

# Fidelity China Special Situations

## Domestic growth focus delivers outperformance

Fidelity China Special Situations (FCSS) aims to achieve long-term capital growth from an actively managed portfolio of stocks mainly listed in China and Chinese companies listed abroad. It is the largest UK investment trust focused on China. Manager Dale Nicholls believes that the COVID-19 crisis has accelerated several of the trends driving Chinese growth and he sees many investment opportunities, especially among under-researched, mis-priced small-cap stocks. Nicholls's unconstrained approach allows him to invest in high-conviction ideas, principally in higher-growth consumer-led sectors, which will benefit from China's strong growth prospects. The trust has delivered significant outperformance against its MSCI China benchmark since inception.

### FCSS's 10-year anniversary video with manager Nicholls



Source: Fidelity China Special Situations

## The market opportunity

China has the second-largest economy in the world and it is on a path to become the largest. For long-term investors seeking to build a diversified portfolio, China is becoming too big to ignore. The strongest driver of Chinese consumption growth in coming years will remain the rapid expansion of China's middle class, and investors may benefit from focusing on stocks that are best placed to capitalise on this trend.

## Why consider investing in FCSS?

- Offers direct exposure to China's robust, long-term growth prospects.
- Provides access to broader market opportunities due to a focus on small and mid-sized companies and a capacity to purchase unlisted stocks prior to IPOs.
- Ability to leverage and take short positions to potentially enhance returns.
- Experienced manager with a strong track record, supported by in-depth research by Fidelity's dedicated China and Asia analysts.

## Board hopes to continue annual dividend rises

In early June 2020, the board expressed its aspiration to continue to increase its annual dividend and the ability to realise this ambition is enhanced by FCSS's revenue reserves. The board has a single-digit discount policy and has been proactive in its efforts to stabilise the discount during recent market volatility. There is scope for the discount to narrow should investor sentiment towards China, especially Chinese small-cap companies, improve.

### Investment trusts

21 July 2020

**Price** 301.0p  
**Market cap** £1,553m  
**AUM** £2,028m

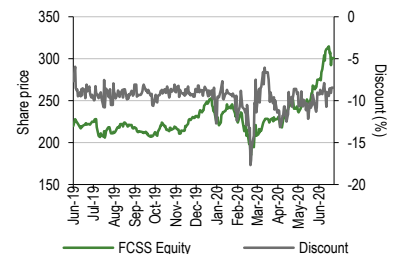
NAV\* 328.8p  
 Discount to NAV 8.4%

\*Including income. As at 17 July 2020.

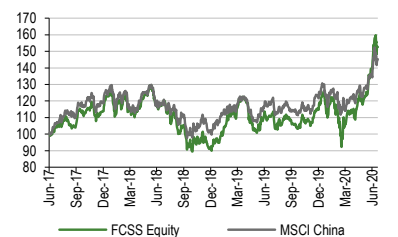
Yield 1.4%  
 Ongoing charge 0.99%  
 Ordinary shares in issue 516.1m  
 Code FCSS  
 Primary exchange LSE  
 AIC sector Country Specialist:  
 Asia Pacific ex-Japan

Benchmark MSCI China

### Share price/discount performance



### Three-year performance vs index



52-week high/low 315.0p 185.0p  
 NAV\*\* high/low 348.9p 223.2p

\*\*Including income.

### Gearing

Gross\* 27.3%  
 Net\* 23.6%

\*As at 30 June 2020.

### Analysts

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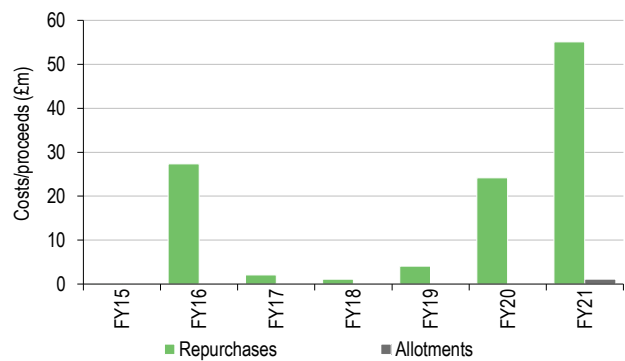
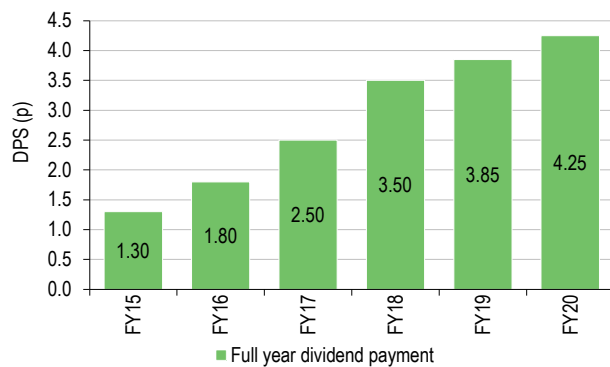
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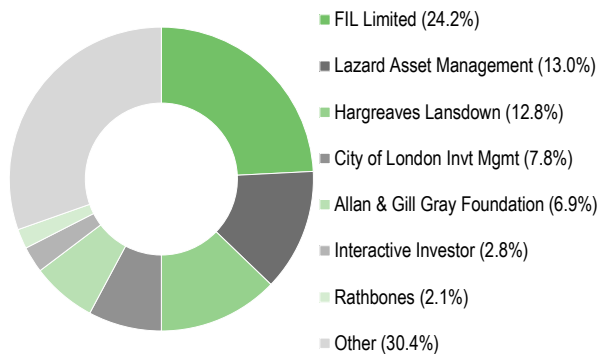
**Fidelity China Special Situations is a research client of Edison Investment Research Limited**

### Exhibit 1: Trust at a glance

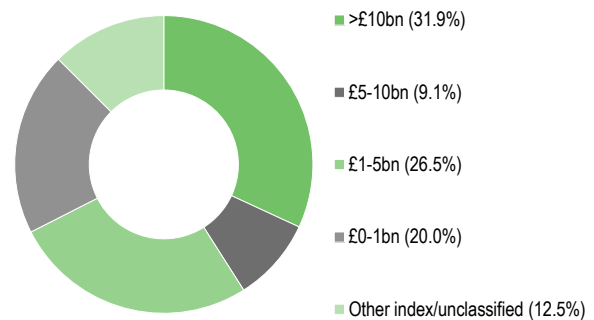
Investment objective and fund background		Recent developments			
Fidelity China Special Situations aims to achieve long-term capital growth from an actively managed portfolio comprised primarily of securities issued by companies listed in China, and Chinese companies listed elsewhere. It may also invest in listed companies with significant interests in China. Futures, options and CFDs are used to provide gearing, as well as to take short positions.		<ul style="list-style-type: none"> <li>23 July 2020: AGM to be held virtually, with presentations to be made available online at <a href="http://fidelity.co.uk/china">fidelity.co.uk/china</a>.</li> <li>4 June 2020: FY20 dividend increased by 10.4% to 4.25p per share.</li> <li>4 June 2020: Annual results to 31 March 2020 – NAV TR -5.9% vs benchmark TR -1.0%. Share price TR -6.5%.</li> </ul>			
Forthcoming		Capital structure		Fund details	
AGM	July 2020	Ongoing charges	0.99% (March 2020)	Group	Fidelity International
Interim results	November 2020	Net gearing*	23.6%	Manager	Dale Nicholls
Year end	31 March	Annual mgmt fee	Variable: 0.7%-1.1% of net assets	Address	Beech Gate, Millfield Lane, Lower Kingswood, Tadworth, Surrey, KT20 6RP
Dividend paid	July 2020	Performance fee	None	Phone	0800 41 41 10
Launch date	April 2010	Trust life	Indefinite	Website	<a href="http://www.fidelity.co.uk/chinaspecial">www.fidelity.co.uk/chinaspecial</a>
Continuation vote	No	Loan facilities	\$100m revolving		
Dividend policy and history (financial years)			Share buyback policy and history (financial years)		
Although focused on capital growth, FCSS pays an annual dividend, which has increased every year since inception.			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.		



#### Shareholder base (as at 30 June 2020)



#### Portfolio exposure by market cap (as at 30 June 2020)



#### Top 10 Holdings (as at 30 June 2020)

Country	Sector	Portfolio weight**		Benchmark weight (%)	Active weight vs benchmark (%)
		30 June 2020	30 June 2019***		
Tencent	Communication services	11.1	14.3	15.6	(4.5)
Alibaba	Consumer discretionary	10.2	9.8	17.1	(6.9)
21Vianet	Information technology	4.0	2.0	0.0	4.0
China MeiDong Auto	Consumer discretionary	3.6	4.0	0.0	3.6
Wuxi AppTec Co	Healthcare	2.2	N/A	0.2	2.0
China Pacific Insurance Group	Financials	2.0	5.0	0.4	1.6
Hutchinson China Meditech	Healthcare	2.0	1.9	0.1	1.9
Skshu Paint Co	Materials	1.9	N/A	0.0	1.9
Innovent Buildings	Healthcare	1.8	N/A	0.3	1.5
Noah Holdings	Financials	1.7	1.9	0.0	1.7
<b>Top 10 (%of holdings)t</b>		<b>40.4</b>	<b>37.5</b>		

Source: Fidelity China Special Situations, Edison Investment Research, Bloomberg, 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-June 2019 top 10.

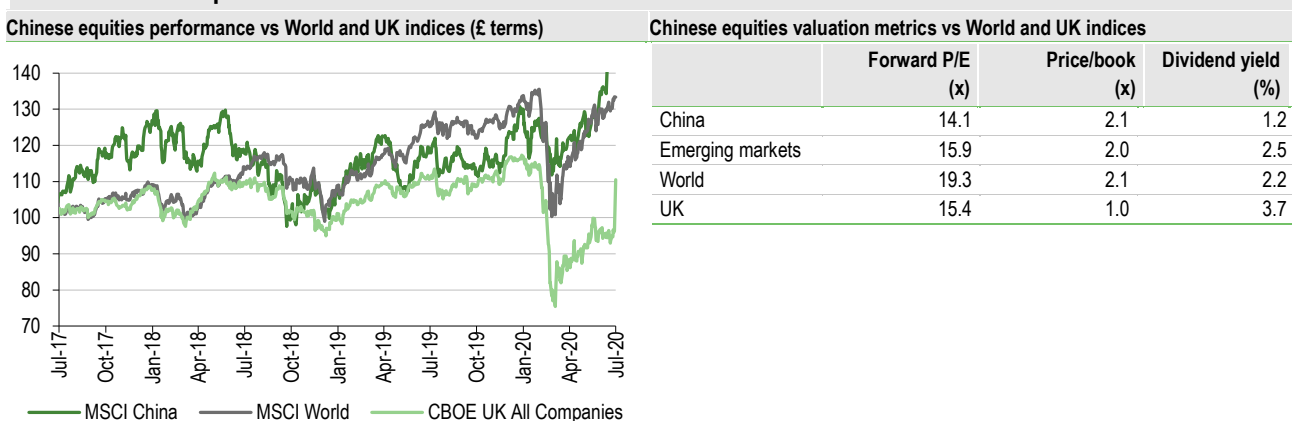
## Market outlook: Underpinned by growth prospects

The Chinese government's efforts to fight the COVID-19 virus outbreak by effectively shutting down the economy and restricting the movement of citizens, caused the economy to contract by 6.8% in the three months ending March 2020, compared to the same period last year. These restrictions were lifted in early April and since then, China has led the way out of the global health and economic crisis, supported by fiscal stimulus measures including vouchers to encourage consumer spending. Chinese GDP rose by 3.2% in the three months to end-June 2020, compared to June 2019, exceeding market expectations. The recent National People's Congress meeting mapped out China's policy for further support, including measures to increase credit access for small and medium-sized enterprises through state-owned banks. As the economy re-opens, there is a risk of a second wave of infections, but procedures now in place mean that any resurgence in cases should be detected and managed rapidly, avoiding the need for another widespread, economically debilitating lockdown.

Consensus opinion predicts a significant rebound in the Chinese economy. The International Monetary Fund (IMF) is forecasting GDP growth of 1.0% for 2020 as a whole and 8.2% in 2021. This compares favourably with a forecast 3.0% contraction in growth across emerging markets and developing economies generally in 2020, followed by a projected rebound of 5.9% in 2021. The IMF predicts a more severe contraction of 8.0% in GDP growth in the advanced economies this year, followed by a rise of 4.8% in 2021. This apparent resurgence in China's growth prospects has benefitted the Chinese stock market. After falling 25% from its January high, the MSCI China Index has rebounded sharply since late March.

Until a vaccine is developed, global financial markets will be at risk of further volatility. The Chinese market is potentially subject to additional pressures associated with increasing uncertainty about China's relationship with Hong Kong and jitters about the course of US-China trade talks. Tensions on this front are likely to continue to simmer and possibly escalate in the run-up to the US presidential election in November. These uncertainties do not, however, detract from the very favourable longer-term outlook for the Chinese economy, in absolute and relative terms. Strong growth combined with increasing investor attention as China claims a greater share of global indices may drive higher valuations for Chinese equities over the longer term.

**Exhibit 2: Market performance and valuation**



Source: Refinitiv, Edison Investment Research. Note: Valuation data as at 17 July 2020.

## Fund profile: Focus on consumer sector opportunities

FCSS was launched in April 2010. Its objective is to achieve long-term capital growth by actively managing a diversified portfolio of companies listed in China and Hong Kong and Chinese firms

listed elsewhere. The trust can also invest in companies with significant interests in China. Fidelity International provides FCSS with investment management services. Dale Nicholls has been the trust's portfolio manager since April 2014. He has more than 15 years' experience investing in China and has worked at Fidelity for 24 years. Nicholls is based in Hong Kong.

The portfolio usually comprises around 150 holdings, most of which are listed in China or Hong Kong. FCSS uses the MSCI China index (sterling adjusted) as its benchmark. The manager focuses on sectors with strong growth prospects, particularly those likely to benefit from the tremendous spending power of China's burgeoning middle class and from structural reform. Holdings are biased towards small to mid-cap companies, as Nicholls believes that companies in these sectors are often under-researched and mis-priced and thus offer the most attractive opportunities. Up to 10% of the portfolio can be held in unlisted investments and the manager has scope to initiate short positions worth up to 15% of the portfolio. Gearing of up to 30% of net assets is permitted, although gearing rarely rises much above 20%.

## **The fund manager: Dale Nicholls**

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### **The manager's view: Crisis fuels trends and creates opportunity**

Nicholls believes that the COVID-19 crisis has accelerated many of the broad trends already in place in China. The shift online, be it in e-commerce or services like online education, coupled with the need to manage the data that drives this, will become even more significant and should benefit about 40% of the trust's holdings says Nicholls. This proportion rises to well over 50% with the addition of healthcare and life insurance, which the manager expects will also experience further structural growth due to the crisis.

However, while the virus may have provided significant impetus to some of the consumption trends on which Nicholls was already focussed, he believes the strongest driver of consumption growth in coming years will remain the natural growth and development of China's middle class. He also reiterates his conviction regarding the long-term value offered by small-cap companies. While conceding that this sector had been out of favour with investors for some time before the beginning of the latest market downturn, he remains convinced that 'as long as these companies execute and deliver on their strategies and earnings over the medium term, this should be reflected in stock prices over time'.

Another factor which Nicholls expects will support the portfolio over time is the increasingly significant role China will assume in global equity and bond markets over the next decade. China's share of the MSCI AC World index has risen from 1.9% to 4.9% over the past 10 years and the manager expects its share to continue to rise. As it does, China will be increasingly difficult for global investors to ignore. 'The sheer breadth and depth of China's onshore markets and the lack of institutional investors means that stocks are relatively under-researched and provide rich stock-picking opportunities for active investors' Nicholls maintains. This shift will be assisted by the fact that China is increasing open to foreign capital inflows. Market access for international investors has been improved in recent years by the launch of the Hong Kong-Shanghai Stock Connect programme in late 2014 and the extension of the Hong Kong-Shenzhen Stock Connect.

The manager expects the trend towards greater foreign investment in Chinese markets to play out against a background of continued US-China tensions over coming decades. He foresees further protracted and sometimes acrimonious rounds of trade negotiations following last year's 'Phase One' trade deal, with near-term progress likely hampered by accusations related to China's role in the outbreak of COVID-19 and escalating rhetoric ahead of the US presidential election in November.

Months of protest in Hong Kong have added to US-China tensions and investor unease and aggregate valuations of many Hong Kong equities are at historic lows. Nicholls says that while it is difficult to predict when prices will recover, a recent uptick in privatisation deals and rising market participation by mainland Chinese investors could provide potential catalysts for improved performance of the Hong Kong market. 'As much of the world approaches zero or negative interest rates, there aren't many places to find a rich supply of stocks with stable growth, high dividend yields and low earnings multiples. Given time, as the macro dust settles, global investors should be lured back by companies that continue to create value for shareholders' he says.

However, Nicholls stresses that geopolitical tensions will not distract him from his ongoing pursuit of long-term capital growth via investments in private, well-managed companies in sectors such as consumer, technology and pharmaceuticals, which he expects will benefit from structural change in the domestic Chinese economy. The manager believes that 'volatility is not always a bad thing'. It can create opportunities to invest in high quality companies at attractive valuations and he sees the current environment as certainly one of those times. Nicholls expects volatility to continue and possibly increase as the US election approaches and he welcomes the chance to take full advantage of any opportunities it generates, as they unfold.

## **Asset allocation**

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### **Investment process: Well-resourced bottom-up search for value**

FCSS invests directly in companies based within China and Hong Kong, or which draw most of their revenues from China. The manager believes that the growth of China's middle class and the refocusing of China's economy towards domestic consumption will drive economic growth and stock markets over the medium to long term. FCSS therefore focuses on well-managed, cash-generative but undervalued companies delivering goods and services that will benefit from these trends. The portfolio typically comprises 130-150 stocks. Manager Dale Nicholls favours small and medium-sized companies, with the view that such companies are under-researched and thus often undervalued relative to their long-term growth potential. However, the trust also has scope to invest in large and mega-cap companies such as state-owned enterprises, where they represent good value. Exposure to the broadest possible set of investment opportunities within China is enhanced by FCSS's capacity to invest up to 10% of the portfolio in unlisted companies, in anticipation of a rise in value on eventual listing. There is also scope to employ short positions up to 15% of the value of the portfolio, while derivatives are used for gearing purposes and to enhance the efficiency of the portfolio management process.

The manager uses in-depth bottom-up fundamental analysis to identify potential investments and monitor existing holdings. The stock selection process is supported by Fidelity's well-resourced China and Asian regional research teams based in Hong Kong, Shanghai and Singapore. Nicholls believes this gives Fidelity a unique ability to discover and research the many opportunities available amongst under-researched and mis-priced small cap companies. In total, these teams now comprise 21 analysts, following the recent addition of three juniors from Fidelity's intern program and the appointment of a highly experienced healthcare specialist.

Company meetings and site visits are integral to FCSS's investment process, both before and after investment. The manager's access to companies and other stakeholders is good and he conducts more than 500 face-to-face meetings across China each year. Since the outbreak of the coronavirus, a full schedule of meetings has been maintained online. Analysts have also increased their level of engagement with management teams to understand the individual challenges companies face and how they are dealing with significant declines in revenue. Scrutiny of companies' balance sheets and cash flows has also increased.

Environmental, Social and Governance (ESG) considerations are embedded into the fundamental analysis of each holding and potential investment. This approach is based on the manager's experience that Chinese companies with higher corporate governance standards tend to outperform, whereas those with weak governance may find themselves dogged by concerns about their social or environmental impact. Fidelity International has a proprietary ESG rating system, which quantifies relevant factors and allows comparison of various companies. Where necessary, the manager engages directly with company management either before or after investment, to lobby for better disclosure and governance practices and to ensure responsible sourcing, for example, in the garment industry.

## Current portfolio positioning

Since the beginning of the coronavirus crisis, the manager has maintained his core focus on consumer and technology-related companies, which he expects to benefit from the domestic Chinese structural growth drivers he has highlighted over past years. The portfolio is almost exclusive focussed on the domestic Chinese economy, with 88% of revenues currently derived from Greater China (China, Hong Kong and Taiwan).

Price action seen since the outbreak of the virus has created many opportunities to purchase well-managed companies that the manager previously considered attractive but too expensive. One example of his response to such opportunities is the initiation of a position in aircraft lessor BOC Aviation, on the expectation that it will weather the downturn better than peers. In previous downturns, while some airlines have struggled and failed, airline lessors have benefitted by re-leasing aircraft to stronger survivors. The manager believes that although this position is based on a somewhat contrarian view given the outlook for much of the aviation sector, current conditions should provide an opportunity for BOC to use its balance sheet strength to grow its leasing book.

In March 2020, FCSS also acquired a new position in Pony.ai, an unlisted company which is China's leading autonomous driving technology company, based in Silicon Valley and China. The company is one of five leading global players in this fledging industry, where competition by new entrants is limited by high capital requirements and the technological advances realised by existing players. The manager is impressed by Pony.ai's management team and by its strategic partnerships with leading car manufacturers, including Toyota and Hyundai.

Nicholls has also added new positions in ceramics manufacturer Monalisa Group, apparel manufacturer Crystal International Group, Convenience Retail Asia and e-commerce service provider Weimob, although this was sold in mid-July. A holding in wealth manager Noah Holdings has been increased following a recent fall in price, due to the manager's conviction that this company can recover from recent fraud-related losses and realise its long-term growth potential. Other oversold names have been purchased and profits have been taken on short positions. Exposure to the domestic travel sector has risen on the view that demand for travel is a priority for the Chinese middle class, and while international travel remains forbidden, domestic travel will benefit. Since the lifting on the lockdown, hotel occupancy is already back to around 40-50% and is expected to continue to increase.

The manager has also closed positions in companies expected to struggle as a result of the crisis. Outright sales include China Taiping Insurance, Clear Media and Nanking Kangni Mech and Electrical Co. Profitable positions in Tencent Holdings, Kingsoft and China MeiDong Auto Holdings have been trimmed.

At the end of June 2020, the top 10 holdings represented 40.4% of the portfolio, up from 37.5% a year earlier (see Exhibit 1). China MeiDong Auto Holdings, which focuses on the premium car market, has been a long term holding whose recent performance has been enhanced by new store openings and growth in margins. Tech giants Alibaba Group and Tencent are viewed by the manager as central pillars in the Chinese economy and so have remained core holdings. However,

the portfolio is underweight these companies relative to the benchmark, in order to allow the manager to take advantage of more attractive opportunities elsewhere. Nicholls's conviction regarding the merits of small-cap stocks is reflected in the fact that while the portfolio is relatively concentrated amongst its top 10 holdings, the remainder of its holdings comprise a further 130 or so small positions in mainly small-cap companies.

Due to the manager's focus on high growth areas of the domestic Chinese economy, it is not surprising that the portfolio's sector exposures vary markedly from the benchmark (Exhibit 3) It maintains significant overweights to information technology (+8.3pp), healthcare (+5.9pp) and a more modest overweights to materials (+2.7pp) and consumer discretionary (+1.1pp) and underweights to communications services (-7.1pp) and financials (-5.1pp) and). The portfolio has no exposure to banks, as the manager believes they are likely to take the brunt of any financial stress and he prefers to maintain exposure to the financials sector via insurers, including overweight positions in China Pacific Insurance and China Life Insurance. An underweight to real estate reflects the manager's preference to maintain indirect exposure to this sector via holdings in consumer durable stocks.

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

GICS sector	Portfolio 30 June 2020	Portfolio 30 June 2019	Change (pp)	Benchmark 30 June 2020	Active weight vs index (pp)	Trust weight/ index weight (x)
Consumer discretionary	32.5	28.5	4.0	31.4	1.1	1.0
Communication services	15.7	16.4	(0.7)	22.8	(7.1)	0.7
Information technology	13.4	16.2	(2.9)	5.1	8.3	2.6
Healthcare	11.5	7.0	4.5	5.6	5.9	2.0
Financials	10.6	14.9	(4.3)	15.7	(5.1)	0.7
Industrials	5.3	9.0	(3.7)	4.8	0.5	1.1
Materials	4.6	1.8	2.8	1.9	2.7	2.4
Consumer staples	3.6	3.9	(0.3)	4.0	(0.4)	0.9
Energy	1.7	1.3	0.4	2.1	(0.4)	0.8
Real estate	1.3	0.8	0.5	4.6	(3.3)	0.3
Utilities	(0.1)	0.2	(0.3)	2.0	(2.1)	(0.0)
	<b>100.0</b>	<b>100.0</b>		<b>100.0</b>		

Source: Fidelity China Special Situations, Edison Investment Research

About 54% of FCSS's holdings are listed on the Hong Kong Stock Exchange, either as China 'H' class shares, which are privately-owned Chinese companies (16.2%), China red chips, which are partially-owned by the Chinese government (short position, -2.9%) or other Greater China stocks (40.2%). A further 10.8% of holdings are listed on one of the two mainland China exchanges in Shanghai or Shenzhen and most of the balance of quoted stock holdings are listed in the US. The acquisition of the position in Pony.ai increased the portfolio's exposure to unlisted stocks to 4.3% at the end of June 2020, via six holdings (Exhibit 4).

**Exhibit 4: Portfolio geographical exposure vs benchmark (% unless stated)**

Country/region	Portfolio 30 June 2020	Portfolio 30 June 2019	Change (pp)	Benchmark 30 June 2020	Active weight vs index (pp)	Trust weight/ index weight (x)
China 'A' shares	10.5	8.4	2.1	11.5	(1.0)	0.9
China 'B' shares	0.3	1.7	(1.4)	0.1	0.2	3.2
China 'H' shares*	16.2	18.0	(1.8)	18.7	(2.6)	0.9
China red chips*	(2.9)	5.4	(8.4)	7.6	(10.5)	(0.4)
Other stocks listed in HK**	40.2	37.3	2.9	31.9	8.2	1.3
Singapore	0.0	0.0	0.0	0.0	0.0	N/A
USA	27.6	24.2	3.4	30.1	(2.5)	0.9
Taiwan	1.8	2.6	(0.8)	0.0	1.8	N/A
Australia	0.0	0.3	(0.3)	0.0	0.0	N/A
United Kingdom	2.1	2.1	0.0	0.0	2.1	N/A
Canada	0.0	0.0	0.0	0.0	0.0	N/A
Unlisted	4.3	4.4	(0.1)	0.0	4.3	N/A
Other	(0.1)	(4.4)	4.3	0.0	(0.1)	N/A
Total	<b>100.0</b>	<b>100.0</b>		<b>100.0</b>		

Source: Fidelity China Special Situations, Edison Investment Research

At the onset of the COVID-19 crisis, the manager used derivatives to provide some downside protection and he took profits on these as the market declined. He has since added some new short positions as protection in the current rally. At the end of June 2020, net market gearing (which nets off short positions) was 23.6%, up from levels in the low teens in February, as the manager used leverage to take advantage of opportunities in the market and closed short positions.

## Performance: Volatility no drag on solid performance

**Exhibit 5: Five-year discrete performance data**

12 months ending	Share price (%)	NAV (%)	MSCI China (%)	MSCI China Small Cap (%)	MSCI World (%)	CBOE UK All Companies (%)
30/06/16	(3.5)	(0.4)	(9.6)	(15.2)	15.1	1.7
30/06/17	44.4	34.3	36.2	17.8	22.3	18.3
30/06/18	18.4	18.1	19.5	13.8	9.9	9.5
30/06/19	(7.3)	(12.8)	(3.1)	(10.7)	10.9	0.3
30/06/20	27.7	29.0	16.7	(0.1)	6.5	(13.6)

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

Despite the COVID-19-related volatility in global equity markets, FCSS has delivered positive returns on a one-, three-, six- and 12-month basis. Returns have also been positive over three, five and ten-years and the trust has outperformed its benchmark in most periods (Exhibit 6 and 7). The trust has also outperformed the MSCI China Small Cap, the MSCI AC Asia ex-Japan and the CBOE UK All Companies indices over all periods shown. This sustained outperformance against the UK market serves as a reminder to UK investors of the potential benefits of diversification away from their home market. FCSS has also outperformed the MSCI World index in most periods, despite this index's heavy concentration of mega-cap growth stocks.

**Exhibit 6: Share price and NAV total return performance, relative to indices (%)**

	1 month	3 months	6 months	1 year	3 years	5 years	10 years
Price relative to MSCI China	9.2	12.4	10.0	9.5	3.7	17.5	40.0
NAV relative to MSCI China	6.6	12.3	10.4	10.5	(1.6)	7.0	53.1
Price relative to MSCI China Small Cap	7.1	14.6	16.0	27.8	38.0	92.6	150.2
NAV relative to MSCI China Small Cap	4.6	14.5	16.4	29.1	30.9	75.4	173.7
Price relative to MSCI AC Asia ex-Japan	9.8	11.0	19.5	21.6	18.9	22.0	47.4
NAV relative to MSCI AC Asia ex-Japan	7.2	11.0	20.0	22.8	12.7	11.1	61.3
Price relative to MSCI World	15.9	8.5	20.6	19.9	8.0	6.9	6.2
NAV relative to MSCI World	13.2	8.4	21.0	21.1	2.4	(2.7)	16.2
Price relative to CBOE UK All Companies	16.8	18.0	49.0	47.9	47.7	71.1	85.9
NAV relative to CBOE UK All Companies	14.1	18.0	49.6	49.3	40.1	55.8	103.4

Source: Refinitiv, Edison Investment Research. Note: Date to end-June 2020. Geometric calculation.

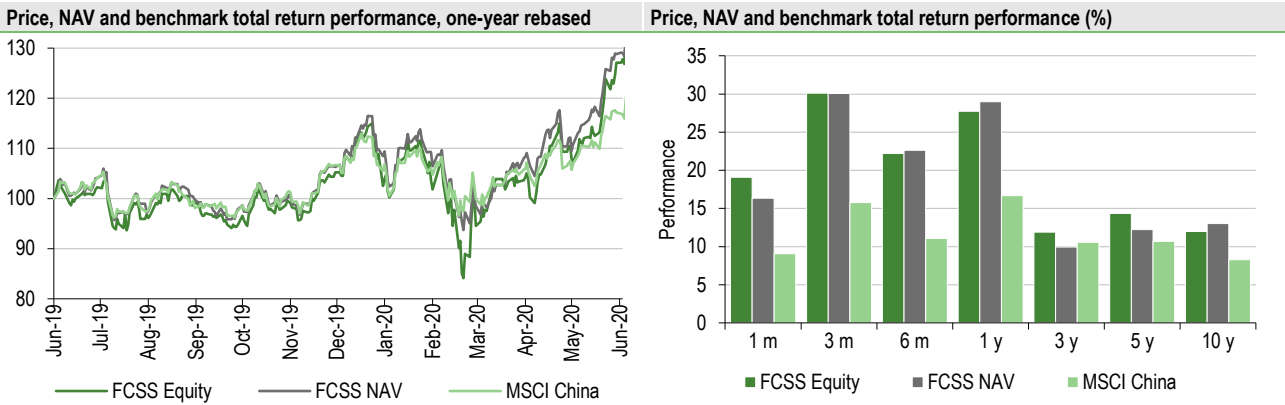
In terms of the contribution of individual stocks to FCSS's performance, China MeiDong Auto Holdings has made the largest contribution to returns over the past year, due to an improvement in new car sales margins and a surge in pent-up demand as the lockdown lifted. 21Vianet Group, the leading carrier-neutral internet data centre in China, also contributed significantly, thanks to fast growth in China's internet infrastructure industry. The trust's holdings in Tencent and Alibaba have seen accelerated growth due to the virus, although the underweight positions in both these stocks dragged on relative returns. Recent performance has been further assisted by the outperformance of many of FCSS's small cap holdings. Having been out of favour amongst investors for some time, in the last couple of months value stocks have outperformed larger growth stocks.

Adverse effects of stock selection on performance over the past year include China Life Insurance and China Taiping Insurance. This sector has suffered because the lockdown has prevented brokers from conducting the face-to-face meetings which Chinese insurance clients prefer before signing contracts. Wealth manager Noah Holdings was also hurt by a decline in transaction volumes after the virus outbreak, while Aurora Mobile detracted from returns due to weakness in advertising revenues and some one-off losses. Luxury goods and services have been slow to



recover since the easing of the lockdown, and returns were reduced by the poor performance of the online upmarket fashion retailer Secoo.

**Exhibit 7: Investment trust performance to 30 June 2020**



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

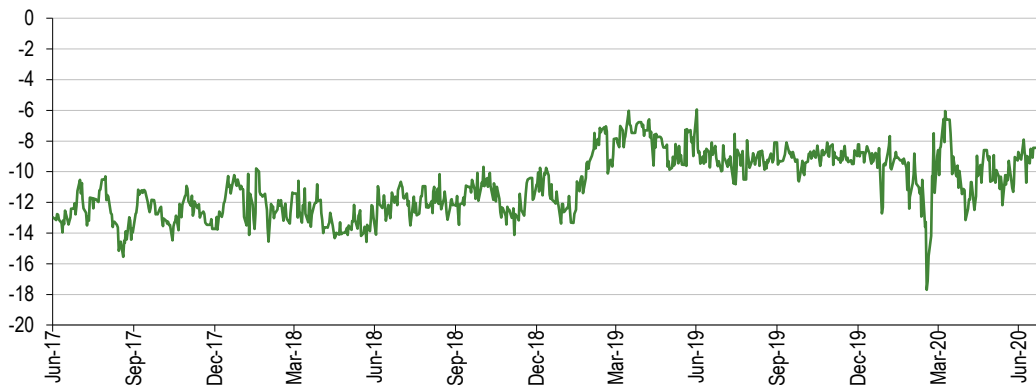
**Exhibit 8: NAV total return performance relative to index over 10 years**



Source: Refinitiv, Edison Investment Research

**Discount: Actively managed to a single-digit target**

**Exhibit 9: Share price discount to NAV (including income) over three years (%)**



Source: Refinitiv, Edison Investment Research

Historically, FCSS’s share price discount to NAV has been driven by investor sentiment towards China. After trading in a range of 10-15% from late 2016 until February 2019, the discount to NAV (including income) narrowed to a new trading range of 6-10% until the onset of COVID-19 in

February 2020 (see Exhibit 9). In June 2019, the board adopted a formal discount control policy under which it seeks to maintain the discount in single digits in normal market conditions and will, subject to market conditions, repurchase shares to this end. During FY20, the board repurchased 10.8m ordinary shares into treasury, representing c 2% of the share capital. At the onset of COVID-19, the discount widened sharply and the board has since been proactively managing the discount. So far in FY21, it has repurchased a further 21.6m shares into treasury. The discount currently stands at 8.4% and there is scope for it to narrow as and when investor sentiment towards China, especially small-cap stocks, improves.

## Capital structure and fees

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FCSS is a closed-end investment company with one class of share. There are currently 516.1m ordinary shares on issue, with a further 55.3m shares held in treasury. As discussed above, in June 2019, the board adopted a formal discount policy, which aims to keep the share price discount to NAV below 10%. The board has been proactively managing the discount during the COVID-19 crisis.

FCSS has capacity for total gearing up to 30% of NAV, with borrowings restricted to 25%. Net market gearing is typically held in a 10-30% range. As at 31 March 2020, FCSS had gross gearing of 25.2% versus 26.1% the previous year. Once short positions are netted off, net gearing was 23.2% compared to 20.9% at end-FY19. Net gearing has since risen slightly to 23.6%. FCSS's unsecured \$150m fixed rate facility agreement with Scotiabank Europe matured on 14 February 2020 and on the same day the trust entered into a new three-year \$100m unsecured fixed rate facility agreement with the same lender at a rate of 2.606% pa. FCSS also uses contracts for difference (CFDs) to achieve further gearing.

Since July 2018, FCSS has had a variable management fee arrangement with FIL Investment Services (UK), calculated by referencing performance relative to the MSCI China Index. Under this arrangement, the Company pays an annual management fee of 0.90% on net assets, with a +/- 0.20% variation fee based on NAV returns relative to the benchmark. FY20 was the first full year that the variable management fee was in place and it has led to a reduction in fees compared to the previous fee structure. The ongoing charge for FY20 was 0.99%, compared with 1.02% in FY19 and 1.11% in FY18. For FY20, the variable element of the management fee was a credit of 0.20%, compared to a credit of 0.09% in the previous year, so for FY20 the ongoing charge including the variable element was 0.79%, a reduction on FY19's charge of 0.93%. Management fees and costs are allocated to capital and revenue on a 75:25 ratio respectively, which reflects relative historical contributions to total returns.

## Dividend policy and record

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At FCSS's launch, it was envisaged that investors' returns would come from capital growth and the trust has no obligation to pay a dividend. However, in the 10 years since then, the portfolio has consistently generated a significant level of income, thanks to the manager's focus on cash-generative businesses, and this has enabled FCSS not only to pay an annual dividend, but to increase it every year since inception. For the year ended 31 March 2020, the board recommends a final dividend of 4.25p per share for approval by shareholders at the AGM to be held on 23 July 2020. This represents a dividend yield of 1.4% based on the current share price and is an increase of 10.4% versus the 3.85p per share paid in FY19. This represents a healthy annual increase, especially in comparison to more mature stock markets and is motivated by the board's recognition that with interest rates decreasing, dividends have become a more important part of shareholders' total return. The board recently expressed its hope that FCSS will continue to increase its annual

dividend. The trust's capacity to realise this ambition is enhanced by the fact that it has built up revenue reserves equating to 2.27p per share, which can be used to smooth future dividend distributions.

## Peer group comparison

Exhibit 10 provides a comparison of FCSS against a peer group comprising open- and closed-ended funds that invest in Chinese equities. Aside from FSCC, JPMorgan China Growth and Income is the only other closed-ended fund in the AIC Country Specialist: Asia Pacific ex-Japan sector which focuses on China, so the table shows averages for the AIC Asia Pacific sector. The table also includes IA China/Greater China sector funds larger than £300m with a track record of more than five years.

FCSS's NAV total return exceeds the averages of the AIC Asia Pacific ex-Japan sector and the IA China/Greater China sector over all periods. Its current share price discount to NAV is narrower than the average of the AIC peer group and its ongoing charge is the lowest of all funds in both the AIC and IA peer groups. FCSS's gearing is higher than its closed-ended peers and its dividend yield of 1.4% is slightly below the average of its AIC peers.

**Exhibit 10: Selected peer group investing in Chinese equities as at 17 July 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
<b>Fidelity China Special Ord</b>	1553	36.3	42.3	105.2	267.0	(6.5)	0.99	Yes	124	1.4
JPMorgan China Growth & Income	310	57.8	77.1	120.9	246	(11.8)	1.26	No	108	0.9
<b>Asia Pacific average</b>	<b>376</b>	<b>0.0</b>	<b>7.4</b>	<b>54.9</b>	<b>142.1</b>	<b>(11.8)</b>	<b>1.66</b>		<b>104</b>	<b>1.6</b>
Allianz China Equity	351.1	22.8	34.6	70.8	115.9		2.31	No		0.0
AS SIVAC I China Equity	475.5	8.4	30.6	68.5	98.3		1.98	No		0.0
Barings Hong Kong	1,404.0	27.8	45.3	92.8	116.4		1.70	No		0.1
Fidelity China Focus	2,251.2	(3.9)	10.3	49.5	101.5		1.91	No		1.2
First State Greater China	556.2	12.4	39.6	93.6	193.3		1.82	No		0.2
HSBC GIF Chinese Equity	944.7	20.7	31.5	72.2	101.1		2.40	No		0.0
Janus Henderson China Opps	898.9	13.2	29.0	94.0	148.4		1.71	No		0.2
Schroders ISF Greater China	1,442.2	24.2	46.1	118.1	181.3		1.85	No		1.6
Templeton China	320.6	18.4	40.5	89.4	93.2		2.44	No		0.0
<b>Open-ended funds average</b>	<b>960.5</b>	<b>16.0</b>	<b>34.2</b>	<b>83.2</b>	<b>127.7</b>		<b>2.01</b>			<b>0.7</b>

Source: Morningstar, Edison Investment Research. Note: \*Performance to 16 July 2020 based on ex-par NAV. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

## The board

FCSS's board is comprised of five members, chaired by Nicholas Bull, who joined the board in February 2010 and was appointed chair in July 2016. Elisabeth Scott is the senior independent director, having joined the board in November 2011. Mike Balfour became a board member in October 2018 and has chaired the audit and risk committee since the departure of David Causer in July 2019. Linda Yueh joined the board in June 2019. Peter Pleydell-Bouverie, who has served on the Board since the trust's launch in April 2010, will step down in July 2020. A search is underway for his replacement. Board members have a wide range of skills and experience in the areas of corporate finance, financial services, investment management and academia.

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