EDISON

Fidelity China Special Situations

Accessing China's long-term growth potential

Investment trusts

Fidelity China Special Situations (FCSS) is a specialist, actively managed closed-ended fund that invests in Chinese and other related equities to provide exposure to the secular growth of the Chinese economy. The trust has outperformed its MSCI China benchmark by over 25% since launch in 2010 and its NAV total return is ahead of open-ended and closed-ended peers over three years. The portfolio is focused on consumption-led sectors expected to grow faster than GDP and the manager is avoiding sectors such as banks where risks are considered to be greatest.

12 months ending	Total share price return (%)	Total NAV return (%)	MSCI China (%)	MSCI World (%)	FTSE All-Share (%)
29/02/12	(18.1)	(15.1)	0.6	0.7	1.5
28/02/13	9.0	14.1	9.8	17.2	14.1
28/02/14	13.7	18.4	(9.9)	10.8	13.3
28/02/15	27.7	32.7	29.5	17.6	5.6

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

Investment strategy: Chinese stock picking

The portfolio is constructed through bottom-up stock selection, without reference to the benchmark MSCI China index. The manager looks for undervalued companies with good long-term growth prospects, cash-generative businesses and strong management teams. The aim is to find companies trading on valuations that do not reflect the quality and potential of the business. This leads to a bias towards smaller companies that tend to be less well researched. Meeting management is an essential part of the process to understand companies and monitor progress. Risk management is a priority with third-party background checks strengthening due diligence procedures. Futures, options and contracts for difference (CFDs) are used to provide gearing as well as to take short positions.

Market outlook: Favourable prospects

While Chinese GDP growth is expected to slow further in 2015, over the medium-term, the economy is expected to grow faster than other emerging and advanced economies, suggesting a favourable environment for corporate earnings growth. A shift to more sustainable consumption-led growth and ongoing structural reforms are encouraging signs for the long-term. Market sentiment reflects concerns over further economic slowdown, however, the Chinese government has scope to provide further stimulus and recent interest rate cuts show their willingness to act. Although Chinese 'A' share and Hong Kong market forward P/E multiples have increased recently, they are at 15% and 17% discounts to world markets. Lower valuations combined with China's superior economic growth prospects provide a favourable backdrop for Chinese equities to outperform over the medium-term.

Valuation: Discount at wider end of 12-month range

While FCSS's current 11.1% share price discount to NAV (including income) is at the wider end of its 12-month range, it is comparable to other capital growth focused funds across Asia Pacific ex-Japan. FCSS pays an annual dividend, which it has increased each year since launch and currently yields 0.8%.

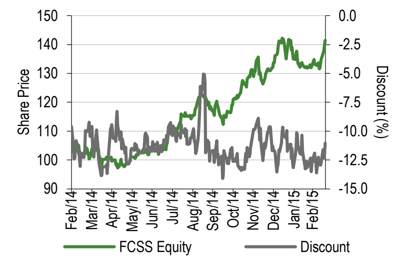
20 March 2015

Price	**141.5p**
Market cap	**£808m**
AUM	**£1,139m**
NAV*	157.7p
Discount to NAV	10.3%
NAV**	159.1p
Discount to NAV	11.1%

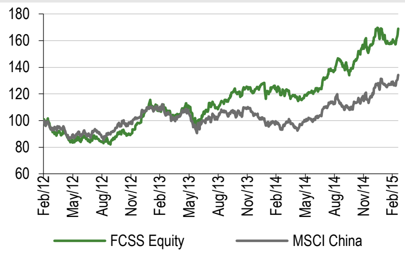
*Excluding income. **Including income.

Yield	0.8%
Ordinary shares in issue	571.3m
Code	FCSS
Primary exchange	LSE
AIC sector	Country specialists – Asia Pacific

Share price/discount performance*



Three-year cumulative perf. graph



52-week high/low	142.2p	97.2p
NAV** high/low	159.8p	107.4p

**Including income.

Gearing

Gross asset exposure	126.7%
Net asset exposure*	122.6%

*Market exposure net of short positions.

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 or Hong Kong and Chinese companies listed elsewhere. It may also invest in listed companies with significant interests in China and Hong Kong.

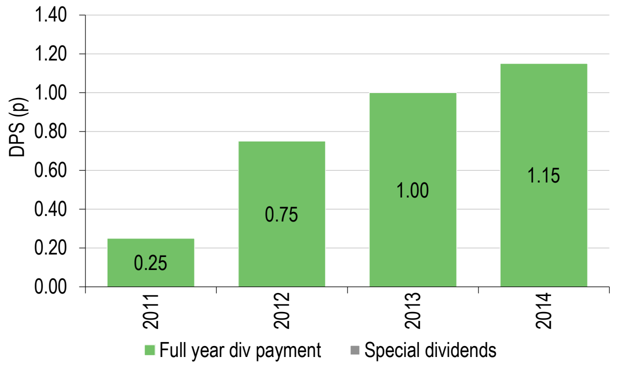
Recent developments

- 19 November 2014: Results for six months to 30 Sept 2014. NAV TR +16.8% vs. +10.1% MSCI China index.
- 19 August 2014: IMS for three months to 30 June 2014. NAV TR +1.8% vs. +2.9% MSCI China index.

Forthcoming		Capital structure		Fund details	
AGM	July 2015	Ongoing charges	1.45% (2.45% incl. perf. fee)	Group	Fidelity Worldwide Investment
Preliminary results	June 2015	Net asset exposure*	122.6%	Managers	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	See page 7		
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

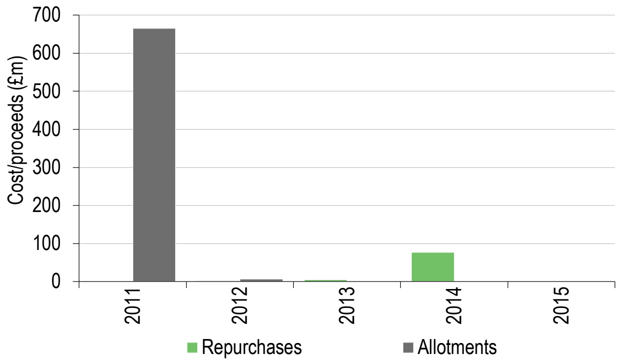
Dividend policy and history

Dividends are paid annually. While focused on capital growth, as an investment trust, FCSS will pay out at least 85% of income received.



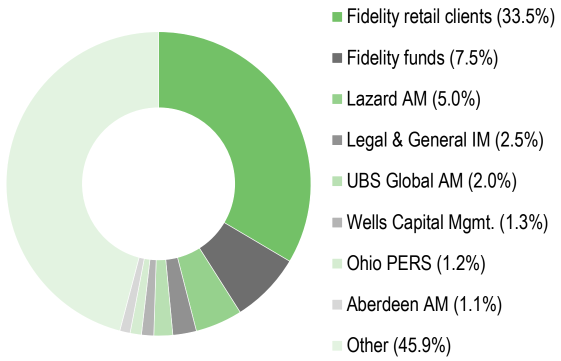
Share buyback policy and history

FCSS will buy back shares at a discount or issue them at a premium to keep the share price close to NAV. There is no rigid discount control mechanism.



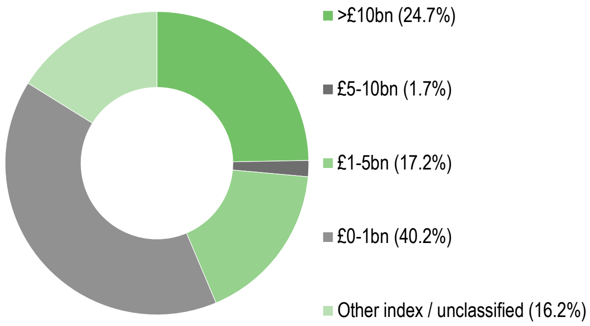
Shareholder base (as at 20 February 2015)

The directors report that over 80,000 private investors are FCSS shareholders, the majority being Fidelity ISA and share plan clients.



Portfolio exposure by market cap (as at 31 January 2015)

FCSS has a small- and mid-cap bias reflecting the manager's view that these stocks tend to be less researched and provide more mis-pricing opportunities.



Top 10 holdings (as at 31 January 2015)

			Portfolio weight %	
Company	**Country of listing**	**Sector**	**31 January 2015**	**31 January 2014****
Tencent	China	Information Technology	7.3	4.9
Ping An Insurance	China	Financials	4.7	N/A
China Pacific Insurance	China	Financials	3.3	N/A
Lee's Pharmaceutical	Hong Kong	Healthcare	2.0	N/A
Hutchison China Meditech	Hong Kong	Healthcare	2.0	2.2
Netease	China	Information Technology	1.8	2.2
SAIC Motor	China	Consumer Discretionary	1.7	2.2
Alibaba	Grand Cayman	Information Technology	1.5	2.6
Citic Securities	China	Financials	1.5	3.4
Daqin Railway	China	Industrials	1.5	N/A
Top 10			**27.3**	**N/A**

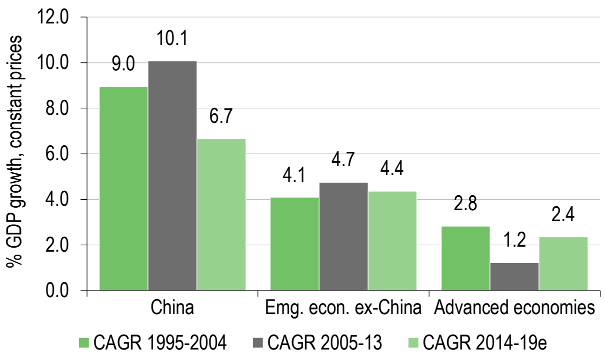
Source: Fidelity China Special Situations, Edison Investment Research, Morningstar, Thomson. Note: *Market exposure net of short positions; **N/A where not in January 2014 top 10.

Market outlook: Favourable prospects

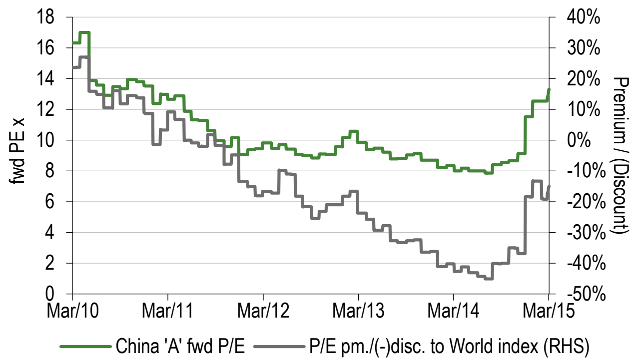
Chinese GDP growth is predicted to slow further from the 7.4% achieved in 2014 (Exhibit 2) and over the medium-term remain significantly below the average rate of the last 20 years. However, China's economy is expected to grow at one of the highest rates in the Asian region, appreciably faster than other emerging as well as advanced economies, which provides a favourable environment for corporate earnings growth. While market sentiment continues to be affected by concerns over further economic slowdown in the near-term, the Chinese government's focus on rebalancing the economy away from investment-led growth to more sustainable consumption-led growth and pursuit of structural reforms are encouraging signs for the long-term. Unlike in many advanced economies, the Chinese government has scope to provide further stimulus to the economy and has shown a willingness to act, as demonstrated by recent cuts in interest rates.

Exhibit 2: China GDP growth and market valuation compared

GDP growth rate – China vs. other emerging & advanced economies



Datastream China 'A' index forward P/E multiple vs. world



Source: IMF October 2014 WEO, Thomson Datastream, Edison Investment Research

Although a de-rating of domestically-traded Chinese equities[1] has persisted for most of the last five years (Exhibit 2 right-hand chart) with the discount to world markets expanding considerably, the last six months has seen a significant re-rating of Chinese 'A' shares. The Hong Kong Shanghai Stock Connect programme, increasing investor access to domestically-traded Chinese shares, is arguably the major contributing factor. Even though the forward P/E multiple of the Chinese 'A' share market has risen sharply from its 7.9x low in August 2014 to 13.3x, this is 8% below the average P/E multiple across Asia ex-Japan markets and a 15% discount to world markets. On a P/E multiple of 13.0x, the Hong Kong market is at a 17% discount to world markets. The discount of both Hong-Kong and domestically-listed Chinese shares to world markets combined with the superior growth prospects of the Chinese economy, and consumption-led sectors in particular, provide a favourable backdrop for Chinese equities to outperform over the medium-term.

Fund profile: China-focused investment

FCSS is a closed-ended investment trust company listed on the LSE, launched in April 2010 principally to provide UK investors with a suitable route to access the China growth story within a diversified portfolio. FCSS's investment objective is to achieve long-term capital growth from an actively managed portfolio, primarily comprising securities of companies listed in China or Hong Kong and Chinese companies listed on other recognised exchanges. The trust may also invest in other listed companies with significant interests in China and Hong Kong. Performance is benchmarked against the MSCI China index expressed in UK sterling. The investment portfolio is managed by Fidelity Worldwide Investment (Fidelity) whose investment approach is characterised

[1] Principal Chinese share categories are 'A' and 'B' shares traded on domestic Chinese stock exchanges; 'H' shares and Red chips listed on the Hong Kong Stock Exchange.

by bottom-up stock picking facilitated by extensive research capabilities. Anthony Bolton managed the trust from launch and was succeeded by Dale Nicholls in April 2014. Nicholls has over 18 years' investment experience principally within the Asia-Pacific region and has managed Fidelity's Pacific Fund since September 2003. While Nicholls is not solely focused on FCSS, China is the Pacific fund's largest overweight position and there is a large overlap in holdings between the two funds.

The fund manager: Dale Nicholls

The manager's view: Attractive opportunities for investors

Dale Nicholls sees slowing economic growth as a natural part of the rebalancing of the Chinese economy towards consumption which should lead to more sustainable long-term growth. He anticipates consumption-led industries growing faster than the overall economy over the medium- to long-term which underpins the portfolio's principal investment focus. While acknowledging that imbalances exist in the credit and property markets, he considers that the current negative market sentiment overplays the risks of both a credit crisis and a collapse in property prices. Major reforms were announced at the third plenary, including a key initiative to reduce government market intervention, subsequent actions tend to confirm the government's resolve to implement them. Nicholls sees the extent of the reforms together with the shift to a consumption-led economy creating compelling long-term investment opportunities, particularly in the consumer, IT and healthcare sectors.

E-commerce in China is considered to have strong medium-term growth potential driven by increasing internet penetration in China as well as rapid consumer adoption rates. Portfolio exposure is provided by top 10 holdings Netease and Alibaba and by Bitauto. Although the Alibaba holding was substantially reduced on valuation grounds post its September 2014 IPO, it is believed to have considerable growth potential from business expansion opportunities such as merchant financing as well as the underlying market growth.

Nicholls has identified insurance and autos as underpenetrated areas of consumption expected to be direct beneficiaries of government reforms, urbanisation and an increasingly affluent middle class, enabling them to grow significantly faster than the wider market. Exposure to insurance has increased over the last 12 months with Ping An and China Pacific insurance now top 10 holdings. Top 10 holding SAIC Motor provides auto exposure while Gree Electrical Appliances and Zheijiang Supor Cookware provide further exposure to mass-market consumption.

Sectors where reforms are expected to act as a strong medium-term stimulus include healthcare and railways. Welfare reforms are expected to improve healthcare access for over 100 million people by 2020 supporting growth prospects for portfolio holdings Lee's Pharmaceutical, Shanghai Fosun and Phoenix Healthcare. Railways remain an important area for infrastructure investment and a move to market pricing provides scope for operators such as top 10 holding Daqin Railway, a recent addition to the portfolio, to see substantial margin improvement.

Asset allocation

Investment process: Bottom-up stock selection

The portfolio is constructed using a bottom-up stock selection approach and allocations are not set with reference to the benchmark index. Overall, the manager looks for undervalued companies that can deliver outperformance over the long term and seeks to identify companies with good long-term growth prospects, cash-generative businesses and strong management teams. The aim is to find companies trading on valuations that do not reflect the quality and potential of the business. This provides a bias towards smaller companies that tend to be less well researched where there is greater potential for the shares to be mispriced. Meeting management is an essential part of the process to gain an understanding of companies and monitor their progress. The portfolio manager undertakes an intensive schedule of c 700 company meetings and visits each year. He is supported by Fidelity's significant worldwide resources, with 24 analysts providing relevant stock coverage, including 10 analysts dedicated purely to Chinese equities. Risk management is seen as key to the investment process with third-party resources employed to provide additional due diligence checks on companies and corporate governance verification prior to FCSS making an investment.

FCSS uses futures, options and contracts for difference (CFDs) to enhance portfolio performance, as well as for efficient portfolio management and hedging. The trust can invest in domestically-traded China 'A' and 'B' shares, Hong Kong-listed China 'H' shares and Red chips as well as shares listed on other exchanges providing exposure to China. Up to 5% of gross assets may be invested in unlisted securities and the aggregate gross asset exposure of short positions is limited to 15%.

Current portfolio positioning

The portfolio currently comprises c 140 holdings compared with 112 at the start of the financial year. This reflects the large number of attractive new investment opportunities identified by the manager which were added to the portfolio as some of the larger holdings were reduced. The manager is in the process of selling some of the smaller less liquid investments and expects the number of portfolio holdings to decline from the current level. Portfolio turnover of c 30% in the six months to 30 September 2014 was similar to historical levels but the manager reports an increase in the second half of the year as profits were taken in some larger holdings. The portfolio retains a small- and mid-cap bias with stocks below £1bn market cap representing 40% of the portfolio (see Exhibit 1). There are currently no unquoted holdings in the portfolio.

Exhibit 3: Portfolio exposure by sector vs benchmark (%)

	Portfolio end January 2015	Portfolio end January 2014*	Change	MSCI China index weight	Active weight vs index	Trust weight/ index weight
Consumer Discretionary	22.9	24.1	-1.3	4.6	18.3	5.0
Information Technology	20.3	25.1	-4.8	13.5	6.8	1.5
Financials	20.0	23.9	-3.9	40.0	-20.0	0.5
Industrials	9.6	4.9	4.7	6.9	2.7	1.4
Healthcare	8.7	12.0	-3.3	2.2	6.5	4.0
Utilities	4.1	3.0	1.1	4.1	0.0	1.0
Consumer Staples	4.0	2.4	1.6	4.3	-0.3	0.9
Materials	3.8	1.3	2.5	2.4	1.5	1.6
Energy	3.1	4.6	-1.5	10.2	-7.1	0.3
Telecommunication Services	1.5	1.1	0.4	11.8	-10.3	0.1
Futures & Options	2.0	-2.6	4.5	0.0	2.0	N/A
	100.0	**100.0**		**100.0**		

Source: Fidelity China Special Situations, Edison Investment Research. Note: *Adjusted for 2.6% exposure to Alibaba which was reclassified from Consumer Discretionary to Information Technology in September 2014.

As shown in Exhibit 3, the largest active overweight positions are in consumer discretionary, information technology and healthcare with the largest active underweight positions in financials, telecom services and energy. The overweights represent industries where the manager expects the greatest positive effects from ongoing reforms and the shift to a consumption-led economy. The underweight position in financials is due to no banks being held in the portfolio reflecting the manager's view that the proportion of non-performing loans will continue to rise. However, within financials, the portfolio has overweight positions in insurance, brokerage and real estate. The underweights in telecom services and energy are primarily on valuation grounds.

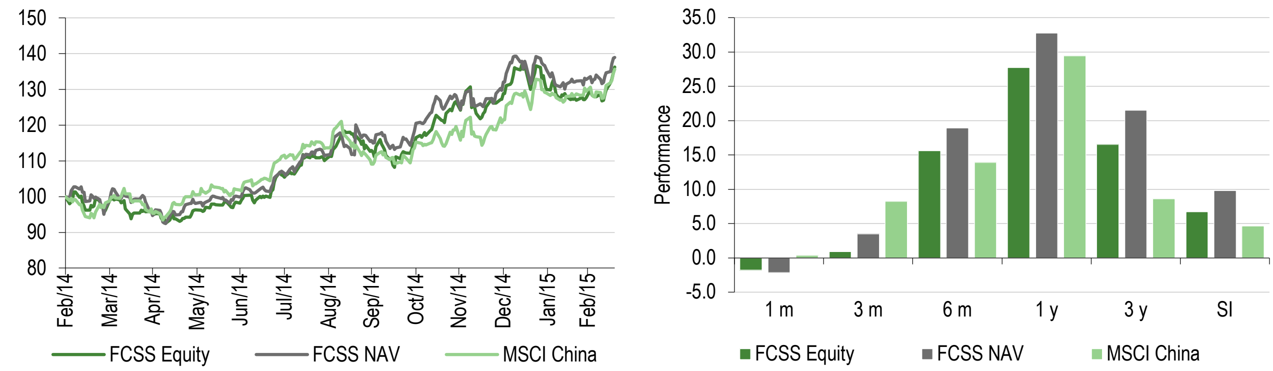
Performance: Outperformance since launch

As shown in Exhibit 5, FCSS's NAV total return has outperformed its MSCI China index benchmark over one and three years and since launch in April 2010. Performance has been ahead of the MSCI

World and FTSE All-Share indices over one and three years and slightly below and above these indices respectively since launch. This reflects the underperformance of the Chinese market relative to world markets from early 2011 through to mid-2014 and its relative outperformance over the last six months. Exhibit 6 illustrates that, following a period of relative underperformance during 2011 and 2012, FCSS achieved considerable outperformance during 2013 and 2014.

Exhibit 4: Investment trust performance to 28 February 2015

Price, NAV and benchmark total return performance, one-year rebased | **Price, NAV and benchmark total return performance (%)**



Source: Thomson Datastream, Edison Investment Research. Note: Index performance is sterling-adjusted. Three-year and SI (since inception) performance figures annualised. Inception date is 19 April 2010.

Exhibit 5: Share price and NAV total return performance, versus indices (percentage points)

	One month	Three months	Six months	One year	Three years	Since inception
Price versus MSCI China	(2.1)	(6.8)	1.5	(1.3)	23.6	10.0
NAV versus MSCI China	(2.4)	(4.4)	4.4	2.5	40.1	26.4
Price versus MSCI World	(4.6)	(2.7)	5.1	8.6	3.6	(16.5)
NAV versus MSCI World	(4.9)	(0.3)	8.1	12.9	17.5	(4.1)
Price versus FTSE All-Share	(5.3)	(3.7)	11.1	21.0	16.0	(8.2)
NAV versus FTSE All-Share	(5.6)	(1.2)	14.3	25.8	31.5	5.4

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-February 2015. Geometric calculation.

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

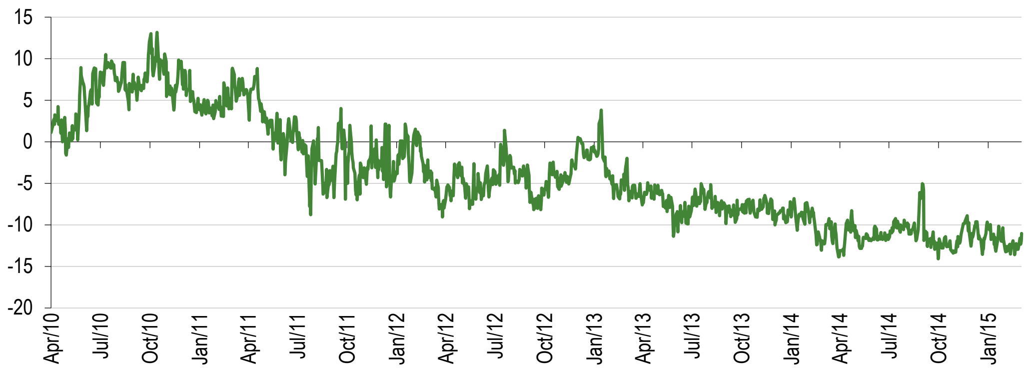
Source: Thomson Datastream, Edison Investment Research

Discount: Relatively stable over last 12 months

As illustrated in Exhibit 7, having traded at a premium following launch, FCSS's share price moved to a discount to NAV (including income) in June 2011 and has subsequently followed a slow but steady widening trend. The widening discount in 2011 and 2012 could be considered to reflect FCSS's relatively weak performance while in 2013 and 2014 it is arguably a reflection of negative market sentiment towards China. The discount has been relatively stable over the last year and currently stands at 11.1%, marginally narrower than its 12-month average of 11.3%.

Although the board believes that it is in the best interests of shareholders for the share price to track closely to NAV, it has made no commitment to maintain the discount at a particular level. While 81.9m shares, representing 12.5% of the shares in issue, were repurchased and cancelled in the year to 31 March 2014, only 0.1m shares have been repurchased in the current financial year.

Exhibit 7: Share price premium / discount to NAV (including income) since launch (%)



Source: Thomson Datastream, Edison Investment Research. Note: Negative values indicate a discount, positive values a premium.

Capital structure and fees

FCSS has 571.3m shares in issue. The trust has authority to repurchase up to 14.99% of the shares in issue and hold up to 10% in treasury, to be re-issued at or above NAV so that the net effect of repurchase and re-issue is to enhance NAV per share. The board considers that long-term prospects for the fund make a modest level of gearing beneficial. This can be achieved using bank debt, CFDs and other derivatives. Borrowing is permitted up to 25% of NAV and there is a 30% limit on gross asset exposure exceeding NAV. FCSS has a fully-drawn three-year US$150m (c 11% of NAV) variable rate loan facility and gross asset exposure was 127% of NAV at 31 January 2015.

The annual management fee was reduced from 1.2% to 1.0% of NAV in April 2014. In addition, the investment manager is entitled to a 15% annual performance fee on returns more than 2% above the benchmark MSCI China index, subject to a cap of 1.0% of NAV (reduced from 1.5% in April 2014). For the year to 31 March 2014, £7.7m and £6.4m in management and performance fees were payable and ongoing charges were 2.45% (1.45% excluding performance fees).

Dividend policy

FCSS aims to achieve long-term capital growth and dividends are not expected to constitute a material element of returns to shareholders. However, as an investment trust, FCSS is required to distribute 85% of its income and it also has the flexibility to pay dividends out of capital profits if circumstances should warrant this in the future. A dividend is paid annually and has been increased in each of the three years since the first distribution in 2011 (see Exhibit 1).

Peer group comparison

Exhibit 8 illustrates a comparison of FCSS with a selected peer group of closed-ended and open-ended funds focused on China and Greater China equities. Only one other constituent of the AIC country specialists Asia-Pacific sector, JPMorgan Chinese, is focused on Chinese equities so we have also shown the average figures for AIC Asia-Pacific ex-Japan sector funds (35% average exposure to China and Greater China). Open-ended peers comprise funds over £250m in size from the IMA China/Greater China sector. FCSS's NAV total return compares favourably with closed-ended and open-ended peers over one and three years, achieving a similar performance to the two leading open-ended funds over one year and substantial outperformance vs all open-ended peers over three years. In terms of risk-adjusted returns, FCSS's Sharpe ratios of 2.5 and 1.3 over one and three years rank towards the top of the closed-ended peer group. The reduction in the management fee from 1 April 2014 should lower FCSS's ongoing charge to c 1.25% in the current financial year, which is a broadly similar level to closed-ended peers and compares favourably with the open-ended peer group average total expense ratio (TER) of 1.93%.

Exhibit 8: Funds investing in Chinese equities: Total returns, Discounts and Charges as at 19 March 2015

% unless stated	Market cap/ Fund size £m	NAV TR 1 Year	NAV TR 3 Year	NAV TR 5 Year	NAV TR 10 Year	Sharpe 1y (NAV)	Sharpe 3y (NAV)	Discount (ex-par)	Ongoing Charge / TER	Net Gearing	Dividend yield (%)
Fidelity China Special Situations	805.5	39.7	88.8			2.5	1.3	(10.7)	1.46	126	0.8
JPMorgan Chinese	146.7	33.9	52.4	51.0	293.6	1.8	0.9	(13.0)	1.40	108	0.8
Asia-Pacific ex-Japan average	**295.7**	**25.2**	**34.8**	**59.8**	**258.9**	**1.8**	**0.8**	**(8.4)**	**1.15**	**103**	**1.9**
Mutual Funds											
Aberdeen Global Chinese Equity	1,110.3	21.1							1.97		
Allianz China Equity	332.2	37.7	35.8	24.3					2.28		
Fidelity China Focus	2,705.6	45.9	46.2	30.8	366.3				1.93		
First State Greater China Growth	489.2	25.8	43.2	57.6	367.7				1.84		
GAM Star China Equity	1,271.4	15.3							1.56		
Henderson China Opportunities	606.3	28.8	44.1	31.7	275.0				1.73		
HSBC GIF Chinese Equity	1,258.8	45.4	43.4	23.5					1.90		
Invesco Perpetual Hong Kong & China	349.6	19.7	51.8	40.1	265.1				1.69		
Schroder ISF Greater China	628.9	29.6	30.2	27.4	248.5				1.94		
Templeton China	573.9	26.0	10.0	9.7					2.45		
Average	**932.6**	**29.5**	**38.1**	**30.6**	**304.5**				**1.93**		

Source: Morningstar, FE Trustnet, Thomson Datastream, Edison Investment Research. Note: TR=total return. The Sharpe ratio is a measure of risk-adjusted return. The ratios we show are calculated by Morningstar for the past 12- and 36-month periods by dividing a fund's annualised excess returns over the risk-free rate by its annualised standard deviation. Net gearing is total assets less cash and cash equivalents as a percentage of shareholders' funds.

The board

The board comprises six non-executive directors, all of whom are independent, with the exception of Andrew Wells. John Owen (chairman), Nicholas Bull, David Causer and Peter Pleydell-Bouverie have served on the board since February 2010. Elisabeth Scott was appointed to the board in November 2011 and Andrew Wells (Fidelity's Global Chief Investment Officer, Fixed Income) was appointed in May 2012.

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