Guinness Best of China Fund

INVESTMENT COMMENTARY – April 2021

Launch date	**15.12.15**
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Aim

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

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

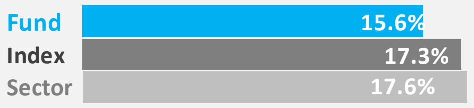
Performance (in GBP) 31.03.2021

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

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

	1 year	3 years	From launch
Fund	41.3	27.6	115.7
Index	36.6	38.6	136.0
Sector	40.9	42.0	133.2

Annualised % total return from launch (GBP)



Risk analysis (annualised, weekly, from launch)

	Index	Sector	Fund
Alpha	0.0	0.0	-1.4
Beta	1.0	1.0	1.1
Info ratio	0.0	0.0	-0.2
Max drwdn	-18.0	-21.7	-25.7
Tracking err	0.0	0.0	6.5
Volatility	17.9	18.3	19.3
Sharpe ratio	0.8	0.7	0.6

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 March, the Best of China Fund fell 2.2% (in USD, Z class) while the MSCI Golden Dragon Net Total Return Index fell 4.2%. Therefore the Fund outperformed by 2.0%.
- MSCI China fell 6.6%, MSCI Hong Kong rose 0.6% and MSCI Taiwan fell 1.1%. The Shenzhen Component Index fell 6.1% while the Shanghai Stock Exchange Composite Index fell 3.6%.
- The sell-off that started in February continued in March, as MSCI China Growth fell 8.2% while MSCI China Value fell 4.9%.
- In MSCI China, the strongest sectors were Utilities (total return of +3.9%), Financials (+0.3%) and Real Estate (+0.3%) while the weakest were Materials (-10.0%), Communication Services (-9.8%) and Consumer Discretionary (-9.5%).
- In MSCI Hong Kong, the Real Estate and Financials indexes fell 2.9% and 0.9% respectively.
- In Taiwan, the Information Technology Index, which makes up more than 70% of the local index, fell 2.2%.
- In the Fund, strong performers were China Medical System, Novatek Electronics and China Lesso. Weaker stocks were Geely, New Oriental Education and Xinyi Solar.

Fund Objectives

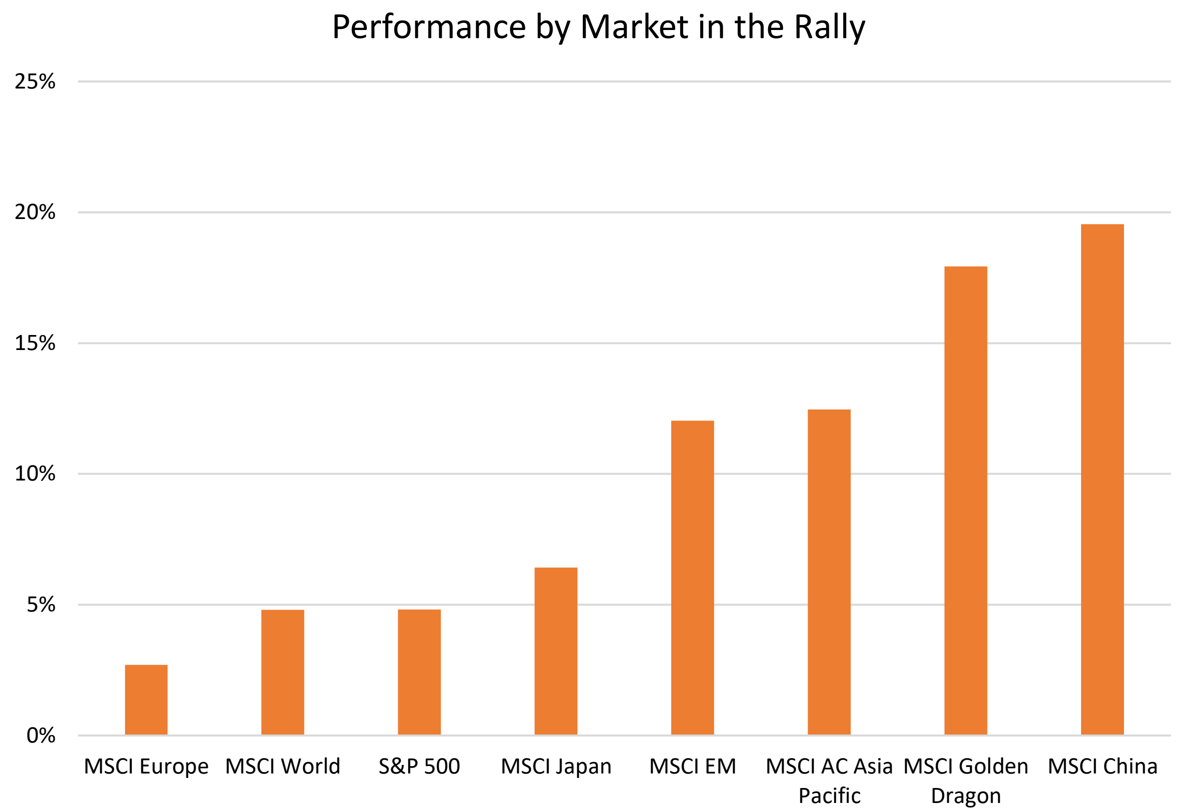
The Fund is designed to give exposure to the structural growth opportunities present in Greater China. We identify industries we think can grow earnings over the long-term, giving us more confidence that companies in these industries can grow their earnings over time. We then apply a set of quantitative filters to identify quality, profitable companies with strong balance sheets. Quality is defined as a return on capital above the cost of capital while a strong balance sheet is defined as debt/equity less than 150%. Note that the Fund itself has debt/equity of 33% and net debt/equity of -18% i.e. our companies have enough cash on the balance sheet to pay off their low levels of debt. We are interested in profitable, high return on capital businesses that can take advantage of the structural growth opportunities we have defined. In the portfolio, we are looking for companies that we think can grow earnings over time, and by enough to offset mean reversion in the valuation multiple.

This process results in an equally weighted portfolio of 32 positions. Based on consensus earnings estimates, the Fund is expected to grow earnings by 16% a year for the next three years (final 2020 results have yet to come through for all our holdings, so we are comparing expected 2022 earnings vs reported 2019 earnings). This compares to 10% expected annual earnings growth for the benchmark, the MSCI Golden Dragon Index. The Fund trades at a P/E ratio of 16.5x on estimated 2021 earnings which puts it at an 3% discount to the MSCI Golden Dragon Index. Thus, relative to its benchmark, the Fund offers higher expected earnings growth at a slightly cheaper price. It does so at a return of equity (ROE) of 21% compared to 10% for the benchmark. The Fund manages to achieve this without allocating a large allocation to TSMC, Tencent and Alibaba, which each make up ~10% of the index.

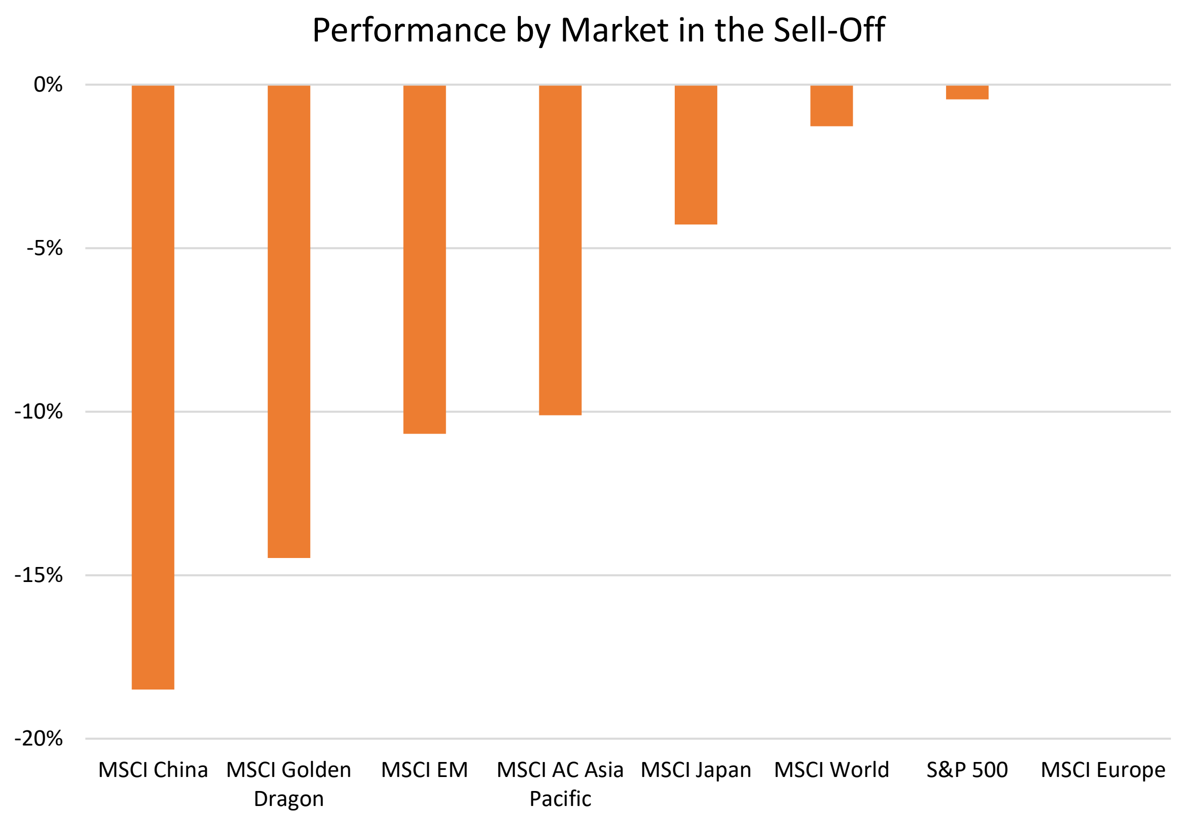
Market Review

Market performance in the first quarter can be split into two halves. In the first half, which lasted to mid-February, Chinese markets were the strongest compared to the major markets shown below. The rally was led by large-cap tech stocks such as Tencent, Alibaba and Meituan Diapning, which contributed to 67% of MSCI China’s increase in January. The rally in Hong Kong listed stocks was also partly driven by southbound flows from the mainland, where assets in the mutual fund industry rose 48% to $3.1tn in 2020.

After markets reopened following the Chinese New Year holidays, they sold off sharply. The main cause was rising bond yields in the US which led to a sell-off in higher growth stocks whose valuations have benefited from lower discount rates. Comments by the PBOC also indicated monetary policy was unlikely to be loosened further, adding upward pressure to the discount rates used by market participants.



(Returns in USD, 31/12/20 – 17/02/21)



(Returns in USD, 17/02/21 – 25/03/21)

Past performance should not be taken as an indicator of future performance. The value of investments and any income arising from them can fall as well as rise as a result of market and currency fluctuations.

In the sell-off, China was consequently the weakest market relative to major markets. MSCI China Growth fell 23% while MSCI China Value fell 13%. When valuing companies using a discounted cash flow (DCF) approach, we are careful with the discount rates we use. Market implied discount rates in Hong Kong, which are driven by rates in the US, have dropped to their lowest level in the past ten years. While we think in the short-term interest rates are unlikely to rise, we do think there is a possibility in the medium-term they could increase which would have the effect of lowering valuations. We are therefore, using a higher discount rate when carrying out our sensitivity analysis using the DCF approach, in order to build a margin of safety; if interest rates do modestly increase, we think there is still room for meaningful upside in the companies we own.

(Returns in USD, 31/12/20 – 17/02/21)

In March, 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
China Medical System (+1.0%)	Geely (-0.6%)
Underweight in Tencent (+0.6%)	New Oriental Education (-0.6%)
Novatek Microelectronics (+0.5%)	Xinyi Solar (-0.6%)
China Lesso (+0.5%)	Autohome (-0.5%)
CSPC Pharmaceutical (+0.5%)	Sany Heavy Industry (-0.5%)

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

Attribution for the first quarter is also shown below:

Top 5 Contributors	Top 5 Detractors
China Medical System (+2.3%)	Xinyi Solar (-0.7%)
Novatek Microelectronics (+1.5%)	New Oriental Education (-0.7%)
China Lesso (+1.1%)	Geely (-0.6%)
Yuhong (+1.1%)	Underweight in Tencent (-0.4%)
Suofeiya (+0.9%)	Hon Hai (not held) (-0.3%)

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

During the rally which lasted till Feb 17th, the Fund rose 22.2% while the benchmark rose 17.9% - so the Fund outperformed by 4.2%. In the resulting selloff lasting till March 25th, the Fund fell by 12.8% while the benchmark fell by 14.5% - so the Fund outperformed by 1.7%.

We are pleased that the Fund outperformed in both rising and falling markets. We are particularly pleased that the Fund outperformed in the rally despite its structural underweight in the large tech stocks which dominate the index. The Fund is run on an equally weighted basis which means that, assuming 32 stocks and a 1% cash position, each stock has a neutral weight of 3.1%. As of March 31st, in the benchmark, Tencent and Alibaba had a weight of 9.6% and 9.1% respectively. Thus in the rally in the first half of the quarter, the Fund lost approximately 2.1% and 1.1% of relative performance simply from its structural underweight to Tencent and Alibaba. However, Fund holdings China Medical System, Yuhong, Suofeiya, Novatek Microelectronics and Sany Heavy Industry all added between 1.2% and 2.3% of relative performance.

In the sell-off, the structural underweight in the large cap tech stocks helped the Fund. The underweight in Tencent contributed to 1.5% of relative performance, while the underweight in Alibaba added a further 1.2%. Not holding highly valued tech stocks such as Meituan, Pinduoduo and Nio also helped. These three companies are examples of newly listed companies which have yet to prove that they can persistently generate a high return on capital. We intentionally avoid these types of companies – we prefer to invest in businesses which have already demonstrated that their capital allocation decisions lead to a high return on investment.

The strongest stock in the Fund in the first quarter was China Medical System (CMS). The company was historically a contract sales organisation that sold drugs on behalf of foreign companies in China. Its focus was on generics, an area in which the government has initiated significant price cuts to lower overall healthcare costs. As a business dealing exclusively in generics, CMS's share price sold off sharply in 2019 and was weak in 2020. We felt the share price during this period was implying the worst case scenario so continued to add to the position as part of the Fund's rebalancing process. Over time, CMS has delivered. Price cuts for its generic products have been well below average. The business has signed deals to build its innovative pipeline, where pricing power is much higher compared to generics. In 2020, CMS delivered revenue growth of 14% and EPS growth of 30%.

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

On the other hand, Xinyi Solar was the biggest drag on performance in the first quarter. It is the world's largest manufacturer of solar glass and so through its economies of scale, benefits as the low-cost producer in the industry. It also stands out as a high-quality manufacturer of durable solar glass. Governments around the world are committing to a cleaner future which we expect should mean plenty of demand for Xinyi's products. When we initiated the position in February, we did expect a derating in the valuation multiple but did not expect it to come so soon. In the sell-off we added to the position because we think the stock has become even more attractively priced.

Company Updates

Venustech is a provider of cybersecurity services and it released its preliminary 2020 results. Revenue grew 18% while net profit grew 22%, implying the expected acceleration of revenue and earnings came through in the fourth quarter. New growth drivers include cloud security and industrial security.

China Resources Gas's (CRG) second half revenue grew 16% while net income grew 30%. A recovery in industrial activity led to a rebound in sales from this segment. While the government had forced price cuts to stimulate the economy, upstream prices were also lower so actually the company's gross margin increased. Looking forward, management is guiding for high teens growth in gas volume in 2021. CRG is in a net cash position so is also looking for acquisitions which can add value of the business.

Sino Biopharmaceutical (SBP) reported 2020 revenue which was down 2% while earnings per share (EPS) was flat. The hepatitis business has been affected by price cuts and so the segment, which used to account for 44% of sales in 2017, now only contributes to 16% of sales. On the other hand the oncology segment has grown to account for 32% of sales. SBP has switched is marketing focus towards these newer segments such as oncology where the company has more pricing power. Its novel drug, anlotinib, can be used to treat different forms of cancer and the product is expected to become a blockbuster drug. The company is also expecting its orthopaedic and respiratory segments to become growth drivers in the future. To achieve this objective, SBP bought Softhale, which is based in Belgium, to boost its presence in the respiratory market.

China Lilang, a retailer of men's suits and casualwear, had a weak 2020. Its online presence is relatively trivial compared to its physical stores, and so revenue fell 27% in 2020. However, the company is seeing a gradual recovery in sales, with retail sales up 10-15% in the fourth quarter. Management has a positive outlook for the company and is aiming to increase its store count by 100 to 150 in 2021. Overall the company is targeting retail sales growth of at least 10% in 2021.

Sany Heavy Industry reported revenue growth of 31% and EPS growth of 33% in 2020. It is China's largest manufacturer of excavators and concrete machinery, which includes mixers and pumps. The market was concerned about a drop in Sany's gross margin but we think much of the drop can be explained by changes in accounting treatments and higher sales of lower margin excavators. Sany increased its R&D spending by 33% to focus on electrification and automation technology. Using its flagship factory as an example of the benefits of automation, it expects to save 30% floorspace and 50% labour, while increasing production capacity 50%.

Supor reported a revenue decline of 6% and net profit decline of 4% in 2020. As a manufacturer of kitchen appliances and small household appliances, Supor's sales suffered in the first half of the year as retail stores were shut. But looking at results over 2020, we can see a gradual recovery as revenue growth accelerated from 1% in the third quarter to 7% in the fourth quarter. Sales have additionally been supported through export orders for parent Group SEB in France.

Portfolio Switches

We bought Fuling Zhacai, a condiment company focused on the production of zhacai and paocai. Zhacai is made using mustard roots and is commonly eaten with rice and buns. Fuling Zhacai has a long history of manufacturing zhacai and has a market share of 36%, when defined by value. 28% of sales are from the South where the company is based, but there is a fairly even split between the other major regions of China. Fuling Zhacai has been able to pass on cost increases to its customers which is a strong indicator of its pricing power, allowing the company to earn a high return on capital over time.

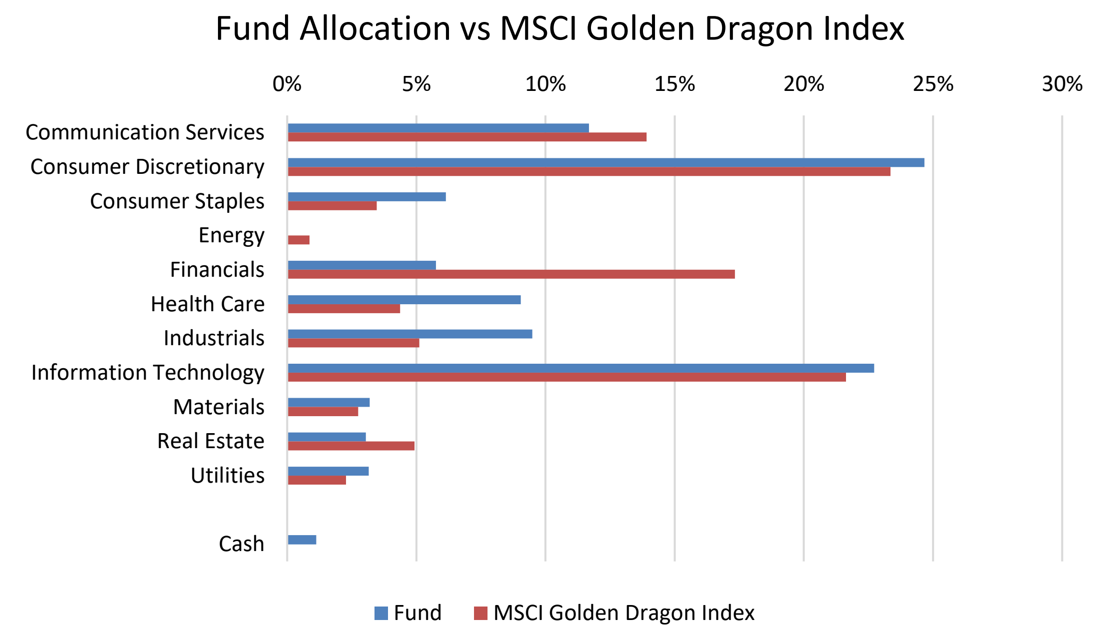
In the current ESG process we employ, when looking at Environmental and Social risks, we look at the material risks for the company and then assess how well management is responding to these risks. For Fuling Zhacai, the key risks include Raw Material Sourcing, Packaging Material & Waste and Product Safety Quality. The problem with Fuling Zhacai, along with many Chinese companies, is the lack of disclosure relating to these risks. This makes it very difficult to carry out genuinely useful ESG analysis which aids the investment process.

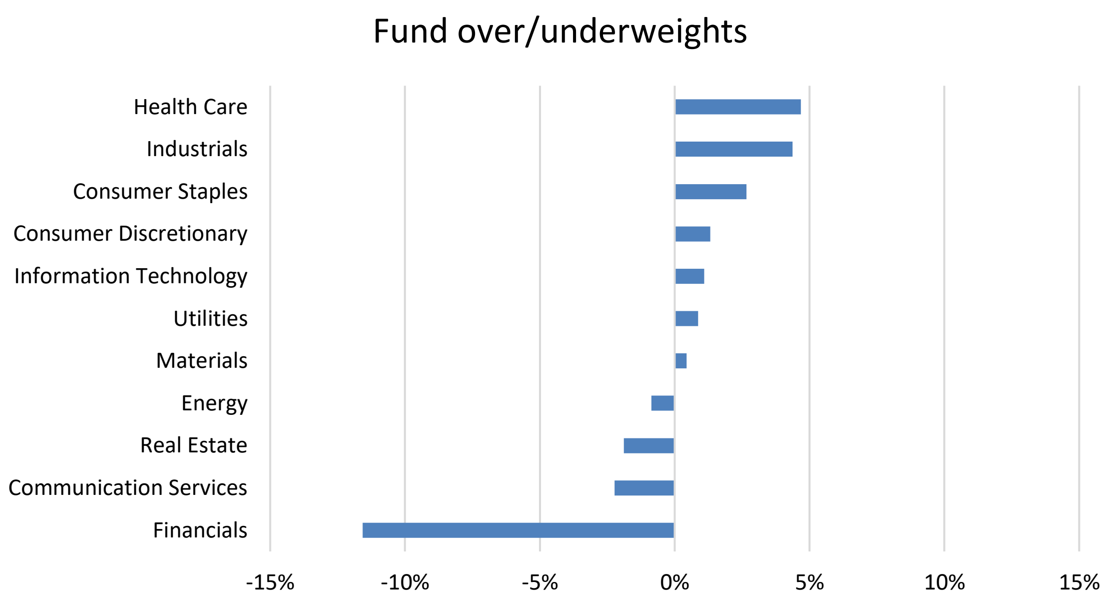
So we wrote directly to the company to ask about their approach to the identified ESG risks. For example, in its annual report the company does not disclose its waste policies. However, in response to our questions, the company revealed that based on local laws it must ship relevant waste materials to qualified waste treatment firms. After hearing back from the company, we concluded that through management could be more proactive on certain issues, overall its operates in accordance with national laws and has some form of risk management in place. We thought the business seemed well positioned to cope with the major Environmental risks relevant to the business. Therefore we initiated a position in March.

Since the end of 2019, when we shifted the Fund's focus towards structural growth, we have sold 15 positions and bought 13 positions. For a portfolio of just over 30 stocks, this is significant turnover. For each new position in the Fund, the due diligence process is extensive. We break down the income statement and "clean" it to reflect the true state of finances, where the aim is to identify recurring earnings e.g. we typically strip out government subsidies from earnings. We break down the balance sheet to identify sources of resilience and risk e.g. assessing the risk of a write-off for intangible assets. Detailed accounting checks are conducted to make sure we are not investing in a fraudulent company. The qualitative review is where we look at the history of the company and management. It is also where we interpret much of the financial data e.g. how has operating cashflow evolved, and what is the business doing with this cash? ESG considerations naturally fit in with this part of the process as we learn more about the company. Finally, valuations are considered. Markets are relatively expensive relative to their long-term average and we are looking for companies that can grow earnings by enough to offset mean reversion in the valuation multiple.

Portfolio Positioning

The Fund is significantly underweight in Financials, while moderately overweight in Health Care and Industrials.





Summary view & outlook

We believe the portfolio offers exposure to companies that are well placed to take advantage of the structural growth opportunities in China. We expect these companies to grow their earnings over time while earning a high return on capital. This expectation is not based on hope and is instead based on these companies already achieving a high return on capital over time. We are not interested in businesses which are in growing industries but where the growth has yet to lead cashflow coming through. Additionally, we pay close attention to valuations. Due to loose monetary policy, discount rates are at low levels relative to history. We assume that at some point in the medium-term, they will increase and so are not using these ultra-low rates as the basis for our valuation. Tackling the problem from another angle, we are expecting valuation multiples to fall at some point in the future. Therefore we are looking for companies that can grow earnings by enough to offset this multiple compression.

We are watching several interesting ideas on our watchlist. These are companies with good business models but where we think valuations are currently too demanding. Some of these companies sold off much more sharply than the broader market in the sell-off. Despite this fall, we feel they still do not offer higher upside than the current holdings in the Fund. So we continue to conduct due diligence on these companies on the watchlist so that if valuations become more attractive, we are ready to act.

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

Data sources

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

Index and stock data: *Bloomberg*

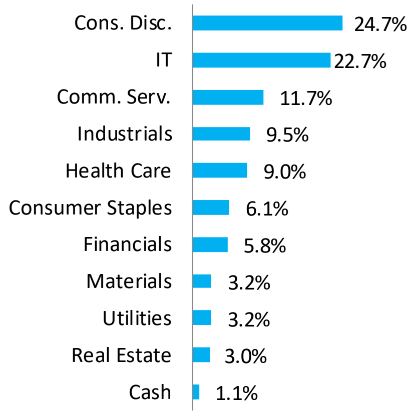
PORTFOLIO

31/03/2021

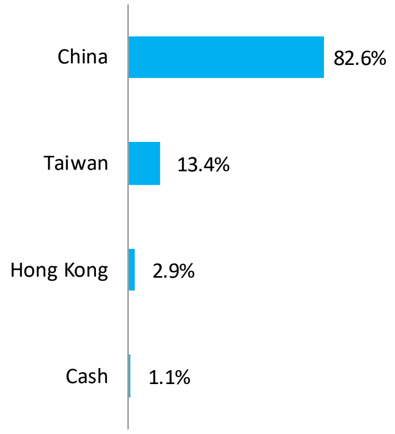
Fund top 10 holdings

Novatek Microelectronics	3.7%
China Lesso Group	3.6%
Catcher Technology	3.6%
Suofeiya Home Collection	3.4%
CSPC Pharmaceutical Gro	3.3%
Haier Smart Home	3.2%
Beijing Oriental Yuhong	3.2%
Inner Mongolia Yili Indust	3.2%
Venustech Group	3.2%
Baidu	3.2%
% of Fund in top 10	33.6%
Total number of stocks	37

Sector analysis



Geographic allocation



PERFORMANCE

31/03/2021

Annualised % total return from launch (GBP)

Fund (Z Class, 0.74% OCF)	15.6%
MSCI Golden Dragon Index	17.3%
IA China/Greater China sector average	17.6%

Discrete years % total return (GBP)	Mar'21	Mar'20	Mar'19	Mar'18	Mar'17
Fund (Z Class, 0.74% OCF)	41.3	-5.8	-4.2	15.6	42.7
MSCI Golden Dragon Index	36.6	-2.1	3.7	16.0	37.7
IA China/Greater China sector average	40.9	-0.2	0.9	19.1	36.0

Cumulative % total return (GBP)	1 month	Year-to-date	1 year	3 years	5 years	From launch
Fund (Z Class, 0.74% OCF)	-1.2	7.2	41.3	27.6	110.5	115.7
MSCI Golden Dragon Index	-2.9	2.0	36.6	38.6	121.5	136.0
IA China/Greater China sector average	-4.7	-0.9	40.9	42.0	129.9	133.2

RISK ANALYSIS

31/03/2021

Annualised, weekly, from launch on 15.12.15, in GBP	Index	Sector	Fund
Alpha	0.00	0.00	-1.39
Beta	1.00	1.00	1.01
Information ratio	0.00	0.00	-0.22
Maximum drawdown	-17.98	-21.67	-25.74
R squared	1.00	1.00	0.89
Sharpe ratio	0.75	0.72	0.61
Tracking error	0.00	0.00	6.53
Volatility	17.92	18.27	19.27

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

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

Important information

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

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

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Risk

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

Documentation

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

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

Residency

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

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

Structure & regulation

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

Switzerland

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Telephone calls will be recorded and monitored.