Fidelity China Special Situations

Focused on China's long-term growth potential

Investment trusts

Fidelity China Special Situations (FCSS) invests in Chinese and other related equities providing exposure to the secular growth of the Chinese economy. Dale Nicholls recently took over as manager from Anthony Bolton and he continues the focus on identifying mispriced shares in cash-generative companies with good long-term growth prospects and strong management teams. There is a bias towards smaller companies that are less well researched, but tend to be higher risk. Although exhibiting above-average volatility, the Chinese market offers a combination of favourable growth prospects and potential for re-rating driven by ongoing market reforms.

12 months ending	Share price (%)	NAV (%)	MSCI China Index (%)	MSCI World Index (%)	FTSE All-Share Index (%)
31/08/11	(15.3)	(7.6)	(5.7)	8.6	7.3
31/08/12	(16.6)	(17.3)	(5.7)	11.5	10.2
31/08/13	29.5	37.0	17.5	21.5	18.9
31/08/14	26.1	29.3	9.8	13.4	10.3

Source: Thomson Datastream. Note: 12-month rolling discrete total return performance.

Investment strategy: Bottom-up stock picking

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 identify companies that are not well understood by the market where the shares are mispriced and this leads to a focus on smaller companies that tend to be less well researched. Meeting company management teams is considered an essential part of the process to understand companies, as well as monitor progress. Due diligence has been strengthened since inception, including the use of third-party background checks on companies and management teams.

Market outlook: Long-term growth potential

Medium-term growth forecasts for China are significantly ahead of forecasts for other large emerging and advanced economies, which should provide a favourable backdrop for Chinese corporate earnings growth. Additionally, Chinese and Hong Kong markets have de-rated compared with world markets over the past 18 months and China 'A' share market valuation metrics appear to offer significant upside on both a historical basis and relative to other markets. Although there are risks, the combination of favourable growth prospects, attractive valuations relative to other world markets and the potential for ongoing market reforms to act as a catalyst for re-rating presents an attractive environment for investors who can accept periods of short-term volatility.

Valuation: Discount has widened

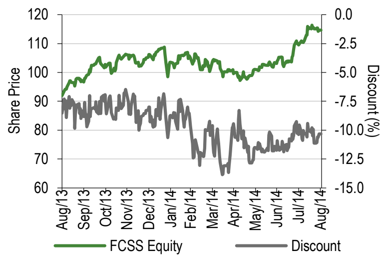
FCSS's share price traded at a premium to NAV following launch, but by October 2010 the premium started to narrow, moving to a discount in June 2011. Subsequently, there has been a widening of the discount to around 10% currently. Although its primary focus is on capital growth, FCSS pays an annual dividend, which it has increased each year since launch and currently yields 1%.

2 September 2014

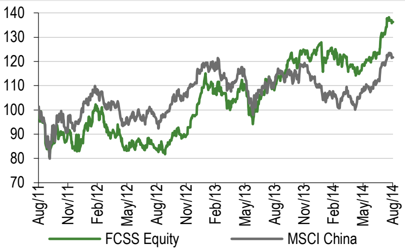
Price	**114.7p**
Market cap	**£655m**
AUM	**£883m**

NAV*	127.0p
Discount to NAV	9.7%
NAV**	127.9p
Discount to NAV	10.3%
*Excluding income. **Including income.	
Yield	1.0%
Ordinary shares in issue	571.4m
Code	FCSS
Primary exchange	LSE
AIC sector	Country specialists – Asia Pacific

Share price/discount performance*



Three-year cumulative perf. graph



52-week high/low	116.4p	92.0p
NAV* high/low	128.8p	99.2p

*Excluding income.

Gearing

Gross asset exposure	26.8%
Net asset exposure*	19.4%

*Market exposure net of short positions.

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Edison profile page

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

Exhibit 1: Fidelity China Special Situations 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.

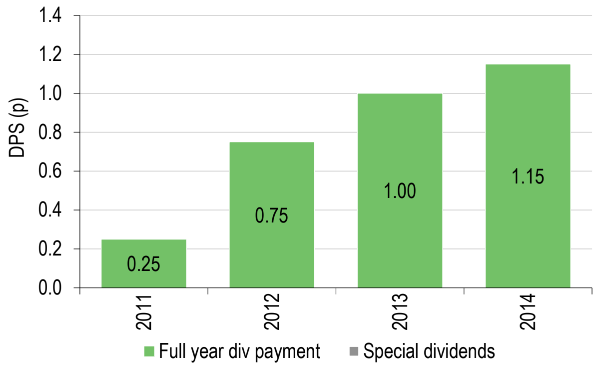
Recent developments

6 June 2014: Annual results for the year ended 31 March. NAV TR +19.5% versus -6.9% from benchmark MSCI China Index.
1 April 2014: Dale Nicholls succeeds Anthony Bolton as portfolio manager.
19 March 2014: Annual fee reduced from 1.2% to 1.0% and performance fee terms reduced.

Forthcoming		Capital structure		Fund details	
AGM	July 2015	Ongoing charge	1.45% (2.45% incl. perf. fee)	Group	Fidelity Worldwide Investment
Interim results	November 2014	Net asset exposure*	19.4%	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	See page 11		
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

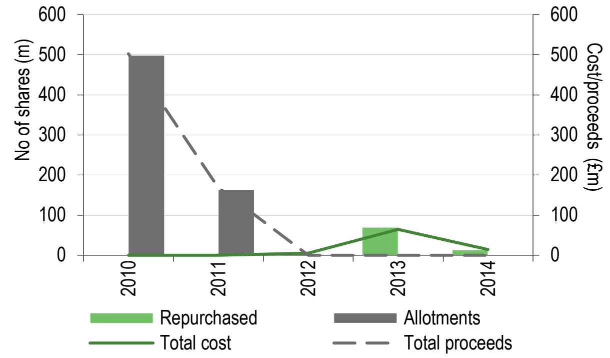
Dividend payments

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



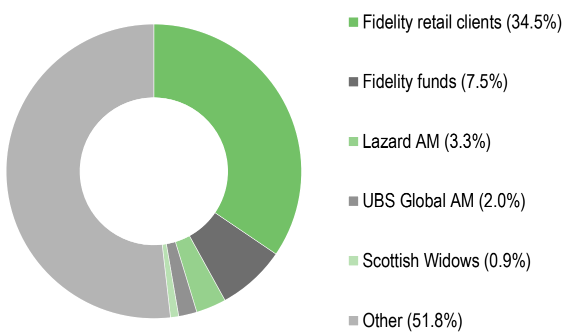
Share buyback policy and history

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.



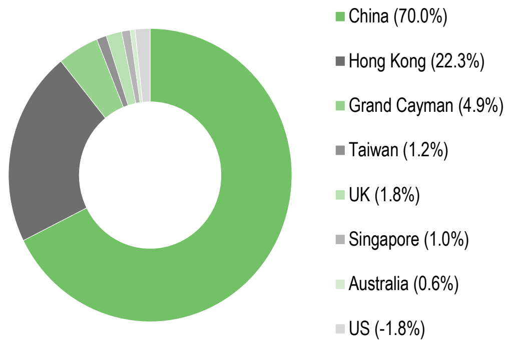
Shareholder base (as at 15 August 2014)

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



Geographical exposures of portfolio (as at 31 July 2014)

FCSS invests in companies listed in China or Hong Kong and Chinese companies listed on other recognised exchanges.



Top 10 holdings as at 31 July 2014

			Portfolio weight %	
Company	**Country of listing**	**Sector**	**31 July 2014**	**31 July 2013****
Tencent	China	Information Technology	8.0	4.3
Alibaba	Grand Cayman	Consumer Discretionary	3.7	N/A
Citic Securities	China	Financials	3.5	3.0
Ping An Insurance	China	Financials	3.2	2.4
Hutchison China MediTech	Hong Kong	Health Care	2.5	N/A
Lee's Pharmaceutical	Hong Kong	Health Care	2.2	N/A
BitAuto	China	Information Technology	2.2	N/A
Green Dragon Gas	Hong Kong	Energy	2.0	N/A
21Vianet	China	Information Technology	1.9	2.5
China Pacific Insurance	China	Financials	1.8	N/A
Top 10			**31.0**	**N/A**

Source: Source: Fidelity China Special Situations, Edison Investment Research, Morningstar, Thomson. Note: *Market exposure net of short positions; **N/A where not in July 2013 top 10.

Investing in Chinese equities

Accessing Chinese equities is not straightforward due to the number of categories of Chinese shares listed on stock exchanges in China and Hong Kong with different currency denominations and investment restrictions. Investing through a fund can provide an effective way to overcome these issues. Reforms that are underway to open up access to the Chinese market may help to crystallise value as share liquidity increases.

The principal Chinese share categories are:

- **China 'A' shares** – shares traded on the Chinese Stock Exchanges in Chinese renminbi. Since 2003, foreign investors have been able to invest in 'A' shares.
- **China 'B' shares** – shares traded on the Shenzhen and Shanghai stock exchanges in Hong Kong dollars and US dollars respectively. Since February 2001, 'B' shares have been available to domestic Chinese individuals as well as foreign individuals and institutional investors.
- **China 'H' shares** – shares in companies incorporated in China, listed on the Hong Kong Stock Exchange and traded in Hong Kong dollars. 'H' shares are available to non-Chinese investors.
- **Red chips** – China-based companies, incorporated outside China and listed on the Hong Kong Stock Exchange. Many are controlled by the Chinese state, provinces or municipalities.

Although trading in China 'A' shares by foreign investors is relatively restricted, market reforms are gradually increasing market access. Launched in 2003, the Qualified Foreign Institutional Investor (QFII) scheme enables foreign investors to invest in 'A' shares subject to allocated quotas. In 2012 and 2013, eligibility requirements were lowered and the aggregate investment quota was increased from US$30bn to US$150bn. The RQFII (Renminbi QFII) scheme was introduced in 2011, allowing Chinese financial institutions to invest renminbi funds raised in Hong Kong in the Chinese stock market and in 2012 RQFII 'A' share ETFs were launched. In 2013, the RQFII scheme was extended to include non-Chinese financial institutions and renminbi funds raised outside Hong Kong.

In April 2014, the Shanghai and Hong Kong stock exchanges announced a mutual market access programme expected to launch in October 2014 in which all overseas institutional and individual investors are able to participate. No individual quotas will be allocated, but an initial aggregate quota for investment inflows into China of c US$50bn has been set. In the short term, this is likely to lead to a narrowing of the discounts between China 'A' and 'H' shares and in the longer term there is potential for China 'A' shares to be added to global indices, further improving market liquidity.

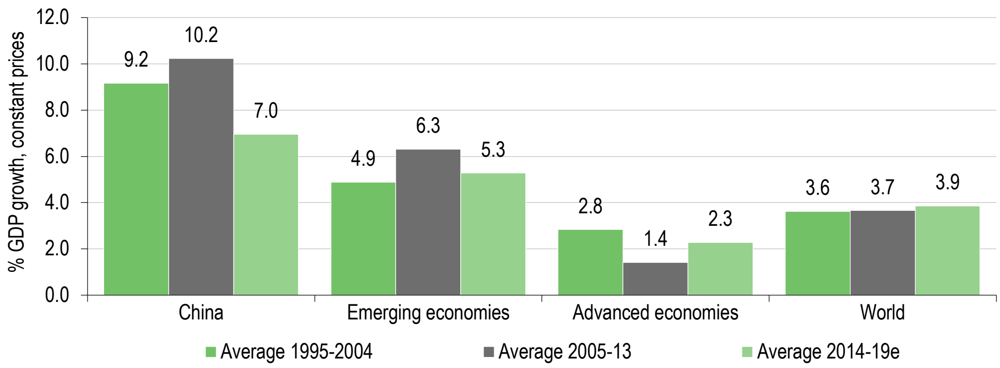
Chinese market outlook: Long-term growth potential

The primary attractions of investing in China are the secular growth of the economy and relatively immature capital markets. China's economic growth is widely forecasted to outpace advanced economies and most other emerging economies over at least the next five years, providing a favourable environment for corporate earnings growth. Private companies account for a disproportionately small share of the Chinese equity market relative to their contribution to economic output primarily due to regulatory restrictions. This creates the prospect of a potentially large number of companies seeking to come to market as regulatory barriers are reduced, substantially expanding the range of potential investment opportunities.

China's investment and export-led economy has achieved growth averaging c 10% pa over the last 20 years, driven by rapid industrialisation and urbanisation, significantly outpacing global GDP growth. Over the last decade, the contribution of investment to GDP has grown much faster than consumption, which currently accounts for only c 35% of GDP, around half the level seen in developed countries such as the US. Following the 2008 global financial crisis, investment growth was supported by a large expansion in credit, leading to concerns over the potential overheating of the property market, a key growth driver. Since 2012, growth has slowed to c 7% pa while the Chinese government has focused on rebalancing the economy through promoting consumption.

Recent market sentiment has been affected by a continuing focus on the decline in China's economic growth rate and the risks of further economic slowdown. However, the slowdown needs to be put into perspective as medium-term growth forecasts for China are significantly higher than for both advanced economies and other emerging economies (see Exhibit 2). This provides a favourable context for Chinese corporate earnings growth over the medium term. Additionally, the current relatively controlled decline in growth appears to present less risk than a potential future sharp slowdown, which could occur if greater stimulus was injected to boost near-term growth.

Exhibit 2: Average % real GDP growth – China vs emerging, advanced economies & world

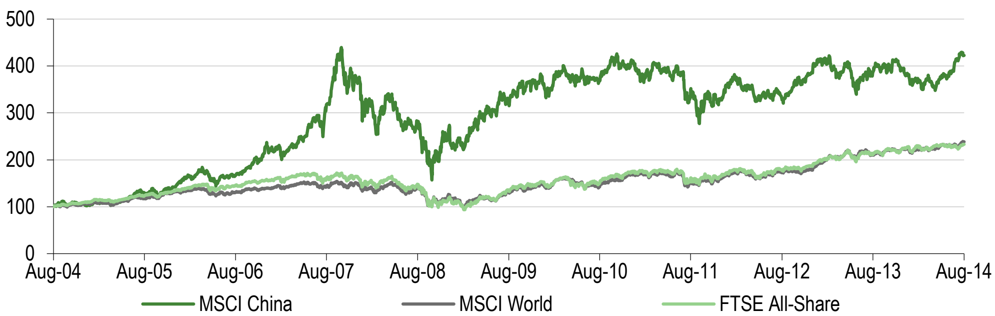


Source: IMF April 2014 WEO, Edison Investment Research

In a July 2014 report on China, the IMF highlighted a low but rising risk of an economic hard landing due to an unsustainable growth pattern since the global financial crisis. Reining in credit growth, local government borrowing and investment, and implementation of the announced reform agenda were seen as requirements to promote a rebalancing of the economy. Although anticipated to lead to somewhat lower growth in the near term, this would be offset by the benefit of higher medium-term income and consumption.

Exhibit 3 illustrates the outperformance of the MSCI China Index over the last 10 years compared with the MSCI World and FTSE All-Share indices, as well as the relatively high volatility of the MSCI China Index.[1] Outperformance has been substantial in rising markets such as during June 2004 to October 2007. However, this is countered by substantial underperformance in falling markets such as during October 2007 to October 2008.

Exhibit 3: MSCI China, MSCI World and FTSE All-Share indices over 10 years



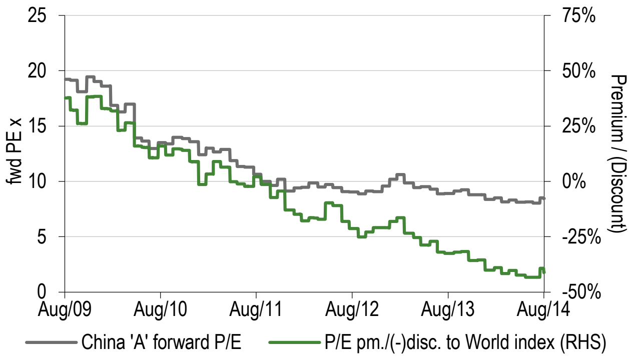
Source: Thomson Datastream, Edison Investment Research. Note: Sterling-adjusted, total return indices.

Also worth noting is the fact that the MSCI China index (sterling-adjusted) has still not exceeded its October 2007 peak, in contrast with both MSCI World and FTSE All-Share indices.

1 Annualised standard deviation over 10 years to end July 2014, MSCI China 27% vs MSCI World 16%.

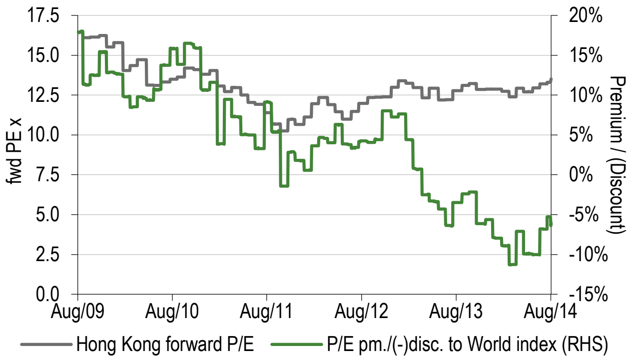
Exhibit 4 illustrates the significant de-rating of China 'A' shares in both absolute terms and relative to world markets over the last five years. While the premium rating in 2009 was justified by expectations of continued strong economic growth, the current rating appears to discount further economic slowdown. Exhibit 5 illustrates that, compared with China 'A' shares, Hong Kong-listed shares have traded at relatively stable average P/E multiples over the last five years. However, their relative valuation has declined due to the re-rating of world markets over the past 18 months.

Exhibit 4: Datastream China 'A' Index forward P/E



Source: Thomson Datastream, Edison Investment Research

Exhibit 5: Datastream Hong Kong Index forward P/E



Source: Thomson Datastream, Edison Investment Research

Exhibit 6 highlights the greater apparent scope for valuation upside across Asia ex-Japan in comparison with the US and UK, which are trading at or close to 10-year peak levels. In particular, the Chinese market valuation stands out at close to its 10-year low and substantially below its 10-year average level. The current forward P/E multiple for the Hong Kong share index is in line with the 10-year average, but significantly below its peak level.

Exhibit 6: China 'A' and Hong Kong forward P/Es vs Asia, the US, UK, world over 10 years

Price to earnings (forward)	Last	High	Low	Average	Last % of average
China 'A'	8.5	36.7	8.0	14.6	58%
Hong Kong	13.5	19.6	9.2	13.5	100%
Asia ex-Japan	12.5	16.9	8.7	12.2	103%
US	16.4	16.4	10.8	13.6	120%
UK	14.0	14.2	8.6	11.3	123%
World	14.4	14.5	10.0	12.4	116%

Source: Thomson Datastream, Edison Investment Research. Note: Data to 29 August 2014.

This leaves China 'A' share valuations appearing attractive on both a historical basis and in comparison with world markets. Anticipated further market deregulation could act as a catalyst for a re-rating of the market with scope for significant potential upside. Hong Kong share valuations also appear attractive relative to world markets with scope for the market to move higher. Medium-term growth forecasts for China should support above-average Chinese corporate earnings growth, providing further scope for the market to move higher. Although there are risks, the combination of favourable growth prospects, attractive valuations relative to other world markets and the potential for market reforms to act as a catalyst for re-rating suggests an attractive investment environment.

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 distinctive investment approach is bottom-up stock picking facilitated by extensive research capabilities. Fidelity has had a presence in Asia since 1969 and currently has offices in seven countries across the region, including in three cities in mainland China and in Hong Kong. The Hong Kong office is Fidelity's second largest in the region. Fidelity was granted a QFII licence in September 2010 and has received a US$400m total quota allocation, with US$127.5m allocated to FCSS that permits it to invest in China 'A' shares.

Anthony Bolton managed the trust from launch to 31 March 2014 and was succeeded by Dale Nicholls on 1 April 2104. Dale Nicholls has 18 years' investment experience. He joined Fidelity as a research analyst in 1996, covering a number of sectors in the Japanese market, gaining exposure to Chinese companies while analysing market dynamics for the industries under coverage. He managed Japanese sector funds for the Fidelity Japanese office from 1999 and became portfolio manager of Fidelity Funds Pacific Fund in September 2003. He has also previously managed a number of regional small-cap strategies, including Fidelity Funds Asian Smaller Companies Fund. 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: Positive on mid-term growth opportunities

Dale Nicholls comments that his approach to management of the trust is very similar to that followed by Anthony Bolton and, given that they shared similar views on the Chinese market, many of the portfolio changes since the handover have been natural changes rather than restructuring. Other changes include investments in the paper and packaging industries and railway operators, one of the state-owned enterprise (SOE) sectors seen as well-positioned to benefit from reforms, with tariffs anticipated to rise significantly.

Nicholls's overall view is that China is transitioning from credit-driven investment and export-reliant growth to a period of more sustainable consumer-driven growth, which should provide a more stable investment environment. He would not be concerned to see economic growth decline to 5% as he considers that this is a strong growth rate in a global context and, with consumption growing faster than overall GDP, would still provide a healthy environment for stronger companies to grow. He considers banking to be one of the key sectors that will be negatively affected by reforms, with net interest margins likely to contract and further increases in the level of non-performing loans, particularly among capital-intensive SOEs.

Nicholls remains positive on mid-term growth opportunities in the consumer discretionary sector driven by Chinese government efforts to promote domestic consumption and ongoing urbanisation that should support the continuing growth of the middle class. Based on this view and current valuations, he likes companies exposed to rising Chinese wealth and underpenetrated areas of consumption. The trust has holdings in companies that should benefit from consumption upgrades, such as SAIC Motor, which manufactures Volkswagen and GM vehicles, and Gree Electric Appliances, which produces high-quality air conditioning units. The portfolio's exposure to the theme of increased travel by mainland Chinese includes China Lodging, which owns and manages mid-range hotels across China, and China International Travel, a major tourist travel agent.

While Nicholls is positive on the long-term outlook for the Chinese internet and software sector, he considers that shorter-term valuations are less compelling following a strong run over the last 18 months. Information technology holdings were trimmed in Q114, but recent sector volatility has provided the opportunity to add to holdings in higher-quality companies in the sector.

FCSS has no investments in Chinese banks despite their low valuation due to the manager's concerns over ongoing regulatory risks and the risk of rising levels of bad debt. By contrast, he sees opportunities in the insurance sector where valuations are cheap and mid-term growth prospects strong, although he cautions that each company's individual exposures need to be understood. Recent reforms, such as enabling insurance firms to invest in a wider range of assets and changing annuity rules, are also considered to be positive for the sector. The manager also has a favourable view towards brokers, as they are expected to play an increasingly important role in financial market reform with many markets still in the early stages of development. Brokers with strong underwriting skills, such as top 10 holding Citic Securities, are anticipated to benefit as companies increasingly look to the markets to raise funds.

Improving healthcare is a major priority for the Chinese government and increasing signs of support for the development of private hospitals has influenced a number of portfolio investments in the sector. Hospital management group Phoenix Healthcare is a leader in this area as is Fosun International, a conglomerate with a controlling stake in five hospitals. Alongside these, the portfolio has investments in a number of Chinese healthcare companies with attractive pipelines of drugs in different stages of development, which the manager believes are not reflected in market valuations.

Despite recent setbacks, the renewable energy sector is considered to be an area with great long-term growth potential. Pollution is among the top issues for the government to address and China wants to become more energy self-sufficient, both of which the manager expects to drive renewable energy demand. Additionally, the government has a stated goal in its five-year plan to increase its use of non-fossil fuels to 15% of total energy consumption by 2020.

Asset allocation

Investment process: Bottom-up stock selection

The manager seeks to achieve long-term capital growth through investing in a diversified portfolio consisting primarily of securities issued by companies listed in China or Hong Kong and Chinese companies listed on other recognised exchanges, as well as other listed companies with significant interests in China or Hong Kong. While the manager aims to achieve a capital return in excess of the equivalent return on the MSCI China Index, as expressed in UK sterling, a bottom-up stock selection approach is adopted and allocations are not set with reference to the benchmark.

Overall, the manager looks for undervalued companies that can deliver outperformance over the long term and he seeks to identify companies with the following three characteristics:

- good long-term growth prospects;
- cash-generative businesses; and
- strong management teams.

The aim is to identify companies that are not well understood by the market, whose qualities are not fully reflected in valuations. This leads the manager to focus on smaller companies that tend to be less well researched where there is greater potential for the shares to be mispriced. As higher risks can be associated with investing in smaller companies, risk management is seen as key to the investment process. The manager considers meeting company management teams an essential part of the process to understand them and monitor their progress. An intensive schedule is undertaken by the portfolio manager, meeting with c 700 management teams each year, as well as visiting company assets. Company meetings are seen as a good source of investment ideas.

Fidelity has significant resources on which the manager is able to draw, including 12 analysts dedicated to Chinese and Hong Kong equities out of the 51 analysts covering the Asia ex-Japan region. The manager takes advantage of the global research generated by Fidelity's research analysts to maintain awareness of broader industry trends that may provide insight into market developments in China. An analyst will usually accompany the manager to company meetings and site visits, as well as maintaining industry data sheets used by the manager to monitor valuations across each sector. Third-party resources are increasingly used to perform due diligence checks on companies and verify corporate governance before FCSS makes an investment. This follows fraud claims surrounding Sino-Forest and China Integrated Energy in 2011.

FCSS is permitted to invest in equities, index-linked, equity-linked and other debt securities, cash deposits, money market instruments, foreign currency exchange transactions, equity-related securities, forward transactions and other interests including derivative instruments. Forward transactions and derivatives, including futures, options and contracts for difference (CFDs), may be used to enhance portfolio performance, as well as for efficient portfolio management and hedging. The trust can invest in China 'A' shares, both directly through the investment manager's QFII licence and indirectly through brokers that have a QFII facility.

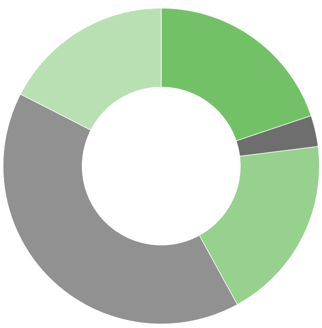
The board's view is that long-term prospects for the fund are such that a modest level of gearing is considered beneficial. Gearing can be achieved through a combination of bank debt, CFDs and other derivatives, with the board imposing a 30% limit on gross asset exposure exceeding NAV.

The trust's interest in any one investment is restricted to 15% of the portfolio value on acquisition, and up to 5% of gross assets may be invested in unlisted securities issued in companies that carry on business, or that have significant interests, in China or Hong Kong. Board policy is that aggregate gross asset exposure of short positions will not exceed 15% and total exposure to any single counterparty from all activities, including cash management and the use of derivatives, should not exceed 15% of gross assets.

Current portfolio positioning

As at 31 March 2014, immediately prior to the change of manager, the portfolio comprised 112 holdings and the current manager expects this could decline to c 100 as some of the smaller holdings are sold. Portfolio turnover is typically 50-60%, although this depends on market events. 2014 turnover may be modestly higher, having increased from 15% in Q1 to 20% in Q2. As shown in Exhibit 8, portfolio concentration in the top 10 and top 20 investments is less pronounced than in the benchmark index, which is probably a reflection of the fund's small- and mid-cap focus. Exhibit 7 illustrates FCSS's market cap exposure, highlighting that stocks with market caps below £5bn represent over 50% of the portfolio.

Exhibit 7: Portfolio exposure by market cap at 31 July 2014



Source: FCSS, Edison Investment Research

Exhibit 8: Portfolio concentration vs benchmark at 31 July 2014

% of total net assets	Portfolio	MSCI China Index	Difference
Top 10	37.3	52.1	-14.8
Top 20	54.3	63.7	-9.4
Top 50	84.8	80.7	4.1

Source: FCSS, Edison Investment Research

Exhibit 9 shows how the FCSS portfolio was invested across different markets and share categories as at 30 June 2014 and how this compares to a year earlier. The main changes over the year are increased exposures to Hong Kong-listed and China 'H' shares and reductions in US-listed and China 'A' and 'B' shares. Shares listed elsewhere include China stocks listed predominantly in Taiwan, UK and Singapore. Exhibit 9 also highlights that the benchmark MSCI China Index has less diversified exposure, primarily comprising China 'H', red chip and Hong Kong-listed shares with a small component of China 'B' shares.

Exhibit 9: Portfolio exposure by country or type of listing vs benchmark (%)

	Portfolio end June 2014*	Portfolio end June 2013	Change from 2013	MSCI China Index weight	Active weight vs index
China 'A' and 'B' shares	12.9	17.6	-4.7	0.4	12.5
China 'H' shares	8.8	3.5	5.3	50.4	-41.6
Red chips	3.6	4.0	-0.4	25.2	-21.6
Hong Kong-listed	52.4	45.0	7.4	24.0	28.4
US-listed	13.4	20.5	-7.1	0.0	13.4
Listed elsewhere	4.4	6.9	-2.5	0.0	4.4
Unlisted	4.5	2.6	1.9	0.0	4.5
	100.0	**100.0**		**100.0**	

Source: Fidelity China Special Situations, Edison Investment Research. Note: *Latest data available.

As at 30 June 2014, FCSS held unlisted investments representing 4.5% of gross asset exposure. The principal unlisted investment is Alibaba, a top 10 holding as at 31 July 2014, representing 3.7% of the portfolio (see Exhibit 1), which is scheduled to come to market in September 2014.

Exhibit 10 shows portfolio sector exposures at 31 July 2014 compared with a year earlier and the benchmark. The principal changes over the last 12 months are reduced weightings in financials and information technology sectors and increases in materials, industrials and energy. While the decrease in financials exposure reflects the manager's view outlined earlier (see page 6), it also reflects the exit from top 10 holding Wing Hang Bank, which received an agreed offer from Singapore's OCBC bank in March 2014. Relative to the benchmark index, FCSS has significant overweight positions in consumer discretionary, healthcare and information technology sectors and significant underweight exposures to financials, telecommunications services and energy.

Exhibit 10: Portfolio exposure by sector vs benchmark (%)

	Portfolio end July 2014	Portfolio end July 2013	Change from 2013	MSCI China Index weight	Active weight vs index	Trust weight/ index weight
Consumer Discretionary	25.0	25.3	-0.3	5.3	19.6	4.7
Financials	20.4	24.4	-4.1	37.2	-16.8	0.5
Information Technology	20.3	24.4	-4.2	13.3	7.0	1.5
Health Care	10.6	11.2	-0.6	1.7	8.9	6.2
Industrials	6.0	4.4	1.6	6.2	-0.2	1.0
Energy	5.2	3.8	1.4	13.7	-8.5	0.4
Utilities	3.9	2.8	1.0	3.8	0.0	1.0
Materials	3.8	N/A	N/A	2.9	0.9	1.3
Consumer Staples	2.7	2.2	0.5	5.2	-2.5	0.5
Telecommunication Services	0.9	N/A	N/A	10.7	-9.7	0.1
Futures & Options	1.4	N/A	N/A	0.0	1.4	N/A
	100.0	**100.0**		**100.0**		

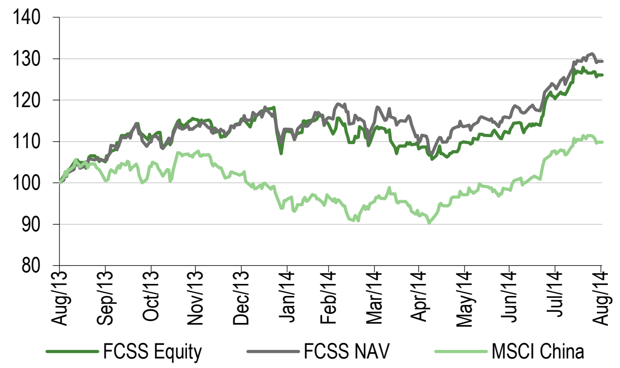
Source: Fidelity China Special Situations, Edison Investment Research

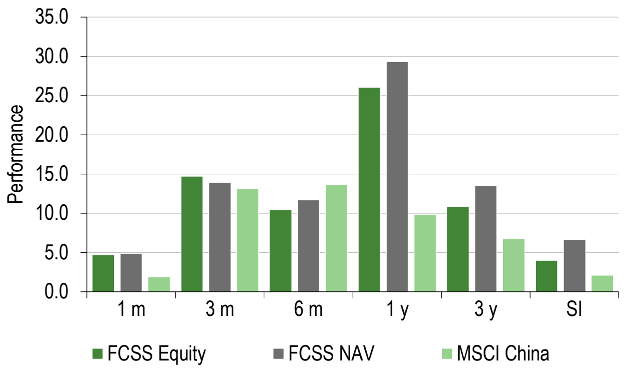
Performance: Outperformance since launch

FCSS has outperformed its MSCI China Index benchmark in terms of price and NAV total return over one and three years and since inception. While outperforming over one year, FCSS has underperformed the MSCI World and FTSE All-Share indices since inception, which reflects the more volatile performance of the Chinese market compared with developed markets. Over three years, FCSS's performance has been similar to the FTSE All-Share Index, although below the MSCI World Index. Exhibit 13 illustrates the trust's relative underperformance during 2011 and 2012, followed by strong relative outperformance from December 2012 to March 2014.

Exhibit 11: Investment trust performance

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





Source: Thomson Datastream, Edison Investment Research. Note: *Three-year and since inception (SI) figures annualised. Inception date is 19 April 2010. Data to end August 2014.

Exhibit 12: Share price and NAV total return performance, relative to indices

	One month	Three months	Six months	One year	Three years	Since inception
Price relative to MSCI China Index	2.8	1.4	(2.8)	14.8	12.0	8.4
NAV relative to MSCI China Index	3.0	0.7	(1.7)	17.8	20.3	21.1
Price relative to MSCI World Index	0.8	10.8	3.3	11.2	(11.3)	(20.6)
NAV relative to MSCI World Index	0.9	10.0	4.5	14.1	(4.6)	(11.3)
Price relative to FTSE All-Share Index	2.5	14.1	8.9	14.3	(5.7)	(17.4)
NAV relative to FTSE All-Share Index	2.7	13.3	10.1	17.2	1.3	(7.7)

Source: Thomson Datastream, Edison Investment Research. Note: Data to end August 2014. Geometric calculation.

Exhibit 13: NAV performance relative to MSCI China Index since launch

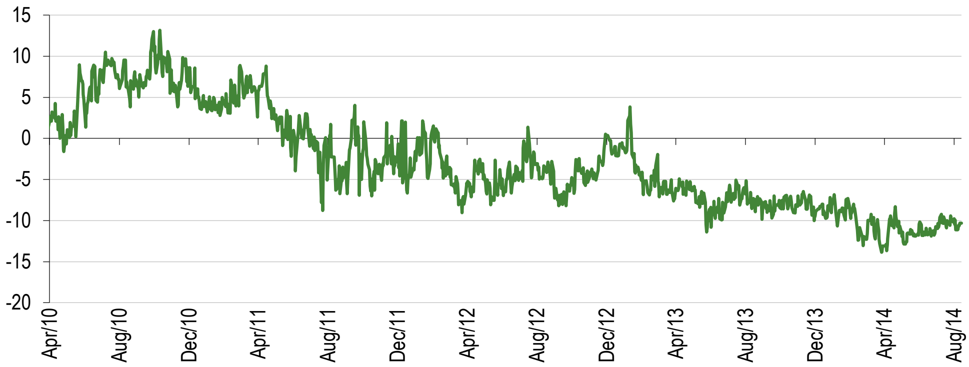
Source: Thomson Datastream, Edison Investment Research

Discount: Has widened to about 10%

As illustrated in Exhibit 14, FCSS's share price moved to a premium to NAV following launch. However, from November 2010, the premium started to narrow and the shares moved to a discount in June 2011. Subsequently there has been a slow but steady widening of the discount to the current level of c 10%. Arguably, the widening discount was driven by FCSS's relative underperformance during 2011 and 2012 and subsequently negative market sentiment towards China has outweighed the fund's improved performance.

The board believes that it is in the best interests of shareholders if the share price tracks closely to the underlying NAV and has the ability to issue shares at a premium to NAV and to buy back shares at a discount to NAV when it is considered to be in the best interests of shareholders. During the year to 31 March 2014, 81.9m shares were repurchased at a discount and cancelled.

Exhibit 14: 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 571.4m ordinary shares in issue. The trust has authority to repurchase up to 14.99% of its issued share capital and, during the year to 31 March 2014, 81.9m shares representing 12.5% of the shares in issue were repurchased for cancellation. No shares have been repurchased since 31 March 2014. FCSS has authority to hold up to 10% of the issued share capital in treasury to be re-issued at or at a premium to NAV so that the net effect of repurchasing and re-issuing the shares would be to enhance NAV per share.

For the year to 31 March 2014, the annual management fee was 1.2% of NAV (reduced from 1.5% on 1 April 2013) and with effect from 1 April 2014, this has been further reduced to 1.0% of NAV. In addition, the investment managers are entitled to an annual performance fee of 15% of any change in NAV attributable to performance, which is more than 2% above the returns on the MSCI China Index, subject to a cap of 1.0% (reduced from 1.5% with effect from 1 April 2014) of the average NAV during the year. Any outperformance above this cap will no longer be carried forward and underperformance must be made good before any further performance fee becomes payable. For the year ended 31 March 2014, management fees totalled £7.7m, performance fees of £6.4m were awarded and ongoing charges were 1.45% of average NAV.

Dividend policy

FCSS's objective is 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. Dividends are paid annually and FCSS has increased the dividend each year since launch. As a result of recent changes in tax and company law, investment companies are no longer prohibited from paying dividends out of capital profits. While the board has no current intention to pay dividends out of capital profits, at the 2014 AGM, FCSS revised its Articles of Association to provide this flexibility should circumstances warrant it in the future.

Peer group comparison

Exhibit 15 illustrates a peer group comparison across closed-ended and open-ended funds focused on investing in China and Greater China equities. Although FCSS is a member of the AIC country specialists Asia-Pacific sector, only one other constituent, JPMorgan Chinese, is focused on China, reducing the relevance of performance comparisons against this sector. Instead, we include the AIC Asia-Pacific ex-Japan sector average data as a closed-ended comparison. For the open-ended peer group, we have selected funds over £250m in size from the IMA China/Greater China sector. FCSS's NAV total return performance leads both closed-ended and open-ended peers over one year by a considerable margin and is the top performer over three years. FCSS's Sharpe ratio of 2.1 over one year points to attractive risk-adjusted returns, while the Sharpe ratio below one over three years is similar to closed-ended peers. The lower management fee from 1 April 2014 should reduce FCSS's ongoing charge to c 1.25%, which is similar to closed-ended peers and compares favourably with the 1.89% open-ended peer group average total expense ratio (TER).

Exhibit 15: Funds investing in Chinese equities: Total returns, Sharpe ratios, discounts and charges

	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	655.3	29.0	53.7			2.1	0.5	(10.1)	1.43	123	1.0
JPMorgan Chinese	129.2	14.3	34.8	61.9	265.4	0.9	0.3	(10.5)	1.31	107	1.0
Asia-Pac. ex-Japan weighted average		13.3	40.5	97.8	308.0	0.2	0.5	(5.3)	1.14	102	2.1
Mutual Funds											
Aberdeen Global Chinese Equity	1,478.8	3.4							1.97		
Allianz China Equity	333.6	8.9	16.3	25.5					2.30		
Fidelity China Focus	1,851.7	8.9	11.9	27.6					1.92		
First State Greater China Growth	591.6	10.7	35.1	86.8	408.0				1.83		
GAM Star China Equity	1,445.0	11.1							1.55		
Henderson China Opportunities	424.5	12.5	15.1	44.5	260.4				1.77		
HSBC GIF Chinese Equity	1,081.9	5.9	11.2	18.8					1.90		
Invesco Perpetual Hong Kong & China	308.4	13.4	43.0	67.0	282.4				1.69		
Schroder ISF Greater China	548.8	10.2	17.4	39.6					1.93		
Templeton China	580.2	4.9	(3.5)	20.7					2.45		
Weighted average		**8.2**	**15.3**	**35.8**	**331.4**				**1.89**		

Source: Morningstar, FE Trustnet, Thomson Datastream as at 29 August 2014. Notes: 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/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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