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Fidelity China Special Situations

FCSS has outperformed in a challenging year...

Update
23 May 2024

Overview

Fidelity China Special Situations (FCSS) offers investors direct exposure to the Chinese growth story from a diverse range of sources. Manager Dale Nicholls has a bias to small- and mid-cap companies as he views them as the best way to capture the growth opportunities from the increasing wealth of the Chinese consumer and to generate excess returns. The trust also has structural **Gearing** in place to support the upside potential. Furthermore, the manager can invest in private companies, with a current weighting in the mid-teens, to create further differentiation from the benchmark and broaden the growth opportunities.

Whilst the manager is focussed primarily on capital growth, FCSS has increased its **Dividend** in every year since inception with the most recent annual dividend offering a historic yield of 3%. The trust was awarded **Kepler's Income & Growth** rating for 2024.

Dale has delivered significant outperformance of the benchmark over the long term. Relative performance in the short term has also been strong, albeit against the backdrop of challenging conditions for broader Chinese markets. This has contributed to the shares trading at a wide **Discount** to NAV of c. 9%, wider than the five-year average. The board has been active with share buybacks as part of their discount control approach.

The trust has recently combined with abrdn China, having completed in March 2024. This has led to a growth in the asset base and is expected to contribute towards lower **Charges** going forward.

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Analyst's View

We believe FCSS is a good example of a manager maximising the capabilities of the investment trust structure (see **Portfolio**). By investing in a well-diversified portfolio with a bias to small and mid-sized businesses, unlisted companies and by running structural **Gearing**, manager Dale Nicholls offers investors something totally different to what they could get from an index tracker, and can capitalise on the plethora of opportunities that the Chinese growth story still offers due to his strong active management approach. As such, we believe FCSS could make for an attractive holding as part of a core global equity portfolio that can deliver very strong alpha over the long term, albeit with some periods of volatility.

We believe the opportunity right now is particularly compelling. China has been through a very challenging period, though the headwinds are arguably easing, and valuations remain very attractive. Recently published GDP figures came in above expectations which could indicate the economy is beginning to turn around. Furthermore, the trust is trading at a wide **Discount** which could make for an attractive entry point, especially when the board has an effective discount control mechanism to keep the level within single figures.

FCSS also has an impressive **Dividend** track record which we believe can complement total returns. Despite not being a focus for Dale, the dividend has been raised every year since the trust's inception, is fully covered by revenues and there are enough revenue reserves to cover the dividend for nearly two years. As such, we believe the dividend is likely to continue to be a feature going forward, with the current share price weakness making the current c. 3% historic yield an attractive entry point.

BULL
Strong relative performance over a number of time-periods
Portfolio offers a range of features that differentiate it from peers and the index
Trust pays an attractive dividend with growth potential that can complement total returns

BEAR
Use of structural gearing can amplify downside as well as supporting upside
Small- and mid-cap bias can often struggle in weak economic conditions
Ability to sell private holdings is hindered by weak markets limiting potential for IPOs

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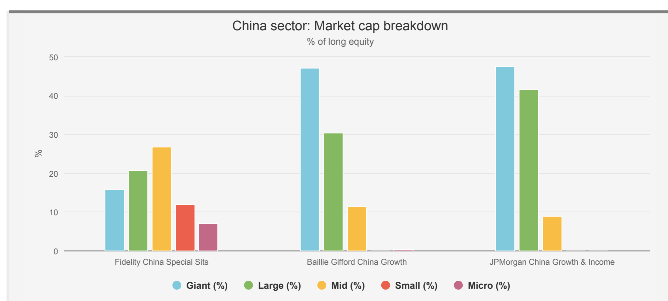
Portfolio

Dale Nicholls recently passed his ten-year anniversary in managing Fidelity China Special Situations (FCSS). His goal is to build a portfolio that offers direct exposure to the Chinese growth story from a diverse range of sources. He can invest across the market-cap spectrum, from established large caps such as Alibaba, to a notable allocation to small and medium-sized (SMID) companies. Companies can be listed on various markets, though are primarily centred around the Chinese and Hong Kong exchanges. Furthermore, Dale can invest in private companies. All of these avenues allow Dale to capture the growing wealth of the Chinese consumer and subsequent spending.

FCSS is the largest trust in the AIC China/Greater China sector, with assets of over £1.1bn. In November 2023, the board proposed a combination with abrdn China (ACIC). This was subsequently approved and cSompleted on 14/03/2024 leading to FCSS acquiring £126.6m of ACIC's assets which have now been incorporated into FCSS.

Regardless of the corporate activity, Dale's investment approach remains the same. He continues to focus on the SMID-cap space as this allows him to differentiate the portfolio versus both his benchmark, the MSCI China Index, and peers as we have shown in the table below. Furthermore, this approach allows him to access a wider range of growth opportunities and therefore the ability to deliver significant outperformance over the long term. Dale has the wide resources of the Fidelity analyst team, who provide analytical support and input to help identify the best opportunities from the very large Chinese market, although Dale will still make the final decision as to which stocks to allocate to.

Fig.1: Small Cap Allocations



Source: Morningstar, as at 11/04/2024

Another standout feature of FCSS is the ability to invest in unlisted companies. This allows Dale to invest in companies at earlier stages of their growth journey and brings the potential for alpha generation over the index. The current allocation (as at 17/05/2024) is 12.9% which is near the maximum weighting meaning that before any new additions are made, existing holdings will need to be sold, typically through listing. However, Dale believes this is unlikely in the near term due to the weak market environment and therefore these firms are likely to continue to enjoy the benefits that come with remaining privately owned. As a result, there is unlikely to be any notable change in this area in the short term.

Dale's approach uses bottom-up stock selection which drives portfolio allocations. He also has a strong focus on valuations, which has led to the trust having a value bias at present, something we discussed in **our previous note**. This has grown in the past couple of years as valuations have fallen, especially in companies focussed on the domestic consumer, which Dale has been tilting the portfolio to in the past few months. However, Dale's focus on maximising capital growth means this style bias can change over time.

This activity centres around the so called 'domestic champions'. These are Chinese companies focussed on their home market, with the potential to benefit from a recovery in consumer spending. This has been depressed as consumer confidence took a hit following weakness in the property sector, which is often a source of savings for Chinese citizens. However, Dale believes confidence is returning, with some policy support towards the housing sector leading to some early signs of improvement, thus increasing the potential for consumers to start spending. Furthermore, many of the companies in this space are beginning to expand their businesses overseas which offers diversification and could lead to further growth.

One example of this is home appliance firm Hisense. The company has focussed on creating a strong brand, including working with well-respected industry names like Hitachi, and has been producing strong earnings growth domestically, for example through the likes of increased demand for air conditioning units. Furthermore, Hisense has developed its product mix, including a focus on TVs, and has been increasing its overseas profitability. As such, Dale believes the firm could not only be a beneficiary of a turnaround in domestic spending but also from continued overseas expansion.

However, he remains conscious of the macro issues affecting Chinese companies operating overseas. There are many firms he likes from a bottom-up perspective, but their operations could be undermined by geopolitical concern towards China, and negative sentiment could lead to share price weakness. As such, Dale has been balancing the increasing demand potential and macro sensitivities, leading to him trimming some holdings which he believes could be exposed to US restrictions.

Elsewhere in the consumer spending space, Dale is positioning the portfolio around the bifurcation of the Chinese consumer. He highlights that firms at either end of the spectrum, either low cost value-for-money companies, or the luxury, top end firms are doing well, but at the expense of mid-market firms. He points to MINISO, a Chinese 'Poundland' equivalent as one example of the low end doing well, though he has taken some profits from his holding in the past year.

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On the high end, he has taken exposure to jewellery companies such as Luk Fook. This is a high-quality name with a management team who have executed their strategy well. Over the long term, Dale expects the firm to benefit from the increasing wealth of the Chinese consumer, though more short term, it is seeing improved trading as consumers look to buy gold as a potential store of value following weakness in the property sector. These holdings have contributed to the consumer discretionary sector being the largest allocation in the portfolio.

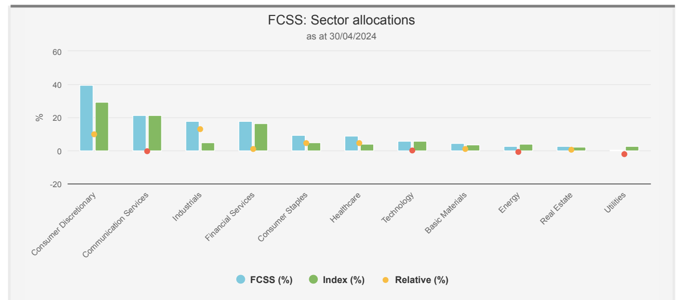
The largest overweight allocation though is to the industrials sector. One contributor to this has been a new holding in freight company Sinotrans. It is one of the largest active holdings in the portfolio and the third largest transporter in volume globally. The company had been under pressure with the economic slowdown but Dale believes it is arguably through its hardest period and has recently benefitted from a pick-up in demand which should feed through to an increase in profits. The company is a partly state-owned enterprise (SOE), though Dale and the team have engaged with the management team to improve their operations, including better treatment of minority shareholders, to foster the culture of a public company.

The portfolio is underweight SOEs, though the manager notes there are signs of their conduct improving. Dale notes that there are signs Chinese SOEs are beginning to look to Japanese corporate governance reforms for guidance, as this has recently been the subject of significant focus in Japan and has led to positive investor outcomes, such as an increase in dividends. This hasn't been widely acknowledged by other investors, but is something Dale is aware of due to his closeness to the region and is a good example of the team's in-depth knowledge, in our opinion.

The innovation theme in the portfolio is also contributing to the industrials overweight. This includes holdings focussed on robotics and automation. It has been an area of significant R&D spending for the country, enabling firms to catch up to industry leading firms from the likes of Germany and Japan within a decade. However, whilst Dale believes Chinese firms have superior offerings in many cases, they are now trading at a discount to their global peers due to negative sentiment to China. Conversely, Dale currently holds short positions in some electric vehicle firms, as well as firms focussed on AI due to the high level of momentum and run up in valuations. We discussed Dale's shorting capabilities in **our previous note**.

Dale has sold down most of his bank stocks in the past year. Generally, banks fail to meet the growth profile Dale is after and are often too linked to the government. Broader financials though, remain a notable weight in the portfolio and a small overweight relative to the benchmark. As a result of the significant **Gearing** level of the trust, only a few sectors have notable underweight allocations as the manager has identified few growth opportunities at attractive valuations.

Fig.2: Sector Allocations



Source: Fidelity

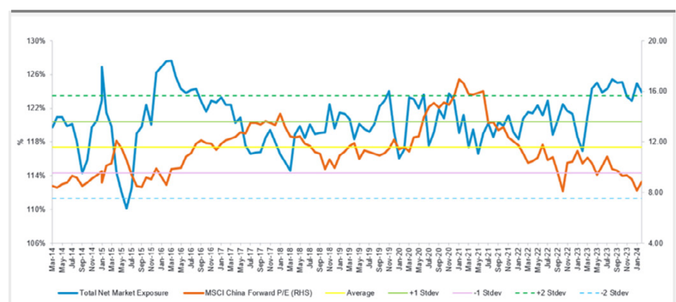
Gearing

FCSS is likely to have structural gearing in place as Dale aims to capture the long-term growth potential of the Chinese market. The trust typically has a gearing range of between 20% and 25%, though Dale is permitted to take net exposure up to 30%, with the level taken a reflection of his views on the market and valuations.

He has access to a mix of facilities. Previously, there was a one-year loan facility, last renewed in February 2023 at a rate of 6.335%. We understand the board is considering a range of tenors and will adopt the best facility for optimising the benefits to the trust and the cost of funding. Dale can also use CFDs, which are financial instruments that allow the manager to take more exposure than the amount invested. CFDs are also used to take short positions in stocks (see **Portfolio**). We understand the board wishes to maintain a diversified range of financing options in the future and therefore the use of both a loan facility and CFDs will likely continue.

The level of net exposure was 118.5% as at 30/04/2024, with the gross market exposure, which is the net exposure plus the short exposure at 122.8%. The chart below demonstrates the net market exposure for the past ten years in contrast to market valuations, showing how the manager has taken on more gearing as valuations have fallen in the past couple of years.

Fig.3: Net Market Exposure



Source: Fidelity, as at 29/02/2024

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Performance

Over the long term, FCSS has delivered significant outperformance of its benchmark, the MSCI China Index, producing a return that is almost 28 percentage points higher over five years. This good relative performance has also somewhat offset the significant headwinds the market has faced in absolute terms, particularly in the past few years. This has led to a total NAV return over the five years to 17/05/2024 of 19.4% versus the index which fell 8.3% which we have shown in the chart below. We have used an ETF as a proxy for the index.

Fig.4: Five-Year Performance

Source: Morningstar

Past performance is not a reliable indicator of future results.

Small and mid-caps tend to underperform in falling markets, as was the case in 2022, where the index fell by 12.1% over the calendar year, though FCSS fell 15.2%. However, it is interesting to note that while the market fell across the full 2023 calendar year, FCSS outperformed despite its SMID-cap bias. This was not the case in the first part of the year, with FCSS initially underperforming the initial fall, as we detailed in **our previous note**, though the later part of the year saw better relative performance. This was largely as a result of positive stock selection as we have detailed below. Also weighing in down markets is the trust's structural **Gearing** which can amplify upside as well as downside. However, markets typically rise over the long term and therefore this is expected to be beneficial throughout the cycle.

In the past 18 months, the market has experienced a period of high volatility following the reopening of the economy post lockdown. Consensus was that this would lead to a sharp recovery in spending, contributing to a market rally from late 2022 onwards. This rally peaked in February 2023, but the spending recovery failed to materialise, and the market fell back throughout the remainder of the year.

FCSS managed to outperform the falling market though, with stock selection the primary reason for this, albeit this was somewhat offset by negative sector allocation. One example of this was Dale's significantly underweight position in banks which was a positive contributor as the weaker macro environment led to weaker loan generation, although an overweight to the broader financials sector through the likes of insurance offset some of these relative gains.

The overweight allocation to consumer discretionary companies was the biggest positive contributor to performance in the twelve months to 29/02/2024. This includes the likes of Hisense and PDD Holdings, which operates under the Temu brand in overseas markets and has been delivering strong revenue growth. Stock selection was positive from these names, though the broad overweight to the sector was a negative over the course of the year. We note that Dale has been taking profits in some of these names, such as low-cost retailer MINISO (see **Portfolio**).

Going forward, Dale expects earnings to have a sizeable impact on performance, reflecting a market that is more fundamentally focussed than macro. He notes that the most recent earnings season has seen big diversions from those reporting as the impacts of 2023's slowdown play out. We believe this shift in focus could be positive for Dale's stock selection approach and his ability to generate alpha, as well as leading to a broader pick up in sentiment should the earnings season begin to demonstrate better profitability from Chinese companies. We note that Chinese first quarter GDP data released on 16/04/2024 saw the economy grow by 5.3%, above both expectations and the government's own goal of 5%.

However, for corporate earnings to recover, especially in the consumer facing names, Dale believes the outlook for the property sector may need to improve. However, Dale highlights that Chinese household finances are in relatively good shape, and they have reduced their own debt burden, though remain concerned over the property sector due to its use as a store in wealth in China. There has been some government policy support to improve the sector, though these have somewhat disappointed investors with their impact.

Regardless, Dale believes that all the negative news surrounding China is being priced into valuations, but the upsides, namely a recovery in consumer spending and small policy fixes of the property sector, are not. In the chart below, we have shown the one-year performance of the trust which has outperformed the benchmark, albeit in a period that has had its challenges. The market has had a sharp rally in the near term, though the manager believes the market continues to trade at attractive valuations. Furthermore, macro headwinds have become less impactful, with stock specific factors having increased in prominence. We believe this could be seen as an encouraging sign for an active stock picker such as Dale, as the market offers the potential for alpha generation, as well as a broad recovery in the region, which would likely be amplified by FCSS' SMID bias and high level of gearing.

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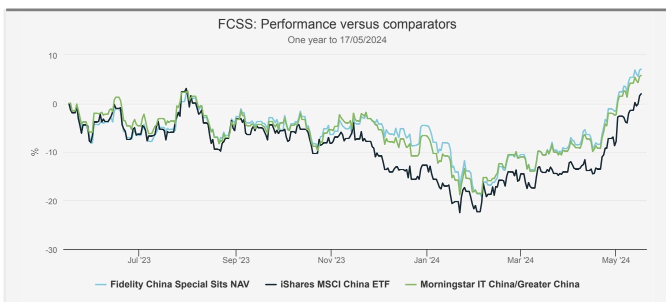
Fig.5: One-Year Performance

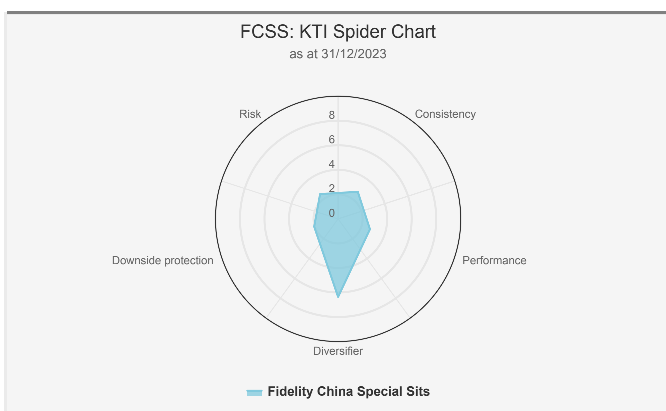


Source: Morningstar

Past performance is not a reliable indicator of future results.

Our proprietary KTI Spider Chart is shown below. This shows how FCSS has performed versus a wider peer group of 22 global emerging markets investment trusts over the past five years, in some key categories. Each category is scored out of ten and scores are normalised to the peer group, with a higher score indicating a superior characteristic. FCSS scores above average as a diversifier, primarily as a result of low correlations versus both equity and bond indices. The scores for consistency and performance are below average which we would attribute to the rise and pull back of the Chinese market over the past five years, especially against the peer group covering global emerging markets. FCSS also scores below average for risk as a result of a higher volatility score relative to the peer group. The trust has a below-average score for downside protection. This is a result of both the scores for the worst five months and downside capture being below average.

Fig.6: KTI Spider Chart



Source: Morningstar

Past performance is not a reliable indicator of future results.

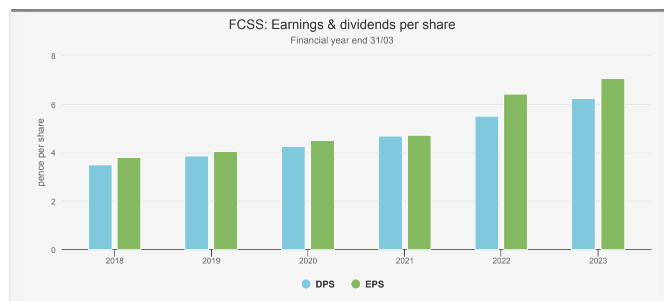
Dividend

Dale's focus for FCSS is predominantly on delivering capital growth. As a result, he is unlikely to have much consideration for income generation as part of the investment process. Furthermore, Dale has a preference towards small and mid-caps which typically use any excess capital to reinvest back into their companies to grow, rather than to pay out to shareholders by way of a dividend.

That being said, the trust does pay an annual dividend that has increased every year since inception. The most recent dividend was 6.25p, earned on 15/06/2023. This indicates an historic yield of 2.6% based on the current share price. This dividend was fully covered by revenue, and the trust continues to hold substantial income reserves which are nearly double the most recent annual dividend. As such, we believe the dividend is well supported going forward.

Whilst the past year has been a challenging one in absolute terms for the trust, it has increased the prominence of the yield of FCSS, especially with the admirable track record of dividend increases. As such, whilst we don't believe the dividend should be the central tenet of an investment into FCSS, we do think it could increase its appeal at these levels.

Fig.7: EPS & DPS



Source: Fidelity

Management

Dale Nicholls has been managing FCSS for ten years, having taken over management from Anthony Bolton, the trust's first portfolio manager, in April 2014. Dale worked with Anthony for some months before taking over full management responsibilities. He has 29 years of investment experience and also manages the open-ended Fidelity Funds 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 Hong Kong 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.

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Discount

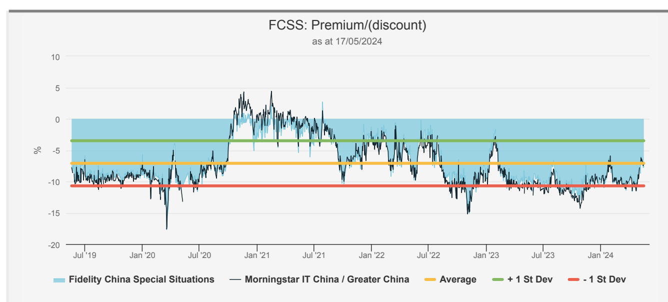
FCSS has traded at a discount for much of the past five years, especially so over the past year since an expected economic boom post re-opening from lockdown in early 2023 failed to materialise. The current discount is 7.7%, slightly wider than the five-year average of 7.1% though approximately in line with the sector average.

FCSS is by far the largest trust in the China sector, especially so since the combination with ACIC, leaving the sector at just three trusts. Of the total net assets of £1.5bn, FCSS accounts for c. £1.2bn. As a result, the discount of the sector average matches FCSS quite tightly.

We believe the current discount is a reflection of broader negative sentiment towards China following a challenging couple of years. However, as we have discussed in **Performance**, the manager argues these headwinds are showing signs of easing and therefore, we think the discount could begin narrowing should the country begin to put its economic challenges behind it and move towards recovery. We believe the recent rally in the market could be an indication of this.

The board has a discount control mechanism with the goal of keeping the discount level within single digits. As a result of the weakness in the past two years, the board has been active with share buybacks. In the financial year to March 2023, the board bought back c. 25.6m shares, equal to 4.5% of the share capital, with over 18m bought back in the following year. We believe this can be seen as supportive to the current discount.

Fig.8: Discount



Source: Morningstar

Charges

FCSS management fee is structured in a way that it aligns the interests of both shareholders and managers, with a tiered charge based on the level of net assets, as well as a variable element depending on performance.

As we discussed in our previous note, fees were reduced in July 2023; with the first tier of assets up to £1.5bn the manager receives a fee of 0.85% and 0.7% on amounts above this. Both of these fees are variable by 20 basis points depending on performance, meaning the first tier can range from 0.65% to 1.05%. 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.

As a result of the recent merger with ACIC, the asset base of FCSS has risen, standing at c. £1.2bn as at 09/04/2024. We understand this increased size will lead to lower ongoing costs due to fixed costs being spread over a wider asset base. Furthermore, Fidelity has waived its management fee on the transferred assets until September 2024 as well as contributing to the merger costs. The most recently published OCF was 1.17% for the six months covered by the interim statement though we note this included the full 0.2% of the variable management fee for outperformance and doesn't include the benefits of the larger asset combination.

The latest KID RIY is 1.78% which compares to the simple average of the sector of 1.91%, according to JPMorgan 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 though we note that only 70% of the portfolio is covered by their ratings largely due to Dale's bias towards small and mid-size companies.

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