EDISON

Fidelity China Special Situations

Attractive valuations and growth prospects

Investment trusts

Fidelity China Special Situations (FCSS) invests in a diversified portfolio of Chinese equities, seeking exposure to higher-quality companies, primarily in faster growing, consumer-orientated areas of the economy. FCSS provides actively managed exposure to the Chinese market, following a bottom-up investment approach, unconstrained by index weightings, and currently has no holdings in banks or property, which are considered to be higher-risk sectors. FCSS has achieved a 14.5% pa NAV total return since its launch in April 2010, and its performance is considerably ahead of the MSCI China index and the world market over three and five years.

12 months ending	Share price (%)	NAV (%)	MSCI China (%)	MSCI World (%)	FTSE All-Share (%)
31/08/13	29.5	37.0	17.5	21.5	18.9
31/08/14	26.1	29.2	9.8	13.4	10.3
31/08/15	6.3	10.8	(1.9)	4.1	(2.3)
31/08/16	41.7	42.8	27.2	26.0	11.7
31/08/17	35.1	29.4	37.5	18.8	14.3

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

Investment strategy: Selecting for quality and value

The manager follows a bottom-up investment approach to maintain a diversified portfolio of 130-140 holdings, with a bias to small- and mid-cap stocks, which tend to be under-researched and hence more frequently mispriced. There is a focus on faster growing, consumer-orientated companies with robust cash flows and capable management teams. Fidelity analysts provide in-depth stock coverage, with site visits and company meetings considered essential to the process, and risk management is viewed as a priority. FCSS has US$150m of borrowing and uses futures, options and contracts for difference (CFDs) to add gearing, as well as to take short positions. Unlisted securities may comprise up to 10% of the portfolio.

Market outlook: Positive fundamentals

Despite valuations rising over the last year, China's 'H' share market trades at a 7.2x forward P/E multiple compared with 15.6x for the world market. Corporate earnings growth remains strong, reflecting China's superior GDP growth. Historical market volatility provides grounds for caution, but investors with a long-term view may be attracted by China's robust growth and discounted market valuation. The inclusion of China 'A' shares in MSCI emerging market indices from June 2018 may further encourage interest. A fund with a bottom-up approach, focusing on faster growing segments of China's economy, may appeal as a route to gain exposure.

Valuation: Narrowing discount; rising dividend

FCSS's share price discount to NAV cum income has followed a narrowing trend for more than one year, moving from 19.5% in July 2016 to 14.9% currently, which compares to its 11.8% five-year average. FCSS has traded at a premium as high as 13.2% since its launch in 2010, suggesting significant scope for further narrowing. A reallocation of expenses will raise the proportion of revenue returns from FY17, resulting in higher dividend distributions than otherwise (see page 7).

15 September 2017

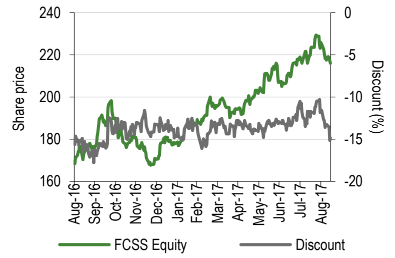
Price	**216.0p**
Market cap	**£1,192m**
AUM	**£1,496m**

NAV*	250.8p
Discount to NAV	13.9%
NAV**	253.7p
Discount to NAV	14.9%

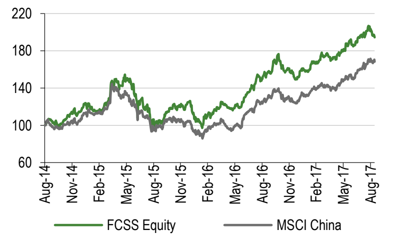
*Excluding income. **Including income. As at 14 September 2017.

Yield	1.2%
Ordinary shares in issue	551.9m
Code	FCSS
Primary exchange	LSE
AIC sector	Country Specialists: Asia Pacific
Benchmark	MSCI China

Share price/discount performance



Three-year performance vs index



52-week high/low	229.5p	167.6p
NAV** high/low	257.7p	195.8p

**Including income.

Gearing

Gross market gearing*	24.8%
Net market gearing*	16.6%

*As at 31 July 2017.

Analysts

Gavin Wood +44 (0)20 3681 2503
Mel Jenner +44 (0)20 3077 5720
investmenttrusts@edisongroup.com
Edison profile page

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

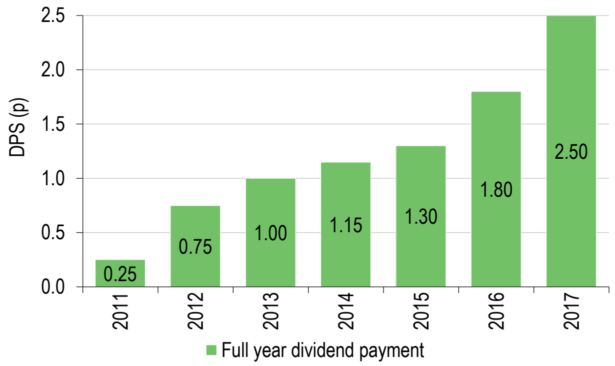
Exhibit 1: Trust at a glance

Investment objective and fund background	Recent developments
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.	■ 12 June 2017: FY17 results to 31 March 2017 – NAV TR +38.8% versus benchmark TR +37.6%; share price TR +45.8%. ■ 14 February 2017: Entered into new US$150m three-year revolving credit facility with Scotiabank Europe. ■ 21 November 2016: Interim results to 30 September 2016. NAV TR +29.1% versus benchmark TR +26.2%. Share price TR +30.8%.

Forthcoming		Capital structure		Fund details	
AGM	July 2018	Ongoing charges	1.16% (FY17)	Group	Fidelity International
Interim results	November 2017	Net market gearing*	16.6%	Manager	Dale Nicholls
Year end	31 March	Annual mgmt fee	1.0% of net assets	Address	Beech Gate, Millfield Lane, Lower Kingswood, Tadworth, KT20 6RP
Dividend paid	July	Performance fee	15% above benchmark +2% (cap: 1.0% of average net assets)		
Launch date	April 2010	Trust life	Indefinite	Phone	0800 41 41 10
Continuation vote	No	Loan facilities	US$150m revolving	Website	fidelity.co.uk/chinaspecial

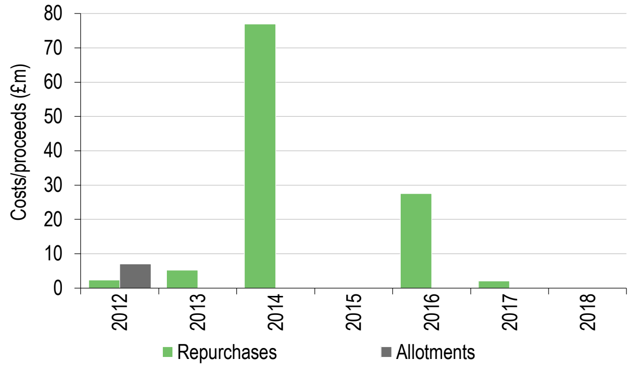
Dividend policy and history (financial years)

Although focused on capital growth, as an investment trust FCSS pays out at least 85% of income received as an annual dividend.

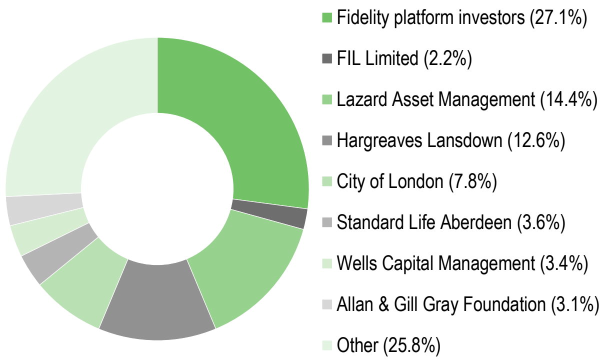


Share buyback policy and history (financial years)

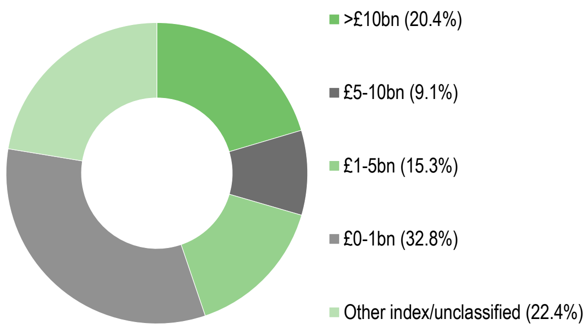
FCSS has annually renewed authority to buy back up 14.99% of its shares at a discount to NAV and allot up to 10% of issued capital at a premium to NAV. There is no rigid discount control mechanism.



Shareholder base (as at 10 September 2017)



Portfolio exposure by market cap (as at 31 July 2017)



Top 10 holdings (as at 31 July 2017)

			Portfolio weight (%)			
Company	**Country**	**Sector**	**31 July 2017**	**31 July 2016****	**Benchmark weight (%)**	**Active weight vs benchmark (%)**
Tencent	China	Information technology	14.4	11.1	16.2	(1.8)
Alibaba	China	Information technology	10.0	4.7	12.4	(2.4)
China Pacific Insurance	China	Financials	5.2	5.2	0.8	4.4
China Life Insurance	China	Financials	3.1	N/A	1.7	1.4
Hutchison China MediTech	Hong Kong	Healthcare	2.9	2.1	0.0	2.9
Ctrip	China	Consumer discretionary	2.7	2.3	1.6	1.1
58.com	China	Information technology	2.1	N/A	0.3	1.8
China Petroleum	China	Energy	2.1	2.8	1.4	0.7
China MeiDong Auto	China	Consumer discretionary	1.9	N/A	0.0	1.9
Citic Telecom	Hong Kong	Telecom services	1.8	2.9	0.0	1.8
Top 10 (% of holdings)			**46.2**	**38.0**		

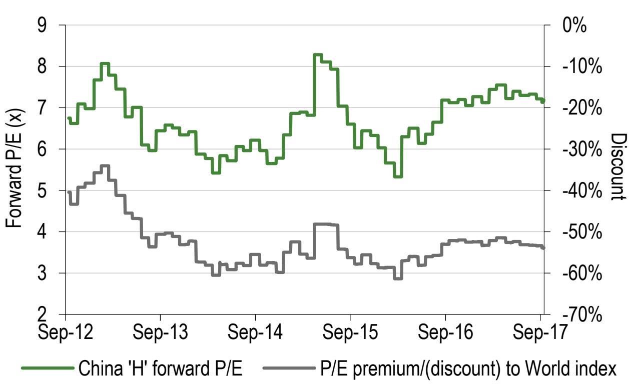
Source: Fidelity China Special Situations, Edison Investment Research, Bloomberg, Morningstar. Note: *Gearing net of short positions. **N/A where not in July 2016 top 10.

Market outlook: Attractive fundamentals

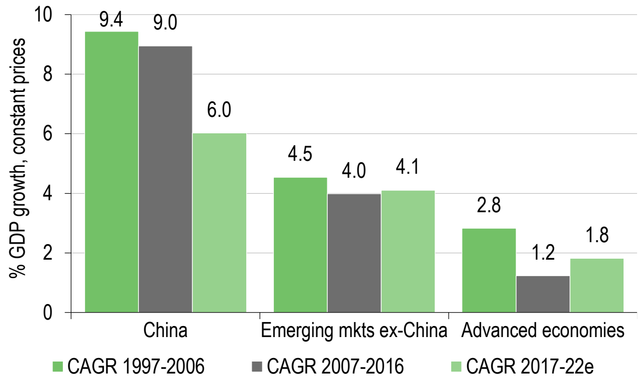
As illustrated in Exhibit 2 (left-hand chart), China's 'H' share market valuation has been relatively stable over the past year and the current 7.2x forward P/E multiple represents a discount of 53.9% to the world market's 15.6x multiple. This discounted valuation contrasts sharply with Chinese corporate earnings growth prospects, which reflect China's superior medium-term economic growth projections. Fears over China's slowing economic growth may be tempered by the recent stability of GDP data, and China's medium-term GDP growth forecasts remain considerably above projections for advanced economies and other emerging market economies (see Exhibit 2 right-hand chart).

Exhibit 2: Market performance and valuation

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, Edison Investment Research, IMF WEO April 2017. Note: Valuation data as at 14 September 2017.

The Chinese stock market can be volatile, as seen in 2015 when there was a 30% correction, triggered by economic slowdown and exacerbated by stock suspensions and forced selling by retail investors funded by margin lending. However, investors with a longer-term view may be attracted by the combination of China's growth prospects and discounted market valuation. A diversified fund with a bottom-up investment approach, focusing on faster growing, consumer-driven segments of the economy, may appeal as a route to gain exposure. The first inclusion of China 'A' shares in MSCI emerging markets indices from June 2018 at a 5% partial inclusion factor and the potential for this weighting to increase over the medium term may provide further appeal.

Fund profile: Differentiated Chinese equity exposure

FCSS is an LSE-listed investment trust, which aims to generate long-term capital growth from an actively managed diversified portfolio, primarily comprising companies listed in China or Hong Kong and Chinese companies listed on other recognised exchanges. The portfolio may also include non-Chinese listed companies with significant operations in China and Hong Kong. Performance is benchmarked against the MSCI China index (sterling adjusted), but sector allocations are not constrained by index weightings. FCSS has been managed by Fidelity International since its launch in April 2010, with Dale Nicholls acting as portfolio manager since April 2014. Based in Hong Kong, Nicholls has 23 years' investment experience and has managed Asian equity portfolios at Fidelity since 2003. As well as FCSS, he currently manages the Fidelity Funds Pacific Fund.

Individual holdings are limited to 15% of the portfolio at the time of investment, with unlisted investments allowed up to 10% in total. Derivatives are used for efficient portfolio management and hedging, with total short exposure restricted to 15% of gross assets. FCSS may borrow up to 25% of net assets, with total gearing from borrowings and derivatives limited to 30% of net assets. FCSS invests in China 'A' shares using Fidelity's Qualified Foreign Institutional Investor (QFII) licence, as well as through brokers who hold a QFII.

The fund manager: Dale Nicholls

The manager's view: Valuations remain compelling

Nicholls views Chinese stock market valuations as compelling relative to history and other markets, given strong corporate earnings growth prospects, despite the marked rise in P/E and price/book multiples over the last year. He highlights the 15.3% forecast EPS growth for the MSCI China index in 2017 compared to 10.3% for the US S&P 500 index, and notes that forecast EPS growth for the MSCI China index excluding banks is 27.5%. As well as avoiding banks, where Nicholls expects to see earnings growth limited by rising non-performing loan provisions, FCSS has no holdings in the residential property sector, where tightening measures have considerably slowed price growth.

Nicholls maintains a consistent focus on companies with superior long-term growth prospects and has not been distracted by the cyclical stock rally that has seen the MSCI China index outperform FCSS over recent months. However, he notes that the market rally has created opportunities to take short positions, and these are reflected in FCSS's net gearing declining to 16.6% at end-July 2017, down from 21.1% at end-May 2017. At end-March 2017, index hedges totalled 4.3% of net assets and seven short positions amounted to 2.6%; these have been added to in recent months.

FCSS's sizeable positions in Tencent and Alibaba contributed strong absolute returns over the last year, although the trust's underweight exposure in both stocks detracted from relative performance. Nicholls notes that the 2017 market rally has been led by large-cap stocks and FCSS's bias to small and mid-caps has been a major contributor to recent underperformance of the index. Among the leading contributors to performance versus the index were AIM-listed biopharmaceutical company, Hutchison China MediTech, and car dealership, China MeiDong Auto, which is focused on growing its service business and covers mid- to high-end brands including BMW and Porsche.

While FCSS has achieved a strong NAV total return of c 30% over the last year, Nicholls highlights that performance has been held back by short sellers targeting portfolio holdings CT Environmental and Sinosoft Technology. The Fidelity team's in-depth analysis supports the manager's continued confidence in the long-term prospects of both companies, and Nicholls has taken advantage of the share price falls to add to FCSS's holdings.

Nicholls retains a positive view on the insurance sector, despite recent regulatory scrutiny and concerns over property and casualty business performance, and has added to FCSS's holding in China Life Insurance, which has moved into the top 10 holdings, alongside China Pacific Insurance. A positive outlook is also maintained for each of FCSS's four unlisted investments, Didi Chuxing, China Internet Plus, Yiguo and Aurora Mobile, which together account for c 4% of the portfolio.

Asset allocation

Investment process: Consumer-focused, bottom-up selection

FCSS adopts a bottom-up investment approach, seeking to invest primarily in companies operating in industries with above-average growth prospects, which are strongly cash generative and run by capable management teams. There is a bias to mid- and small-caps, where greater opportunity is seen to identify companies with long-term growth potential that is not reflected in their share prices. Companies are analysed in detail prior to investment, with the manager drawing on the resources of Fidelity's team of 23 analysts researching Chinese equities (based in Hong Kong, Singapore and Shanghai). Small-cap stocks often present higher risks, making risk management an important part of the investment process. Company meetings are a key element in assessing potential new investments as well as monitoring the progress of existing portfolio companies. FCSS typically holds 130-140 stocks and uses futures, options and CFDs, aiming to enhance performance.

Current portfolio positioning

Although comprising over 100 holdings, FCSS's portfolio is relatively concentrated, with the top 10 positions accounting for 46.2% at end-July 2017, up from 38.0% a year earlier. Sector exposures are highly differentiated from the benchmark index (see Exhibit 3) – a result of the manager's stock-picking approach and focus on faster growing, consumer-orientated sectors. Information technology has become the largest portfolio exposure over the last 12 months, dominated by top 10 holdings Tencent and Alibaba (see Exhibit 1), although FCSS is underweight in both of these stocks and the sector remains one of the most significant underweight positions. The largest active sector exposures in the portfolio are a 17.4pp overweight in consumer discretionary and a 13.0bp underweight in financials, due to FCSS not holding any Chinese bank stocks.

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

	Portfolio end-July 2017	Portfolio end-July 2016	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/ index weight (x)
Information technology	29.2	22.8	6.4	38.8	(9.5)	0.8
Consumer discretionary	27.6	28.6	(1.0)	10.2	17.4	2.7
Industrials	12.6	13.9	(1.3)	4.7	7.9	2.7
Financials	10.5	10.6	(0.0)	23.5	(13.0)	0.4
Consumer staples	6.8	7.8	(1.0)	1.7	5.1	4.0
Healthcare	5.0	3.6	1.4	1.9	3.1	2.6
Energy	2.5	3.6	(1.1)	4.9	(2.4)	0.5
Utilities	1.8	2.2	(0.4)	2.5	(0.7)	0.7
Telecommunication services	1.5	3.0	(1.5)	5.9	(4.4)	0.3
Materials	1.4	3.9	(2.5)	1.2	0.2	1.2
Real estate*	1.0	N/A	N/A	4.7	(3.7)	0.2
	100.0	**100.0**		**100.0**		

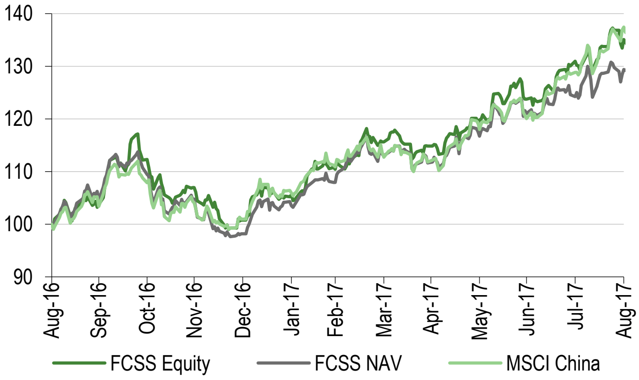
Source: Fidelity China Special Situations, Edison Investment Research. Note: *Real estate classified within financials sector in July 2016.

Performance: Strong absolute returns over five years

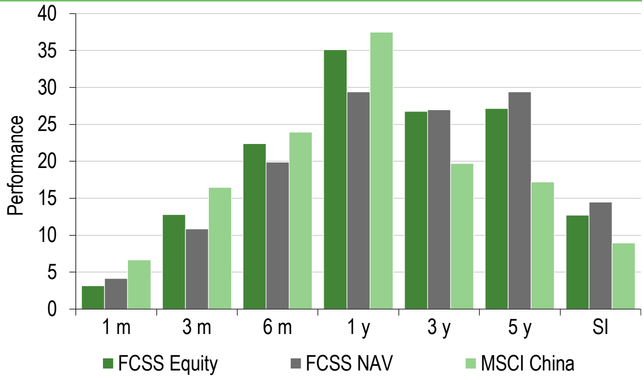
As illustrated in Exhibit 4, while FCSS underperformed its MSCI China benchmark over one year, it achieved a strong 29.4% absolute return over this period and has also delivered annual returns of more than 25% over three and five years, significantly outperforming the benchmark over these longer periods. A large part of the underperformance over one year has occurred during the last three months, which the manager attributes to a rally in cyclical stocks triggered by inflation returning after a deflationary period during the first half of 2017. This rally has seen the MSCI China Small Cap index underperform the MSCI China index by c 18% in 2017 to end-August. FCSS's portfolio has a bias to small and mid-caps and provides highly differentiated exposure versus the benchmark (see Exhibit 3), therefore periods of diverging performance should be expected.

Exhibit 4: Investment trust performance to 31 August 2017

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



Price, NAV and benchmark total return performance (%)



Source: Thomson Datastream, Edison Investment Research. Note: Three-year, five-year and SI (since inception) performance figures annualised. Inception date is 16 April 2010.

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

	One month	Three months	Six months	One year	Three years	Five years	SI
Price relative to MSCI China	(3.3)	(3.2)	(1.3)	(1.7)	18.7	50.3	28.7
NAV relative to MSCI China	(2.4)	(4.8)	(3.3)	(5.9)	19.4	63.8	44.5
Price relative to MSCI World	0.6	9.2	17.2	13.8	30.7	54.9	3.8
NAV relative to MSCI World	1.6	7.4	14.8	9.0	31.4	68.9	16.5
Price relative to FTSE All-Share	1.7	12.7	16.2	18.2	63.2	103.1	34.9
NAV relative to FTSE All-Share	2.7	10.8	13.8	13.2	64.1	121.5	51.4

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

Exhibit 5 shows that FCSS's share price and NAV total return has outperformed the MSCI World and FTSE All-Share indices over one, three and five years, and since the trust's inception in April 2010, helped by notably strong relative performance over six months. Exhibit 6 puts the recent underperformance of the benchmark in context relative to the strong outperformance from end-2013 to mid-2016.

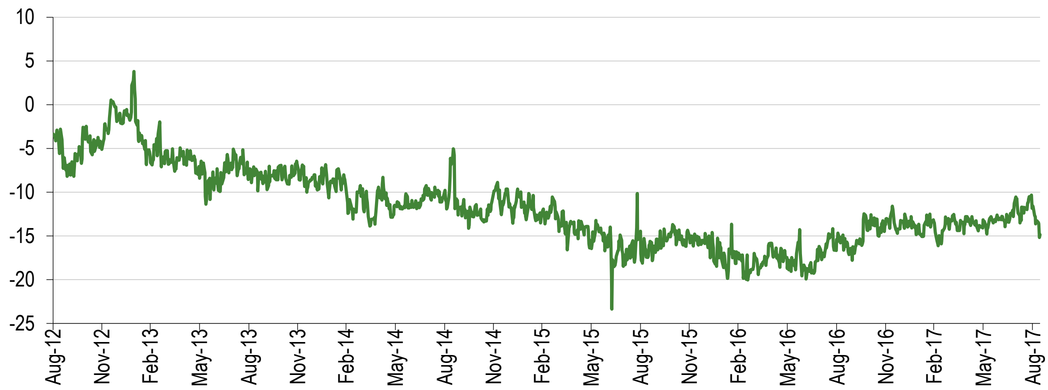
Exhibit 6: NAV total return performance relative to benchmark since launch

Source: Thomson Datastream, Edison Investment Research

Discount: Narrowing trend established

As illustrated in Exhibit 7, having gradually widened from a three-year low of 5.0% in September 2014, FCSS's share price discount to NAV including income has established a narrowing trend over the last year, moving from 19.5% in July 2016 to its current level of 14.9%. The current discount is similar to its 14.5% three-year average but wider than its 13.7% and 11.8% one- and five-year averages. Since launch in 2010, FCSS shares have traded between a 13.2% premium and a 23.4% discount, suggesting significant scope for the discount to narrow further should investor sentiment towards Chinese equities continue to improve.

Exhibit 7: Share price discount/premium to NAV (including income) over five years (%)



Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

FCSS is a conventional investment trust with a single share class and currently has 551.9m ordinary shares in issue, with a further 19.4m shares held in treasury. In February 2017, a new US$150m three-year revolving credit facility was agreed with Scotiabank Europe, and this is fully drawn down, equating to c 8% gearing. Further gearing is added using contracts for difference (CFDs) on a number of portfolio holdings, and FCSS had 24.8% gross gearing at end-July 2017, which compares to the 30% maximum permitted level.

FCSS pays management fees to its investment manager, Fidelity International, at an annual rate of 1.0% of net assets, calculated monthly (quarterly before April 2016). An annual performance fee of 15% is payable on returns more than 2.0% above the benchmark, capped at 1.0% of average net assets. Excess outperformance is not carried forward but underperformance must be recovered before any further performance fee is payable. For FY17 (to 31 March 2017), the ongoing charge (excluding performance fees) was 1.16%, slightly lower than 1.20% in FY16.

From launch, FCSS allocated management fees and finance costs equally between revenue and capital. However, capital gains have contributed the bulk of returns and this is expected to continue, leading the board to move to a 75:25 allocation of these expenses between capital and revenue, with effect from 1 April 2017. Total returns will not be affected by this change, but the proportion of revenue returns will be higher in future years, thereby increasing dividend distributions.

Dividend policy and record

Although FCSS has a capital growth objective, as an investment trust it pays out at least 85% of its revenue earnings and the annual dividend has increased every year since 2011 (see Exhibit 1). Over the last five years, the compound annual growth in the dividend is c 27%. The 2017 dividend was increased by 38.9%, a similar increase to the previous year, and the 2.50p dividend paid in July 2017 represents a 1.2% dividend yield. The 2017 dividend was 1.17x covered and FCSS has accumulated revenue reserves equating to 1.75p per share. The change in allocation of fees and expenses between revenue and capital accounts – noted above – will result in a relative increase in the level of future dividend distributions.

Peer group comparison

Exhibit 8 shows a comparison of FCSS with other funds investing in Chinese equities. JPMorgan Chinese is the only other AIC Country Specialists: Asia Pacific fund that focuses on Chinese equities, so we show averages for the AIC Asia Pacific ex-Japan sector, which has 37% aggregate exposure to China & Greater China, giving it greater relevance. We also include open-ended funds larger than £250m from the IA China/Greater China sector. Over one year, FCSS's NAV total return is ahead of the Asia Pacific ex-Japan weighted average but lower than JPMorgan Chinese and the IA China/Greater China sector average. However, over three and five years, FCSS leads all the funds shown by a significant margin, with its NAV total return considerably ahead of both open- and closed-ended peer group averages. FCSS's ongoing charge is similar to the AIC Asia Pacific ex-Japan sector average and appreciably lower than the IA China/Greater China sector average. FCSS employs higher than average gearing among closed-ended peers and, while its share price discount to NAV is above the Asia Pacific ex-Japan average, it is only modestly wider than the 12.2% weighted average of the AIC Country Specialists: Asia Pacific sector. FCSS's dividend yield is below average among closed-ended peers, but higher than the average of its open-ended peers.

Exhibit 8: Funds investing in Chinese equities (as at 14 September 2017*)

% unless stated	Market cap/ fund size £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	Discount (ex-par)	Ongoing charge	Performance fee	Net gearing	Dividend yield (%)
Fidelity China Special Situations	1,192.1	27.1	100.2	254.6	(13.4)	1.16	Yes	117	1.2
JPMorgan Chinese	199.2	36.4	69.0	137.2	(12.8)	1.44	No	109	0.6
Asia Pacific ex-Japan weighted avg		**22.7**	**44.7**	**82.6**	**(6.1)**	**1.12**		**104**	**2.2**
Open-ended funds									
Aberdeen Global Chinese Equity	463.4	19.3	29.1	44.9		1.99	No		0.0
Allianz China Equity	345.0	22.1	54.0	93.7		2.29	No		1.3
Baring Hong Kong China	1,524.0	28.9	59.4	99.7		1.70	No		0.2
Fidelity China Focus	3,205.1	29.4	78.6	130.4		1.91	No		0.5
First State Greater China Growth	446.9	23.6	48.5	95.4		1.84	No		0.9
GAM Star China Equity	730.7	28.9	50.6	119.5		1.09	No		0.9
Henderson China Opportunities	879.3	30.4	73.5	146.6		1.74	No		0.0
HSBC GIF Chinese Equity	1,238.1	33.1	69.1	111.0		2.40	No		0.0
Invesco PRC Equity	585.1	32.2	65.4	112.5		3.12	No		0.0
Invesco Perpetual HK & China	356.1	28.8	52.4	137.5		1.69	No		0.5
JPM Greater China	406.3	30.0	61.9	117.0		1.82	No		1.3
Neuberger Berman China Equity	902.5	37.5				2.12	No		0.0
Schroder ISF Greater China	778.5	31.3	72.6	122.9		1.87	No		1.6
Templeton China	428.9	29.0	46.0	65.0		2.47	No		0.0
Open-ended funds weighted avg		**29.8**	**65.1**	**114.6**		**1.96**			**0.6**

Source: Morningstar, Edison Investment Research. Note: *Performance data to 13 September 2017. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

The board

FCSS's board comprises six directors, five of whom are independent of the manager. Nicholas Bull joined the board in February 2010 and assumed the role of chairman in July 2016. Elisabeth Scott (appointed November 2011) has acted as senior independent director since July 2016. The other three independent directors are David Causer (appointed February 2010), Peter Pleydell-Bouverie (appointed February 2010) and Vera Hong Wei (appointed March 2016). John Ford (appointed July 2016) is Fidelity International's global chief investment officer, fixed income, solutions and real estate, and is therefore considered to be a non-independent director.

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
295 Madison Avenue, 18th Floor
10017, New York
US

Sydney +61 (0)2 8249 8342
Level 12, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia