# Guinness Best of China Fund

## INVESTMENT COMMENTARY – March 2021

| | |
|---|---|
| **Launch date** | **15.12.15** |
| **Team** | **Edmund Harriss** (manager)<br>**Sharukh Malik** (manager)<br>**Mark Hammonds** (analyst) |

### Aim

Guinness Best of China Fund is designed to provide investors with exposure to economic expansion and demographic trends in China and Taiwan.

The Fund is managed for capital growth and invests in profitable companies generating persistently high return on capital over the business cycle.

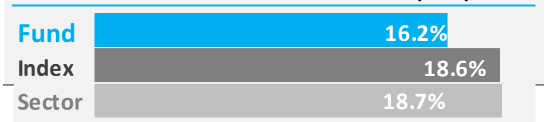
### Performance (in GBP) 28.02.2021

| | |
|---|---|
| **Fund** | Best of China Fund (Z Cls, 0.74% OCF) |
| **Index** | MSCI Golden Dragon |
| **Sector** | IA China/Greater China |

| | 2020 | 2019 | 2018 |
|---|---|---|---|
| **Fund** | 14.8 | 26.0 | -20.3 |
| **Index** | 24.2 | 19.0 | -9.5 |
| **Sector** | 33.6 | 22.2 | -14.2 |

| | 1 year | 3 years | From launch |
|---|---|---|---|
| **Fund** | 31.4 | 24.1 | 118.4 |
| **Index** | 32.1 | 37.2 | 143.1 |
| **Sector** | 40.5 | 42.5 | 144.8 |

**Annualised % total return from launch (GBP)**




**Risk analysis** (annualised, weekly, from launch)

| | Index | Sector | Fund |
|---|---|---|---|
| **Alpha** | 0.0 | 0.2 | -2.1 |
| **Beta** | 1.0 | 1.0 | 1.0 |
| **Info ratio** | 0.0 | 0.0 | -0.3 |
| **Max drwdn** | -17.8 | -21.7 | -25.7 |
| **Tracking err** | 0 | 5 | 7 |
| **Volatility** | 18.0 | 18.4 | 19.4 |
| **Sharpe ratio** | 0.8 | 0.8 | 0.6 |

## Fund & Market

- In February, the Best of China Fund rose 2.7% (in USD, Z class) while the MSCI Golden Dragon Net Total Return Index rose 0.8%. The Fund outperformed by 2.6% in the rally in the first half of the month and then underperformed slightly by 0.4% in the sell-off, ending the month 1.9% ahead of the benchmark.
- MSCI China fell 1.0%, MSCI Hong Kong rose 4.7% and MSCI Taiwan rose 4.6%. 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 Taiwan, the Information Technology Index, which makes up more than 70% of the local index, rose 4.0%.
- In the Fund, strong performers were Novatek Microelectronics, Baidu and Sino Biopharmaceutical. Weaker stocks were Geely, Haier Smart Home and Venustech.

# Events in February

- The 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 incentivising 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.

- Meanwhile Taiwan published its priority list and is planning to start vaccinations in March. Taiwan has had less than 955 cases in total so is in less of a rush to start vaccinating due to its effective containment policies.

## Portfolio Performance

In February, the top and bottom five contributors to performance are shown below, with the contribution to relative performance shown in brackets:

| Top 5 Contributors | Top 5 Detractors |
|---|---|
| Novatek Microelectronics (+0.6%) | Venustech (-0.3%) |
| Sino Biopharmaceutical (+0.5%) | Geely (-0.2%) |
| Baidu (+0.5%) | Haier Smart Home (-0.2%) |
| Underweight in Alibaba (+0.4%) | Lead Intelligent (-0.2%) |
| China Medical System (+0.4%) | Supor (-0.2%) |

*Attribution relative to a portfolio holding the weighted average of the iShares MSCI China ETF, iShares MSCI Hong Kong ETF and iShares MSCI Taiwan ETF.*

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 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 expecting 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 expected to grow earnings by low double-digits in the first quarter.

Novatek Microelectronics reported strong growth in earnings. While the fourth quarter is usually slow, revenue is being supported as more people are working from home, boosting demand for displays and so demand for the display drivers Novatek produces. For its System on Chip (SoC) product, which combines multiple functions into one product, Novatek is seeing such strong demand that some orders have been pushed back from Q4 2020 into Q1 2021. Additionally, as foundry capacity is tight across the industry, Novatek has been able to pass on rising costs onto its customers, protecting its margins. Prices for its drivers were raised in Q3 2020 and will be raised again in Q1 2021, indicating Novatek's pricing power.

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. It is difficult to value Apollo however, 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 favourably 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 centre 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, the music business will 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 as the year before 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.

In the fourth quarter, Elite Material's revenue grew 11% while EPS fell 18%. Earnings growth was weaker than expected due to a fall in gross margins, which we expect Elite to reverse as it passes through rising copper costs onto its customers. A foreign exchange loss also went against the company due to the weaker US dollar/stronger New Taiwan dollar. Elite is seeing robust demand across its smartphone, infrastructure and automobile clients and expects this to continue into what is usually a seasonally slower first quarter. The infrastructure business, where Elite provides copper clad laminates for servers, is expected to grow revenue 20-30% in 2021 as Elite gains market share in the current generation of Intel's Whitley server platform.

# 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.

# Summary view & 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 can 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 31 positions. Based on consensus earnings estimates, the Fund is expected to grow earnings by 17% a year for the next three years compared to 10% for the benchmark, the MSCI Golden Dragon Index and 9% for the MSCI China Index. The Fund trades at a P/E ratio of 15.6x on estimated 2021 earnings which puts it at a 12% discount to the MSCI Golden Dragon Index and a 9% discount to the MSCI China Index. Thus, relative to its benchmark, the Fund offers higher expected earnings growth at a cheaper price. The Fund manages to do this without allocating a large allocation to TSMC, Tencent and Alibaba, which each make up ~10% of the index.

**Edmund Harriss** (portfolio manager)
**Mark Hammonds, CFA** (analyst)
**Sharukh Malik, CFA** (analyst)

**Data sources**

Fund performance: *Financial Express, total return 0.74% OCF*

Index and stock data: *Bloomberg*

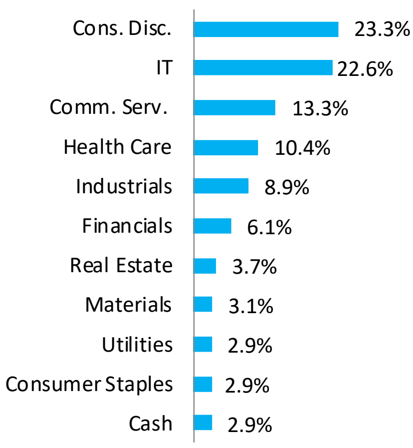
## PORTFOLIO

28/02/2021

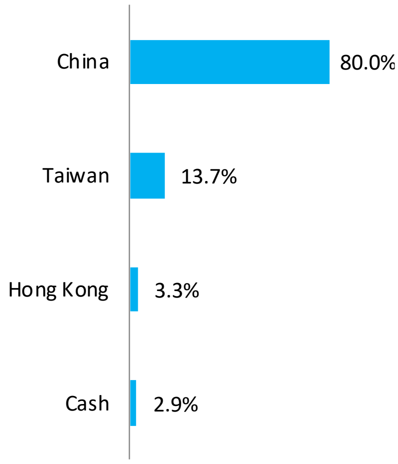
### Fund top 10 holdings

| | |
|---|---|
| Baidu | 4.3% |
| China Medical System | 3.7% |
| China Overseas Land | 3.7% |
| Novatek Microelectronics | 3.7% |
| Elite Material | 3.6% |
| Suofeiya Home Collection | 3.6% |
| Catcher Technology | 3.5% |
| CSPC Pharmaceutical Gro | 3.4% |
| Sino Biopharmaceutical | 3.3% |
| China Lesso Group | 3.2% |
| % of Fund in top 10 | 36.0% |
| Total number of stocks | 35 |

### Sector analysis




### Geographic allocation




## PERFORMANCE

28/02/2021

### Annualised % total return from launch (GBP)

| | |
|---|---|
| Fund (Z Class, 0.74% OCF) | 16.2% |
| MSCI Golden Dragon Index | 18.6% |
| IA China/Greater China sector average | 18.7% |

| Discrete years % total return (GBP) | Feb '21 | Feb '20 | Feb '19 | Feb '18 | Feb '17 |
|---|---|---|---|---|---|
| **Fund (Z Class, 0.74% OCF)** | 31.4 | 8.4 | -12.8 | 25.4 | 45.5 |
| MSCI Golden Dragon Index | 32.1 | 8.8 | -4.5 | 22.9 | 45.0 |
| IA China/Greater China sector average | 40.5 | 9.8 | -7.7 | 27.6 | 41.1 |

| Cumulative % total return (GBP) | 1 month | Year-to-date | 1 year | 3 years | 5 years | From launch |
|---|---|---|---|---|---|---|
| **Fund (Z Class, 0.74% OCF)** | 1.0 | 8.5 | 31.4 | 24.1 | 126.4 | 118.4 |
| MSCI Golden Dragon Index | -1.0 | 5.1 | 32.1 | 37.2 | 144.4 | 143.1 |
| IA China/Greater China sector average | -2.0 | 4.0 | 40.5 | 42.5 | 156.4 | 144.8 |

## RISK ANALYSIS

28/02/2021

| Annualised, weekly, from launch on 15.12.15, in GBP | Index | Sector | Fund |
|---|---|---|---|
| Alpha | 0.00 | 0.15 | -2.10 |
| Beta | 1.00 | 0.98 | 1.01 |
| Information ratio | 0.00 | -0.04 | -0.33 |
| Maximum drawdown | -17.78 | -21.67 | -25.74 |
| R squared | 1.00 | 0.93 | 0.89 |
| Sharpe ratio | 0.82 | 0.79 | 0.63 |
| Tracking error | 0.00 | 4.76 | 6.52 |
| Volatility | 18.02 | 18.36 | 19.37 |

**Past performance should not be taken as an indicator of future performance. The value of this investment and any income arising from it can fall as well as rise as a result of market and currency fluctuations. Returns for share classes with a different OCF will vary accordingly**

Source: Financial Express, bid to bid, total return (0.74% OCF). Fund launch date: 15.12.2015.

# Important information

**Issued by Guinness Asset Management Limited**, authorised and regulated by the Financial Conduct Authority.

This report is primarily designed to inform you about Guinness Best of China Fund. It may provide information about the Fund's portfolio, including recent activity and performance. It contains facts relating to the equity markets and our own interpretation. Any investment decision should take account of the subjectivity of the comments contained in the report.

This document is provided for information only and all the information contained in it is believed to be reliable but may be inaccurate or incomplete; any opinions stated are honestly held at the time of writing, but are not guaranteed. The contents of the document should not therefore be relied upon. It should not be taken as a recommendation to make an investment in the Fund or to buy or sell individual securities, nor does it constitute an offer for sale.

## Risk

The Guinness Best of China Fund is an equity fund. Investors should be willing and able to assume the risks of equity investing. The value of an investment and the income from it can fall as well as rise as a result of market and currency movement, and you may not get back the amount originally invested. Details on the risk factors are included in the Fund's documentation, available on our website. Shareholders should note that all or part of the fees and expenses will be charged to the capital of the Fund. This will have the effect of lowering the capital value of your investment.

## Documentation

The documentation needed to make an investment, including the Prospectus, the Key Investor Information Document (KIID) and the Application Form, is available from the website www.guinnessfunds.com , or free of charge from:-

- the Manager Link Fund Manager Solutions (Ireland) Ltd, 2 Grand Canal Square, Grand Canal Harbour, Dublin 2, Ireland; or,
- the Promoter and Investment Manager: Guinness Asset Management Ltd, 18 Smith Square, London SW1P 3HZ.

## Residency

In countries where the Fund is not registered for sale or in any other circumstances where its distribution is not authorised or is unlawful, the Fund should not be distributed to resident Retail Clients.

**NOTE: THIS INVESTMENT IS NOT FOR SALE TO U.S. PERSONS.**

## Structure & regulation

The Fund is a sub-fund of Guinness Asset Management Funds PLC (the "Company"), an open-ended umbrella-type investment company, incorporated in Ireland and authorised and supervised by the Central Bank of Ireland, which operates under EU legislation. If you are in any doubt about the suitability of investing in this Fund, please consult your investment or other professional adviser.

## Switzerland

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## Singapore

The Fund is not authorised or recognised by the Monetary Authority of Singapore ("MAS") and shares are not allowed to be offered to the retail public. The Fund is registered with the MAS as a Restricted Foreign Scheme. Shares of the Fund may only be offered to institutional and accredited investors (as defined in the Securities and Futures Act (Cap.289)) ('SFA') and this material is limited to the investors in those categories

**Telephone calls** will be recorded and monitored.