund now trades on a price to earnings multiple of 10.3x, based on estimated 2019 earnings, while the fund's discount to the MSCI Zhong Hua Index has widened to nearly 20%. We believe that now is a good time to be looking at investing in China as valuations have come down markedly since January. Fears over trade are bringing valuation multiples down, even for companies that actually have little exposure to a trade war. We have high confidence in the continuation of the portfolio companies' operating performance. The 'market' may not like them at the moment, but we attribute this to sentiment which can change quickly. The drivers of such a change would be positive progress in trade negotiations and/or a Chinese domestic growth response to recent fiscal support efforts (of which we have seen some signs already).

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

Performance

Year-to-date, the fund is down 9.72% while the benchmark is down 6.62%. Much of the fund's underperformance came in January, where markets were extremely strong. The rest of the fund's underperformance comes down to individual companies with their own headwinds – Tongda and Netease were weak in August.

As of 8/31/2018	YTD	1 Year	3 Year	5 Year	10 Year
China & Hong Kong Fund (ICHKX)	**-9.72%**	**0.41%**	**14.53%**	**6.94%**	**4.52%**
Hang Seng Composite Index	**-6.62%**	**1.87%**	**12.00%**	**8.12%**	**6.02%**

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

Expense Ratio: 1.64%

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.

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.

Hang Seng Composite Index is a market capitalization-weighted index of 40 of the largest companies that trade on the Hong Kong Exchange.

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.

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 08/31/18:

Holding	Weight
1. CNOOC Ltd	4.31%
2. Hollysys Automation Technologies Ltd	3.69%
3. Yangzijiang Shipbuilding Holdings Ltd	3.65%
4. China Construction Bank Corp - H Shares	3.54%
5. Anhui Conch Cement Co Ltd - H Shares	3.52%
6. Ping An Insurance Group Co of China Ltd - H Shares	3.45%
7. Noah Holdings Ltd	3.40%
8. China Merchants Bank Co Ltd - H Shares	3.38%
9. BOC Hong Kong Holdings Ltd	3.34%
10. Baidu Inc	3.34%

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

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