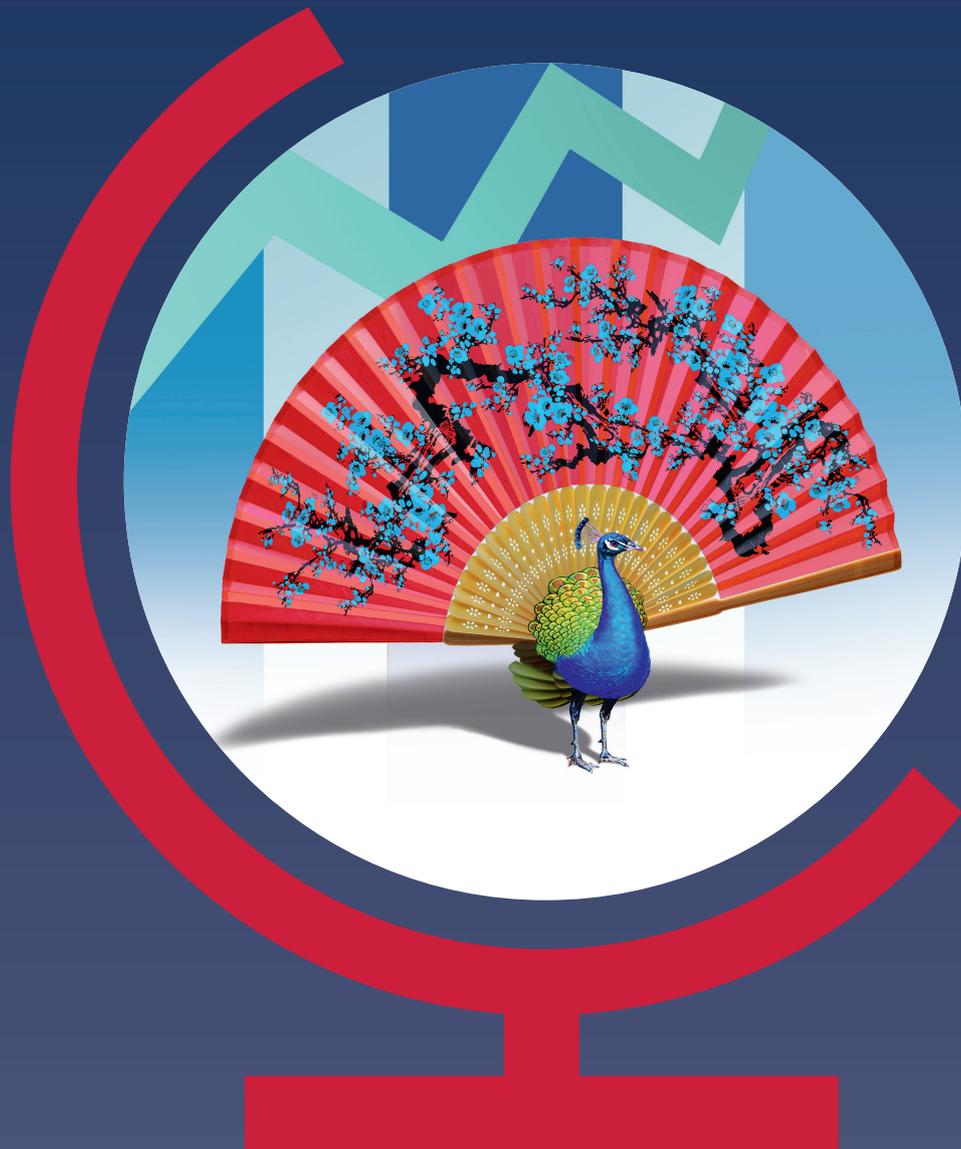


GUINNESS CHINA A SHARE FUND

INVESTMENT CASE



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

POSITIVELY DIFFERENT

GUINNESS
GLOBAL INVESTORS

ABOUT GUINNESS GLOBAL INVESTORS

Guinness Global Investors is an independent active fund manager specialising in long-only equity funds. The company is 100% employee-owned, with a significant long-term holding controlled by the Guinness family. We offer a range of strategies which share a focus on profitable businesses with high return on investment and strong balance sheets. Active management, high conviction and identifying value are the central pillars of our philosophy and they are delivered in the form of concentrated, equally weighted portfolios, which balance concentration and risk.

RISK & PERFORMANCE

The Guinness China A Share 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. The Fund invests only in stocks of companies that are based in, or with significant business activities in China; it is therefore susceptible to the performance of that region. In addition, at least 80% of the assets will be in China A shares, which have a greater participation by retail investors than other markets, so its performance may be more volatile. Further details on the risk factors are included in the Fund's documentation, available on our website (guinnessgi.com/literature).

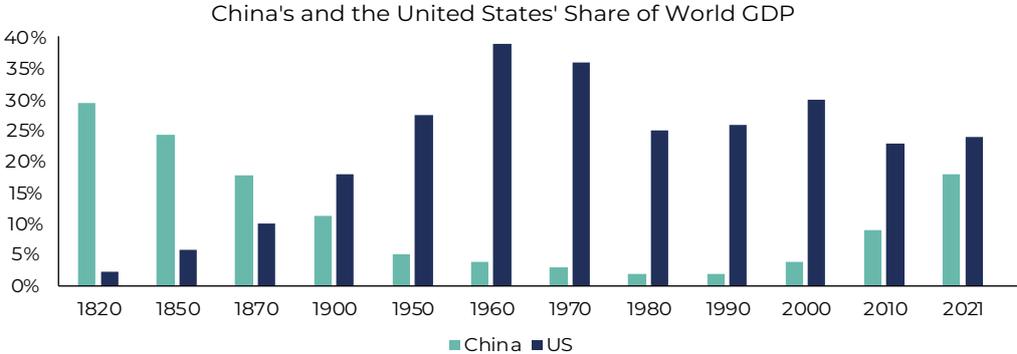
The Fund is actively managed and uses the MSCI China A Onshore Index as a comparator benchmark only. The Fund invests in quality, profitable companies exposed to the structural growth themes we have identified in the China A share market.

Performance: Past performance does not predict future returns.

Investors should note that fees and expenses are charged to the capital of the Fund. This reduces the return on your investment by an amount equivalent to the Ongoing Charges Figure (OCF). The current OCF for the share class used for the fund performance returns is 0.89%. Returns for share classes with a different OCF will vary accordingly. Transaction costs also apply and are incurred when a fund buys or sells holdings. The performance returns do not reflect any initial charge; any such charge will also reduce the return.

INTRODUCTION

The Chinese economy is the second largest in the world, and we think at some point it will surpass the US to become the world's largest. While this will mark a change compared to the past 100 years, it will actually be a return to its earlier pre-eminence. The chart below shows that in 1820, China's share of global GDP was 30%, while the United States' share was just 2%. China then suffered its "century of humiliation", during which internal decline was matched by a series of land concessions to foreign powers, meaning China saw its share of global GDP fall to 5% by 1950. Simultaneously, the US economy boomed, taking China's place as the world's largest and accounting for 39% of world GDP by 1960. China stagnated in the decades following the Second World War, and it was only after Deng Xiaoping became leader that the country began to grow rapidly. Deng's famous southern tour in 1992 led to a series of economic reforms which helped to propel China's share of global GDP from 2% in 1990 to 18% by 2021. Meanwhile, the US's share has fallen from its peak of 39% in 1960 to 24% in 2021.



Source: Maddison Project Database 2020, World Bank, Guinness Global Investors calculations



However, China's share of global equity markets is much smaller than its share of GDP, in stark contrast to other major economies. We believe that over time this gap should close and Chinese markets are likely to take up a significantly larger share of major equity benchmarks. We argue this is likely to be driven by rising demand for China A shares. These are onshore shares trading on mainland listed exchanges, namely Shanghai and Shenzhen. These are different to offshore listed stocks trading in Hong Kong and American Depository Receipts (ADRs) trading in the US.

The main reasons to buy China A shares include:

- Growth: Investors looking for growing companies cannot ignore China A shares, which account for nearly a quarter of the world's earnings compounds.
- Diversification: China offers much lower correlation to developed markets than other major markets. This is very attractive as the United States normalises monetary policy and investors seek to diversify away from American markets.
- Size: there are now nearly as many liquid companies in the A share market than there are in the United States.
- Under-ownership: China accounts for only 3% of the MSCI All Country World Index even though China accounts for 18% of world GDP. We expect demand for A shares to grow as index inclusion factors increase, investors seek dedicated China exposure, and domestic demand grows.



Due to rising demand for Chinese equities, we expect that in the medium term, many investors will split China out of their emerging markets allocation and will have a dedicated China equity allocation. Therefore, sophisticated investors should be thinking seriously about China A shares today, in order to take advantage of this expected future demand.

Although investing in China presents many opportunities, it also brings challenges. These include government influence, relatively volatile equity markets, market access issues, corporate governance, language barriers, geopolitical tensions and accounting issues. While these are real challenges, we do not believe they are insurmountable. With a carefully designed process, we argue, investors can avoid companies which are exposed to them.

We adopt a disciplined approach towards investing in China. We keep it as simple as we can, so it is both understandable and repeatable on a consistent basis. We identify what we believe are China's long-term structural growth themes and have created an investment universe of companies that we believe are best placed to convert these themes into superior profitability. To enter our investment universe, a company not only needs to give exposure to one of the themes, but must also have a superior cash return on investment without having excessive debt on its balance sheet. From this universe we select a small group of companies for the portfolio whose current market price undervalues the probable future returns on capital over the next three to five years. Generally, we look for companies with the following characteristics, which are of equal importance:

- High return on capital
- Ability to convert revenues into cashflows
- Growing operating cashflows, which we expect to continue to grow
- The ability to deploy this cash at a high rate of return
- Sensibly structured balance sheet with no excessive debt
- Management which we trust to grow the business
- Absence of activities judged to be harmful to society's wider interests
- Growth opportunities undervalued by the market

Understanding the structural, regulatory, and economic backdrop in China is important. So too is financial analysis enabled by a detailed understanding of the linkages between profit and loss, balance sheet and cash flow statements. Cash is the lifeblood of any business, and we spend more time studying the conversion of revenues into cash earnings than on the top-down story. This paper describes in more depth why investors should even consider China to begin with, how to address specific issues, and why we think we have the right approach to deliver superior long term returns.

WHY GUINNESS FOR CHINA EQUITIES?

- We have a strict focus on cash returns on investment. We are not hoping for companies to generate an acceptable return on investment; instead, our companies have already shown evidence they can do so. This focus on businesses which are already cash-generative can help the Fund in times of economic weakness, when cash becomes crucial.
- We have access to the same information as everyone else, but it is what we do with this information that gives us our edge. We create our own financial models which we think better reflect reality. We do not solely rely on third-party data sources as they can incorrectly categorise data.
- Our independence and size allow quick decision making. We do not have an investment committee.
- Our equally weighted portfolio leads to high active share.
- We are not based in China. We do not get attached to stocks or surrounded by groupthink.
- We focus on total return, not just earnings growth, which is a vital distinction to make for a growth fund. We take valuations into account, which is important given rising global interest rates and risks from unexpected sources e.g. tech regulation. This is not a 'growth at all costs' fund.

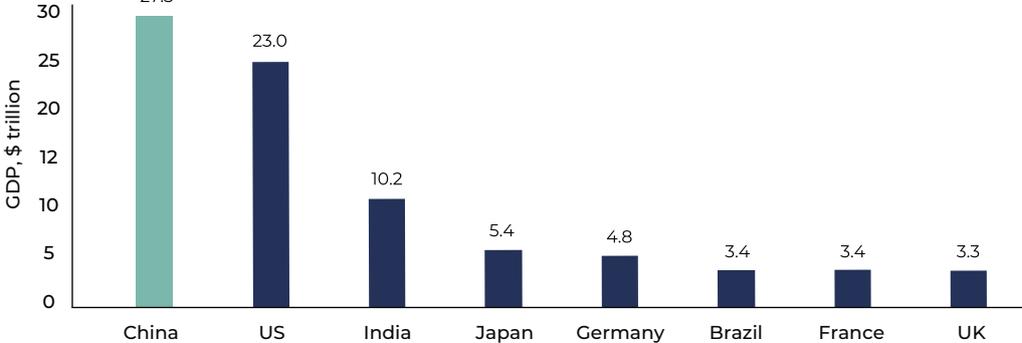
WHY CHINA?

Nominal GDP in 2021 Amongst Major Economies



Source: World Bank, Guinness Global Investors calculations as at 31.12.2021

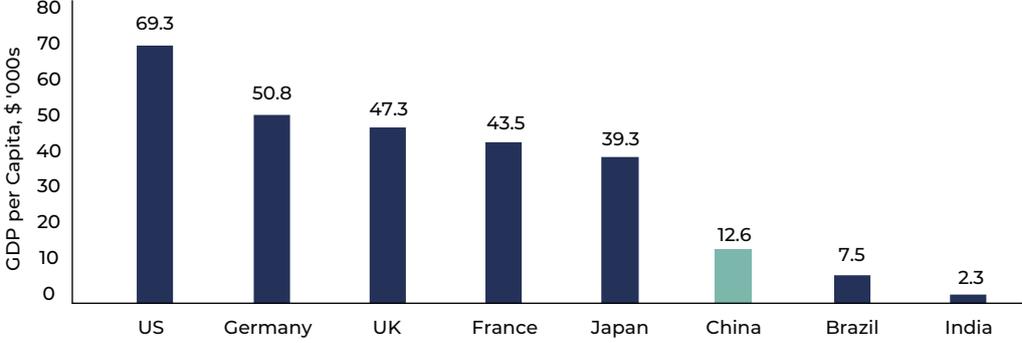
GDP (PPP) in 2021 Amongst Major Economies



Source: World Bank, Guinness Global Investors calculations as at 31.12.2021

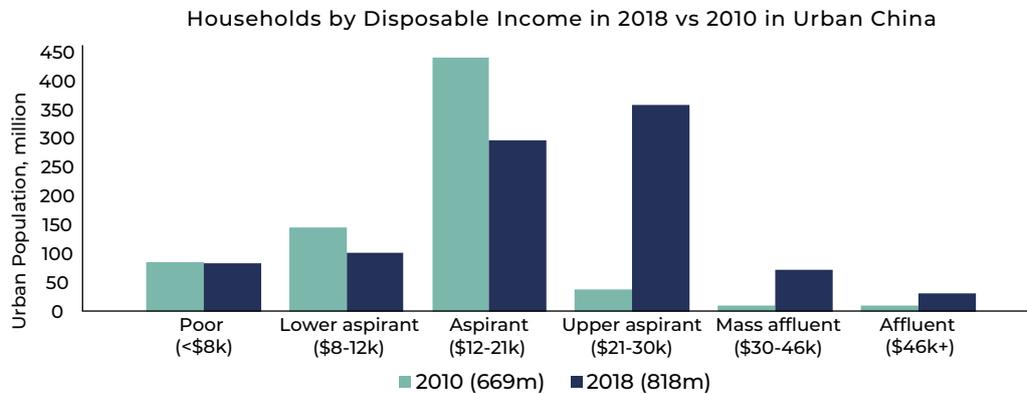
The Chinese growth story is well known. When looking at GDP on a nominal basis, the Chinese economy is the second largest in the world, only behind that of the US. However, some argue that because of volatile market exchange rates, nominal GDP figures stated in US dollars can be unstable. There are other ways to compare GDP between countries and one method is to focus on purchasing power parity (PPP). The PPP approach measures the cost of purchasing the same basket of goods in different countries, reflecting that it is likely the same good is cheaper in a developing country than in a developed country. The PPP method uses this ratio of prices as the exchange rate to convert each country's GDP to US dollars, instead of the market exchange rate. If measuring GDP on a PPP basis, the Chinese economy is the largest in the world.

GDP per Capita in 2021 Amongst Major Economies



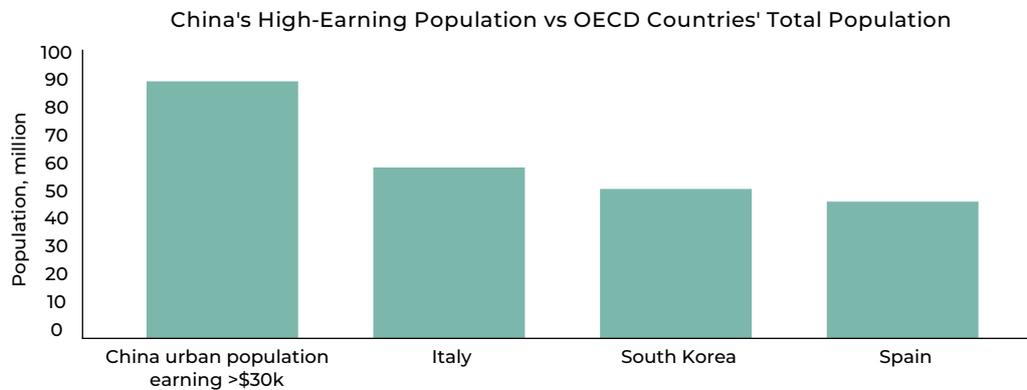
Source: World Bank, Guinness Global Investors calculations as at 31.12.2021

We argue that despite China's large economy there is still much more room for economic growth. If we look at GDP per capita we see the average income in the country is just over \$12,000. This compares to \$40,000 - \$50,000 in most developed economies and \$69,000 in the US. So while the Chinese economy is large in the absolute sense, the average consumer has just entered the middle class.



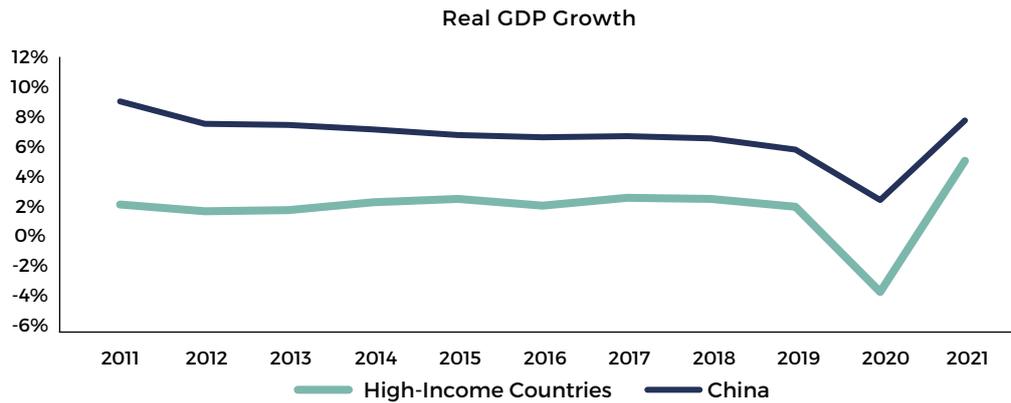
Source: World Bank, Guinness Global Investors calculations as at 31.12.2018

The chart above, showing the number of urban residents in brackets according to annual household disposable income, demonstrates how China's middle class is growing and becoming richer. In 2018 there were 161m urban households whose annual income was less than \$12,000 and which had, in other words, not yet reached the middle class. Over time, as China's economy grows, we expect more consumers to enter the middle class.



Source: World Bank, Guinness Global Investors calculations as at 31.12.2018

Another way of looking at China's growing wealth is to focus on China's higher earners who are more active in the luxury market. In 2018 there were 89m urban residents whose household income was at least \$30,000 a year. To put this into context, countries with a household income of around \$30,000 include Italy, South Korea and Spain. The chart above shows China has more wealthy residents than the entire population of each of these countries. This segment of China is already an important contributor to both Chinese and foreign brands; they buy the latest iPhones, buy luxury goods from European fashion brands, and so on. Over time, we expect China's urban elite to continue to grow as the economy grows.

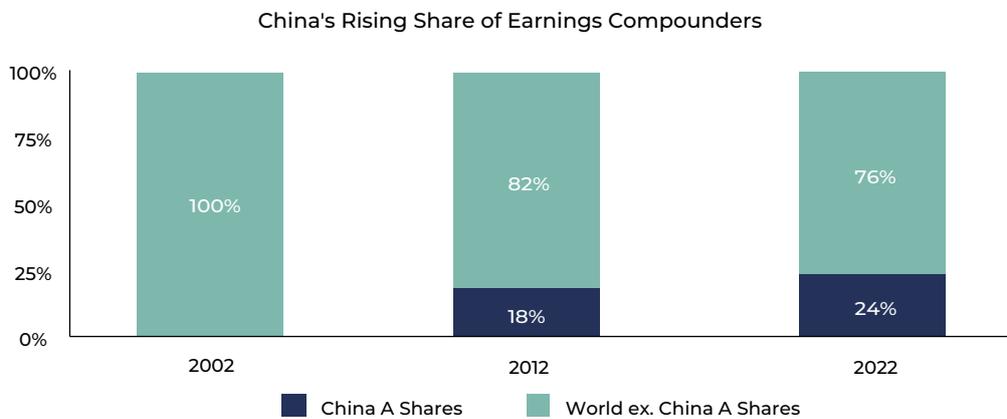


Source: World Bank, Guinness Global Investors calculations as at 31.12.2021. High-Income refers to the World Bank's definition of high-income countries.

Pre-Covid, China's economy was growing at a much higher rate than high-income markets. Though the days of China growing at 8-10% a year are over, we do think in the medium term the Chinese economy could grow at 3-4% a year. This would continue to mean it grows faster than developed markets, increasing the size of the addressable market for Chinese and foreign companies.

WHY CHINA A SHARES?

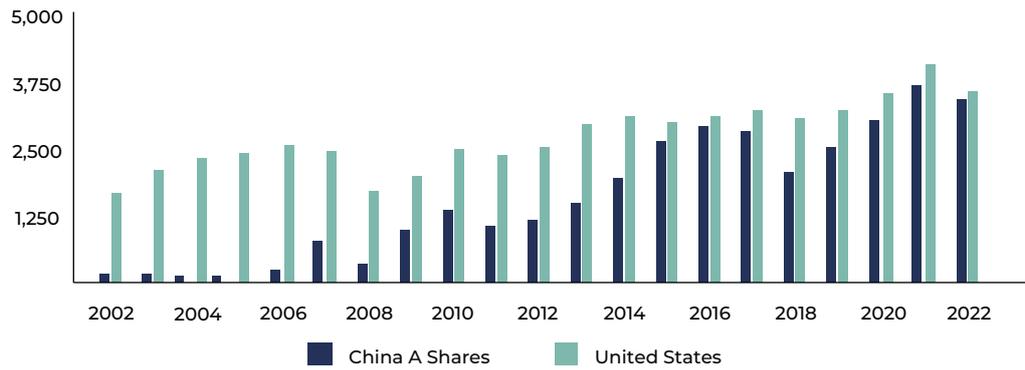
For those investors looking for growing companies, China A Shares cannot be ignored. China A shares accounted for nearly a quarter of all earnings compounders worldwide. (An earnings compounder is defined here as a company with a 10 year compound annual growth rate in earnings of at least 15%). Yet most investors do not have a dedicated China A share allocation.



Source: Bloomberg, Guinness calculations: 31.12.22. No. of companies as of the last day of each year. Minimum market cap \$500m.

China A shares are also very liquid and now there are nearly as many liquid stocks in the onshore market as in the United States. 20 years ago, there were only 157 liquid China A shares compared to nearly 1,700 in the United States. Over the past 20 years, there has been a clear trend of more onshore stocks to pick from. In 2022, there were 3,391 liquid A shares, slightly less than in the US.

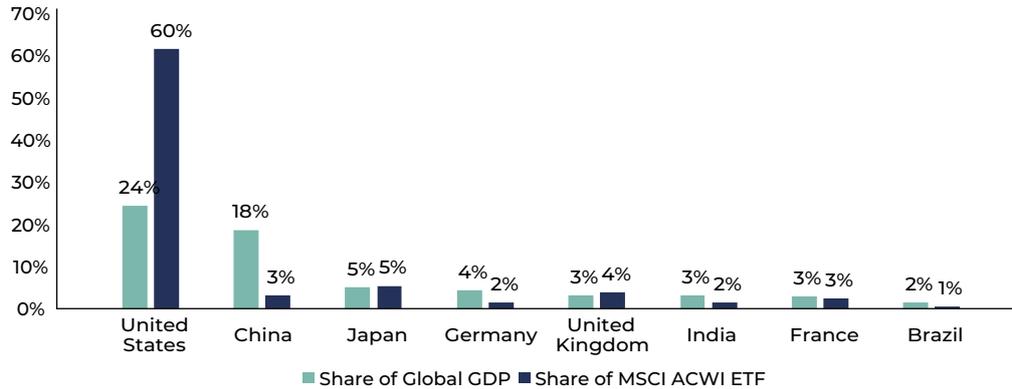
Rising Number of Liquid China A Shares



(Source: Bloomberg, Guinness calculations: 31.12.22. No. of companies as of the last day of each year. Minimum market cap \$500m.)

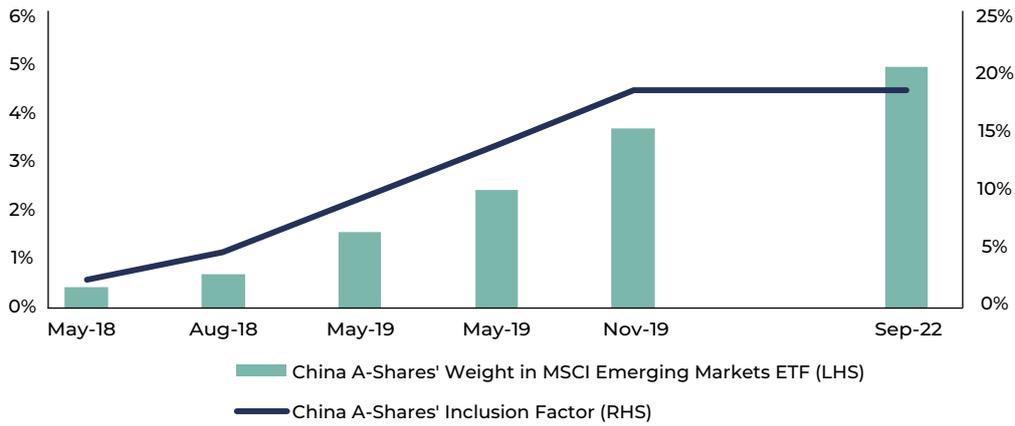
Despite China's large share of the global economy, its equity markets are smaller relative to domestic GDP than one may think. As of 30th September 2022, China only accounted for 3% of the MSCI All Country World Index, much lower than its 18% share of global GDP. As you can see below, the US has very developed financial markets and a 60% share of global equity markets, well above its 24% share of global GDP. Other major economies have equity shares roughly in line with their GDP shares. China is the clear outlier here, representing an opportunity for investors, as we believe China's equity share of global markets is likely to increase over time.

Major Economies' GDP and Equity Shares



Source: World Bank, Guinness Global Investors calculations. GDP refers to 2021 nominal GDP. MSCI ACWI ETF refers to the weights derived from the iShares MSCI All Country World ETF (ACWI US), as of 30/09/22. Categorisations based on domicile.

China A-Shares increasing Weight in the MSCI Emerging Markets Index.

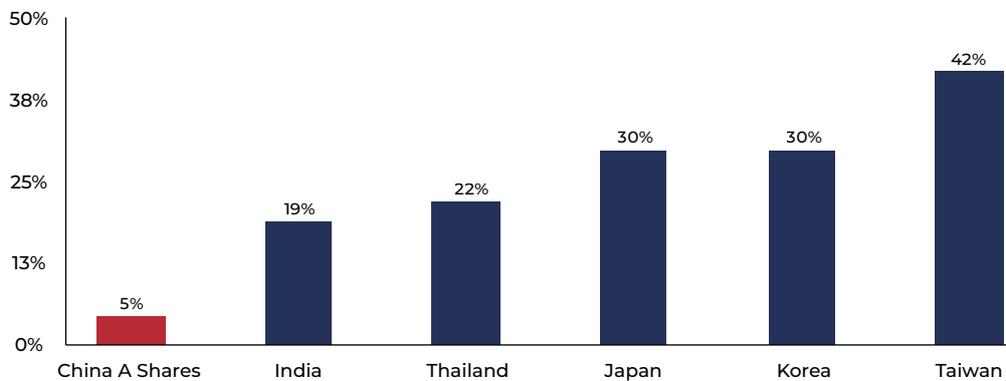


Source: Bloomberg, Guinness Global Investors calculations as at 30.09.2022. ETF refers to the iShares MSCI Emerging Markets ETF (EEM US)

What could drive this increase? One factor is linked to the treatment of China A-shares, which are mainland shares listed in Shanghai and Shenzhen. Currently, index providers only include a portion of the capitalisations of these A-shares in their indexes, but this portion (the inclusion factor) has increased over time. MSCI started including China A-shares in its major benchmarks with an inclusion factor of 2.5% in May 2018. The inclusion factor has gradually increased to 20%, meaning China A-shares' weight in the MSCI Emerging Markets Index has increased from 0.5% in May 2018 to 5.4% in September 2022. We expect the inclusion factor to increase as the A-share market opens up, involving improvements over settlement cycles, hedging instruments and derivatives, as well as access to onshore Renminbi. This is likely to lead to greater demand for A-shares, as passive funds are obliged to match the new index weights. The secondary effect is that A-shares' weight and so China's overall weight in global benchmarks would increase, making China harder to ignore for asset allocators.

China A shares' relatively low inclusion factor explains why foreign ownership is low compared to other Asian markets. Foreigners only own 5% of the China A share market, compared to 19% in India, 30% in Japan and 42% in Taiwan. We argue there is considerable room for foreign ownership in the onshore market to increase, driven by A shares' rising inclusion factor and greater attention towards Chinese equities.

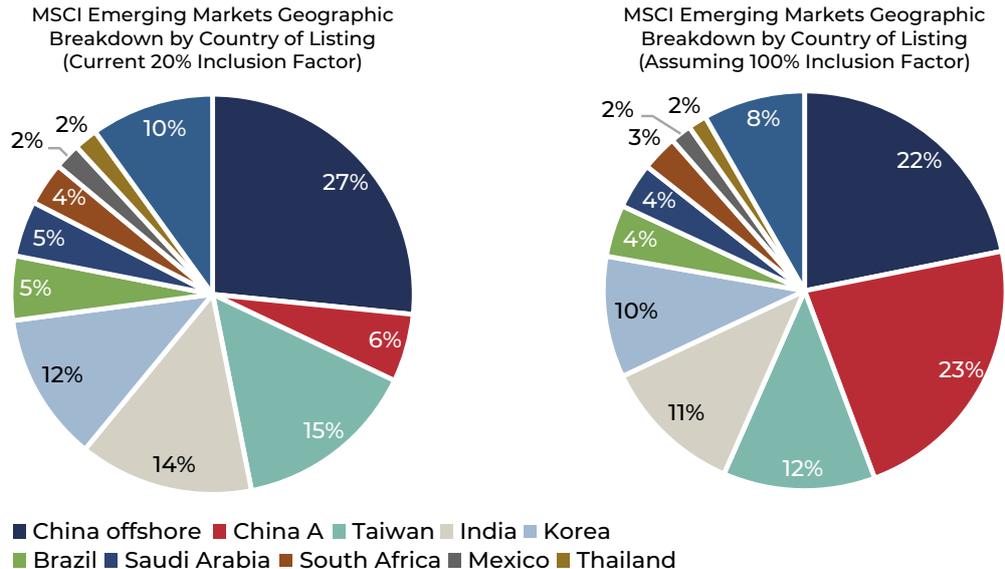
Equity Foreign Ownership



(Source – Goldman Sachs, Feb-22)



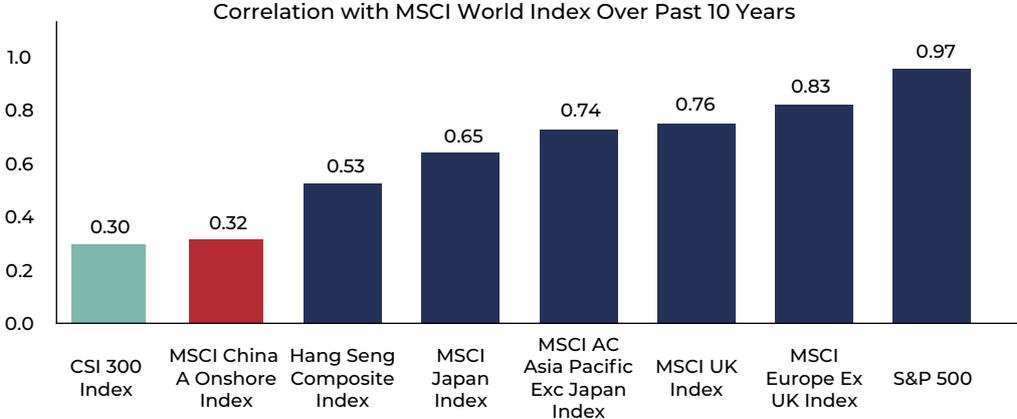
We believe that investors are likely to adopt a dedicated China allocation, meaning China and the rest of emerging markets will become separate allocations. When considering China's weight in the emerging markets index, we must sum up the total offshore (Hong Kong and US ADR) and onshore (China A-share) exposure. If China A-shares were to be included at a 100% inclusion factor, China's total weight in the MSCI Emerging Markets Index would increase from the current level of 33% to 45%, making China nearly half of the index. At this point, investors may be getting more China exposure than they would like in an emerging markets index and so may prefer to make separate allocations to China and to the rest of emerging markets. If most investors initiate dedicated China exposure, this could lead to greater demand for China A shares.



Source: Morgan Stanley, Guinness Global Investors calculations. Data as of 31/07/22

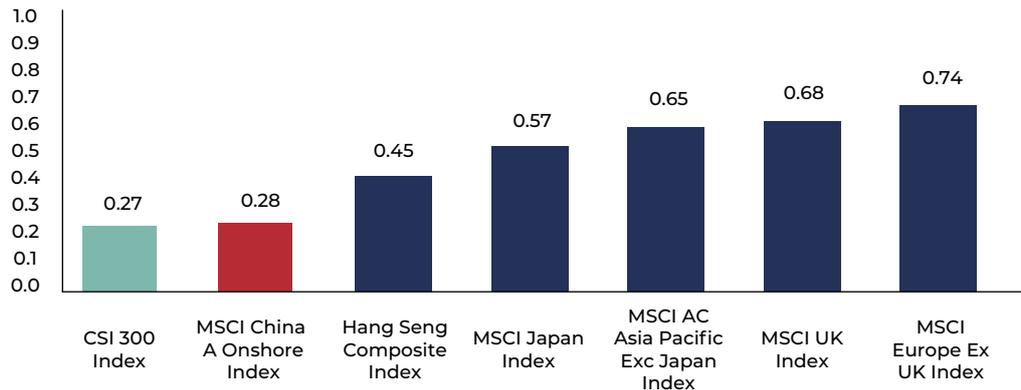
DIVERSIFICATION

Chinese markets offer investors the benefit of diversification given their low correlation to developed markets. We show below the correlation of major markets against the MSCI World Index and S&P 500 Index over the past decade. It is clear that historically China A shares have had very low correlation to developed market indexes, offering even less correlation than the Hang Seng Composite Index. For those looking to diversify away from developed markets, China A shares are an attractive opportunity.



(Source: Bloomberg, Guinness Global Investor calculations. Data from 31/12/12 – 31/12/22.)

Correlation with S&P 500 Index Over Past 10 Years



(Source: Bloomberg, Guinness Global Investor calculations. Data from 31/12/12 – 31/12/22.)

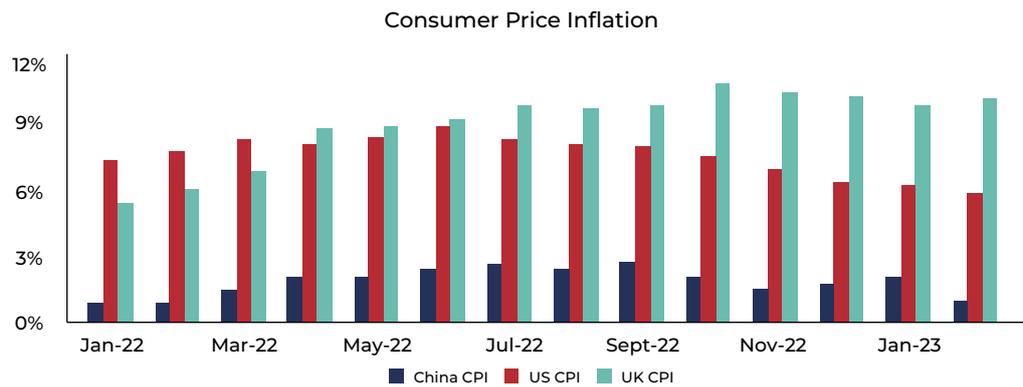
DIVERGING MONETARY POLICIES

M2 Money Supply Year-on-Year Growth



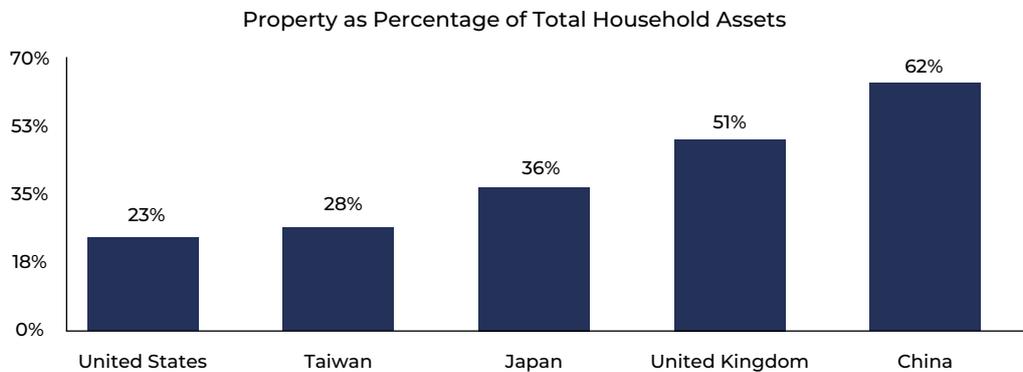
(Data from 31/12/19 to 28/02/23, source: Bloomberg, Guinness Global Investors calculations)

In response to the original Covid outbreak, central banks in developed countries loosened monetary policy considerably. The chart above shows the US significantly increased its money supply in 2020 in response to Covid and that while the rate of increase slowed in 2021, it was still substantial. This surge in liquidity led to substantial consumer price inflation in the US. Meanwhile, in China, the money supply growth rate moderated in 2020 and 2021 and inflation is not as great a problem, as we can see below. In 2022, we can see the monetary situation has reversed, as the US is tightening while China is easing. We expect China's looser policy to be more supportive for businesses relative to that of the US.



Source: Bloomberg. Data from 31/12/21 to 28/02/23

There is also large potential for domestic Chinese wealth to flow to the China A share market. In China, property makes up a far larger component of household wealth than in other major markets. Given policymakers insistence that “housing is for living, not for speculation”, we believe in the medium to long term that housing is unlikely to be such a dominant asset class in China. This implies that over time, funds may flow from property towards other assets such as the onshore equity market.



Source – Goldman Sachs, A Share primer, Feb-22

Pension reforms is another area that is likely to lead to less prominence on property, as well as greater demand for China A shares. In China, there is a basic public pension scheme but provision of employer sponsored and individual private plans is marginal at best. However the government is planning on making the pension system more robust and attractive which is bullish for A shares. For example in 2022, the government announced reforms to private plans. Individuals could contribute up to CNY 12,000 (\$1,742) for their pension, which could be deducted from their annual income for tax purposes. The tax rate on pension benefits was cut from 7.5% to 3.0% and income from pension investments was no longer to be taxed. The new scheme was initially trialled in 36 cities with the intention of eventually rolling out across the country. Given that under a full rollout, approximately 1.0 billion people are eligible for the private plan, the long-term potential demand arising from this reform is positive for China A shares.

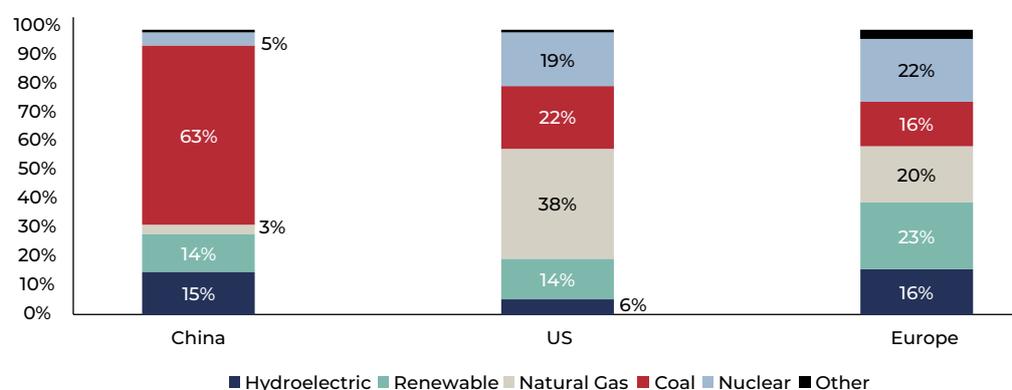
STRUCTURAL GROWTH

China has developed since the 1980s from a predominantly agrarian economy into a diversified, middle-income economy which is integrated into global supply chains. This has supported a burgeoning consumer class which, in spite of recent economic headwinds, remains fundamentally optimistic about national and personal prospects. At this stage of the country's development, policy is aimed at moving the country toward becoming a higher-income consumer economy. This leads us to focus on an investment framework of long-term structural growth themes.

The rising numbers and affluence of the middle class underpin China's long-term goals. This group at the lower end aspires to an urban lifestyle that includes comfortable living, home and car ownership, dining out and leisure. At the higher end there is greater focus on healthcare and financial goals including savings, pensions and insurance. The way in which such products and services are promoted, distributed and consumed is as interesting as what is consumed. Technology solutions have been developed and eagerly adopted by the next-generation consumers, and the overwhelming success of the technology giants lies behind the regulatory changes that we have seen in China and elsewhere.

As a matter of necessity, industrial policies have been developed to respond to the demographic challenges posed by fewer workers and more retirees in coming years. Labour is now a scarcer and more valuable resource, and with fewer workers available to support each retiree, the work they do needs to generate more value that increase wages and tax revenues. Manufacturing upgrades with a focus on pillar industries, in which China can take substantial market share, is another long-term theme. The government's Made in China 2025 plan aims to make China competitive in industries such as 5G, data centres, ultra-high-voltage lines and electric vehicles.

Electricity Generation in 2021



Source: BP Statistical Review of World Energy June 2022, Guinness Global Investors calculations

China is central to the success of reaching global carbon emissions targets, as laid out at COP26. In 2021 China generated 8,534 Terawatt-hours of electricity or 30% of the world's total, as much as the US (15%) and Europe (14%) combined. However, 63% of China's electricity generation comes from coal-fired plants, compared to 22% in the US and 16% in Europe. This and other coal-burning activities in heavy industry have made China the largest carbon emitter in the world. The resulting pollution led to industrial smog covering major cities, leading policymakers to promise "to make our skies blue again".

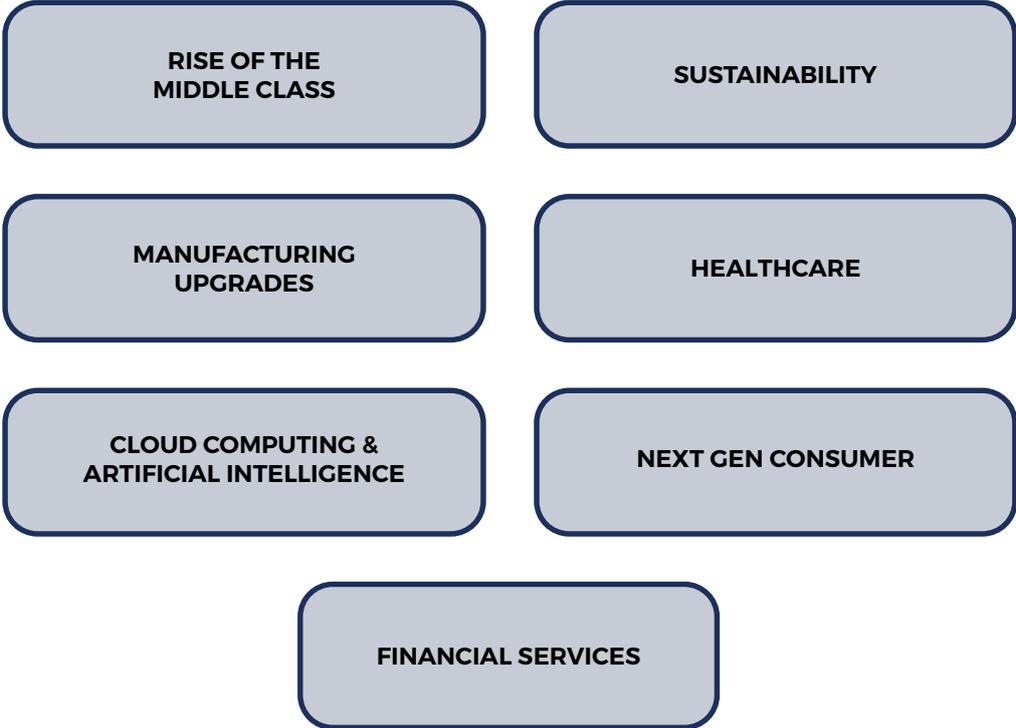
In the medium term, China aims for its carbon dioxide emissions to peak before 2030. China's long-term plan is to achieve carbon neutrality in 2060. To achieve this, policymakers are targeting for the non-fossil share of total energy demand to rise from 17% to over 80% by 2060. China is already the world's largest generator of solar and wind energy, and is clearly going to have to increase its spend significantly further.

HOW TO INVEST IN CHINA A SHARES

We have argued that investors should have dedicated China exposure, but how best to get it? There are three components to shareholder return: earnings growth, the change in the valuation multiple, and the dividend yield. We believe that in the long term it is the earnings growth of each company which has the biggest effect on shareholder returns. But how best to find companies which can grow earnings over time? We see no evidence that past earnings growth is a good predictor for future earnings growth, nor that past asset growth is a good predictor for future asset growth.

We argue that a focus on structural growth themes is the best approach for identifying companies which can grow earnings, the philosophy being that companies in industries that are expected to grow are likely to also grow their earnings, with obvious caveats that we expand on later. We analyse trends we see in China as well as in global markets to identify these structural growth themes. Some of these trends are global in nature, such the evolution in technology systems and applications. Others are more specific to China's plans – for example, policymakers' views on infrastructure, covering not just traditional infrastructure such as roads and railways, but also 5G, data centres and artificial intelligence. Therefore, to understand the unique trends in China, we also look at policy documents and five-year plans issued by the government. We have consolidated these trends into the following seven structural growth themes.

STRUCTURAL GROWTH THEMES





A BRIEF EXPLANATION OF EACH OF THE STRUCTURAL GROWTH THEMES IS PROVIDED BELOW.

Rise of the Middle Class

- As China's middle class grows, we expect the amount spent on consumption upgrades to increase. Examples include buying better home appliances or increasing consumption of dairy products.
- Urbanisation is an important subtheme, since although China's urbanisation rate has increased significantly over the past few decades, it still lags several familiar developed markets. Here, the opportunity set includes property developers as well as those providing related services such as building materials and home furnishings.

Sustainability

- The subthemes are centred around Energy Transition, Electric Vehicles and Waste Reduction.
- China's long-term plan is to achieve carbon neutrality in 2060. Associated with this is peak energy demand forecast to peak around 2035, that coal power should be phased out by 2050, and that renewable energy should meet 80% of total energy demand by 2060.
- Simultaneously, the government is aiming for electric vehicles to have a 20% market share by 2025, benefiting automobile manufacturers as well as the broader supply chain.

Manufacturing Upgrades

- Through the Made in China 2025 plan, which emphasises the localisation of production, we see how China plans to move up the value chain.
- One area in which China currently lags its competitors is in semiconductors, especially in the most cutting-edge chips, which are dominated by foreign competitors. Chinese policymakers have allocated billions in subsidies to fund R&D and investment in the domestic chip industry, which we expect to lead eventually to more competitive domestic chip companies.
- China's view of infrastructure includes traditional infrastructure, such as a world-class rail system, but also includes newer forms of infrastructure such as 5G, data centres, ultra-high-voltage lines, electric vehicle charging stations, industrial Internet of Things (IoT) and artificial intelligence.
- We believe the top-down support from policymakers should support the development of competitive firms in these areas.

Healthcare

- China's population is ageing, with the portion of the population aged 60 and over increasing from 7% in 2000 to 19% in 2020. As this occurs, the incidence of certain illnesses is likely to increase, leading to greater demand for suitable treatments.
- Domestic pharmaceutical companies can fulfil some of this demand but often lag in developing the most cutting-edge drugs.
- Again, we see that policymakers have incentivised Chinese pharmaceuticals to invest more in developing their own drugs rather than manufacture generic products. The domestic pharmaceutical industry is increasing its spend on R&D, which we expect should lead to more Chinese firms developing their own innovative drugs.
- In addition, there are interesting opportunities in genomics, medical equipment and provision of medical services.

Cloud Computing & Artificial Intelligence

- The demand for cloud services is increasing globally and this is no different in China. Opportunities exist to those who provide cloud services as well as to those who manufacture components and hardware which underpin the cloud.
- The presence of the cloud also leads to rising demand for Software-as-a-Service (SaaS), covering IT services and the cybersecurity market.
- Artificial Intelligence is an evolving field, and interesting opportunities cover autonomous vehicles and facial recognition as well as consumer-facing applications such as smart speakers.

Next Gen Consumer

- For certain goods and services the manner of consumption is rapidly evolving, not just for younger consumers but also for older groups.
- E-commerce is an obvious example and includes those such as Alibaba and JD.com, as well as less well-known names such as the delivery companies.
- Consumers are spending more of their leisure time online by playing video games, using streaming services or listening to music. Tencent, NetEase and iQiyi are just some of the well-known companies giving exposure to these opportunities.

Financial Services

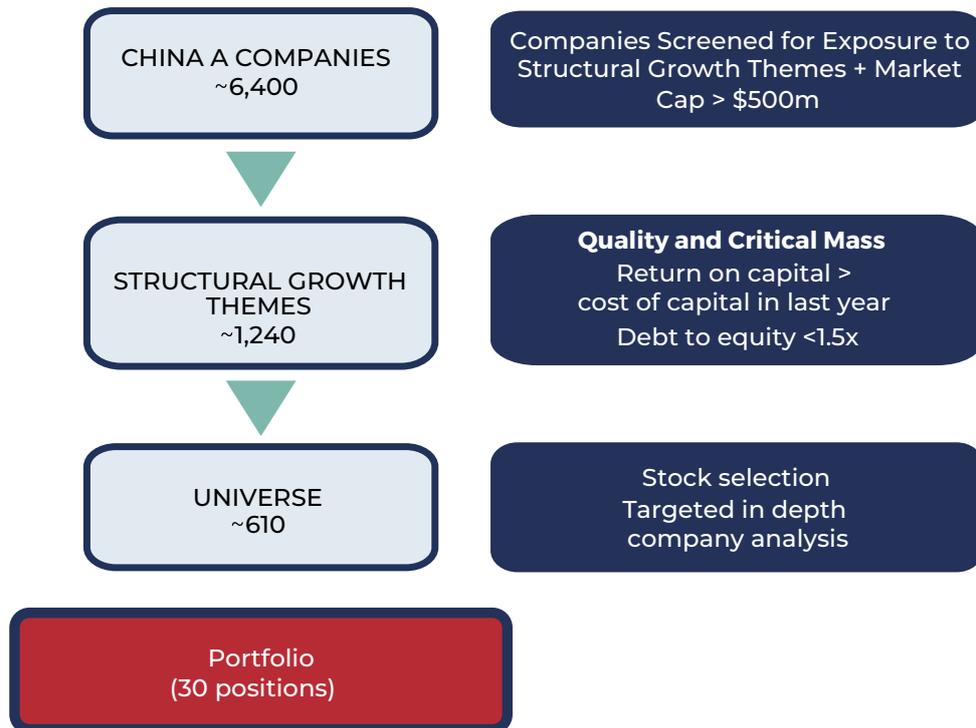
- Wealth Management is an interesting area where currently equities make up a relatively small portion of China's open-ended funds. We expect equities to take market share from money market funds.
- We also expect demand for life and health insurance to increase as China's middle class grows.
- In capital markets, as China makes up a larger portion of global portfolios, we expect the demand for Chinese equities to increase. This should lead to greater demand for the services of brokers and operators of stock exchanges.

A DISCIPLINED THEMATIC APPROACH

There are risks associated with a thematic approach. A pure thematic approach can lead to investments in companies which give exposure to a structural growth theme but are poorly run businesses. Such businesses may show some of the following characteristics: they are loss-making, have poor corporate governance, generate a low return on capital, cannot convert revenues into cashflows or have poorly structured balance sheets. Our method of avoiding them is to add a quality filter – that is, we look for companies with a cash return on capital above the cost of capital. These companies are profitable and are creating shareholder value. This helps us avoid early-stage and more volatile companies, and leads us to companies which already convert revenues to earnings. Note that a quality filter does not exclude stocks which have generated significant performance over many years.

Another risk of a thematic approach arises from valuations. A thematic approach can lead to investors crowding into fashionable areas and paying too much for future growth. The market may be predicting high growth rates for companies too far into the future, which not many can sustain over the medium to long term. Investors may expect interest rates to remain low too far into the future, which was the case in late 2021 when investors did not appreciate how quickly the Fed would increase interest rates. Our solution to avoid paying too much is to impose a valuation discipline – we are happy to pay a premium for higher growth, but we are looking for companies which can grow earnings by enough to offset a potential reduction in valuation multiples.

INVESTMENT PROCESS



Starting with c.6,400 China A shares, we screen for:

- Exposure to one of the seven structural growth themes.
- Market capitalisation above \$500m. This means that there is enough daily liquidity in the stock that the Fund can efficiently deploy inflows and address outflows. This also ensures that as the Fund grows, it can still invest in companies without becoming the dominant shareholder.

After applying these two filters, we are left with c.1240 companies. We then apply the following criteria to identify the quality companies within this group:

- Cash return on capital above the cost of capital in the last financial year.
- Debt/equity less than 150%. We are looking for companies with strong balance sheets and so restrict the amount of leverage we target.

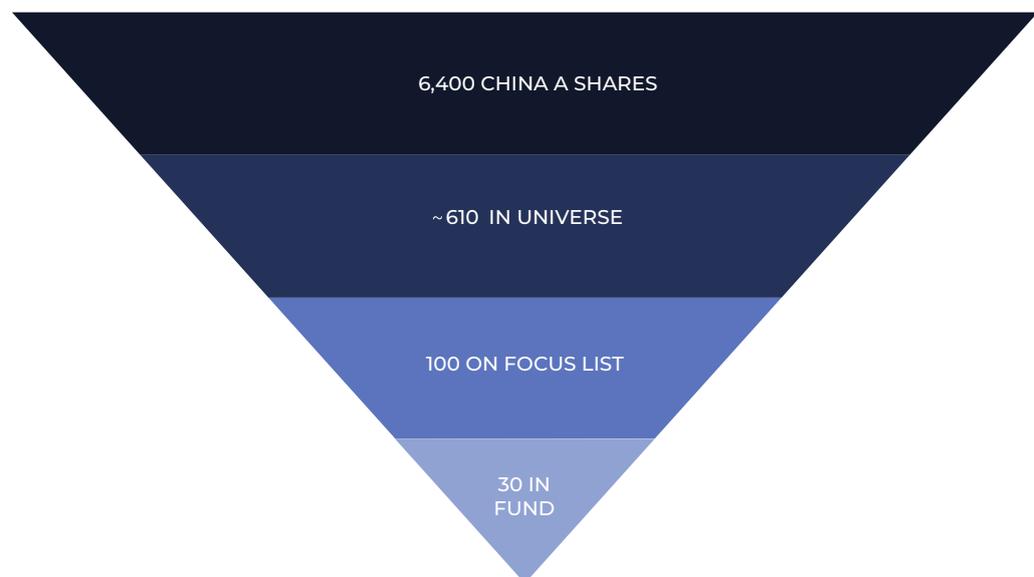
After applying these criteria, we are left with an investible universe of c.610 China A shares.

STOCK SELECTION

IDEA GENERATION

The next stage is to narrow the 610 stocks in the universe for further due diligence. The universe is screened for interesting ideas – metrics that are screened include, but are not limited to, the following:

- **EXPECTED EARNINGS GROWTH**, based on consensus analyst estimates. We are looking for companies that are expected to grow earnings over time, or to grow at an attractive rate relative to the overall market.
- **EARNINGS REVISIONS**, based on consensus analyst estimates. Companies with positive earnings revisions are prioritised over companies with flat or negative revisions. Companies with better earnings revisions relative to their competitors are also prioritised.
- **DIVIDEND PAYOUT RATIO**. Especially in the China A share market, the payout ratio can indicate the growth prospects of a company.
- **MARKET VALUATION** assigned to cashflows arising from future capex.



Once we have identified a stock to conduct due diligence on, there are three possible outcomes:

- **ADD TO THE PORTFOLIO** if the stock passes all checks and is better than an existing idea.
- **ADD TO THE WATCHLIST** if the fundamentals are good, but the price is too high, or the stock is not better than an existing idea.
- **REJECT** if we do not like the fundamentals.

Shopping



DUE DILIGENCE

The first stage of the due diligence process involves understanding the financial statements. The income statement is broken down and 'cleaned' to reflect the true state of finances. Ultimately, we are interested in recurring, operating earnings. Some of the items of interest are:

- Impact from government subsidies and favourable tax policies – can the business cope without this support? When material, we 'clean' the income statement by removing subsidies from operating income, to allow us to accurately calculate the operating margin.
- Income from Wealth Management Products (WMPs) – how important is this to net income?
- Operating margins and R&D – in some cases, R&D expenses can significantly impact margins, so we may calculate margins both including and excluding R&D. This allows us to measure efficiency before a discretionary investment like R&D is made.

The balance sheet is also broken down to identify sources of resilience and risk. For example, we look at:

- Composition of cash – breakdown between cash and short-term investments. Is there a risk of impairment to short-term investments? For example, if a company has invested in risky WMPs, there is a possibility that short-term investments may not be worth their accounting value, which could impact the income statement if there is a write-off.
- Receivables – what is the likelihood of a write-off? To answer this question, we can look at whether there has been a significant increase in receivables overdue, or whether receivable days (how long it takes to get paid) has increased.
- Intangible assets – what are the assumptions used to value goodwill? Do we agree with these assumptions?

We eventually create a cashflow statement built on our own calculations, taking into account the answers to some of the questions above, rather than using cashflows as defined by management.

- We view R&D as an investment for future growth, so typically add it back to net income when calculating gross cashflow. Correspondingly, we categorise R&D as an investment outflow.
- Chinese companies can, at times, hold restricted cash for the purpose of generating a higher return on cash. We regard this as a financing decision rather than an operating decision, so where material, we exclude restricted cash from operating cashflow calculations, and re-categorise as a financial cashflow.

The interpretation of these various calculations is written in the qualitative review, which is an important part of the due diligence process. Here we pay attention to the different types of cashflow – gross, operating and free cashflow, as each reveals different information. In the qualitative review we do the following:

- Look for evidence of pricing power, through the stability of the gross margin.
- Understand the evolution in gross and operating cashflow. We are looking for businesses which can grow both types of cashflow.
- Calculate the conversion ratio between gross and operating cashflow. We are looking for most of gross cashflow to be converted to operating cashflow. It is of no use to us if all of gross cashflow is being drained by working capital requirements.
- Understand the use of operating cashflow, and the potential returns of these uses and investments. We are looking for sensible capital allocation, for businesses with the ability to redeploy this operating cashflow at a high rate of return. We are not interested in businesses which are making poor capital allocation decisions. For this reason, we regard operating cashflow as more important than free cashflow.

The next step is to carry out a series of accounting checks. There have been well known instances of accounting irregularities with Chinese companies, but we argue these companies represent a very small part of the China universe. Nonetheless we aim to identify anomalies in the financial accounts, covering revenue recognition, capitalisation and amortisation, asset valuations, effective tax rates and the return on cash and WMPs. Some examples include:

- Net fixed asset turnover comparisons – if asset turnover is significantly different to direct competitors, do we understand why?
- Capital allocation – is there evidence of significant write-offs to capitalised assets in the past?
- Capitalisation policies – is the implied depreciation rate in line with peers who use similar assets?
- Effective tax rates – do we understand the reconciliation between the statutory tax rate and the effective tax rate?

The final stage is to take into account ESG risks. On governance, we have a standardised checklist identifying any red flags. Broadly speaking, the checklist covers independence and structure of both the board and key committees (compensation, audit, nomination), entrenchment and overboarding, diversity, company control and corruption policies. Within the environmental and social pillars, we consider the materiality of each risk in addition to how well management does to mitigate the risk. We use third-party reports to gain an initial understanding of the issues, but then conduct our own due diligence to form a final conclusion. We also analyse carbon data and labour management for all companies, regardless of industry. A detailed description of how we analyse ESG risks in the Asia team at Guinness Global Investors is published separately.

VALUATIONS

If a company passes the preceding analysis, the final stage is to assess valuations. We recognise the market can overhype certain growth stocks and assign a higher valuation than is warranted. Therefore, we look for stocks where we believe earnings growth can offset a potential valuation derating. We primarily do this using two methods: a discounted cash flow (DCF) approach and an earnings approach. In the DCF approach, we use different combinations of revenue growth and margins to assess valuations in each scenario. We also factor in whether we are using the correct discount rate, bearing in mind that interest rates in developed markets are increasing. In the earnings approach, we use different combinations of earnings growth and final valuation multiples to assess upside in each scenario.

PORTFOLIO CONSTRUCTION

The Fund is run on an equally weighted basis, meaning it has high conviction in 30 stocks. We believe our equally weighted portfolio gives us the best balance of maintaining stock concentration (with no long tail to dilute performance) whilst capping stock-specific risk (with neutral weight c.3.3% in any individual position). This also provides us with a structural sell discipline, as we have to sell an existing position to buy a new position. We do not spend time managing a long tail of smaller positions.

SELL DISCIPLINE

We may sell a position for the following reasons:

- Valuation – upside no longer attractive.
- Growth – company not expected to increase earnings at an acceptable rate.
- Thematic exposure – company no longer provides exposure to a structural growth theme.
- Quality – return on capital profile becomes unattractive.
- Balance sheet – leverage becomes unacceptable.
- Conviction – a new idea is better.

CONCLUSION

We argue China A shares are attractive for investors looking for growing, liquid companies. China A shares also have low correlation to developed markets and so can also provide diversification benefits. In 2023, China is likely to be the only major economy to see an acceleration in economic growth and so the operating environment for A share companies is likely to become much more supportive for earnings growth. Though there are risks with investing in onshore equities, we argue we have a disciplined process which steers investors away from these risks. Through this process we invest in high-quality, growing companies which give exposure to the structural growth themes in the A share market, a style Guinness has been using across the business for some time. This process results in a Fund whose holdings have historically grown sales and earnings at a premium to the broader market, at a much higher return on equity. We follow a valuation discipline to make sure we do not overpay for this growth. We believe our systematic approach gives investors a solution which results in outcomes which are superior to the broader market.





SHARUKH MALIK, CFA

Sharukh Malik has been investing in China since joining the firm in 2015. A self-taught Mandarin speaker to a proficient level, Sharukh has led the firm's expansion into the China A share market. He has been co-manager of the Guinness Greater China Fund since 2020. Sharukh graduated from Fitzwilliam College, University of Cambridge, in 2014 with a degree in Economics and is a CFA charterholder.



EDMUND HARRISS

Edmund has managed Asian Funds since 1994 both from London and from Hong Kong. He graduated from Christ Church, University of Oxford, with a Master's degree in Management Studies and has a Bachelor's degree in History from the University of York.

IMPORTANT INFORMATION

Issued by Guinness Global investors which is a trading name of Guinness Asset Management Limited which is authorised and regulated by the Financial Conduct Authority.

This report is primarily designed to inform you about Guinness Greater 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.

DOCUMENTATION

The documentation needed to make an investment, including the Prospectus, the Key Investor Information Document (KIID), Key Information Document (KID) and the Application Form, is available in English from www.guinnessgi.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.

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

This is an advertising document. The prospectus and KID 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'Île, 1204 Geneva, Switzerland.

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.



Guinness Global Investors is a trading name of Guinness Asset Management Ltd., which is authorised and regulated by the Financial Conduct Authority (223077).

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