Guinness Atkinson

Asia Pacific Dividend Builder Fund

Review of September 2019

GUINNESS ATKINSON FUNDS

Fund and Market

- Asian markets as measured by MSCI AC Pacific ex Japan Index rose 0.5% in GBP terms, 2.7% in 1.7% in USD terms.
- During the month Asian markets were marginally weaker than developed markets, as measured by the MSCI World Index. Within emerging markets Asia was better than emerging Europe, Middle East and Africa (EMEA) but behind Latin America as measured by the MSCI regional indices.
- The strongest market in the region was Korea, which rose 6.5% in USD terms as measured by MSCI Korea Index, but which remains one of only two markets in Asia to show a negative return this year, the other market being Malaysia. The weakest market during the month was Indonesia, down 2.9% in US dollar terms. China and Hong Kong were flat and down 0.6% respectively as measured by their MSCI Indices.
- From a sector perspective, Technology and Energy led the way while the Health Care and Consumer Discretionary sectors lagged.
- Leading portfolio holdings during the month included Technology names AAC Technologies, Largan Precision and Catcher Technology, which were accompanied by Corporate Travel, Thai energy company PTT and Yangzijiang Shipbuilding.
- Lagging names included Technology names Elite Material and Novatek Microelectronics and Health Care names China Medical Services, Sonic Healthcare and St Shine Optical.

Events in September

- Technology stocks rallied in September following a successful launch of Apple's new iPhone, which saw strong demand due to competitive pricing, and due to expectations of a recovery in semiconductor (memory) prices.
- The price of oil rocketed in September following the attacks on Aramco's facilities. The market had not focused on quite how much of Saudi Arabian output goes through this facility. Prices came back down on expectations of a reasonably speedy resumption of operations.
- The Indian economy remains sluggish and consensus estimates for earnings have continued to come down, but the market received a boost from an unexpected decision to cut the corporate tax rate to around 25% from the previous average rate of 35%.
- The Indian rupee strengthened following the withdrawal in August of short- and long-term capital gains tax which prompted foreign flows back into equities.

- All Asian currencies strengthened against the dollar in September. The strongest after the Indian rupee were the Korean Won and Taiwan dollar, both beneficiaries of a more positive outlook on technology. Korea's, however, is weighed down by weaker domestic activity and the possibility of further interest rate cuts.
- FTSE Russell deferred a decision to exclude Malaysian bonds from its World Government Bond Index (WGBI). It also decided against including Chinese bonds. The WGBI is a compact index, focusing exclusively on government bonds, and has a wide passive following.

The International Monetary Fund (IMF) recently published its updated World Economic Outlook, which describes the global economy as being in a synchronized slowdown. The forecast for global growth for 2019 has been downgraded to 3% (growth in 2017 was 3.8%) and is projected to recover somewhat in 2020 to 3.4%. For investors, we think the important things lie in the details.

There is a marked slowdown in manufacturing and investment evident in the advanced economic areas (the US and Euro area) as well as in China and the advanced Asian economies (Korea, Singapore and Taiwan). The duration and extent of trade disputes between the US and China, the US and the Euro area and between Japan and Korea contribute to an ebbing of business confidence and the deferral of long-range spending plans. In China, a slowdown related to much-needed debt reduction has been exacerbated by the trade dispute. Idiosyncratic factors are also evident, such as the Brexit impact on the UK and broader Euro area and the effects on the car industry of changing emissions standards and the expiry of Chinese tax incentives for car buyers.

The manufacturing slowdown is best understood in terms of trade and investment. Trade volumes grew only 1% in the first six months of this year compared to the same period in 2018. A significant proportion of investment and imports is related to capital and intermediate goods involved in trade-related industrial activity. Therefore, we see the spillover effects of the US-China trade dispute play out through the global supply chain that feeds China's manufacturing base, for example.

This is not the whole story, however. In the technology area, in semiconductors in particular, the slowdown has been linked to a period of oversupply caused by both too much production capacity and weaker smartphone demand. The latter is a function of a lengthening smartphone upgrade cycle, as technology leaps have been smaller, and in that context, the pricing of devices being too aggressive – a problem which Apple has had to address in its latest product launch, and which appears to be working. Optimism is rising for semiconductors into 2020. The launch of fifth generation (5G) devices represents a significant technological advance requiring substantial investment in telecom networks and will be felt in both consumer and industrial sectors over time.

In contrast to manufacturing and investment, the services sector in the leading economies remains strong. It is here that job creation and wage growth is evident and this supports consumer confidence, which remains high, especially in the advanced economies of the US, Euro area, and the developed economies of Asia. In emerging markets, confidence appears to be unchanged from 2018 but is looking "wobbly."

The key macro question is whether or when the slowdown in manufacturing will feed through to consumer confidence. The dislocations discussed above have been in place for some time and are evidently placing a drag on growth. Low interest rates have helped stave off the worst of the short-term impact and have kept asset prices buoyant, but it also seems the impact of support from this source is diminishing. The US was able to increase interest rates only to 2.5% by the end of the 2016 to mid-2018 upswing before cutting again. Interest rates and inflation elsewhere remain low. There is an argument for a concerted effort on the fiscal front to provide support; with long-term interest rates at around 2% or less in the advanced economies, governments could afford to increase borrowing if the proceeds were intelligently directed into long-term productive assets. Remember the discussions about creaking US infrastructure and the economic boost such investment might generate?

At present, we live in a world of intense economic uncertainty. The recovery in growth to 3.4% in 2020 posited by the IMF is expected to come from an improvement in emerging economies currently under strain – Iran, Saudi Arabia, Turkey, Brazil, India – not from the consumer economies of the US and Europe. Even limited trade agreements, if they appear durable, would do much to lift manufacturing confidence in the short term. In the longer term, the problem of weak productivity growth which has been evident for a number of years needs to be addressed. This requires a focus not only in production efficiency through automation but also through developing labor force skills. In this respect the recent film "American Factory" gives a valuable insight not only into the difficulties of integrating a Chinese and a US labor force, but also the challenges that lie ahead for factories and workers regardless of location and origin.

Implications for portfolio strategy

We always emphasize our focus on the operational quality of the companies themselves when we describe our approach. This is because we are looking for those businesses that are not excessively dependent upon factors outside their control, as for cyclical industries such as steel companies, commodity producers, petrochemicals and airlines. However, we still consider wider operating conditions when forming a view on future prospects.

The strength in services and consumer confidence is an undoubted positive, but the risks remain that slower manufacturing and investment may catch up. In such an environment we are keen to avoid second and third tier businesses (in terms of product or service market share). In the event of slower activity these

types of business are like to be the first to see a drop-off in volume business because they are not the first-choice supplier; in effect, their success up to now has been driven by volume growth against a background of favorable macro conditions.

We are also looking carefully at those that have reported elevated levels of capital expenditure in recent years. Capital expenditure (capex), in our minds, needs to be split between what is required to sustain the business (maintenance capex) and what is required to grow the business (growth capex). This again goes back to whether the business has tight capex discipline and is spending to meet identifiable demand growth, or whether it is simply an attempt to scale up and take market share. When considering the current macro backdrop, it could turn out to be poor timing for such an approach and the effect will be felt in terms of negative operating leverage or simply that future demand growth fails to keep pace with the new production capacity that has been added.

We believe that we have the types of companies in the portfolio that are well able to manage a slower growth environment because each of them has something special to offer or has a management team that already has long experience of operating in a competitive environment. There are some names in the portfolio that have suffered from negative operating leverage in the past year, focused in the smartphone area (AAC Technologies, Catcher Technology and Hon Hai Precision). These three were notably hurt by the weak response to Apple's iPhone X range launched last year. We have stuck with them first because we believe that these are fundamentally good businesses, and secondly because the product "miss" would be addressed. The pricing of the iPhone 11 has been such that demand has been good – as acknowledged recently by Huawei, a major competitor, which described the new pricing as a "significant risk" to them in China.

A further factor we must consider is the slowdown in Chinese growth. The story is complicated inasmuch as it is uneven. Efforts to manage debt have exerted a drag on growth and trade tensions have exacerbated this. China's policy response has been measured, not least because any sudden surge in liquidity is likely to lead to a resumption of debt accumulation. Efforts to increase infrastructure investment as a means of driving growth have been hindered by a shortage of new projects offering higher returns. As a local government official from Sichuan recently pointed out, they already have enough roads and bridges. Water treatments and sewage systems, while necessary, offer much lower returns. Chinese state banks, which in the past only needed to know a project had government approval before agreeing to lend, now need to see sufficient cash flow generation to service the debt.

Portfolio changes

We made another change to the portfolio this month, selling our position in Pacific Textiles and replacing it with a holding in Godrej Consumer Products.

The decision to sell Pacific Textiles was based upon on our view that revenue growth remains elusive and that therefore we expect the growth in cash flow that would underpin dividend growth is not likely to come through. We replaced the position with a holding in Godrej Consumer Products, an Indian company whose products fall into four broad categories: soap, hair care, household insecticides (mosquito repellent) and air care (fresheners). A little over half its revenue comes from India, with Indonesia, Africa, Middle East, IS and Latin America the other main markets. We like the geographic diversification and we like the growing market share in the soap and insecticide product areas. Recent tax cuts in India have helped boost investor sentiment towards Indian equities, increasing Godrej's share price. While the company is unlikely to have a large direct benefit from the lower rates, the indirect boost from higher consumption is likely to be beneficial.

The effect of the switch is to increase our exposure to India in the portfolio from one stock to two (5.5% at neutral weight; actual weight will vary with market fluctuations). As with the switch last month, the fundamental characteristics of the purchased company positions the portfolio more in line with expected dividend growth. The shift is marginal, but the overall effect is to improve the quality of the growth profile by steering towards companies with a greater likelihood of dividend growth while ensuring this is reasonably priced.

Outlook

The US and China are working toward putting together a "Phase 1" trade deal for the two presidents to sign in November. As part of this the US opted not raise tariffs further in October, but no decision has yet been made on whether to proceed with the planned extension of tariffs in December. The thorny issues around technology transfers, intellectual property protections and state support for industry have yet to be resolved, but for now, an armistice would be very welcome.

Portfolio strategy remains focused on ensuring the robustness of cash flow growth that is required to underpin dividend growth. The portfolio currently trades at a discount of 11% to the broad market as measured by consensus estimates for the MSCI AC Pacific ex Japan Index.

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

Sharukh Malik (analyst)

Performance

As of 9/30/2019	YTD	1 Year	3 Year	5 Year	10 Year
Asia Pacific Dividend Builder Fund (GAADX)	11.02%	-3.33%	5.91%	6.06%	6.98%
MSCI AC Pacific ex Japan Net Return Index	8.35%	-2.32%	6.53%	4.10%	5.52%

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 recoup a portion or all of such amounts absorbed at any time within three fiscal years after the fiscal year in which such amounts were absorbed, subject to the expense cap in place at the time recoupment is sought, which cannot exceed the expense cap at the time of the waiver. The expense limitation agreement may be terminated by the Board of the Fund at any time without penalty upon 60 days' notice.*

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 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.

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 09/30/19

1	Largan Precision Co Ltd	3.18%
2	Godrej Consumer Products Ltd	3.15%
3	Taiwan Semiconductor Manufacturing Co Ltd	3.11%
4	Tisco Financial Group PCL/Foreign	3.08%
5	PTT PCL /Foreign	3.06%
6	Infosys Ltd	3.05%
7	KT&G Corp	3.01%
8	Elite Material Co Ltd	2.97%
9	Janus Henderson Group PLC	2.91%
10	Hon Hai Precision Industry Co Ltd	2.90%

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

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