Fidelity China Special Situations

Domestic trends drive sustained outperformance

Investment trusts
Chinese Equities

Fidelity China Special Situations (FCSS) aims to deliver long-term capital growth from a portfolio of stocks listed mainly in China and Chinese companies listed abroad. Manager Dale Nicholls focuses on consumer-led sectors, which have the greatest exposure to China's growth prospects and he sees many great investment opportunities, especially among lesser-known, smaller-cap stocks and unlisted companies. Nicholls believes these businesses are driving innovation and change but are often undervalued. FCSS has delivered significant outright returns and outperformance of its MSCI China benchmark and the UK market since the fund's inception in 2010.

Steady NAV outperformance versus the benchmark over 10 years

Source: Refinitiv, Edison Investment Research

The market opportunity

The Chinese economy is the second largest in the world. It is forecast to be the only major economy to register positive growth in 2020 and its trajectory in 2021 and beyond will be underpinned by the rapid expansion of China's middle class. Yet Chinese stock markets are undervalued compared to the US, offering interesting investment opportunities for patient investors with a long-term view.

Why consider investing in FCSS?

- The largest UK investment trust focused on China, offering direct and diversified exposure to the very positive growth prospects of this economy.
- Consistently positive absolute returns and solid performance compared to the benchmark and UK market.
- An experienced manager with a very strong track record, supported by the extensive resources of Fidelity's dedicated China and Asia research teams.

Positive sentiment supports move towards par

FCSS's board has a single-digit discount policy and has been proactive in its efforts to stabilise the discount during this year's market volatility. More recently, the trust has, at times, traded at a small premium as investor sentiment towards China, especially small-cap companies, has improved. FCSS's shares are presently trading at a discount of 0.6% and the fund offers a yield of 1.1%. The board hopes to continue its 10-year record of annual dividend increases and its ability to do so is supported by FCSS's revenue reserves.

11 December 2020

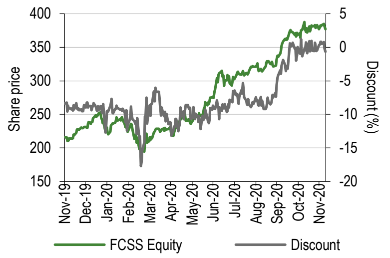
Price	**£377.0p**
Market cap	**£1,943m**
AUM	**£2,416m**

NAV**	379.4p
Discount to NAV	0.6%

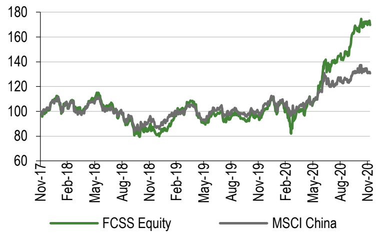
*Excluding income. **Including income. At 9 December 2020.

Yield	1.1%
Ordinary shares in issue	515.5m
Code	FCSS
Primary exchange	LSE
AIC sector	Country specialist: Asia Pacific ex-Japan
Benchmark	MSCI China

Share price/discount performance



Three-year performance vs index



52-week high/low	388.0p	185.0p
NAV** high/low	388.8p	223.2p

**Including income.

Gearing

Gross market gearing*	24.4%
Net market gearing*	20.8%

*At 31 October 2020.

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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 comprised primarily of securities issued by companies listed in China and Chinese companies listed elsewhere. It may also invest in listed companies with significant interests in China. Futures, options and CFDs are used to provide gearing, as well as to take short positions.

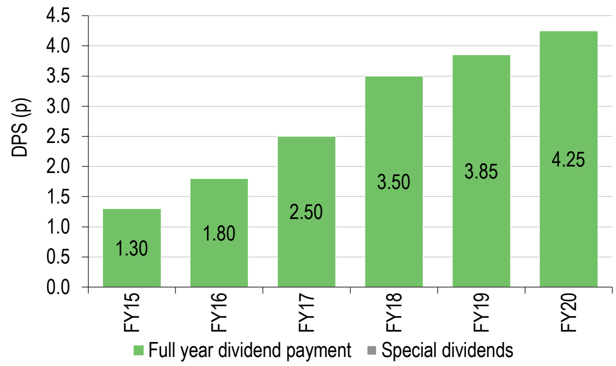
Recent developments

- 8 Dec 2020: H121 results released for six months ended 30 September 2020. Share price and NAV TRs of 56.2% and 51.1% respectively, compared to a benchmark return of 24.4%.
- 28 Aug 2020: Vanessa Donegan appointed to the board, from 1 September 2020, replacing Peter Pleydell-Bouverie, who stepped down in July 2020.

Forthcoming		Capital structure		Fund details	
AGM	July 2021	Ongoing charges	0.98% (6 mths ended Sep 20)	Group	Fidelity International
Interim results	December 2020	Net market gearing*	20.8%	Manager	Dale Nicholls
Year end	31 March	Annual mgmt fee	Variable: 0.90% of net assets +/- 0.20%. (See page 8 for further detail.)	Address	Beech Gate, Millfield Lane, Lower Kingswood, Tadworth, Surrey, KT20 6RP
Dividend paid	July 2021	Performance fee	None		
Launch date	April 2010	Trust life	Indefinite	Phone	0800 41 41 10
Continuation vote	No	Loan facilities	$100m revolving	Website	www.fidelity.co.uk/chinaspecial

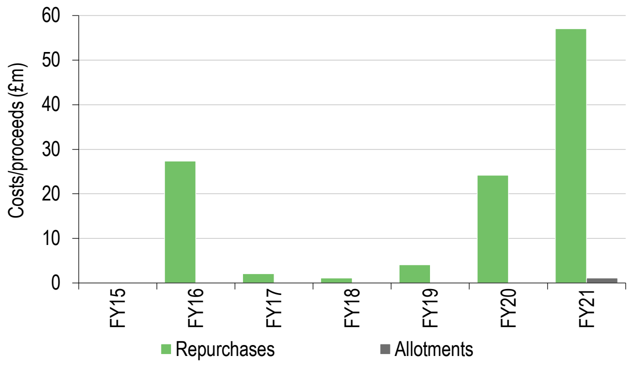
Dividend policy and history (financial years)

Although focused on capital growth, FCSS pays an annual dividend, which has increased every year since inception.

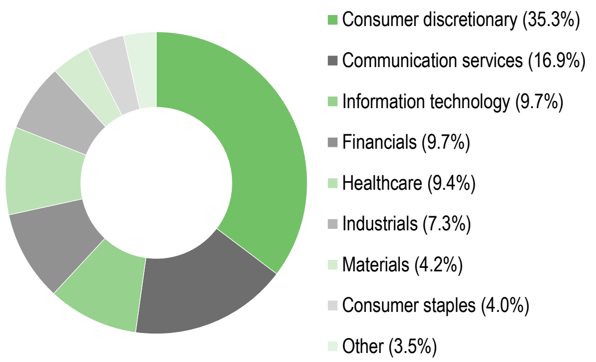


Share buyback policy and history (financial years)

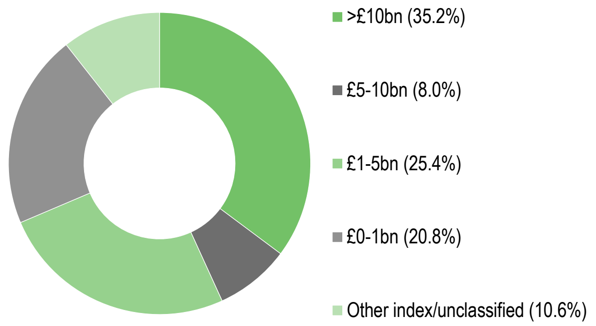
FCSS has authority to buy back up to 14.99% and allot up to 10% of its shares in issue. A formal single-digit discount control policy was adopted in June 2018.



Portfolio exposure by sector (at 31 October 2020)



Portfolio exposure by market cap (at 31 October 2020)



Top 10 holdings (at 31 October 2020)

		Portfolio weight %**			
Company	**Sector**	**31 October 2020**	**31 October 2019*** **	**Benchmark weight (%)**	**Active weight vs benchmark (%)**
Alibaba	Consumer discretionary	11.3	9.8	20.3	(9.0)
Tencent	Communication services	10.4	14.3	15.5	(5.1)
China MeiDong Auto	Consumer discretionary	3.8	4.0	0.0	3.8
21Vianet	Information technology	2.6	2.0	0.0	2.6
Ping An Insurance Group	Financials	2.3	N/A	2.4	(0.1)
Wuxi AppTec Co	Healthcare	2.1	N/A	0.2	1.9
China Pacific Insurance Group	Financials	1.8	5.0	0.4	1.4
Skshu Paint Co	Materials	1.7	N/A	0.0	1.7
Hutchinson China Meditech	Healthcare	1.7	1.7	0.1	1.6
China Life Insurance	Financials	1.4	1.9	0.6	0.8
Top 10 (% of portfolio)		**39.1**	**36.1**		

Source: Fidelity China Special Situations, Edison Investment Research, Morningstar. Note: *Gearing net of short positions. **Adjusted for gearing and index hedges (holdings data may differ from non-adjusted data displayed in FCSS's factsheet). ***N/A where not in end-October 2019 top 10.

The manager's view: China trends offer opportunity and value

The post-pandemic recovery in the Chinese economy is gathering momentum and FCSS's manager, Dale Nicholls, has been spending a lot of time analysing how different the world will look in the wake of the virus. Probably the most striking development the manager sees is the acceleration of the shift online in so many aspects of life, including e-learning, gaming and medtech, but particularly in fintech and e-commerce. This has been a global trend, but Nicholls believes it is happening fastest in China, with what he calls 'amazing' businesses such as Alibaba and Tencent (FCSS's top two holdings) 'dominating market share and leading the world'. He views Tencent's strategy of linking with offline retailers via data sharing, in-store collection points and other measures to entice potential customers as especially canny.

The other major theme that has been the focus of Nicholl's attention for some time is the rise of China's middle class. This mega-trend is driving domestic demand for a range of consumer goods and services. The manager cites China's auto sector as one beneficiary, which is already the biggest such market in the world but is still under-penetrated. Auto dealers such as China MeiDong Auto Holdings, (FCSS's third largest holding), which focuses on premium international brands such as BMW, Porsche and Lexus, have performed strongly but still have great growth potential says Nicholls. He also expects wealth management, insurance and travel companies to be long-term beneficiaries of rising demand from China's middle class and he sees a plethora of great investment opportunities, especially among smaller-cap and unlisted companies, which he believes are driving innovation and change in China.

Chinese stocks also offer great value says Nicholls. 'China has five of the biggest stock markets in the world, yet shares are still significantly discounted versus the US market. Furthermore, small-cap companies are trading at discounts to larger-cap businesses'. As in other markets, value stocks look particularly inexpensive. Nicholls welcomes the recent improvement in investor sentiment towards such stocks, which has partially reversed their underperformance, as FCSS has significant holdings in value names. 'It's gratifying to see our views on these companies confirmed by a rise in valuations' says Nicholls, who sees scope for the value gap to continue to close as investors recognise the potential of Chinese value and small-cap stocks.

In the manager's view, investors should not be discouraged from taking advantage of Chinese investment opportunities by events such as the Chinese government's recent steps to tighten regulation over fintech companies. He argues that such moves have been on the horizon for some time and are not surprising given the government's concerns about the regulatory gap between the fintech companies and the traditional banks. The associated delay in the launch of Ant, the financial services arm of the Chinese tech giant Alibaba is likely to be temporary, in Nicholls' view. Some see these tightening moves as a harbinger of wider restrictions. The manager believes further regulation is likely to be focused on the anti-competition practices of e-commerce giants such as Alibaba and Tencent. He feels regulation poses a lesser risk for smaller companies and unlisted businesses. In fact, says Nicholls, smaller e-commerce players such as JD.com and Pinduoduo may even benefit, as larger competitors are forced to spend time and resources adapting to the new regulatory landscape.

The manager concludes by asserting that FCSS offers a great investment opportunity for retail investors seeking exposure to China. 'It is hard to compete with the depth of research coverage provided by Fidelity's team on the ground, which is in constant touch with companies and stays on top of developments as they unfold' he says. 'In addition, the trust also offers retail investors much greater diversification across companies, sectors and cap size than they might hope to achieve by direct stock-by-stock investment.'

The portfolio

At end October 2020, FCSS's top 10 holdings represented 39.1% of the portfolio, up from 36.1% year earlier. The portfolio's largest holdings were in tech giants Alibaba (11.3%) and Tencent (10.4%), which are viewed by the manager as integral to the Chinese economy and thus remain core holdings. However, despite the size of these positions, they are also the portfolio's largest underweights versus the benchmark. FCSS is 9.0pp underweight Alibaba and 5.1pp underweight Tencent (Exhibit 1). FCSS's largest overweights among its top 10 holdings are its out-of-index positions in China Meudong Auto (3.8pp overweight), the premium brand auto dealer, 21 Vianet (2.6pp overweight), China's largest carrier-neutral internet and data centre service provider and Skshu Paint Co (1.7pp). Its top 10 holdings also include notable overweight positions in Wuxi App Tech Co, an innovative pharmaceutical research and development provider, and pharmaceutical company Hutchinson China Meditech.

One of the largest changes to FCSS's portfolio over the last year has been an increased exposure to insurance companies. This is consistent with Nicholls' view that the insurance market has great potential for demand to increase, including but not exclusively, demand for health insurance. This sector's long-term growth potential is not factored into share prices at current levels, according to the manager. The other, near-term positive for this sector is that with virus restrictions lifting, insurance brokers can resume face-to-face client meetings, which is the traditional way of conducting business in this sector. At end October 2020, there were three insurance companies in FCSS's top 10 holdings, including overweight positions in China Pacific Insurance and China Life Insurance. Its position in Ping An Insurance was initiated at an attractive level after the Q120 market sell-off.

FCSS's exposure to financials, which represented 9.7% of the portfolio at end-October (Exhibit 1), is comprised exclusively of insurance companies. The portfolio has no exposure to banks or to Alibaba's fin tech arm, Ant, whose IPO was recently delayed. This allocation to financials is close to benchmark. The portfolio's largest relative overweight positions on a sectoral basis are information technology, healthcare and consumer discretionary. Within the consumer discretionary sector, the manager expects the travel industry to perform especially well, both in the near term as it continues to rebound from the global shutdown in travel and in the longer term, thanks to sustained demand growth from China's burgeoning middle class. The manager prefers to gain exposure to this theme through the trust's holdings of Trip.com and some hotel holdings with good business models and roll out of new premises. The portfolio does not have exposure to airports or airlines.

FCSS has positions in six unlisted companies, representing 5.8% of gross assets at end-November 2020. Nicholls believes investing in such companies gives the trust exposure to unique businesses with significant upside growth potential. Unlisted holdings include Pony.ai, which is China's leading autonomous driving technology company, with what the manager believes is a compelling story. It is one of the five leading global players in this potentially huge new market and Nicholls views its recent strategic partnership with Toyota as very significant. FCSS's other unlisted holdings include DGI International, the leading consumer drone manufacturer, which accounts for 70% of the global market, Didi Chuxing Technology, a ride-hailing app with a 90% market share, and SenseTime, an information technology company focused on artificial intelligence and computer vision. ByteDance, an internet technology company that owns the video-sharing app TikTok, completes the list. It is the fastest-growing company in history and, in the manager's view, continues to create value. FCSS's most recent unlisted company acquisition, made in November 2020, was Full Truck Alliance, a car and cargo-matching platform.

Nicholls argues that the unlisted company space holds many of China's most innovative and entrepreneurial companies and there is a huge amount of activity and opportunity at the pre-IPO stage for investors, such as FCSS, with patience and a long-term perspective. However, this sector is less well known, and extensive bottom-up research of the kind conducted by Fidelity is required to identify significantly mispriced opportunities. The manager is looking at a number of potential investments, especially in technology, healthcare and consumer-related areas, that are best placed to benefit from growing consumer demand, and he expects the overall weight of unlisted companies in the portfolio to be higher in six months' time.

FCSS's positions comprise shorts in individual stocks and put options on indices, to which the manager adds when volatility is low and put options are attractively priced. At end-October 2020, net market gearing (which nets off short positions) stood at 20.8%. This level of gearing, which is relatively high compared to FCSS's peers, reflects the manager's conviction in the portfolio and his desire to increase exposure to the many opportunities available in China.

Performance: Maintaining consistent outperformance

Exhibit 2: Five-year discrete performance data

12 months ending	Share price (%)	NAV (%)	MSCI China (%)	MSCI China Small Cap (%)	MSCI World (%)	CBOE UK All Companies (%)
30/11/16	34.8	32.6	25.4	20.1	25.0	9.9
30/11/17	30.3	26.3	34.1	7.2	14.8	13.7
30/11/18	(13.2)	(12.0)	(6.5)	(8.5)	6.8	(1.8)
30/11/19	10.2	5.1	5.8	(4.7)	13.6	11.3
30/11/20	77.4	61.8	32.4	24.8	11.5	(11.2)

Source: Refinitiv. Note: All % on a total return basis in pounds sterling.

FCSS has delivered positive absolute returns and outperformed its benchmark over both the short term and longer term (Exhibit 3). Over the three months to end November 2020, FCSS returned 17.4% on a share price basis and 8.4% on a NAV basis, compared to a benchmark total return of 5.6%. It has also outperformed its benchmark over one, three, five and 10 years. In addition, the trust has outperformed the MSCI China Small Cap index, the MSCI AC Asia ex-Japan index and the MSCI World index over one, three, five and 10 years (Exhibit 4), despite its heavy concentration of mega-cap US growth stocks. FCSS has also outperformed the UK market over all periods except one month, which serves as a reminder to UK investors of the potential benefits of diversification away from their home market.

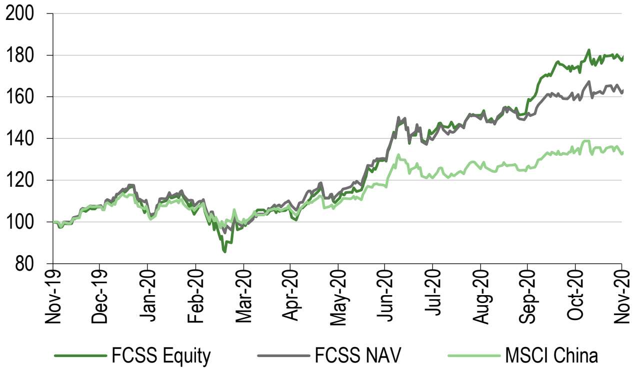
The top contributors to FCSS's relative performance over the three months to end-October 2020 included FCSS's overweight to China MeiDong Auto Holdings, thanks to its strong portfolio of luxury brands, its growing market share, strong revenues from aftersales service and an improvement in new car margins. An overweight to KE Holdings, a provider of online and offline property brokerage and housing services, was another major contributor to performance, as was the overweight to Yadea, a major player in the e-bike and scooter market, which has benefited from a surge in demand as people seek to avoid public transport. The trust's non-index position in SenseTime, an unlisted tech company focused on artificial intelligence, also enhanced performance, as did underweight positions in China Construction Bank and China Mobile.

These positive influences on relative performance over the three months ended October 2020 were only partially offset by the adverse effect of an underweight position in Alibaba and Nicholls' decision not to hold JD.com, Alibaba's smaller competitor, or Meituan, China's leading e-commerce platform or Nio, an auto manufacturer. An overweight to wealth manager Noah had a smaller adverse effect due to weaker activity following the virus outbreak, which has prevented face-to-face meetings with prospective clients. An overweight to the ceramics manufacturer Monalisa Group also hurt performance.

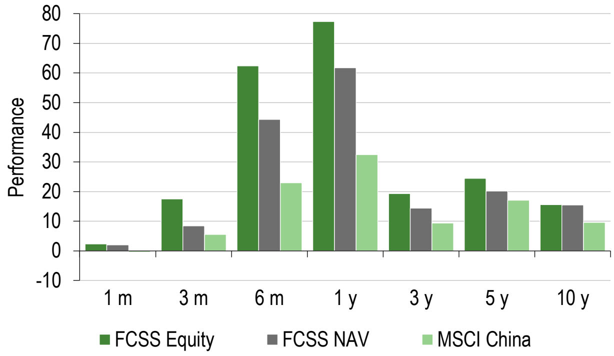
On a sectoral basis, the trust's underweight exposure to real estate was the most significant contributor to relative performance over the three months to end-October. Overweight positions in healthcare and consumer staples also contributed to a lesser degree, as did FCSS's use of derivatives to take short positions on individual stocks and market indices. The main sectoral detractors from performance over this period were overweight exposures to materials and consumer discretionary.

Exhibit 3: Investment trust performance to 30 November 2020

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



Price, NAV and benchmark total return performance (%)



Source: Refinitiv, Edison Investment Research. Note: Three, five and 10-year performance figures annualised.

Exhibit 4: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to MSCI China	2.8	11.2	32.0	34.0	29.6	35.4	49.7
NAV relative to MSCI China	2.5	2.7	17.4	22.1	14.2	13.8	53.5
Price relative to MSCI China Small Cap	(4.5)	10.0	28.0	42.2	56.0	112.9	171.2
NAV relative to MSCI China Small Cap	(4.8)	1.5	13.8	29.7	37.5	78.9	178.1
Price relative to MSCI AC Asia ex-Japan	(2.2)	7.0	31.4	46.2	36.4	48.0	61.4
NAV relative to MSCI AC Asia ex-Japan	(2.5)	(1.2)	16.8	33.3	20.2	24.3	65.5
Price relative to MSCI World	(6.4)	10.8	44.5	59.1	25.4	53.5	10.3
NAV relative to MSCI World	(6.6)	2.3	28.4	45.0	10.5	29.0	13.1
Price relative to CBOE UK All Companies	(9.9)	9.8	51.8	99.8	74.8	145.5	103.2
NAV relative to CBOE UK All Companies	(10.2)	1.3	35.0	82.2	54.0	106.3	108.3

Source: Refinitiv, Edison Investment Research. Note: Data to end-November 2020. Geometric calculation.

Exhibit 5: NAV total return performance relative to index over three years

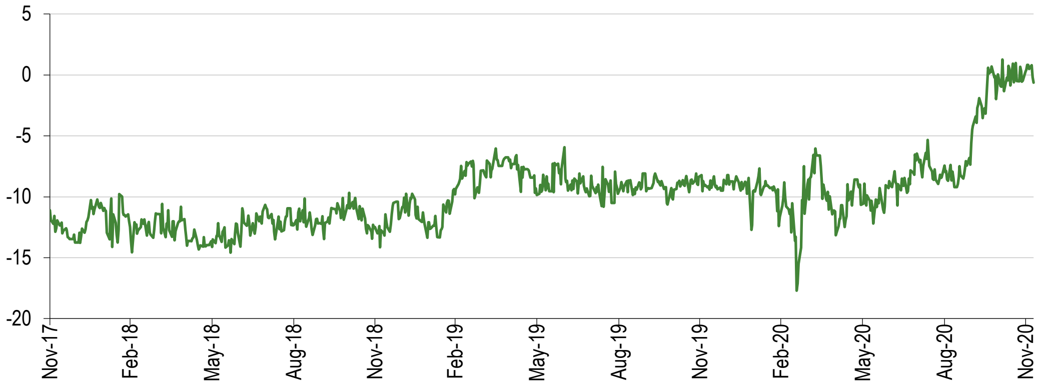
Source: Refinitiv, Edison Investment Research

Valuation: Rerating moves share price towards par

After trading at a discount to cum-income NAV of around 10% for most of the past two years, FCSS has experienced a significant rerating in recent months as investor sentiment towards China in general, and the trust in particular, has improved. This rerating has been assisted by the easing in trade tensions between China and the US. The trust has recently traded at a small premium, although it is presently trading at a discount of 0.6% (Exhibit 6). This compares favourably with average discounts of 7.8%, 9.8%, 11.8% and 9.2% over one, three, five and 10 years, respectively.

In June 2019, the board adopted a formal discount control policy, which aims to limit the discount to single digits in normal market conditions. It has the authority, renewed annually, to repurchase up to 14.99% of the trust's shares and it used this capacity to stabilise share price volatility and the discount from the onset of the coronavirus crisis, up until September 2020 (Exhibit 1). So far in FY21, the board has repurchased a total of 22.9m shares into treasury, at a total cost of £57.0m. The number of shares in issue currently stands at 515.5m, with a further 55.6m shares held in treasury. Although FCSS has, at times, recently traded at a small premium, the board has so far given no guidance on whether it will issue new shares to maintain the share price close to NAV.

Exhibit 6: Share price premium/discount to NAV (including income) over three years (%)



Source: Refinitiv, Edison Investment Research

Peer group comparison

Exhibit 7 gives a comparison of FCSS against a peer group comprising both closed- and open-ended funds that invest in Chinese equities. In addition to FCSS, JPMorgan China Growth and Income and the recently launched Baillie Gifford China Growth Trust (BGCG, previously Witan Pacific Investment Trust) are the only other closed-ended funds in the AIC Country Specialist: Asia Pacific ex-Japan sector that focus on China. The table therefore shows the averages for the whole AIC Asia Pacific sector. In addition, it includes IA China/Greater China sector funds larger than £300m, with a track record of more than five years.

Exhibit 7: Selected peer group invested in Chinese equities at 9 December 2020*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (cum-fair)	Ongoing charge	Perf. fee	Net gearing	Dividend yield
Fidelity China Special	1,943.3	69.9	56.9	158.6	336.2	(0.6)	0.98	No	121	1.1
Baillie Gifford China Growth	260.4	21.8	21.8	81.6	129.2	19.3	0.99	Yes	97	1.4
JPMorgan China Growth & Income	309.7	57.8	77.1	120.9	246.0	(11.8)	1.26	No	108	0.9
Asia Pacific average	**434.0**	**23.8**	**19.1**	**84.2**	**171.8**	**(7.2)**	**1.64**		**104**	**1.3**
Allianz China Equity	510.3	41.7	38.6	99.6	134.4		2.31	No		0.0
AS SICAV I All China Equity	515.9	34.1	46.1	111.6	127.2		1.98	No		0.0
Barings Hong Kong	1,556.2	49.2	54.1	134.8	146.5		1.70	No		0.1
Fidelity China Focus	1,781.0	1.5	0.8	59.3	94.9		1.91	No		1.4
HSBC GIF Chinese Equity	967.4	32.3	30.9	103.6	119.5		2.40	No		0.0
Janus Henderson China Opps	788.4	28.9	27.5	113.3	168.1		1.71	No		0.2
Schroder ISF Greater China	2,249.0	43.5	57.1	162.0	219.5		1.85	No		1.4
Templeton China	375.1	33.3	43.0	118.9	105.8		2.44	No		0.0
Open-ended funds average	**1,092.9**	**33.1**	**37.2**	**112.9**	**139.5**		**2.04**			**0.8**

Source: Morningstar, Edison Investment Research. Note: *Performance to 8 December 2020 based on ex-par NAV. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

FCSS has outperformed its two closed-ended China-focused peers over one, five and 10 years and ranks second over three years, when it underperformed JPMorgan China Growth and Income. FCSS has very comfortably outperformed the average of all funds in the AIC Country Specialist: Asia Pacific ex-Japan sector over all periods shown. In addition, it has also outperformed all funds in the IA China/Greater China sector, over all periods except over three and five years, where Schroder ISF Greater China outperformed marginally. On the date shown in the table, FCSS's share price discount to NAV was 0.6%, compared to an average discount of 7.2% for the AIC peer group, and its ongoing charge, at 0.98% (for the six months ended 30 September 2020), is at the low end of the range for the sector as a whole. In line with most of its closed- and open-ended peers, FCSS does not charge a performance fee, but its management fee is performance related. (The board recently agreed a new tiered fee of 0.90% on the first £1.5bn of net assets, reducing to 0.70% on net assets over £1.5bn. The new fee structure will take effect from 1 April 2021. The variable, performance-based element of the fee structure will remain unchanged.) FCSS employs more gearing than any of its closed-ended peers and offers a yield slightly lower than the average for these funds.

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