Guinness Atkinson

Asia Pacific Dividend Builder Fund

Review of April 2019

Summary Review & Outlook

Fund & Market

- Asian markets rose in April by 1.5% in GBP terms/1.9% in EUR USD terms (as measured by MSCI AC Pacific ex Japan Net Return Index).
- This was strong performance in a global context until the end of the month when growing concerns about China stimulus and a strong dollar caused markets to pull back in the last five trading days.
- Qualcomm's was a significant driver of fund performance during the month following Apple's withdrawal from its long legal suit against the company which caused its stock price to surge over 50%.
- Other strong performers were Hon Hai Group (also known as Foxconn), DBS Group in Singapore, BOC Hong Kong, AAC Technologies, Hanon Systems in Korea and Luk Fook, a retailer of jewelry in Hong Kong - which all rose between 6% and 18% over the month.
- Our weakest stock was Li & Fung, which was down 8%, followed by Elite Material, China Mobile, Pacific Textile and China Lilang which were down between 4% and 7%.
- Leading regional markets in the quarter were Singapore, Taiwan, China and Thailand; leading sectors were Consumer Discretionary, Communication Services, IT and Financials.
- Lagging markets were Indonesia, Hong Kong, Korea and Malaysia. Lagging sectors were Utilities, Energy, Materials, Industrials and Real Estate.

Events in April

- On the trade talks: Xi Jinping's speech at the recent Belt & Road Initiative forum dwelt on steps China will take on intellectual property, market opening, and fair competition, effectively addressing and giving his seal of approval for the concessions required to get a deal done.
- Reports indicate Chinese policymakers are considering stimulating auto demand. Proposals include subsidizing replacement of older, dirtier vehicles with new electric vehicles and removal of the vehicle tax for rural residents who replace their vehicles with an engine size below 1.6L. Auto makers in China and Europe rose on the news.
- DBS reports that it plans to stop financing coal-fired power stations in the region once existing commitments are complete in 2021.
- Korean company Coway reported that sales of air purifiers in China were weaker in the first quarter, citing lower air pollution in Chinese cities as one of the reasons for reduced demand.
- Chinese economic growth of 6.4% in the first quarter was higher than expected. The data followed improved manufacturing output and trade data in recent months.
- China's onshore bonds began to be included into the Bloomberg Barclays Global Aggregate Bond Index, a process that will continue until the end of 2020.

Market & thematic comments

- Qualcomm

The resolution of the dispute between **Qualcomm** and Apple has received plenty of coverage and so we won't rehearse all of it here; but as holders of Qualcomm we have obviously taken a keen interest. The dramatic decision by Apple on the second day of the defining course case in this dispute, we think, allows us to draw some important conclusions:

1. Qualcomm does indeed have a competitive advantage in chip design for mobile modems;
2. Intel's withdrawal from that business shows it does not have a competitive edge in this market, despite confident assertions to the contrary only recently;
3. 5G demands, with its high data volumes, require a high-quality solution that is not easily replicable;
4. Apple's service revenues are not yet a substitute for handset sales - the risk of a delay to the new 5G handset presents too great a business risk to Apple.
5. Apple is under intense competitive pressures. Samsung has been joined by Huawei in the top-end handset space and Apple's brand price premium is no longer secure as evidenced by falling device sales and the comparatively weak response to the recent XR model.

- Chinese banks

Chinese banks reported results of the first quarter. The sector overall reported strong revenue growth and accelerating pre-provision operating profit growth of 16% that was better than market expectations. The banks we hold did better still, with China Construction Bank (CCB) and ICBC both reporting net interest margins of ~2.3% compared to their peer average of 2.1%, and China Merchants Bank (CMB) reporting a 2.7% margin versus the China private sector bank average of 2.4%. Fee income was also strong, mostly attributed to wealth management product (WMP) fees; this is an area we might be concerned about, but we have high conviction that the Big Four Banks in China and China Merchants are applying the tighter WMP requirements imposed by the regulator and the central bank.

Net profit growth was more muted, at ~5% for the sector (11% for CMB). The slower growth was due to higher provisioning. Reported non-performing loans remained little changed, with CCB at 1.46% of total loans, ICBC 1.51%, CMB at 1.35% and Minsheng Bank at 1.75%; however, the provision coverage increased. This brings us to why we hold these banks. Many of our peers are scared off by the China debt story and a lack of confidence in banks' asset quality. The decision we have to make is whether, after taking into account the likelihood that there are more bad debts in the system, we think that banks have the capacity and willingness to address these issues while maintaining overall stability. Our argument is that Chinese banks overly discount the risks and underprice the prospects for stability. In short, they are too gloomy, and this presents an opportunity for us, which has delivered out-performance in four of the last five years.

China's financial reform effort has been characterized by many, including us, as a deleveraging program and in part that is true. There are ongoing efforts to reduce debt and corporate debt to GDP is coming down. Banks are also writing off bad debts and the higher provisioning charges just discussed are directly related to that. But perhaps it would be more accurate to view China's financial reforms in terms of making the system safer, more stable. There are daily open market operations to manage the supply and price of credit; the degree to which banks can lend to one another has been limited; assets have been brought out of the shadow banking arena back into the formal banking sector; capital adequacy and risk weighting requirements have been raised. 2018 was the first year in a decade where shadow banking assets declined (down 6.5% to $9.1 trillion or 23.5% of China's banking industry assets, according to Moody's).

- China's bond markets

The results have been promising. And linked to this new stability and safety comes the opening of **China's bond markets**. Most comments have focused on the opportunity offered by a 'new' bond asset class that is deep and liquid as well as having a lower correlation to global benchmarks. (The same is true of Chinese A share equities.) This is certainly interesting for Global and Emerging Markets (EM) bond managers, even though the addition of these bonds to the Bloomberg Barclays Global Aggregate Bond Index will not be complete until 2020. However, in our opinion it also speaks to growing confidence amongst Chinese financial policy makers.

Opening the government bond market is a big step that can have a significant impact on monetary policy management because of the introductions of portfolio flows which can often be far greater in bond markets than they are in equities. There are estimates that the combination of stock and bond market opening could generate portfolio flows of $200 billion a year on average. Even for a market of China's size, such flows would be significant especially when we also remember that flows can move out as well as in. This suggests that the central bank, after years of maintaining barricades around the financial system, is now confident in its robustness. That is not to say that the risks have disappeared, but this is a step change that we believe has huge implications for how we should think about Asia over the next 10 years.

Portfolio update

JB Hi-Fi in Australia reported sales growth in the first 3 months of this year of 2.6%, but in difficult trading conditions in Australia this is a good performance. The market has been negative on the sector and so this news following on from better than expected news from the prior quarter, though modest, has kept the share price moving. The continued turnaround in from the homeware business, The Good Guys, is especially welcome.

DBS in Singapore continues to report strong results with the first quarter 2019 reporting record revenues, pre-provision operating profit and net profit. We were especially struck by the bank's commitment to cease new lending to fund coal-fired power stations.

Janus Henderson offered a very mixed picture in its quarterly results: fund performance has improved sequentially but fund outflows continue and will take time to turn. The loss of an emerging markets equity team (whose fund performance somewhat lags our own EM income fund) is also likely to trigger redemptions.

Hanon Systems has completed the acquisition of the fluid pressure and control unit of Magna International which makes it a leading supplier of thermal and energy management systems. These improve the efficiency of both conventional and electrified power efficiency and so is applicable to internal combustion engine, hybrid and pure electric vehicles. The unit employs 4,100 people across nine manufacturing and engineering facilities in Europe, Asia and America.

Elite Material continues its recovery. The stock is one of our best performers this year after suffering a torrid 18 months prior, on slowing revenues and loss of orders. Digitimes in Taiwan reports that the company will replace Panasonic as a major supplier of copper-clad laminates for Apple's 2019 iPhone and has in fact secured as much as 70% of the orders for laminates used in substrate-like Printed Circuit Boards (PCBs). The importance of this is two-fold – first, the material helps the process of miniaturization of the PCB so gives a key benefit for the manufacture and design of the overall device and second, it's harder to produce and so is higher margin.

Aflac reported results for the first quarter that were uneventful with operating earnings up 7% on last year, which is exactly what we want from this bolt-on healthcare insurer. The main operation in Japan (~70% of the total business) saw premium income fall 2% but it delivered strong investment income growth of 4%. The US business (~30% of the total) saw premium growth up 2.4% and investment income also rose by 1.1% but operating expenses weighed. In the US we are confident that expenses can be managed, while in Japan we think that premium growth will be helped by the recent tie up with Japan Post (office) which adds to distribution.

Outlook

Our view on the prospects for the Fund and for Asia is little changed. The companies we hold have reported in line with our expectations and there have been no surprises. The sharp rally in Qualcomm has been a long time coming but based on our fundamental view of its competitive advantage, was not a shock. The outlook for China is also little changed. We inch closer to a trade deal but as we have seen from recent comments from President Trump, a deal cannot be taken as granted. There are plenty of signs that the slowdown in the domestic economy has now moderated. The dollar has been strong for a while and we do not expect it to move sharply higher given the interest rate outlook. In any case, Asia's sensitivity to this is not what is was: dollar debt as a proportion of the whole is well below Asian crisis levels and with most countries running current account surpluses and well-capitalized banking sectors, the region does not look vulnerable from this direction.

In the medium term, the China risk remains. High debt levels are an overhang but given the source of that debt funding is predominantly domestic we would have to look domestically for the source of a crisis. This could take the form of an economic slowdown brought about by a policy misstep, perhaps, combining with rapid monetary tightening in response to an inflationary or exogenous shock. There are no signs of these kinds of pressures in any of the data we are looking at.

This brings us back to working out what returns on capital our portfolio holdings are capable of generating and how much of that is priced in by the market. The Fund is trading at a 16% discount to the market (as measured by the MSCI AC Pacific ex Japan Index); if we exclude the deep value names the discount narrows to around 3% but importantly, that discount is still there and attached to a group of companies whose operating performances have been well above the average for many years.

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

GUINNESS ATKINSON FUNDS

Performance

As of 4/30/2019	YTD	1 Year	3 Year	5 Year	10 Year
Asia Pacific Dividend Builder Fund (GAADX)	16.33%	-0.37%	12.62%	8.27%	10.99%
MSCI AC Pacific ex Japan Net Return Index	13.99%	-3.24%	11.96%	5.27%	9.71%

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); 3.27% (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, 2020. 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.

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 04/30/19:

1	QUALCOMM Inc	3.45%
2	Hon Hai Precision Industry Co Ltd	3.18%
3	Novatek Microelectronics Corp	3.13%
4	Largan Precision Co Ltd	3.01%
5	Yangzijiang Shipbuilding Holdings Ltd	3.00%
6	DBS Group Holdings	2.98%

7	Lilang China Co	2.94%
8	Luk Fook Holdings International Ltd	2.94%
9	China Merchants Bank Co Ltd - H Shares	2.88%
10	Taiwan Semiconductor Manufacturing Co Ltd	2.85%

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

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