Guinness Best of China Fund

INVESTMENT COMMENTARY – September 2021

Launch date	**15.12.15**
Team	**Edmund Harriss** (manager) **Sharukh Malik** (manager) **Mark Hammonds**

Aim

This is a marketing communication. Please refer to the prospectus and KIID for the Fund before making any final investment decisions.

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) 31.08.2021

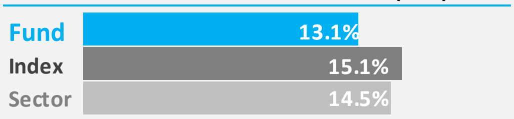
Past performance does not predict future returns

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	12.0	23.9	101.6
Index	5.5	29.4	123.1
Sector	2.0	34.5	117.1

Annualised % total return from launch (GBP)



Risk analysis (annualised, weekly, from launch)

	Index	Sector	Fund
Alpha	0.0	-0.2	-1.4
Beta	1.0	1.0	1.0
Info ratio	0.0	-0.1	-0.3
Max drwdn	-20.6	-23.8	-25.7
Tracking err	0.0	4.9	6.7
Volatility	18.0	18.3	19.1
Sharpe ratio	0.6	0.6	0.5

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.

Source: Financial Express, bid to bid, total return 0.74% OCF. Returns for share classes with a different OCF will vary accordingly

Fund & Market

- In August, the Best of China Fund was flat (in USD, Z class) while the MSCI Golden Dragon Net Total Return (NTR) Index rose 1.1% and the MSCI China Net Total Return (NTR) Index was flat.

- In the regulatory-led sell-off, the Fund outperformed due to its underweight in the large online tech stocks which are a large part of the index. In the sell-off (31/07/21 – 20/08/21), the Fund outperformed the MSCI Golden Dragon NTR Index by 2.6% and the MSCI China NTR Index by 4.1%. As the tech stocks rebounded, the Fund gave back its relative gains to end flat in the month.

- Year-to-date, the Best of China Fund has risen 0.9% while the MSCI Golden Dragon NTR Index has fallen 3.0% and the MSCI China NTR Index has fallen 12.3%.

- In August, MSCI China was flat, MSCI Taiwan rose 4.5% and MSCI Hong Kong fell 0.7%. The CSI 300 Index rose 0.1%.

- In August, MSCI China Value rose 0.3% while MSCI China Growth fell 0.3%.

- In China, the strongest sectors were Energy (total return of +11.5%), Materials (+9.4%) and Industrials (+5.5%) while the weakest were Health Care (-6.4%), Consumer Discretionary (-1.6%) and Communication Services (-1.3%).

- In Hong Kong, the Real Estate and Financials indices fell 4.1% and 0.9% respectively.

- In Taiwan, the Information Technology Index, which makes up more than 70% of the local market, rose 4.4%.

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- In the Fund, strong performers were Xinyi Solar, Nari Technology, JD.com, Haier Smart Home and China Overseas Land. Weaker stocks were Fuling Zhacai, Shengyi Tech, Alibaba, Ping An and Novatek Microelectronics.

Market Overview

The government has been talking up its focus on “common prosperity”. The term has been used in the past, with it being mentioned by Mao Zedong and Deng Xiaoping. Under Deng, the focus was on allowing some to prosper before others through free markets, which would eventually allow the achievement of common prosperity for all. In the past year, the government made common prosperity an objective, after deeming that the problem of extreme poverty had been solved. That being said, there is no precise definition of what it actually means. Given what we have read, we regard common prosperity as a term with multiple aims. The primary aim is to reduce income and wealth inequality. Notes released after Party meetings indicate that the Party wants more chances for wealth generation. They aim to make the middle class bigger but also mention the need to “adjust excessive incomes and prohibit illicit income to promote social fairness and justice”. We interpret this as a continued focus on economic growth, but with an evolved taxation system to redistribute income. Other goals include:

- A more inclusive and fair education system.
- A system which allows more people to become wealthy.
- Improving elderly care and medical security.
- Protecting property and intellectual property rights.
- Improving incomes in rural areas.

The Party has also given statements indicating what common prosperity does not mean – an official said it does not mean "killing the rich to help the poor", while another stressed that the phrase does not translate to egalitarianism.

In Zhejiang province, where Xi Jinping was Party Secretary between 2002 and 2007, the local government has established a common prosperity pilot zone. The pilot aims to double household income within 10 years, which will require economic growth if the target is to be met. In the press release, there is more focus on how to achieve growth rather than on taxes and redistribution of income.

In terms of the impact on portfolio management, we interpret common prosperity as investing in stocks which:

- Do not have a negative impact on wider society.
- Do not make it harder for the low- and middle-income consumers to grow their incomes and welfare over time.
- Align with the state’s view of what is needed to drive economic growth in the next decade. Our focus on structural growth themes means we are well placed for this. Areas of exposure include

Sustainability, Manufacturing Upgrades, Cloud Computing & Artificial Intelligence and Healthcare.

Motivation

We believe there are several motivations behind the government's focus on common prosperity:

- To reduce widening income and wealth inequality. One measure to calculate income inequality is the Gini Coefficient. A value of zero means an equal society (where all incomes are the same) whilst a value of 100 means maximum inequality (e.g. one person has all the income). Based on data from the World Bank, the Gini coefficient for China is 39 compared to 41 for the US and 35 for the UK. Given that China is a socialist country, this is a surprising result. For context, the Gini coefficients are 28 for Norway, 30 for Sweden and 28 for Denmark.

- To improve poor corporate behaviour, which maximises profits to shareholders while in some cases, is also detrimental to wider society – see below for obvious examples.

- To check the power of large companies, especially in the tech space. In November 2020, Jack Ma essentially criticised the government's approach to financing directly to their faces. Following the speech, which was not received well by the government, there was a notable increase in government regulation in the tech space. Given the amount of data these online tech companies possess, as well as the fact some operate social media platforms, they arguably present a potential threat to the Party's rule over China.

Actions

Over the past few months, various industries have faced regulatory actions. We think many of these moves do have understandable rationale:

- Online platforms such as Alibaba were barred from restricting merchants to exclusivity deals, where the merchant can only sell on one platform. This practice was to the clear detriment of the seller as well as consumers, who faced less choice.

- Food delivery drivers to be paid the minimum wage and to be offered access to insurance.

- Chinese courts ruled that the "996" practice (working from 9am to 9pm, 6 days a week), which is popular in tech companies, is illegal. The practice has long been criticised and this intensified this year after two employees of Pinduoduo died in separate incidents, which were potentially linked to arduous working hours.

- People under the age of 18 to be restricted to only three hours of gaming on weekends. While we think this is too restrictive, the move does have some rationale. Hundreds of millions of people in China have some form of visual impairment, which may be linked to excessive screen use. Additionally, in 2019 the World Health Organisation (WHO) formally classed gaming disorders as a behavioural disease.

- The government is intending for much of the for-profit education sector to turn non-profit. The government is concerned that the gap between richer and poorer students could further increase, given the popularity of after-school tuition services in middle class families. Additionally, expensive tuition is likely to discourage families from having more children, which makes it much harder for China to increase its birth rate. The government's action marked a repeat of what has occurred in Korea.

- The *People's Daily* called for greater supervision of the online healthcare sector. In particular, it called for better supervision and standards in the prescription of medicines. In some cases, online platforms distributed medicines before they were actually prescribed.

- The Personal Information Protection Law (PIPL) was passed and becomes effective in November. Where algorithms decide which adverts and information are shown to users, users will have the option for their personal data to be ignored by the algorithm. The law also sets out a framework outlining why and how personal data can be used, much like Europe's GDPR. Companies can be fined up to 5% of their revenue if they violate the law.

However, there are some actions which have less to do with improving market failures or reducing inequality, and more to do with maintaining power. Data is the recurring theme in these cases, which can be used as a justification for more state involvement. For example, concerns over data security were used to justify the removal of Didi's app from app stores. The official justification was the government was concerned over potentially sensitive data flowing between domestic and foreign entities, though we question how much data genuinely left the country in this case. Nonetheless, data security concerns have forced multinationals such as Apple and Tesla to keep most of their data within China. More broadly, the issue of data is relevant in the case of surveillance, facial recognition, the digital renminbi and the evolving social security system.

Company Responses

In response to the new regulations, we have seen several companies allocate funds towards common prosperity initiatives. Both Alibaba and Tencent have pledged $15.5bn, while the founders of companies including Bytedance, Pinduoduo and Xiaomi have followed. While some of the headlines in Western reports suggest these are donations with no economic value, we do not think it so clear cut. We have the suspicion that some of these investments are being marketed as aligned with common prosperity, but are normal commercial investments that would have been made anyway at some point in the future. For example, Alibaba's $15.5bn investment aims to deliver on 10 key initiatives by 2025, focusing on "technology innovation, economic development, high-quality employment creation, care for vulnerable groups, and establishing a common prosperity development fund." Some of Alibaba's funds will be used to:

- "Support small and medium-sized enterprises to expand into new overseas markets" – Alibaba can do this through its platform AliExpress, for example.

- "Improve the welfare of gig economy workers" – Alibaba operates Ele.me, its food delivery service. This initiative may just mean Alibaba will pay its drivers more, or will pay for some of their insurance.

- "Enhance healthcare capability in less developed areas" – Alibaba operates Alibaba Health Information Technology, one of the largest online healthcare platforms in China.

Similarly, Tencent will invest $15.5bn with a focus on:

- Innovation in the educational sector – Tencent Education offers classes used by more than 100 million students.
- "Public welfare digitisation" – Tencent Meeting has more than 100m registered users.
- Medical assistance – Tencent backs WeDoctor, an online health platform which gives patients access to GPs, hospitals, pharmacies and insurers.
- Rural economic efficiency – Tencent's AI applications could be relevant here, as it has trialled its AI solutions to help improve agricultural yields.

These investments fit in line with the government's objectives of common prosperity, which means these companies could be less likely to face regulatory action. No doubt, a portion of the capital invested can be thought of as a social contribution with little expected return. But some of these investments may have eventually been made anyway – the current focus on common prosperity means they are being frontloaded. These investments do have commercial appeal but are currently being marketed as investments in common prosperity. It would not surprise us if some of the investments discussed end up earning a return on capital well above the cost of capital.

Portfolio Performance

In August, 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
Underweight in Alibaba (+1.4%)	Shengyi Technology (-0.6%)
Xinyi Solar (+0.7%)	Meituan (not held) (-0.6%)
Nari Technology (+0.4%)	Fuling Zhacai (-0.4%)
China Overseas Land & Investment (+0.3%)	Li Ning (-0.2%)
Elite Material (+0.3%)	Novatek Microelectronics (-0.2%)

Source: Guinness Asset Management, data as of 31/08/2021.
Attribution relative to the iShares MSCI China ETF.

In August, the Fund was flat while the MSCI Golden Dragon NTR Index rose 1.1% and the MSCI China NTR Index was flat.

In the Fund, strong performers were Xinyi Solar, Nari Technology, JD.com, Haier Smart Home and China Overseas Land. Weaker stocks were Fuling Zhacai, Shengyi Tech, Alibaba, Ping An and Novatek Microelectronics.

Xinyi Solar reported interim results where revenue increased 75% and net income increased 118%. Results were driven by both higher volume and higher blended average selling prices (ASPs). New production lines are helping the company cope with strong demand. While spot prices for solar glass have been falling since April, the company's blended gross margin only fell by two percentage points compared to the second half of 2020, supported by the more stable solar farm business.

Nari Technology's first half revenue and net income grew 22% and 34% respectively. Orders for the company's main product, power communications equipment, were robust. Management expect 15-20% growth a year for this segment over the next few years. Sales related to the buildout of Ultra High Voltage lines grew 90% year as more lines were completed. Encouragingly the company is diversifying its customer base, as revenue from non-grid customers grew 28%.

JD.com reported second quarter revenue growth of 26%. Despite the regulatory headwinds and weaker than expected macro data, sales have remained resilient, and management expect retail sales growth of 20-25% in the third quarter. As the company is expanding its non-retail business, costs are increasing at a faster rate than sales. That being said, we are seeing signs the company is being sensible. For example, JD is refining its roll out of community group purchases (CGP) and is now targeting particular areas rather than the whole country – this should lower the impact on margins. Given the regulatory changes affecting the sector, the company highlights it already fully covers social security insurance for its delivery workers, so unlike some of its peers, will not face higher costs from new regulations.

China Overseas Land & Investment (COLI) reported 1H21 results with core net profit (excluding the effects of investment property revaluation and foreign exchange) up 2%, in line with expectations. The Chinese real estate sector can be a worrying sector, but COLI is easily the best positioned in our view. It has the lowest debt ratios of its peers (debt to equity 67%, net debt to equity 33%) and its investment grade credit rating, also the best in the sector, gives it access to the lowest cost of funding at 3.6%. COLI's business is property development with 40% of its landbank in Tier 1 cities (Beijing, Shanghai, Hong Kong etc.) and in urban renewal projects. The stock offers a combination of strong balance sheet, good market position, and a stabilizing margin trend that suggests earnings growth is likely to track sales growth more closely. We believe the company has a strong enough balance sheet to weather weakness in the property market. But more importantly, if the property market is to become volatile because of problems with Evergrande, COLI has the ability to acquire good quality assets trading at depressed prices.

Fuling Zhacai reported first half revenue growth of 13% but earnings contraction of 17%. Fuling Zhacai was able to increase its gross margin despite higher raw material costs, a sign of the business's strong pricing power. Earnings fell because promotion expenses increased, as the company is trying to target more customers. We see these marketing expenses as an investment to generate future earnings growth, and so are comfortable with the stock despite the fall in earnings.

Ping An Insurance Group reported interim results for 1H21 that were better than forecast with net book value and operating profit above expectation. The dividend was increased by 5%. The value of new business in the life insurance segment dropped significantly as a result of declining first year premiums and lower margins. This is consistent with Ping An's drive to reduce the number of sales agents but to increase productivity, which remained unchanged on last year but with an 11% lower headcount. This lies behind the improvement at the operating profit level. Property & Casualty however, was a highlight with credit and guarantee insurance leading the way resulting in a Combined ratio (costs and expenses divided by revenues earned) falling to 95.9%, thereby increasing profits. Another strong contribution from Ping An Bank and the announcement of a share buyback made for a good set of results.

Stock Switches

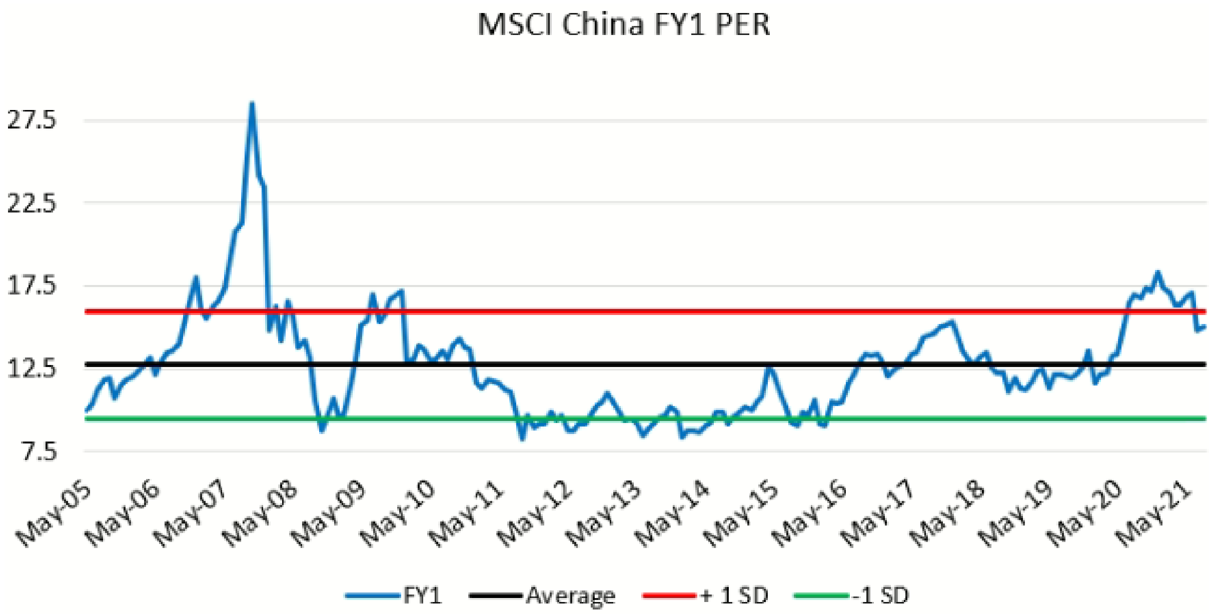
In June we sold New Oriental Education and in July we sold Yuhong. In response, in August we bought AIA and Shengyi Technology.

AIA gives the fund exposure to growing demand for life and health insurance. It is headquartered in Hong Kong and derived more than 50% of its revenue from the China region. AIA also has exposure to Southeast Asia, namely Thailand, Malaysia and Singapore. However, much of the future earnings growth is likely to come from mainland China. AIA is targeting the rising middle class in the country and we believe there is a lot of room for the company to grow from a relatively low base. AIA targets the premium end of the market, using its highly trained workforce which is viewed as giving some of the best service in the industry. This is backed up by AIA's very low turnover rate amongst its staff, relative to its competitors.

Shengyi Technology makes copper clad laminates (CCLs), which are the main base material for printed circuit boards (PCBs). It benefits from multiple trends which point to greater demand for CCLs and PCBs: growing popularity of 5G compatible devices, growing demand for servers and cloud services as well as localisation towards Chinese suppliers in the Chinese market. Shengyi is quickly moving up the value chain, supporting a gradual rise in margins over time.

Summary view & outlook

Valuations have come down from the peak earlier this year and relative to its longer-term average, the Chinese market is not cheap, as seen below. However, this long-term average does include a long period after the financial crisis, where China was in a bear market and was trading below 10x. During this period, producer price inflation was negative and the property market was in a relative slump. We do not think that these conditions are about to repeat. This depressed period for the index also did not include the highly rated technology stocks which began to dominate the market from 2017 onwards.



Data as of 31/08/21. (Source – Bloomberg, Guinness Asset Management calculations)

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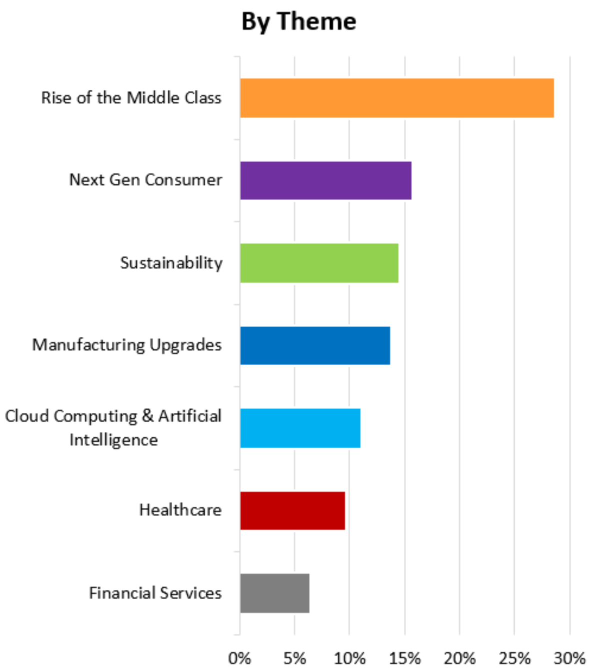
Looking at China since 2013, much of the multiple compression this year has come from Privately Owned Enterprises (POEs) rather than State Owned Enterprises (SOEs). Multiples for POEs are now in line with their eight-year average, while the multiple for SOEs remain cheap (reflecting the lower efficiency for these businesses). We think that, overall, multiples in China are now reasonable. Downward earnings revisions are currently greatest for the offshore Internet stocks, where estimates for 2021 and 2022 have been cut by 27%. Private businesses more generally also seeing downward revisions of 13%, as earnings expectations became too bullish after China had a good run in 2020, and the economy is now slowing down as stimulus is being gradually wound down. On the other hand, state owned enterprises are seeing positive earnings revisions of 9%.

It is of course impossible to say how much more the market can fall. But at these prices, China certainly is an attractive proposition. What is more interesting is that there are many good ideas apart from online tech companies which have been driving recent weakness. For example, based on consensus earnings expectations, the two-year earnings growth rate for Tencent and Alibaba is now 4% and 8% respectively. This means they are expected to be among the slower growth companies in the fund. Areas such as sustainable energy, import substitution, and China's move up the manufacturing chain are worth considering – many of the companies in these industries do not conflict with the recent focus on common prosperity.

For example, in the China fund, where online tech companies are less than 20% of the fund, we are being asked to pay 15x on 2021 earnings for expected ~14% earnings growth a year, for the next two years. There is so much more than just online tech if one is interested in the growth opportunities in China. The themes and subthemes in the fund reflect this:



Data as of 30/06/21.

Below we briefly outline some of the Hong-Kong listed stocks in the Fund which we think are interesting:

- **Manufacturing Upgrades/Sustainability** – Geely. We think Geely is one of China's best run car companies and is well placed to deal with the changes in the industry. The company benefits from cooperation with Volvo, which its parent company owns, where the two use the same design system to save costs. The parent company also owns a stake in Daimler and the two are working together to build new engines for hybrid vehicles. Geely's new EV brand *Zeekr* just raised $500m in funding, valuing it at $9bn. Geely has also set up a joint venture with Baidu, which is China's most advanced companies in the autonomous driving field.

- **Healthcare** – CSPC Pharmaceutical. An ageing population means demand for pharmaceutical products is expected to increase – in 2020, 19% of the population was over 60 years old vs only 7% in 2000. CSPC gives exposure to the cardiovascular and oncology fields. The company is increasing its R&D spend to increase exposure to the innovative segment of the market, where pricing power is stronger.

- **Rise of the Middle Class** – Haier Smart Home. Haier is one of China's largest manufacturers of household appliances, covering fridges, washing machines, TVs etc. Haier owns several brands to target different parts of the market, in order to take advantage of consumption upgrades. For example, its premium brand, *Casarte*, grew sales 74% in 1H21.

- **Sustainability** – Xinyi Solar. Is the world's largest manufacturer of solar glass, which is used in the construction of solar panels. The company benefits from economies of scale due to its size, meaning it is one of the lower cost producers in the industry. Xinyi Solar is also known for the quality of its products, which is especially important as bifacial panels become more popular. These are more efficient but thinner panels, so quality is a key factor.

Edmund Harriss
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Portfolio Managers

Data sources

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

Index and stock data: *Bloomberg*

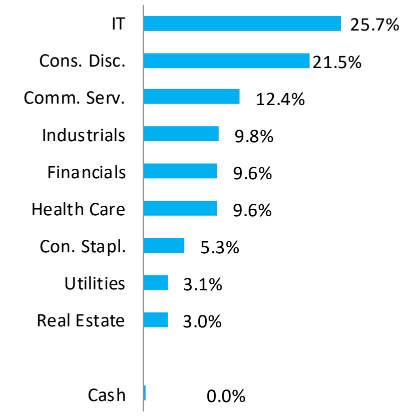
PORTFOLIO

31/08/2021

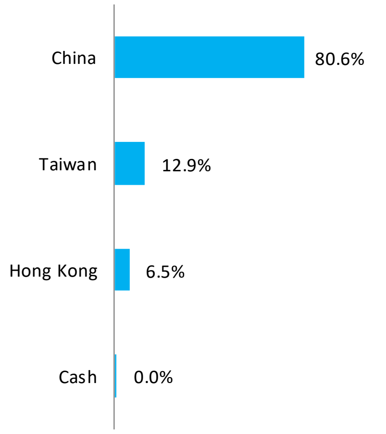
Fund top 10 holdings

Xinyi Solar	3.8%
Autohome	3.7%
Taiwan Semiconductor	3.6%
NARI Technology	3.5%
China Merchants Bank	3.4%
Geely Automobile Holdings	3.4%
Elite Material	3.3%
China Lesso Group	3.3%
JD.com	3.3%
Sino Biopharmaceutical	3.3%
% of Fund in top 10	34.8%
Total number of stocks	32

Sector analysis



Geographic allocation



PERFORMANCE

31/08/2021

Past performance does not predict future returns

Annualised % total return from launch (GBP)

Fund (Z Class, 0.74% OCF)	13.1%
MSCI Golden Dragon Index	15.1%
IA China/Greater China sector average	14.5%

Discrete years % total return (GBP)	Aug '21	Aug '20	Aug '19	Aug '18	Aug '17
Fund (Z Class, 0.74% OCF)	12.0	12.3	-1.5	-3.0	37.4
MSCI Golden Dragon Index	5.5	20.0	2.2	0.9	32.5
IA China/Greater China sector average	2.0	25.8	4.8	0.7	30.8

Cumulative % total return (GBP)	1 month	Year-to-date	1 year	3 years	5 years	From launch
Fund (Z Class, 0.74% OCF)	1.1	0.1	12.0	23.9	65.1	101.6
MSCI Golden Dragon Index	2.1	-3.6	5.5	29.4	73.0	123.1
IA China/Greater China sector average	0.5	-7.7	2.0	34.5	77.2	117.1

RISK ANALYSIS

31/08/2021

Annualised, weekly, from launch on 15.12.15, in GBP	Index	Sector	Fund
Alpha	0.00	-0.18	-1.39
Beta	1.00	0.98	0.99
Information ratio	0.00	-0.11	-0.25
Maximum drawdown	-20.57	-23.77	-25.74
R squared	1.00	0.93	0.88
Sharpe ratio	0.60	0.56	0.47
Tracking error	0.00	4.89	6.69
Volatility	18.00	18.33	19.06

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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 in English from www.guinnessfunds.com or free of charge from:-

- the Manager: Link Fund Manager Solutions (Ireland) Ltd (LFMSI), 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.

LFMSI, as UCITS Man Co, has the right to terminate the arrangements made for the marketing of funds in accordance with the UCITS Directive.

Investor Rights

A summary of investor rights in English is available here: https://www.linkgroup.eu/policy-statements/irish-management-company/

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.