



# Fidelity China Special Situations



FCSS is a highly differentiated way to access the growth potential in China...

Update  
06 July 2022

## Overview

Fidelity China Special Situations (FCSS) offers a highly differentiated way to invest in the growth potential in China via an active strategy which gives the manager the freedom to generate alpha in multiple ways.

FCSS has been managed by Dale Nicholls since 2014, and he runs a portfolio which is heavily tilted towards small- and mid-caps and has substantial unlisted equity exposure, currently in the mid-teens. Dale also uses derivatives to take long or short positions in companies as well as to effectively gear up the portfolio. In fact, **Gearing** is a feature of the trust, adding to the growth potential: it has averaged 20% since Dale took over.

Thematically, the largest feature of the portfolio is the exposure to the growing wealth and changing purchasing choices of the Chinese consumer. While he is happy to own the well-known large-caps when he sees value in them, the portfolio is packed with lesser-known companies which are strong in their niche and/or which are at an earlier stage of their growth trajectory. As such, these tend to be in the small-cap part of the investible universe. Growth is the aim and earnings growth is a key characteristic which Dale looks for. But he is also sensitive to valuations, as we discuss under **Portfolio**.

Dale has the advantage of working with Fidelity’s large, locally based analyst teams, with analysts working in onshore China, as well as elsewhere in the Asia Pacific region. Their coverage of Chinese companies, and their peers elsewhere, gives Dale a 360-degree view of many companies’ operations, and the deep human resources allows for substantial investment in the unlisted sphere.

FCSS’s shares trade at a wide **Discount** of 10.9% at the time of writing compared to a five-year average of 7.3%. Chinese markets have been weak overall since the end of the pandemic, but Dale sees as many exciting growth stories as before.

## Kepler View

We think FCSS looks like an excellent way for long-term investors to access the growth potential in China. The gearing, small and mid-cap tilt and active approach all bring risks, but they all add extra growth potential, which could reap dividends in the long run. Interestingly, large-caps have outperformed SMIDs in recent years in China. This is in contrast to the long-term tendency for smaller companies to deliver greater earnings growth. Dale does own large-caps, where he sees the best long-term earnings growth potential, but nonetheless a return to the historical norm would help FCSS in relative terms. We think this shift in market dynamics may be brought about by structurally higher interest rates and a retreat from globalisation.

At the time of writing, FCSS trades at a double-digit discount. We think this represents an opportunity. Historically, the trust has seen its discount narrow when Chinese equities are in favour and we see the potential for the same to happen again. That said, we cannot predict when, and it may not be in the short term. Nonetheless, the discount provides extra return potential in any rally and is defended by the board with buybacks.

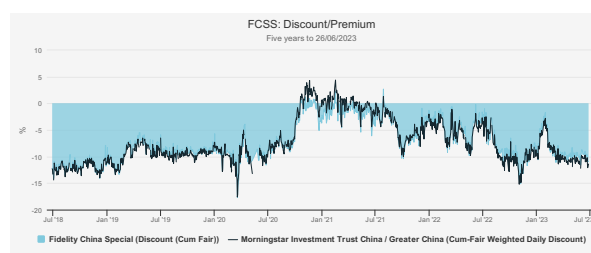
### Analysts:

**Thomas McMahon**  
+44 (0)203 795 0070



### Key Information:

Price (p)	203
Discount/Premium (%)	-10.9
OCF (%)	0.98
Gearing (%)	27
Yield (%)	3.1
Ticker	FCSS
Market cap (£)	978,390,708



### BULL

- Manager has full toolkit for adding alpha
- Offers differentiated exposure to Chinese small and mid-caps via the work of a broad local analyst team
- Current wide discount could provide good entry point

### BEAR

- Gearing brings sensitivity to falling markets, as well as rising markets
- Political risk is high in China
- Although charges are higher relative to peers when the trust outperforms, shareholders pay less when the trust underperforms, as a result of the performance-related component. This aligns the interests of manager and shareholders.

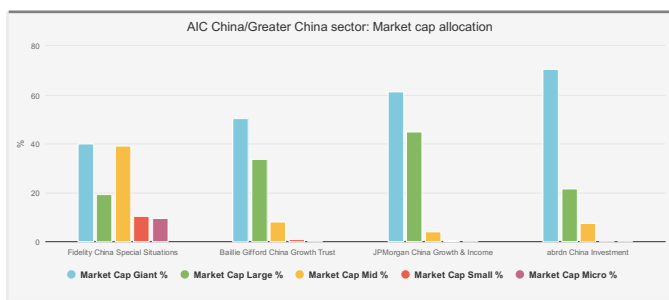


## Portfolio

Fidelity China Special Situations (FCSS) is designed to capture the huge growth potential in the growing wealth and rising standards of living in China. The portfolio is managed by Dale Nicholls, who aims to identify well-run companies with superior growth prospects over the next five to ten years. One of the main themes in the portfolio has historically been and continues to be the Chinese consumer and the growing demand from this sector for more sophisticated goods and services.

One of the key differentiating factors of the portfolio is the focus on the small and mid-cap market. This brings with it greater growth potential and generally greater sensitivity to the domestic economy. It also brings with it greater potential to add alpha against a large-cap Chinese exposure, active or passive, by dipping into areas of the market which are less well-covered by research and less widely held by overseas' investors. Fidelity's large team of analysts, based in Hong Kong and the mainland city of Shanghai, are an advantage in this respect. The table below shows how FCSS's market-cap exposure stands out versus the rest of the peer group.

Fig.1: Size Exposure



Source: Morningstar

We would characterise FCSS as being unashamedly focussed on maximising capital growth. As well as the small and mid-cap exposure, this is supported by the use of **Gearing**, the focus on earnings growth and by the allocation to unlisted investments. These are in companies which are generating earnings, or for which Dale can see a clear path to earnings. Furthermore, they may open up an even broader range of growth opportunities. Fidelity's locally based analysts are essential for Dale to be able to undertake proper research into these opportunities. Unlisted companies make up 14% of the portfolio, so they can collectively make an impact, and Fidelity has invested in their capabilities here by hiring an analyst directly from Tencent (an incubator of many early stage companies) to aid in their research in this space.

All this said, valuations are important in the investment process, with Dale paying keen attention to the price he is asked to pay for earnings growth. Valuations drive many purchases and sales, and contribute to annual turnover

which tends to range between 30% and 60%. The average turnover over the past five years is 52%, according to Morningstar. Turnover tends to pick up when volatility is high, and the five-year average increased due to high turnover in the extremely volatile markets of 2021 and 2022. Additionally, Dale's active approach to gearing brings turnover up mechanically, as he has to buy or sell stocks (or CFDs, see **Gearing**) to adjust the net exposure of the portfolio. The style box below shows that the valuation element in the portfolio has led to a significantly higher allocation to what Morningstar classifies as Value stocks than the peer group.

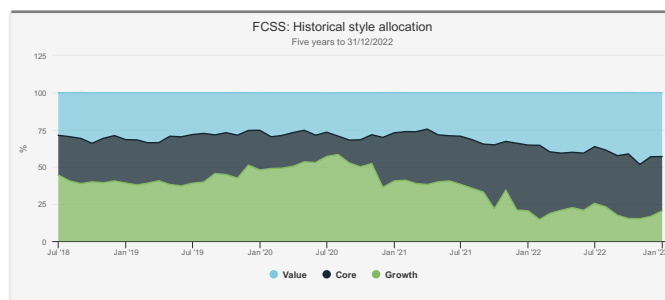
## Style Allocation

	EQUITY STYLE VALUE % (NET)	EQUITY STYLE GROWTH % (NET)	EQUITY STYLE CORE % (NET)
Fidelity China Special Situations	46.00	21.92	38.96
Baillie Gifford China Growth	15.65	40.62	35.90
JPMorgan China Growth & Income	4.26	59.21	40.76
abrdn China Investment Company	12.47	45.34	40.03

Source: Morningstar

The chart below shows how the style allocation has varied over time, with the current allocation to value being above the historical norm. Given how Morningstar defines stocks in these buckets by using various valuation metrics, some of the development is likely due to companies being reclassified as they sell off. However, it also reflects a reduction in the overweights to the consumer sectors and the additions to the holdings in the industrials and financial services sectors, as Dale reacts to valuations and the changing outlook for earnings growth.

Fig.2: Historical Style Breakdown



Source: Morningstar



The consumer theme remains central to the portfolio. Dale believes that the rise of the Chinese consumer has not only driven the success of many of his past holdings, but creates huge potential for growth in various sectors. For example, he increasingly sees the financial services sector as an opportunity. While growth of goods and services is muted and the real estate sector is not driving growth as it has in the recent past, Dale sees the development of China's capital markets as a way for the authorities to generate growth. He sees opportunities in wealth management companies such as Noah, which has ambitions to be the 'UBS of China', and China Renaissance.

However, he continues to find opportunities in the traditional consumer sectors. For example, JNBY Design is a fast-fashion company Dale compares to Zara which he took a position in when it was trading at just 10x earnings. Lao Feng Xiang is a company he views as a long-term winner in the jewellery industry, with earnings growth in the high single-digits and a strong brand. Dale also has large positions in the large-cap platform-style businesses Tencent and Alibaba. While there has been negativity and concerns about political interference in recent years, Dale believes they still have important roles to play in the online and consumer ecosystems, and after such a significant sell-off Alibaba was looking exceptionally cheap. Currently, the largest overweights are in Pony.ai, the unlisted self-driving vehicle company, and Hisense Home Appliances, another off-benchmark stock. FCSS has 3.8% and 3% positions in these stocks, respectively, as at the end of April.

Another differentiating factor of FCSS's portfolio is Dale's ability to short companies. Fidelity has dedicated shorting analysts who are tasked with finding opportunities and assessing the risks and rewards. Dale notes this is a risky business in China, where retail investors can fall in love with blue-sky stocks, meaning that those with weak fundamentals can sometimes sharply outperform regardless. Nonetheless, there was around 4.1% of net exposure in short positions at the end of April. These are taken through contracts for difference (CFDs), as discussed in the **Gearing section**. Short positions will rarely make up more than 100bps of net exposure. They are considered, along with other risk factors, in a quarterly meeting with the CIO, in which Dale has to explain the risks in his portfolio and the justification for taking them. Currently, he finds some opportunities in the competitive automotive sector, although the names of current shorts are never released.

Rather than shorting, option number one is not to take exposure to weak companies. Generally, Dale avoids state-owned enterprises (SOEs). These tend to be larger companies in sectors that generally have lower growth projections. This has worked against the portfolio in the past couple of years, as SOEs have outperformed, but Dale

remains wary of the governance risks of many SOEs and believes these companies tend to display poorer earnings growth over the long term. In keeping with his flexible approach, he took exposure to Sinotrans, the freight company, when it was looking very cheap, and sold it after a significant rally.

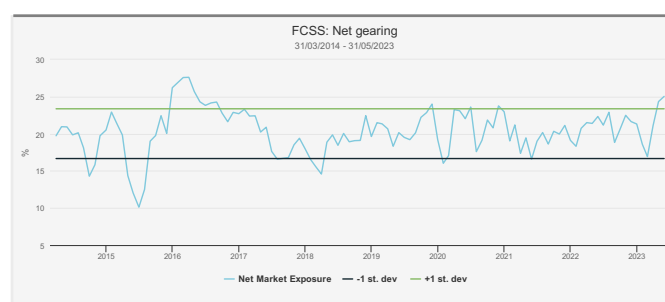
Chinese macro is a puzzle. After the end of its zero-Covid policy, its economic recovery has been weak. Dale puts this down to the consumer being slow to spend. Government support schemes were less generous in China than in Europe, so there is a lesser stock of savings. Meanwhile, consumer psychology seems different, with greater cautiousness. However, even if Chinese GDP growth is lower than in the past, there is still huge potential for markets to do well. By fishing in the small and mid-cap space and by looking to add alpha through stock selection, Dale has the tools to generate significant returns, even if market-level growth is muted. Meanwhile, the **Gearing** offers extra return potential, should markets rise.

## Gearing

Due to its confidence in the long-term growth potential in the Chinese market, the board is content for Dale to maintain a geared position. This brings greater return potential but also magnifies losses when the market falls. FCSS has \$100m of fixed debt which matures in February 2024 and on which it pays 6.335%. Agreed in February 2023, this facility replaces one of the same size which had been taken out for three years at a rate of 2.6%. As the term of the debt is fairly short, the board will have an opportunity to refinance relatively soon, which may prove advantageous if rates fall in the meantime. This facility amounts to c. 8.6% of net assets at the time of writing. In addition, Dale can gear using contracts for difference (CFDs), as well as using options and futures, all of which allow for a geared position to be taken up. For the most part, Dale uses CFDs.

The board allows the manager to determine the gearing level, with an agreed limit of 30% of net assets. As the below chart shows, the actual level has averaged 20.3% since Dale took over management, with Dale tending

Fig.3: Net Gearing



Source: Fidelity

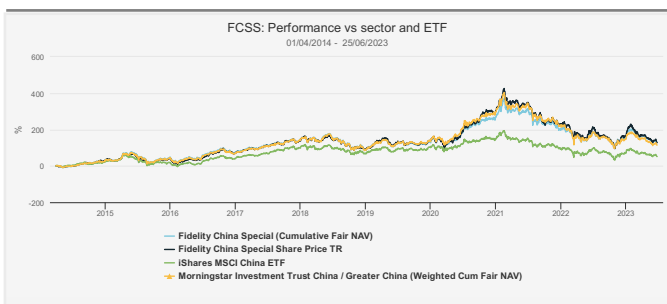


to raise the market exposure when valuations are more attractive and vice-versa. As of the end of May, net gearing was 25.0%.

## Performance

An investment in FCSS has beaten the MSCI China Index benchmark and the weighted average return in the Morningstar China/Greater China sector since Dale took over the portfolio on 01/04/2014. As the chart below shows, the trust has delivered NAV total returns of 130.6% compared to 114.8% for the sector and just 51.7% for the iShares ETF investing in the index. This index itself is up 61.5%.

**Fig.4: Performance During Current Manager’s Tenure**



Source: Morningstar

**Past performance is not a reliable indicator of future results.**

The best relative performance versus the sector came at the very beginning of this period, in 2014 and 2015. In 2016, large-caps began five straight calendar years of outperformance, which only ended in 2021 when the winners over this period sold off the most in a general market collapse. This worked against FCSS, compared to the peer group. While FCSS has outperformed the sector in 2022 and 2023 year to date, this has been in a falling market and the small and mid-cap focus has again worked against it. Market theory would tell us that small and mid-caps have greater growth prospects, which should translate into greater share price growth. This has not been the case in recent years in China or in the US. To some extent, this is bound up with the expansion of a certain number of large tech platforms in ecommerce, social media and gaming, but not entirely; low rates and a period of low barriers to global trade are factors too. If this period proves to be an aberration, rather than a new normal, then the small and mid-cap focus within FCSS could offer better growth prospects than its peers. We note, though, that FCSS has a significant position in Tencent and Alibaba. As such, it is the general preference for large over small which stands to work against it, while the portfolio has exposure to large-cap tech. We think FCSS’s prospects look better in the coming years than they have been, relative to the index, thanks to the greater focus on the domestic economy. One trend which is entrenched in global markets

is friend-shoring and the accompanying scepticism about free trade. We think this favours more domestically-focussed equities and growth trends, such as those that the manager of FCSS focusses on.

The five-year performance chart below highlights what a wild ride the past five years have been for Chinese equities, with a bust as dramatic as the boom. Over this period, FCSS has delivered a NAV total return of -9.8%, while the sector is down 15.3% and the iShares MSCI China ETF fell 23.6%. Given that the trust has had considerable gearing throughout this period and markets have fallen overall, we think this is a reasonable result. The optimism bias of keeping the gearing on should bring benefits when the market sees its next sustained rally.

**Fig.5: Five-Year Performance**

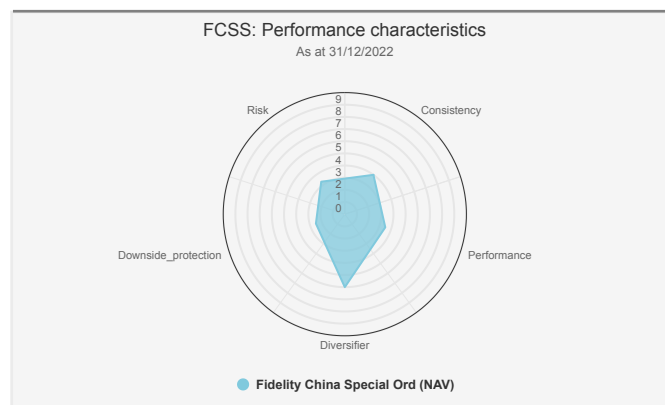


Source: Morningstar

**Past performance is not a reliable indicator of future results.**

Our KTI Spider Chart is displayed below. This is intended to compare trusts using various key performance metrics versus an expanded peer group, in this case of all emerging market trusts. The intention is to build a map of relative performance characteristics, rather than just reward performance, which would be unfair given the varying investment remits within the universe. FCSS’s scores reflect the fact that China has performed poorly overall, with high volatility and some severe market crashes.

**Fig.6: KTI Spider Chart**



Source: Morningstar, Kepler calculations

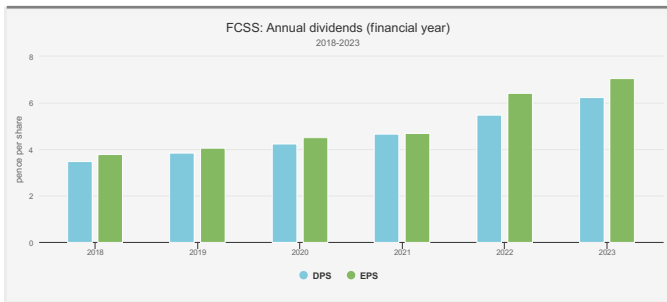
**Past performance is not a reliable indicator of future results.**



## Dividend

FCSS is primarily a vehicle for capital growth, and the small and mid-cap bias and gearing both play into this. However, companies with earnings growth obviously have resources from which to pay dividends. As time has gone on, FCSS’s revenues per share have seen healthy growth, this being passed on in the form of a rising dividend. FCSS pays one dividend per year and the 2023 payout of 6.25p translates to a prospective yield of 3.1%, at the time of writing. The board notes that dividends have become increasingly attractive to investors in the recent low-rate environment, although this environment has changed suddenly over the past year. As a result, we do not think FCSS will appeal to many income-seeking investors while cash accounts offer 3% to 4%, but the compounding growth of the dividend stream is promising for long-term total-return investors.

Fig.7: Annual Dividends



Source: FCSS

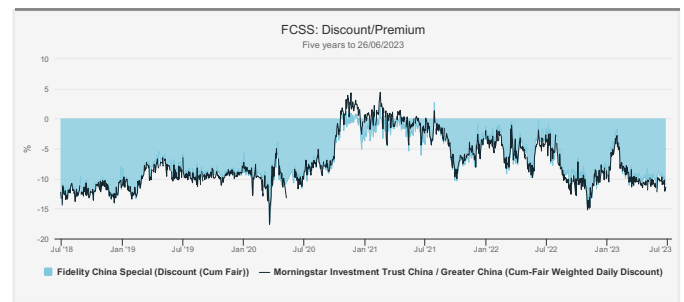
## Management

FCSS has been managed by Dale Nicholls since 01/04/2014. Dale took over from Anthony Bolton, the trust’s first portfolio manager, and worked with him for some months before taking over full management responsibilities. Dale has 29 years of investment experience and also manages the open-ended Fidelity Pacific Fund. This gives him a regional perspective on the markets, which should be helpful in building a picture of the competitive position of companies in China. Dale spends much of his time speaking to management teams and competitors of companies in which he invests, or may choose to invest, engaging with hundreds of companies each year. He began his career with Fidelity in 1996, working in the Japanese equity analyst team and covering various sectors. Dale was promoted to portfolio manager for the FF Pacific Fund in 2003 and portfolio manager for the FF Asian Smaller Companies Fund in 2011. He is based in Singapore and draws on the work of 26 dedicated Greater China analysts based in Shanghai and Hong Kong, as well as their regional colleagues and one dedicated China small-cap analyst.

## Discount

FCSS trades at a discount of 10.9%, at the time of writing, compared to a five-year average discount of 7.3%. Its large relative size, with a market capitalisation of c. £1bn versus a total of around £0.55bn for the three other China trusts combined, means that its discount drives the weighted average discount of the sector. This explains the high correlation between the trust and sector discounts shown below. Notably, the trust’s discount narrowed towards the turn of the year, as China reopened after abandoning its zero-Covid policy. However, as that recovery has faltered, the discount has widened once again. It seems to us that sentiment towards the Chinese market drives the discount for the most part and this seems likely to continue to be the case, particularly given the tendency to run gearing and the focus on higher-risk small and mid-caps. We think this means the current share price discount offers extra return potential for long-term investors, particularly given the buyback policy discussed below. That said, if sentiment remains poor towards China, there is the potential for a wide discount to linger.

Fig.8: Discount



Source: Morningstar

The board aims to maintain the discount in single digits in normal market conditions and uses buybacks to do so. Buybacks have continued in recent months, as the discount has been in double digits.

## Charges

FCSS’s management fee has a performance-related component designed to align the interests of shareholders and managers, i.e. an effective performance fee. From July 2023, following a fee cut for the first tier of net assets, the manager receives 0.85% on the first £1.5bn and 0.7% on amounts above this. However, both numbers are variable by 0.2 percentage points depending on performance, with a maximum fee on the first tier of 1.05% and a minimum of 0.65%. The variable element of the fee increases or decreases 0.033% for each percentage point of the three-year NAV per ordinary share outperformance or underperformance of the MSCI China Index, and is calculated daily.



The latest ongoing charges figure (OCF) is 0.98%, calculated at the end of the last financial year on 31/03/2023. Due to the trust strongly outperforming its index, the full variable component was earned, resulting in an OCF plus variable management fee of 1.18%. We note that the fee paid by shareholders will fall when the trust underperforms and the performance-related component allows for the management fee to rise for outperformance in a falling market.

The latest KID RIY is 1.83%, compared to an average of 1.98% for the sector, according to JPM Cazenove, although we note that calculation methodologies may vary.

## ESG

ESG considerations are embedded in the investment process, primarily through the implementation of the Fidelity Proprietary Sustainability Rating. This is a forward-looking and holistic assessment of a company's ESG risks and opportunities, based on specific indicators appropriate for companies, depending on the sub-sector they are located in. Additionally, analysts produce a Climate Rating, which captures their assessment of which companies are in the best position to transition to net zero, or which have a positive trajectory towards transition. The responsibility falls first on the analysts working on the business fundamentals, but they are supported by a Sustainable Investing Team responsible for consolidating the approach to ESG firm-wide and who assist with ongoing engagement. Managers can also consider external ratings before internal ratings are available, but the internal ratings are ultimately relied upon. Dale is not prohibited from investing in companies which score poorly, but he does have to justify the ESG ratings and carbon footprint of the portfolio in the quarterly fund reviews with Fidelity's CIO, alongside investment risks, such as beta, tracking error and any concentrated positions.

FCSS scores above average on Morningstar's Sustainability Rating. However, as only 71% of the portfolio is covered by their ratings, we would not place too much weight on this. Additionally, we note that MSCI does not cover a high proportion of the trust's holdings; almost 40%, as at 30/04/2023. By operating largely in the small and mid-cap space, Dale has the opportunity to promote ESG considerations amongst companies which may not have given them as much consideration, thus arguably having greater impact.



## Disclaimer

---

This report has been issued by Kepler Partners LLP for communication only to eligible counterparties and professional clients as defined by the Financial Conduct Authority. Its contents may not be suitable for and are not to be communicated to or be relied on by retail clients. It is not an indication as to the suitability or appropriateness of investing in the security or securities discussed.

**The analyst who has prepared this report is aware that Kepler Partners LLP has a relationship with the company covered in this report and/or a conflict of interest which may impair the objectivity of the research.**

**Past performance is not a reliable indicator of future results. The value of investments can fall as well as rise and you may get back less than you invested when you decide to sell your investments. It is strongly recommended that if you are a private investor independent financial advice should be taken before making any investment or financial decision.**

This report is based on factual information only, is solely for information purposes only and any views contained in it must not be construed as investment or tax advice or a recommendation to buy, sell or take any action in relation to any investment.

The information provided on this website is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject Kepler Partners LLP to any registration requirement within such jurisdiction or country. In particular, this website is exclusively for non-US Persons. Persons who access this information are required to inform themselves and to comply with any such restrictions.

The information contained in this website is not intended to constitute, and should not be construed as, investment advice. No representation or warranty, express or implied, is given by any person as to the accuracy or completeness of the information and no responsibility or liability is accepted for the accuracy or sufficiency of any of the information, for any errors, omissions or misstatements, negligent or otherwise. Any views and opinions, whilst given in good faith, are subject to change without notice.

This is not an official confirmation of terms and is not a recommendation, offer or solicitation to buy or sell or take any action in relation to any investment mentioned herein. Any prices or quotations contained herein are indicative only.

Kepler Partners LLP (including its partners, employees and representatives) or a connected person may have positions in or options on the securities detailed in this report, and may buy, sell or offer to purchase or sell such securities from time to time, but will at all times be subject to restrictions imposed by the firm's internal rules. A copy of the firm's Conflict of Interest policy is available on request.

PLEASE SEE ALSO OUR TERMS AND CONDITIONS

Kepler Partners LLP is authorised and regulated by the Financial Conduct Authority (FRN 480590), registered in England and Wales at 70 Conduit Street, London W1S 2GF with registered number OC334771.

