Guinness Atkinson

China & Hong Kong Fund

Review of May 2020

GUINNESS ATKINSON FUNDS

Summary Review & Outlook

Fund & market

- In May, MSCI China fell 0.5%. The Shenzhen Component Index fell 0.5% while the Shanghai Stock Exchange Composite Index fell 1.1%.
- In MSCI China, the strongest sectors were Consumer Discretionary (total return of +4.6%), Consumer Staples (+2.8%) and Health Care (+2.1%) while the weakest were Real Estate (-5.8%), Financials (-4.7%) and Materials (-4.4%).
- In the Fund, positive contribution came from Haitian International (Industrials) as well as Consumer Discretionary names Alibaba, Zhejiang Supor and Haier Electronics. On the other hand, we saw weakness in China Overseas Land & Investment, Hollysys Automation, China Lesso and Geely.

Events in May

- An outbreak of cases emerged in the northeast of China, starting in Heilongjiang province which shares a border with Russia. Cases spread to neighboring Jilin province, with Shulan city locking down like Wuhan did in January. So far, the outbreak seems to have been contained, but serves as a reminder that COVID-19 is likely here to stay until an effective vaccine can be developed.
- The Caixin Purchasing Managers Index, which is more geared towards private enterprises, increased from 49.4 in April to 50.7 in May, indicating an expansion in activity. The production sub-index rose to 54.0, its highest level in nine years as activity makes up for the time lost in February and March. On the other hand, though the new export order sub-index improved to 41.7, this still indicates weak demand from abroad.
- MSCI Hong Kong fell 8.4%, with the Financials and Real Estate sectors, which are by far the largest parts of the local index, falling 8.2% and 13.6%. China is in the process of drafting laws which would ban subversion, separatism, terrorism and “activities of foreign forces” in Hong Kong. This development bypasses Hong Kong’s Legislative Council, leading some to argue this violates the “one country, two systems” principle.
- The move represents greater assertiveness by China. It may be a sign that China has lost confidence in Hong Kong’s government or it could be a broader signal that China feels less constrained by its relationship with the US. The response so far by the US has been to begin the process of removing policy exemptions that give Hong Kong special treatment. This covers export controls, customs, financial transactions and immigration. For now, China may view this as a small price to pay for reasserting control over Hong Kong.
- Tensions between the US and China increased on multiple other fronts. The US tightened export controls on semiconductor exports to Huawei, and now explicit permission is required from the US government. The US Federal Retirement Thrift Investment Board, which manages more than $500bn in assets, postponed a plan to increase its allocation to Chinese shares after pressure from the White House. The US Senate approved a bill to force foreign companies to open their books to the Securities and Exchange Commission, increasing the likelihood that Chinese companies would delist from

American bourses and list elsewhere. Netease and JD.com are on track to launch a secondary listing in Hong Kong, both following on from Alibaba last year.

Market Update

According to analysis by Goldman Sachs covering 90% of Chinese companies' market capitalization, earnings of Chinese companies fell by 22% in the first quarter. As expected, Consumer Staples grew earnings due to higher pork prices and good sales of Baijiu. Banks also grew earnings by 5% but in the future, we expect headwinds from rising non-performing loans and net interest margin compression. Many internet stocks also outperformed, covering gaming, search and e-commerce. Due to the collapse in oil prices, energy stocks faced significant losses; note the Fund has no exposure to the Energy sector. Industrials, Consumer Discretionary and Information Technology saw earnings fall 66%, 59% and 47%. We expect second quarter results to show a better picture as economic data shows the recovery is continuing. As of May 26th, daily coal consumption of major electricity producers was 26% higher year-on-year. Traffic congestion within major cities is back to normal levels, though volume through subways remains a quarter below historical levels. Property sales volume is back to last year levels.

During its annual National People's Congress meeting, the government dropped its GDP growth target given the uncertainty arising from coronavirus. But it was noticeable that the government has a target of creating nine million jobs in urban areas and is targeting an urban unemployment rate of 6%. The government also made it clear it will not stimulate the economy like it did after the global financial crisis, with broad monetary and infrastructure stimulus. Though the official budget deficit is forecasted to be 3.6% of GDP, this does not include all sources of funding for the government, such as from special government bonds and off-budget items like proceeds from land sales. Based on calculations by JP Morgan, China's augmented fiscal deficit will reach 15.1% of GDP in 2020, the highest since 2009. The Ministry of Finance is projecting an official on-budget deficit of 3.6% of GDP and estimates the official on-budget deficit will be RMB 3,760bn. The implied GDP growth target for 2020 is therefore 3.8%, if we use last year's GDP deflator of 1.6%.

The People's Bank of China (PBoC) has already committed RMB 1.8trn (assuming USDCNY 7.10, this is equivalent to $250bn) for a relending program, with 42% of the total deployed as of June 4th. On June 2nd, the PBoC rolled out further measures to support small and medium sized enterprises (SMEs). To help improve cash flows for SMEs, for loans due this year, SMEs can defer payment of principal and interest until March 2021. This is in return for keeping employment stable.

SMEs account for 80% of total employment in China but only 4% of system loans, according to analysis done by JP Morgan. The big five banks lend the majority of their funds to state owned enterprises (SOEs), meaning rural banks and city commercial banks are the main channel through which SMEs access credit. As of March 2020, inclusive finance (which includes SMEs and personal business loans with loans worth less than RMB 10m ($1.4m)) to total loans was only 5% for large banks. This compares to 7% for joint-stock banks, 10% for city commercial banks and 24% for rural financial institutions. Rural financial institutions and city commercial banks contributed to 52% of inclusive finance loans in the first quarter, highlighting their importance.

Due to their smaller size, information asymmetry and potentially riskier cash flows, lending to SMEs is viewed as riskier. This is, for example, reflected in the non-performing loan (NPL) ratio, which was 3.2% for SMEs compared to 1.9% for total loans. So additional incentives are needed to encourage lending to smaller businesses. To help SMEs manage liquidity, the PBOC is now also setting up an additional relending facility worth RMB 400bn ($56bn) targeted towards micro SMEs. The underlying banks issue the loans and the PBoC will use the facility to purchase 40% of new loans, returning them to the underlying bank after a year. This will temporarily reduce the capital needs of these banks when lending to SMEs, making it more likely they will lend to SMEs. The big five banks also have a target of increasing inclusive finance by 40% which implies an increase of RMB 1trn ($141bn).

Portfolio Update

Hollysys is a provider of automation and control technologies, targeting industrial and railway customers. Revenue in the most recent quarter fell 35% year-on-year while net profit fell 50%. Lockdowns and a restriction in movement were obvious impediments to the business, which particularly impacted the higher margin services business which requires an on-site presence. It took until April for the labor return rate to reach 90% as Beijing, where Hollysys is headquartered, only lowered its risk level at the end of April. Management expect that in the second half of this year, business should get a boost as China Railway restarts bidding activity which has been relatively quiet for the past few quarters. Hollysys should get a further boost as China Railway has pledged to increase its railway investment target, which was already CNY 800bn / USD 112bn.

Autohome is China's largest online platform for buying and selling cars. Revenue in the first quarter fell 4%, with a 10% drop in advertisements and lead generations partly offset by an 85% rise in data revenue. 2020 is likely to be challenging if, as expected, car sales fall as a consequence of COVID-19 which is likely to lead to reduced marketing budgets. There are steps, however, that Autohome can take to manage this headwind. More customers are buying Autohome's data products, such as a "Smart Assistant" driven by AI which answers buyer's queries. Clients have consequently seen conversion rates increase by at least 20%. The weakness in the automobile market extended to Geely Automobile, who issued 600m new shares, raising $850m of funds.

Sino Biopharmaceutical's revenue and earnings were flat in the first quarter. Sales in the hepatitis franchise were down 24% as multiple products saw their prices cut as the government reins in healthcare costs. On the other hand, sales of oncology products rose 61%, surpassing hepatitis sales. Anlotinib, used to treat small cell lung cancer, has become an impressive drug for the company monetarily. Sino Biopharmaceutical also launched new oncology generics which are included in the government's centralized purchasing plan, such as abiraterone (used to treat prostate cancer) and gefitinib (used to also treat non-small lung cancer).

Qualcomm reported better than expected results. Smartphone sales fell approximately 21% and Qualcomm is expecting a further 30% fall in handset shipments in the next quarter. However, on a more positive note, average selling prices (ASPs) rose from $23 in the previous quarter to $32 in the most recent quarter. As 5G phones become more popular, Qualcomm should see a significant increase in sales as the market leader in its

space. In China, 5G phones' market share has rapidly increased from 19% in the fourth quarter of 2019 to 40% in May, and we believe the rest of the world is likely to follow this trend.

Baidu also fared better than expected. Though revenue fell 7% in the first quarter, with a 13% decline for the core business, this was offset by better cost control. The number of daily active users of the Baidu App rose by 27 million users in the quarter to 222m. More users are conducting their searches within the app which means Baidu does not need to pay acquisition costs, helping margins. As hospitals drastically curtailed routine operations and procedures in the first two months of the year, revenue from this segment fell significantly and we expect a rebound as hospitals resume normal operations. Though the business has its challenges, we think the valuation is very undemanding based on a conservative sum of the parts approach.

Portfolio Switches

We bought JD.com, one of China's largest e-commerce websites. JD is different from Alibaba in that it has built its own logistics platform so has more control over the quality of its service and the amount of inventory it holds. This means that during the worst of the lockdown, JD was better stocked than many of its peers and its delivery services were less interrupted. JD was initially known for selling electronics but has branched out into apparel and more recently groceries, and so has seen very strong demand this year. In the first quarter, JD's revenue grew 20%, while overall online retail consumption fell 1% according to the National Bureau of Statistics of China, highlighting its strong position. The company is seeing its highest demand by retailers in 17 years for the upcoming 618 Shopping Festival. The purchase of JD.com gives the Fund more exposure to e-commerce, which is likely to see even more adoption this year as coronavirus changes consumer habits.

Summary view & Outlook

The changes we have made to the Fund this year are summarized below:

Out	
Name	**Sector**
Travelsky	Information Technology
CNOOC	Energy
Tongda Group	Information Technology
AAC Technologies	Information Technology

In	
Name	**Sector**
Zhejiang Supor	Consumer Discretionary
JD.com	Consumer Discretionary

Debt/equity for the portfolio, excluding the three banks, is 42% i.e. the Fund is not highly geared. If we look at net debt/equity, which subtracts cash from debt, the figure is -14% i.e. our companies could in theory pay back all of their debt with cash. We measure bank leverage by comparing total assets to total equity. We would consider assets that are 20x the size of equity to be the maximum we would accept for a bank and for an emerging markets bank with their more highly concentrated loan books we think we should be looking at 12-13x. China Merchants Bank is the most leveraged at 12.0x and BOC Hong Kong the least at 10.0x.

Edmund Harriss (portfolio manager)

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Performance

As of 5/31/2020	YTD	1 Year	3 Year	5 Year	10 Year
China & Hong Kong Fund (ICHKX)	-14.22%	3.93%	3.46%	1.32%	3.07%
Hang Seng Composite Index TR	-12.23%	-4.11%	1.72%	0.25%	5.15%

As of 3/31/2020	YTD	1 Year	3 Year	5 Year	10 Year
China & Hong Kong Fund (ICHKX)	-18.73%	-9.51%	2.89%	2.64%	1.40%
Hang Seng Composite Index TR	-14.17%	-12.47%	2.89%	2.24%	4.15%

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

Expense Ratio: 1.69%

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. 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. The China and/or Hong Kong stock markets in which the Fund invests may experience periods of volatility and instability. These fluctuations may cause a security to be worth less than it was at the time of purchase. Market risk applies to individual securities, a particular sector or the entire economy. China and/or Hong Kong stocks may fall out of favor with investors, the value of Chinese currencies may decline relative to the U.S. dollar and/or China or Hong Kong stock markets may decline generally. The Fund invests in invest in small-cap or mid-cap, which involve additional risks such as limited liquidity and greater volatility, than investments in larger companies.

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.

The MSCI Zhong Hua Index is a composite index that comprises the MSCI China and MSCI Hong Kong Index. The index captures large and mid-cap representation across all China securities (B shares, H shares, Red Chips, PChips and foreign listed shares) as well as Hong Kong securities.

MSCI China Index captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). With 703 constituents, the index covers about 85% of this China equity universe.

MSCI Hong Kong Index is a capital weighted stock index designed to measure the performance of the large and mid cap segments of the Hong Kong market. It has 48 constituents and covers approximately 85% of the free float-adjusted market capitalization of Hong Kong equity stocks.

Shanghai Composite Index, also known as SSE Index, is a stock market index of all stocks that are traded at the Shanghai Stock Exchange.

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 5/31/2020:

1.	Sino Biopharmaceutical Ltd	4.07%
2.	Anhui Conch Cement Co Ltd - H Shares	3.93%
3.	Alibaba Group Holding Ltd	3.91%
4.	NetEase Inc - ADR	3.87%
5.	Noah Holdings Ltd	3.83%
6.	Tencent Holdings Ltd	3.77%
7.	Haier Electronics Group Co Ltd	3.57%
8.	Weichai Power Co Ltd - H Shares	3.52%
9.	China Merchants Bank Co Ltd - H Shares	3.50%
10.	JD.com Inc	3.48%

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

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