Guinness Atkinson

China & Hong Kong Fund (ICHKX)

Review of February 2021

GUINNESS ATKINSON FUNDS

Summary Review & Outlook

Market

- In February, MSCI China fell 1.0% and MSCI Hong Kong rose 4.7%. The Shenzhen Component Index fell 2.8% while the Shanghai Stock Exchange Composite Index was flat.
- MSCI China Growth fell 4.2% while MSCI China Value rose 2.7%. Concerns over rising inflation in the developed world and so potentially higher interest rates led to a sell-off in higher growth stocks where perhaps valuations have been boosted by low interest rates. Comments by the PBOC also implied less room for further monetary easing.
- In MSCI China, the strongest sectors were Materials (total return of +12.9%), Real Estate (+11.5%) and Energy (+11.5%) while the weakest were Consumer Staples (-6.9%), Information Technology (-6.3%) and Consumer Discretionary (-4.0%).
- In MSCI Hong Kong, the Real Estate and Financials indexes rose 9.7% and 1.5% respectively.
- In the Fund, strong performers were Baidu, Galaxy Entertainment and Sino Biopharmaceutical while weaker performers were Geely, Haier Smart Home and Venustech.

Events in February

- The People's Bank of China (PBOC) released its monetary policy report for the fourth quarter. While in the preceding report the PBOC was calling for lower effective lending rates, in the new report it is calling for a consolidation, which in our opinion implies rates are unlikely to fall further.
- While not mentioned often in the press, the renminbi has been strong against the US dollar, appreciating from USDCNY 7.1364 on May 31st, 2020 to USDCNY 6.4737 on Feb 26th, 2021. Based on policymakers' recent announcements, we think they want to moderate the strength in the currency by incentivizing outflows and discouraging inflows. In January, the quota for qualified domestic institutional investors was increased, allowing more investments outside of China. In February, officials began to look into the possibility of allowing investors to hold foreign portfolio investments in their annual $50,000 allowance.
- In Hong Kong, new cases of COVID-19 peaked at 131 in January and fell to 22 by the end of February. Social distancing measures were relaxed while gyms and cinemas were reopened. Priority groups began receiving vaccinations at the end of February.

Market Performance

In China, markets were weak after they reopened following the New Year holidays, giving back gains made earlier in the month. The main cause was rising bond yields in the US which led to a sell-off in higher growth stocks whose valuations have benefited from lower discount rates. Comments by the PBOC also indicated monetary policy is unlikely to be loosened further.

When valuing companies using a discounted cash flow approach, we are careful with the discount rates we use. Market implied discount rates in Hong Kong, which are driven by rates in the US, have dropped to their lowest level in the past ten years. While we think in the short-term interest rates are unlikely to rise, we do think there is a possibility in the medium-term they could increase which would have the effect of lowering valuations. We are therefore, using a higher discount rate when carrying out our sensitivity

analysis using the discounted cashflow approach in an effort to build a margin of safety; if interest rates do modestly increase, we think there is still room for meaningful upside in the companies we own.

In the A share market, the implied aggregate discount rate has nearly always been below that of Hong Kong. This is likely because investors have been willing to pay more for the higher growth opportunities present in the mainland, as well as a reflection of the fact that for the most part, it is difficult for capital to leave China and so domestic investors cannot allocate to foreign markets. While discount rates in Hong Kong have meaningfully dropped in the past year, the discount rate in the A share market is only slightly below its five-year average. Though policymakers in China have loosened monetary policy, they have been much more conservative compared to the US because of China's effective containment of COVID-19.

Company Updates

Results have started to come through for the companies held in the Fund and are discussed below.

Autohome is China's largest website for buying and selling new cars. Its main business, which consists of media services (ads) and lead generation (hosting an online platform for dealers), was flat in the fourth quarter. On the other hand, the data and insurance business continued to grow, partly as a result of commissions earned on insurance sold by parent company Ping An Insurance. The company is now anticipating the potential for double digit revenue growth in the first quarter of 2021, boosted by the consolidation of TTP Car's results, in which Autohome took a controlling stake last year. Management think TTP is China's largest platform for buying and selling used cars, so nicely complements the existing business. Even though the number of used cars sold in China declined in 2020, TTP was able to increase its volumes. We think this shows evidence that TTP is already a well-run business and using its knowledge from the new car industry, Autohome should be able to quickly scale the business up. Excluding TTP's contribution, Autohome is still anticipated to grow earnings by low double-digits in the first quarter.

Baidu's core search business was flat, but management's guidance implies a strong recovery in 2021. We have been waiting for the company's investments in new growth areas to pay off and on this front, we saw strong growth in the cloud business where revenues grew 67%. Though the cloud business is currently unprofitable, we can see a path to profitability once it reaches sufficient scale. The difficulty now lies in valuing the other parts of the business related to cars. Baidu's operating system, DuerOS, has been installed in more than one million vehicles and the company is targeting six million installations by 2022. The system allows full integration with mobile apps and offers additional services such as smart navigation and a voice assistant. Since this segment is established and has a clear pricing model, it is possible to value with some degree of confidence.

On the other hand, it is quite difficult to value Baidu's autonomous vehicle unit, Apollo, which was recently granted permission to test fully driverless cars in California. This means Apollo has joined a select few firms such as Waymo and Cruise in having this permit in the state, highlighting its edge versus its Chinese competitors. However, it is difficult to value Apollo because it is very much in the early stages of development – there is currently no wide scale adoption by customers as these autonomous vehicles are still in the testing stage. It is also worth noting that Baidu's efforts in autonomous vehicles are viewed favorably by the Chinese government and here collaboration is increasing. In August 2020, Baidu signed a

CNY 460m (~US$71m) contract with the Guangzhou local government to develop "smart infrastructure". Baidu has developed a control center which allows the local government to monitor real time traffic data using data collected by Baidu's autonomous vehicles, allowing better traffic management. In this case revenue is already coming through, though it is relatively small.

Overall, we use a sum-of-the-parts valuation to value Baidu. The search business is relatively easy to value but is now mature. We use different scenarios to value the cloud and autonomous vehicle segments, which are viewed as the drivers of growth. Based on a probability weighted approach, we think the current share price is a reasonable measure of what Baidu is worth.

Netease's mobile gaming revenue grew 19% in the fourth quarter and we see a solid pipeline of games coming through in 2021. The gaming business has long been a profitable and high return on capital business, supporting investments in newer segments. Through Youdao, Netease offers online tuition services and here revenues grew 170%. The segment is currently unprofitable as it is small, but we like the underlying economics of the industry. Once mature, if Youdao can achieve a return on capital similar to that of New Oriental Education, which is also held in the Fund, it is likely to be a very profitable endeavour. Another growth contributor for Netease is its Cloud Music business which has 800 million registered users. In China there are only ~20 million paying subscribers to music apps so there is a lot of room for the industry to adopt the paid pricing model. We expect that over time, as Netease convinces more of its users to shift towards the paid model, for the music business to become a meaningful contributor to earnings.

Supor released its preliminary results which showed revenue in 2020 fell 6%, though if using the same accounting standards revenue only fell 1%. Net profit meanwhile fell 4%. The full year results imply fourth quarter revenue grew 13% (excluding accounting changes), an acceleration compared to the third quarter. With most of its products sold in physical stores, Supor understandably had a weak first half of the year but we are encouraged by an improved third quarter followed by an acceleration in growth in the fourth quarter. The company has been building out its online presence in response to COVID-19, which we think is sensible given that e-commerce sales are likely to continue taking market share from offline stores.

Portfolio Switches

We bought Xinyi Solar and sold Anhui Conch. Xinyi is the world's largest manufacturer of solar glass and so through its economies of scale, benefits as the low-cost producer in the industry. However, its competitive advantage is not solely a function of its scale. The quality of Xinyi's glass is high relative to its peers, so the company is well trusted by its clients. This is very important given the rising popularity of bifacial panels which need thinner and so more durable glass. Tighter emissions standards also raise the cost of production, as well as the barriers to entry, protecting incumbents such as Xinyi. We believe that the company can grow earnings by enough to offset mean reversion in the valuation multiple. Policymakers in all major regions around the world are aiming to significantly increase investment into renewable energy sources which should bode well for Xinyi.

Anhui Conch Cement was sold as it is difficult to argue, with confidence, that earnings will meaningfully increase in the medium term. The long-term growth driver for the cement industry is ultimately driven by

real estate and infrastructure and at least in the case of infrastructure, there are better names available such as Oriental Yuhong which is held in the fund. Conch Cement is a consolidator but is ultimately a price taker in the cement industry, and so has limited pricing power. The stock is cheap for a reason and we think the upside is higher in Xinyi.

We sold Shenzhen Expressway as it is also difficult to identify the long-term structural growth drivers for the business. The company runs toll roads with revenue concentrated in Shenzhen and the broader Guangdong province. Though margins are relatively high, the business is very capital intensive and so asset turnover is low, resulting in a low overall return on capital.

Outlook

The Fund is designed to give exposure to the structural growth opportunities present in Greater China. We identify industries we think can grow earnings over the long-term, giving us more confidence that companies in these industries will likely grow their earnings over time. We then apply a set of qualitative filters to identify quality, profitable companies with strong balance sheets. Quality is defined as a return on capital above the cost of capital while a strong balance sheet is defined as debt/equity less than 150%. (Note that the Fund itself has debt/equity of 34% and net debt/equity of -16% i.e. our companies have enough cash on the balance sheet to pay off debt). We are interested in profitable, high return on capital businesses that can take advantage of these structural growth opportunities. In the portfolio, we are looking for companies that we think can grow earnings over time, and by enough to offset mean reversion in the valuation multiple.

This process results in a portfolio of 30 positions. Based on consensus earnings estimates, the Fund is expected to grow earnings over the next three years compared to 6% for the MSCI China Index. The Fund trades at a P/E ratio of 18.1x on estimated 2021 earnings which puts it at a 6% premium to the MSCI China Index. Thus, relative to MSCI China, the Fund offers much higher expected earnings growth at a slightly higher price. The Fund manages to do this without allocating a large allocation to Tencent and Alibaba, which each make up 14-15% of the MSCI China index.

Edmund Harriss (portfolio manager)

Performance

As of 2/28/2021	YTD	1 Year	3 Year	5 Year	10 Year
China & Hong Kong Fund (ICHKX)	10.49%	39.18%	8.64%	18.65%	5.03%
Hang Seng Composite Index TR	6.74%	31.25%	5.90%	15.82%	7.08%

As of 12/31/2021	YTD	1 Year	3 Year	5 Year	10 Year
China & Hong Kong Fund (ICHKX)	14.54%	14.54%	5.91%	12.73%	3.83%
Hang Seng Composite Index TR	15.90%	15.90%	4.69%	10.83%	6.27%

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.

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.

Shenzhen Component Index is an index of 500 stocks that are traded at the Shenzhen Stock Exchange.

MSCI China Value Index captures large and mid-cap Chinese securities exhibiting overall value style characteristics. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield.

MSCI China Growth Index captures large and mid cap securities exhibiting overall growth style characteristics across the Chinese equity markets. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend.

Margin of Safety – Buying with a “margin of safety,” a phrase popularized by Benjamin Graham and Warren Buffet, is when a security is purchased for less than its estimated value. This helps protect against permanent capital loss in the case of an unexpected event or analytical mistake. A purchase made with a margin of safety does not guarantee the security will not decline in price.

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 2/28/2021:

1.	Baidu Inc	5.97%
2.	Sany Heavy Industry Co	4.33%
3.	Sino Biopharmaceutical Ltd	4.07%
4.	Wuxi Lead Intelligent Equipment Co Ltd	4.03%
5.	NARI Technology Co Ltd	3.96%
6.	Suofeiya Home Collection	3.84%
7.	JD.com Inc	3.84%
8.	Beijing Oriental Yuhong	3.80%
9.	Venustech Group Inc	3.79%
10.	Tencent Holdings Ltd	3.72%

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

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