# EDISON

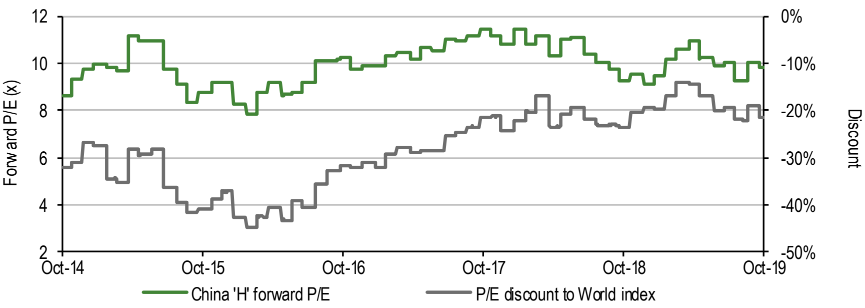
# Fidelity China Special Situations

## Domestic opportunities offer exciting prospects

Investment trusts

**Fidelity China Special Situations (FCSS) offers investors direct exposure to China for a portion of their portfolio, aiming to deliver long-term capital growth from investing in companies listed in China, and Chinese companies listed elsewhere. Since the trust's inception in April 2010, FCSS's NAV total return has increased by nearly 11% pa. The portfolio has a bias towards mid- and small-cap companies, which tend to be less well researched and potentially mispriced. The manager, Dale Nicholls, is focused on opportunities related to rising domestic consumption, which in his view is unlikely to be disrupted by the ongoing US-China trade dispute.**

**Chinese equities trade at a steep discount to global equities**




Source: Refinitiv, Edison Investment research

## The market opportunity

China's economic growth drivers continue to shift away from fixed asset investment and lower-value exports, in favour of domestic consumption. The manager believes there are many exciting long-term investment opportunities arising from structural trends, including urbanisation, rising incomes and technological innovation. As shown in the graph above, Chinese equities' discount to global equities has been in a narrowing trend over the past four years; however, the current discount of c 22% offers potential for further improvement in relative valuation.

## Why consider investing in FCSS?

- Obtain direct exposure to China's continuing growth.
- Fundamental approach to investing in China, supported by Fidelity's extensive research capabilities, involving company visits and in-depth analysis.
- Unconstrained approach allows the manager to invest in his highest-conviction ideas, including up to 10% in unlisted stocks ahead of their listing.
- Proactive board, committed to shareholders' interests; it recently reduced its management fees and introduced a new discount control policy.

## Single-digit discount policy adopted

FCSS currently trades at an 9.1% discount to its cum-income NAV. This is towards the higher end of the trust's most recent range of 6–10% since February 2019, which may reflect the current subdued sentiment towards Chinese equities. The board introduced a single-digit discount policy in June 2019 and actively promotes the trust. There is scope for a narrower discount should investor appetite improve.

**11 November 2019**

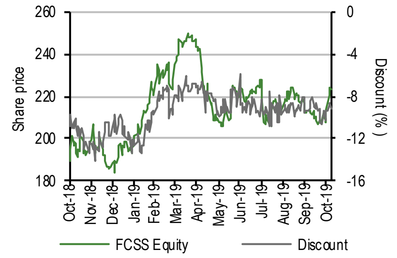
| | |
|---|---|
| **Price** | **223.0p** |
| **Market cap** | **£1,224m** |
| **AUM** | **£1,645m** |

| | |
|---|---|
| NAV* | 245.3p |
| Discount to NAV | 9.1% |

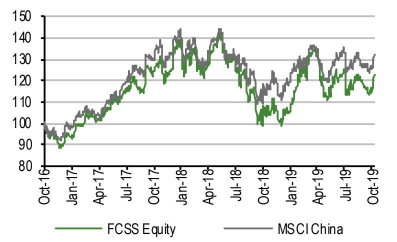
*Including income. As at 8 November 2019.

| | |
|---|---|
| Yield | 1.7% |
| Ordinary shares in issue | 549.0m |
| 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 | 250.0p | 183.4p |
| NAV* high/low | 268.8p | 206.7p |

*Including income.

**Gearing**

| | |
|---|---|
| Gross market gearing* | 25.7% |
| Net market gearing* | 22.2% |

*As at 30 September 2019.

**Analysts**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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**

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

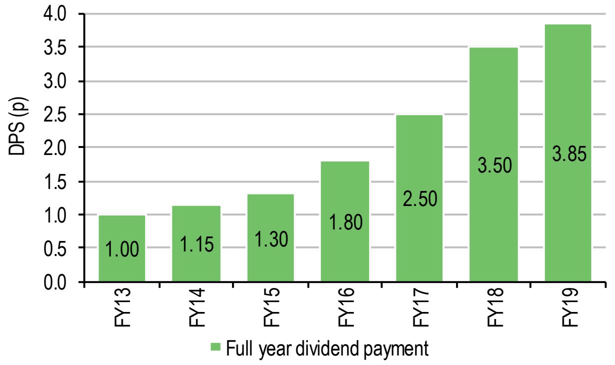
**Recent developments**

- 05 June 2019: Adoption of formal single-digit discount control policy.
- 05 June 2019: Annual results to 31 March 2019 – NAV TR -5.3% versus benchmark TR +0.9%, share price TR -0.3%.
- 05 June 2019: FY19 dividend increased by 10% to 3.85p per share.
- 1 June 2019: Linda Yueh appointed as non-executive director.

| Forthcoming | | Capital structure | | Fund details | |
|---|---|---|---|---|---|
| AGM | July 2020 | Ongoing charges | 1.02% (0.93% incl. variable fee) | Group | Fidelity International |
| Interim results | November 2019 | Net market gearing* | 22.2% | 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 | 30 July 2019 | Performance fee | None | | |
| Launch date | April 2010 | Trust life | Indefinite | Phone | 0800 41 41 10 |
| Continuation vote | No | Loan facilities | US$150m revolving | Website | www.fidelity.co.uk/chinaspecial |

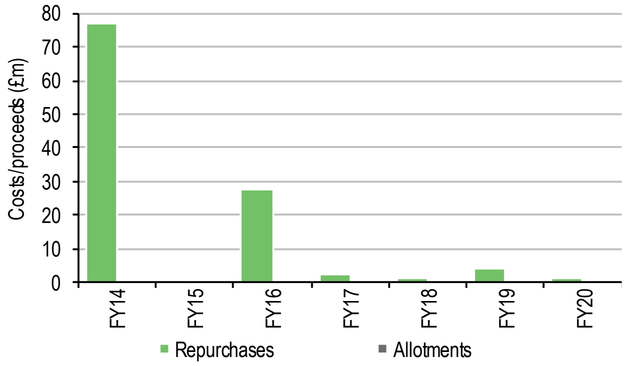
**Dividend policy and history (financial years)**

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

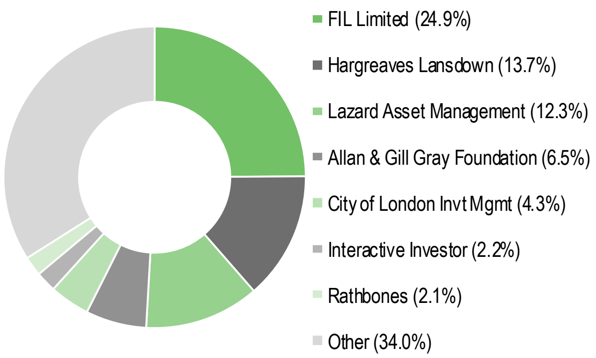



**Share buyback policy and history (financial years)**

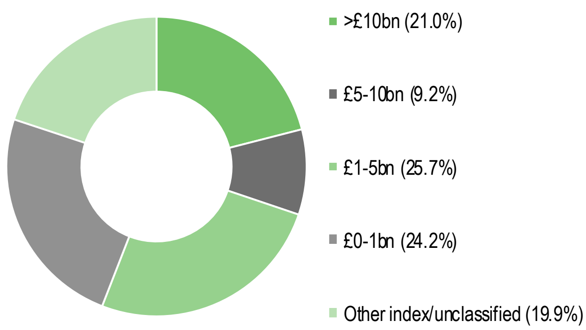
FCSS has authority to buy back up to 14.99% and allot up to 10% of its shares in issue. A formal single-digit discount control policy was adopted in June 2019.




**Shareholder base (as at 30 September 2019)**




**Portfolio exposure by market cap (as at 30 September 2019)**




**Top 10 holdings (as at 30 September 2019)**

| | | Portfolio weight %** | | | |
|---|---|---|---|---|---|
| Company | Sector | 30 Sept 2019 | 30 Sept 2018*** | Benchmark weight (%) | Active weight vs benchmark (%) |
| Tencent | Communication services | 10.9 | 11.6 | 14.1 | (3.2) |
| Alibaba | Consumer discretionary | 7.9 | 8.3 | 13.9 | (6.0) |
| China MeiDong Auto | Consumer discretionary | 4.2 | 2.0 | 0.0 | 4.2 |
| China Pacific Insurance | Financials | 3.5 | 3.8 | 0.6 | 2.9 |
| China Life Insurance | Financials | 2.4 | 1.9 | 1.0 | 1.4 |
| SKSHU Paint | Materials | 1.7 | N/A | 0.0 | 1.7 |
| China Biologic Products | Healthcare | 1.7 | N/A | 0.0 | 1.7 |
| 21Vianet | Information technology | 1.6 | 1.6 | 0.0 | 1.6 |
| Kingdee International Software | Information technology | 1.6 | 1.4 | 0.1 | 1.5 |
| Kingsoft | Information technology | 1.6 | N/A | 0.1 | 1.5 |
| **Top 10 (% of holdings)** | | **37.1** | **36.9** | | |

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-September 2018 top 10.

# The fund manager: Dale Nicholls

## The manager’s view: Domestic consumption holds promise

Nicholls believes that the ongoing US-China trade dispute has resulted in a rift between the two countries that will take a long time to heal, regardless of whether a resolution to the trade dispute is found. Although the tariffs imposed, and the negative rhetoric surrounding the dispute, have hit near-term growth and investor sentiment, the manager says prospects for China and FCSS continue to remain compelling over the medium- to long-term. Nicholls believes that China is committed to upgrading its industrial capabilities to become the global leader in innovation and technology. This aim was articulated in its Made in China 2025 plan, launched in 2015. He notes that the shift of lower-end and more wage sensitive manufacturing capacity out of China has been an ongoing trend for some time; however, its pivotal position in the global supply chain will take time to erode. For example, around 50% of the world’s PCs and 40% of mobile phones are manufactured in China. Furthermore, port infrastructure to facilitate trade is hard to substitute in the short term; China’s top five ports shipped 130m 20 foot equivalent unit containers in 2017, over 3x the volume shipped by the top five ports in ASEAN.

Nicholls finds the most exciting investment opportunities are in domestically oriented companies and the portfolio is positioned to reflect this view. He says China is fiscally constrained and he believes that the government has very limited appetite for broad economic stimulus; however, it is directing policy to promote domestic spending and reforms in areas such as healthcare and pensions. The manager believes the ongoing trend for China’s economy to rebalance away from fixed asset investment and exports in favour of domestic consumption will continue.

# The portfolio

The largest sector exposure in the portfolio remains consumer discretionary, which was 28.5% as at end-September 2019. Since our last report in July 2019, this has increased by 1.5pp, reflecting the outperformance of holdings as well as additions to existing positions. Those included Nasdaq-listed Ctrip, China’s leading online travel company, whose services include accommodation reservations, travel tickets and packaged tours. The manager believes the company is a prime beneficiary of the long-term structural growth in Chinese travel.

Recent outperformers included non-index stock China MeiDong Auto, which is the third largest holding (but the largest active weight). The company distributes autos and offers after-sales services. It primarily operates in smaller cities (tier 3 and tier 4), and has the licence to sell a number of mid- to high-end marques, including Toyota, Lexus, Porsche and BMW. Nicholls believes growth prospects are promising given the company’s expansion plans and China’s rapid urbanisation and rising income trends. Sports brand company Li Ning has also been a strong performer. In the manager’s view, the company has successfully executed its strategy to turnaround its business to become a domestic premium brand. After the Beijing Olympics, Li Ning (and other Chinese sportswear companies) suffered following over-expansion of manufacturing capacity and outlets, which resulted in poor margins and the erosion of brand value; whereas the premium segment of the sportswear market was dominated by foreign players such as Nike and Adidas. The manager thinks that Li Ning has now successfully turned its business around and elevated its brand to a premium position, above that of many foreign names. Nicholls believes premiumisation is an important investment theme and that increasingly, the most desirable brands for Chinese consumers will be homegrown.

The manager has recently introduced eco-friendly paint manufacturer, SKSHU Paint into the portfolio, which he believes is also a beneficiary of the urbanisation investment theme. FCSS has also added to several of its existing positions including ShenZhen YUTO Packaging Technology. The company is a leading packaging company for a broad range of industries including consumer electronics, tobacco and cosmetics. It has invested in automation and introduced innovative products that can be personalised and digitalised. In the manager's view these developments have created a competitive edge for the firm in an otherwise commoditised and labour-intensive industry. Nicholls also added to Noah Holdings, a wealth management company focused on high net worth clients, with minimum assets of RMB3m (around £330,000). In his view, the company has superior product offerings and investment options and he thinks there is significant scope for the company to gain market share given the low penetration and fragmentation of wealth management services in China.

## Performance: Medium- and long-term outperformance

As shown in Exhibits 3 and 4, FCSS has delivered strong absolute and relative performance compared to the benchmark MSCI Emerging Markets index over five years and since its inception in April 2010; however, it has lagged over shorter periods. The manager is focused on investing for capital returns over the long term and the portfolio is meaningfully different from the index; therefore, performance can diverge over shorter and medium terms. The manager notes that the MSCI Emerging Markets Index performance over the past three years has been led by a relatively narrow set of mainly large-cap names. FCSS has a mid- and small-cap bias and has meaningfully outperformed the MSCI Small Cap Index over all years shown.

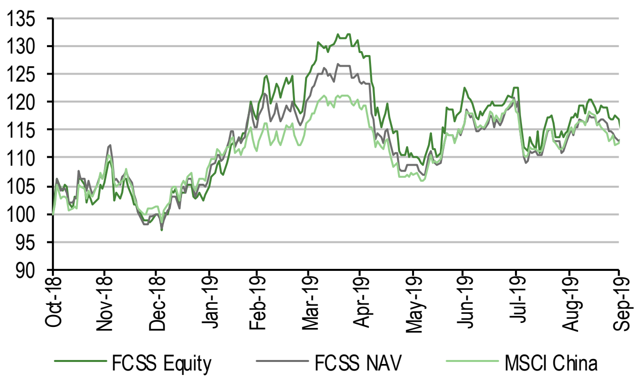
**Exhibit 2: Five-year discrete performance data**

| 12 months ending | Share price (%) | NAV (%) | MSCI China (%) | MSCI China Small Cap (%) | MSCI World (%) | FTSE All-Share (%) |
|---|---|---|---|---|---|---|
| 31/10/15 | 12.1 | 13.3 | 3.1 | 0.9 | 6.0 | 3.0 |
| 31/10/16 | 43.0 | 42.1 | 28.7 | 23.8 | 28.8 | 12.2 |
| 31/10/17 | 24.2 | 22.6 | 29.9 | 11.3 | 13.5 | 13.4 |
| 31/10/18 | (17.8) | (19.2) | (13.3) | (15.6) | 5.7 | (1.5) |
| 31/10/19 | 12.0 | 11.0 | 11.7 | (1.0) | 11.9 | 6.8 |

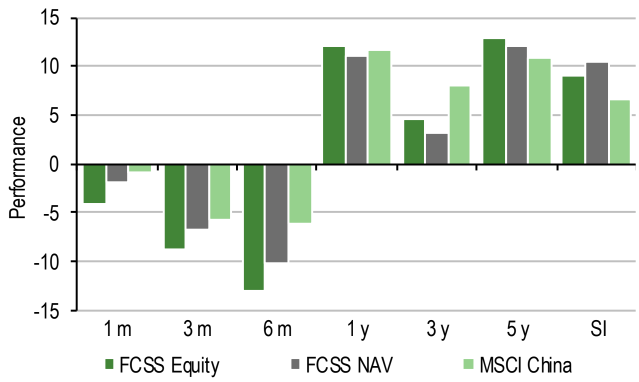
Source: Refinitiv. Note: All % on a total return basis in pounds sterling.

**Exhibit 3: Investment trust performance to 31 October 2019**

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




Price, NAV and benchmark total return performance (%)



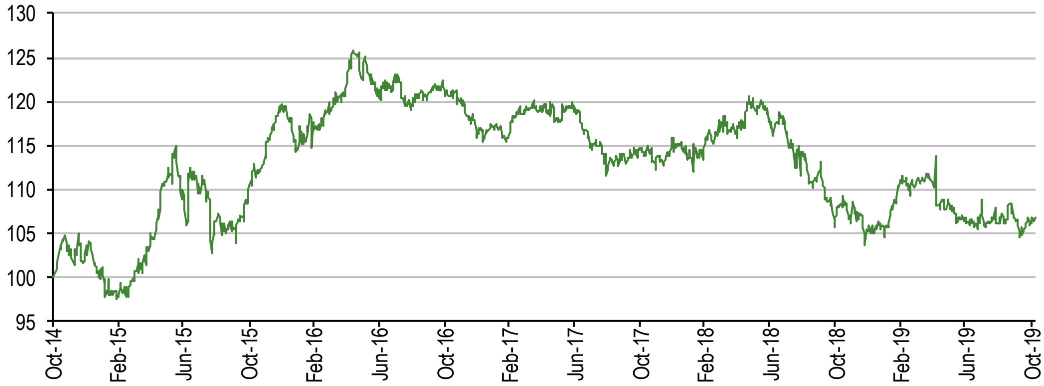

Source: Refinitiv, Edison Investment Research. Note: Three, five and SI (since inception) performance figures annualised. Inception date is 16 April 2010.

**Exhibit 4: 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 | (3.2) | (3.1) | (7.0) | 0.3 | (11.4) | 16.5 | 44.3 |
| NAV relative to MSCI China | (1.0) | (1.1) | (4.1) | (0.7) | (15.9) | 10.1 | 70.6 |
| Price relative to MSCI China Small Cap | (1.4) | 0.4 | (2.0) | 13.0 | 21.4 | 67.2 | 114.9 |
| NAV relative to MSCI China Small Cap | 0.9 | 2.4 | 0.9 | 12.0 | 16.9 | 60.8 | 141.1 |
| Price relative to MSCI World | (1.8) | (6.0) | (17.7) | 0.1 | (20.0) | 0.0 | (49.0) |
| NAV relative to MSCI World | 0.4 | (4.0) | (14.8) | (1.0) | (24.4) | (6.4) | (22.8) |
| Price relative to FTSE All-Share | (2.7) | (6.7) | (13.5) | 5.2 | (5.0) | 45.5 | 38.4 |
| NAV relative to FTSE All-Share | (0.5) | (4.7) | (10.6) | 4.2 | (9.4) | 39.0 | 64.6 |

Source: Refinitiv, Edison Investment Research. Note: Data to end-October 2019. Inception date is 16 April 2010. Geometric calculation.

**Exhibit 5: NAV total return performance relative to benchmark over five years**

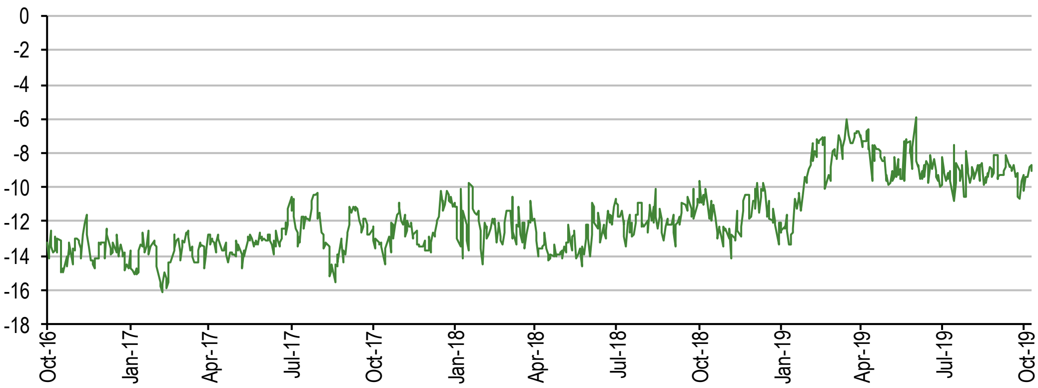



Source: Refinitiv, Edison Investment Research

## Valuation: New single-digit discount control policy

FCSS is currently trading at an 9.1% discount to its cum-income NAV, which is below its three-year average of 11.8%. As shown in Exhibit 6, the trust's discount has been in a narrowing trend over the past three years and broadly traded within a 10–15% range between September 2016 and February 2019, before moving below 10%. The board adopted a formal discount control policy in June 2019, which seeks to maintain the discount in single digits, in normal market conditions. It has the authority (renewed annually) to repurchase up to 14.99% of FCSS shares in issue. During FY19, a modest 1.8m shares were repurchased for a total consideration of £4.1m. Since end-March 2019, 0.5m shares have been repurchased at a cost of £1.0m.

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




Source: Refinitiv, Edison Investment Research

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