Guinness Atkinson

China & Hong Kong Fund

December 2018

Summary Review & Outlook

Fund & market

- Trump and Xi agreed to meet at the G20 meeting at the end of the month, at which a temporary truce was declared in the trade war. The US will postpone increasing tariffs from 10% to 25% for two months, so rather than increasing them on January 1 it will now do so on March 1. The Chinese agreed to buy some agricultural, industrial and energy products.
- The extra time will give the two sides to negotiate. On December 3, the first trading day after the truce was announced, Asian markets were very strong. The Hang Seng Composite Index, the Fund's benchmark, rose 2.6% while the CSI 300 Index (mainland shares) rose 2.8%.
- Consequently, MSCI Hong Kong and China were strong, both rising 7.4% in the month. News reports indicate Apple is cutting orders for the iPhone XR and more generally, perhaps the consensus is Apple will find it difficult to increase the volume of iPhones sold. Companies in the iPhone supply chain were weak as a result.
- The fund lagged it's benchmark for several reasons. VTech (discussed later) and Tongda were the largest laggards.
- The fund does hold Tencent but because the fund is equally weighted, it holds less of the stock than the benchmark. The neutral weight of a stock in the fund is 3.0% while Tencent makes up 9.2% of the benchmark (as of the end of October).
- The Fund has a low exposure to real estate because we find few companies are able to produce consistently high returns on capital and/or are heavily indebted. However, this sector did well during the month and this also cost the Fund.

Portfolio Update

The fund has only one holding in the Real Estate sector which is China Overseas Land & Investment (COLI). There are few property developers which generate a persistent return on capital and have sensible gearing. The sector was strong in November in both Hong Kong and China. In Hong Kong, note that since the Hong Kong dollar is fixed to the US dollar, monetary policy in Hong Kong must follow that of the US. The Chair of the Federal Reserve in the US, Jay Powell, struck a more dovish tone in November. Since interest rates in Hong Kong follow those in the US, this effectively means interest rates in Hong Kong may not rise as much as markets were expecting, leading to potentially lower funding costs for property developers. In China, the sector was strong because more investors are expecting policymakers to loosen policy to stimulate the housing market. Also, the sector is trading at historically low levels and so is becoming attractive to some. We note more coverage on the leverage that some Chinese developers are taking on and the associated funding costs. China Evergrande Group sold five-year bonds with a 13.75% coupon, the most it has ever paid. Next year, many property developers will need to refinance at rates that are much higher than were seen in 2016 and 2017 and there will no doubt be defaults. The companies that are subject to these risks are not the ones this fund aims to invest in.

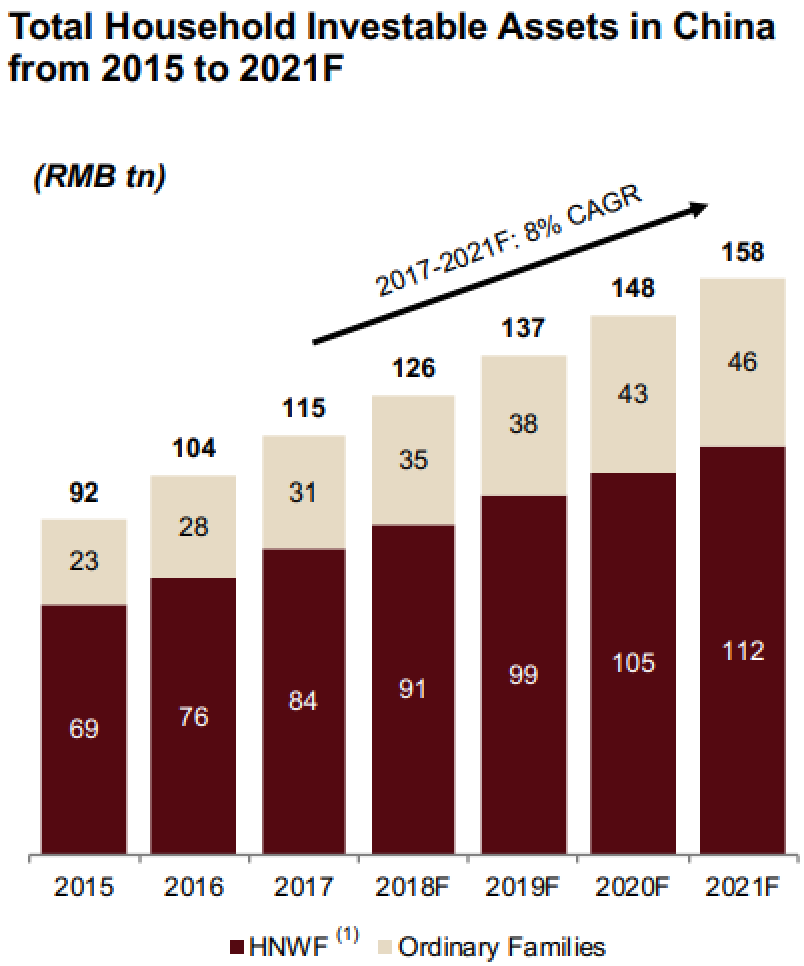
VTech reported unexpectedly weak results. The company is well known for its toys segment but there are other parts to the business. The company produces phones for the residential and commercial market. It also operates a contract manufacturing service, producing goods such as professional audio equipment and medical health products. To us, there do seem to be a few temporary headwinds the business is facing which explains results. In North America two major customers are clearing inventory in baby monitors and DJ equipment, both of which are fast growing businesses. Additionally, a new series of Voice over Internet Protocol (VoIP) phones was delayed until the second half of the year. In Europe, the toys segment was weak because a new logistics vendor was in the process of moving to a new warehouse, leading to delayed shipments. It was encouraging to see VTech's flexibility with regards to tariffs. Certain products are affected but earlier in the year VTech acquired a facility in Malaysia to which it can shift production.

Last month we spoke about Pacific Textiles and its troubles with its factory in Vietnam, arguing these problems should be in the past. The company reported encouraging interim results with a recovery in revenue and earnings. Higher sales volume is coming through a set of more diversified customers. The Vietnam factory is now running at 40% of capacity and management expect it to be running at pre-suspension levels by March 2019. Management also talked about improving energy and resource efficiency through improving waste water and air treatment, as well as better use of automation. The environmental impact of the textile industry is becoming a bigger issue in the press in Western markets and so garment and textile manufacturers which want to remain competitive need to address these concerns. The fact that Pacific Textiles thinks their efforts are paying off is good news.

Noah Holdings is a wealth and asset manager which reported good results. Though volumes were weak, Noah was able to increase its fees, and this is an example of a business we like – one with pricing power. The company is notably putting an emphasis on moving away from one-time commissions to recurring fees. We think Noah is doing well in what is a difficult regulatory environment. Policymakers are cleaning up the wealth management product (WMP) industry through new regulations which means the operating environment is quite difficult at the moment. New rules include:

- Implicit guarantees are no longer allowed. In the past, WMP offered a guaranteed return and to many investors, this was normal. If the WMP did not have the cash flows to support repayment, it would be bailed out. This is no longer allowed.
- Maturity of non-standardized credit assets should be earlier than fund maturity date.
- Limits on leverage on funds have been introduced.
- Publicly offered funds can only invest in standardized credit assets, listed equities, commodities and derivatives. Privately offered funds can only be sold to qualified investors and can invest in more complex assets.

These new rules mean issuance of WMPs has fallen which in our opinion is a good thing, though it does mean the market is slow in the short term as clients get used to the idea that investments do in fact involve risk. Noah is running seminars to educate existing and potential clients on how capital markets will work in the new regulatory regime. But the long-term story remains absolutely intact. The number of high net worth individuals in China continues to grow and they will have assets to invest – this is Noah's target market:



Source: company presentation

Renminbi trillion (RMB tn); High Net Worth Families (HNWF)

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 8.5x, based on estimated 2019 earnings, while the fund's discount to the MSCI Zhong Hua Index is 23%. China is currently out of favor with many investors and now is the time to be looking at investing in the region, when prices are cheap. The fund invests in a set of quality companies which have persistently generated a return on capital above the cost of capital.

Edmund Harriss (portfolio manager)

Performance

As of 11/30/2018	YTD	1 Year	3 Year	5 Year	10 Year
China & Hong Kong Fund (ICHKX)	-15.52%	-13.71%	8.57%	3.17%	9.80%
Hang Seng Composite Index	-13.94%	-11.52%	5.25%	1.21%	6.55%

As of 9/30/2018	YTD	1 Year	3 Year	5 Year	10 Year
China & Hong Kong Fund (ICHKX)	-9.60%	0.10%	13.93%	5.81%	7.00%
Hang Seng Composite Index	-9.47%	-2.22%	8.96%	3.41%	4.47%

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 shown is current to the most recent month and quarter end. To obtain performance as of the most recent month end, please visit www.gafunds.com or call 1-800-915-6565. Total returns reflect a fee waiver in effect and in the absence of this waiver, the total returns would be lower. 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.

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 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.

One cannot invest directly in an Index.

Hang Seng Composite Total Return Index is a market capitalization weighted index that monitors the performance of stocks listed in Hong Kong. **CSI 300 Index** consists of the 300 largest and most liquid A-share stocks. The Index aims to reflect the overall performance of China A-share market. **MSCI Hong Kong Index** is designed to measure the performance of the large and mid-cap segments of the Hong Kong market. **MSCI China Index** captures large and mid-cap representation across H shares, B shares, Red chips, P chips and foreign listings. **MSCI Zhong Hua Index** is a composite index that comprises the MSCI China and MSCI Hong Kong Index, capturing large and mid-cap representation across all China securities and Hong Kong securities.

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

Compound Annual Growth Rate (CAGR) is the year-over-year growth rate of an investment over a specified period of time longer than one year.

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 11/30/18:

1. CNOOC Ltd	4.49%
2. China Merchants Bank Co Ltd - H Shares	3.97%
3. China Overseas Land & Investments Ltd	3.89%

4. Pacific Textiles Holdings Ltd	3.83%
5. Noah Holdings Ltd	3.82%
6. Ping An Insurance Group Co of China Ltd - H Shares	3.76%
7. China Construction Bank Corp - H Shares	3.70%
8. Hollysys Automation Technologies Ltd	3.66%
9. CNY Minsheng Banking - H Shares	3.59%
10. Shenzhen Expressway Co Ltd - H Shares	3.54%

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

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