Guinness Atkinson

China & Hong Kong Fund

Review of October 2020

Summary Review & Outlook

Market

- In October, MSCI China rose 5.3% and MSCI Hong Kong fell 1.2%. The Shenzhen Component Index rose 4.1% while the Shanghai Stock Exchange Composite Index rose 1.7%.
- Meanwhile the S&P 500 fell 2.7%, MSCI Europe fell 5.6% and MSCI Japan fell 1.6%.
- In MSCI China, the strongest sectors were Communication Services (total return of +10.4%), Consumer Discretionary (+6.5%) and Information Technology (+5.1%) while the weakest were Real Estate (-3.8%), Energy (-3.6%) and Industrials (-0.6%).
- In MSCI Hong Kong, the Real Estate and Financials indexes fell 2.9% and 1.1% respectively.

Events in October

- Third quarter gross domestic product (GDP) growth was 4.9%, higher than the second quarter rate of 3.2%. The GDP data implies softness came from slower investment growth which seems at odds with the investment data below, which show fixed asset investment (FAI) growth seems robust. Analysis from Goldman Sachs argues FAI is difficult to measure and so instead they use their own investment tracker to suggest machinery sales have decelerated, which is likely captured well by GDP data but not so much by FAI.
- Industrial production grew 6.9% year-on-year (yoy) in September compared to 5.6% in August. Fixed asset investment (FAI) grew 7.5% yoy in September. Manufacturing investment growth decelerated from 6.6% yoy in August to 2.7% in September while infrastructure investment grew from 7.5% yoy growth in August to 7.5% in September.
- Retail sales grew 3.3% yoy in September, an improvement from 0.5% in August. Automobile sales grew 11.2%.
- The Communist Party of China (CPC) released some details of its next Five-Year Plan. The summary communique did not mention a target goal for GDP growth and instead emphasized higher quality growth, innovation, market reform, domestic demand and final liberalization. The NDRC will submit a detailed draft in March 2021 which is when we should see more concrete proposals.
- The Caixin Purchasing Managers' Index (PMI) rose from 53.0 in September to 53.6 in October. The improvement in the reading was broad based as the production, new orders and new export sub-indexes were strong, while the finished goods inventory index fell, suggesting strong demand in October.
- Reports indicate the People's Bank of China (PBoC) is to suspend the countercyclical factor used to fix the US Dollar (USD) to Chinese Yuan (CNY) rate (USDCNY). The factor was introduced in 2017 to reduce the pressure on the Renminbi but this year we have instead seen strength, with the USDCNY rate moving from 7.1671 in May to 6.6915 in October. This means the Renminbi appreciated by 7.1% against the dollar in the period. The removal of the factor suggests policymakers want to reduce the upward pressure on the currency.

Portfolio Performance

We saw strong performance in the following names. **China Lilang**, a retailer of men's casualwear, reported retail sales that grew 5-10% yoy in the third quarter. This marked the first time Lilang has managed to grow sales this year, as in the first half retail sales fell 30-35%. This positive news led to a rerating in the share price.

Suofeiya is a manufacturer of custom furniture and kitchen cabinets. It reported third quarter sales and net income that grew 17% and 8% yoy. Suofeiya is converting its backlog built up in the first half of the year into revenue and is additionally seeing growing contribution from property developers. For 2020 as a whole, management are expecting sales from the property channel to grow 50% which is key if the company is to take advantage of the growing popularity of furnished homes. Suofeiya also established a joint venture with Shengdu Decoration in Hangzhou, a leading furnishing company. The joint venture will be used to further diversify sales across sales channels, which management deem as increasingly important as their customers' purchasing patterns change.

China Merchants Bank (CMB)'s pre provisioning profits grew 3% yoy while net profit after provisions was flat. Profit growth was driven by net interest margins which grew 0.07% quarter-on-quarter, as higher margin retail loans were extended while corporate loan growth was flat. The wealth management business was also strong as fees from fund distribution rose 159% yoy. Overall, management have a positive outlook given China's relatively stable economic conditions.

New Oriental Education, a leading provider of tuition services, saw revenue fall 8% in its most recent quarter. Revenue in the K-12 business grew 9% yoy as enrollments increased 21%. It was the overseas test prep business which was the source of weakness as sales fell 51% yoy, for obvious reasons. The company is using a combination of online and offline classes to attract students and the approach seems to work particularly well in smaller satellite cities. One of the reasons for this may be because large online courses are typically priced at a 20-30% discount to offline classes, which should be attractive in smaller cities where household incomes are likely lower than larger cities. Management now expect group earnings to start growing going forward which implies they think K-12 revenue growth can accelerate.

The Fund is run on a typically equally weighted basis and so each stock, at its neutral position, has a typical weight of 3.3%. As of October 30, 2020, **Alibaba** and **Tencent** had a weight of 20.3% and 15.5% in MSCI China. During October, the two stocks increased 3.6% and 15.5% which contributed to underperformance for the Fund.

CSPC Pharmaceutical and **China Lesso** were weak but there was no company specific news causing this weakness. We hold CSPC Pharmaceutical because we think it is making good progress in shifting from a generics business towards a more innovative pharmaceutical company. Its spend on R&D, as a percentage of revenue, is likely to be in the same range as its larger, more established peers which we view as a positive signal. China Lesso had been a very strong performer for much of the year and we view the recent weakness as the stock giving back some of its gains. We deployed inflows into the Fund into these two companies as part of the rebalancing process.

Portfolio Switches

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

Sells	
Name	**Sector**
Travelsky	Information Technology
CNOOC	Energy
Tongda Group	Information Technology
AAC Technologies	Information Technology
Dali Foods	Consumer Staples
Qualcomm	Information Technology
Yangzijiang	Industrials
BOC HK	Financials
China Construction Bank	Financials
Noah	Financials
Haitian	Industrials
Hollysys	Information Technology

Buys	
Name	**Sector**
Supor	Consumer Discretionary
JD.com	Consumer Discretionary
Yuhong	Materials
Yili	Consumer Staples
Suofeiya	Consumer Discretionary
Venustech	Information Technology
CSPC Pharmaceutical	Healthcare
Sany Heavy Industry	Industrials
Wuxi Lead Intelligent	Industrials
Nari Technology	Industrials

We sold **Hollysys** and **Haitian International**. Hollysys has been a serial disappointment and its performance has lagged other industrial automation companies. Though the stock looks cheap, we felt even with a recovery in the multiple the upside was higher in the two new entrants into the Fund. Haitian International has been a good contributor to performance for the Fund over the years. The business has managed to navigate this year's volatility very well, but it is difficult to see the long-term structural growth drivers.

We bought **Wuxi Lead Intelligent** and **Nari Technology**. Lead Intelligent is a supplier of battery equipment for electric vehicles. It specializes in the mid stage of the production process, in the winding process used to make cells. Lead Intelligent should benefit from battery manufacturers expansion plans, such as CATL's new €2bn plant in Germany and Northvolt's expansion in Sweden. Nari Technology is a subsidiary of the State Grid Corporation of China and has leading market share in dispatching hardware and software, which transmits real-time information across the grid. We think Nari's valuation is very undemanding for a company which should benefit from increased spending on the grid to support economic growth in China. Further spending on renewable energy should also be supportive to the business. Other growth drivers include China's unique Ultra High Voltage (UHV) and greater adoption of e-IOT smart meters.

Outlook

The focus this year has been selling companies where either the competitive advantage has been lost or the prospect of earnings growth is unlikely. The replacements, we feel, all have a definable competitive advantage, have managed to grow their earnings in the past (pre-COVID) and are likely to do so in the current environment. The Fund has significantly increased its allocation to the A share market which we expect should give it exposure to any rallies in the mainland. We believe the Fund is now better placed to capture the growth opportunities present in China. These growth opportunities lie in structural growth areas such as e-commerce (JD.com), infrastructure stimulus (Yuhong and Sany), cybersecurity (Venustech), electric vehicles (Wuxi Lead) and consumption upgrades (Supor and Suofeiya).

Though we have made many switches this year, our aim is to continue to shift the Fund towards sectors which have structural growth as the main driver. The opportunity set includes industries such as electric vehicles, renewable energy, consumer lending and import substitution. We expect to make more changes over the course of the rest of the year to move the fund to some of these structural growth areas.

Edmund Harriss (portfolio manager)

Performance

As of 10/31/2020	YTD	1 Year	3 Year	5 Year	10 Year
China & Hong Kong Fund (ICHKX)	**-0.13%**	**11.25%**	**3.22%**	**9.03%**	**2.18%**
Hang Seng Composite Index TR	**3.19%**	**9.56%**	**2.41%**	**7.64%**	**4.96%**

As of 9/30/2020	YTD	1 Year	3 Year	5 Year	10 Year
China & Hong Kong Fund (ICHKX)	**-1.23%**	**16.84%**	**4.29%**	**10.88%**	**2.47%**
Hang Seng Composite Index TR	**-0.42%**	**9.68%**	**2.21%**	**8.67%**	**4.92%**

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 10/31/2020:

1.	Alibaba Group Holding Ltd	4.68%
2.	JD.com Inc	4.09%
3.	Tencent Holdings Ltd	4.07%
4.	Sany Heavy Industry Co	3.92%
5.	Wuxi Lead Intelligent Equipment Co Ltd	3.88%
6.	Suofeiya Home Collection	3.81%
7.	Inner Mongolia Yili	3.76%
8.	Geely Automobile Holdings Ltd	3.75%
9.	China Merchants Bank Co Ltd - H Shares	3.58%
10.	Beijing Oriental Yuhong	3.55%

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

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