

Dividend Paying Culture in High Growth Asia

The Asian markets may provide an exciting long-term growth story, but not too many investors feel comfortable to invest in the foreign environment. The Asia Pacific Dividend Fund was set with the idea to provide exposure to this high-growth environment but in a more conservative way and with less volatility. The fund focuses on selecting stable and cash generating businesses that pay out higher than average dividends.

Q: What are your core beliefs when managing the Asia Pacific Dividend fund?

A: The fund was created with the idea to participate in the Asian growth, but in a conservative way. It is designed for investors who are less comfortable with investing outside the U.S. and into high-growth businesses. But although we invest in a growth environment, we seek stable businesses that are well-established and have lower capital expenditure requirements. Overall, the fund provides higher-growth exposure than a domestic U.S. fund, but with less volatility than in a pure Asian fund.

When selecting the companies, we always look for four key elements that, when combined, should generate outperformance over time. Those key factors are quality, value, market sentiment, and price momentum. The overall result is a portfolio that is biased towards quality and value and has a momentum element.

For this fund, the extra element is dividend yield. We look for companies with dividend yields that are 30% higher than the market average and for companies that demonstrate stable payouts. The dividend is a visible sign of the company's health and a measure of stability. It has a positive effect on the discipline of the management. And because we set high thresholds for dividend payments, the companies have to generate the cash to meet them. There-

fore, the companies we select tend to be more mature, with predictable cash flows, and awareness of shareholder value.

Q: Why do you believe that Asia Pacific is a good place to invest in?

A: Asia represents a long-term growth story, not just a recent fad. The global demographics, more than anything else, underpin the strength of the Asian market. As the population in the developed world ages and the number of retirees grows, there are fewer workers to support each retiree. At the same time, in Asia we find younger populations and a much greater number of workers. The lower average age affects the production capacity of Asia and results in faster growth of wealth creation.

There is going to be a transfer of the economic wealth as the retirees in the developed world monetize their savings by selling them. The buyers will be the people who are producing, and the producers are going to be Asian. I believe that this story will continue for a very long time. Through this transformative period, there are a number of ways to invest in Asia, and this fund is all about more conservative investing in Asian growth.

Q: Which countries in the Asia Pacific region do you include in the fund?

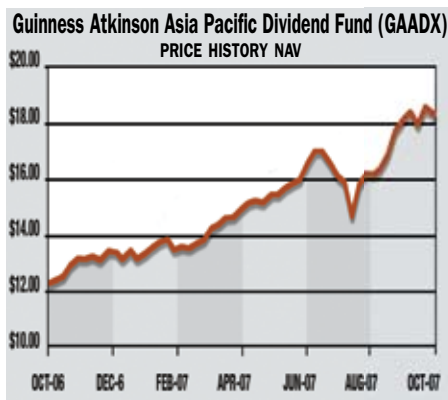
A: The fund was set to include the Asia Pacific region excluding Japan. That means that it can include more developed econo-



EDMUND HARRISS has served as lead manager of the Asia Focus Fund since 2003 and the lead manager of the Asia Pacific Dividend Fund since its March 31, 2006 inception. He also serves as a member of the investment team managing the China & Hong Kong Fund (lead manager since 1998).

Before joining Guinness Atkinson, in April 2003, Harriss was employed by Investec, in July 1993, where he joined the Far East Investment Desk in 1994.

Harriss graduated from Christ Church, University of Oxford, in 1991, with a Masters degree in Management Studies.



mies like Australia and New Zealand, but it remains predominately an Asian fund. That being said, Australia and New Zealand also provide a way to approach Asia, particularly through their natural resources, and we do exploit certain opportunities there. Currently, we have assets in Australia, China through Hong Kong, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand but not in India.

Q: In terms of the global demographics, doesn't it make sense to invest in mainland China and India, since those are the two youngest nations with large domestic economies?

A: Yes, absolutely, and we get exposure to mainland China through companies that are listed in Hong Kong. In India, there are great companies with attractive returns on investment and good yields, but the Indian ADRs have run up quite a bit and trade at a high premium to the underlying local stocks. The difficulty with direct investing in India is related to the onerous bureaucracy and I don't think I could add that an awful lot of value there.

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But it is definitely a market that we look at. The long-term demographic story that will support Asia for the next decades is mostly true about India. It will take 50 years for India to reach the U.S. ratio of four workers per one retiree.

Q: How many companies do pay dividends in the Asia Pacific region?

A: I am not sure of the exact number, but we have a universe of more than 600 companies that pay out dividends. Before the Asian crisis in 1997, the companies tended to retain the earnings for investing into new projects. However, after the crisis, there was vicious retrenchment and credit became a lot harder to get. Companies spent a lot of time de-leveraging and selling off extraneous businesses. They stopped investing because they had created too much capacity, and it took them a while to utilize it.

Since the Asian crisis of 1997, there has been very little capital expenditure and cash has piled up on the balance sheets. We have seen a steady increase in the dividend payout ratios and the number of companies that pay dividends has increased due to the pressure from the shareholders. Gradually, the dividend culture has taken hold, which is a very welcome development.

So we have seen higher payouts and better returns across the region, including China, Malaysia, Singapore, and Taiwan. Consequently, we are also seeing better valuations. In such a scenario, the major risk for the fund is that once the domestic Asian economies take off and utilize the excess capacity, which is a close point, the companies will start investing again. The question is if they will cut the dividends to fund the investments as in the bad old days.

Q: Do you believe that these companies have the business models or the margins to sustain the cash generation that allows them to pay dividends and reinvest in the business?

A: It varies from sector to sector. But, clearly, in recent years the margins look good across Asia. That has allowed many companies to look like good dividend payers and we have to recall their cyclical nature

and the future danger. However, I believe that now there are enough companies with solid penetration in their respective markets, which are no longer too fragmented. We have reached a critical size of companies that can defend their margins.

Q: What are the milestones of your investment process?

A: The first step of the process is quantitative screening of all the stocks in the Asia Pacific region with market capitalization of above \$200 million. I believe that this threshold is high enough to guard against liquidity problems and low enough to include small and mid-cap companies in the mix. There are attractive small companies that represent steadily growing niche businesses, and we like to include them in the portfolio. Such are the companies providing services to larger customers, for example, and they don't necessarily have to invest huge amounts of money to get bigger.

The first screening results in a stock universe of about 1,500 companies. The next step is ranking this universe by the four criteria that I already mentioned - quality, valuation, earnings revisions, and price momentum - and creating a composite rank based on those factors. We measure the quality through return on investment, while the value is determined through discounted cash flow and traditional metrics such as price-to-earnings and price-to-book ratios. In terms of market sentiment, we look for the companies that the market is optimistic about, or companies with positive earnings revisions and strong aggregate earnings forecast. Finally, we look for companies that exhibit a positive price trend.

For the next step, the fundamental research process, we are interested in the top 150 companies in that universe. Overall, the process allows us to define our universe with characteristics that we like, and to narrow it down to a manageable list.

Q: What does the fundamental research process involve?

A: The fundamental research process involves building a financial model, which incorporates the historic data of the income

statement, the balance sheet, and the cash flow statement. Then we try to understand the drivers behind those historic numbers and to make assumptions about the future of the company.

The model is not too complex, but it aims to provide fundamental understanding of the drivers of the revenues and the profits. Whether it refers to the minutes of use for a telephone company, the seats available from an airline, or the number of computers manufactured, it comes down to the same principle and to the understanding of the drivers of the volume, prices, and costs.

We make additional assumptions based on the working capital and capital expenditure requirements and analyze the industry direction and the macroeconomic drivers. Overall, building a financial model and inserting your assumptions means that you have to distill all the information down to hard numbers.

Q: What type of information do you mostly rely on?

A: We derive information from the company prospectus, the annual reports, the quarterly filings and interim statements. We may use brokers' research to get some background on the company, but we do not use their opinions. We may visit the company only at the end of the process to clarify the details. The chief executive may be a very charismatic fellow and, therefore, you may be carried along with his vision. Therefore, we prefer to meet the management after we have developed an unbiased view and a level of understanding of the company.

Q: How do you approach the portfolio construction process? Do you follow any benchmarks?

A: The portfolio is put together on a bottom-up basis and I do not spend too much time worrying about individual weightings. We use a benchmark, the MSCI All Country Far East ex Japan Index, but we deviate widely from it. For example, Australia has a 33% weighting in the benchmark, while it has 7% in the fund. Thailand has a weighting of 2% in the benchmark, while we have invested 21% there. We use the bench-


mark mainly as a framework of the split between individual countries and sectors, but we are not trying to replicate it.

The concentrated portfolio has 40 names that are equally weighted. If I do not like a stock, I wouldn't trim it but I would sell and replace it. We don't have specific limits on the country or sector exposures, but we try to avoid concentration. Currently, we have about a dozen of sectors represented in the fund, including telecommunications, banks, consumer stocks, and utilities. We also split our exposure in a particular country among certain sectors and, more importantly, we would know why we chose those sectors.

Q: What types of risks do you monitor and how do you control them?

A: Diversification is a major risk control as the portfolio is reasonably spread among countries and sectors. But we do very little formal risk monitoring because I don't manage the fund to a benchmark. Our purpose is to provide a diversified portfolio of high-yielding Asian companies. The volatility of the fund is going to be higher than in a U.S. domestic portfolio because Asian markets have higher volatility. But since the fund was launched, its average volatility has been around 14%, compared to 10% for the S&P 500, and 17% for Asia.

We manage the risk of capital loss through the due diligence process and through investing in companies that generate stable cash flows. Such companies may see some deterioration, but if they generate cash, the absolute risk of loss is low.

Overall, I believe that the best way to deal with the risk is to know your exposure and the underlying reasons. Currently, we have a tilt towards finance, materials, and technology sectors. On the country level, we have taken a big position in Thailand and we are under-exposed to Korea and Australia. We have scaled back our exposure to the China growth story, which was a major driver of the performance and the volatility. As we shift towards the domestic Asian growth, I expect the volatility to drop further. So we keep an eye on the risk generated by our exposure, but we don't formally value or manage the risk to a benchmark. 

Guinness Atkinson Asia Pacific Dividend Fund

Symbol	GAADX
Website	www.gafunds.com
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Tel. No.	800-915-6566
Inception	03/31/2006

PORTFOLIO

Total Net Assets*	\$42.4
Avg Mkt Cap (\$ Weighted)*	\$14,940
Average Price/Earnings Ratio	12.84
Average Price/Book Ratio	2.68
Turnover Ratio	34%

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$5,000
Min Subsequent Investment	\$250
Min Initial IRA Investment	\$1,000

RETURNS VS. S&P 500 INDEX

	GAADX	Index
1 Year (Cum.)	55.58%	14.56%
3 Year (Ann.)	N/A	N/A

RETURNS VS. MSCI AC PACIFIC EX JAPAN INDEX

	GAADX	Index
1 Year (Cum.)	55.58%	67.23%
3 Year (Ann.)	N/A	N/A

FEES AND EXPENSES

Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee**	2.00%
Total Expense Ratio	1.98%

PORTFOLIO MANAGER

Edmund Harriss	2006
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*millions **within 1 month after purchase

Data through: 10/31/2007

Source: Company Documents; Lipper

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