EDISON

Fidelity China Special Situations

Still finding investment opportunities

Investment trusts

Fidelity China Special Situations (FCSS) was launched in April 2010 aiming to generate long-term capital growth from investing in Chinese companies or companies that generate the majority of their revenues in China. Manager Dale Nicholls invests for the long term, seeking companies with long-term growth potential that are trading at reasonable valuations. FCSS's NAV and share price absolute total returns have been very strong over the last 12 months, and the trust has meaningfully outperformed the index over one, three and five years and since the fund's inception. FCSS has also outperformed the majority of its open- and closed-ended peers over one, three and five years.

12 months ending	Share price (%)	NAV (%)	MSCI China (%)	MSCI World (%)	FTSE All-Share (%)
31/03/13	15.0	15.6	12.5	18.4	16.8
31/03/14	14.1	19.5	(6.6)	9.0	8.8
31/03/15	39.9	45.7	39.6	19.7	6.6
31/03/16	(4.5)	(0.3)	(16.0)	0.3	(3.9)
31/03/17	45.8	39.3	37.9	32.7	22.0

Source: Thomson Datastream. Note: All % on a total return basis in GBP.

Investment strategy: Focus on quality and value

The manager has a bottom-up investment approach and the bulk of the portfolio is invested in mid- and small-cap stocks with positive growth profiles that he believes are mispriced. He is able to draw on Fidelity's broad analyst team to build a portfolio, typically comprising 130 to 140 positions, focusing on companies with robust cash flows and strong management. Site visits and meeting company managements are a key part of the investment process. Gross gearing at end-February 2017 was 27.5%, this compares to the permitted level of 30.0%.

Market outlook: Improving investor sentiment

Although Chinese equities have been positively re-rated since a five-year relative low in February 2016, on a forward P/E basis, they continue to trade at a c 50% discount to world equities. While the Chinese stock market has historically experienced periods of volatility, investors with a long-term view may see appeal in having exposure to a country with higher forecast economic growth than both developed economies and other emerging markets via a fund targeting sectors which should benefit from a shift from investment- to consumption-led growth.

Valuation: Scope for discount to narrow further

FCSS's current 12.7% share price discount to cum-income NAV is narrower than the 15.6% average of the last 12 months and compares to the averages of the last three and five years and since the trust's inception of 14.3%, 11.1% and 7.3%. The discount has been in a narrowing trend since mid-2016 and there is scope for it to narrow further if investor sentiment towards Chinese equities continues to improve or the manager is able to build on his positive relative performance track record. While managed for capital return, FCSS has increased its annual dividend at an average compound rate of c 25% over the last four years; the current yield is 0.9%.

4 April 2017

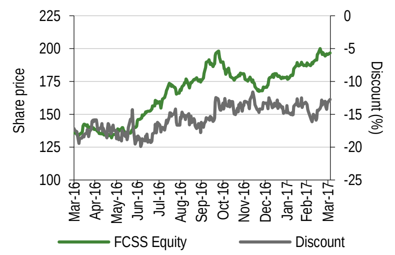
Price	**196.7p**
Market cap	**£1,086m**
AUM	**£1,356m**

NAV*	222.5p
Discount to NAV	11.6%
NAV**	225.3p
Discount to NAV	12.7%

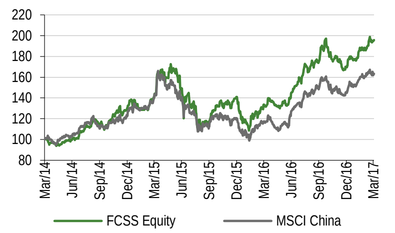
*Excluding income. **Including income. As at 31 March 2017.

Yield	0.9%
Ordinary shares in issue	551.9m
Code	FCSS
Primary exchange	LSE
AIC sector	Country Specialists: Asia Pacific
Benchmark	MSCI China

Share price/discount performance



Three-year performance vs index



52-week high/low	200.0p	132.2p
NAV** high/low	232.8p	159.8p

**Including income.

Gearing

Gross market exposure*	127.5%
Net market exposure*	122.3%

*As at 28 February 2017.

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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. Futures, options and contracts for difference (CFDs) are used to provide gearing, as well as to take short positions.

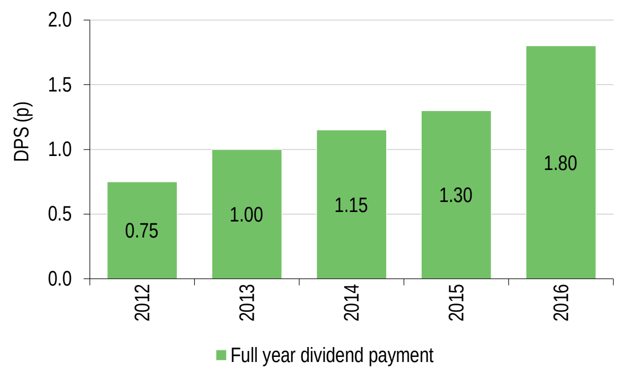
Recent developments

- 14 February 2017: Entered into new $150m three-year revolving credit facility with Scotiabank Europe.
- 21 November 2016: Six months report ending 30 September 2016. NAV TR +29.1% versus benchmark TR +26.2%. Share price TR +30.8%.
- 22 July 2016: Nicholas Bull appointed as chairman of the board following the retirement of John Owen.

Forthcoming		Capital structure		Fund details	
AGM	July 2017	Ongoing charges	1.23% (30 September 2016)	Group	Fidelity International
Final results	June 2017	Net market exposure*	122.3%	Manager	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	$150m revolving	Website	fidelity.co.uk/chinaspecial

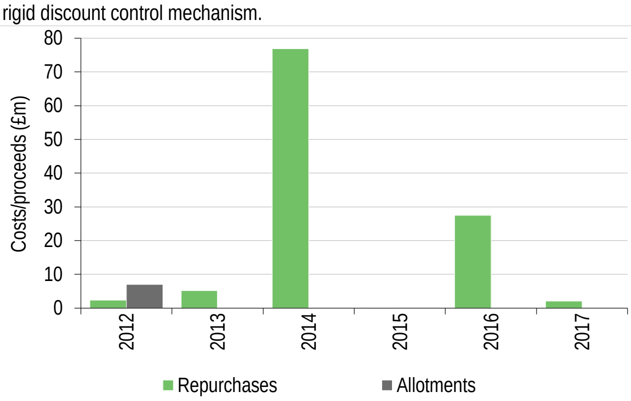
Dividend policy and history (financial years)

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

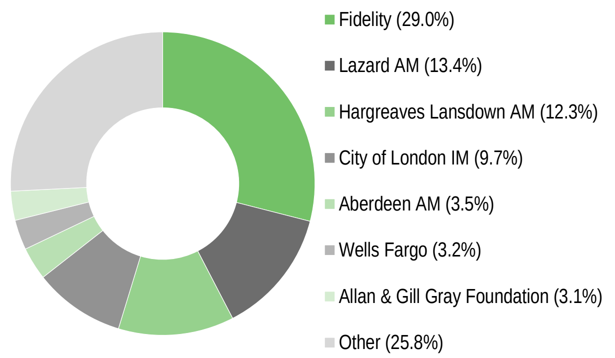


Share buyback policy and history (financial years)

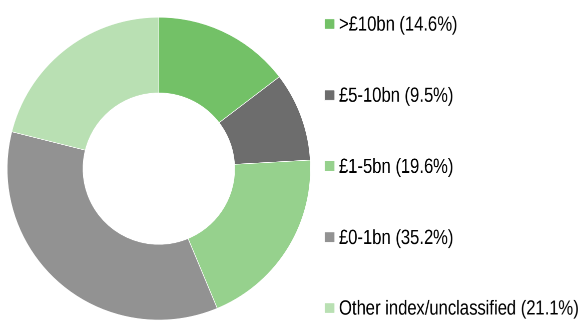
When the board deems it appropriate, FCSS will buy back shares at a discount or issue them at a premium to keep the share price close to NAV. There is no rigid discount control mechanism.



Shareholder base (as at 28 February 2017)



Portfolio exposure by market cap (as at 28 February 2017)



Top 10 holdings (as at 28 February 2017)

			Portfolio weight (%)			
Company	Country	Sector	28 February 2017	29 February 2016**	Benchmark weight (%)	Active weight vs benchmark
Tencent	China	Information technology	11.5	10.2	13.1	(1.6)
Alibaba	China	Information technology	9.5	3.2	10.0	(0.5)
China Pacific Insurance	China	Financials	5.0	5.4	0.8	4.2
China Petroleum & Chem.	China	Energy	2.7	2.1	1.7	1.0
Ctrip	China	Consumer discretionary	2.6	N/A	1.5	1.1
Citic Telecom International	Hong Kong	Telecom services	2.3	3.6	0.0	2.3
Hutchison China MediTech	Hong Kong	Healthcare	2.1	3.2	0.0	2.1
Shanghai Intl. Airport	China	Industrials	1.9	2.8	0.0	1.9
Brilliance China Auto	China	Consumer discretionary	1.9	N/A	0.4	1.5
CT Environmental	China	Utilities	1.8	N/A	0.0	1.8
Top 10			41.3	37.4		

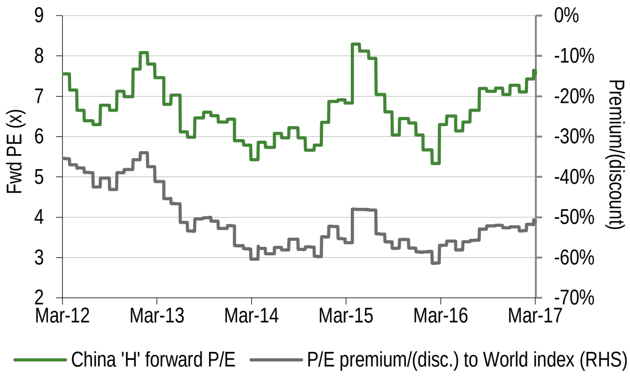
Source: Fidelity China Special Situations, Edison Investment Research, Bloomberg, Morningstar. Note: *Gearing net of short positions. **N/A where not in February 2016 top 10.

Market outlook: Potential for continued revaluation

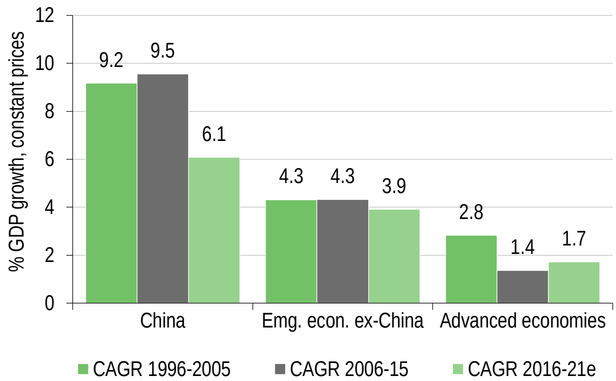
Exhibit 2 (left-hand side) shows the valuation over the last five years of Chinese companies listed in Hong Kong (the 'H' share market). Although there has been some positive revaluation since the relative low point in February 2016, 'H' shares are still trading at a c 50% discount to world indices, which is broadly in line with the average of the last five years. In absolute terms, the current 7.6x forward P/E multiple compares to the 6.6x average of the last five years. There is potential for further rerating of Chinese equities; as shown in Exhibit 2 (right-hand side) in its October 2016 World Economic Outlook, the International Monetary Fund forecasts higher economic growth for China versus both advanced economies and other emerging markets. This could translate into stronger corporate earnings growth for consumer-related sectors such as technology, as China transitions from an investment to a consumption-led economy. Also, if Chinese policymakers increase the emphasis on reform rather than economic growth, there is potential for higher returns from state-owned enterprises (SOEs). While bearing in mind that the Chinese stock market can be volatile, for investors looking to gain exposure to Chinese equities, a fund invested for the long term, with an unconstrained approach and a strong performance track record, may appeal.

Exhibit 2: China GDP growth and market valuation versus world

Datastream China 'H' index forward P/E vs World index over five years



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



Source: Thomson Datastream, Edison Investment Research, IMF WEO October 2016

Fund profile: Broad exposure to Chinese equities

Launched in April 2010, FCSS aims to generate long-term capital growth by investing primarily in a diversified portfolio of companies listed in China or Hong Kong and Chinese companies listed elsewhere. It may also invest in listed companies that have significant operations in China and Hong Kong. Derivatives are permitted for efficient portfolio management and hedging.

At the time of investment, no single position may exceed 15% of the portfolio and short positions are permitted up to 15% of gross assets. FCSS may borrow up to 25% of net assets and gross asset exposure, either from borrowing or derivatives, will not exceed net assets by more than 30%. At the July 2016 AGM, the permitted level of investment in unlisted securities was increased from 5% to 10% of gross assets. FCSS may invest in 'A' shares either directly through the investment manager's Qualified Foreign Institutional Investor (QFII) licence or indirectly through third parties who hold a QFII. The trust is benchmarked against the MSCI China index (sterling adjusted).

Since 1 April 2014, FCSS has been managed by Dale Nicholls, who joined Fidelity in 1996 as a Japanese research analyst and since 2003 has managed portfolios of Asian equities, including China. Along with FCSS, he currently manages the Fidelity Funds Pacific Fund. Nicholls has a bottom-up investment style, seeking undervalued companies that have long-term growth potential.

The fund manager: Dale Nicholls

The manager's view: Still finding undervalued companies

Manager Dale Nicholls notes that there has been sector rotation within the Chinese stock market recently; cyclical companies (including financials) have performed better as an uptick in manufacturing purchasing manager indices and rising commodity prices indicate a more robust Chinese economy. However, the manager is still able to find undervalued steady, long-term growth companies to invest in. He comments that the valuation of Chinese equities remains low versus world equities with news headlines about China focusing on risks to economic growth, the amount of credit and geopolitical issues, which serve to keep relative multiples low. Nicholls believes that over time, stocks should follow earnings growth, so companies with attractive long-term growth profiles should see their share prices rerate positively in the future.

On the political front, the manager believes that with an expected change in five of the seven politburo members at the end of 2017, there will be a prospect of an increased focus on reform and less attention on economic growth. He suggests that the main driver of economic expansion will be domestic consumption as China continues its shift from an investment- to a consumption-led economy. Regarding the talk of protectionism by US president Trump, Nicholls suggests that the relationship between the US and China is already contentious and the trade balance is shifting with the percentage of Chinese exports into the US falling, while the percentage of US exports into China is rising. In addition, China is the second largest holder of US treasury bonds, which strengthens its bargaining position.

Asset allocation

Investment process: Bottom-up, long-term investment

Nicholls invests on a bottom-up basis, primarily in mid and small caps, seeking companies with long-term growth potential that he views as mispriced. He stresses the importance of investing for the long term. Nicholls looks for companies with strong cash generation and capable management teams. He is able to draw on the resources of Fidelity's team of 23 analysts researching Chinese equities (based in Hong Kong, Singapore and Shanghai). Smaller companies tend to be under-researched, which leads to a greater chance of mispricing, providing investment opportunities; however, small stocks can be considered higher risk making the company's risk management an important part of the investment process. Company meetings are a key element both in helping to identify potential new investments and also to monitor the progress of existing portfolio companies. FCSS typically holds a large number of stocks (130-140 companies). Short positions are currently between 200bp and 300bp and unlisted investment exposure is between 300bp and 350bp.

Current portfolio positioning

On a sector basis (Exhibit 3), over the last 12 months the largest increase in exposure was information technology (+4.8pp), while the largest decreases were materials (-3.3pp) and financials (-2.8pp). The largest active weights within the portfolio are an 18.6pp overweight position in the consumer discretionary sector and a 17.4bp underweight position in financials. The consumer discretionary sector is a fertile hunting ground for the manager's style of investing; many companies have attractive long-term growth profiles and Nicholls is able to identify firms trading on attractive valuations. Within financials, FCSS retains a zero weighting in Chinese banks based on the view that the level of non-performing loans will likely rise. Banks are addressing the issue by writing off bad loans, but this is occurring slowly and so may impede earnings growth over a protracted period.

Exhibit 3: Portfolio sector exposure vs benchmark (% unless stated)

	Portfolio end-February 2017	Portfolio end-February 2016	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/ index weight (x)
Consumer discretionary	28.3	27.8	0.5	9.7	18.6	2.9
Information technology	25.9	21.2	4.8	32.4	(6.5)	0.8
Industrials	14.4	13.1	1.3	5.5	8.9	2.6
Financials	9.3	12.1	(2.8)	26.6	(17.4)	0.3
Consumer staples	7.2	6.0	1.2	2.3	4.9	3.1
Healthcare	4.1	4.7	(0.6)	2.0	2.1	2.1
Energy	3.3	3.7	(0.4)	6.2	(2.9)	0.5
Telecom services	2.5	3.7	(1.2)	7.2	(4.7)	0.4
Materials	2.4	5.7	(3.3)	1.5	0.9	1.6
Utilities	2.0	2.1	(0.1)	2.7	(0.6)	0.8
Real estate*	0.6	N/A	N/A	3.9	(3.3)	0.2
	100.0	100.0		100.0		

Source: Fidelity China Special Situations, Edison Investment Research. Note: *Real estate was included in financials in February 2016.

Exposure to SOEs has increased from a mid-teens percentage to c 25% (although still well below the c 45% in the MSCI China benchmark). The manager's view is that in general, SOE reform has been slow, but he suggests that improvements may be on the horizon. He looks for SOE companies where management's interests are aligned with shareholders' (this tends to be less prevalent at SOEs), and which hold strong assets, such as airports, where operators are benefiting from rising consumption trends; internal and overseas air travel is growing at an annual double-digit rate. There is potential for industry reform given that many Chinese airports are losing money and there are opportunities to expand non-aeronautical operations, such as increasing retail operations.

Relatively recent additions to the portfolio include Chaowei Power, Fu Shou Yuan and Yihai. Chaowei Power is China's largest producer of electric bike batteries; in an industry where the top two players control 80% of the market, Chaowei is by far the largest. The pricing environment has been tough, as the two dominant players fought a price war, but is now moderating. The stock is very under researched and trading at a forward P/E multiple of 6.3x. Fu Shou Yuan is the leader in private funeral homes; an industry that is very underdeveloped in China, with plenty of room for a strong operator offering a high-quality service. Customers are not price sensitive and the company is able to invest up-front payments as the ability to offer pre-need arrangements is starting to be permitted. Yihai supplies hot pot condiments, focusing on high-end products (hot pots are a staple meal in China). It is a key supplier to its strategic partner and major shareholder, Haidilao, which is a large and growing restaurant chain. Yihai is leveraging the success at Haidilao to sell its products into the retail channel.

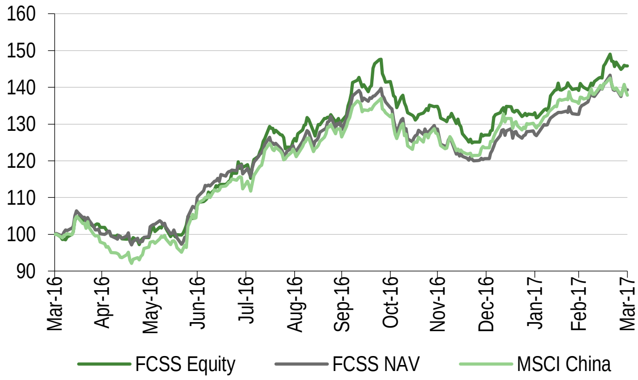
During 2016, the permitted allocation to unlisted investments was increased from 5% to 10%. Since our last report, the manager has invested in a third unlisted company. Along with Didi Chuxing and Meituan-Dianping, FCSS holds a position in Yiguo. This company is backed by Alibaba and at two-to-three times larger than its largest competitor is the clear leader in online fresh food sales. The manager considers that Yiguo has a strong management team, business trends are very strong and it benefits from high traffic on Alibaba's Tmall site. This latest investment means that total unlisted exposure is now between 300bp and 350bp. Nicholls suggests that there is significant entrepreneurial activity in China, especially in the technology sector, so there are plenty of unlisted opportunities in the pipeline. Expected returns from unlisted companies are significantly higher than for quoted securities, given the higher risk and that capital can be tied up for a significant period.

Performance: Strong absolute returns over 12 months

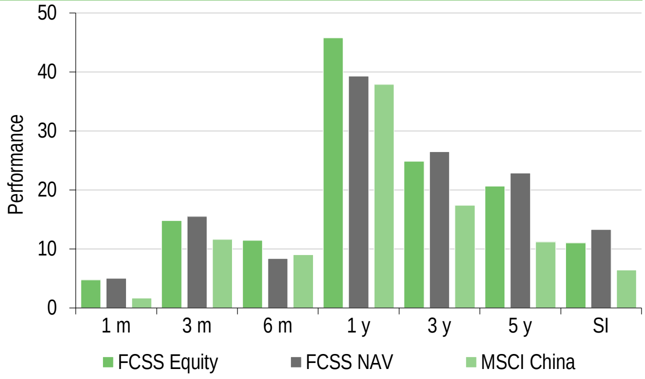
Absolute returns are shown in Exhibit 4 (right-hand side); over the last 12 months, FCSS's share price and NAV total returns of 45.8% and 39.3% respectively have been boosted by the weakness of sterling. FCSS's relative returns are illustrated in Exhibit 5; its NAV total return has outperformed the benchmark over one, three and five years and since inception. The manager comments that over the last six months, the largest detractors to performance are CT Environmental and Sinosoft Technology. Both companies have suffered from negative research coverage by short sellers (investors who sell stock, hoping to buy it back at a significantly lower price). Nicholls has thoroughly investigated the allegations contained in the research reports and has spoken at length to the management teams of both CT Environmental and Sinosoft Technology. He believes that the research is inaccurate and has added to his holdings in both of the companies following share price weakness. As a reference to UK shareholders, we show FCSS's performance versus the FTSE All-Share index. Its share price and NAV total returns have outperformed over one, three and five years and since inception.

Exhibit 4: Investment trust performance to 31 March 2017

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-year, five-year and SI (since inception) performance figures annualised. Inception date is 16 April 2010.

Exhibit 5: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	Since inception
Price relative to MSCI China	3.1	2.9	2.2	5.7	20.4	50.4	34.3
NAV relative to MSCI China	3.3	3.5	(0.6)	1.0	25.1	64.6	54.4
Price relative to MSCI World	4.1	9.0	(1.2)	9.9	22.2	24.2	(7.8)
NAV relative to MSCI World	4.4	9.7	(4.0)	5.0	27.0	35.9	6.0
Price relative to FTSE All-Share	3.5	10.3	3.1	19.5	55.9	61.0	20.1
NAV relative to FTSE All-Share	3.8	11.0	0.3	14.2	62.0	76.2	38.0

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-March 2017. Geometric calculation.

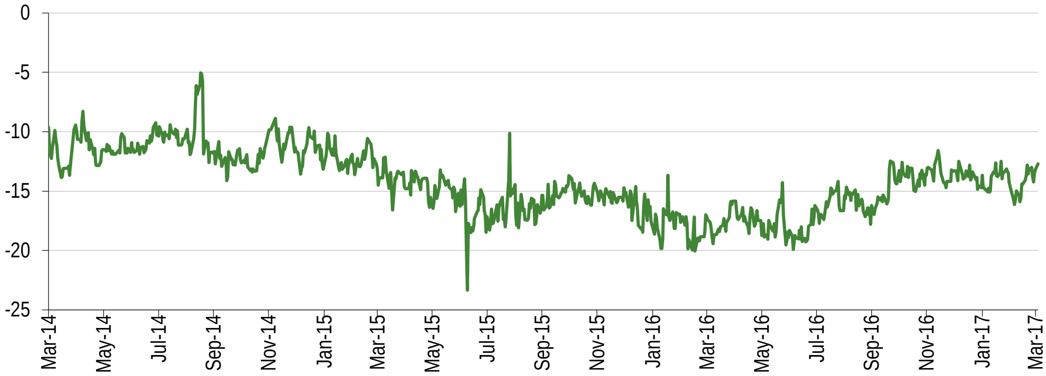
Exhibit 6: NAV total return performance relative to benchmark since launch

Source: Thomson Datastream, Edison Investment Research

Discount: Near-term narrowing trend

FCSS's current 12.7% share price discount to cum-income NAV is narrower than the 15.6% average of the last 12 months (range of 11.6% to 19.9%). It compares to the averages of the last three and five years and since the trust's inception of 14.3%, 11.1% and 7.3%. The discount has been in a narrowing trend since mid-2016 and there is scope for it to narrow further if investor sentiment towards Chinese equities continues to improve. It should be noted that in the past, there have been periods when FCSS traded at a premium; the last time was in early 2013.

Exhibit 7: Share price discount to NAV (including income) over three years (%)



Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

FCSS is a conventional investment trust; there are currently 551.9m ordinary shares outstanding with a further 19.4m shares held in treasury. On 14 February 2017 it entered into a new $150m three-year revolving credit facility with Scotiabank Europe, which is fully drawn down. To achieve further gearing, FCSS uses contracts for difference (CFD) on a number of its portfolio holdings; at end-February 2017, gross gearing was 27.5%. The manager suggests that given the significant rise in the Chinese stock market since May 2016, the level of gearing may come down.

Fidelity International is paid an annual management fee of 1.0% of net assets, on a quarterly basis. An annual performance fee of 15% is payable on returns greater than 2.0% above the benchmark; this is capped at 1.0% of net assets. Excess outperformance may not be carried forward and any underperformance must be made good before any further performance fee is payable. For H117 (ending 30 September 2016), the ongoing charge (excluding performance fees) was 1.23%, which was a 9bp increase versus H116. Including performance fees, the ongoing charge in H117 was 1.38% versus 1.83% in H116.

Dividend policy and record

FCSS aims for capital growth rather than income; however, the annual dividend has increased every year since 2011 (Exhibit 1). Over the last four years, the compound annual growth in the dividend is c 25%. The 2016 dividend of 1.80p was 1.15x covered and was a 38.5% increase versus the prior year. FCSS's current dividend yield is 0.9%.

Peer group comparison

Exhibit 8 shows a comparison of FCSS with other funds investing in Chinese equities. JPMorgan Chinese is the only other fund in AIC Country Specialists: Asia Pacific sector that is focused on Chinese equities, so we show the AIC Asia Pacific ex-Japan sector averages (37% average exposure to China & Greater China). We also include open-ended funds larger than £250m from the IA China/Greater China sector. FCSS's NAV total return is ahead of the Asia Pacific ex-Japan weighted average over one year and significantly ahead over three and five years. It has a similar record versus the open-ended funds shown. FCSS's ongoing charge is modestly wider than the closed-end peer average, it has higher gearing and given its focus on capital growth, a lower-than-average dividend yield.

Exhibit 8: Funds investing in Chinese equities (as at 30 March 2017)

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	Discount (ex-par)	Ongoing charge	Perf. fee	Net gearing	Dividend yield (%)
Fidelity China Special Situations	1,080.1	40.1	106.1	179.1	(11.6)	1.2	Yes	122	0.9
JPMorgan Chinese	163.9	37.3	59.1	86.5	(13.4)	1.4	No	109	0.7
Asia Pacific ex-Jap weighted avg		37.5	55.5	73.9	(7.8)	1.1		103	2.0
Open-ended funds									
Aberdeen Global Chinese Equity	502.7	37.4	44.7	34.1		2.0	No		
Allianz China Equity	331.6	31.4	61.0	65.4		2.3	No		
Baring Hong Kong China	1,434.4	36.5	59.1	60.8		1.8	No		
Fidelity China Focus	3,015.1	40.4	83.1	91.6		1.9	No		
First State Greater China Growth	443.0	36.0	56.4	84.8		1.8	No		
GAM Star China Equity	718.7	34.9	42.3	75.7		1.6	No		
Henderson China Opportunities	546.6	40.9	68.8	94.3		1.7	No		
HSBC GIF Chinese Equity	1,144.2	37.0	63.7	66.3		2.4	No		
Invesco PRC Equity	549.3	35.5	46.4	64.2		3.1	No		
Invesco Perpetual HK & China	317.7	32.1	48.7	98.5		1.7	No		
JPM Greater China	384.0	36.5	57.3	81.1		1.8	No		
Schroder ISF Greater China	606.4	41.5	71.4	81.6		1.9	No		
Templeton China	447.8	35.2	43.8	30.6		2.5	No		
Open-ended funds weighted avg		37.7	64.1	74.9		2.0			

Source: Morningstar, Edison Investment Research. Note: TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

The board

There are six directors on the board at FCSS of whom five are independent of the manager. Chairman Nicholas Bull was appointed in February 2010 and assumed his current role on 22 July 2016. The other four independent members and their dates of appointment are David Causer and Peter Pleydell-Bouverie (both February 2010), Elisabeth Scott (November 2011) and Vera Hong Wei (March 2016). John Ford was appointed on 22 July 2016 as Fidelity International's global chief investment officer, fixed income, solutions and real estate; he is considered a non-independent member of the board.

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