

# Guinness Global Equity Income Fund

A high conviction equity fund managed by Dr. Ian Mortimer, CFA, and Matthew Page, CFA, in accordance with their intelligent investment process for high quality income portfolios.

## INVESTMENT COMMENTARY - March 2014

**Fund size** (28.02.14)

**£45.5m**

### Aim

#### **We don't chase yield, we want capital and dividend growth**

Our aim is long-term capital growth and a steady rising dividend stream.

### Process

#### **Quality before yield**

We buy companies that have generated at least 10% return on investment every year for 10 years.

*"It's a rare achievement for a company to meet our investment criteria – 10% return on investment every year for ten years is a mark of genuine quality. That's where our portfolio starts – persistent cash generation before yield."*



**Guinness Global Equity Income**

**BEST FUND OVER 3 YEARS**

**EQUITY GLOBAL INCOME**

## "Physics envy"

When we consider the potential total return of any prospective investment in the portfolio (or any position we have sold), it can be very instructive to deconstruct that total return into its different sources. In the simplest deconstruction, total return comprises price return and the return from reinvested dividends. Mathematically:

$$(1 + \text{Total Return \%}) = (1 + \text{Price Return \%}) \times (1 + \text{Reinvested Dividend Return \%})$$

Reinvested dividends are a particularly important component of total returns. In our white paper *Why Dividends Matter* we showed that the proportion of the S&P500's total return from reinvested dividends was on average 27% over a one year time horizon, increasing to 38% over three years and 48% over a ten year horizon.

The other great aspect of a dividend is that it always represents a positive return. So while a stock price may fluctuate from day to day, dividends just steadily accumulate. It's easy to forget the importance of dividends when there are more exciting short-term macroeconomic factors that are driving the media agenda. But whenever we buy a position for the Fund, we expect the dividend to make up a meaningful proportion of our total return.

Price return is clearly much harder to predict than the return from dividends. Ultimately price return is driven by whatever the market is willing to pay at a particular point in time. Those who believe markets are efficient would believe that the market price reflects all available information, and is therefore a true and fair value of the company. This implies investors could never systematically outperform the market through any consistent strategy, as the price of an asset will always reflect all available information. We try not to believe things, we prefer to think.

The Efficient Market Hypothesis is a wonderful theory and model, but it is a long way from being a true, deterministic, scientific, physical law like Einstein's theory of relativity. One of the key assumptions behind efficient markets is that all agents/investors behave rationally. That seems like a poor assumption, as the work of Daniel Kahneman, Amos Tversky, Dan Ariely and Daniel

Simons (to name a few) have shown. Humans are far from being rational. Human decisions are more emotional than rational. This causes us all to exhibit biases in our thinking that are very different from what a hypothetical, purely rational human would decide. Psychologists have identified over 150 of these biases, and investors, professional or otherwise, are not immune.

There is an element of what one might call “physics envy” among economists, whereby many of their models and theories assume people act like simple particles, which in turn are governed by natural laws, such as electro-magnetism and gravity for electrons and rationality for economic agents. The great American physicist Richard Feynman once joked, *“Imagine how much harder physics would be if electrons had feelings!”*

Ultimately the proof is in the pudding. If a theory can predict certain characteristics or outcomes then it can be said to be true.

Again Feynman wrote about theories:

*“[The scientific method] is based on the principal that observation is the judge of whether something is so or not. All other aspects and characteristics of science can be understood directly when we understand that observation is the ultimate and final judge of the truth of an idea... If there is an exception to any rule, and if it [the exception] can be proved by observation, that rule is wrong.”*

The Efficient Market Hypothesis fails to predict the frequency of market crashes that have occurred through history, so by Feynman’s standard the EMH is not robust and not true.

Despite the evidence, people continue to hang on to it. How many times did we hear that the financial crisis of 2007/8 was a one in a 100 or 200 year event, even though we know we see crashes in markets much more frequently? Most of these nonsensical calculations are based on the assumption of the efficient market hypothesis, which leads to the convenient but lazy assumption that the returns of asset classes over time will fit a normal distribution or bell curve. It’s convenient because normal distributions are defined purely by

two measures: the mean and the standard deviation. No other inputs are required.

Normal distributions are also straightforward to manipulate mathematically, as opposed to less elegant distributions that exhibit the “fat tails” that would forecast the relevant frequency of market crashes through history.

Normal distributions form the basis of so much of modern finance theory. It is the basis of calculating Beta, which in turn allows you to calculate the cost of equity of a firm, which in turn can be used with numerous other potentially erroneous forecasts to calculate the “value” of a firm. It is the basis of Modern Portfolio Theory, the Efficient Frontier, Portfolio Optimization. It is the fundamental basis for Value at Risk and the Black-Scholes option pricing model.

The insatiable human need for certainty, avoidance of ambiguity and prescience of the future has led to a widely held preference for a using a model that is easy to manipulate as opposed to one whose fundamental assumptions bear a resemblance to reality.

Under stable market conditions (temporary equilibria), these metrics and theories work fairly well. But as metrics like Value at Risk are used to manage risk, it is unfortunate that in the periods of highest risk, such as just before a market crash, they help you least. A risk tool that fails to protect you in a period of high risk is like an ejector seat that works well under normal conditions but fails to eject when you need it most.

The idea that “risk” behaves in a bell-shaped fashion and can be quantified, contained and managed just doesn’t seem quite right. Ultimately we think it is more appropriate to think in terms of “uncertainty” than “risk”, and get comfortable with the fact that risk cannot be fully captured in probability and statistics, or reduced to one number.

To manage uncertainty most effectively, we advocate investing in companies with robust business models and the ability to adapt to changing environments, in a sensibly concentrated, equally-weighted portfolio.

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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.

We think the market, rather than comprising purely rational investors, is made up of smart investors who are subject to behavioural biases and who have differing and evolving goals (different perspectives on what is rational) and different time horizons. This is sufficient to mean cycles can occur, crashes can occur and, most importantly, profitable opportunities will arise if you can avoid herd-like thinking. We think the appropriate framework to consider a financial market is that of a Complex System. Definitions of Complex Systems vary but it is generally accepted that a Complex System should include most or all of the following elements:

**1. The system has feedback loops.**

There are clearly strong feedback loops in financial markets. Momentum-oriented “investors” focus on companies whose share prices are following a trend. If a sufficient number of investors focus on momentum then the actions of momentum investors can lead to further momentum and positive feedback loops can arise. The same can happen with any theme or story if sufficient people become interested in it. Indeed government control of interest rates is meant to take advantage of feedback loops.

Quantitative easing is an extreme example of this. Governments drive down real interest rates by buying huge quantities of bonds, which forces investors into riskier assets, which drives up the value of these assets, that improves levels of wealth and confidence, which in turn leads to further purchase of riskier assets. There are hundreds of feedback loops that evolve over time. Much of the time they compete and cancel each other out. Some are strong and some are weak, some are positive and some are negative. However, when enough of these feedback loops combine, asset bubbles and crashes can occur.

**2. The system is non-stationary.**

This means statistical or dynamic properties that might hold true over one time frame will not necessarily hold true over another time frame. We know this is true. Take volatility as a good example: it tends to spike when there

is fear in the market and fall when there is confidence.

**3. Agents interact.**

For “agents” you can read investors but technically it means anyone who participates in the markets – traders, market makers, mutual funds, hedge funds, ETFs etc. Essentially this means investors talk to each other, they share ideas, they debate, persuade, argue, agree, disagree. They watch the news, they read newspapers, magazines and journals, which are powerful funnels through which an initial point of view can cascade. This in itself can be another source of feedback loops. Believers in efficient markets would presumably argue that this would be pointless, as all investors are rational so by extension they will all agree on the price of an asset.

**4. Agents can adapt their behaviour.**

In reality investors try to adapt what they are doing to what is going on around them. They change their behaviour as their circumstances evolve and adapt to market circumstances, be it the level of fear in the market or their investment time horizon.

**5. The population of agents evolves.**

Market participants have changed significantly over the last 100 years. ETFs have taken significant market share from traditional mutual funds in recent years, while hedge funds grew rapidly through the 1990s. Product and market innovation will continue to have a dynamic impact on how markets function.

**6. The system is a single realisation.**

This is similar to point 2. The market is a constantly evolving system, so how the market behaved over a period in the past may not tell us much about the future.

**7. The system is open.**

This means that the market (the system) is strongly coupled to its environment and so can be affected by outside influence such as economic policy, changes in interest rates, quantitative easing, changes in legislation,

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changes in tax etc. Money can also flow in and out of the system through new companies listing and the repurchase of shares.

One of the key characteristics of a generalised Complex System is that unexpected phenomena emerge spontaneously at the macro level, through the micro-level interactions of many agents over time. In other words market crashes (an unforeseen phenomena) and their observed frequency are well within the expected outcomes of a complex system (unfortunately the spontaneous nature doesn't provide us with any clues as to when they may occur).

These unexpected phenomena are essentially periods of order that arise out of what most of the time looks more like a noisy, but stable, system. In a complex system it makes sense that markets crash, but on the same basis it makes sense that in less extreme circumstances the market may become more excited about a particular theme, story, trend, sector of the market etc. due to the feedback loops and interactions amongst investors. Valuations may well drift far from what might objectively appear justified (both to overvaluation and undervaluation).

The Complex System framework therefore starts by providing a more realistic set of assumptions of how market participants behave and interact, and helps to explain why opportunities for patient investors may arise.

So, when considering the price return element of the total return of a share over short periods of time, what normally drives this return is largely noise. However, as we increase the time horizon over which we measure performance, it becomes more meaningful to deconstruct this price return into multiple expansion (i.e. re-rating) and earnings growth.

Earnings growth is extremely difficult to forecast. Some people will spend hours forecasting every last product line of a company in terms of its growth, margins, demands on working capital etc. While the result of this analysis may give the analyst a good level of confidence in his ultimate forecast for earnings growth, in our minds every

forecast is just another opportunity for error. We spend very little time forecasting earnings growth ourselves. We prefer to look at what the market is expecting as a whole for earnings growth by looking at the collective forecasts of all analysts. We also look at the range of expected forecasts, capturing the most optimistic through to the most pessimistic assumptions. However, we also realise that the whole group of analysts may be well off what seems like a statistically probable level of earnings growth if we were to compare it to the company's historical rate of earnings growth. If a company has maintained operating margins consistently at 10% for the last five years and now the analyst earnings estimates are forecasting margins going to 20% for the next three years, we will be highly sceptical and will want to know why this sudden change of fortunes may occur. Similarly if analysts were forecasting 3% instead of 20% for the next three years we would become very interested.

The second concern comes down to the P/E multiple (or any other valuation multiple). Given that we focus on companies that have generated top quartile return on capital for each of the last ten years, the companies we look at tend to have very robust business models, are capital efficient, and have managed to get through the economic storms of the last ten years in very good shape. That's our definition of quality. We take the view that quality companies show consistency over time. *"Quality is not an act, it is a habit"*, wrote Aristotle. Our analysis has shown that companies that have a ten year track record of generating top quartile return on capital are highly likely to continue to do so for the near future and potentially well beyond. But, despite this robustness of their business models, the valuation multiple assigned to these companies is more often just an indication of current sentiment. If we want to buy a high quality company at an attractive multiple we therefore have to identify where the most fear exists.

We had identified a source of heightened fear this time last year. In our March 2013 update we wrote:

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*“Whilst our investment process is not thematically driven, one theme which we find interesting is the media/analysts’ love of using the word cliff, i.e. patent cliff, fiscal cliff. It’s rather an emotive word and it potentially creates some attractive buying opportunities if everyone gets scared away from stocks associated with the idea. The idea behind patent cliffs is that pharmaceutical companies were all going to suffer because all their blockbuster drugs were going to come off patent. This would allow other companies to start producing the generic equivalents at lower cost, and the company holding the original patent would no longer be able to maintain their premium pricing, meaning their margins would erode over time.*

*Many of these companies were really beaten up a couple of years ago and valuations started to look really attractive as the market continued to extrapolate further bad news. We bought a number of pharmaceutical companies back in 2011 when they were still beaten up as we felt the valuations had all this bad news baked in and concern had gone too far. In reality the “cliffs” associated with patents, when considered at company level, are more like very gentle downward slopes over a prolonged period of time. Large, high quality companies often seem to find a way to deal with these issues. It might take years for any strategies to have any effect but if your holding period is long enough and you buy at the right valuation, you can make decent returns. We are no experts on analysing the potential for new drugs, so we aren’t going to add any value by trying to understand whether drugs in the development cycle are going to be successful or not. We simply saw these stocks as unloved, beaten up, cheap in absolute terms, and cheap relative to their own valuation histories, and they have performed well over the last couple of years.*

*At the end of last year everyone was and generally remains particularly worried about the US fiscal cliff. The issue of the fiscal cliff has been looming for years, but the failure of policymakers in the US to avert the automatic budget cuts has brought it into the spotlight. The market is concerned that US government spending on defence is going to be significantly reduced and this is going to have a*

*meaningful effect on the revenues and margins of defence companies. As a consequence, defence stocks are now looking cheap on our screens and consequently we are looking at them quite closely. A number of companies in the sector are now looking particularly cheap relative to their historic valuations, and relative to other companies in our investable universe, suggesting perhaps this negative sentiment has gone too far and may provide an opportune entry point.”*

We bought US defence contractor Northrop Grumman shortly after we wrote this. When we looked at the valuation multiples we found the company was trading at the lower end of its ten year range, with a 2014 P/E of 9x. We appreciated the concerns surrounding defence spending cuts, but ultimately we thought that the valuation multiples had gone too far.

We invest with a 3-5 year time horizon. Often these types of valuation anomalies will take some time to revert and may well go against us before they come good. We also have to realise it won’t always work.

When we initiated the position, the source of return we felt most confident about was the dividend stream; the company had grown its dividend for the last ten years, the payout ratio was very modest at 30%, and we expected the impact from earnings declines to be slower than the market was forecasting. Share price over-reaction on the downside and our willingness to be patient also gave us some confidence that we could derive a return from a re-rating (multiple expansion). Finally, earnings growth was clearly quite uncertain.

We decided to sell Northrop Grumman at the end of February this year, almost 12 months after we had initially bought it, as sentiment has turned quite rapidly. The total return over the holding period was 80.3% (in USD). Given the relatively short holding period, the proportion of total return from dividends was only 2.5%, while 75.9% came from price appreciation. Of this price appreciation, more than half came from multiple expansion, and the remainder from earnings forecast growth.

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**Northrup Grumman**

Total return in holding period (in USD)

Sources of return	Actual %	Proportion %
<b>Return from dividends</b>	<b>2.5%</b>	<b>3.4%</b>
<b>Price return</b>		
Multiple expansion	38.3%	58.5%
Earnings forecast growth	27.2%	41.5%
	<b>75.9%</b>	<b>96.6%</b>
<b>Total Return</b>	<b>80.3%</b>	<b>100%</b>

When we scan the market for areas of fear right now, it is clearly evident in emerging markets. Over the last three years we have struggled to find attractive value in high quality emerging market companies – in fact they looked positively expensive. However, given the moves over the last nine months, we are now starting to find valuations much more attractive. By looking for companies that are trading at the low end of their ten year valuation range, we are starting to see more Asian companies arise in our screen than we have for the last three years.

We have just bought a position in Hong Kong-listed Li & Fung, which is a global outsourcing company. It’s an interesting example of a company that is

listed in Asia but derives the bulk of its revenues from outside Asia (88%, derived mainly from the US and Europe). Just like Northrup Grumman it is trading at the low end of its ten year valuation range. Partly this is due to general fear surrounding China and emerging market-listed companies, and partly because the holiday season in the US was a little disappointing. They also took a restructuring charge last year on the US arm of their business. So there are reasons why the valuation is attractive, but we have to remember this is another company that has a ten year history of generating top quartile return on capital, and it weathered the financial crisis extremely well.

Our levels of confidence in terms of the sources of total return is the same as Northrup Grumman. Dividends, then multiple expansion, and finally earnings growth. But we may well have to wait considerably longer than we did with Northrup Grumman.

**Dr. Ian Mortimer & Matthew Page**

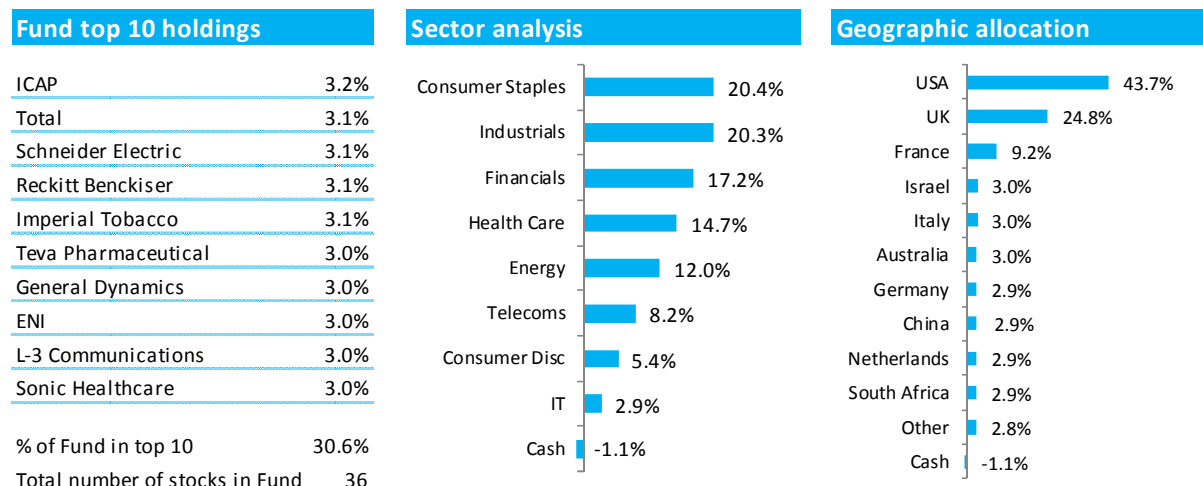
**Co-managers,  
Guinness Global Equity Income Fund**

**March 2014**

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**PORTFOLIO (28.2.14)**



**PERFORMANCE**

**Discrete years % total return (GBP)**

12 months to month end:	Feb '10	Feb '11	Feb '12	Feb '13	Feb '14
Fund C Class (1.5% AMC)	-	-	4.2	14.7	10.1
Fund X class (0.75% AMC)	-	-	5.0	15.6	10.9
MSCI World Index	44.5	13.9	0.1	16.5	10.2
IMA Global Equity Income sector average	36.5	13.3	4.1	15.1	8.3

**Cumulative % total return (GBP)**

28/02/2014	1 month	Year-to-date	1 year	3 years	From launch
Fund X class (0.75% AMC)	3.3	-1.4	10.9	34.6	35.1
MSCI World Index	3.0	-0.1	10.2	28.5	30.9
IMA Global Equity Income sector average	3.6	-0.1	8.3	29.8	29.3

**Annualised % total return from launch (GBP) 28/02/2014**

Fund X class (0.75% AMC)	9.96%
MSCI World Index	8.89%
IMA Global Equity Income sector average	8.47%

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

28/02/2014	Index	Sector	Fund
Alpha	0	1.62	2.72
Beta	1	0.77	0.79
Information ratio	0	-0.04	0.21
Maximum drawdown	-18.26	-15.50	-16.34
R squared	1	0.81	0.89
Sharpe ratio	0	0.41	0.54
Tracking error	0	6.15	4.83
Volatility	14.08	12.08	11.69

**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.**

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### 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](http://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](http://www.carnegie-fund-services.ch). The paying agent is Banque Cantonale de Genève, 17 Quai de l'Île, 1204 Geneva, Switzerland.

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

**GUINNESS**  
—FUNDS—

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