

Fidelity China Special Situations

Market moves creating opportunities

Fidelity China Special Situations (FCSS) is a specialist actively managed fund investing in Chinese equities. The manager focuses on sectors set to benefit from changing consumption trends and the rising middle class where long-term growth is expected to exceed GDP growth. Against a background of market decline and high volatility, FCSS has continued to outperform with NAV total returns ahead of the benchmark MSCI China Index as well as open and closed-ended peers over one, three and five years. The manager continues to find attractive investment opportunities and has recently increased gearing, reflecting a more positive outlook.

12 months ending	Total share price return (%)	Total NAV return (%)	MSCI China (%)	MSCI World (%)	FTSE All-Share (%)
31/03/12	(26.4)	(19.0)	(12.4)	1.5	1.4
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)	(0.5)	(16.0)	0.3	(3.9)

Note: 12-month rolling discrete £-adjusted total return performance.

Investment strategy: Selecting for quality and value

Unconstrained by benchmark allocations, portfolio construction is driven by bottom-up stock selection across a wide spectrum of Chinese equities. The manager seeks companies with good long-term growth prospects, cash-generative businesses and strong management teams, looking to invest at valuations that do not fully reflect the quality and potential of the business. There is a general bias towards small and mid-cap stocks as they tend to be less well researched, so offer more mispricing opportunities. Management meetings and company visits are essential to the process and risk management is a priority, with third-party background checks included in due diligence procedures. FCSS has US\$150m of borrowing and uses futures, options and contracts for difference (CFDs) to add further gearing, as well as to take short positions. Unlisted securities may comprise up to 5% of the portfolio.

Market outlook: Selective opportunities exist

The recent correction in Chinese equities has taken valuations to historically low levels with the MSCI China index trading at a forward P/E multiple of 9.9x at end-March 2016. Concerns remain over the level of corporate debt in relation to GDP against a backdrop of China's slowing economic growth, as well as the prospect of a substantial one-off currency devaluation. However, China's GDP growth remains relatively strong in a global context and the transition towards a consumer-led economy and the development of the middle class suggests more favourable growth prospects for many companies in consumer-oriented sectors.

Valuation: Scope for discount to narrow

Negative sentiment towards China has prevailed over FCSS's strong performance in recent years and the discount has widened to 17.9%. This compares to a 12.0% three-year average, suggesting scope for narrowing as market sentiment improves, supported by a share buyback programme, which restarted in mid-January 2016.

Investment trusts

20 April 2016

Price 141.1p
Market cap £780m
AUM £1,201m

NAV* 169.8p
Discount to NAV 16.9%
NAV** 171.8p
Discount to NAV 17.9%

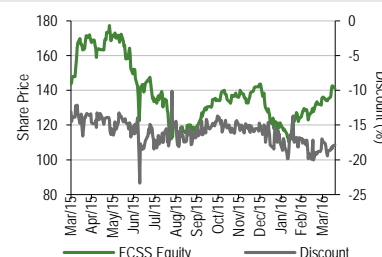
*Excluding income. **Including income.

Yield 0.9%
Ordinary shares in issue 553.1m
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 110.5p
NAV* high/low 206.9p 130.3p

*Including income.

Gearing

Gross market gearing* 127.7%
Net market gearing* 126.7%

*As at 29 February 2016.

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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

- 1 April 2016: 12-month performance to 31 March 2016. NAV total return -0.5% vs -16.0% benchmark MSCI China Index.
- 24 March 2016: Vera Hong Wei appointed as a non-executive director.
- 18 November 2015: Results for six months to 30 September 2015. NAV total return -14.1% vs -19.7% MSCI China Index.
- 12 June 2015: Full-year results to 31 March 2015. NAV total return +45.3% vs +39.3% benchmark MSCI China Index; FY15 dividend +13% to 1.30p.

Forthcoming

AGM	July 2016
Final results	June 2016
Year end	31 March
Dividend paid	July
Launch date	April 2010
Continuation vote	No

Capital structure

Ongoing charges	1.29% (1.94% incl. perf. fee)
Net market gearing*	126.7%
Annual mgmt fee	1.0% of net assets
Performance fee	See page 7
Trust life	Indefinite
Loan facilities	US\$150m revolving

Fund details

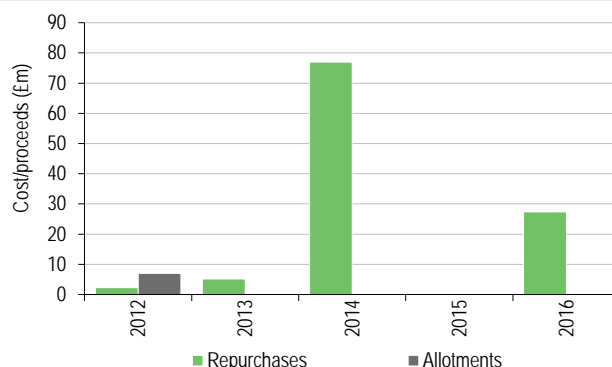
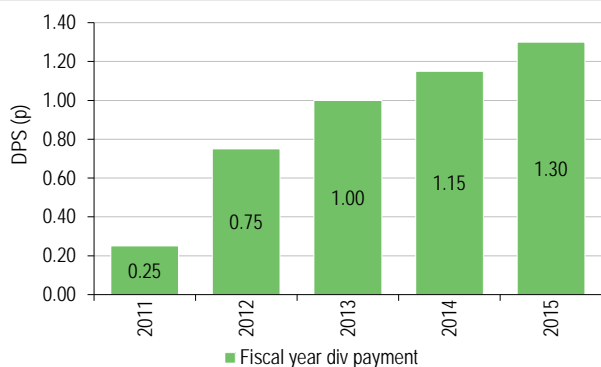
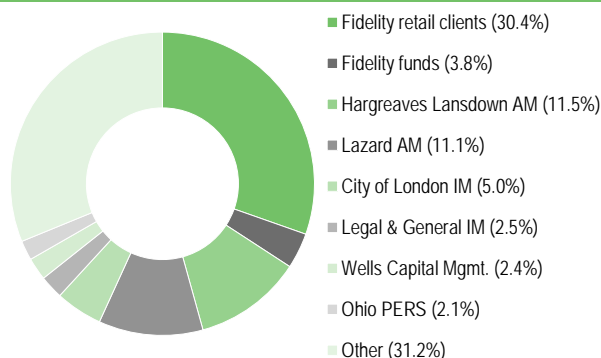
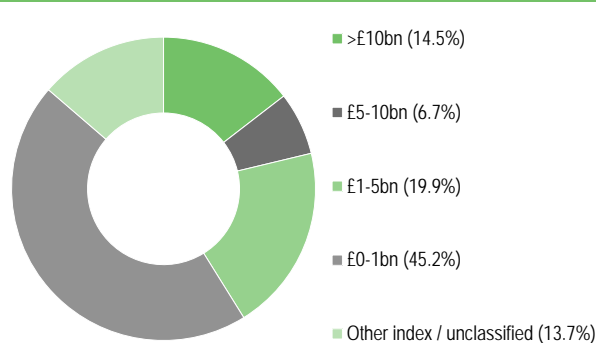
Group	Fidelity International
Manager	Dale Nicholls
Address	Beech Gate, Millfield Lane, Lower Kingswood, Tadworth, KT20 6RP
Phone	0800 41 41 10
Website	www.fidelity.co.uk/chinaspecial

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 15 April 2016)

Portfolio exposure by market cap (as at 29 February 2016)

Top 10 holdings (as at 29 February 2016)

Company	Country of listing	Sector	Portfolio weight %		Benchmark weight %	Active weight vs benchmark
			29 Feb 2016	28 Feb 2015**		
Tencent	China	Information Technology	8.1	7.5	12.1	(4.0)
China Pacific Insurance	China	Financials	4.3	3.5	1.1	3.2
Hutchison China MediTech	Hong Kong	Healthcare	2.5	1.9	0.0	2.5
Citic Telecom International	Hong Kong	Telecom Services	2.8	N/A	0.0	2.8
NetEase	China	Information Technology	1.9	1.6	0.7	1.2
Shanghai Int'l Airport	China	Industrials	2.2	N/A	0.0	2.2
New Oriental Ed. & Tech.	China	Consumer Discretionary	1.8	N/A	0.3	1.5
China Petroleum & Chem.	China	Energy	1.7	N/A	1.8	(0.1)
Alibaba	China	Information Technology	2.5	1.5	4.4	(1.9)
Dongpeng	China	Materials	1.7	N/A	0.0	1.7
Top 10			29.5	N/A	20.4	

Source: Fidelity China Special Situations, Edison Investment Research, Morningstar, Dealogic, IPREO, Thomson. Note: *Market exposure net of short positions (capital structure). **N/A where not in February 2015 top 10.

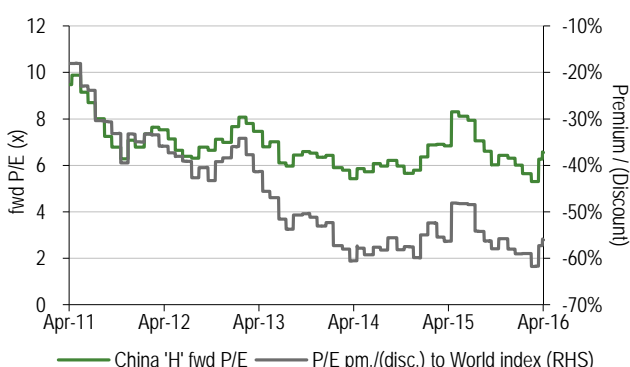
Market outlook: Selective opportunities exist

The sharp correction in Chinese equities in 2015 has seen valuations move substantially lower with the domestic China 'A' share market's forward P/E multiple declining from a peak of 18.2x to its current level of 13.0x. While this represents a 14% discount to world markets, it is not as wide as its five-year average discount of 20%. As illustrated in Exhibit 2 (left-hand chart), the market decline pushed the forward P/E multiple of the Hong Kong-listed China 'H' share market down to a five-year low both in absolute terms and relative to world markets. This suggests significant scope for Chinese equities to move higher due to re-rating as well as earnings growth.

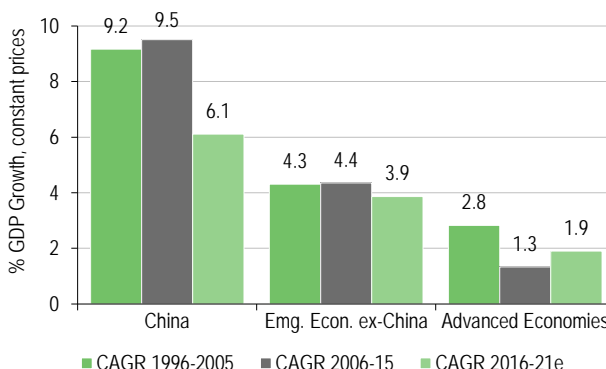
Over the next six years, while GDP growth is projected to be distinctly lower than that achieved over the last 20 years, China is expected to remain one of the faster-growing emerging economies and substantially outpace advanced economies (Exhibit 2 right-hand chart). Concerns over further slowing of the Chinese economy have been driven by weak data from industrial sectors that have historically been the main drivers of growth. However, the Chinese government continues to focus on implementing market reforms and transitioning towards a consumer-driven economy, which implies a more favourable backdrop for corporate earnings growth in consumer-oriented sectors.

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 and advanced economies



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

The disparity in growth prospects and valuations across and within sectors makes a fund such as FCSS with its bottom-up approach appear well-suited to selecting the more sustainable growth opportunities in the Chinese market. While high levels of market volatility over the last year suggest an element of caution may be appropriate for investors seeking to gain exposure to Chinese equities, the associated short-term mispricing of stocks can create investment opportunities for longer-term investors who are not constrained by benchmark allocations.

Fund profile: Investing in Chinese equities

FCSS is an LSE-listed closed-ended investment trust, which was launched in April 2010 to provide UK investors with a simple way to gain exposure to the China growth story in a diversified portfolio. The trust's objective is to achieve long-term capital growth by investing in an actively managed portfolio of Chinese equities, primarily comprising securities of companies listed in China or Hong Kong and Chinese companies listed on other recognised exchanges, but also including other listed companies with significant interests in China and Hong Kong. While portfolio allocations are not constrained by index weightings, performance is benchmarked against the MSCI China Index expressed in UK sterling. The portfolio is managed by Fidelity International (Fidelity), whose investment approach is characterised by bottom-up stock picking facilitated by extensive research capabilities. Anthony Bolton managed the trust from launch, succeeded by Dale Nicholls in April

2014. Nicholls has 20 years' investment experience in the Asia-Pacific region and has managed Fidelity's Pacific Fund since September 2003. While Nicholls is not solely focused on FCSS, China remains 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: Opportunities for stockpickers

Dale Nicholls believes that although China's headline economic growth is slowing, the quality of growth is improving with the rebalancing of the economy towards consumption providing a fertile environment for innovative companies to thrive and reward investors over time. The weakness in freight traffic, steel and cement production is seen as reinforcing the fundamental case for investing in the consumer-oriented sectors of the economy. Nicholls points to the portfolio's 11-12x forward P/E multiple with c 20% expected forward earnings growth, highlighting FCSS's minimal exposure to the energy and materials stocks, which have seen the largest earnings downgrades.

Nicholls has sought to take advantage of share price falls seen as excessive in certain market segments by adding to existing holdings, notably in the industrials, consumer staples and information technology sectors, while also reducing short positions. This has led to an increase in gearing towards the trust's upper limit, corresponding with Nicholls's positive longer-term outlook.

Nicholls highlights the recent addition to the portfolio of Didi Chuxing (formerly Didi Kuaidi), FCSS's first unlisted investment since Alibaba's IPO in September 2014, noting an increasing number of unlisted investment opportunities arising at realistic valuations. Didi Chuxing is the market-leading taxi-hailing service via smartphone app in China with a c 80% market share and its most recent fund-raising implies a c US\$20bn valuation. Formed from the merger of Didi Dache and Kuaidi Dache (backed by Tencent and Alibaba respectively), its closest rival is Uber China.

Asset allocation

Investment process: Unconstrained stock selection

Bottom-up stock selection forms the basis of portfolio construction with allocations unconstrained by benchmark index weightings. Overall, the manager looks for stocks 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. There is a general bias towards small and mid-cap stocks as they tend to be less well researched, so offer more mispricing opportunities. 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 regional resources, with 23 analysts providing relevant stock coverage, including 12 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

FCSS holds c 140 investments with the top 10 holdings representing 29.5% of the portfolio at 29 February 2016 (see Exhibit 1), modestly higher than 27.3% a year earlier. The trust's exposure is significantly less concentrated than the MSCI China Index, which had 157 constituents with the top 10 accounting for 50.1%. The manager reports portfolio turnover of c 80% in FY16, only slightly higher than recent years (68.3% in FY15 and 59.0% in FY14) despite increased market volatility and a change in the benchmark index composition during the year.¹ A small/mid-cap bias is retained with stocks below £1bn market cap representing 45% of the portfolio (Exhibit 1).

Exhibit 3: Portfolio sector exposure vs benchmark (%)

	Portfolio end Feb 2016	Portfolio end Feb 2015	Change	Index weight	Active weight vs index	Trust weight/index weight
Consumer Discretionary	27.8	24.9	2.9	6.0	21.8	4.6
Information Technology	21.2	20.1	1.1	23.8	(2.6)	0.9
Industrials	13.1	10.2	2.9	7.1	6.0	1.8
Financials	12.1	20.7	(8.7)	35.3	(23.2)	0.3
Consumer Staples	6.0	3.8	2.2	3.0	3.0	2.0
Materials	5.7	3.8	1.9	1.4	4.3	4.1
Healthcare	4.7	8.0	(3.2)	2.2	2.5	2.2
Energy	3.7	3.6	0.1	7.2	(3.5)	0.5
Telecommunication Services	3.7	1.6	2.1	10.4	(6.7)	0.4
Utilities	2.1	3.4	(1.3)	3.7	(1.6)	0.6
	100.0	100.0		100.0		

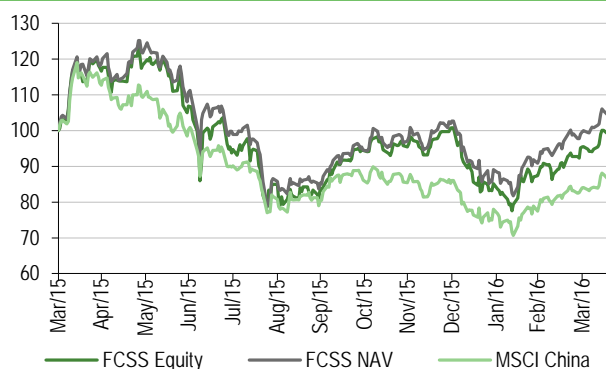
Source: Fidelity China Special Situations, Edison Investment Research

The most significant change in FCSS's portfolio's sector exposure over the year to end-February 2016 was an 8.7pp reduction in financials, partly reflecting the sell-off of former top 10 holdings Ping An Insurance and Citic Securities during the market correction. The portfolio has no holdings in Chinese banks, contributing to a significant underweight in financials, and the other predominant active exposure is an overweight in consumer discretionary (Exhibit 3), with an increased active position in each (-3.7pp and +1.6pp respectively). The greatest change in active weight was an 8.9pp reduction in information technology, moving the sector to underweight. This was driven by the change in index composition, which saw its information technology weighting increase from 13.8% to 23.8% over the year to end-February 2016. Other active underweight exposures in the portfolio broadly correspond with sectors dominated by state-owned enterprises.

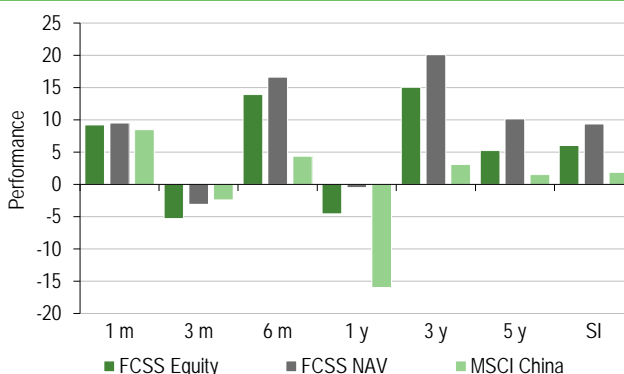
Performance: Substantial three-year outperformance

Exhibit 4: Investment trust performance to 31 March 2016

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.

¹ On 1 December 2015, all 14 US-listed ADRs of Chinese companies were added to the MSCI China Index (eight information technology stocks including Alibaba and Baidu, and six consumer discretionary stocks).

Exhibit 5: Share price and NAV total return relative performance, versus indices

	One month	Three months	Six months	One year	Three years	Five years	SI
Price relative to MSCI China	0.7	(3.0)	9.1	13.6	39.1	19.5	27.0
NAV relative to MSCI China	0.9	(0.7)	11.7	18.5	58.2	50.2	52.6
Price relative to MSCI World	5.4	(7.5)	2.5	(4.8)	16.4	(18.0)	(16.1)
NAV relative to MSCI World	5.7	(5.3)	5.0	(0.8)	32.3	3.1	0.8
Price relative to FTSE All-Share	7.2	(4.9)	10.0	(0.6)	36.7	(2.2)	0.5
NAV relative to FTSE All-Share	7.4	(2.7)	12.7	3.6	55.5	23.0	20.6

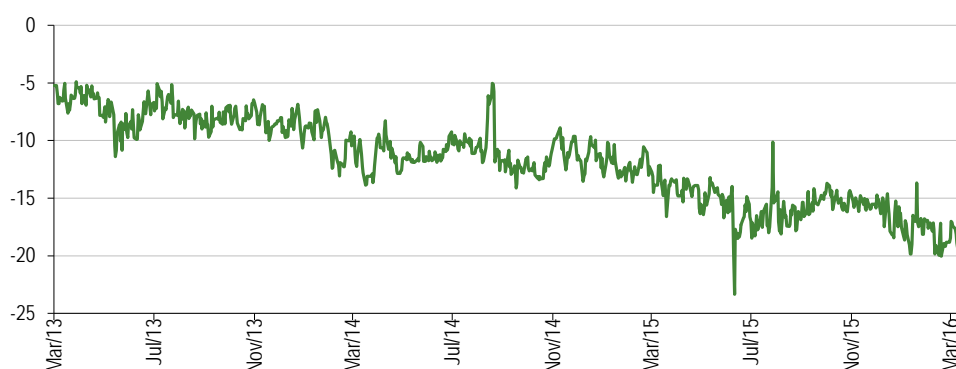
Source: Thomson Datastream, Edison Investment Research. Note: Data to end-March 2016. Geometric calculation.

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


Source: Thomson Datastream, Edison Investment Research

As shown in Exhibit 5, FCSS's share price and NAV total return have both outperformed the MSCI China Index over one, three and five years and since the trust's inception in April 2010. Although not immune to market swings and the overriding market downtrend, the trust's performance has been differentiated from its benchmark, with a strong relative performance achieved over the last year (Exhibit 4). FCSS's substantial outperformance of its benchmark since December 2012 in NAV terms has outweighed a weaker relative performance during 2011 and 2012 (Exhibit 6). The Chinese market as represented by MSCI China 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 Chinese equities as a whole, FCSS's NAV total return has outperformed the FTSE All-Share Index over all time periods of one year or longer and delivered a similar performance to the MSCI World index over one and five years and since inception while materially outperforming over three years.

Discount: Scope for narrowing

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


Source: Thomson Datastream, Edison Investment Research

The board has made no commitment to maintain the discount at a particular level but believes that it is in the best interests of shareholders for the share price to track closely to NAV. Having made only one repurchase of 0.1m shares in the year to 31 March 2015, the trust started buying back shares into treasury more actively in April 2015, with the discount standing at c 14%. Share buybacks continued during the Chinese market decline through to September 2015 when pressure on the discount alleviated. Buybacks were restarted in mid-January 2016 at a modest pace as the Chinese market weakened again with 3.9m shares subsequently repurchased.

As illustrated in Exhibit 7, FCSS's share price discount to NAV (including income) has followed a widening trend over the last three years with negative market sentiment towards China prevailing over the trust's strong performance. The discount currently stands at 17.9%, which compares to its three-year average of 12.0%, suggesting scope for it to narrow when market sentiment improves supported by share buybacks.

Capital structure and fees

FCSS has 553.1m shares in issue with a further 18.2m shares held in treasury. FCSS has authority to buy back up to 14.99% and allot up to 10% of its shares in issue and repurchased 17.9m (3.1% of issued capital) in the year to 31 March 2016. Shares may only be repurchased at prices below prevailing NAV per share, and only reissued from treasury at or above prevailing 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 130% of net assets and stood at 127.7% at 29 February 2016. Net gearing (market exposure net of short positions) was 126.7% at 29 February 2016, up from 119.2% at end-December 2015 and a low of 110.0% at end-June 2015.

A management fee is paid to Fidelity International at a rate of 1.0% pa of net assets. In addition, a 15% performance fee is payable on returns more than 2% above the benchmark MSCI China Index, capped at 1.0% of net assets. There is no carry forward of excess outperformance but underperformance must be fully recouped before any further performance fee is payable. Ongoing charges were 1.29% (1.94% including performance fees) in FY15 and equivalent to an annualised rate of 1.14% (1.70% including performance fees) in H116.

Dividend policy

FCSS aims to achieve long-term capital growth and dividends are not expected to constitute a material element of returns to shareholders. However, as an investment trust, FCSS distributes at least 85% of its net income with 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). In line with income growth, the FY15 dividend was increased by 13% to 1.30p representing a 0.9% yield. Adjusting for payment of the FY15 dividend, revenue reserves at 31 March 2015 equated to 1.0p per share.

Peer group comparison

Exhibit 8 shows a comparison of FCSS with similar closed-ended funds as well as open-ended funds larger than £250m from the IA China/Greater China sector. JPMorgan Chinese is the only other closed-end fund focused on Chinese equities, so we show AIC Asia-Pacific ex-Japan sector averages (39% average exposure to China and Greater China). FCSS's NAV total return ranks at

or close to the top of the closed-ended and open-ended peer groups over one, three and five years, with very substantial outperformance over three years. In terms of risk-adjusted returns, FCSS's Sharpe ratio is less than one over one year, reflecting recent market volatility, but greater than one over three years, ranking at the top of the peer group. FCSS's ongoing charge of 1.29% (excluding performance fees) is at a broadly similar level to closed-ended peers and compares favourably with the open-ended peer group average of 1.72%.

Exhibit 8: Funds investing in Chinese equities – total returns, discounts and charges as at 18 April 2016

% 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	Perf. fee	Net Gearing	Dividend yield (%)
Fidelity China Special Situations	780.4	(12.5)	88.1	63.8		(0.7)	1.1	(16.5)	1.29	Yes	127	0.9
JPMorgan Chinese	128.6	(17.7)	23.7	21.5	150.4	(1.1)	0.4	(14.2)	1.40	No	111	1.0
Asia-Pacific ex-Japan average	264.0	(8.1)	9.1	29.8	142.2	(1.1)	0.0	(8.8)	1.12		103	2.3
Open-ended funds												
Aberdeen Global Chinese Equity	476.6	(12.9)	(5.9)	(1.6)	94.3	(1.2)	(0.4)		1.98	No		
Allianz China Equity	280.0	(20.5)	28.4	11.0		(1.2)	0.4		1.43	No		
Baring Hong Kong China	1,209.9	(21.1)	21.2	1.4	121.4	(1.3)	0.3		1.29	No		
Fidelity China Focus	2,805.8	(17.5)	35.3	21.6	186.9	(1.1)	0.5		1.91	No		0.7
First State Greater China Growth	399.8	(13.0)	16.1	35.7	213.7	(1.1)	0.2		1.82	No		1.0
Henderson China Opportunities	419.4	(12.6)	32.6	12.7	142.5	(0.9)	0.5		1.73	No		0.7
Invesco Perpetual HK & China	290.4	(8.3)	32.7	37.0	163.5	(1.0)	0.5		1.69	No		0.8
Schroder ISF Greater China	441.5	(12.8)	29.7	22.0	134.4	(1.0)	0.5		1.92	No		2.7
Open-ended funds average	790.4	(14.8)	23.8	17.5	151.0	(1.1)	0.3		1.72			1.2

Source: Morningstar, Edison Investment Research. Note: TR=total return. Sharpe ratio is a measure of risk-adjusted return. The ratios shown 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 equivalents as a percentage of net assets.

The board

Following the appointment of Vera Hong Wei as a director with effect from 24 March 2016, the board comprises seven non-executive directors, all of whom are independent, with the exception of Andrew Wells. Ms Wei is a Chinese national with 18 years' experience in the Chinese financial industry, which spans the central bank, commercial bank and asset management sectors. Her previous roles include managing director of Greenwoods Asset Management, vice general manager of Ping An Annuity in Shanghai, head of corporate banking at Shenzhen Development Bank and director of the People's Bank of China. 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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