Guinness Atkinson

Asia Pacific Dividend Builder Fund

Review of March 2019

Summary Review & Outlook

Fund & Market

- Asian markets ended the quarter 9.4% higher in GBP terms (14.2% in EUR and 11.9% in USD) as measured by MSCI AC Pacific ex Japan net return Index.
- The main market drivers were low valuations following the global sell-off at the end of 2018, the Federal Reserve's reversal of course on interest rates improving narrative surrounding US-China trade talks and the deferral of additional tariff measures.
- Fund performance was initially driven by a 'relief' rally but pushed higher as company results came through in February and March.
- Over the quarter the best performers were IT names Elite Material, Largan Precision and Novatek Microelectronics. These were followed by retailer China Lilang, China Merchants Bank, Janus Henderson and Corporate Travel (both listed in Australia) and then by Yangzijiang Shipbuilding and JB HiFi.
- On the weaker side, Public Bank in Malaysia was the only decliner. The other main laggards were KT&G Corp, Pacific Textiles, Qualcomm, AAC Technologies, Hanon Systems, Hon Hai and Chinese banks ICBC and China Construction Bank.
- Leading regional markets and sectors in the quarter were China/Hong Kong and Australia/New Zealand and Consumer Discretionary, Real estate, Materials and IT. Lagging markets were the south-east Asian markets, with Malaysia barely moving, and Korea/Taiwan. Lagging sectors were Utilities, Health Care, Industrials and Financials.

Events in March

- US-China trade talks remain front of mind and there is clearly impetus from both sides towards reaching a conclusion.

- The Federal Reserve confirmed its change of course on interest rates, saying they could be on hold for "some time" as its focus shifted to global risks. They have also decided to slow the pace of drawing down the central bank's bond holdings.

- Thailand held its first election since 2014. It seems likely that the new government will be pro-military, which amounts to a continuation of the last five years, with a democratic veneer. This will not lead to any change to the Fund's Thai exposure.

- The US Dollar index strengthened in March, but this was largely explained by Euro weakness; Sterling and the Japanese yen both strengthened. In Asia, currencies were largely unaffected with the exceptions of a weaker Indonesian rupiah and Philippine peso.

With their rise this year, Asian markets have recovered the losses incurred since June 30, 2018. We have observed across global markets that quality names have done well in the rally where we might have expected 'distressed' companies to have led. This leads us to believe that behind the apparent bullishness there is nervousness about what may lie ahead. We can see weakness coming out of Europe and the further deferral of expectations for a normalization of monetary policy. This is also evident in the reappearance of negative bond yields in Europe, including among some of the high-grade European corporate bonds. We also see this nervousness in the recent change in US monetary policy direction, where the prior focus on domestic strength has now broadened to take account of global risks.

Some of these risks were deemed by markets to have diminished a little following the release of China's Purchasing Managers Index (PMI) data. This measure seeks to provide a measure of manufacturing activity and outlook where a reading above 50 denotes expansion and below, contraction. The components of the index include measures of output, new orders, employment, supplier times, inventory, export orders among others, all expressed in terms of expansion or contraction. In China, this indicator of industrial health jumped back into expansion after four months of weakness and was led by domestic output, new orders and services, while the export side remained weak. It appears that China's efforts to support the domestic economy as growth slowed last year (one of the factors behind the market sell-off) are beginning to bear fruit.

Other interesting data concern the impact of the trade dispute between China and the US on the Asia region. We discussed last month how the US is losing approximately $40 billion of exports to China on an annualized basis out of the total of $130 billion, but China of course, is losing too. We can see from US data that the import prices of goods from China are holding up, suggesting that US consumers are bearing the costs of tariff increases and that the impact on China is felt through lower volumes. This is consistent with the contraction in export orders reported in China's PMI data discussed above. However, while China's exports to the US have fallen, its exports to the rest of the world are stable.

Moreover, in emerging Asia, exports from the region into China have dropped while trade with the US and within the region excluding China has also been stable. It suggests that supply chains are evolving, something that has been underway for a while, and this evolution has accelerated since the trade dispute intensified. If we were to identify one major beneficiary, it would be Vietnam. There are still plenty of bottlenecks in Vietnamese production including the availability of skilled labor and the development of industrial clusters that are a significant and hard-to-replicate element of China's competitiveness. But Vietnam is following China's template and is busily scooping up the lower-end manufacturing that China is in fact happy to lose.

Our summary view of the trade issue is that it is unlikely to de-rail the Asian manufacturing story. What it will do is speed up the alteration in structure. China has sought to divest itself in recent years of lower-end, labor and material-intensive manufacturing in favor of higher-value-added, capital-intensive production which better reflects the changing stages of demographic and economic development. This restructuring process has accelerated, and we expect it to accelerate the rise of nations such as

Vietnam, Cambodia and Laos which are likely to follow the Chinese development model. On the immediate question of resolution, our view remains that both sides have moved beyond the megaphone stage and into the negotiation process with a view to avoid further intensification. The costs are evident to the US, to China and to world trade and world growth – and there is a US presidential election coming up soon.

Portfolio change

We have made a change to the portfolio with the purchase of China Medical Systems to replace **Delta Electronics (Thailand).** Delta is in process of being taken private by its largest shareholder, Delta Electronics of Taiwan. The process has been agreed and the share price has hit a ceiling, so we decided to sell rather than wait for the corporate action to complete.

China Medical Systems is a stock we watched for a while before adding it to the portfolio. The company acts as a pharmaceutical distributor to doctors and hospitals for both branded and generic drugs. The regulatory structure in China is changing as the government, as with governments everywhere, seeks to reduce healthcare costs. The changes have introduced significant new competition, with alternative offerings available resulting in substantial price cuts in certain cases. China Medical Systems has seen a significant drop in its share price which we believe significantly exceeds its exposure to these changes. In addition, the company has tied up with companies in the US, UK, France, Switzerland and Israel to secure rights to sell formulations to treat strokes, brain cancer and respiratory distress down to onychomycosis (toenail fungus, which we needn't dwell on). The recent 2018 results delivered the consistency we look for: gross profit, operating profit, net profit and dividend growth all moving in line, up 10.5%-12.5%, and an unchanged dividend payout of 40% of earnings.

Portfolio update

DBS Group in Singapore reported good results back in February and releases its annual report at the end of March. We are very happy with this position and think that the market has overlooked the potential for this business. The bank reported the highest return on equity (net profit divided by equity) since 2007 at 12.1%, which is impressive given the increased capital adequacy requirements imposed on banks over the last 10 years. The earnings outlook remains very positive. Valuations, however, remain well below the historic average. We think that investors are concerned about the impact of the trade dispute between China and the US and have underestimated the progress DBS has made in developing its technology platform. In the annual report the chairman addressed the first concern by noting not only that the proportion of China's economy represented by trade has shrunk, but that the US share is now down to c.19%. He also observed that while China's competitive advantages mean that supply chains are unlikely to see a sudden shift, those that do are likely to remain in the region and that this would have a minimal impact on DBS's business. This is in line with argument we made above. The cost reductions, stability and asset quality, especially in China, and improved profitability speak to the success the bank has made with its technology investment and integration. The ordinary dividend for 2018 increased 30%, in line with a 28% growth in net profit.

Chinese banks mostly issued preliminary results in the earlier part of the year. More detail has come out since then which makes us happy to continue holding them. In sum, net profit was slightly lower than expectations but balance sheet quality improved. The key metrics that we focus on are profits before provisions, which grew 10%, to assess profits from operations; and on the balance sheet side we focus on non-performing loan recognition and write offs. A tightening on the balance sheet side should be reflected in higher provisioning costs in the income side which will mean lower net profits, which grew 5%. However, if operating profits are strong enough at the pre-provision level then the banks can afford to address the bad debt issues more aggressively, which is what they have been doing. Reported non-performing loans (NPL) are still around 1.5%, not much changed from the level in 2013, but adjusted for those the banks have disposed of or written off, the figure is 6%. Over the last five years banks have increased their clean-up efforts and year by year the NPL level adjusted for disposals and write-offs has risen by around 1% per annum.

This is in line with the argument we have made over the last five years, that the China bank clean-up is a 10-year project, not a two-year project; that the write-downs will progress as profitability allows and that stability can be maintained because of the domestic nature of both debt and bank funding sources. The low valuations of Chinese banks, in our opinion, have represented a wider misunderstanding of China's domestic debt dynamics and have presented us with an opportunity.

Our investment case for holding shares in China Construction Bank, ICBC and China Minsheng Bank is that we believe them to be undervalued because of concerns about balance sheet strength and doubts about the ability and willingness of managements to address it. In the recent results we have seen faster loan write-offs and tighter non-performing loan recognition, which should be supportive of our valuation argument. The net profit number is therefore more a function of how aggressive the banks are willing to be in provisioning. The steady growth of pre-provision operating profit lies behind the 5%-8% dividend growth seen from the big banks and strong growth in cash dividend (as opposed to shares) delivered by Minsheng Bank. We do not expect to see much net profit growth while this is under way and thus the total return thesis is based upon valuation expansion and modest dividend growth.

Hon Hai Precision reported results on the last day of the quarter which beat expectations. The primary driver was cost-cutting, but there were also more positive signs, with additional smartphone orders coming through. Margins were also helped by lower prices for memory chips. The market has been looking for cost controls to deliver meaningful margin expansion and this appears to have come through in the last quarter of 2018 with gross margin 1% higher to 7% and operating margins back up to 3.6%. In recent news we hear that Foxconn Technology, a subsidiary of Hon Hai, is to trial production of the new iPhone in India at its facility outside Chennai. Apple is not a major player in the Indian smartphone market but has been facing increased pressure in China. India has 500 million smartphone users and 140 million devices were sold in 2018, many of them Chinese brands; only 1.7 million were iPhones.

China Mobile reported some uninspiring results with revenue, profits and dividend fractionally higher than last year. The focus remains on the personal mobile business where the company aims to develop 4G VoLTE, which puts voice traffic over the LTE network. LTE which is a data-only technology, unlike the 2G/3G connections which are currently used. VoLTE has three times the voice and data capacity of 3G and six times that of 2G and is an intermediate step before 5G technology. As we have noted previously, the 5G story is more about operators than consumers: it allows for greater capacity on the networks, which will allow greater speed and connectivity between devices, and is less about simply accelerating download speeds for smartphones. China Mobile's outlook for the coming year could best be described as cautious. There are no plans for additional capital management to reduce the substantial cash pile on the balance sheet.

Outlook

Trade issues remain to be resolved but there appears to be a growing impetus toward reaching an accommodation. The best outcome we think will be a pause on escalation and a period of assessment. A wholesale tariff roll-back seems unlikely to us.

In the technology sector it appears that management in both the US and Asia are pinning their hopes on a recovery in the second half. To our minds there appears to be a lack of detail in precisely what these hopes are based on. An inventory adjustment seems to be part of the story, as new orders for components have been weak in recent months so presumably these will rise. However, we know that in the memory space conditions are difficult, prompting an unusual profit warning from Samsung Electronics. From our perspective, it is another reminder to focus on those names with unique selling propositions – for example, Largan Precision with its next-generation lenses; Novatek Microelectronics with its combined touch controller and display driver chips; and Elite Material with its environmentally-friendly halogen-free laminate for printed circuit boards.

As for the rest, the structural themes of growing consumption and regionally-focused economic activity remain in place and we seek to capture these through leading companies in retail, health care, finance and manufacturing. We believe long track records of superior profitability are likely to show persistence and deliver a strong basis for us to take a view on valuations. The portfolio can be categorized as Large Company/Value but unlike many in the 'Value' category our strategy has incorporated profit growth which has been visible to investors in the form of dividend growth over time. At the time of writing the portfolio valuation is at a 17% discount to the market as measured by the MSCI AC Pacific ex Japan Index, and has earnings growth as forecast by the consensus of 7% per annum over the next two years.

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

Performance

As of 3/31/2019	YTD	1 Year	3 Year	5 Year	10 Year
Asia Pacific Dividend Builder Fund (GAADX)	**13.43%**	**-5.15%**	**10.97%**	**7.96%**	**12.52%**
MSCI AC Pacific ex Japan Net Return Index	**11.88%**	**-4.33%**	**11.25%**	**5.13%**	**11.04%**

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

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

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 Advisor has contractually agreed to reduce its fees and/or pay Fund expenses (excluding Acquired Fund Fees and Expenses, interest, taxes, dividends on short positions and extraordinary expenses) in order to limit the Fund's Total Annual Operating Expenses to 1.10% through June 30, 2019. To the extent that the Advisor absorbs expenses to satisfy this cap, it may seek repayment of a portion or all of such amounts at any time within three fiscal years after the fiscal year in which such amounts were absorbed.

As of November 2018, the MSCI AC Pacific Ex-Japan Net Return was used instead of the Gross Return. MSCI AC Pacific Ex-Japan Net Return reflects deduction for withholding tax but reflects no deduction for fees and expenses. Net Return is net of local withholding taxes that any investor would typically pay.

***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 Net 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. It reflects deductions from reinvested dividends for withholding tax but reflects no deduction for fees and expenses.

One cannot invest directly in an Index.

Price/Earnings Ratio (PER) 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 02/28/19:

1	Elite Material Co Ltd	3.74%
2	Lilang China Co	3.32%
3	Novatek Microelectronics Corp	3.21%
4	Largan Precision Co Ltd	3.12%
5	Yangzijiang Shipbuilding Holdings Ltd	2.99%
6	China Merchants Bank Co Ltd - H Shares	2.94%
7	Tisco Financial Group PCL/Foreign	2.89%
8	Luk Fook Holdings International Ltd	2.87%
9	St Shine Optical Co Ltd	2.84%
10	Taiwan Semiconductor Manufacturing Co Ltd	2.83%

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

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