# Guinness Global Equity Income Fund

## INVESTMENT COMMENTARY - May 2014

### About the Fund

Guinness Global Equity Income Fund is designed to provide investors with global exposure to dividend-paying companies.

The Fund is managed for income and capital growth and invests in profitable companies that have generated persistently high return on capital over the last decade, and that are well placed to pay a sustainable dividend into the future.

| | |
|---|---|
| **Fund size** | £50.9m |
| **Launch date** | 31.12.10 |
| **Managers** | Dr. Ian Mortimer, CFA<br>Matthew Page, CFA |

### Performance — 30.4.14

| | 1 year | 3 years | From launch |
|---|---|---|---|
| **Fund** | 8.7 | 34.5 | 38.0 |
| **Index** | 8.5 | 28.8 | 31.5 |
| **Sector** | 7.1 | 28.7 | 31.0 |

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


| | |
|---|---|
| **Benchmark index** | MSCI World Index |
| **IMA sector** | Global Equity Income |

**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.

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**Guinness Global Equity Income**

***BEST FUND OVER 3 YEARS***

EQUITY GLOBAL INCOME

## Portfolio review

In April the Fund was up 0.53%, compared to the MSCI World Index fall of 0.26%, thereby outperforming by 0.79%. Demand for value stocks continued to be strong through the month. Some of our most attractively valued companies are in the energy sector, and these performed particularly well, with our positions in CNOOC, Total and Royal Dutch Shell all comfortably outperforming the benchmark. The IT sector, which has had a very strong run for the last 18 months and now looks relatively expensive, underperformed in April and our underweight exposure to this sector helped our performance.

We did not make any changes to the portfolio in April.

## Concentrated equally weighted portfolios

One question we are often asked when meeting investors is, why do we run the Fund as a concentrated, equally-weighted portfolio?

At first it doesn't sound particularly sophisticated to split a portfolio into a number of equally-weighted positions, perhaps even a bit of a blunt tool. Shouldn't the portfolio construction process be more complicated and dynamic than that? Aren't fund managers meant to assess consistently the potential upside for each and every company they own, and dynamically adjust the weights in their portfolio accordingly? If managers aren't changing their weights based on how share prices have moved then what are they spending their time doing? Don't you want to see a portfolio that contains some large weights to the manager's favourite companies, a portfolio with conviction?

What we are most interested in is, how can we maximise the chance of generating good returns. If


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that means we end up using a method that looks relatively simple, then so be it.

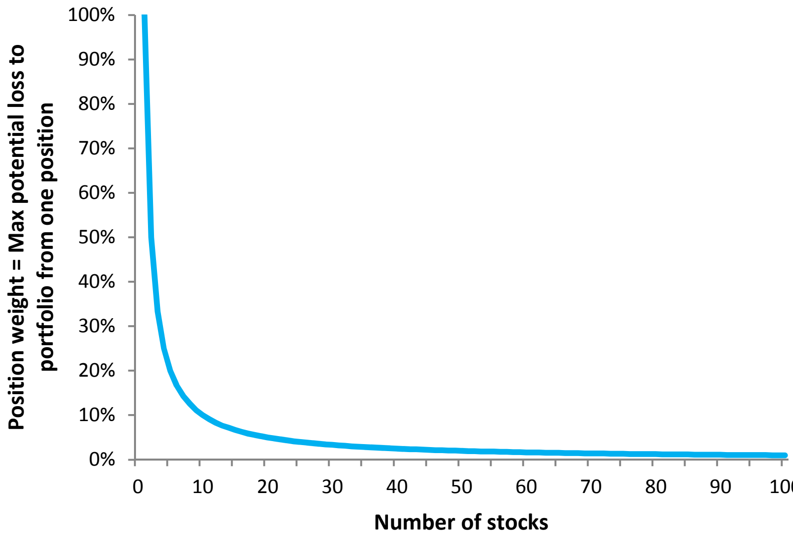
The elegance and efficiency of an equal weighted portfolio are part of the attraction, but there are some very good reasons as to why one should construct a portfolio on an equally-weighted basis.

**Why concentrated?**

First, it's worth considering why we run the Fund as a concentrated portfolio (typically 35 companies) as opposed to a broadly diversified portfolio.

Going back to fundamentals, the reason we all create a portfolio of stocks rather than investing in just one company is the benefits of diversification. By adding additional stocks to a portfolio we reduce the potential loss to the portfolio caused by any single investment going sour due to a company-specific issue.

What's interesting is how quickly you can reduce this stock specific risk to a portfolio by increasing the number of equally-weighted positions in a portfolio. The chart below shows this. When you have just one position in a portfolio the potential loss is obviously 100%, with five positions it's 20%, with ten positions it's 10%, etc.




| No. of positions | Max potential loss from a single position | Reduction in stock specific risk by adding 10 positions |
|---|---|---|
| 1 | 100.00% | |
| 10 | 10.00% | 10.00% |
| 20 | 5.00% | 5.00% |
| 30 | 3.33% | 1.67% |
| 40 | 2.50% | 0.83% |
| 50 | 2.00% | 0.50% |
| 60 | 1.67% | 0.33% |
| 70 | 1.43% | 0.24% |
| 80 | 1.25% | 0.18% |
| 90 | 1.11% | 0.14% |
| 100 | 1.00% | 0.11% |

We think the sweet spot in terms of balancing the need for diversification to limit stock-specific risk and having sufficient weight in our positions so that any appreciation will have a meaningful impact on the portfolio is when you get to a level of 30 to 40 positions. At 30 positions your maximum potential loss to the portfolio from an individual position is 3.33% while at 40 positions it is 2.5%.

Adding additional positions to a portfolio always has an ever diminishing effect on reducing stock specific risk, but beyond 40 positions the additional benefit is really quite small. At the same time, every additional stock we might consider including in a portfolio causes a very linear increase in the amount of time required to perform due diligence and ongoing monitoring.

History shows that unexpected bankruptcies do happen, and even though we invest in companies that consistently earn high return on capital and are very unlikely to go bankrupt, we can't ignore this risk. If the worst was to happen and one of our positions was to go bust then we feel that a loss of 2.5-3.33% to the portfolio – while obviously disappointing – would be by no means disastrous to the overall portfolio.

**Why equally-weighted?**

When you consider the potential total return of a share you have bought, there are really two dimensions to this total return to consider. First is the scale of the total return (both in terms of the size and whether it is positive or negative), and second is the time frame over which the return is realised.

With this in mind it is worth asking a number of questions.

1. **Do we think we can identify companies that are undervalued and will likely provide a positive total return?**
   Yes. In our investment process there are two stages in identifying companies we think can outperform. First, we have identified a group of companies that the market frequently underestimates regarding the persistency of their return on capital. Our analysis of companies that have a long history of consistently earning high return on capital shows that they tend to outperform the rest of the market over a cycle. There will be periods throughout this cycle where they underperform, but over the longer term they outperform. So that is our starting point.

   The second element is then trying to identify the companies within this group that look particularly attractively valued relative to the broader group. Being confident in the likelihood of these types of companies to continue to earn high return on capital in the future means we can take a more contrarian view relative to the market, and add companies to the portfolio when they are unloved and offering attractive value.

   We have developed a robust process for identifying these companies, and whilst we won't get every decision right we think we will more often than not.

2. **How confident can you be in the scale of this potential total return?**
   There are clearly various ways you can come up with a target price for a company, be it through a simple or multi-stage discounted-cash-flow model, a multiple and a forecast earnings or cashflow number, dividend discount models etc. We are very cautious about the usefulness of coming up with a single target price and prefer to consider a range of valuations.

   All these methods require some element of forecasting and all these methods are highly sensitive to a number of key assumptions. Often when you make small adjustments to inputs, such as the discount rate or long-term growth rate, you can see quite a wide swing in the warranted valuation of the company. Given these sensitivities, our confidence in any explicit upside prediction must be cautious.

Therefore, given we consider a range of potential valuations for each company, we cannot simply rank every company we own by its potential upside.

We also have to realise that there are many exogenous shocks that can occur over the period of holding the company. These are largely impossible to predict, but they can have a marked effect on the warranted valuation of the company.

3. **Can you predict the timeframe over which this return will be realised correctly more times than incorrectly?**
   Can we come up with reasons why we think company X which we own might move closer to our range of target prices faster than company Y or Z or any other of our 35 positions? If we ranked all 35, how often would we get more than half correct? Whilst it would be tempting to claim we could do this, the honest answer is we don't think we can, and nor do we think anyone can. There will be occasions when people get it right, but statistically this is more often luck than skill.

To summarise, when we considered these questions we come to the following conclusions:

| | | |
|---|---|---|
| **1.** | **Do you think you can identify companies that are undervalued and will likely provide a positive total return?** | *Yes* |
| **2.** | **How confident can you be in the scale of this potential total return?** | *Not very* |
| **3.** | **Can you predict the timeframe over which this return will be realised correctly more times than incorrectly?** | *No* |

When you consider the answers to these questions and consider how to construct a portfolio, you quite quickly come to the conclusion that creating an equally-weighted portfolio works to our strengths. We think we can identify companies that are undervalued and will likely provide a decent return, but we don't have much certainty in the scale of this return, we know we won't get them all right and some will lose us money, and we have no idea of the timescale over which this will occur.

So, let every good idea we come up with have an equal weight in the portfolio, and the market will decide when a more reasonable valuation will be reached.

If we did have misplaced confidence in a precise target price and in the timescale over which we thought this valuation anomaly would be realised, then you could see why you might weight your positions according to your conviction.

**Advantages**

Running a concentrated equally weighted portfolio has a number of advantages.

1. **High Active share**
   By having a concentrated portfolio with stock weights that are not influenced by the benchmark, then by design we will always have a high active share. As of 30$^{th}$ April 2014 the largest position in the MSCI World Index was Apple at 1.64%. If we hold 35 positions in the portfolio, all equally

weighted, each position will be 2.9%, and therefore every position we hold will have an active weight relative to our benchmark. Since we launched the Fund our active share has always been above 90%.

2. **Rebalancing effect**
Having an equally-weighted portfolio removes some of the behavioural biases that all fund managers need to be aware of and control. Loss aversion is a key behavioural bias, but an equally weighted portfolio creates a strict discipline to counteract this. By having an equally-weighted portfolio we have to rebalance it periodically. Clearly we don't want to rebalance too frequently as it will just create additional trading costs which we want to keep to an absolute minimum, so we tend to rebalance every two to three months. This forces us to go against the market trend and corresponding media narrative and buy some more of the companies that have underperformed the portfolio as a whole and reduce our holding in companies that have outperformed the portfolio.

   If we have a scenario where one of the companies we own has performed particularly poorly, then the rebalancing process forces us to decide whether we want to continue to own it, in which case we have to buy some more, or if something about our initial thesis for purchase has changed then we must sell the entire position. What we can never do is have a long tail of small "legacy" positions which we don't have conviction in.

3. **One in, one out**
Often it can be easier to identify companies we would like to own in the portfolio than it is to find something we already own that we should be selling. By having a one in, one out policy it forces us to consider which is the position in the portfolio that we like the least. We can't just add another position. This keeps the portfolio up-to-date with our best ideas.

4. **Limited stock specific risk**
Having a concentrated and equally-weighted portfolio limits your stock-specific risk to a reasonable level. If you don't have an equally-weighted portfolio then your stock-specific risk is limited to the size of your largest position. It's easy to think of large cap companies that might have made up a significant proportion of non-equally weighted portfolios, that didn't turn out so well!

5. **Conviction in every position**
Some might argue that by equally-weighting the portfolio we are limiting the scale of conviction we can have in any one company. Is it higher conviction to have much higher weights in five companies and small weights in 30, or equal weights in all 35?

   The equal weighted portfolio construction allows us to have the same weight in the portfolio for a company that has a £1 billion market cap as a company that has a £100 billion market cap. In our minds that demonstrates high conviction.

   But aren't smaller companies more risky than larger companies? Perhaps that is true as a generalisation (it partly depends on your definition of risk), but there are plenty of exceptions. We would argue that the likes of Facebook (Mkt Cap $150 billion) and Amazon (Mkt Cap $137 billion) trading on P/Es of 75x and 466x respectively are higher risk than the smallest company we have ever owned in the portfolio, which is H&R Block. When we bought it in 2012 it had a market cap of $4 billion and traded on a P/E of 10x. Not to mention its very long history of paying an increasing dividend, an attractive dividend yield of 4.5% and a $250m per year share repurchase programme.

In a concentrated portfolio we aren't looking for generalisations, we are dealing with best ideas in individual stocks with specific mispricings, anomalies and opportunities. We are looking for the exceptions and outliers.

We are willing to back our convictions in a controlled and considered manner whilst at the same time ensuring we are not having overly concentrated exposure to specific sectors.

Thank you for your continued support.

**Dr. Ian Mortimer & Matthew Page**
**Co-managers, Guinness Global Equity Income Fund**

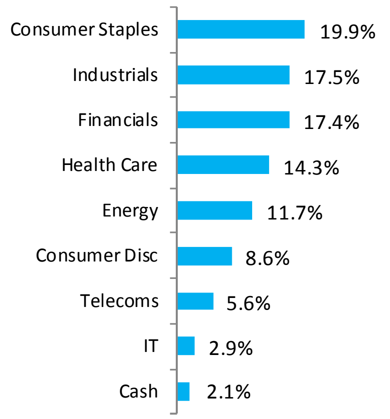
**May 2014**

## PORTFOLIO (30.04.14)

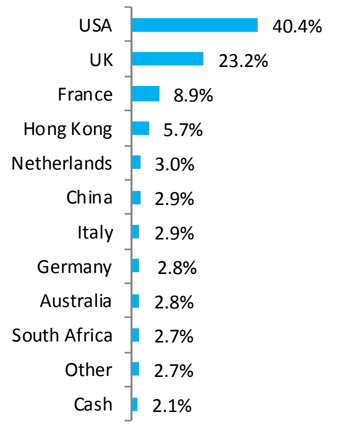
### Fund top 10 holdings

| | |
|---|---|
| Aberdeen Asset Management | 3.3% |
| Abbvie | 3.1% |
| Total | 3.1% |
| Unilever | 3.0% |
| Schneider Electric | 3.0% |
| Royal Dutch Shell | 3.0% |
| Merck & Co | 3.0% |
| Illinois Tool Works | 2.9% |
| Meggitt | 2.9% |
| General Dynamics | 2.9% |
| % of Fund in top 10 | 30.1% |
| Total number of stocks in Fund | 34 |

### Sector analysis




### Geographic allocation




## PERFORMANCE

### Discrete years % total return (GBP)

| 12 months to month end: | Apr '10 | Apr '11 | Apr '12 | Apr '13 | Apr '14 |
|---|---|---|---|---|---|
| Fund C Class (1.5% AMC) | - | - | 0.4 | 21.2 | 7.2 |
| Fund X class (0.75% AMC) | - | - | 1.1 | 22.1 | 8.0 |
| MSCI World Index | 32.6 | 8.5 | -2.0 | 21.8 | 7.5 |
| IMA Global Equity Income sector average | 28.4 | 11.4 | -0.9 | 21.6 | 6.0 |

### Cumulative % total return (GBP)

| 30/04/2014 | 1 month | Year-to-date | 1 year | 3 years | From launch |
|---|---|---|---|---|---|
| Fund X class (0.75% AMC) | 0.5 | 0.8 | 8.0 | 33.3 | 38.0 |
| MSCI World Index | -0.3 | 0.3 | 7.5 | 28.2 | 31.5 |
| IMA Global Equity Income sector average | 0.3 | 1.3 | 6.0 | 27.8 | 31.0 |

### Annualised % total return from launch (GBP) 30/04/2014

| | |
|---|---|
| Fund X class (0.75% AMC) | 10.16% |
| MSCI World Index | 8.56% |
| IMA Global Equity Income sector average | 8.45% |

### Risk analysis - Annualised, weekly, from launch on 31.12.10, in GBP

| 30/04/2014 | Index | Sector | Fund |
|---|---|---|---|
| Alpha | 0 | 1.79 | 3.11 |
| Beta | 1 | 0.77 | 0.79 |
| Information ratio | 0 | 0.00 | 0.30 |
| Maximum drawdown | -18.26 | -15.50 | -16.34 |
| R squared | 1 | 0.81 | 0.89 |
| Sharpe ratio | 0 | 0.39 | 0.54 |
| Tracking error | 0 | 6.08 | 4.83 |
| Volatility | 13.95 | 11.97 | 11.60 |

**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. Fund launch date: 31.12.10. **Fund X class**: Simulated performance based on actual returns of E share class (available from Fund launch), calculated in GBP. **IMA sector** performance based on highest fee share classes for each fund (C Class (1.5% AMC) for Guinness Global Equity Income). **See Notes overleaf.**

## Performance data notes

**1)** The performance numbers displayed on the previous page are calculated in GBP (Sterling). Please note: The Fund's X class was launched on 15/02/2012. The performance shown is a simulation for X class performance being based on the actual performance of the Fund's E class, which has the same annual management charge as the X class, and has existed since the Fund's launch. The Fund's E class is denominated in USD but for the purposes of this performance data its performance is calculated in GBP. Hence the Fund's E Share class is used here to illustrate the performance of a GBP-based clean-fee (RDR-compliant) share class since the Fund's launch on 31.12.10.

**2)** The performance of the IMA Global Equity Income sector is based on the average of the highest fee share class of each constituent fund, e.g. C class for the Guinness Global Equity Income Fund, with an annual management fee of 1.5%.

# 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 Global Equity Income Fund. It may provide information about the Fund’s portfolio, including recent activity and performance. It contains facts relating to the energy market 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 Global Equity Income 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: Capita Financial Managers (Ireland) Limited, 2 Grand Canal Square, Grand Canal Harbour, Dublin 2, Ireland; or,
- the Promoter and Investment Manager: Guinness Asset Management Ltd, 14 Queen Anne's Gate, London SW1H 9AA.

**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. The Fund has been approved by the Financial Conduct Authority for sale in the UK. If you are in any doubt about the suitability of investing in this Fund, please consult your investment or other professional adviser.

**Switzerland**

The prospectus and KIID for Switzerland, the articles of association, and the annual and semi-annual reports can be obtained free of charge from the representative in Switzerland, Carnegie Fund Services S.A., 11, rue du Général-Dufour, 1204 Geneva, Switzerland, Tel. +41 22 705 11 77, www.carnegie-fund-services.ch. The paying agent is Banque Cantonale de Genève, 17 Quai de l'Ile, 1204 Geneva, Switzerland.

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