

GUINNESS

# Global Equity Income Fund

ELITE RATED ™  
by FundCalibre.com

Annual review

# 2018

Dr Ian Mortimer, CFA & Matthew Page, CFA  
Portfolio managers

**GUINNESS**  
ASSET MANAGEMENT

<b>Fund size (31.12.18)</b>	<b>£526m</b>
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<b>Launch date</b>	<b>31.12.10</b>
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### Aim

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

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

<b>Performance</b>	31.12.18
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<b>Fund</b>	Guinness Global Equity Income (Y CIs)
<b>Index</b>	MSCI World Index
<b>Sector</b>	IMA Global Equity Income

	1 year	3 years	From launch
<b>Fund</b>	0.7	40.1	115.9
<b>Index</b>	-3.0	39.0	112.9
<b>Sector</b>	-5.8	28.1	79.5

### Annualised % gross total return from launch (GBP)

<b>Fund</b>	<b>10.1%</b>
<b>Index</b>	<b>9.9%</b>
<b>Sector</b>	<b>7.6%</b>

### Risk analysis (annualised, weekly, from launch)

	Index	Sector	Fund
<b>Alpha</b>	0	0.2	1.5
<b>Beta</b>	1	0.8	0.9
<b>Info ratio</b>	0	-0.3	0.0
<b>Max drwdn</b>	-18.3	-15.5	-16.3
<b>Tracking err</b>	0	6.1	4.5
<b>Volatility</b>	13.6	11.5	12.3
<b>Sharpe ratio</b>	0.5	0.4	0.5

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

Source: Financial Express, bid to bid, total return  
**Fund Y class:** Simulated performance based on actual returns of E share class (available from Fund launch), calculated in GBP.

# Annual review

In 2018 the Guinness Global Equity Income Fund produced a total return of 0.74% (in GBP), compared to the MSCI World Net TR Index return of -3.04%. The Fund therefore outperformed the Index by 3.78%.

Since the Fund's launch at the end of 2010, it has produced a cumulative total return of 115.9% (in GBP), compared to the MSCI World Net TR Index return of 112.9%. The Fund has therefore outperformed the Index by 3.0%, placing it 2<sup>nd</sup> in the IA Global Equity Income Sector since launch.

- The philosophy and process behind the Guinness Global Equity Income Fund was designed by Ian Mortimer and Matthew Page and they have co-managed the Fund since launch in December 2010.
- The Fund seeks to invest in good quality businesses which have persistently high returns on capital and strong balance sheets, are highly cash generative, and are trading at attractive valuations.
- The Fund takes a long-term view, holding companies for 3-5 years on average in a concentrated portfolio (35 stocks) of equally weighted positions with an active share of >90% versus the MSCI World benchmark.
- We target a moderate yield (currently 3.0%) but look for good potential for dividend growth (the distribution in GBP has grown every year since launch at 4.8% CAGR).
- Performance has been strong; against peers in the IA Global Equity Income Sector the Fund is in the top decile over one year, over three years and since launch on 31<sup>st</sup> December 2010.
- 2018 has seen volatile equity markets, and the Fund has outperformed in periods of market weakness such as the market falls at the beginning of February and in October. The February sell-off was driven in part by concerns of faster interest rate rises in the US which caused higher dividend yield stocks – so-called 'bond proxies' – to underperform. The Fund's focus on dividend growth meant that exposure to these 'higher duration' equities was low (and especially relative to peers), leading to outperformance versus the benchmark and peers.

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## Guinness Global Equity Income Fund

- Indeed, the Fund has captured only 66% of market downside on average in the four corrections (those with over 10% drawdown) since launch and has outperformed in each of the largest drawdowns in the last eight years.
- We are seeing plenty of interest in the Fund, which has grown in AUM from £360m at the start of the year to over £526m today.
- We believe the Fund's balanced approach – seeking a return from a combination of cash flow growth, multiple expansion, and dividends – alongside a focus on quality characteristics, means it is well placed whatever the future market direction.

## Performance

Geopolitics matters, and 2018 provided a firm reminder. In stark contrast to the conditions of 2017, the past year was characterised by weaker markets and a return of volatility. Markets ceased to be immune to uncertainty and thus were prone to turbulence as investors digested the various economic, corporate, and political news releases. During the year, the Guinness Global Equity Income Fund performed as we would expect; the Fund is positioned with the aim of preserving capital in falling markets and keeping up with growing markets.

The performance of the strategy remains very strong versus the MSCI World Index and IA Global Equity Income Sector peers over both the short term and the long term.

The Fund ranks in the top decile of the IA Global Equity Income sector over one year, over three years, and since launch in 2010. It has outperformed its sector average in six of the eight calendar years since launch and we are pleased to see positive returns in all eight.

	1 year	3 years	5 years	Since Launch (31/12/2010)
<b>Guinness Global Equity Income Fund</b>	<b>0.7%</b>	<b>40.1%</b>	<b>57.6%</b>	<b>115.9%</b>
<b>MSCI World Net TR Index</b>	-3.0%	39.0%	62.5%	112.9%
<b>IA Global Equity Income Sector</b>	-5.8%	28.1%	38.7%	79.5%
<b>Position in IA Sector</b>	5/56 funds	3/47 funds	9/40 funds	2/20 funds
<b>Quartile</b>	1 <sup>st</sup>	1 <sup>st</sup>	1 <sup>st</sup>	1 <sup>st</sup>
<b>Decile</b>	1 <sup>st</sup>	1 <sup>st</sup>	3 <sup>rd</sup>	1 <sup>st</sup>

Figure 1 – Cumulative total return in GBP, as of 31st December 2018. Source: Financial Express.

	2011	2012	2013	2014	2015	2016	2017	2018
<b>Guinness Global Equity Income Fund</b>	<b>2.7%</b>	<b>5.5%</b>	<b>26.3%</b>	<b>10.1%</b>	<b>2.2%</b>	<b>26.9%</b>	<b>9.6%</b>	<b>0.7%</b>
<b>MSCI World Net TR Index</b>	-4.8%	10.7%	24.3%	11.5%	4.9%	28.2%	11.8%	-3.0%
<b>IA Global Equity Income Sector</b>	-2.1%	9.7%	20.4%	6.7%	1.5%	23.2%	10.4%	-5.8%

Figure 2 – Calendar year total return in GBP, as of 31st December 2018. Source: Financial Express.

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## Guinness Global Equity Income Fund

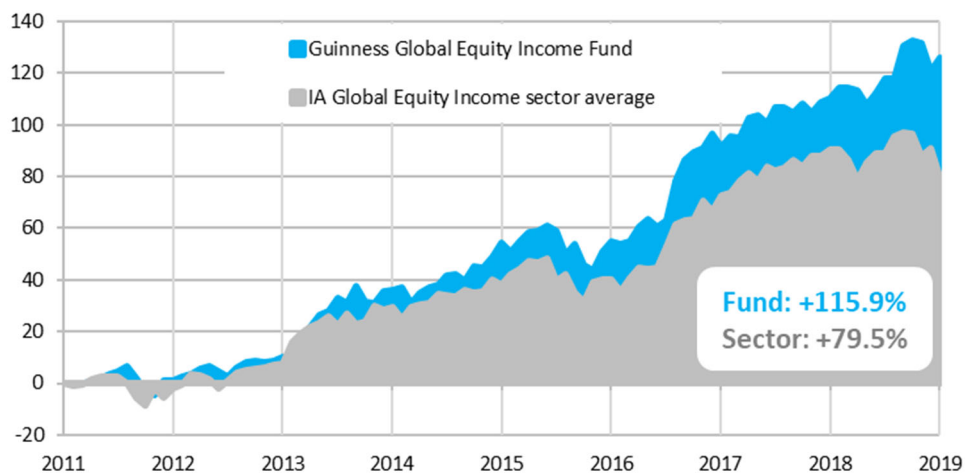


Figure 3 – Cumulative total return in GBP as of 31st December 2018. Source: Financial Express.

### Dividends

Importantly, our focus on companies that offer the potential for dividend growth rather than simply a high dividend yield means the Fund has been able to increase the dividend distribution every year. This year the Fund grew the dividend by 5.4% (Y-class, in GBP), while the annualised growth rate over the last eight years has been 4.8%.

Over 2018, Sterling weakness helped to boost the dividend of non-UK holdings as Brexit uncertainty weighed on the currency. This was especially the case with US companies, for whom Dollar strength exacerbated the effect. We would expect to see positive year-on-year growth in the Fund’s Sterling dividend distribution in 2019, although we appreciate that a reversal in the currency trends seen in the past year would be a headwind.

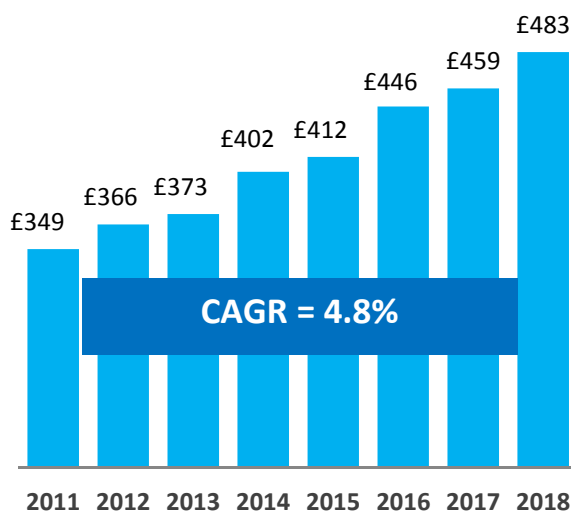


Figure 4 – Dividend Growth. Source: Guinness Asset Management.

Based on the price at year end, the Fund has a historic 12-month dividend yield of 2.9%.

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## Review of 2018

The MSCI World Index closed at its record high of 2248.93 on 26 January 2018. Since then the index fell to a closing low of 1795.28 on 25 December 2018, a fall of 20.2% from its peak. Though the market subsequently recovered slightly, the fall of more than 20% from its peak technically means that the market entered bear territory. Accordingly, 2018 was the worst year since 2008 and the eighth worst year for the MSCI World Index since 1970; its negative return of -8.2% (gross TR in USD) gave it one of only 13 years in the last 48 to end the year with a loss.

Prior to the fall, stock markets were in their longest bull run in history, which began when the market troughed in March 2009. The MSCI World Index rose 227% from its low of 688.63 on 9 March 2009 as equities benefited from loose monetary policy. As the global economy recovered, stock markets profited especially, and bond yields were suppressed. Companies could borrow cheaply to strengthen their balance sheets and they benefitted from a pick-up in consumer confidence and demand.

The Guinness Global Equity Income Fund’s focus on quality companies at attractive valuations means it tends to outperform in down markets and keep up with rising markets. Over the course of the year this was generally the outcome we saw, and the Fund outperformed the MSCI World Index overall.

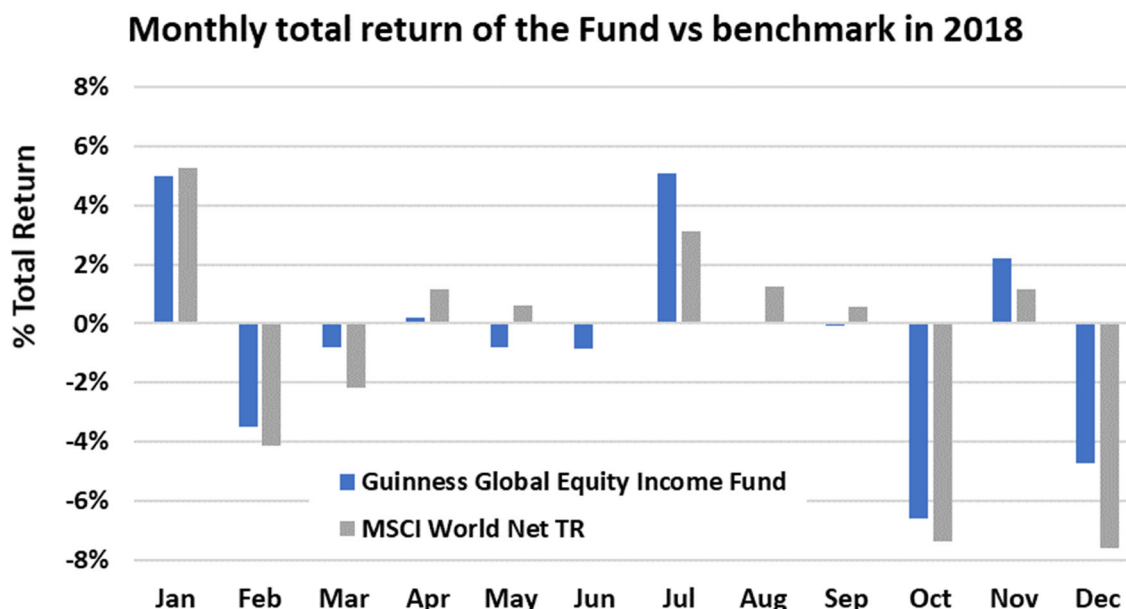


Figure 5 – Monthly total return of Fund vs benchmark in 2018, in USD. Source: Bloomberg.

As the chart above shows, there were only two months which saw the MSCI World Index return greater than 3% (in USD): January and July. The Fund performed broadly in line with the market in January and outperformed in July due to particularly strong stock selection: 74% of stocks in the portfolio had positive absolute returns and 17% of the portfolio actually had double digit total returns.

There were three months in which the Index fell more than 4% (in USD): February, October and December. In each of these, the Fund outperformed the market. In fact, if we look at the two figures below, we see that the Fund has outperformed in each of the largest drawdowns seen in the eight years since launch in 2010.

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## Guinness Global Equity Income Fund

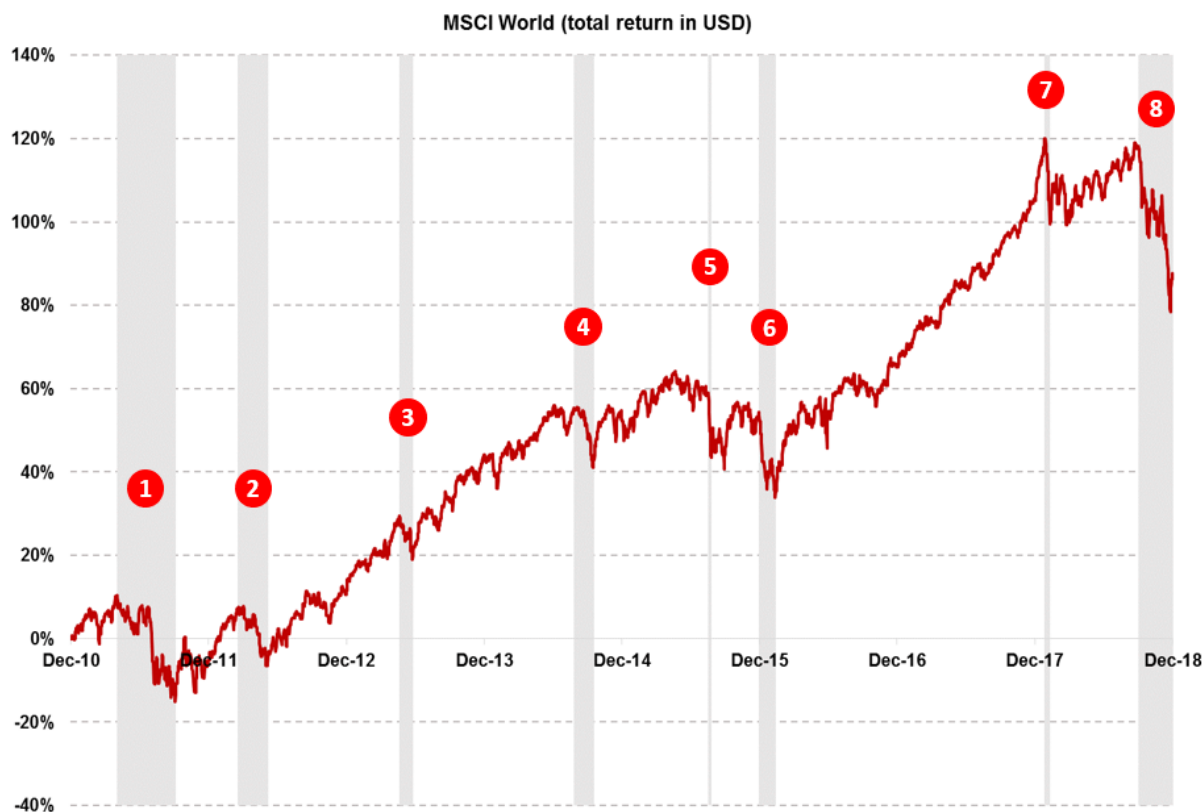


Figure 6 – Largest drawdowns in global equity markets since launch (31<sup>st</sup> December 2010). Source: Bloomberg.

	Start date	End date	MSCI World Index	Guinness Global Equity Income	Fund relative performance	Reason for sell off
1	02/05/2011	04/10/2011	-22.0%	-15.6%	6.4%	European crisis / Greece
2	19/03/2012	04/06/2012	-12.5%	-8.9%	3.5%	US credit rating downgrade
3	21/05/2013	24/06/2013	-7.7%	-5.2%	2.5%	"Taper tantrum"
4	27/08/2014	16/10/2014	-8.8%	-8.3%	0.5%	Oil price sell off
5	17/08/2015	25/08/2015	-9.4%	-8.5%	0.9%	Chinese stock market decline
6	31/12/2015	11/02/2016	-11.5%	-6.1%	5.4%	China growth concerns
7	26/01/2018	08/02/2018	-9.0%	-7.1%	2.0%	Volatility spike / Inflation concerns
8	03/10/2018	25/12/2018	-17.5%	-12.0%	5.5%	Tech sell off / US-China trade issues

Figure 7 – Performance of Fund vs benchmark in the largest drawdowns since launch. Source: Bloomberg.

We can see from Figure 6 how at the start of 2018 global equity markets surged ever higher on optimism over the strength of the world economy, big US tax cuts and upbeat corporate earnings releases. The MSCI World Index enjoyed its best January since 1994 and global growth forecasts for 2018 and 2019 were raised

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by 0.2%, to 3.9% in both years. This was, however, followed by the largest ever one-day spike in the CBOE Volatility (VIX) Index, the first 10% market correction since early 2016, and a subsequent 8% rebound (all in USD).

February’s sell-off was triggered not by weaker economic data but by an acceleration in wage growth in the US. Average hourly earnings increased 2.5% year-on-year in December 2017 after a similarly strong November number; data released in early February 2018 confirmed an unexpected further pick-up in wage growth during January (2.9%). The updates strengthened the prospect of more aggressive rate hikes and prompted investors to consider the implications for bond markets. 10-year US treasury yields rose to a high of 2.95% in February, raising speculation that the long-term downward trend in yields had been broken.

This was all before March, a month in which the year’s early optimism was faced with rising inflationary pressures, Federal Reserve (Fed) rate hikes, and protectionist threats. These headwinds would go on to dominate commentary for much of the year that followed. As many anticipated, the Fed raised rates by 25 basis points in March, June, September and December – ending the year at a range of 2.25-2.5%. This had severe knock-on effects on equity markets, particularly in the third quarter, after Fed chair Jay Powell contributed to a sharp sell-off by saying interest rates were “a long way from neutral”. This hinted that the central bank might continue monetary tightening despite inadvertently slowing economic growth. That triggered a stock market tremor that grew in intensity and culminated in a sell-off dubbed ‘Red October’.

October in fact became the pivotal month when the outperformance of growth companies was supplanted by outperformance of value stocks.

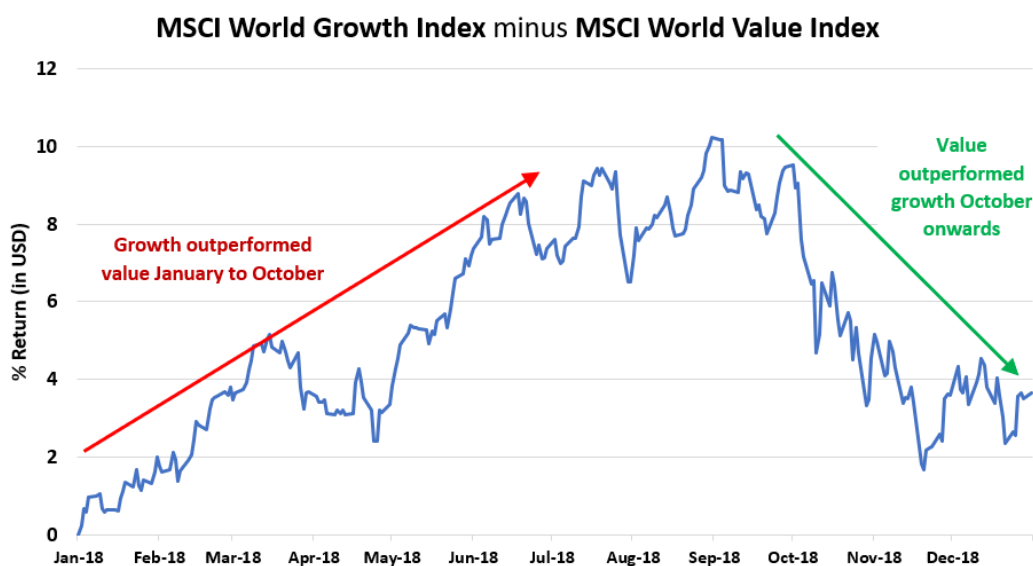


Figure 8: MSCI World style performance in 2018 (TR in USD), as of 31<sup>st</sup> December 2018. Source: Bloomberg.

This bias towards ‘Value’ is a factor behind the Fund’s outperformance in each of the last three months of the year. We also saw a shift in the market as investors switched from Cyclical sectors to Defensive ones. Strong performance seen in the first three quarters of the year from sectors such as IT and Consumer Discretionary was reversed in the final three months.

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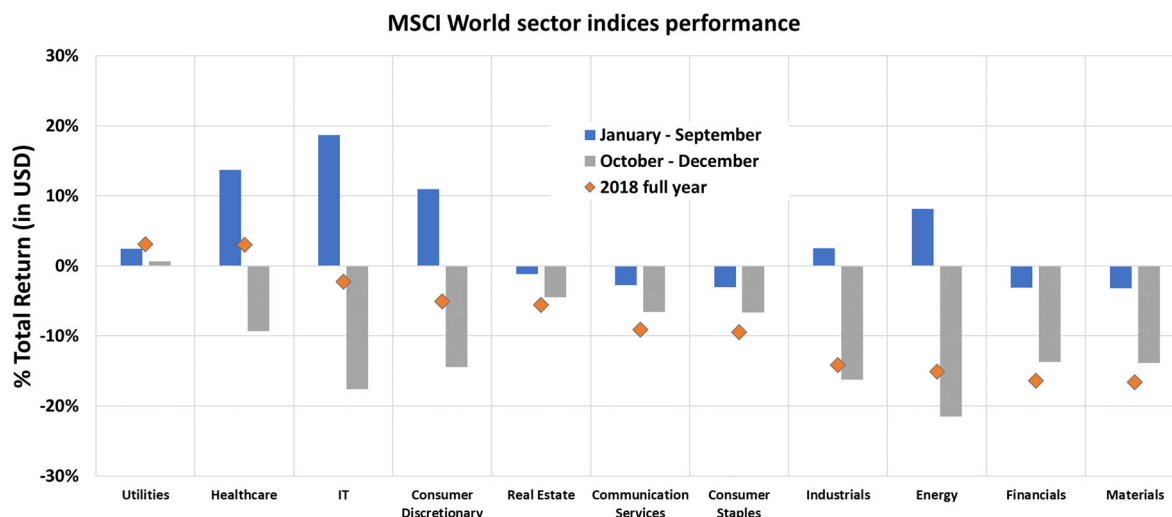


Figure 9: MSCI World sector performance in 2018 as of 31st December 2018. Source: Bloomberg.

By the end of the year, Utilities and Healthcare were the only two sectors in positive territory. Healthcare stocks had a persistently strong run in 2018 after many stocks surpassed analysts’ earnings and revenue growth expectations. Being overweight here benefitted the Fund’s performance.

In a rare occurrence, Utilities were the best-performing over the year. Power companies surged in the sell-offs in the year, particularly in October, when they had their best month relative to the market since 2001, rallying more than 3% and beating the S&P 500 by 12%. Such an outperformance had occurred only four times previously, all surrounding market crashes (chart 10). Although the Fund has zero exposure to the sector, the drag on active performance was minimal since Utilities make up only 3% of the MSCI World Index.

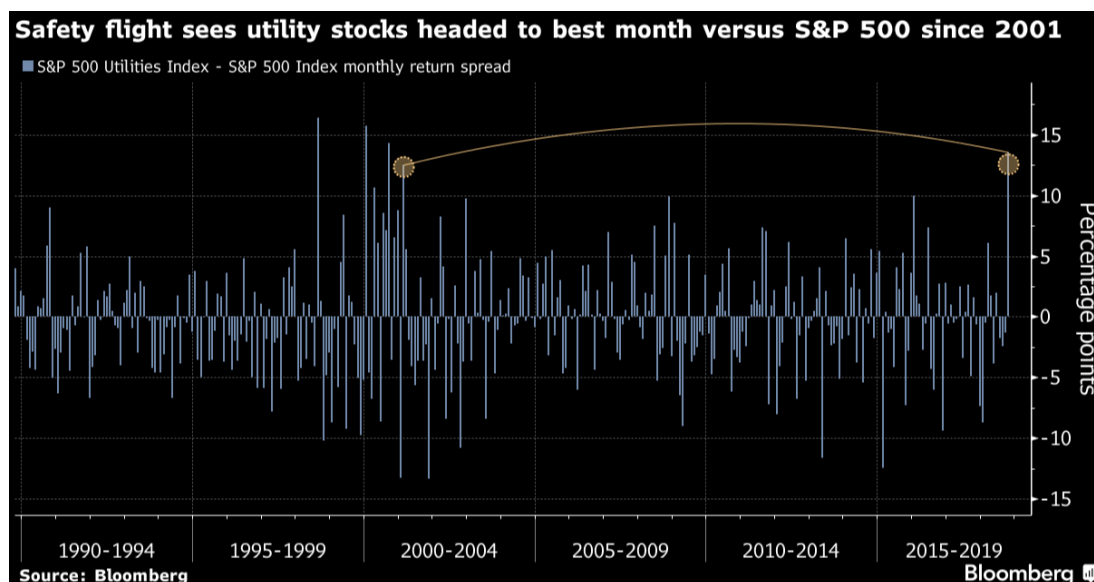


Figure 10. Source: Bloomberg. As of 31<sup>st</sup> October 2018

Among the worst-performing sectors were Materials and Financials. These are traditionally referred to as ‘cyclical’ sectors as demand for the goods and services they supply is typically dependent on the health of the economy; the better the outlook, the better they should perform. The Fund holds no positions in Materials, which benefited performance, and holds no banks.

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Banks and asset managers notably underperformed due to cyclical concerns and contagion from rising bond yields. Our Financials exposure comes from security exchanges (NEX Group, CME Group, Deutsche Boerse) and insurance (Arthur Gallagher, Aflac), which all performed well overall. In fact, NEX Group (UK domicile, Financials sector) was the best performer in the Fund over the year after it was bid for by CME Group at the end of Q1 2018. NEX's share price had an initial increase of c.50%, and with the probability of another bid decreasing, we saw an opportunity to take profits from our position. The valuation at time of sale stood at around 30 times 1-year forward earnings, compared to a 10-year average of 12 times.

Energy also underperformed this year, and the Fund was somewhat immune given it only holds one position in the sector. The price of oil peaked in October at around US\$85 a barrel and then started its rather rapid decline in November, tumbling to 15-month lows mid-December. The weakness was driven by concerns over demand not meeting expectations as global growth concerns increased. Furthermore, investors fretted over increases in supply as shale oil production in the US continued to grow rapidly and OPEC seemed unwilling to cut production, all of which had a negative impact on the sector's performance.

The Fund's largest overweight is to Consumer Staples (c.16% vs the MSCI World Index) and this did not meaningfully add nor subtract from Fund performance relative to the benchmark over the year. There was outperformance in shorter periods, such as the sell-off in October which was led by technology stocks and higher growth companies, though there was some underperformance when the market rallied from mid-February onwards.

IT – the star performer of 2017 – started the year the strongest before tailing off. Though the Fund is underweight, stock selection in the sector contributed positively. Some technology stocks were priced for significant growth at the start of the year and were vulnerable to bad news. The first of this came in March as investors were confronted by a threat to the handful of tech behemoths known as the FAANGs, which in recent years have powered US stocks higher. Claims in March that analysis group Cambridge Analytica had mined the personal data of 50 million Facebook users for use in the US presidential election crystallised fears that big tech risked tougher regulation. The Fund did not have exposure to the 'high-flying' FAANG-type stocks and therefore did not suffer in the sell-offs. Long-term holdings Microsoft and Cisco continued to perform well. CA was subject to a bid (from Broadcom) and was subsequently sold. Following the bid, Broadcom fell c.20% (as the market saw a bid for a software company as tangential to Broadcom's core semiconductor business) and the Fund took advantage by initiating a new position in the stock. Broadcom subsequently rallied and has added to Fund performance over the short term.

Looking at the year geographically, performance was influenced heavily by political drama, and global equities were particularly rocked by fears of a global trade war. The US administration initially announced tariffs on steel and aluminium imports, followed by a 25% tariff on \$50bn worth of Chinese imports, followed by a further 10% on \$200bn. The Chinese, in response, announced initial tariffs on \$3bn, raised that to \$50bn, and then again by an additional \$60bn. As it stands, there is a 'truce' until March 2019 in order for both sides to negotiate. The outcome of the discussions – if any – remains one of the biggest uncertainties going into the new year. Amid the tensions, Chinese growth has disappointed throughout the year and left the region as one of the worst-performing in 2018 (MSCI China Index returned -18.7% in USD). In contrast, the US was the best performer (MSCI US Index returned -4.5% in USD in 2018).

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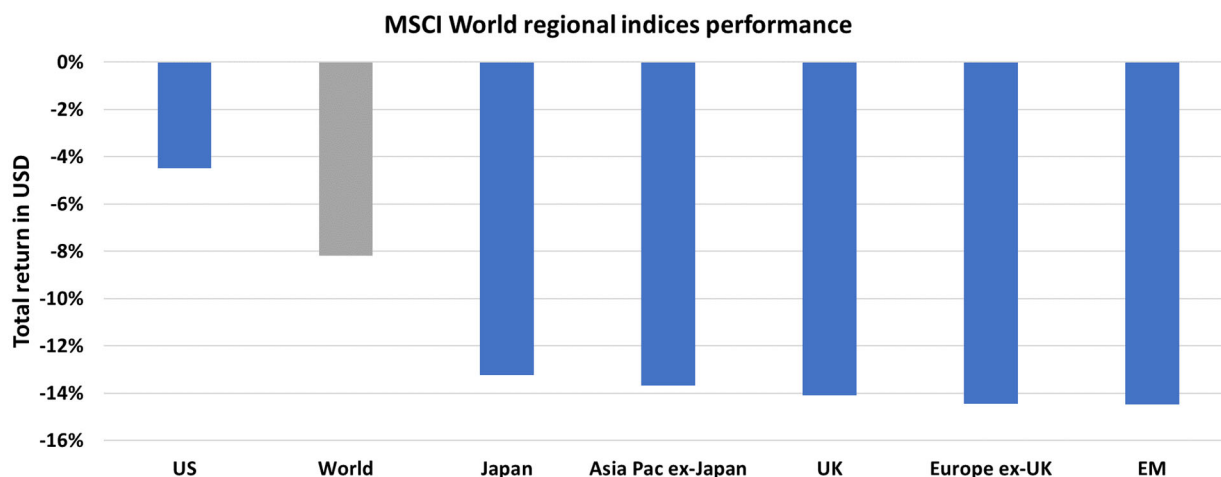


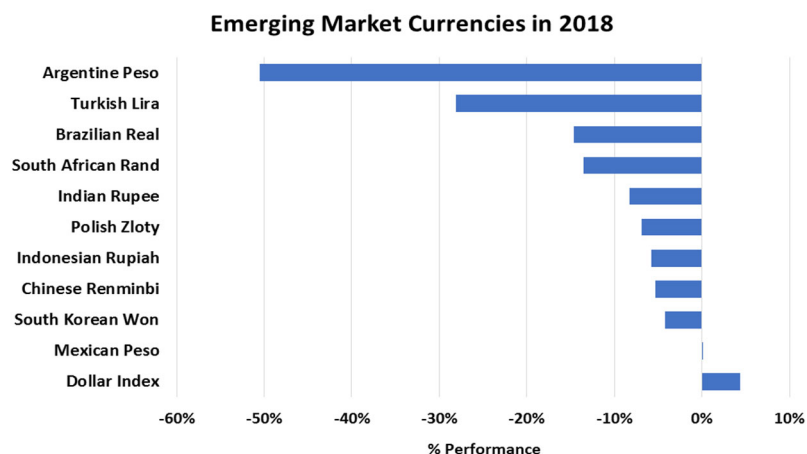
Figure 11 – Regional Performance (TR in USD) as of 31<sup>st</sup> December 2018. Source: Bloomberg.

The US was supported by robust corporate profitability leading on from the initial tax cuts, as well as strong economic growth numbers. There were significant advances with respect to trade with Mexico and Canada. The United States–Mexico–Canada Agreement (USMCA), or NAFTA 2.0 as it is also referred to, gives the US more access to Canada's dairy market, incentivises more domestic production of cars and trucks, increases environmental and labour regulations, and introduces updated intellectual property protections. This was a significant victory for President Trump just before the November mid-term elections. The election results came in broadly as markets expected, with the Democrats taking control of the House of Representatives and the Republicans increasing their majority in the Senate. With the Democrats unlikely to back further tax cuts, one of the key implications of the election was reduced fiscal support for the US economy. However, the market also saw a Republican Senate and President as pro-growth.

Though the Fund is currently around 20% underweight the US, there was not any meaningful effect on performance. Any drag on the allocation effect was somewhat offset by good stock selection. In fact, out of the top 10 performing stocks in the Fund, eight were US-domiciled.

Asia and Emerging Markets performed particularly poorly due to the uncertainty surrounding trade tariffs and the persistently strong US Dollar that characterised much of the year. The Dollar index, a broad measure of the currency, jumped more than 8% between mid-April and mid-August. This made commodities and foreign debt more expensive and hurt EM currencies. The Turkish Lira was one of the hardest hit; it plunged due to a combination of higher inflation, doubts over the central bank's resolve to raise rates, and political dramas. Argentina also suffered and was forced to ask the IMF to speed up the disbursement of much-needed cash; the central bank in late August lifted interest rates from 45% to 60% and the Peso dropped 12% on the day.

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**Figure 12 – % performance of emerging market currencies (based against the US Dollar) in 2018. As of 31st December 2018. Source: Bloomberg.**

Europe also faced its fair share of issues. The European Central Bank began to unwind its Quantitative Easing programme and markets have been trading sluggishly due to the various political events. The most notable surrounded Italy, where elections in March saw populist parties Five Star and the League come out on top and subsequently form a coalition government. Italian bond yields spiralled higher as investors scrutinised the new government's spending plans, estimated to include an increase of over €100bn. When the budget was announced in October, the EU was prompted to begin disciplinary measures against Italy for breaking the bloc's fiscal rules. Eventually an agreement was reached at the end of December, allowing Italy to dodge painful sanctions and leading to more normalised bond yields after a rocky year. In Germany, pressure on Angela Merkel mounted following election results in Hesse when the CDU and Socialists each lost around 11% of the vote, prompting her to announce that she would stand down as chairman of the CDU in December and not seek re-election in 2021. France had problems with social unrest stemming from rising fuel prices, higher costs of living and claims that a disproportionate burden of government's tax reforms were falling on the working and middle classes.

In the UK, the year has been characterised by Brexit developments. A withdrawal pact was agreed between the UK and the EU, but amid considerable criticism from both the Labour Party and within the Conservative Party, Prime Minister Theresa May was forced to defer a Parliamentary 'meaningful vote' on the agreement. Many protests and senior resignations eventually sparked a no-confidence vote in the PM's leadership of the Conservative Party which she won. The uncertainty surrounding Brexit continues to impact the UK market negatively, and it remains to be seen what will actually be achieved before the looming March 29<sup>th</sup> deadline.

As we enter 2019, analysts are cutting their forecasts for corporate earnings, economic data is showing slower growth, trade tensions are still looming, interest rate uncertainty remains, Brexit worries continue, and the slope of the US yield curve, commonly measured by looking at the difference between two- and 10-year Treasury yields, stands at its lowest level since 2007. Historically, an inversion of the yield curve – when short-term yields rise above longer-dated ones – has proved an accurate predictor of a recession. While no economists are predicting that for 2019, uncertainties remain, and the new year brings with it a nervousness not seen for many years.

The big question as we enter 2019 is whether many of the approaching headwinds will prove to be as strong as expectations have factored in. As ever, rather than try to determine which way the macro or political winds will blow in the near term, we maintain our focus on companies that can deliver a sustainable, rising income streams alongside capital growth over the long term. Holding good quality companies that have persistently generated high levels of return on capital gives us confidence that the Fund is well placed to

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weather different market conditions. It has been pleasing to see over the last year that stock selection has been a major contributor to the Fund’s outperformance versus the benchmark.

## Individual Stock Performance

When we look at how individual companies within the portfolio performed in 2018, we see that in the top five, we have two IT stocks, two Financial stocks, and one Healthcare stock (figure 13). This is testament to the bottom-up philosophy of the Guinness Global Equity Income Fund, focusing on quality companies at attractive valuations. It is also worth noting that the Fund is benchmark and sector agnostic – positions are based on high-conviction, bottom-up fundamental analysis.

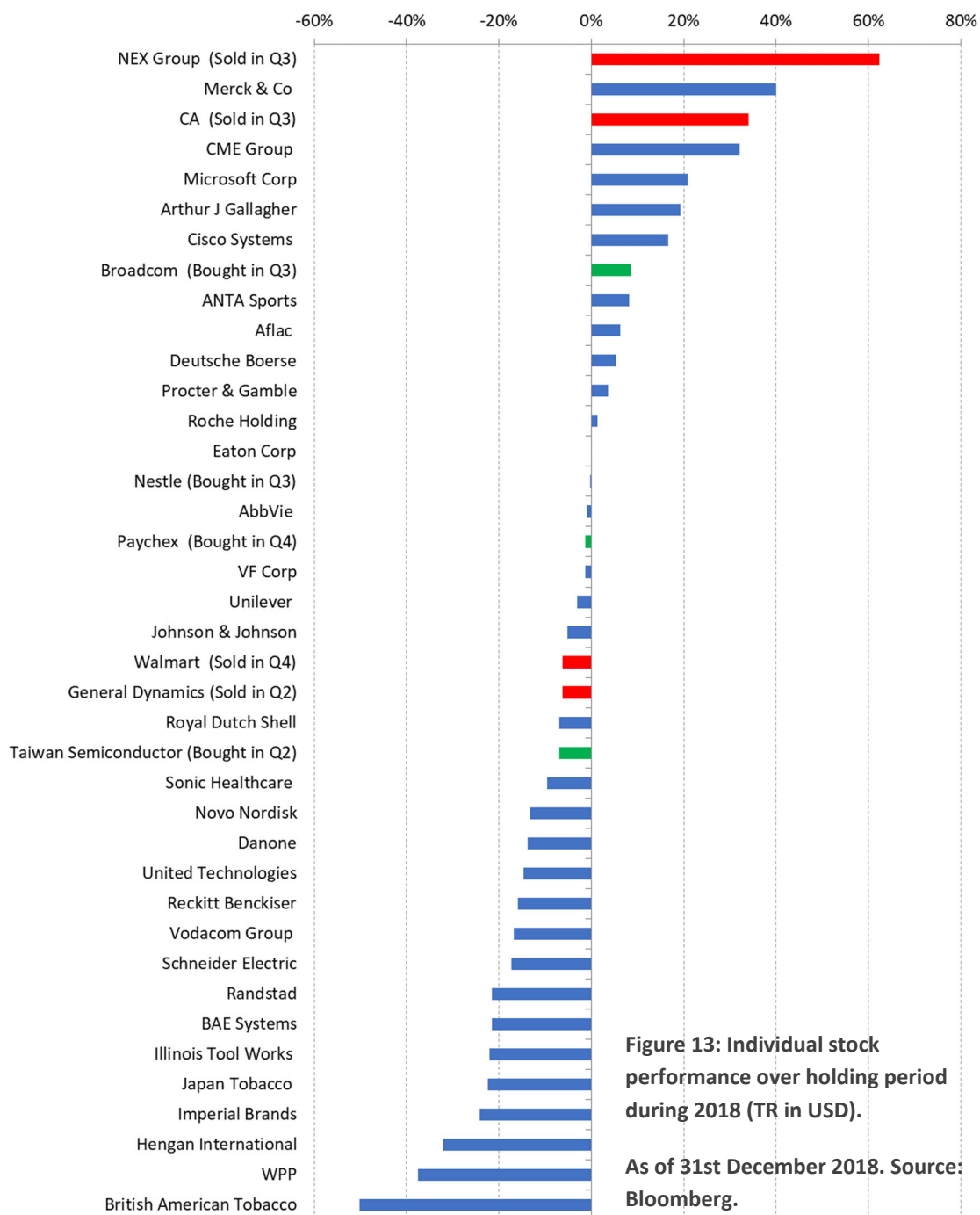


Figure 13: Individual stock performance over holding period during 2018 (TR in USD).

As of 31st December 2018. Source: Bloomberg.

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NEX Group, CA Inc, CME Group and Broadcom (all amongst the top performers) were all involved with M&A activity, and we detail our thoughts on these below when referring to the changes made to the portfolio.

The other two stocks that had stand-out performance were Merck (+40% in USD) and Microsoft (+21% in USD).

**Merck**, the global Healthcare company, was the second-best performer in the year. Best-selling drugs in the pharmaceutical segment include type 2 diabetes drug Januvia, which brings in about \$4 billion in revenues annually. Other products earning more than \$2 billion include diabetes drug Janumet, HPV vaccine Gardasil, and cholesterol medication Zetia. Meanwhile, \$1 billion top sellers include cholesterol medication Vytorin, skin antibiotic treatment Cubicin, HIV therapy Isentress, inflammatory treatment Remicade, cancer drug Keytruda, and chickenpox vaccine ProQuad. Strong performance in the year came after Merck’s lung cancer drug, Keytruda, won a string of clinical trials, placing it in the top spot for treating lung cancer. Estimates suggest that Keytruda could bring in \$12.5 billion by 2022; the clinical trials proved a huge positive for Merck, as it continues to expand its drug portfolio with its R&D efforts.



**Microsoft** also performed very well in the year. The software maker’s cloud transformation has seen buoyant demand. Azure cloud services, used to store and run customers’ applications in Microsoft’s data centres, is number two in the cloud sector behind Amazon Web Services, though the market is growing fast enough to lift both companies’ revenues. Windows and Office subscribers are likely to give Microsoft an edge as corporate users shift newer workloads to the cloud for greater agility. Margins should also continue to improve – as they have been doing – as cloud-based applications and infrastructure products gain scale. Azure continues to expand phenomenally, helping commercial cloud revenue surpass \$29 billion in the past 12 months. With greater hybrid-cloud adoption, its server segment should also show strength. We have held Microsoft in the Fund since launch in 2010.



Azure is the company’s main revenue growth driver:

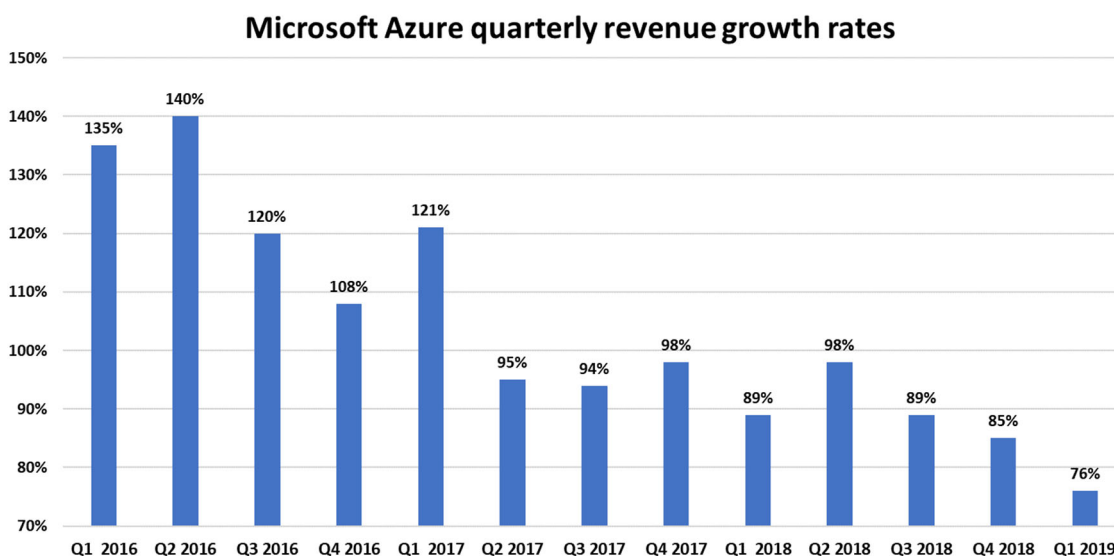


Figure 14: Quarters follow Company’s Fiscal Year. Source: Bloomberg Intelligence.

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The worst-performing stocks in the year included the three tobacco names we own: **British American Tobacco** (-50% in USD), **Imperial Brands** (-24% in USD) and **Japan Tobacco** (-22% in USD). The market's confidence in the tobacco industry was dented by news that the US Food and Drug Administration plans to pursue a ban on menthol cigarettes. The US is the industry's largest and most profitable market, and increased regulation would be expected to impact sales in the country.



Our selection process is bottom-up, focusing on the fundamentals of a company. We seek company characteristics and trends that we believe support the philosophy of the Fund: particularly quality, value, dividend. The tobacco industry's enviable cash generation, high barriers to entry and committed approach to returning income to shareholders has therefore attracted our attention.

- In quality terms, each of our three companies has a high cashflow return on investment consistently around 20% and above for the last 10 years. This is significantly higher than the real cost of capital and has contributed to significant outperformance of the industry over the long term.
- Value: 2-year forward PE multipliers currently stand at 8x, 8.6x and 11.6x respectively for British American Tobacco, Imperial Brands and Japan Tobacco. For each, this is below the historical 10-year average.
- We believe that these companies are attractively valued given that each is expected to grow earnings in the high single digits for the next two years and has been increasing its dividends every year for at least the last 20 years and at an annualised rate of close to 10%.
- The current trailing dividend yields are market leading; they stand at 7.8%, 7.7%, 5.7% for British American Tobacco, Imperial Brands and Japan Tobacco respectively.
- We also find the valuation compelling given that these companies have been able to sustain very high gross margins and grow year-on-year revenues for the last three years. This is despite the numerous concerns outlined in depth below, which we believe have been overplayed in the market.

### Regulatory Pressure

In an increasingly hostile regulatory environment over the past few decades, tobacco companies have survived negative headlines, advertising restrictions and even smoking bans - proving their model for profit and cash generation to be resilient under great pressure. More recent threats from the US FDA are aimed at reducing nicotine levels in traditional cigarettes and the banning of menthols. We believe this could take many years to implement and the impact could well be limited by the considerable investment in new technology already taking place.

### Government Pressure/Activism

2017 and 2018 witnessed an above-average increase in excise duties across several developed markets, prompting concerns regarding sales and consumption of tobacco. History demonstrates, however, that tobacco majors can recoup lost revenues through above-inflation price hikes, while industry consolidation adds to pricing powers.

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Government tax revenues also stand to counter significant policy change: in the UK, in 2017, revenue from levies on tobacco sales was £9.5 billion (source: HM Revenue and Customs). Any meaningful measures taken to price consumers out of cigarettes would squeeze government revenue.

### Rising Interest Rates

As Fed rates rise steadily, there is concern over the impact on high-yielding Consumer Staples such as tobacco stocks, which are often seen as being more sensitive to the bond market. However, we believe the notion of 'bond proxies' lacks substance; a crucial differentiator lies in the fact that bond coupons are fixed whereas tobacco dividend payments can grow and have been growing substantially in the last few years. Further, sentiment has priced in much of the negativity of interest rate changes, and the companies we hold have a long history of performing well against a variety of bond market scenarios.

### Competition from substitute tobacco products

Consolidation in the industry (BATS's \$64.5bn acquisition of Reynolds American in 2017 being the most recent high-profile example) alongside the high barriers to entry means competition is limited and that these large players are the best placed to drive R&D in new products. Recent underperformance has stemmed from slower-than-expected adoption of alternative tobacco products in Japan which caused concerns over adoption of the product worldwide. The slower adoption has not however affected the long-term growth forecasts.

We note that the market is worried about the long-term structural issues affecting the in companies in the tobacco industry. We believe, however, that this has led to over-discounted valuations for these stocks, hence we continue to find them compelling holdings in the Fund.

Another holding that has faced a difficult 2018 is WPP (-37% in USD). We have held a position since Q3 2015. After 18 months of good performance (+47% in USD to Q1 2017), over the last year the company has faced both internal and external challenges. The advertising group, which until October 2018 was the world's largest (by market cap), has seen its stock market value fall after losses of large global clients, with the most recent including Ford, American Express and United Airlines. This forced management to announce lower sales guidance from -0.5% decline to -1.0% decline. WPP's CEO Mark Read, who was confirmed in charge in September, faces an uphill task in trying to steady the ship after the abrupt departure of founder and former CEO Sir Martin Sorrell earlier this year. Not only did the departure sour sentiment for WPP, it also shed light on the significant uncertainty regarding the outlook of the advertising industry at a time when competitive forces are rife.

The logo for WPP, consisting of the letters 'WPP' in a large, bold, serif font.

New strategies underway at WPP seem to focus on merging advertising networks and selling lower-growth parts of the business to become more streamlined overall. Further, the return on capital profile is high and stable, operating margins are around 20%, the company has historically had positive sales growth every year since 2002 (including 2009), the dividend is well covered and growing, and the balance sheet is strong. We are therefore minded to maintain our holding in the company at this stage, particularly given that market pessimism seems overdone: the company's shares trade on a 1-year forward price-to-earnings multiple of 7.9x – almost two standard deviations below its 10-year average – and the current dividend yield is close to 7%. Looking at peers, the general advertising environment seems more positive than at the start of 2018, and the December analyst day provided further comfort that management is implementing extensive restructuring plans to achieve better profitability and growth.

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## Changes to the Portfolio

In 2018 we sold four positions and bought four new positions, leaving the portfolio with 35 positions at the end of the year. This was fewer changes than in 2017, and slightly less than the historical average.

	2011	2012	2013	2014	2015	2016	2017	2018
<b>Buys</b>	8	4	7	2	7	4	5	4
<b>Sales</b>	9	3	8	3	6	4	5	4
<b>Total holdings</b>	35	36	35	34	35	35	35	35

Figure 15: Number of changes to the portfolio.

In the first quarter, we made no changes to the portfolio.

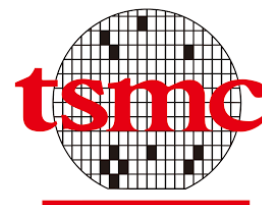
In the second quarter, we made one change to replace General Dynamics Corporation with Taiwan Semiconductor Manufacturing Company (TSMC).

**General Dynamics (GD)**, the diversified military defence company, has been held in the Fund since launch and has been a stand-out

**GENERAL DYNAMICS**

performer with a holding period return of 217% (in USD). GD is a prime military contractor to the Pentagon (the US government accounts for about 60% of sales). The company's military operations include information systems, marine systems, combat equipment and an aerospace unit. Recently, GD acquired CRSA, a provider of information technology services to the federal government, for about \$9.7 billion in cash and the assumption of debt. We decided to take profits on GD after strong performance led to a 1-year forward PE Ratio of 16.7 (much higher than its historical 10-year average) and dividend yield fell to 1.9%.

**TSMC** is a pure-play foundry business which manufactures integrated circuits used in computers, communication equipment, consumer electronics, and automotive and industrial equipment. At the time of purchase we were drawn to the company's very low debt-to-equity ratio of 12%, its dividend yield of 3% and double-digit earnings and profit growth estimates. Bought with a 2-year forward PE Ratio of 14.5, we saw the company as attractively valued given its above-market-average growth forecasts. Revenues and gross margins have increased



every year for the last eight and returns on capital have been consistently high for the last 10 years. The company's recent rally points to optimism regarding future sales and profit growth which are expected to rise as the use of artificial intelligence applications and the emerging adoption of 5G communication standards boost demand for high-end semiconductors. The company's leadership in manufacturing technology, along with GlobalFoundries' decision to suspend its seven-nanometre product development, will allow TSMC to solidify its market share in high-performance computing chips and to maintain its industry-leading profit margin.

In the third quarter, we made two changes to the portfolio. We bought new positions in Broadcom and Nestlé and sold our holdings in CA Technologies and NEX Group.

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**Broadcom** announced that it would buy CA Technologies for US\$18.9bn, the chipmaker's first major takeover since it was blocked by President Trump from pursuing a bid for rival Qualcomm earlier this year. Broadcom manufactures digital and analogue semiconductors and serves four primary markets: wired infrastructure, wireless communications, enterprise storage, and industrial & others. With a history of successfully integrating acquisitions, Broadcom has been able to grow revenues and gross profits every year consistently. At time of purchase, the stock was trading on a 1-year forward PE ratio of 10.6x, which is significantly cheaper compared to history and versus the market. We found this particularly attractive given the strong growth profile of Broadcom and the semiconductor industry in general.



Upon announcement of its acquisition of CA, Broadcom sold off due to market pessimism; CA's legacy software assets were seen as highly tangential to Broadcom's core business. This provided an attractive entry point. For Broadcom's acquisition to be deemed successful in the future, it will need to divest quickly the pieces it deems non-core while integrating elements that are synergistic. Substantial SG&A cuts are likely: CA's SG&A intensity stood at 36% of sales, while Broadcom operates at below 6%. While this gap cannot be bridged entirely due to differences in the industries each company operates in, it can be narrowed. Broadcom has a history of dramatically improving operating and gross margins through scale and cost-cuts in its target companies.

**CA Technologies** was one of the best performers in the year (+34% in USD in our holding period in 2018) after the takeover bid from Broadcom led to a strong share price rally in July. This presented a good profit-taking opportunity. We initiated a position in CA at the end of 2015 and it returned 63% (in USD). The software company provides tools for managing networks, databases, applications, storage, security, and other systems. Primarily serving large enterprises, its applications work across both mainframes and cloud computing environments. Revenues and gross profit have been falling in recent years mainly due to a lack of organic growth and a decrease in software subscriptions. Cash flow return on investment has also been gradually falling year-on-year, and although acquisitions have added to inorganic sales growth, they have also added to net debt. The bid from Broadcom led to a 18% rise in CA's share price and this provided an attractive sell opportunity.



We also bought a position in **Nestlé**. Measured by revenue, the Swiss multinational is the largest food company in the world, and it is active in almost every country. 29 of Nestlé's brands have annual sales of over a billion Dollars, including Nespresso & Nescafé coffee, Kit-Kat chocolates, Nesquik drinking chocolate, Stouffer's frozen food, Vittel and Perrier water, Haagen-Dazs ice cream, Purina pet food, DiGiorno pizza and Maggi noodles.



In recent years Nestlé has struggled to lift its revenues due to sluggish consumer spending in Europe and the US as well as changes in consumer tastes. In fiscal 2017 sales growth was close to zero, but in 2018 the company made significant strides by investing in high-growth businesses like bottled water, coffee, infant nutrition, and pet care. It recently paid more than \$7 billion for rights to sell Starbucks packaged coffees and teas worldwide and acquired Atrium, a Canadian manufacturer of OTC health supplements, for \$2.3 billion. Further, its 2018 strategy has consisted of many divestitures including the \$2.8 billion sale of its famous confectionery business (9% of net revenue and including brands such as Butterfinger, Crunch, Wonka, and Smarties) to Ferrero, the maker of Nutella and Ferrero Rocher. The move comes amid declining sales in the unit and a general repositioning towards healthier and faster-growing

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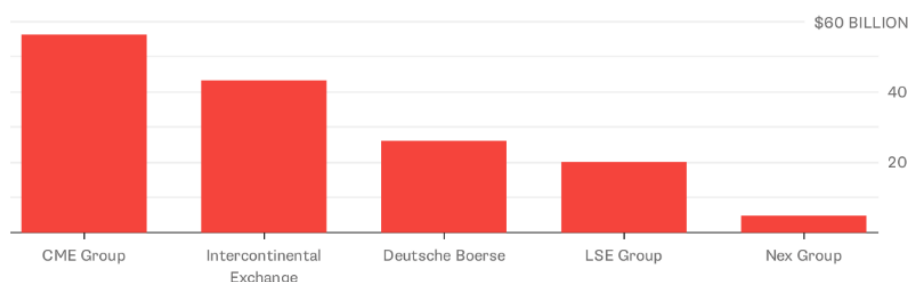
categories. We therefore believed that market pessimism allowed us an attractive entry point into a business that is highly cash-generative, has a very strong balance sheet, and provides an attractive 3% dividend yield.

As part of our ‘one in, one out’ policy, we sold a position in **NEX Group** (our best-performing stock of the year, up 62% in USD in our holding period in 2018). The financial technology firm, which provides electronic trading platforms, will be CME Group’s largest overseas acquisition and its largest since it bought Nymex for \$11bn in 2008. CME Group, which we also own in the Fund, owns and operates both the Chicago Board of Trade and the Chicago Mercantile Exchange. It will pay 500 pence and 0.0444 in new CME shares for each NEX Group share. The market has seen the latest wave of consolidation in global exchange markets as positive for both companies, with annual expense synergies expected to reach \$200m per year by 2021.



**Spot The Target**

Nex Group looks like an easy morsel for the larger exchange groups



Note: Market capitalization  
Source: Bloomberg

BloombergGadfly

"At a time when market participants are seeking ways to lower trading costs and manage risk more effectively, this acquisition will create significant value and efficiencies for clients globally," CME Group’s CEO, Terry Duffy, said. "As one organization, we will be able to employ the complementary strengths of each company to serve a wider client base while diversifying our combined businesses across futures, cash and OTC products, and post-trade services."

After the CME bid was announced at the end of Q1 2018, NEX’s share price had an initial increase of around 50%. The new price level was sustained, and with the probability of another bid decreasing, we saw an opportunity to take profits from our position in NEX. The valuation at time of sale stood at c.30 times on a 1-year forward price-to-earnings basis, compared to a 10-year average of 12 times.

**CME Group** (+32% in USD) was also rewarded by the market for its NEX bid and for an increase in average daily trading volumes in the year. The acquisition should allow the



exchange to offer clients significant margin savings and provide access to a large base of bank clients to whom it could market its core futures, options and data products. The deal should also support CME's international expansion plans, since 50% of NEX's revenue is generated outside of the US. Data and analytics are a key focus area for the company in 2019, with an outlook to expand recurring revenue. CME is also particularly well placed to benefit from increased interest rate hedging around Fed rate hikes and rising U. oil exports thanks to its dominant Fed Funds and WTI futures contracts. The company has largely opted to pursue an organic growth strategy, and this has meant low debt-to-equity at 10% with returns on capital increasing every year for the last five.

**In the fourth quarter of the year, we made one change. We sold Walmart and bought Paychex.**

Walmart, the world’s largest retailer, had been held in the Fund since the beginning of 2016 – the second time we have held a position over



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the life of the Fund. At purchase in 2016 the company was trading at its highest ever dividend yield (over 3.2%) and the market was very pessimistic about the company’s growth prospects. However, the company returned over 50% (in USD) over the holding period and has been seen to make the right moves to further its online competitiveness against Amazon by expanding its web marketplace, acquiring several internet-based retailers, and expanding its online grocery business. Although it has been rewarded for recognizing the threat of e-commerce to its traditional retail operations, the company has seen falling cash flow returns on investment and the desirable ‘quality’ characteristics we seek in all our holdings have diminished. Competitive pressures have led to slower sales growth and narrower margins and led us to replace the holding for a more compelling idea in the form of Paychex.

**Paychex** is a leading US provider of payroll processing and related HR services to small and medium-sized businesses. Over 50% of revenues come from payroll outsourcing – a task for which smaller firms are very willing to use a specialist. Once integrated into a client’s business, renewal rates are extremely high, and the cashflows that back the 3.1% dividend yield are very stable as a result. Paychex is an asset-light business that requires minimal capital expenditure. It has no long-term debt and has grown its revenues and earnings for the past three years in a row at an average rate of 7% and 10% respectively. Along with high returns on capital and wide profit margins, we find Paychex to be a very high-quality business. The recent market sell-offs, particularly in the IT sector, gave us an attractive entry point when the stock traded on par with peers and at its 10-year average despite, in our view, deserving a premium based on superior return on equity and free cash flow. The company also continues to acquire in order to expand services and gain market share, while returning capital to shareholders in the form of buybacks and growing dividends.



## Portfolio Positioning

The charts below show the sector and geographic breakdown of the portfolio at the year-end and over the last eight years. The main effect of the changes we made to the portfolio in 2018 was to increase our exposure to IT after market sell-offs provided us attractive entry opportunities. In terms of sector weightings, the Fund continues to have a zero weighting to Utilities, Materials and Real Estate. The largest overweight positions are to Consumer Staples, Industrials and Healthcare.

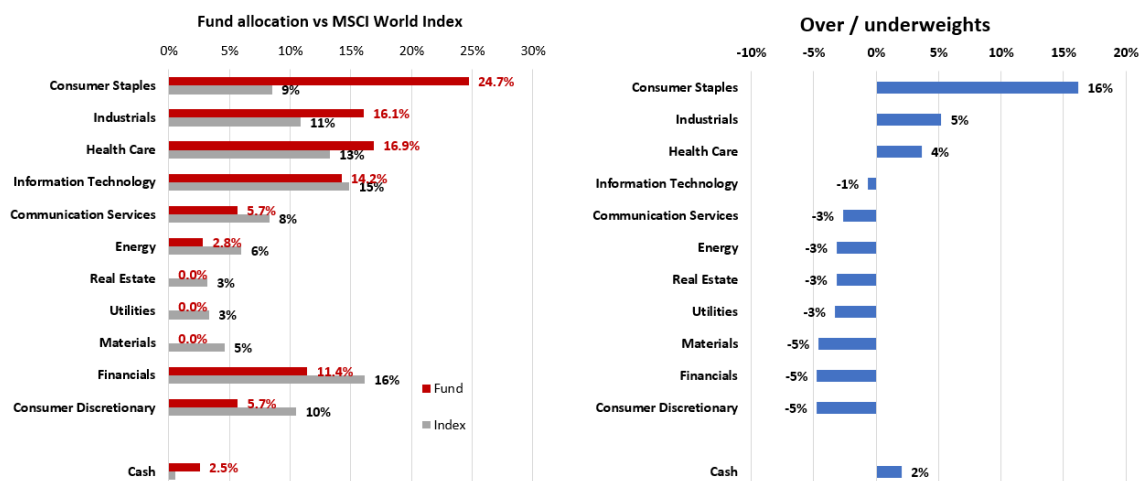


Figure 16 – Portfolio sector breakdown versus the MSCI World Index. Source: Guinness Asset Management, Bloomberg (data as of 31st December 2018).

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## Guinness Global Equity Income Fund

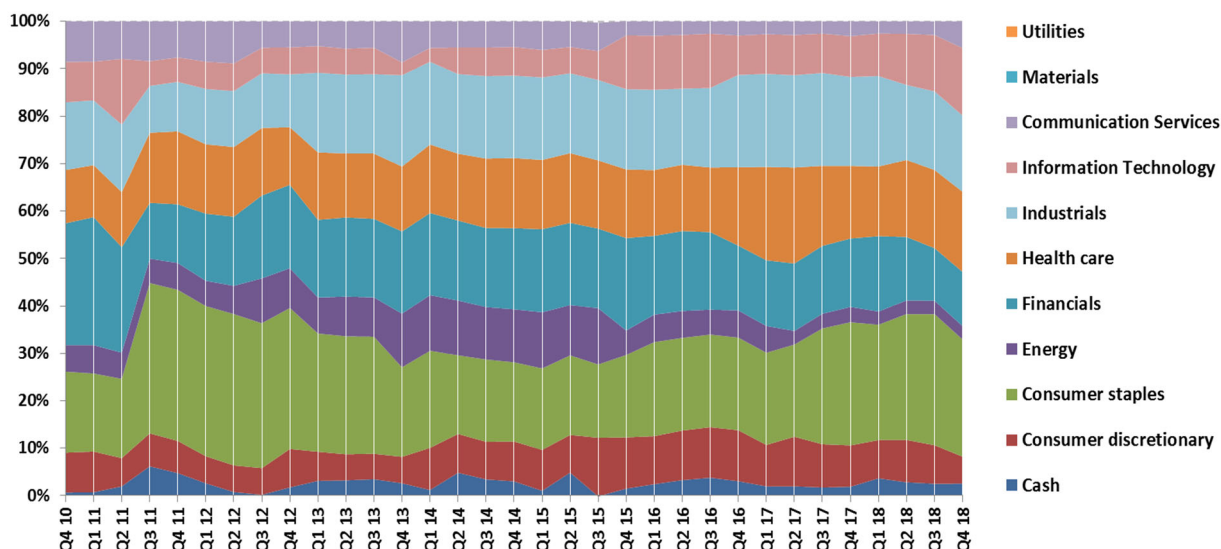


Figure 17 – Portfolio sector breakdown (to 31st December 2018). Source: Guinness Asset Management.

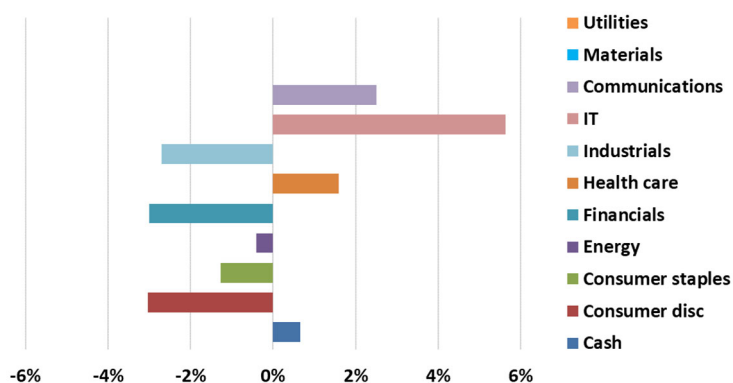


Figure 18 – Year-on-year change in sector breakdown (31st December 2018 vs 31st December 2017). Source: Guinness Asset Management.

Under the new GICS Sector reclassification, effective 1st October 2018, the Telecommunication Services sector was renamed Communication Services. As part of the changes, WPP was reclassified from Consumer Discretionary to Communication Services. We therefore have two positions in the new Communications Sector: WPP and Vodacom.

In terms of geographic allocation, we reduced our UK and North America weighting while increasing our exposure to Europe ex-UK. This is based on bottom-up, fundamental stock analysis, rather than regional bets.

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## Guinness Global Equity Income Fund

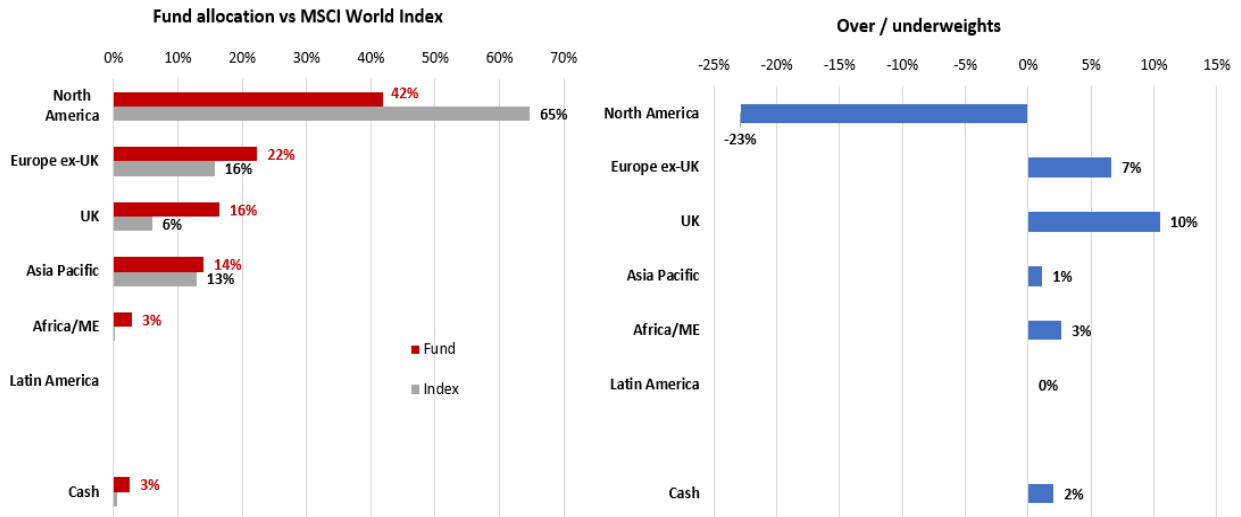


Figure 19 – Portfolio geographic breakdown versus the MSCI World Index. Source: Guinness Asset Management, Bloomberg (data as of 31st December 2018).

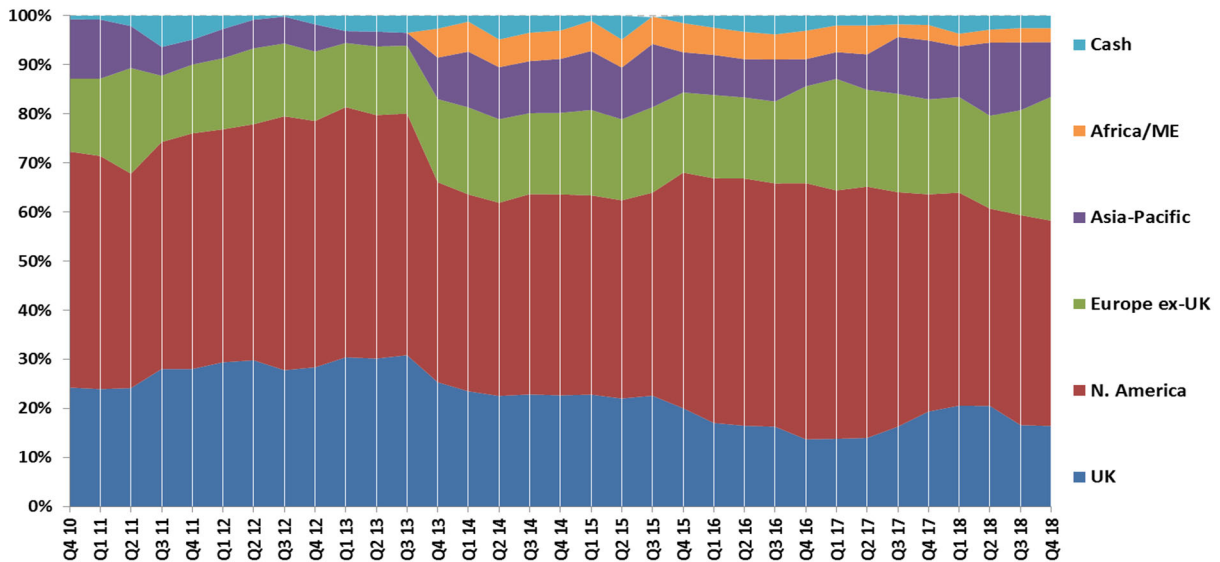


Figure 20 – Portfolio geographic breakdown (as of 31st December 2018). Source: Guinness Asset Management.

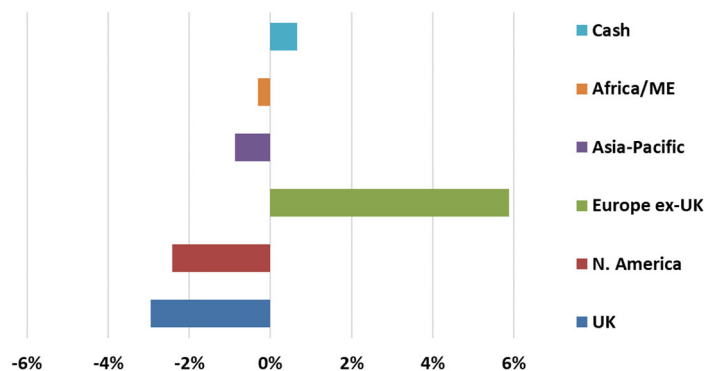


Figure 21 – Year-on-year change in geographic breakdown (31st December 2018 vs 31st December 2017). Source: Guinness Asset Management.

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## Outlook

The four key tenets to our approach are: quality, value, dividend, and conviction. We monitor the Fund to ensure that what we say we will deliver through stock selection is reflected at portfolio level.

At the year end, we are happy to report that the portfolio continues to deliver on all four of these measures relative to the benchmark MSCI World Index.

		Fund	MSCI World Index
Quality	Average 10 year Cashflow Return on Investment	17%	8%
	Weighted average net debt / equity	40%	67%
Value	PE (2019e)	13.7	14.3
	FCF Yield (LTM)	6.6%	5.5%
Dividend	Dividend Yield (LTM)	2.9%	2.7%
	Weighted average payout ratio	53%	47%
Conviction	Number of stocks	35	1650
	Active share	94%	-

**Figure 22 – Portfolio metrics versus index as of 31<sup>st</sup> December 2018. Source: Guinness Asset Management, Credit Suisse HOLT, Bloomberg.**

At the end of the year the Fund was trading on 13.7 times 2019 expected earnings; a discount of 4.4% to the broad market. Additionally, on a free cash flow basis, the Fund trades at a 20% discount to the market. This is especially pleasing given that the expected growth rate of the Fund is higher than the benchmark based on earnings expectations at the turn of the year.

2019 brings more sensitive markets and many uncertainties: over interest rates, trade tariffs, government shutdowns, Brexit, elections, recessions, and many more unknown-unknowns. These risks should be considered in the context that global equities now trade below their 10-year average price-to-earnings multiple, while our Fund is at a discount to the market despite holding higher-quality companies. Our constant approach of focusing on the quality of the underlying companies we own should stand us in good stead in our search for rising income streams and long-term capital growth.

As ever we would like to thank you for your continued support and we wish you all a prosperous 2019.

**Matthew Page, CFA**  
**Dr Ian Mortimer, CFA**

**Portfolio managers, Guinness Global Equity Income Fund**

**January 2019**

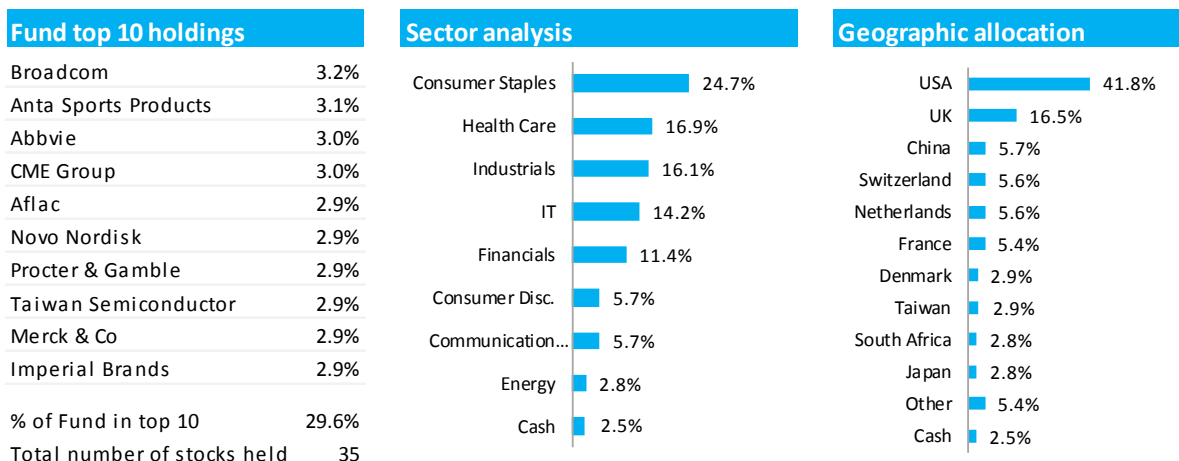
*All Index and performance data source: Bloomberg, except Fund performance data, which is sourced from Financial Express and Guinness Asset Management.*

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PORTFOLIO

31/12/2018



PERFORMANCE

31/12/2018

Annualised % total return from launch (GBP)

Fund (Y class, 0.99%OCF)	10.1%
MSCI World Index	9.9%
IA Global Equity Income sector average	7.6%

Discrete years % total return (GBP)

	Dec '14	Dec '15	Dec '16	Dec '17	Dec '18
Fund (Y class, 0.99%OCF)	10.1	2.2	26.9	9.6	0.7
MSCI World Index	12.1	5.5	29.0	12.4	-2.5
IA Global Equity Income sector average	6.7	1.5	23.2	10.4	-5.8

Cumulative % total return (GBP)

	1 month	Year-to-date	1 year	3 years	5 years	From launch
Fund (Y class, 0.99%OCF)	-4.5	0.7	0.7	40.1	57.6	115.9
MSCI World Index	-7.4	-3.0	-3.0	39.0	62.5	112.9
IA Global Equity Income sector average	-6.0	-5.8	-5.8	28.1	38.7	79.5

RISK ANALYSIS

31/12/2018

Annualised, weekly, from launch on 31.12.10, in GBP	Index	Sector	Fund
Alpha	0	0.17	1.53
Beta	1	0.76	0.85
Information ratio	0	-0.33	0.04
Maximum drawdown	-18.26	-15.50	-16.34
R squared	1	0.80	0.89
Sharpe ratio	1	0.35	0.53
Tracking error	0	6.11	4.53
Volatility	13.83	11.48	12.28

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 Y class (0.99% OCF):** Simulated performance based on actual returns of E share class (available from Fund launch), calculated in GBP. **Please see Performance data notes overleaf.**

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### Performance data notes

The performance numbers displayed on the previous page are calculated in GBP (Sterling). Please note: The Fund's Y class was launched on 11.03.15. The performance shown is a composite simulation for Y class performance being based on the actual performance of the Fund's E class, which has an annual management charge 0.75%, 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.

### 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 equity markets and our own interpretation. Any investment decision should take account of the subjectivity of the comments contained in the report.

This document is provided for information only and all the information contained in it is believed to be reliable but may be inaccurate or incomplete; any opinions stated are honestly held at the time of writing, but are not guaranteed. The contents of the document should not therefore be relied upon. It should not be taken as a recommendation to make an investment in the Fund or to buy or sell individual securities, nor does it constitute an offer for sale.

#### Risk

The Guinness 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: 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, 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. 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.

#### 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**

ASSET MANAGEMENT

Guinness Asset Management Ltd is authorised and regulated by the Financial Conduct Authority

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