Fidelity China Special Situations

Seeking out and capitalising on structural winners

Investment trusts
Chinese equities

1 June 2021

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 undervalued companies. He favours consumer sectors set to benefit from structural trends driven by the burgeoning growth of China's middle class. He sees most opportunities in mid- and small-cap technology, healthcare and e-commerce stocks and among unlisted companies, all of which are often under-researched and thus mispriced. For Nicholls, the recent pull-back in Chinese markets has created 'a great environment in which good but undervalued companies offer even better value'. Nicholls' approach has delivered absolute returns and outperformance of FCSS's peers, and its benchmark, the MSCI China Index both recently and long term. Relative performance has been especially strong over the past year, thanks to superior stock selection and sector allocation decisions.

NAV outperformance versus the benchmark over 10 years

Source: Refinitiv, Edison Investment Research

Why consider China now?

The long-term investment case for China remains well supported by several key factors, including strong economic growth and the government's focus on high-quality development driven by innovation, technological self-sufficiency and domestic demand. Chinese equities are also attractively priced, trading at a significant discount to world markets, and may benefit over time as and when foreign investors reduce their significant underweight to this market.

The analyst's view

This trust may appeal to investors seeking an entrée into the many opportunities arising from China's medium-term growth prospects and major structural changes underway in the country. By investing in China and in Chinese companies listed elsewhere, in companies with significant interests in China and in unlisted companies (up to 10% of the portfolio), FCSS offers investors direct access and very wide-ranging exposure to the investment opportunities on offer in China, which are much greater than investors could hope to achieve by direct stock-by-stock investment. FCSS's offering is also broader and more diversified than that of its peers.

NOT INTENDED FOR PERSONS IN THE EEA

Price		**417.0p**
Market cap		**£2,149m**
AUM		**£2,913m**
NAV*		424.0p
Discount to NAV		1.7%
*Including income. At 27 May 2021.		
Yield		1.0%
Shares in issue		515.5m
Code		FCSS
Primary exchange		LSE
AIC sector		Country specialist: Asia Pacific ex-Japan
Benchmark		MSCI China
52-week high/low	498.0p	218.0p
NAV** high/low	497.7p	248.9p
**Including income.		

Gearing

Net market gearing***	19.5%
*** At 30 April 2021	

Fund objective

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.

Bull points

- Largest UK investment trust focused on China, offering direct and diversified exposure to China's medium-term growth.
- Strong absolute and relative performance over the short and long term.
- 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 took effect from 1 April 2021.

Bear points

- The trust's relatively high gearing exposes it to further market downside.
- Persistent uncertainty about the regulatory environment for some companies.
- Trade tensions with the US likely to persist in the long term, with potentially detrimental implications for some sectors.

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Recent market developments

Chinese equities have outperformed other markets significantly over the past year, supported by the country's relatively strong recovery. China is the only major economy to have registered positive growth in 2020, and in its April 2021 forecasting round, the International Monetary Fund (IMF) revised up its forecast for Chinese GDP growth in 2021 to 8.4%, from 8.1% in its January projections. The IMF expects the Chinese economy to grow by a further 5.6% in 2022, unchanged from its January projections. This compared with the IMF's forecast for growth in the advanced economies of 5.1% in 2021 and 3.6% in 2022. China has also handled localised coronavirus breakouts decisively, ensuring they have not robbed the recovery of momentum. The Chinese market, as measured by the MSCI China Index, rose nearly 30% over 2020, almost twice the 16.8% increase in the MSCI AC World Index. However, in March, Chinese stocks gave back some of these gains, declining 6.3%, while global markets registered a 2.7% gain.

The manager's view: Opportunities abound

FCSS's manager, Dale Nicholls, says the recent pull-back in Chinese equities was not unexpected. The market saw a strong rally in late 2020. In addition, rising bond yields, driven by expectations of inflation pressures, put pressure on equity valuations, especially highly valued growth, tech and momentum stocks, whose prices were, in Nicholls' view, looking 'particularly stretched'. These high valuations have led Nicholls to take some profits in recent months. He has trimmed holdings in several names, including premium car dealer China MeiDong Auto Holding. This position was cut from 5% of the portfolio to 1%, removing it from the trust's top 10 holding list (Exhibit 1) and reducing the holding to an underweight versus the benchmark. Nicholls also reduced exposure to tech giant Alibaba from 15.1% to 11.3%, increasing the trust's underweight in this stock, compared to the index, although Alibaba remained the trust's second largest position at the end of March.

Exhibit 1: Top 10 holdings (at 30 April 2021)

Company	Sector	Portfolio weight %**		Benchmark weight (%)	Active weight vs benchmark (%)
		31 April 2021	31 April 2020***		
Tencent	Communication services	8.9	10.9	14.9	(6.0)
Alibaba	Consumer discretionary	8.0	9.5	14.1	(6.1)
Wuxi AppTec Co	Healthcare	2.5	1.8	0.3	2.2
Skshu Paint Co	Materials	2.3	1.7	0.0	2.3
Ping An Insurance Group	Financials	2.0	N/A	2.3	(0.3)
Noah Holdings	Financials	1.9	2.0	0.0	1.9
21Vianet	Information technology	1.6	2.9	0.1	1.5
Asia Cuanon Technology	Materials	1.6	N/A	0.0	1.6
Beijing Oriental Yuhong	Materials	1.6	N/A	0.0	1.6
Kuaishou Technology	Communications services	1.5	N/A	0.2	1.3
Top 10 (% of portfolio)		**31.9**	**41.1**		

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-April 2020 top 10.

Despite China's better growth prospects and the outperformance of Chinese equities, Chinese stocks continue to trade at a significant discount to other major markets; according to Datastream valuations, on a forward P/E basis, Chinese H shares are currently trading at a multiple of 11.7x and A class shares are trading at 14.7x, compared to a multiple of 19.1x for the world market. For Nicholls, this increases the attractiveness of the Chinese market, and he sees the recent volatility as creating a good opportunity for him to invest in the lagging stocks he sees in several sectors. 'There are many stocks which now offer even better value' he says.

Nicholls focuses on undervalued companies with good long-term growth prospects, that have been underestimated by the wider market. He favours sectors that will benefit most from the long-term structural changes underway in China, including the growth in tech businesses, healthcare and related insurance services and e-commerce, many of which have been given further impetus by the pandemic. The consumer trend towards upgrading possessions and buying premium brands, also remains strong, especially in the auto sector. The opportunities he sees tend to cluster in the medium- and small-cap space, where companies are under-researched by Fidelity's competitors and often mis-priced. The manager cites as an example the many Hong Kong small caps trading at single digit PE multiples, even when their businesses are proven and generating healthy cash flows. Nicholls also sees opportunities among unlisted companies, which are also off the radar of many analysts.

Recent acquisitions within the tech sector include a new position in RS Technologies, a dominant global player in silicon wafer recycling (components in semiconductor production). This company is listed in Japan but is well positioned to benefit from growth in China, where it is expanding facilities to manufacture new wafers. Within healthcare, Nicholls has increased exposure to B-Soft, China's second largest healthcare IT vendor, which has a 6% market share. B-Soft's main business is the provision of hospital and clinical information systems, a growing field due to health care reforms, and the business is supported by an effective salesforce. The manager took advantage of near-term stock price weakness to increase FCSS's exposure to LexinFintech Holdings, a leading online retail and consumer finance platform. He also added to an existing position in SKSHU Paint, one of China's largest paint manufacturers, which he likes in part due to management focus on cost control and operating efficiency. This stock is a top five holding and has been a major contributor to performance over the past year, as investors continue to recognise the company's growth potential. Another recent addition in the materials sector is Asia Cuanon Technology, another of China's largest paint manufacturers that also provides a range of insulation and building products. Nicholls believes the company is well-positioned to expand market share and benefit from the trends towards urban renewal and domestic renovation.

Exhibit 2: Portfolio sector exposure vs index (% unless stated)

Sector	Portfolio weight %			Index weight (%)	Active weight vs index (pp)	Trust weight/ index weight (x)
	31 Apr 2021	31 Apr 2020	Change (pp)			
Consumer discretionary	26.3	33.9	(7.7)	34.1	(7.8)	0.8
Communication services	19.7	14.8	4.9	20.5	(0.8)	1.0
Financials	10.8	10.6	0.2	13.7	(2.9)	0.8
Information technology	11.4	12.9	(1.6)	6.0	5.3	1.9
Industrials	10.0	6.2	3.8	4.7	5.3	2.1
Healthcare	10.0	10.0	0.0	7.3	2.7	1.4
Materials	6.7	4.3	2.3	2.3	4.4	2.9
Consumer staples	2.6	4.2	(1.6)	4.4	(1.8)	0.6
Energy	1.5	2.2	(0.7)	1.2	0.3	1.2
Real estate	0.5	1.0	(0.4)	3.8	(3.3)	0.1
Utilities	0.5	(0.1)	0.6	1.9	(1.4)	0.2
	100	**100**		**100**		

Source: Fidelity China Special Situations, Edison investment Research

As foreshadowed in our last note, Nicholls has also added a new name to FCSS's holdings in unlisted companies. In addition to the six holdings discussed in that note – Didi, DJI Holdings, SenseTime, ByteDance, Pony.ai and Full Truck Alliance – the portfolio now also owns Venturous Holdings and Chime Biologics, a biologics contract research and manufacturing company that is benefiting from the strong growth and development activity in the market for pharmaceutical biologics. As at end April 2021, the trust's holdings in these seven unlisted stocks total 7.8% of the portfolio. The manager expects some of these holdings to list in the next 12 to 18 months. At the end of April 2021, the portfolio held 163 stocks.

FCSS's short stock positions accounted for 3.4% of the portfolio at the end of April and index puts totalled 8.2% of the portfolio, positions the manager views as protection against the risk of further market downside. As at end April 2021, net market gearing, which nets off short positions, stood at 19.5%. This level of gearing is high compared to FCSS's peers (see Exhibit 6) and reflects the manager's confidence in FCSS's portfolio, the market outlook and his wish to maximise exposure to the many opportunities available in the Chinese market.

Performance

Exhibit 3: Five-year discrete performance data

12 months ending	Share price (%)	NAV (%)	MSCI China (%)	MSCI China Small Cap (%)	MSCI World (%)	CBOE UK All Companies (%)
30/04/17	42.0	36.8	39.7	25.5	30.6	20.3
30/04/18	26.1	24.5	27.3	12.0	6.9	8.1
30/04/19	2.0	(3.4)	1.5	(6.6)	13.1	2.5
30/04/20	(4.7)	(0.5)	1.4	(12.6)	(0.2)	(17.2)
30/04/21	93.5	74.5	24.9	47.3	33.0	25.3

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

FCSS's performance has been very strong in absolute and relative terms over the past year. Over the three months to end-April 2021, the trust returned 3.8% on a net asset value (NAV) basis and 4.4% on a share price basis, significantly outpacing the benchmark return of -6.7%. Over the year to end-April 2021, it returned 93.5% in NAV terms and 74.5% in share price terms, compared to the benchmark return of 24.9% (Exhibit 5, RHS). However, the trust's longer-term performance is also very solid. It has outperformed its benchmark, and the MSCI China Small Cap Index, the MSCI AC Asia ex-Japan Index and the MSCI World Index over three, five and 10 years. Furthermore, it has also outperformed the UK market over these periods (Exhibit 4) – a reminder to UK investors of the potential merits of diversification beyond the UK market.

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	2.5	11.3	18.3	54.8	46.3	47.3	73.9
NAV relative to MSCI China	3.2	11.9	20.4	39.6	30.6	25.0	88.5
Price relative to MSCI China Small Cap	0.7	(0.4)	(6.4)	31.3	56.4	99.0	157.2
NAV relative to MSCI China Small Cap	1.3	0.2	(4.7)	18.4	39.5	68.9	178.7
Price relative to MSCI AC Asia ex-Japan	1.4	3.5	3.7	43.1	42.7	59.1	84.6
NAV relative to MSCI AC Asia ex-Japan	2.1	4.1	5.6	29.1	27.3	35.0	100.1
Price relative to MSCI World	(0.7)	(5.7)	(2.5)	45.5	25.3	60.7	31.2
NAV relative to MSCI World	(0.1)	(5.2)	(0.8)	31.2	11.8	36.3	42.2
Price relative to CBOE UK All Companies	(0.3)	(6.4)	(8.9)	54.4	76.9	143.5	137.8
NAV relative to CBOE UK All Companies	0.3	(5.9)	(7.2)	39.3	57.8	106.7	157.8

Source: Refinitiv, Edison Investment Research. Note: Data to end-April 2021. Geometric calculation.

Over the 12 months to end-February 2021, both sector and stock selection made significant contributions to FCSS's exceptional performance. At the sector level, allocation decisions in all sectors enhanced returns. The largest contributions were from underweight positions in communications services and financials, and overweights in consumer discretionary, IT, real estate, healthcare and materials. At the stock level, selections in consumer discretionary, IT, materials and communication services stocks added most to performance. Luxury auto trader China Meidong Auto Holding was the largest single contributor over the year, although it has detracted in recent months – the share price has continued to rise after the manager's decision to take some profits on this holding and move to an underweight position relative to the benchmark. Other notable contributions to returns over the past year were made by 21 Vianet, China's largest carrier-neutral internet and data service provider, e-bike and scooter manufacturer Yadea and SKSHU Paint Co.

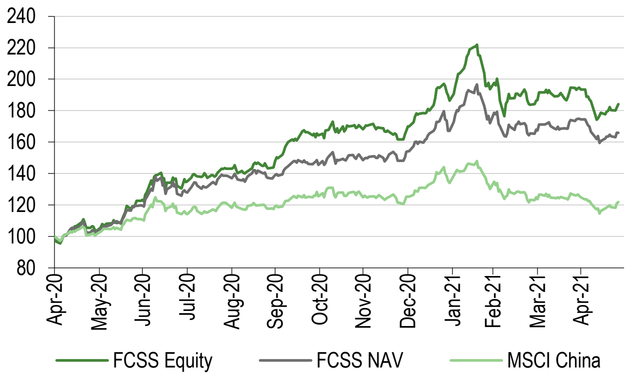
More recently, at the stock level, listing gains from the participation in the Hong Kong initial public offering of TikTok rival Kuaishou Technology were the lead contributor. The shares listed in January 2021 at HK$115 per share and peaked at HK$415 per share in mid-February. They are now trading around HK$270. Kuaishou, now a top 10 holding, is one of the most popular social platforms in

China and has seen a robust expansion in users in recent years. It has diverse video content supplied by its userbase and fosters a highly interactive community, with a strong network effect. The company's growth outlook remains promising, supported by increased monetisation of its user base, via advertising and livestreaming e-commerce. An overweight to Intron Technology, an auto parts producer, also enhanced relative returns, as did a (recently increased) underweight to e-commerce giant Alibaba, which has come under selling pressure due to fears of further regulatory crackdowns against monopolistic behaviour.

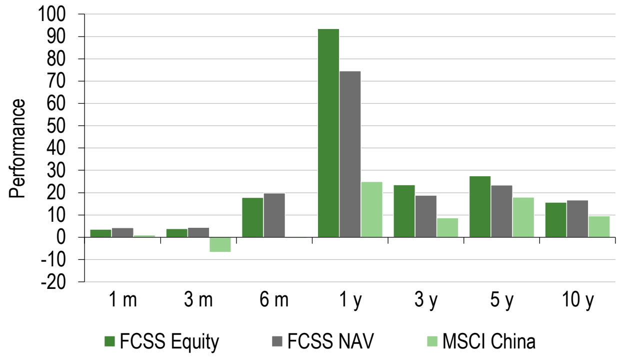
Conversely, not holding internet search engine company Baidu was the main detractor from recent relative performance, as its shares rose on the back of a potential improvement in its earnings from internet value added and cloud services. However, the manager has chosen not to hold this stock due to his concerns over structural challenges in search advertisements and what he views as the company's excessive focus on monetisation, over the provision of quality search results. The stretched valuations of Baidu's automated driving business are another area of concern.

Exhibit 5: Investment company performance to 30 April 2021

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



Price, NAV and index total return performance (%)



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

Peer group comparison

Exhibit 6: Selected peer group invested in Chinese equities at 1 June 2021*

% 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	2,141.8	60.9	50.5	178.6	372.3	(1.7)	0.90	No	120	1.0
Baillie Gifford China Growth	287.4	31.9	22.8	82.0	140.7	4.2	0.74	No	99	1.5
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	**464.4**	**51.6**	**33.1**	**106.3**	**206.0**	**(5.7)**	**1.52**		**103**	**1.3**
Allianz China Equity	519.5	29.4	26.8	112.2	134.9		2.30	No		0.0
AS SICAV I All China Equity	497.9	35.0	37.3	120.6	134.6		1.98	No		0.0
Barings Hong Kong China	1,705.0	38.1	46.3	156.0	151.0		1.70	No		0.0
Fidelity China Focus	1,707.2	9.2	(5.2)	72.1	102.3		1.91	No		1.4
Janus Henderson China Opps	733.3	22.3	16.8	118.4	165.2		1.71	No		0.1
Schroder ISF Greater China	3,122.5	40.8	49.7	182.5	239.2		1.85	No		0.9
Templeton China	434.1	28.0	27.1	124.2	108.6		2.45	No		0.0
Open-ended funds average	**1,245.6**	**29.0**	**28.4**	**126.6**	**148.0**		**1.99**			**0.8**

Source: Morningstar, Edison Investment Research. Note: *Performance to 28 May 2021 based on ex-par NAV. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

FCSS is a member of the AIC Country Specialist: Asia Pacific ex-Japan sector. 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 funds in this group to focus on China. FCSS differs from its closest peers in several respects. In addition to being by far the largest of the three, it has a greater focus on mid- and small-cap companies and unlisted names. FCSS's portfolio is also much more diversified at the stock level – it typically holds around 160 stocks, two-to-three times as many as either if its peers.

Given FCSS's small closed-ended peer group, Exhibit 6 provides a comparison of FCSS against a peer group comprising both closed- and open-ended funds that invest in Chinese equities. The table shows the averages for the whole AIC Asia Pacific sector. In addition, it includes IA China/Greater China sector open-ended funds larger than £300m, with a track record of more than five years.

FCSS has outperformed both its two closed-ended China-focused peers over one, five and 10 years and 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 shown, with the exception of Schroder ISF Greater China, which outpaced FCSS over 5 years. FCSS's share price discount to NAV was 1.7%, compared to an average discount of 5.7% for the AIC peer group, and its ongoing charge, at 0.90%, 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 took 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 below the average for these funds.

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