

GUINNESS

Asian Equity Income Fund

A high conviction equity fund managed by Edmund Harriss in accordance with an intelligent investment process for high quality income portfolios.

Annual review

2015

GUINNESS

ASSET MANAGEMENT LTD

Launch date 19.12.13**Fund size** £14.2m**Team** Edmund Harriss (manager)
Mark Hammonds (analyst)**Aim**

The Guinness Asian Equity Income Fund is designed to provide investors with exposure to high quality dividend-paying companies in the Asia Pacific region. The Fund aims to provide long-term capital appreciation and a source of income that has the potential to grow over time.

Performance (in GBP) 31/12/2015

Fund	Guinness Asian Equity Income (X)
Index	MSCI AC Pacific ex Japan Index
Sector	IA Asia Pacific ex Japan

	2013	2014	2015
Fund	-	17.6	1.2
Index	2.0	7.8	-4.4
Sector	1.9	9.5	-3.4

	1 year	2 year	From launch
Fund	1.2	19.0	19.5
Index	-4.4	3.1	4.1
Sector	-3.4	5.8	6.9

Annualised % total return from launch (GBP)

Fund	9.2%
Index	2.0%
Sector	3.4%

Risk analysis (annualised, weekly, from launch)

	Index	Sector	Fund
Alpha	0	1.5	7.6
Beta	1	0.9	0.8
Info ratio	0	0.4	1.2
Max drwn	-25.6	-23.2	-19.9
Tracking err	0	3.7	6.0
Volatility	14.5	12.7	13.1
Sharpe ratio	0.0	0.0	0.4

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 in GBP.

Annual review

Performance

In 2015 Asian markets fell 4.1% (MSCI Pacific ex Japan Index, in GBP). Japan, by contrast, was the best major equity market in the world, rising 16%. The Fund did 5.6% better than the Index, delivering a positive total return of 1.2%. In the fourth quarter Asian markets saw stronger performance, with a sharp bounce in October (+6.0%), which the Fund lagged by 1.5% in the month.

Since launch (19th December 2013), the Fund has returned 19.5%, over 15% ahead of the Index return of 4.1%.

Asian market review

Investors have had to contend with significant geopolitical and economic uncertainty in 2015; the two are inextricably linked and there is no obvious path to a solution. Lower commodity prices have been a boon to western consumers and have also come as a relief to manufacturing economies in emerging markets. But to the producers, falling prices have revealed structural weaknesses and substantially increased economic and political instability. The diverging economic fortunes of the US and the Eurozone have probably the greatest ramifications, because world demand growth cannot be driven by the US alone. And running alongside all of this, although overblown, is China's economic transition and deceleration.

The first few trading days in 2016 have had a decidedly surreal quality to them. Chinese growth is slowing, but this is well known, and it's still projected to grow 6.5%. Global markets are looking at China's stock markets and attempting to read through to underlying conditions. This is a fool's game. We need to consider the role of China's equity markets as a source of capital for companies and to look at the make-up of investor participants. In the first 11 months of 2015, domestic stock markets only provided 4.5% of all corporate needs; 18% came from the domestic bond market while 77.5% came from banks.

To gauge China's economic health with regard to domestic capital needs and availability, we should be watching money supply data for central bank policy, interbank rates for short-term liquidity availability, and domestic bond yields for longer-term expectations. Narrow money supply (M1) has been accelerating since July 2015 (from 6% growth to 15.7% at the last reading); broader money supply (M2) has been steady at approximately 13.5% growth over the same period. Interbank rates are largely unchanged today from one

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month ago, three months ago and six months ago, suggesting local liquidity is not stretched. Bond yields have also dropped in support of government efforts to lower interest rates and to keep them there.

The investor base driving domestic equity market prices is largely (around 80%) made up of retail investors. Longer-term equity investors such as insurance companies have less than 15% equity exposure in their investment assets. These retail investors, as has been amply demonstrated, have a strong gambling emphasis (you might call this 'a strong bias toward momentum'), and pay little regard to valuation. Their expectations centre on second-guessing government policy – will they cut interest rates/increase liquidity/add extra stimulus? – and they have an investment horizon measurable in minutes. The stock markets are not important enough as a source of capital and do not have a substantial enough base of sophisticated investor for the markets to act as a discounting mechanism for long-term (or even medium term) economic prospects.

What we have witnessed amid the market turbulence in China are cack-handed efforts by an inexperienced regulatory regime attempting to control the unravelling of a retail-driven bull market that they fuelled in the first place. The prospect of a resumption of Initial Public Offerings, the removal of a sales ban imposed to support the market last August and the use of 'circuit breakers' were all designed to dampen volatility and return the markets to a 'normal' function, but have had precisely the opposite effect on a structurally skittish investor base.

Although it might seem that the best place to be is under the bed, it pays us to be more measured in our analysis. All of the Fund's exposure to China is through companies listed on the Hong Kong Stock Exchange, not the Chinese domestic 'A' shares that are the subject of intervention by the authorities. These companies report their accounts in accordance with International Accounting Standards (or other proximate standards). We look for companies whose equity value depends on the stability and strength of future operating cash flows as well as the dividends they will pay us. Analysis of companies in emerging markets has its challenges, but by looking at those with long track records that are operating in competitive sectors we can increase our confidence in their ability to cope with future uncertainty. We look at companies that have earned a return on invested capital above their cost of capital for eight consecutive years: that is long enough, we believe, to suggest a company has a solid business. It is also long enough to make it less likely the numbers are being fudged. Poor management shows up eventually.

Rather than deterring us from investing, volatility can present opportunities. If the weight of political, economic and market uncertainty is too great, there is a likelihood that the market is undervaluing some good businesses.

Today, Asia ex-Japan is trading at valuations seen only in crisis periods (1998, 2001 and 2008). We are often asked when it is a good time to invest in Asia. We cannot predict short-term market movements with any precision. However, we can say that looking across the region we believe economic conditions are comparatively benign (comparative both to Asia's past and to other emerging markets today). We believe also that China's growth is not slowing precipitously: heavy industry and construction-related sectors are definitely struggling, and this investment-related area makes up the largest share of GDP, but services and consumption-related areas are stronger and indicate economic transition is underway. GDP growth is too blunt a measure for us to assess prospects, so we look at items such as car sales, electricity production and consumption by sector, money supply, sub-components of the Purchasing Managers Index, oil imports (volume and price), and inflation in both consumer and producer prices. These reveal in greater detail areas of weakness and strength.

From an Asian perspective, in 2015 we have been relieved by the fall in the price of oil and of other commodity prices. China has saved over \$100 billion in the import bill just from the lower prices of oil and iron ore. China's oil product demand grew over the first ten months of 2015 by 6.7% year-on-year (IEA data). In Indonesia, Malaysia and Thailand the lower oil price has enabled governments to abolish fuel subsidies that proved such a drain on government coffers. For export manufacturers it has brought down the cost of raw materials and allowed wages to rise (good for consumption) without significantly damaging margins. The fall in oil prices is not a sign of weakening demand, in our view, but a problem of oversupply from the expansion of US shale production.

Stronger economic growth in the US has provided an ongoing source of demand for Asian manufactured goods (in contrast to Europe), but US demand is not what it was. From 2000 up to the time of the financial crisis, Chinese exports to the US grew 20% to 30% a year, while Europe was even better. This year they have grown

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about 6%. Indications are that American consumers have focused more in recent years on paying down debt than on increasing consumption. However, US strength has also brought about a sharp appreciation in the dollar, which on a trade-weighted basis is now the strongest since 2003. In Asia, the Chinese yuan fell 4% while the rest of the region's currencies (excluding Japan) were down 8.8% on a weighted-average basis against the dollar.

Overall economic conditions in the region are not bad when compared with other developed markets (for which read Europe) or other emerging markets. Economic growth in Asia ex Japan is expected to have been 5.4% in 2015, compared to world GDP growth of 2.6% (based on IMF data). (Excluding China, world economic growth in 2015 is estimated to have been 1.9%, and Asia ex Japan 3.7%.) Inflation is still mild, with most reporting rates below 2%, the outstanding exception being Indonesia at 6.8%. Most countries are running trade surpluses and are well able to tolerate the currency weakness seen so far. They may be willing to tolerate further weakness this year, which is in sharp contrast to the likes of Brazil, South Africa, Russia and Turkey. China still has the ability to apply monetary easing measures to support the economy if necessary. In short, at the end of 2015 in terms of growth, leverage, foreign exchange reserves and financial sector stability, Asia is a world away from the 1997 crisis levels that market valuations appear to imply.

Performance drivers

In the fourth quarter the Fund lagged the broad market, which rose over 8% (in GBP). The main drags on relative performance were concentrated among technology names, specifically telephone handset-related businesses, and retail stocks in Hong Kong and China. Among the technology names, Catcher, Largan and Hon Hai Precision fell in December ahead of sales growth that tapered off, and Apple revised down end demand forecasts for the next quarter (a strong negative for these companies in its supply chain). While short term guidance was lower than the market had been hoping for, demand is expected to pick up toward the second half of 2016 on the back of new products. On the positive side, semiconductor stocks Novatek and TSMC were strong performers over the period. Leading performers over the quarter were St Shine Optical, whose sales are now back on a growth trend, and our one Japanese name, Relo Holdings, which has continued to do well.

In 2015 as a whole leading stocks were Relo Holdings, Henderson Group, St Shine Optical, Pacific Textiles, AAC Technologies, KT&G and China Lilang. All of these rose by more than 20% over the course of the year (total return in USD), and all are in different sectors including real estate, textile, technology, healthcare, apparel and in retail. There is also a good geographic spread amongst these companies – they're based in Australia, China, Hong Kong, Korea, Japan and Taiwan. The weakest stocks were Luk Fook (jewellery retail in Hong Kong), Belle (shoe retailing in China), LPN Development (real estate in Thailand), Qualcomm (technology, US/China), PTT (energy, Thailand) and Digi.com (mobile telecom services, Malaysia) which fell by 25% or more. *(All stock performance data in USD.)*

Across the portfolio, twenty of the thirty-six holding outperformed the market over the whole year.

Portfolio changes

There were three stock changes in 2015. At the start of the third quarter the management of Huabao International decided, after seven years, to omit its final dividend. The company justified this by highlighting the special dividend paid on top of its ordinary dividend at the interim stage and uncertain industry conditions ahead. We sold the position and purchased Aflac Inc, a US-listed health insurer that generates much of its business in Japan. The second stock change was triggered by the acquisition of iiNet, an internet service provider in Australia, by TPG Telecom. In its place we purchased Largan Precision, a manufacturer of high-end camera lenses. The third change was the sale of Shenzhou International on valuation grounds. In its place we put in Belle International, a designer and retailer of footwear in China.

Outlook

Our view remains that the Asia region offers investors a good long-term opportunity. The long-term story is one of a rising standard of living on the back of rising real wages and increasing domestic consumption. China's economy is still expected to grow 6.5% in 2016, while the rest of the region is forecast (using IMF data) to grow 4.1%, compared to world growth of 2.9%. Stock market valuations in Asia, as we have said, look cheap.

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There is still considerable scope for China to adjust policy in line with economic needs. Foreign exchange reserves are still substantial at \$3.3 trillion, while an expected record trade surplus is likely to give an extra buffer against capital outflows, which are likely to continue. Banking sector liquidity can be augmented by the release of deposits that commercial banks have been required to place with the central bank (so-called Required Reserves). These have risen from 6% of China's commercial banks' deposit base in 2003 to more than 20% by the beginning of 2015 in response to capital inflows.

The key to Chinese economic stability today lies in the real estate sector and so far property sales and prices have been solid. Longer term issues are whether China can continue its transition, cut excess production capacity at a time when debt levels are still high and not fall back into renewed credit expansion. In this respect, Premier Li Keqiang has publicly ruled out the use of strong stimulus and a flood of liquidity to propel growth. He is instead pushing for new business models and economic drivers (economic transition) and for concrete steps to reduce overcapacity.

We view the recent rise in US interest rates as being a positive development. However, the outlook is by no means clear. The first move was a tentative step and the Fed minutes suggest the decision was a closer call than initially thought. The Federal Reserve has pencilled in four interest rate rises. If they pursue this regardless of external conditions, the associated monetary tightening and liquidity withdrawal could spark a mid-recovery downturn. Further rises will likely depend on rising core PCE (Personal Consumption Expenditure) inflation. That has been weak in recent years as consumers have focused on paying down debt, but this process may be coming to an end. Higher consumption would be a positive and welcome development for Asia.

Edmund Harriss (fund manager)

Mark Hammonds (investment analyst)

PERFORMANCE

31/12/2015

Discrete years % total return (GBP)	Dec '11	Dec '12	Dec '13	Dec '14	Dec '15
Fund (X class, 0.75% AMC)	-	-	-	17.6	1.2
MSCI AC Pacific ex Japan Index	-13.0	16.7	2.0	7.8	-4.4
IA Asia Pacific ex Japan	-16.8	15.9	1.9	9.5	-3.4
Cumulative % total return (GBP)	1 month	Year- to-date	1 year	3 years	From launch
Fund (X class, 0.75% AMC)	-0.2	-	1.2	-	19.5
MSCI AC Pacific ex Japan Index	2.3	-	-4.4	5.1	4.1
IA Asia Pacific ex Japan	1.6	-	-3.4	7.8	6.9

Annualised % total return from launch (GBP)

Fund (X class, 0.75% AMC)	9.15%
MSCI AC Pacific ex Japan Index	1.98%
IA Asia Pacific ex Japan	3.35%

Risk analysis - Annualised, weekly, from launch on 19.12.2013, in GBP

31/12/2015	Index	Sector	Fund
Alpha	0	1.54	7.57
Beta	1	0.83	0.83
Information ratio	0	0.38	1.23
Maximum drawdown	-25.55	-23.20	-19.85
R squared	1	0.95	0.83
Sharpe ratio	0.00	0.00	0.42
Tracking error	0	3.66	5.95
Volatility	14.46	12.66	13.11

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Source: Financial Express, bid to bid, total return. Fund launch date: 19.12.2013.

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Process recap

While many investors will already be familiar with the Fund's investment process, we repeat it here for new investors that have joined us during the year.

Guinness Asian Equity Income Fund

The Fund is a concentrated, equally-weighted portfolio of 36 dividend-paying stocks that have achieved a persistently high return on invested capital. It is designed to deliver a combination of capital growth and dividend growth over time.

Stock selection

The Fund builds on the successful Guinness Global Equity Income methodology in selecting stocks from a universe of good quality companies. In Asia this means looking for companies that, excluding inflation, have generated a 'real' return on investment of at least 8% for each of the previous eight years.

Why 'real' return?

A 'real' return measure strips out variation in inflation rates across the region to give equivalence among returns on investment.

Why 8%?

By setting the threshold at 8% we can be confident the returns are above the average real cost of capital. These companies are truly creating value.

Why every year?

This excludes highly cyclical companies or those with high but declining or volatile earnings.

Why eight years?

Business cycles tend to last less than eight years. Eight consecutive years of success demonstrates a company's ability to make it through hard times as well as good.

We have found that good companies tend to stay good; 86% of companies that achieved a real return on investment of 8% or more in each of the previous 8 years will do so again the following year.

Balance sheet strength and critical mass

To ensure strength, stability and liquidity in the companies in our universe, we then apply debt and market capitalisation constraints. For inclusion, a company's ratio of debt to equity cannot exceed 100% (for banks, the ratio of equity to total assets must be at least 5%), and the stock must have a market capitalisation of at least US\$500 million. There are currently 280 companies in Asia Pacific that meet these criteria.

The importance of dividends

Dividend investing requires us to establish whether a company is able (and willing) to pay and sustain a dividend over time. We focus on quality companies as the primary criteria for universe selection: companies that can generate persistently high returns can grow their business, increase their cash flows and sustain and grow their dividend. These businesses have demonstrated management skill, competitive advantage and/or an ability to allocate capital efficiently to generate these returns year after year. Companies' use of capital is important; we want to see a sustainable dividend stream, we do not want them to pay out all earnings (as would a high dividend stock) at the expense of growing the business.

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Constructing the portfolio

The portfolio is equally-weighted across 36 positions. This discipline means we invest in each position with high conviction. We do this because:

1. We do not know when value will be realised.

We cannot know with certainty how much value there is in a stock, just a range of probable outcomes. Variable weightings requires an overlaying of probable values with a probability set of timings which we think detracts from the process. "There is a long-term investment opportunity in Asia. But opportunity and risk go hand-in-hand; the key for investors is how to manage that trade-off."

2. It sharpens the purchase and sale discipline.

A purchase of a new position must be accompanied by a sale of an existing position; a one in-one out approach forces us to maintain high conviction in our decision-making and in our portfolio.

Most investors are aware (and behavioural finance studies agree) that in the real world, 'rational economic man' does not exist and stock markets are not efficient. Loss aversion is one of the key behavioural biases that portfolio managers must confront. The discipline of equal weighting counteracts it. Sensible periodic rebalancing forces us to go against market movement and (assuming our original rationale still stands) buy more of a company that has underperformed, and trim our holdings in companies that have outperformed. If our longer-term conviction proves correct, the Fund will benefit materially.

An equally-weighted portfolio is efficient and ensures clarity and discipline:

1. The number of holdings is fixed, and manager conviction is maintained; we can never grow a long tail of "legacy losers" in which we no longer have conviction.
2. A high active share relative to a benchmark is a given, and the stock-specific risk of an individual position is capped (at 2.75% in a 36 stock portfolio).

Our focus, therefore, is on stock selection, which is based on a regular weekly screen of the 280 companies in our universe by quality, value, earnings forecasts revisions and price momentum. Value at this stage becomes the dominant factor.

Value bias: due diligence and stock research

Our research and due diligence work for potential purchases focuses on the gap between the value of the stock we believe is warranted by the company's current operations, its prospects and the value placed on it by the market today. A position may be sold when the dividend contribution to the portfolio is insufficient, when the stock is (in our opinion) fully valued, if the company falls out of our universe, the balance sheet becomes stretched or, simply, if we find a better idea.

Summary

The Fund is designed to give investors exposure to one of the world's fastest growing regions, which will have a significant influence over our economic future. However, with change and opportunity comes risk. We address this by investing in companies with winning track records, that generate sufficient cash to reinvest in their business and then deliver sufficient returns to make that reinvestment worthwhile, and that are committed to paying growing dividends to shareholders.

PORTFOLIO

31/12/2015

Fund top 10 holdings	Sector analysis	Geographic allocation
Relo Holdings 3.3%	Financials 34.0%	China 30.2%
JB Hi-fi 3.0%	IT 24.3%	Taiwan 19.1%
PTT Public Company 2.9%	Consumer Disc 19.2%	Hong Kong 13.6%
DiGi.COM 2.9%	Energy 5.7%	Australia 8.3%
Henderson Group 2.9%	Telecoms 5.6%	Thailand 8.1%
Qualcomm 2.9%	Health Care 5.3%	USA 5.6%
China Minsheng Banking 2.9%	Industrials 2.7%	Singapore 5.5%
Novatek Microelectronics 2.9%	Consumer Staples 2.6%	Japan 3.3%
China Merchants Bank 2.8%	Cash 0.6%	Malaysia 2.9%
Li & Fung 2.8%		South Korea 2.6%
% of Fund in top 10 29.3%		Cash 0.6%
Total number of stocks in Fund 36		

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 equities and equity markets invested in by the Guinness Asian 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 Asian 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. The Fund invests only in stocks of companies that are traded on Asian stock exchanges or that do at least half of their business in Asia; it is therefore susceptible to the performance of that region, and can be volatile. Details on the risk factors are included in the Fund's documentation, available on our website. Shareholders should note that all or part of the fees and expenses will be charged to the capital of the Fund. This will have the effect of lowering the capital value of your investment.

Documentation

The documentation needed to make an investment, including the Prospectus, the Key Investor Information

Document (KIID) and the Application Form, is available from the website www.guinnessfunds.com, or free of charge from:-

- the Manager: Capita Financial Managers (Ireland) Limited, 2 Grand Canal Square, Grand Canal Harbour, Dublin 2, Ireland; or,
- the Promoter and Investment Manager: Guinness Asset Management Ltd, 14 Queen Anne's Gate, London SW1H 9AA.

Residency

In countries where the Fund is not registered for sale or in any other circumstances where its distribution is not authorised or is unlawful, the Fund should not be distributed to resident Retail Clients. **NOTE: THIS INVESTMENT IS NOT FOR SALE TO U.S. PERSONS.**

Structure & regulation

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

Switzerland

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

Telephone calls may be recorded and monitored.

GUINNESS

ASSET MANAGEMENT LTD

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