Fidelity China Special Situations

Outperforming in volatile markets

Investment trusts

Fidelity China Special Situations (FCSS) is a specialist actively managed fund focused on Chinese equities. Against the background of exceptional market volatility recently, FCSS has outperformed with NAV total returns ahead of the benchmark MSCI China index over one, three and five years, and it has substantially outperformed all closed- and open-ended peers over three years. The manager has maintained a consistent investment approach through recent market fluctuations focusing on consumption-led sectors where long-term growth is expected to exceed GDP growth.

12 months ending	Total share price return (%)	Total NAV return (%)	MSCI China (%)	MSCI World (%)	FTSE All-Share (%)
31/07/12	(22.8)	(21.2)	(9.8)	3.3	0.4
31/07/13	28.1	33.9	11.8	28.1	24.3
31/07/14	20.4	25.0	8.2	4.7	5.6
31/07/15	24.2	34.9	11.5	14.1	5.4

Note: Twelve-month rolling discrete £-adjusted total return performance.

Investment strategy: China-focused stock selection

Portfolio construction is based on bottom-up stock selection across a broad range of Chinese equities, unconstrained by the benchmark MSCI China index. The manager seeks undervalued companies with good long-term growth prospects, cash-generative businesses and strong management teams, aiming to invest in companies at valuations that do not reflect the quality and potential of the business. This has led to a bias towards smaller companies as they tend to be less well researched. Meeting management is an essential part of the process and risk management is a priority, with third-party background checks strengthening due diligence procedures. Futures, options and contracts for difference (CFDs) are used to provide gearing, as well as to take short positions.

Market outlook: Opportunities still exist

The strong 12-month Chinese stockmarket rally ended abruptly in April 2015 with a sharp correction. Increased market volatility and government market intervention have added to the uncertainty over the near-term market direction with concerns raised over any spillover from the correction to an already slowing economy. Even so it still seems reasonable to expect Chinese growth to be relatively attractive over the medium to long term providing a favourable backdrop for corporate earnings, with rebalancing improving growth prospects in consumer-oriented sectors. While the broader Chinese market valuation post-correction suggests limited scope for re-rating, the wide range of valuations across stocks and the potential for market volatility to persist suggests an environment that may suit stock pickers.

Valuation: Widening discount

FCSS's share price discount to NAV (including income) has followed a widening trend since June 2011. Negative market sentiment towards China has prevailed over FCSS's strong performance since 2013 and the discount currently stands at 17.6%, which compares to its one-year average of 12.5%, suggesting scope for it to narrow when market sentiment improves.

4 August 2015

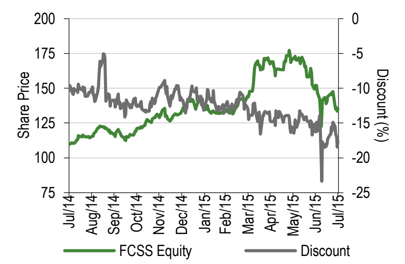
Price	**132.6p**
Market cap	**£740m**
AUM	**£1,115m**

NAV*	162.5p
Discount to NAV	17.0%
NAV**	163.7p
Discount to NAV	17.6%

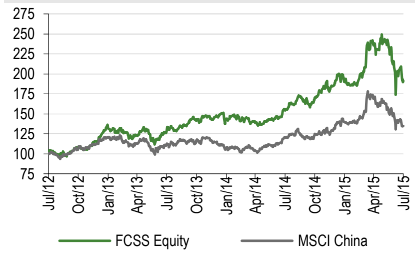
*Excluding income. **Including income.

Yield	1.0%
Ordinary shares in issue	557.7m
Code	FCSS
Primary exchange	LSE
AIC sector	Country specialists – Asia Pacific

Share price/discount performance*



Three-year cumulative perf. graph



52-week high/low	177.3p	109.9p
NAV** high/low	206.9p	121.5p

**Including income.

Gearing

Gross asset exposure	121.6%
Net asset exposure*	110.0%

*Market exposure net of short positions.

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Edison profile page

Fidelity China Special Situations is a research client of Edison Investment Research Limited

Exhibit 1: Trust at a glance

Investment objective and fund background

Fidelity China Special Situations aims to achieve long-term capital growth from an actively managed portfolio made up primarily of securities issued by companies listed in China or Hong Kong and Chinese companies listed elsewhere. It may also invest in listed companies with significant interests in China and Hong Kong.

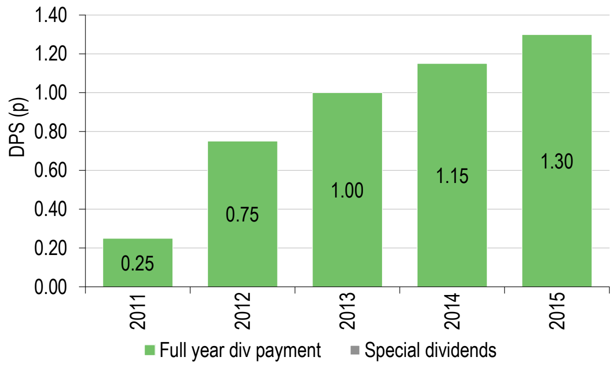
Recent developments

- 12 March 2015: Full-year results to 31 March 2015. NAV TR +45.3% vs +39.3% benchmark MSCI China index; FY15 dividend +13% to 1.30p.
- 19 November 2014: Results for six months to 30 September 2014. NAV TR +16.8% vs +10.1% MSCI China index.

Forthcoming		Capital structure		Fund details	
AGM	July 2016	Ongoing charges	1.29% (1.94% incl. perf. fee)	Group	Fidelity Worldwide Investment
Interim results	November 2015	Net asset exposure*	110.0%	Managers	Dale Nicholls
Year end	31 March	Annual mgmt fee	1.0% of net assets	Address	Beech Gate, Millfield Lane, Lower Kingswood, Tadworth, KT20 6RP
Dividend paid	July	Performance fee	See page 7		
Launch date	April 2010	Trust life	Indefinite	Phone	0800 41 41 10
Continuation vote	No	Loan facilities	US$150m revolving	Website	www.fidelity.co.uk/chinaspecial

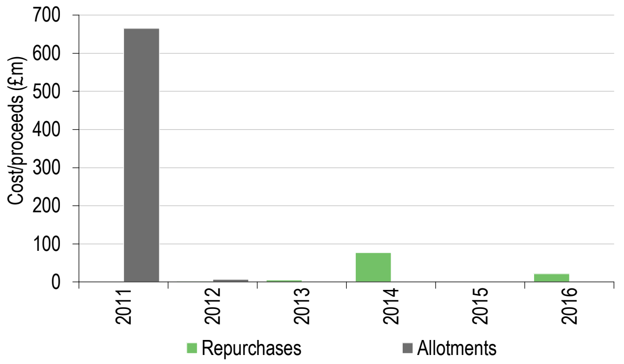
Dividend policy and history

Dividends are paid annually. While focused on capital growth, as an investment trust, FCSS will pay out at least 85% of income received.



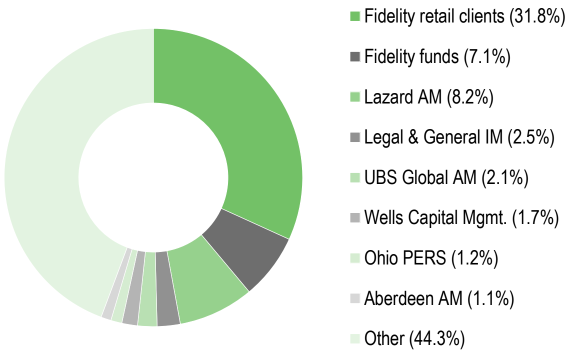
Share buyback policy and history

FCSS will buy back shares at a discount or issue them at a premium to keep the share price close to NAV. There is no rigid discount control mechanism.



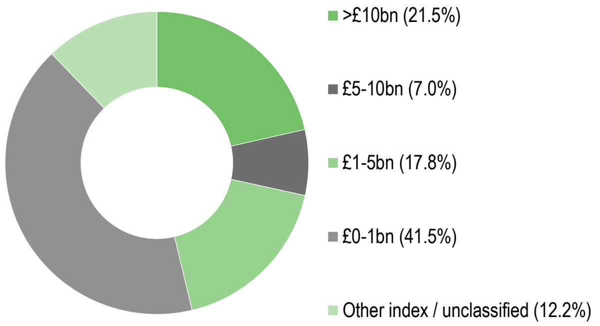
Shareholder base (as at 29 July 2015)

The directors report that over 80,000 private investors are FCSS shareholders, the majority being Fidelity ISA and share plan clients.



Portfolio exposure by market cap (as at 30 June 2015)

FCSS has a small- and mid-cap bias reflecting the manager's view that these stocks tend to be less researched and provide more mispricing opportunities.



Top 10 holdings (as at 30 June 2015)

Company	Country of listing	Sector	Portfolio weight % 30 June 2015	Portfolio weight % 30 June 2014**	Benchmark weight %	Active weight vs benchmark
Tencent	China	Information Technology	7.6	8.2	10.3	(2.7)
Ping An Insurance	China	Financials	5.4	2.8	3.5	1.9
China Pacific Insurance	China	Financials	3.2	N/A	1.3	1.9
Shanghai Int'l Airport	China	Industrials	2.5	N/A	0.0	2.5
China Lodging Group	China	Consumer Discretionary	2.2	N/A	0.0	2.2
Citic Telecom International	Hong Kong	Telecom Services	2.2	N/A	0.0	2.2
Netease	China	Information Technology	2.1	N/A	0.0	2.1
Hutchison China Meditech	Hong Kong	Healthcare	2.0	2.5	0.0	2.0
Citic Securities	China	Financials	1.9	3.2	0.8	1.1
Lee's Pharmaceutical	Hong Kong	Healthcare	1.8	2.3	0.0	1.8
Top 10			**30.8**	**N/A**	**15.9**	

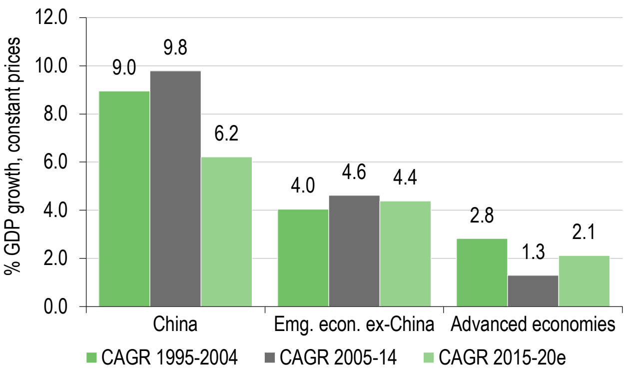
Source: Fidelity China Special Situations, Edison Investment Research, Morningstar, Thomson. Note: *Market exposure net of short positions (capital structure). **N/A where not in June 2014 top 10.

Market outlook: Opportunities still exist

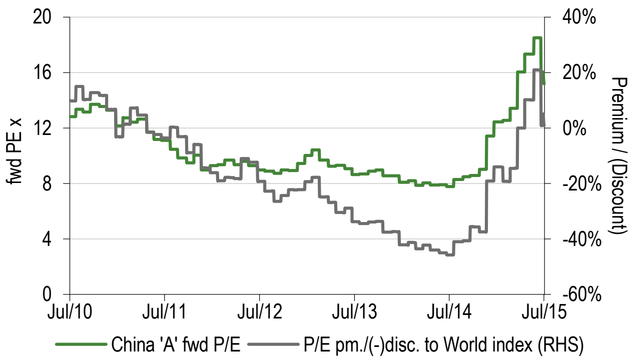
An exceptionally strong 12-month Chinese stockmarket rally ended abruptly in April 2015 with a sharp correction over the following three months. This sequence of events saw the MSCI China index gain 75% in sterling terms before falling by 27%. While this translated into a strong net gain of 29% for the index, increased market volatility, together with a large number of share suspensions, market intervention by the government and concerns over the potential effect of the market correction on an already slowing economy, have clouded the near-term outlook. The rally propelled the China 'A' share market forward P/E multiple from a c 45% discount to a c 20% premium relative to world markets (Exhibit 2 right-hand chart). The correction has eliminated this premium, but prospects for the market to move higher due to re-rating seem greatly diminished compared with a year ago and it is uncertain whether the correction has fully run its course.

Exhibit 2: China GDP growth and market valuation versus world

Average % real GDP growth – China vs emerging & advanced economies



Datastream China 'A' index forward P/E vs world



Source: IMF April 2015 WEO, Thomson Datastream, Edison Investment Research

Although concerns exist over the slowing of the Chinese economy, it is still expected to grow at a relatively attractive rate over the next five years, as reflected in the IMF's April projections (Exhibit 2 left-hand chart). This provides a positive backdrop for corporate earnings growth and consumer-oriented sectors are expected to see faster growth due to the rebalancing of the economy away from fixed-asset investment. The broader market valuation suggests limited scope for re-rating, but not all stocks participated in the rally to the same extent and there is a wide range of valuations across individual companies. The variation in growth prospects and valuations across sectors and individual stocks make a fund such as FCSS with its bottom-up approach to stock selection appear well-suited to accessing the more sustainable growth opportunities in the Chinese market.

Fund profile: China-focused investment

Launched in April 2010, FCSS is a closed-ended investment trust listed on the LSE, aiming to provide UK investors with a suitable route to access the China growth story in a diversified portfolio. FCSS's investment objective is to achieve long-term capital growth from an actively managed portfolio, primarily comprising securities of companies listed in China or Hong Kong and Chinese companies listed on other recognised exchanges, while also investing in other listed companies with significant interests in China and Hong Kong. Performance is benchmarked against the MSCI China index expressed in UK sterling and the portfolio is managed by Fidelity Worldwide Investment (Fidelity), whose investment approach is characterised by bottom-up stock picking facilitated by extensive research capabilities. Fidelity has held a QFII licence since September 2010, recently increasing its quota from US$400m to US$1.2bn. This provides scope for FCSS to increase substantially the US$125m it utilises to invest directly in China 'A' shares rather than indirectly using the Hong Kong-Shanghai Stock Connect programme. Anthony Bolton managed the trust from launch and was succeeded by Dale Nicholls in April 2014. Nicholls has 20 years' investment experience principally in the Asia-Pacific region and has managed Fidelity's Pacific Fund since September 2003. While Nicholls is not solely focused on FCSS, China represents the Pacific fund's largest exposure and there is a large overlap in holdings between the two funds.

The fund manager: Dale Nicholls

The manager's view: Rebalancing of economy still underway

Dale Nicholls remains sanguine about recent Chinese market volatility, stock suspensions and government market intervention and does not anticipate any major ramifications for the Chinese economy. He sees the main implication for the portfolio as the less promising outlook for brokerage stocks with a slower pace of IPO activity expected. He notes that FCSS sold down brokerage holdings including Citic Securities and Haitong Securities in March, April and May from 5-6% of the portfolio to c 2% and valuations have fallen to a level where he would consider adding to exposure.

Nicholls acknowledges the disappointing rate of progress of China's reform programme and expresses misgivings about recent government efforts to support financial markets, but sees the rebalancing to a consumer-led economy as still underway and this continues to drive core themes in the portfolio such as growing mass-market consumption, rising internet penetration and increasing Chinese middle class affluence. Growing numbers of Chinese overseas travellers and the opening of Shanghai Disneyland in 2016 are expected to benefit Shanghai International Airport, one of the largest new additions to the portfolio, considered to have expansion potential, as well as scope to improve returns through developing its retail concessions. Another recent portfolio addition reflecting the infrastructure theme is Qingdao Port International, seen to be growing its value-added services and trading on an undemanding 10x P/E multiple.

Insurance is still viewed as an attractive sector benefiting from a growing market for higher-margin protection products. Structural growth drivers for the healthcare sector remain in place but exposure has been reduced as valuations are less attractive and pricing pressures are growing, particularly for pharmaceutical companies. Although the portfolio remains underweight telecoms, Citic Telecom, the largest fixed-line and mobile operator in Macau, has been added reflecting its strong market position and the potential for its parent company to inject assets with good development prospects.

Asset allocation

Investment process: Bottom-up stock selection

The portfolio is constructed using a bottom-up stock selection approach and allocations are not set with reference to the benchmark index. Overall, the manager looks for undervalued companies that can deliver outperformance over the long term and seeks to identify companies with good long-term growth prospects, cash-generative businesses and strong management teams. The aim is to find companies trading on valuations that do not reflect the quality and potential of the business. This leads to a bias towards smaller companies that tend to be less well researched and where there is greater potential for the shares to be mispriced. Meeting management is considered an essential part of the process to gain an understanding of companies and monitor their progress. The portfolio manager undertakes an intensive schedule of c 700 company meetings and visits each year. The manager is supported by Fidelity's significant resources, with 24 analysts providing relevant stock coverage, including 10 analysts dedicated to Chinese equities. Risk management is seen as key to the investment process with third-party resources employed to provide additional due diligence checks on companies and corporate governance verification before FCSS makes an investment.

FCSS uses futures, options and CFDs to enhance portfolio performance, as well as for efficient portfolio management and hedging. The trust can invest in China 'A' shares, both directly through the investment manager's QFII licence and indirectly through brokers that have a QFII facility. Up to 5% of gross assets may be invested in unlisted securities and the aggregate gross asset exposure of short positions is limited to 15%.

Current portfolio positioning

At 30 June 2015, FCSS held c 140 investments with the top 10 holdings representing 30.8% of the portfolio (Exhibit 1), similar to 31.7% a year earlier. The manager reports portfolio turnover of c 20% in the June 2015 quarter, similar to the c 70% rate in FY15, with no major increase in portfolio activity in July 2015. Five changes in the top 10 holdings over the year include three new additions to the portfolio, while all five stocks leaving the top 10 remain in the portfolio. Although the manager currently reports finding most value in larger-cap stocks in the 'A' share segment of the market, a small/mid-cap bias is retained overall, and stocks below £1bn market cap represent over 40% of the portfolio (Exhibit 1). No unlisted shares have been held since Alibaba's IPO in September 2014.

As shown in Exhibit 3, while there were shifts in sector exposure over the year to end June 2015, the predominant active exposures remain underweight financials and overweight consumer discretionary, with an increased active position in each. Other significant changes in active weights were 6.0pp and 3.5pp reductions in the information technology and healthcare overweights and 4.2pp increases in industrials and consumer staples moving both sectors to overweight. Active underweight exposures broadly reflect the sectors dominated by state-owned enterprises.

Exhibit 3: Portfolio total sector exposure analysis vs benchmark (%)

	Portfolio end June 2015	Portfolio end June 2014*	Change	MSCI China index weight	Active weight vs index	Trust weight/ index weight
Consumer Discretionary	25.5	22.8	2.7	4.5	21.0	5.7
Financials	19.5	17.6	1.9	43.2	(23.7)	0.5
Information Technology	19.3	25.3	(6.0)	13.4	5.9	1.4
Industrials	10.9	5.6	5.4	7.5	3.4	1.5
Health Care	8.2	11.3	(3.2)	2.1	6.1	3.9
Consumer Staples	5.4	3.0	2.4	3.7	1.7	1.5
Materials	3.6	3.1	0.5	2.3	1.3	1.6
Energy	2.7	6.0	(3.3)	9.0	(6.3)	0.3
Telecommunication Services	2.6	1.0	1.6	10.1	(7.5)	0.3
Utilities	2.3	4.3	(2.1)	4.2	(1.9)	0.5
	100.0	**100.0**		**100.0**		

Source: Fidelity China Special Situations, Edison Investment Research. Note: *Adjusted for 4.6% exposure to Alibaba, which was reclassified from Consumer Discretionary to Information Technology in September 2014.

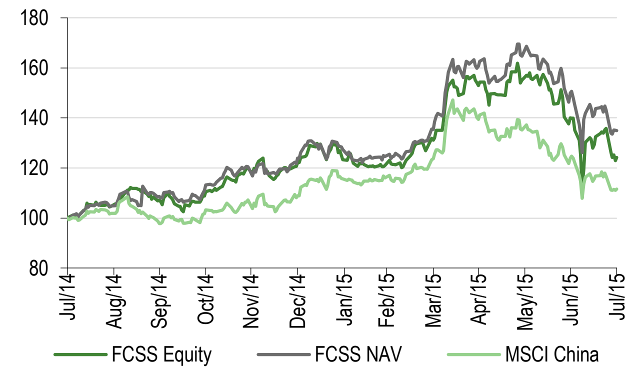
As well as gaining exposure to individual equities directly and through CFDs, FCSS has used Hang Seng China Enterprises index call options to act as a hedge against its underweight banks exposure and a FTSE China 50 index short ETF to hedge against a general fall in the market. Net index exposure as a proportion of net assets was moved steadily from a 3.0% long position at end March 2015 to a 5.1% short position at end June 2015. CFDs are also used to take short positions in individual stocks and the manager reports that these reached 3-4% of net assets in July 2015.

Performance: Strong three-year outperformance

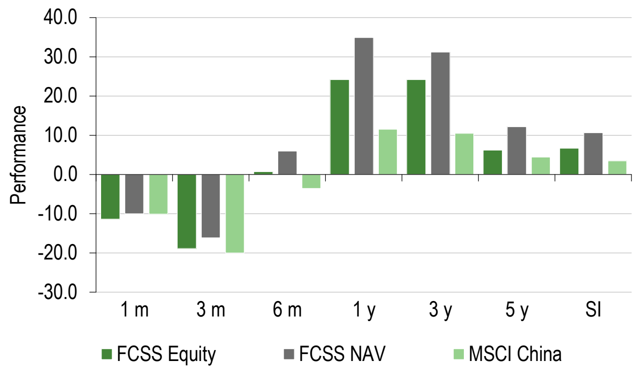
As shown in Exhibit 5, FCSS has outperformed its MSCI China index benchmark over one, three and five years and since its inception in April 2010. As illustrated in Exhibit 4, the trust has delivered strong absolute and relative performance over the last year, achieving greater outperformance during the 24% decline of the benchmark index in sterling terms since mid-April 2015. Exhibit 6 shows that after a weaker performance during 2011 and 2012, FCSS has strongly outperformed the benchmark index since December 2012 despite a recent dip arising from its exposure to the 'A' share market (not represented in the MSCI China index). The Chinese market itself showed a relatively weak performance compared with world markets from early 2011 to mid-2014, followed by strong outperformance as the index climbed 75% in sterling terms from May 2014 to April 2015. In spite of the recent sharp decline of the Chinese market, FCSS has outperformed both the MSCI World and FTSE All-Share indices over one and three years, helped by recently reduced net gearing, along with strong financials and information technology contributions.

Exhibit 4: Investment trust performance to 31 July 2015

Price, NAV and benchmark total return performance, one-year rebased



Price, NAV and benchmark total return performance (%)



Source: Thomson Datastream, Edison Investment Research. Note: Three and five-year and SI (since inception) performance figures annualised. Inception date is 19 April 2010.

Exhibit 5: Share price and NAV total return performance, versus indices (percentage points)

	One month	Three months	Six months	One year	Three years	Five years	Since inception
Price versus MSCI China	(1.5)	1.5	4.4	11.3	41.9	8.7	17.4
NAV versus MSCI China	0.0	4.9	9.8	21.0	67.3	42.5	42.3
Price versus MSCI World	(13.6)	(17.5)	(2.0)	8.8	25.1	(24.7)	(14.2)
NAV versus MSCI World	(12.3)	(14.7)	3.1	18.2	47.5	(1.3)	4.0
Price versus FTSE All-Share	(13.4)	(17.0)	(2.0)	17.8	38.4	(15.2)	(5.0)
NAV versus FTSE All-Share	(12.1)	(14.2)	3.1	28.1	63.2	11.2	15.1

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-July 2015. Geometric calculation.

Exhibit 6: NAV performance relative to MSCI China index since launch

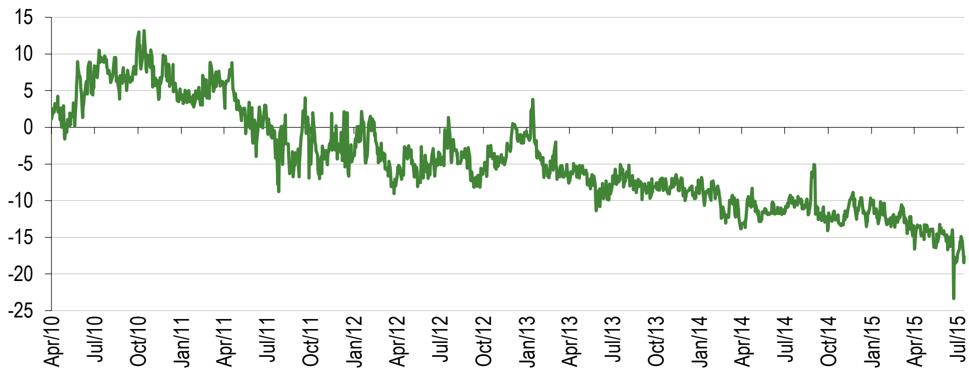
Source: Thomson Datastream, Edison Investment Research

Discount: Widening trend

Although the board has made no commitment to maintain the discount at a particular level, it believes that it is in the best interests of shareholders for the share price to track closely to NAV and in April 2015, with the discount at c 14%, the trust recommenced buying back shares into treasury.

As illustrated in Exhibit 7, after trading at a premium following launch in April 2010, FCSS shares moved to a discount to NAV (including income) in June 2011. The discount subsequently followed a widening trend, arguably reflecting FCSS's weak relative performance during 2011 and 2012, with negative market sentiment towards China prevailing over the trust's strong performance since 2013. The discount currently stands at 17.6%, which compares to its one-year average of 12.5%, suggesting scope for it to narrow when market sentiment improves.

Exhibit 7: Share price premium/discount to NAV (including income) since launch (%)



Source: Thomson Datastream, Edison Investment Research. Note: Negative values indicate a discount, positive values a premium.

Capital structure and fees

FCSS has 557.7m shares in issue with a further 13.7m shares held in treasury, having repurchased 13.6m (2.4% of issued capital) since April 2015. FCSS has authority to buy back up to 14.99% and allot up to 10% of the issued share capital. Shares may only be repurchased at prices below NAV per share, either for cancellation or to be held in treasury, and subsequently reissued at or above NAV per share. FCSS has a fully drawn US$150m three-year credit facility (to February 2017), representing c 10% of net assets against a 25% limit, and uses CFDs to achieve further gearing. Gearing is reported as the gross market exposure provided by equity and CFD investments plus the gross value of futures and options positions. This is restricted to a maximum 30% of net assets and stood at 21.6% at 30 June 2015. Net gearing (market exposure net of short positions) was 10.0% at 30 June 2015, down from 21.1% at end March 2015, with the manager reducing gross gearing and increasing short positions in April and May 2015 during the later stages of the market rally.

From April 2014, the management fee was reduced from 1.2% pa to 1.0% pa of net assets and the cap on performance fees was lowered from 1.5% to 1.0%, with excess outperformance no longer carried forward. A 15% performance fee is paid on returns more than 2% above the benchmark MSCI China index. For FY15, ongoing charges were 1.29% (1.94% including performance fees).

Dividend policy

Although dividends are not expected to constitute a material element of returns to shareholders, as an investment trust, FCSS distributes at least 85% of its income and it also has the flexibility to pay dividends out of capital profits if circumstances should warrant. A dividend is paid annually and has been increased in each of the four years since the first distribution in 2011 (see Exhibit 1). The FY15 dividend was increased by 13% to 1.30p representing a 1.0% yield. Adjusting for payment of the FY15 dividend, revenue reserves at 31 March 2015 represented 1.0p per share.

Peer group comparison

Exhibit 8 shows a comparison of FCSS with similar closed-ended funds and a selected peer group of open-ended funds focused on China and Greater China equities. JPMorgan Chinese is the only other fund in the AIC country specialists Asia-Pacific sector that is focused on Chinese equities, so we show AIC Asia-Pacific ex-Japan sector averages (39% average exposure to China and Greater China). Open-ended peers comprise funds larger than £250m from the IA China/Greater China sector. FCSS's NAV total return leads closed-ended and open-ended peers over one, three and five years, with very substantial outperformance over three years. In terms of risk-adjusted returns, FCSS's Sharpe ratios of 2.2 and 1.7 over one and three years rank at or close to the top of the closed-ended peer group. FCSS's ongoing charge of 1.29% is at a broadly similar level to closed-ended peers and compares favourably with the open-ended peer group average of 1.93%.

Exhibit 8: Funds investing in Chinese equities: Total returns, Discounts and Charges as at 28 July 2015

% unless stated	Market cap/ fund size £m	NAV TR 1 Year	NAV TR 3 Year	NAV TR 5 Year	NAV TR 10 Year	Sharpe 1y (NAV)	Sharpe 3y (NAV)	Discount (ex-par)	Ongoing charge/ TER	Net gearing	Dividend yield (%)
Fidelity China Special Situations	763.0	32.7	123.5	72.3		2.2	1.7	(15.6)	1.29	125	1.0
JPMorgan Chinese	126.3	9.8	49.8	43.3	206.5	1.4	1.2	(15.2)	1.40	114	1.0
Asia-Pacific ex-Japan average	**265.9**	**2.3**	**27.0**	**44.5**	**182.6**	**0.7**	**0.8**	**(9.1)**	**1.15**	**103**	**2.2**
Mutual Funds											
Aberdeen Global Chinese Equity	932.5	4.7							1.97		
Allianz China Equity	339.6	19.0	43.8	24.9					2.28		
Fidelity China Focus	3,776.7	24.9	51.6	31.3	304.2				1.93		
First State Greater China Growth	432.0	5.3	36.6	45.8	266.2				1.84		
GAM Star China Equity	1,202.1	8.9	63.0						1.55		
Henderson China Opportunities	575.8	9.9	49.9	26.2	224.8				1.73		
HSBC GIF Chinese Equity	1,260.5	16.2	41.5	23.1					1.90		
Invesco Perpetual Hong Kong & China	345.9	6.7	60.8	47.7	222.8				1.69		
Schroder ISF Greater China	578.8	12.0	37.1	24.5	178.5				1.94		
Templeton China	535.9	2.5	12.7	1.2					2.45		
Average	**998.0**	**11.0**	**44.1**	**28.1**	**239.3**				**1.93**		

Source: Morningstar, FE Trustnet, Thomson Datastream, Edison Investment Research. Note: TR = total return. The Sharpe ratio is a measure of risk-adjusted return. The ratios we show are calculated by Morningstar for the past 12- and 36-month periods by dividing a fund's annualised excess returns over the risk-free rate by its annualised standard deviation. Net gearing is total assets less cash and cash equivalents as a percentage of shareholders' funds.

The board

The board comprises six non-executive directors, all of whom are independent, with the exception of Andrew Wells. John Owen (chairman), Nicholas Bull (senior independent director), David Causer and Peter Pleydell-Bouverie have served on the board since February 2010. Elisabeth Scott was appointed as a director in November 2011 and Andrew Wells (Fidelity's global chief investment officer, fixed income) joined the board in May 2012.

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