

#### **Fund and Market**

- Asian markets fell sharply in March, as the coronavirus spread around the world. For the month, the MSCI Pacific ex Japan Net Total Return Index fell 13.00% (all figures in USD unless stated otherwise). Since then (to April 20<sup>th</sup>) the market has risen 6.89%.
- During the month, the best performing sectors were communication services, health care and consumer staples; the weakest were energy, real estate and financials. This was also reflected over the quarter.
- China has been the notable outperformer over the past month and over the first quarter. The weakest have been Indonesia, Thailand, Australia, India and Singapore.
- Chinese stocks in utilities, banks, insurance, communication services, health care and consumer discretionary have worked best. These have been joined by technology names like Elite Material and Novatek Microelectronics along with Ascendas REIT in Singapore and Public Bank in Malaysia.
- Weak names in the month, and over the quarter, include Corporate Travel, Tisco Finance, JB Hi-Fi, Janus Henderson, Tech Mahindra and DBS.

#### **Events in March**

- The coronavirus continued to spread across the world, with Italy and Spain particularly badly affected by the health crisis.
- Major lockdowns were announced in multiple countries, bringing widespread severe economic disruption.
- The Fed cut interest rates by 100 basis points to zero (at the lower end of the range) on March 15<sup>th</sup> (a Sunday). A range of supportive measures were introduced, including \$700bn additional asset purchases and dollar swap lines with foreign central banks.
- Further policy measures were announced by the Fed on March 23<sup>rd</sup>, which included a pledge to buy corporate bonds for the first time. The package removed the existing cap on asset purchases.
- Congress approved a \$2tn package to support the economy, with a combination of spending, business lending and loan guarantees.
- By the end of the month, the US surpassed China as the country with the largest number of confirmed coronavirus cases.
- Oil fell dramatically after a breakdown in relations between Saudi Arabia and Russia, and a failure to agree production cuts. The WTI oil price declined 54%.

## Market Update

Almost 90% of the world's GDP has been impacted by the pandemic; 16% of GDP (i.e. China) is in the process of lifting restrictions. The manner and speed with which households and economies open up will be key to evaluating recovery prospects. Today, it is too early to do so with any kind of certainty and so we rely on scenario analysis which of course produces an enormous range of results.

A recent scenario, offered by independent research house Oxford Economics, presents the following outlook: The World economy is expected to contract by 2.8% in 2020, with advanced economies contracting by 4.5% and Emerging markets by 1.1%. This is expected to be followed by a rebound in 2021 with World growth of 5.9%, with Advanced economies growing 6.2% (led by the US) and Emerging markets growing 7.2% (led by China and India). Oxford Economics expects the third quarter of this year to mark the start of the recovery. Critical to these assumptions, however, is the speed with which the world can ease up on the lockdowns; but just as important is the size and structure of the spending response to support and then stimulate economic activity. Longer term, it is the level of activity achieved rather than the percentage change that will matter more to us.

We think from a macro perspective that, albeit with caveats, there are optimistic signs from Asia which of course is further through the pandemic. Restrictions in China, Korea, Taiwan and Hong Kong are being lifted. New cases are being identified but at much lower levels. High frequency data from the world's largest manufacturing economy are pointing north, especially in March. According to government data, the work resumption rate in large industrial companies is back to 98.6% as of March 28<sup>th</sup>, while that for smaller enterprises is up from 33% at the end of February to 80% as of April 10<sup>th</sup>. This was supported by monthly data that showed sequential (i.e. compared to the prior month) recovery in industrial production, retail sales and property sales. Compared to the same period last year, activity levels are lower but at this stage we can identify moderating pressure.

There have been government responses across the region to provide economic support with interest rate cuts, expansion of credit along with fiscal responses including tax cuts and government spending. The situation is helped by the relatively strong financial position of governments and banking sectors. Indeed, globally the banking sector is much better capitalized and balance sheets a lot cleaner going into this crisis than in the run-up to 2008.

The feedback from companies has been cautious, as one would expect. Those reporting full year results cited uncertainty in various aspects of their businesses. The quarterly results season just beginning now is perhaps more informative. For example, we saw Taiwan Semiconductor presenting a positive view for their business driven by demand for chips from telecom handsets and high-performance computing. The company has warned that slowing handset demand will drag on revenues in the second half, but the market was most impressed by its commitment to maintain its US\$16 billion capital expenditure plan this year. China Mobile saw a slight drop in revenue for the first quarter due to a drop in handset sales; revenues from telecom services, which make up the bulk of the business however, grew. The loss of 4m subscribers should be seen against a total subscriber base of 946 million as at the end of March.

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**Fund view**

- **Financial health**

Our focus on Quality businesses rests upon two pillars: superior operating performance (as measured by returns on capital) that rests upon a solid financial platform (i.e. a strong balance sheet). At a time when operations have been severely disrupted, for a period about whose duration we are uncertain, the focus needs to be on the resilience of those financial platforms. Those with strong balance sheets are the ones best placed to turn their operating advantages into cash flows. Capital intensive businesses are potentially vulnerable.

Our balance sheet analysis of each company has therefore focused on structure and liquidity which we can consider in terms of the following categories: Liquid assets, Working capital structure, Operating assets and Sources of Funding. Taking each of these in turn we have considered the following:

**Liquid assets:** Cash component, the identity of Cash Equivalents and Short-Term investments (with higher credit quality) together with any personal pledges of shares by company directors as collateral or issuance of company repayment guarantees to support loans to subsidiaries or associates that might exist.

**Working capital structure:** Related to liquidity, we consider how quickly Accounts Receivables ( i.e. sales made but not yet paid for) may be converted into cash, how much money is tied up in inventory and finished goods and finally Accounts Payable, the amounts due to suppliers and how soon they are expected to be paid.

**Operating assets:** This consists of the Property, Plant and Equipment. Does the company own these assets, or does it lease (rent) them? How quickly do they need replacing and how expensive would it be to do so?

**Sources of Funding:** This means a consideration of the proportions funded by the company's own resources (equity) and the proportion of external funding (i.e. debt). The size and maturity structure of external funding are critical in times of stress. Interest must still be paid on borrowing and if the maturity structure is wrong, a company can be fined itself with a substantial proportion of debt falling due at a time when it is hardest to refinance.

A capital-intensive business, therefore, is one which has a sizeable proportion of its assets tied up in equipment and working capital; in a time of economic stress, when activity is low then these businesses can quickly run into trouble. Airlines are a perfect example of what can go wrong. Taiwan Semiconductor is another capital-intensive business, but for them it all seems to be going right and the reason for that is that their exceptional production technology has delivered high quality chips that have commanded higher prices at far lower costs than their peers have achieved. This has generated sufficient cash for them to afford \$10 billion of capital expenditure in any year to keep them out in front without recourse to significant debt funding. At the last balance sheet date, the cash they held on the balance sheet was 2.8x the size of their borrowings. The debt they have, is primarily short-term debt to

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fund working capital requirements through the year while the cash is there to fund the capital expenditure, and the intended dividend.

The analysis of the portfolio was split between the non-bank portion 81% and bank portion 19%. The non-bank portion had total debt to equity of 36%, so 63% of our companies' operations were funded with their own resources. When we take account of cash, we can see the overall portfolio was net cash, which is to say that the aggregate cash balances were greater than the amounts borrowed. We are most concerned with the position for the next twelve months after which (and in all likelihood well before) business activity will resume.

In terms of interest coverage, we compare operating income (defined as revenues less operating costs but before interest costs, depreciation charges and tax) to interest expense. The lowest coverage was Hon Hai Precision whose interest costs were 2.7x covered by operating income. The next lowest were the two Singapore real estate investment trusts (REITs) with 4x and 5x coverage. In the rest of the portfolio, interest expenses were over 10x covered.

Refinancing risk is the next consideration. We looked at near term financial obligations by combining Short term borrowing, the amount of Long-term debt falling due in the next twelve months and Lease expenses and looking at what would happen if there was no access of any kind to further financing. All but five stocks seem able to cover this fully with cash on hand. The five stocks that could not were three REITs (Ascendas REIT, CapitaLand Mall Trust and The Link REIT), Sonic Healthcare and Luk Fook. The maximum exposure at 6% of equity was with Ascendas REIT. The other four had exposures that were less than 2% of equity.

In the bank portion of the portfolio we primarily consider the capital base and the degree to which it is geared by measuring assets to equity. The banks in our portfolio have equity leverage of 8-12 times, which is to say the assets on the balance sheet which consist of loans, bonds or other interest earning instruments are 8-12 times the size of the equity base. This is rather lower than the 15-20 times leverage that is common among developed market financial institutions. In the years following the Asian financial crisis bank leverage in the region came down and capital bases increased, which meant that they were largely unscathed in the global financial crisis 10 years' on. Further financial reforms, especially in China, saw a reduction in shadow banking activity with more brought onto the balance sheet and more capital set aside to support it.

- **Operations and Dividends**

Earnings estimates for this year are a moving target. Much will depend on the ability and willingness of consumers to begin a return to normal. A significant proportion of the portfolio might be described as economically sensitive. We have exposure to consumer electronics through technology manufacturing, to consumer discretionary segments like clothing, home appliances as well as insurance. There is also exposure to commercial lending and finance businesses which are linked to economic activity. The problem we have right now is that the nature of this event can be seen to have first, second and third

order effects. As the market tries to get to grips with this, we have seen share prices move wildly across the board.

But what we have on our side, are businesses with core strengths to weather the storm and competitive advantages and market positions which should enable them once again to grow cash flows and dividends once activity resumes. So operating performance in cash flow terms and the resultant dividends are likely to continue to be the most important long-term determinants of performance.

We are confident in the strength of our companies' financial platforms and we have not changed our views on the operating skills, strengths in production and distribution and their overall competitive advantages in normal conditions. We expect our companies to have the ability and willingness to pay dividends but expect this to be tested in the coming year. Companies in Asian and Emerging Markets tend to have dividend policies that are calculated as a proportion of earnings, otherwise known as a Pay-out ratio. In developed markets, a progressive dividend policy, where the company seeks to increase (or at least maintain) the dividend per share from year to year, is more common. We hold some in the portfolio, like Aflac, Janus Henderson, Sonic Healthcare but for the most part the companies operate a pay-out ratio policy.

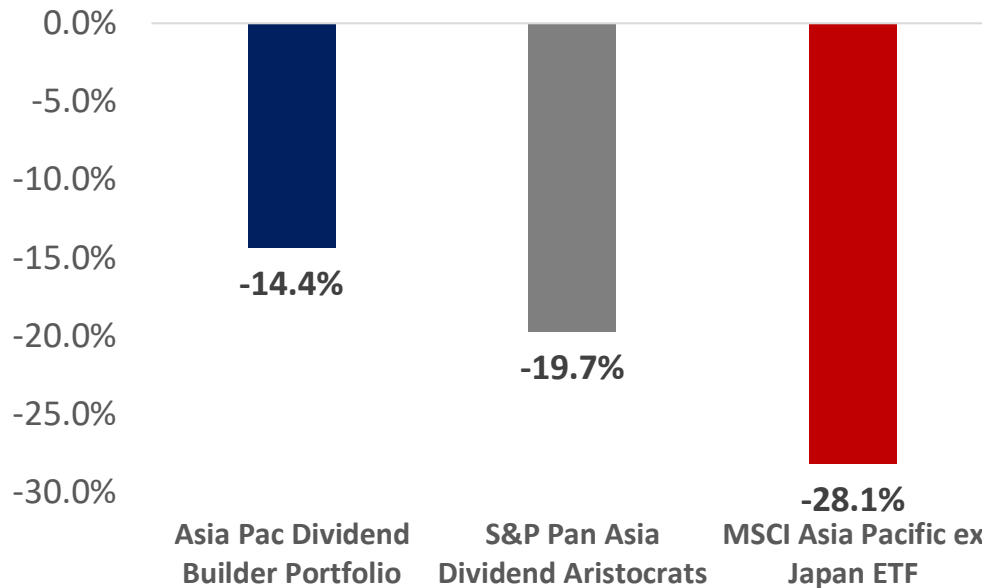
Therefore, when we assess dividends paid by our companies, we are very often looking for some stability in the pay-out ratio. What this will mean however, is that in a year when earnings drop dividends are likely to fall too. Consensus estimates for company earnings in 2020 have of course been coming down. The latest estimate for our portfolio companies is for a decline of 8.6% in 2020 followed by a 9.7% recovery in 2021. But it is important to remember this is still a moving target.

We had a look back to the financial crisis and its aftermath from 2007-10 to see how dividends from the companies we hold in the portfolio today fared back then. The situation then was driven by different dynamics and so should not be seen as a template for what happens next. But it can tell us a little about how the management groups of these companies reacted in a period of high uncertainty and economic disruption.

Figure 1 shows the change in dividends per share in 2008 for thirty three of the thirty-six companies we hold (the remaining three did not report dividends in 2007) and compares them to the 2008 dividend performance of companies that presently constitute the S&P Pan Asia Dividend Aristocrats Index and the MSCI Asia Pacific ex Japan Index.

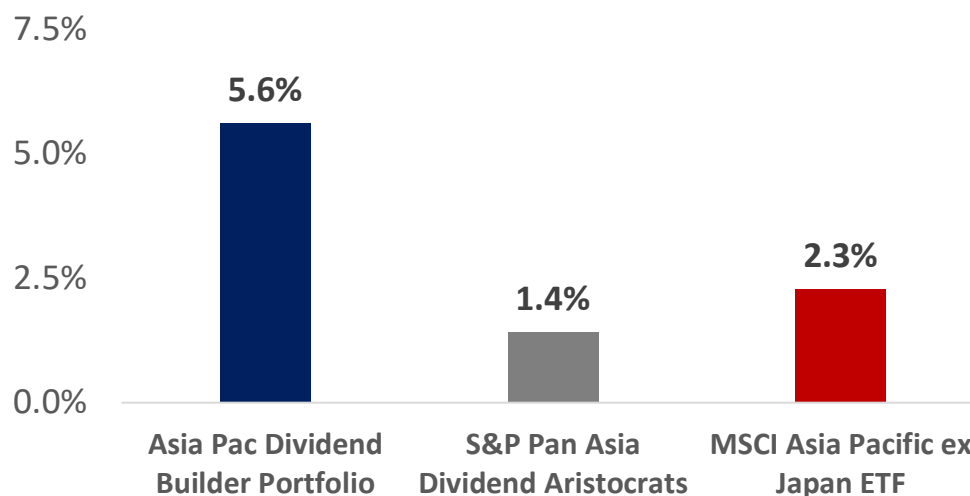
Figure 2 shows the average annual growth rate of dividends from these same groups over the 2007-10 period.

**Figure 1:**  
**Dividend Growth 2008 vs 2007, in US\$ terms**



*Sources: Bloomberg, Company data and Guinness Atkinson Asset Management calculations. Figures are based on dividends per share reported 2007 and 2008, in US\$ terms, by the companies held in the portfolios as of March 31, 2020. For Asian Equity Income, 33 of the 36 companies held reported dividends in the period; for S&P Pan Asia Dividend Aristocrats 91 out of 100 companies reported and for MSCI Asia Pacific ex Japan Index, for which we use the Lyxor ETF (AEJ FP) as a proxy, 748 companies out of 1,236 reported.*

**Figure 2:**  
**Annualized Dividend Growth 2007-10, in US\$ terms**



*Sources: Bloomberg, Company data and Guinness Atkinson Asset Management calculations. Figures are based on dividends per share reported between 2007 and 2010, in US\$ terms, by the companies held in the portfolios as of March 31, 2020. For Asian Equity Income, 33 of the 36 companies held reported dividends in the period; for S&P Pan Asia Dividend Aristocrats 91 out of 100 companies reported and for MSCI Asia Pacific ex Japan Index, for which we use the Lyxor ETF (AEJ FP) as a proxy, 748 companies out of 1,236 reported.*

As of the end of March, 22 out of our 36 companies had reported full year results and overall dividend growth was running at 2.3% in US dollar terms compared to the same period last year. This calculation takes into account that one of the companies in the portfolio, AAC Technologies, omitted its final dividend.

## Portfolio Update

Outperforming names in the portfolio during the month and quarter have been concentrated among the Chinese stocks. China Construction Bank, China Merchants Bank, Ping An (in Financials), China Mobile (in Communications services) and China Resources Gas (in Utilities) have worked well for us. Alongside these were Catcher Technology and Taiwan Semiconductor Manufacturing. All the rest were under-performers over the period.

The weakest stock in the portfolio has been Corporate Travel Management, for whom business has dried up. The balance sheet, however, is strong and is differentiated from other travel companies by its business model. It is in the corporate business, not the leisure business and so it does not block book tours which sit on the balance sheet before being sold on. The company operates on a pass-through

basis, receiving payments and passing onto airlines on a thirty-day cycle while taking fees along the way. This means the balance sheet is light, debt is small and because the core business asset is a technology platform, the cost base is variable. The company has access to ample credit lines should it need them to cover its fixed costs for an extended period.

The rest of the portfolio includes Staples, Discretionary, Health care, Real Estate, Insurance, Asset Management and Technology services across the rest of Asia designed to give us exposure to the structural trends that existed before this crisis and remain in place. Since the end of the quarter we have seen a broadening in the number and types of names that are outperforming and while we are not necessarily happy with share price action over the quarter, we remain confident in the operating strengths of the businesses themselves. If, in the old saying, the proof of the pudding is in the eating, then we believe the proof of these companies will be in the dividends they pay.

Over the quarter we have made two changes to the portfolio, both driven by new ideas that we have been watching for a while and waiting for an attractive entry point. The first is Zhejiang Supor, a China A share company which makes kitchen equipment (the parent SEB, a French company owns Tefal) and second is Shenzhou International, a textile company supplying the likes of Nike, Adidas and Ralph Lauren. We sold Li & Fung to make way for one of these names. A second company was sold more recently, and we will discuss that next month. For a while we were at 37 names and the delay in the second sale was a matter of timing – the volatile conditions that suited the purchase did not equally suit the sale, hence the timing difference. The portfolio is now back at thirty-six positions.

## Outlook

We continue to try and ground our view of prospects for the portfolio on the separate pillars of basic financial strength, operational cash flows, dividend streams and valuation. As you may judge going through that list, the level of uncertainty rises at each step. However, we take a longer-term view when building the investment case for each position. This means that even in a time of significant disruption, we are confident that the businesses are much less at risk of failing, in our opinion.. Some may resume more slowly than others, but all have fundamental financial and operational strengths, in our view.

The valuation question is harder, especially if it is considered in terms of multiples of earnings over the next couple of years. But our core approach is different. We think about the cash flows these companies are capable of generating over time and what these cash flows are worth in today's money. In this context, a disruption over the next year to two years does not have such a great impact on valuation assumptions and helps us separate out the intense noise of current market volatility from fundamental long-term assessment of value. This has been our approach since the Fund was launched and we shall stick to it.

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

**Sharukh Malik** (analyst)



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**Performance**

as of 3/31/2020	YTD	1 YR	3 YR	5 YR	10 YR
Asia Pacific Dividend Builder Fund	-21.11%	-16.31%	-1.00%	1.59%	4.36%
MSCI AC Pacific ex Japan NR	-19.74%	-13.70%	0.17%	1.01%	3.52%

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](http://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](http://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. The Asia Pacific stock markets may experience periods of volatility and instability. Some domestic China "A" Shares are available through the Hong Kong Stock Connect or Shenzhen Stock Connect, which may be subject to risks of trading suspensions, quota limitations and additional risk. The Fund may invest in small-cap or**

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**mid-cap companies, which involves additional risks such as limited liquidity and greater volatility, than in larger companies.**

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.

MSCI Asia Pacific ex Japan is of the same construction and with the same countries with the additions of India and Pakistan.

The S&P Pan Asia Dividend Aristocrats® Index measures the performance of constituents within the S&P Pan Asia Broad Market Index that have followed a policy of consistently increasing dividends every year for at least seven years.

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.

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 3/31/20

1.	Corporate Travel Management Ltd	3.54%
2.	Aflac Inc	3.27%
3.	Public Bank Bhd	3.08%
4.	China Mobile Ltd	2.91%
5.	Janus Henderson Group PLC	2.85%
6.	PTT PCL /Foreign	2.84%
7.	QUALCOMM Inc	2.79%
8.	Ascendas Real Estate Investment Trust	2.72%
9.	China Resources Gas Group Ltd	2.70%
10.	AAC Technologies Holdings Inc	2.69%

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

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