Closed End Investments

Source: Refinitiv

Market data

EPIC/TKR	FCSS
Price (p)	325.5
12m high (p)	503
12m low (p)	319.5
Shares (m)	515.5
Mkt cap (£m)	1,678
NAVNAV (p, 16 Sep '21)	348.4
Discount to NAV	7%
Country of listing	UK
Market	STMM (FTSE250)

Description

The investment objective of Fidelity China Special Situations (FCSS) is long-term capital growth from an actively managed portfolio made up primarily of securities issued by companies in China, both listed and unlisted, as well as Chinese companies listed elsewhere. The company may invest in companies with significant interests in China.

Company information

Chair	Nicholas Bull
NED	Linda Yeuh (SID), Mike Balfour, Vanessa Donegan, Alastair Bruce
Fund Mgr	Dale Nicholls

https://investment-trusts.fidelity.co.uk/fidelity-china-special-situations/?p=0&c=10

Key shareholders

Total retail (Mar'21)	60.56%
Lazard AM	9.90%
City of London IM	4.8%
Allan & Gill Gray Foundation	7.06%

Diary

Mid-Sep'21	End-Aug factsheet

Analyst

Mark Thomas 020 3693 7075
mt@hardmanandco.com

FIDELITY CHINA SPECIAL SITUATIONS PLC

China growth story + market-beating style

FCSS offers investors a one-stop shop, providing their portfolios with a diverse Chinese exposure across stocks, sectors, market capitalisations and unlisted companies, all based on the underlying value of each investment. China offers superior GDP growth, a growing middle class and modernisation. FCSS has a flexible mandate, and the closed-ended structure can make high-return, illiquid investments. It has scale, and the shares are liquid. Fidelity's stock-picking and gearing have led to total returns ca.3x the market since launch. Regulation is a risk and an opportunity. Other risks include sentiment to FCSS's style and volatility.

- **Investment approach:** Fidelity's local and global teams are an advantage over many competitors in identifying growth businesses at reasonable valuations. The portfolio is actively managed, and positioned for opportunities from domestic-demand-driven growth and tech-enablement. It has a small-cap bias, and can invest up to 15% of net assets, plus borrowings in unlisted companies.

- **Regulation risk:** Our analysis reviews i) the Chinese government's objectives, and why this should see targeted measures, ii) why the market reaction was so dramatic, iii) the risk of new regulation and the secondary costs, iv) international and historical perspectives, and v) the range of opportunities it creates for FCSS.

- **Valuation:** FCSS's portfolio is largely listed equities, but it still trades at a 7% discount to NAV. The discount has been falling since 2016 but recently rose slightly, on market regulation concerns. The rating is in the middle of the peer range. The dividend has increased every year since 2011, and the yield is 1.4%.

- **Risks:** Further regulation in China is something to monitor, but FCSS's exposure appears limited, and noise around the issue can create investment opportunities. Trade wars may affect sentiment, but FCSS is domestically focused. Sentiment can go against FCSS's investment style. Returns are expected to be volatile.

- **Investment summary:** In general, FCSS invests in the huge opportunities from New China, with growth in the middle classes, and supportive government policies towards domestic demand and innovation expected to underpin superior GDP growth. Fidelity's stock-picking, gearing and being able to make illiquid investments, together with the compounding benefits from investment outperformance, have seen total share returns ca.3x the market since launch. There are risks from further regulations, but these may also create opportunities. Investor appetite for FCSS's style may vary, and investors should expect volatile returns. The share price is at a 7% discount to NAV.

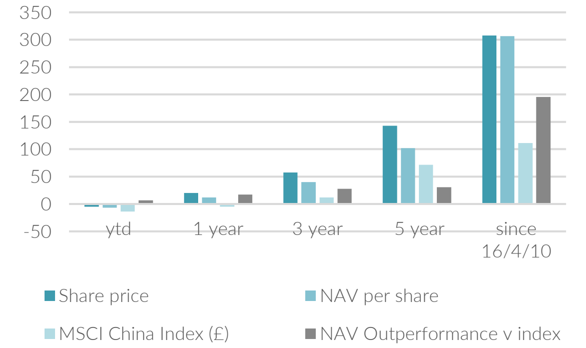
Financial summary and valuation

Year-end March (£000)	2018	2019	2020	2021	2022E	2023E
Investment Income	29,000	30,910	33,016	32,781	47,865	46,878
Gains/losses on fin inst. FV	212,441	-25,386	-57,341	725,388	-86,691	210,558
Invest management fees	-14,193	-11,543	-9,440	-18,591	-20,296	-21,122
Other expenses	-1,630	-1,214	-1,177	-1,368	-1,300	-1,350
PBT	274,675	-77,177	-82,587	991,375	-28,839	266,547
Investments (£m)	1,496	1,423	1,290	2,167	2,106	2,341
Cash	80,439	86,963	38,523	66,404	67,660	64,537
NAV (£m)*	1,503	1,402	1,273	2,183	2,128	2,365
NAV per share (p)	2.73	2.55	2.36	4.23	4.13	4.59
Discount to NAV	-12%	-8%	-9%	-1%	-21%	-29%
Yield	1.1%	1.2%	1.3%	1.4%	1.5%	1.7%

*2018-21 NAV on year-end s/p, 2022-23E NAV on current s/p. Source: Hardman & Co Research

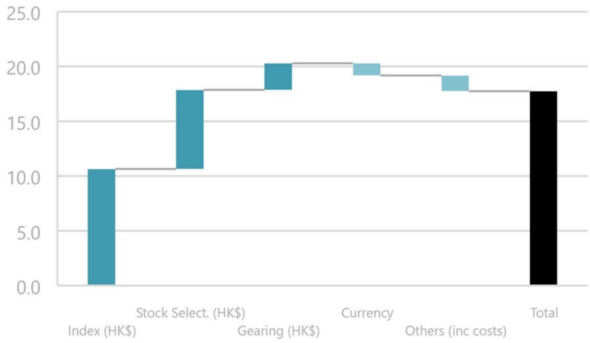
Table of contents

Cumulative growth (%, as reported in the July 2021 Factsheet)



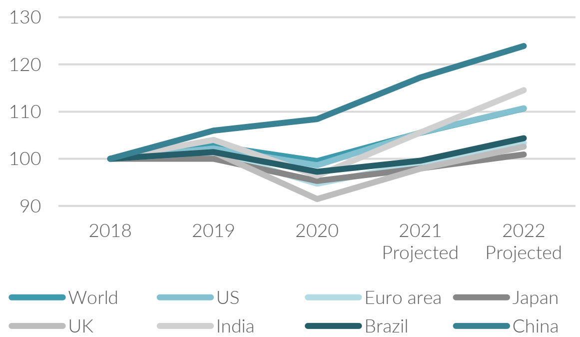
- FCSS cumulative NAV and share price growth is 3x MSCI China Index levels since launch. Outperformance has been seen over YTD, one, three, and five years and since launch.
- On a 10-year view, it is the best-performing listed vehicle with returns ca.30% above the average. FCSS's performance would beat all open-ended Chinese investment vehicles over three years.
- Despite the recent Chinese market correction, the outperformance vs. UK markets has been ca.3x since launch.

FCSS average annual NAV attribution 2011-21 (%)



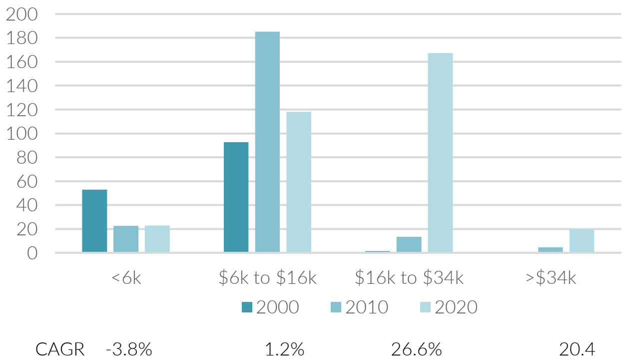
- FCSS stock selection, on average, increased market returns by two thirds from 2011-21. In FY'21, it more than doubled market gains. The gearing, within the closed-ended structure, allowed for further increased returns.
- Long-term total return performance then benefits from the compounding effects of higher performance.
- This structure also sees good corporate governance (including ESG) and disclosure.
- Small currency and other cost effects see average annual NAV growth of 17.7% since launch.

IMF World Economic Outlook (July) growth estimates indexed to 2018 at 100



- China's forecast real GDP growth is well ahead of global growth and developed markets. GDP growth is not enough to drive markets higher, but they are a positive tailwind.
- China, nearly uniquely, grew during 2020, reflecting effective economic levers controlling the economy.
- Growth going forward will be very different from in the past, with the key driver being domestic demand not low-cost manufacturing exports. FCSS is positioned for this dynamic.

Number of urban households by annual household income (m) and CAGR rate 2000 to 2020E (%)



- Historically, China's superior growth was driven by being the cheap manufacturer to the world.
- Recent and future superior growth has been and will be driven by a different dynamic – the rise of an urban, increasingly wealthy, middle class with high levels of discretionary spending and domestic demand.
- FCSS's portfolio is positioned for this dynamic, which is largely unaffected by regulatory changes. Looking at why the Chinese government enacted these changes indicates a relatively limited likely exposure to future changes too.

Source: Company data; IMF, p14 MacKinsey report, Meet the 2020 Chinese Consumer; Hardman & Co Research

Summary

We believe that many investors looking at FCSS will already like the China story, and so we have structured our note to lead with answering the question of why FCSS may be the best route to that market. Investors wanting to know more about the Chinese market appeal should go to pages 12-15. We have dedicated a separate section to regulatory risk (including the potential opportunities it creates) and its impact on FCSS, before considering the other risks.

Investment positives

FCSS's closed-ended structure means it can take long-term conviction positions in illiquid assets, has good corporate governance and disclosure and is a highly liquid investment

FCSS, being a closed-ended fund, can invest in small and unlisted illiquid investments, including unlisted ones, as it does not need to hold cash against redemptions as open-ended vehicles do. This structure also ensures good corporate governance with its directors usually spending a week a year in China. Good governance has helped a strong ESG ethos. FCSS has good disclosure, and its structure and investment policies allow gearing, and shorting, which have added to returns. Being a FTSE 250 member, with a market capitalisation of £1.7bn, means investors have a highly liquid asset, which is tradeable through the whole day.

FCSS outperformed Chinese markets, listed peers, open-ended peers and UK indices over most time horizons

FCSS has materially outperformed the MSCI China Index over YTD, one-, three- and five-year time horizons. Since launch in April 2010, its cumulative NAV, and share price, growths are treble that of the index. Over a 10-year view, it is the best-performing listed vehicle with returns of ca.30% above the average. We believe its five-year total return would put FCSS in the top quartile of Chinese open-ended vehicles and be the top performer on a three-year view. Against UK indices, its total return since launch has shown a similar beat despite the recent Chinese market correction.

Manager has competitive advantages over local and global peers in its research teams and delivered higher (compounding) returns over long term

These performances reflect being in an attractive market and the value added by the manager and FCSS itself. From 2011 to 2021, Fidelity's stock selection and use of focused gearing have nearly doubled the MSCI China Index annual contribution to NAV growth, adding, on average, 9.6% p.a. Compounding these higher returns then delivers even more value over time. FCSS's focus is value in structural growth businesses with competitive advantages and strong management teams. Research by a long-established, large, local team is a competitive advantage over many global players (some have had local presences for less than two years) while access to Fidelity's global analysts, and the manager's regional experience, give a perspective unavailable to many domestic competitors.

FCSS has a flexible mandate, including unlisted investments, and an active approach, including using derivatives

FCSS's investment policies allow optimal investment choice and include i) a broad mandate with flexibility to take the best opportunities available, ii) an active approach, typically turning over the portfolio every two years, with even higher turnover when opportunities are the greatest (e.g. FY'21), iii) unlisted investments accounting for 9% of net assets (immediate peers nil) allowing FCSS access to value created in the run up to IPOs, and iv) an active use of derivatives, which delivered £267m of gains in FY'21 (peers nil).

Fees have steadily declined over 10 years and will reduce further

In terms of fees i) FCSS's fees have been on steadily declining trend over the past 10 years, ii) fees reduced in 2018 and again from 1 April 2021, which is important evidence of the board's relationship with the manager, iii) the performance-related variable fee element can reduce managers' charges by nearly a quarter in periods of weak performance, and iv) FCSS has one of the lowest charges among Association of Investment Companies (AIC) Asian Country specialists. FCSS benefits from economies of scale with an NAV of £1.8bn.

Dividend increased every year since launch

While capital appreciation is the key objective of the fund (dividend yield is 1.4%), the payout has been increased in every year since launch.

Looking forward, Chinese growth to be driven by domestic demand in a rapidly maturing economy

Given the socio-demographic trends, strong GDP growth was, and is, needed for Chinese social cohesion. Since the late 1970s, China delivered growth by de-regulation, and its focus on resource-intensive manufacturing, exports, and low-paid labour. These trends are now largely over. Looking forward, China is developing into a more mature economy, and we expect further opening of its capital markets over time.

Investment-neutral factors

Neutral issues include discount control mechanism, gearing, ESG, currency and limited correlation to indices

We characterise the following as neutral issues:

- While FCSS has a discount-control policy in place to limit the discount to NAV to single-digit percentages, in practice, this has seen limited activity and, at current ratings, is unlikely to be triggered.
- Over the long term, FCSS's gearing has added value (2010-21: +2.4% p.a. average annual NAV accretion), but it also increases volatility in returns. The controlled amount and structure of gearing should not create liquidity issues.
- Fidelity's and FCSS's own approach to ESG are long-established, thorough and detailed. Importantly, it is not only seen as a social responsibility but also a lever to add value. We characterise the factor as neutral because the Chinese market, albeit improving, is behind many other countries in terms of its ESG.
- Other issues include i) complex currency exposure – FCSS's policy not to hedge has been proved right over the long term, albeit it has seen some more volatility in returns, and ii) given the management approach outlined above, it is not surprising that FCSS's share price is not closely correlated to indices, which may surprise some investors. Just because the Chinese markets may be rising or falling, it does not mean FCSS will follow suit.

Investment risks/downsides

Recent regulatory announcements have led to a sharp market correction

A series of announcements since November 2020 have hit a range of large-cap Chinese companies. The 2021 effect has been so dramatic because i) China has taken action more rapidly than many other countries, ii) the announcements were not expected, and iii) there remains uncertainty as to what will be affected next.

We have identified three distinct objectives, each of which affects only a targeted group of companies

Understanding why the regulations are changing is key to appreciating future risks and we have identified three distinct drivers, each likely to affect different stocks. They include i) concerns on social inequality – most affect the largest companies and those with poor consumer/worker protections, ii) data protection and related national security – mainly affecting technology and tech-enabled businesses, and iii) preservation of Communist Party power by limiting the development of potential rivals – greatest impact on largest companies.

We expect more announcements in these areas

Going forward, we expect more regulations as the Chinese economy matures into a developed market, although we expect investor sentiment on this subject to go through cycles and perhaps reduce from its current peak. Investors should not only focus on direct regulatory costs but also secondary ones like compliance and where companies try to head off changes with their own "common prosperity" initiatives.

Ongoing regulation has been a feature in the past and share price recovered; a feature also for many countries/industries

We have put these risks into their historical and international perspective. Despite the recent correction, Tencent's share price is still nearly double the level it fell to post regulatory concerns in 2018. China is far from unique in seeing regulatory strains. UK investors need only look to the non-prime lending market or Plus500, which fell two thirds on regulatory pressure in 2015 and then nearly trebled in the subsequent 18 months.

Range of opportunities for a fundamental research-led house, which has expertise to identify real risk from sentiment. Long-term China growth story unaffected.

Regulatory changes also create a number of opportunities for FCSS, including: i) a general market sell-off creates value opportunities in unaffected businesses; ii) ESG regulations will create new markets like EV where Fidelity's global research can best identify local opportunities; iii) research can help identify the real risks and not be driven by sentiment; iv) the long-term Chinese growth driver of domestic demand is unaffected; v) FCSS's bias to small/medium cap is likely to be less affected than funds invested in large-cap names; and vi) more domestic listings play to Fidelity's local analytical resources.

Investment focus may be out of favour and the approach is likely to generate return volatility

FCSS faces the company-specific risk that its style of investing can be out of favour and, in such times, it faces a headwind compared with benchmarks. Gearing may compound the issue. FCSS's investment style is also likely to generate high volatility in both absolute terms and relative to benchmarks.

Domestic focus reduces geopolitical risk; range of potential macroeconomic pressures, but Chinese authorities have tools to manage these risks

Other risks include i) geopolitical risks – we believe tensions between the US and China are embedded for many years, but the direct portfolio risk is limited with just 3% of investee company revenue coming from the US, ii) Chinese market volatility with notable corrections in 2007, 2009 and 2015, but, unlike those periods, we do not see the speculative bubbles that built ahead of these corrections, iii) a range of economic risks, including the level of private debt, the exposure of the banking system to stress scenarios where non-performing loans double, loss-making state-owned enterprises, the shadow-banking market, localised rapid house price appreciation, and an ageing population. However, the authorities appear to have levers to manage these risks, which they have done successfully in the past (e.g. in 2020).

Portfolio (as at end-July 2021)

Bias of portfolio to small and mid-cap stocks. Has holdings in large-cap names but underweight relative to index.

Total equity exposure was 120% of total net assets (TNA), including 33% in companies with market cap exceeding £10bn (index 74%), 15% in £5bn-£10bn (index 10%), 31% in £1bn-£5bn (index 10%) and 33% in sub-£1bn (index 0.3%). The balance is in other indices/unclassified. By sector, the most overweight positions are in Industrials (16% TNA vs. index 5%), IT (16% vs. 7%), Healthcare (16% vs. 8%) and Materials (10% vs. 3%). Country of listings included HK (43% vs. 48%), US (20% vs. 16%) as well as China A shares (25% vs. 14%) and China H shares (17% vs. 18%). Its biggest underweight positions were in Meituan (-3.1% vs. index), Alibaba (2.7%), China Construction Bank (2.4%) and Tencent (2.4%). The top 10 holdings accounted for 41% of the fund. 9% of TNA is in unlisted positions.

Valuation

Discount below long-run averages but above level at start of year

The current 7% discount to NAV is below the medium-term average but is above the levels at the start of 2021. We believe up to a third of the discount may be attributable to the delay in NAV recognition from unlisted holdings (subject to a three-monthly valuation cycle), but the portfolio is largely listed and liquid. Sentiment to regulation risk appears to drive the balance and we believe this may revert to more normal levels in due course.

Investment attractions

As noted above, this section starts with why FCSS offers an attractive option to invest in China, and goes on to review why China itself is an attractive market.

Why FCSS (1): large, liquid, closed-ended structure

Closed-ended structures like FCSS outperform open-ended ones as they have less cash drag, can invest long term, offer more favourable trading options, have good corporate governance and allow gearing

FCSS was launched to offer sterling-based investors an exposure to China. There are many open-ended investment vehicles available to those wanting such an exposure, but we see three advantages in FCSS's closed-ended structure, including:

- The manager can make longer-term decisions, without having to worry about the need to hold liquidity against potential redemptions. This means FCSS can exploit any illiquidity premium in investments. We note that FCSS has 9% of TNA in unlisted investments (cap recently raised to 15%) and a further 33% in companies with a market capitalisation of less than £1bn.[1]
- Being listed on a stock exchange, FCSS offers investors the ability to buy and sell shares at any time within normal trading hours, benefitting from the good liquidity associated with being a FTSE250 company with a market capitalisation of £1.7bn. LSE trading data indicates that, in the year to June 2021, on average, there were more than 10,000 trades per month with an average monthly value traded of ca.£90m. Being listed means there is good corporate governance with a board of directors providing an additional layer of oversight to protect investors' interests and *inter alia* promote ESG.
- Gearing – taking FCSS's disclosed attribution analysis, on average, FY'11-21 gearing added 2.4% to annual returns, nearly a quarter of the MSCI China Index contribution over the period. The higher-return benefit then compounds over time giving an even better outperformance. Gearing also increases the volatility of returns, which we discuss in more detail below.

We estimate top performer over three years and top quartile over five years against open-ended funds

The AIC has indicated that, across all closed-ended vehicles, it believes the incremental return is more than 1% p.a. higher than in open-ended comparable vehicles. Looking at FCSS over the past three years, its performance would beat all China/Greater China open-ended funds available to retail investors on the Fidelity Funds website and it would be top quartile over five years.

Why FCSS (2): superior investor returns

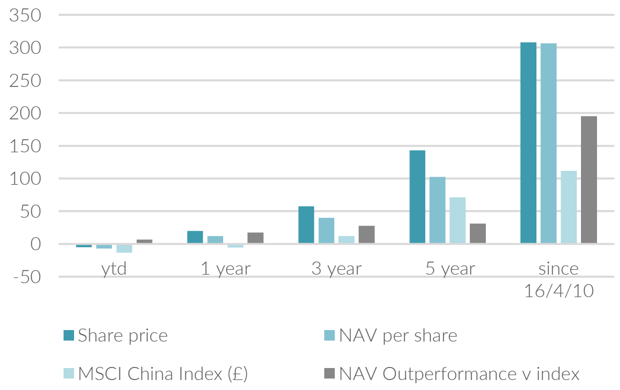
Against MSCI China Index and open-ended peers

FCSS has outperformed the benchmark indices over YTD, one-, three-, and five-year time horizons

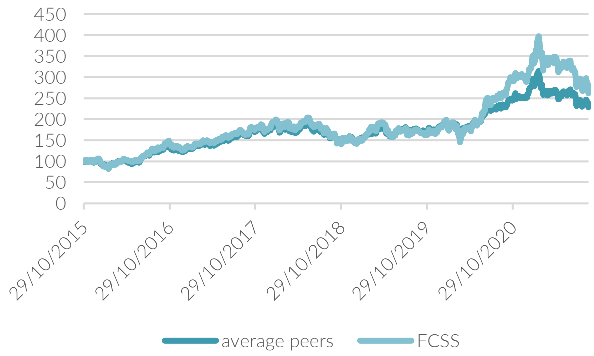
As can be seen in the left-hand chart below, at the end of July 2021, FCSS's cumulative growth outperformed the MSCI China Index on each of YTD, one-, three-, and five-year time horizons with the cumulative NAV growth since launch at ca.3x the level of the index. The right-hand chart shows the outperformance against the larger China open-ended vehicles.

[1] 31 July 2021 Factsheet

Cumulative growth in share price, NAV, and MSCI China Index (%)



FCSS and open-ended peers' total return indexed to 100 October 2015 (start date of all peers)



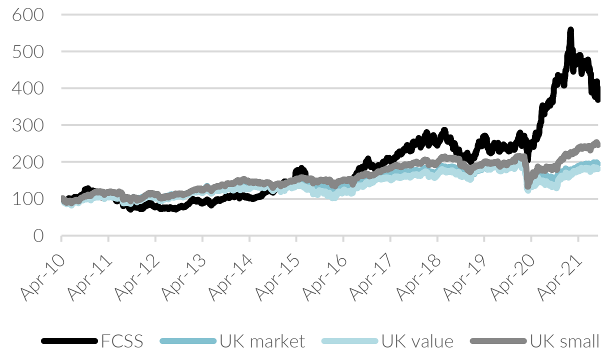
Note: Peers include Barings HK China A GBP, HSBC GIF Chines Equity B, Ninety One GSF All China Equity IX, Schroder ISF Greater China A, Source: Refinitiv, July Factsheet, Hardman & Co Research

Against UK indices

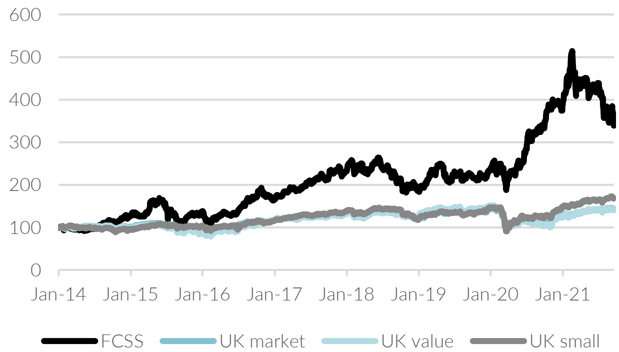
Against UK indices, it has been even better

As noted above, FCSS was established to offer sterling-based investors exposure to China and the majority of its shareholders are retail (67% as at 31 March 2021). Therefore, we believe it appropriate to consider how FCSS has performed against UK benchmark indices. As the chart below shows, the total return from FCSS has significantly outperformed the UK market despite the recent correction.

FCSS share price, UK whole and small markets indexed to 100 at 16 Apr 2010 (launch)



FCSS share price, UK whole and small markets indexed to 100 1 Jan 2014 (manager's appointment)



Source: Refinitiv, Hardman & Co Research

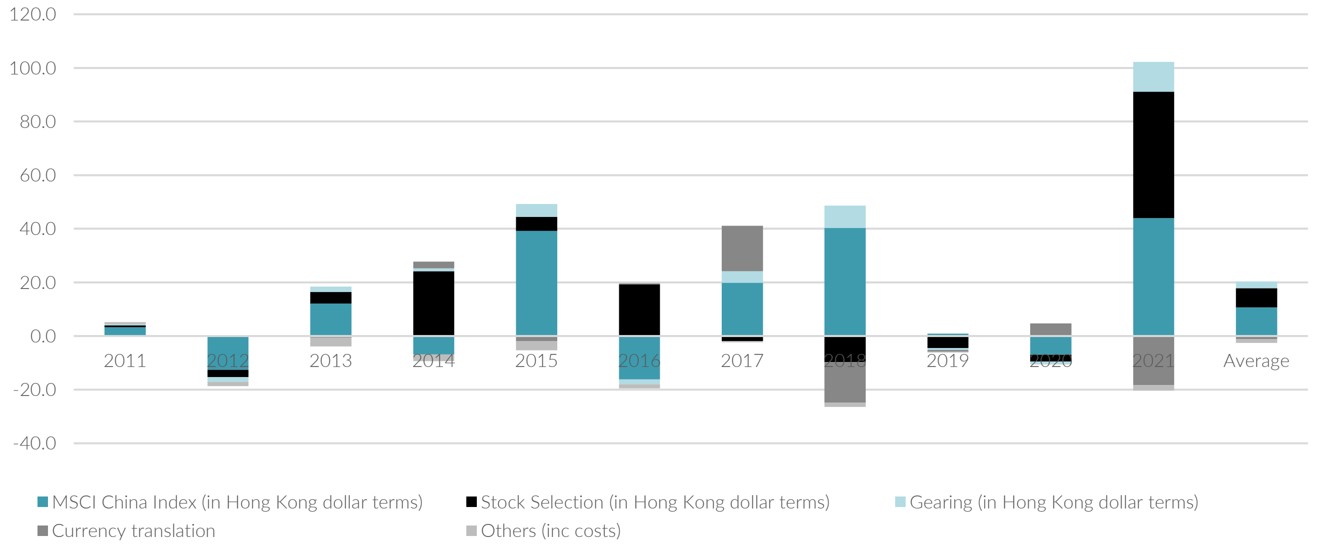
Why FCSS (3): investor returns driven by value added by Fidelity

Summary: stock selection & gearing have added value

From FY'11-21, manager's stock selection and focused gearing nearly doubled gross NAV contribution from a rising MSCI China Index

The chart below shows the attribution analysis provided by FCSS in its Report and Accounts. On average, FY'11-20 saw 11.3% NAV annual accretion of which the index accounted for 7.3%, stock selection 3.2% and gearing 1.6% (the balance being the effects of currency, costs, cash and other effects). FY'21 was an extraordinary year with the index adding 44.0% while stock selection added 47.1% and the gearing effect was a further 11.1%. In terms of gross performance, taking the whole period FY'11-21, the stock selection and gearing by the manager have added 9.6% to annual NAV, nearly doubling the average annual index contribution of 10.7%. Over time, investors benefit from the compounding value of the higher returns (over 10 years, a 10% p.a. growth gives a total return of 60%, but 15% compounds see the investment quadruple).

Annual attribution analysis of NAV changes since 2011 (FY ending March, %)



Source: FCSS Report and Accounts, Hardman & Co Research

FCSS's focus is value in structural growth businesses with competitive advantages and strong management teams

It is important, therefore, to understand how the manager goes about making the investment decisions that have generated this performance. Fidelity's focus is on the underlying value of companies assessed by their growth prospects over the medium term, underlying competitive strengths and the quality of management teams. This is overlaid with thematic drivers such as potential beneficiaries of a "new China", including the shift to online usage and structural growth in areas like healthcare and life insurance. Its valuation discipline has led to a bias towards smaller companies (see Portfolio section below). Certain sectors are unattractive to FCSS, such as pure commodity-related plays, banks and real estate. The latter two appear particularly exposed to unpredictable regulatory intervention.

Research a competitive advantage in identifying mis-valued companies

Ideas are primarily generated by the fund manager and the on-the-ground local analysts, complemented by Fidelity's global research and joining the dots from multiple other information sources, including thematic industry research. The manager spends most of their time in company meetings, and likes to know multiple layers of management to really understand the business. Relative to global peers, Fidelity has a large, long-established research team based in both Shanghai and Hong Kong (Baillie Gifford, for example, only opened its Shanghai office at the end of 2019). The manager also manages a broader Asian fund, and has a wide-reaching Asian experience, which can give unique insights into how Chinese companies may evolve. Fidelity's global footprint can give it a perspective of themes, which is simply unavailable to more domestically focused competitors.

Board usually spends a week in China – meeting management teams as well as local analysts

Additionally, we highlight the level of board supervision. We found the Chairman's comments on p3 of the 2021 Report and Accounts about the board's due diligence trip to China especially interesting. The board undertakes an annual due diligence trip to China and, in the COVID-19 world, this was done virtually. In the prior year, when it was a physical trip, in addition to meeting Fidelity International's investment and research teams in Hong Kong and spending time with the analysts who cover the individual stocks, members of the board met economists and industry experts and the executive management teams of 17 companies (total holding at time, 138), including half the unlisted investments.

Flexible mandate

FCSS has broad mandate, which introduces flexibility to take best opportunities available, e.g. sub-£1bn market capitalisation

One of the features of FCSS is its flexible mandate, which means it can optimise investments by any measure, including listing location, market capitalisation, as well as the stock-picking process identified above. The left-hand chart below shows its weighting by market capitalisation. As can be seen, it is significantly underweight large cap and overweight smaller businesses, especially in the sub-£1bn market capitalisation area. This is an area where there is less research and more pricing anomalies. In our view, there is also greater chance of takeover activity, illiquidity discounts and transformational growth, all of which provide potential upside.

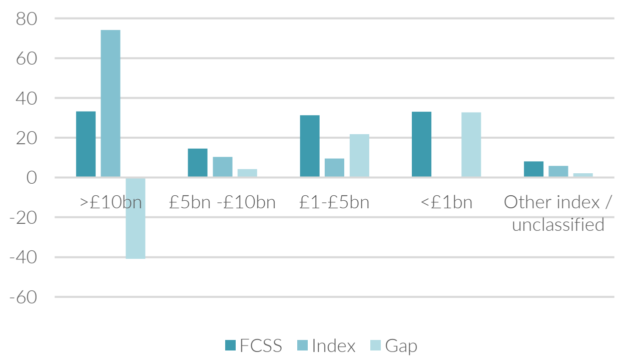
FCSS is an active investor, on average, turning over the portfolio every two years. FY'21 saw 60% turnover.

The right-hand chart below shows that FCSS is an active investor, typically turning over its portfolio ever two years. When markets are not normal (e.g. FY'16, or FY'21), it becomes much more active. We are encouraged that the manager's active management does not appear to have sacred cows and it will consider opportunities outside its usual themes. For example, the weighting in the materials sector has nearly doubled since March 2020, as the valuations became increasingly attractive, and industry consolidation is a catalyst for value realisation.

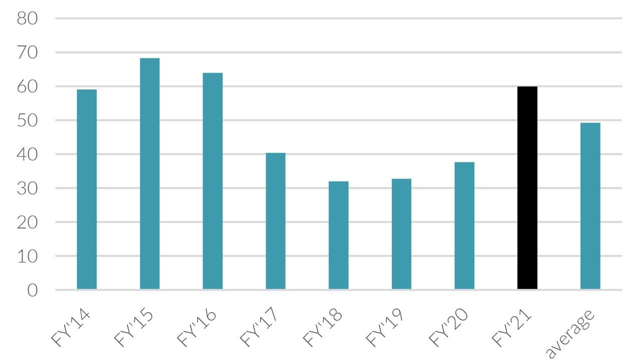
Selectively, and very carefully, can short

The manager can also take short positions. In July 2021, it had one unnamed position, which accounted for 2.1% of the index (i.e. similar size to Ping An, China Construction Bank or JD.com Inc), but FCCS's exposure was -0.5% of TNA. We understand the conviction to short has to be very high, given the cost of borrowing and the market anomalies we identify below. The risk that a herd of less-informed investors can maintain and exacerbate over-valuations for a sustained period is real.

Split of portfolio by market capitalisation (%)



Portfolio turnover* since manager appointed (%)



** Calculated by taking the average of the total amount of securities purchased and the total amount of securities sold in the reporting year divided by the average fair value of investments. Source: July Factsheet and report and accounts, Hardman & Co Research*

Unlisted investments

Unlisted investments account for 9% of NAV (peers nil), allowing FCSS access to value created in run up to IPOs. FCSS has appetite to grow this part of the business.

FCSS first invested in Alibaba in September 2012, two years ahead of IPO, during which time FCSS's stake rose in value from £15.5m to £74.8m. It uses the same analyst skills to identify mis-valued companies as it does in the listed space. With unlisted investments, its focus has been on businesses typically close to their IPO in order to capture the rapid value accretion that is often seen at that time. FCSS is not trying to be a private equity investor involved in the active management of the business, but rather is an active, supportive shareholder whose presence on the share register brings both financial and reputational gains for the investee company. It also builds relationships, which can lead to an extended holding once the company has listed. FCSS's flexible mandate now allows up to 15% of net assets plus borrowings in unlisted investments. Prior to 2021, the cap was 10% and actual exposures rarely exceeded 6% with the new limit being indicative of growing opportunities in this area. We understand that it is in part due to FCSS's historical success in this area that has made it an attractive go-to partner and so it is being approached with more propositions than in the past.

Active user of derivatives

£267m of gains on derivatives in FY'21. Peers have not used them recently.

One further aspect of FCSS's flexible mandate is its use of derivatives. In its FY'21 results, FCSS reported gains on derivatives of £267m. Peers have not used them recently – Baillie Gifford China Growth (formerly Witan Pacific Investment Trust) nil year to January 2021, JP Morgan China Growth and Income also nil 18 months to March 2021. This is a material differentiator and compares with FCSS's total income of £33m and gains on investments of £725m. Most of these gains were realised in the year, and so were not at risk from the recent market correction.

FCSS goes long CFDs to increase existing positions in cost-effective way, requiring limited cash support CFDs and put options on indices to manage protection to the downside

The FY'21 report showed that the two main uses of derivatives were: i) long contract for differences (CFDs) to increase the effective holding in an investee company in a cash-efficient manner whereby there is a bias to the largest, most liquid names where derivative pricing is the most competitive; and ii) portfolio hedging with short positions giving an element of protection to the downside. As noted above, on occasions, there is selective shorting of a particular investment but this is limited.

Why FCSS (4): falling, variable and relatively low fees

FCSS's fees have been on steadily declining trend

Ongoing charges, excluding the variable element, have been on a steadily declining trend, falling every year since FY'13 (as shown in the table below). In FY'21, ongoing charges were just over half the level incurred in FY'13. *Inter alia*, this includes the economies of scale from being such a large-scale provider (net assets have more than trebled since 2013) as well as the board's focus on this issue.

Ongoing charges exc. variable management fee* (% average net asset values for FY ending March)

2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
1.93	1.70	1.80	1.45	1.29	1.20	1.16	1.11	1.02	0.99	0.97

** Defined as total operational expense (excluding finance costs and taxation) incurred by FCSS as a percentage of average net asset values, Source: FCSS Report and Accounts, Hardman & Co Research*

Fees reduced again from 1 April 2021, important evidence of board's relationship with the manager

Looking forward, FCSS agreed a new fee arrangement with the manager effective from 1 April 2021, with the revised fee structure to be on a tiered basis of 0.90% on the first £1.5bn NAV reducing to 0.70% on NAV above this level. The benefit increases as the NAV grows. As important as the financial reward is, the fact that the FCSS board is clearly effective in its discussions with Fidelity.

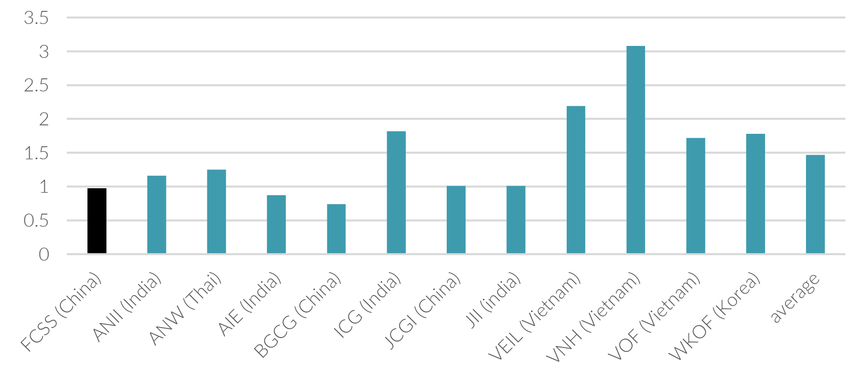
Performance-related variable fee element can reduce manager's charges by nearly a quarter

FCSS has also had a variable management fee structure (VMF) in place from 1 July 2018. The base fee above can see a +/- 0.20% variation fee based on performance relative to FCSS's benchmark index (the MSCI China Index). Unsurprisingly, in FY'21, the total fee was 1.09%, close the maximum level.

FCSS one of lowest charges among AIC Asian country specialists

We also note that relative to other companies in the AIC country specialists' sub-sector, FCSS's ongoing charges are about two thirds of the average. A number of pan-Asian and emerging market investment companies have a heavy weighting in China. These vehicles typically have a range of fees but generally are at ca.1%, in line with FCSS's ongoing charges.

AIC-basis ongoing charges (%) for Asian country specialists



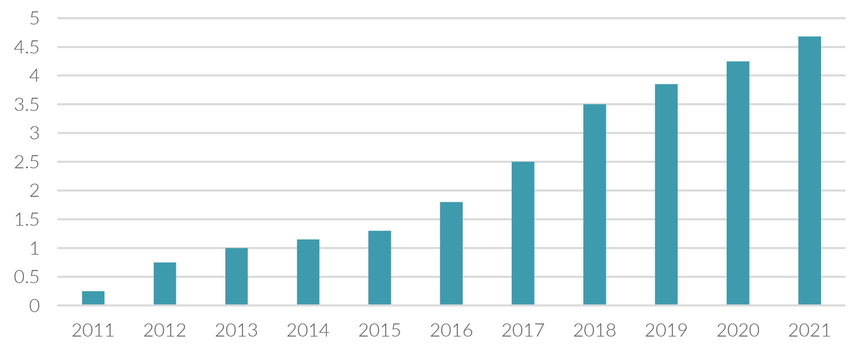
Source: Companies' websites accessed September 2021, Hardman & Co Research

Why FCSS (5): 10 years of rising dividends

Dividend not the key driver, but it has been increased in each of the past 10 years

We believe that most investors will see the capital gains from Chinese growth and Fidelity's management as the key attractions of FCSS with the yield (1.4%) being an added bonus. However, FCSS has had a progressive dividend policy throughout its existence, and has indicated that it intends to continue to do so in the future. In a period of low-income returns from other investments, such a policy may have an increasing value.

Dividend history since launch (p)



Source: Report and Accounts, FY ending March Hardman & Co Research

Why China (1): macro growth

The chart on p3 showed the superior GDP growth. While GDP growth alone is not sufficient to drive markets, we believe it is a helpful tailwind rather than headwind for many potential investee companies.

Since late 1970s, China growth was delivered by de-regulation, and focus on resource-intensive manufacturing, exports, and low-paid labour, but these trends are all slowing

In order to have confidence in the sustainability of superior growth, it is important to understand why China has consistently delivered such growth in the past and what are the levers going forward. The story is not new. A 1997 review by the IMF asked *Why is China growing so fast*? and pointed to reforms in 1978, which encouraged the formation of private businesses, reduced regulation on foreign trade and investment, relaxed state control over some prices, and saw investment in infrastructure, industrial production and education. We believe that this first phase of China's super-charged growth, based on resource-intensive manufacturing, exports, and low-paid labour has, however, now run its course.

Looking forward, October 2020 five-year plan highlights how China will evolve with more reforms/opening up, expanding domestic demand with innovation and modernisation at the core

Looking forward, we expect that a different set of drivers will become more important in delivering superior growth. In late October 2020, the Central Committee of the Communist Party held a plenum to outline the next (14th) five-year plan covering 2021-25. We think some of the key extracts from the resultant communique were: "*unswervingly promote reform and opening up… grasp the strategic basis of expanding domestic demand, deepen supply-side structural reforms, intensify macro policy responses … innovation should be the core position … technological independence and self-reliance should be the strategic support of the country's development*". Unusually, the five-year plan also outlined longer-term (2035) goals, which included "*Major breakthroughs in key core technologies and entry into the forefront of innovative countries; basic realization of new industrialization, informatization, urbanization, and agricultural modernization, and establishment of a modern economic system; basic realization of the modernization of the national governance system and governance capabilities*." In summary, we see the key drivers going forward as being domestic demand within a modern, tech-enabled economy.

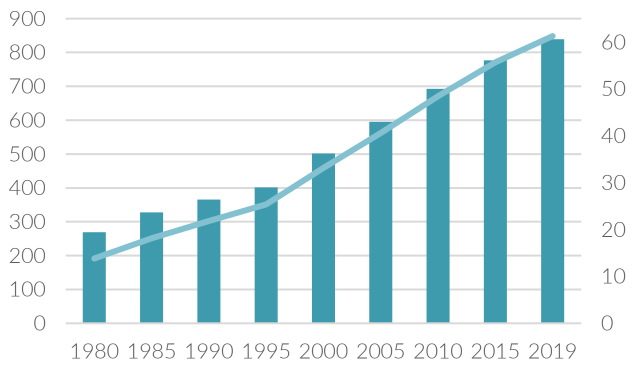
Why China (2): rising middle classes, urbanisation and domestic demand

Urbanisation

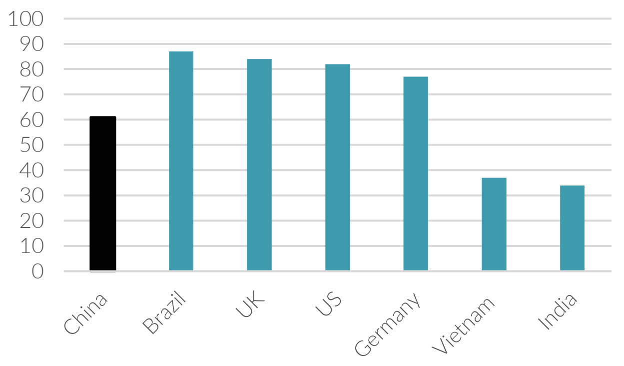
China seen steady increase in urban population but remains well below developed markets

As can be seen in the charts below, the urban population in China has grown rapidly in nominal terms (from ca.200m in 1980 to 458m in 2000 to ca.850m currently) and also as a percentage of the population (from 19% to 36% to 61%, respectively). The right-hand chart below shows how it is also differentiated from developed markets where the typical proportion of population in urban centres is ca.80%.

China's urban population, m (LHS) and % total (RHS)



2019 urbanisation rates across various countries (%)



Source: Statista https://www.statista.com/statistics/263765/total-population-of-china/ https://www.statista.com/statistics/270162/urbanization-in-china/ (LHS), *Hardman & Co Research*

The five-year plan communique above noted that under the last plan "*55.75 million rural poor people have been lifted out of poverty and more than 60 million new jobs have been created in urban areas….must continue their efforts and work together to ensure that the fight against poverty is won*". [2] Put simply, the equivalent of nearly the entire population of UK has moved in just five years.

Rising middle classes

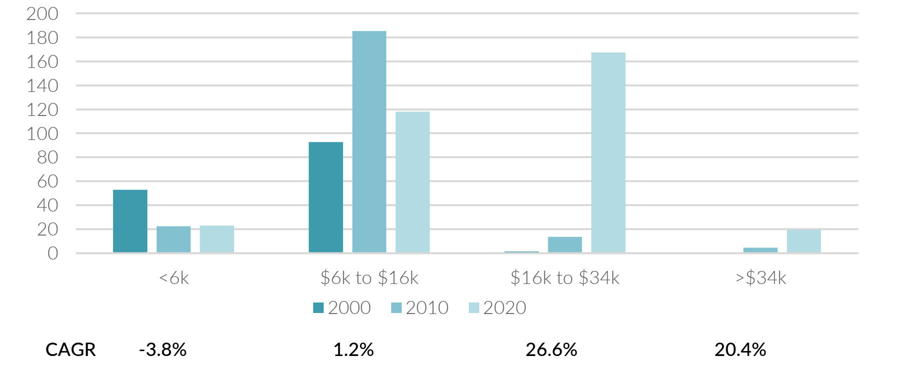
Another driver to GDP growth is rise in middle classes and especially in their discretionary spend…

The *Kearney Consumer Wealth and Spending Study* concurs with our view that as consumers' income and wealth rise, their spending habits change with a much greater proportion of income spent on discretionary items rather than basic necessities. Additionally, China will see a huge increase in the number of older people requiring more healthcare. By way of example, the Global Demographics

[2] http://www.gov.cn/xinwen/2020-10/29/content_5555877.htm

piece, The Growing demand for Healthcare in China, indicated that the number of people over 45 would rise from 271m to 412m over 10 years and that healthcare would rise from 5.3% of GDP in 2018 to 5.9% by 2028 (still well below old Asian countries such as Japan where the spend is 7%-10%). Page 21 of the MacKinsey report, Meet the 2020 Chinese Consumer, noted that it expected the proportion of household income spent on food would fall from 43% in 2000 to just 20% in 2020 (a CAGR nominal spend growth of 7.2%). In contrast, it saw CAGR in semi-necessities of 10.9% and discretionary spend of 13.4%. The chart below shows the urban households by income bracket, which highlights the growth from both factors.

Number of urban households by annual household income (m) and CAGR rate (%) 2000 to 2020E



Source: p14 MacKinsey report, Meet the 2020 Chinese Consumer, Hardman & Co Research

…leading to domestic, household demand driving future growth…

According to OECD data, China's Household spending has seen growth nearly 3x the estimated EU average. We also note the 19 January 2021 release by the National Bureau of statistics of China, which detailed the mix of consumption spending by households. Some of the categories are a little general, but it indicates that, in 2020, non-discretionary spend – defined as being housing, transport, clothing and food (lumped together with tobacco and alcohol) – accounted for nearly three quarters of total spending. As the population ages and becomes increasingly wealthy, the potential growth for discretionary spending as the population upgrades its home, leisure and environment is huge.

…and this is reflected in FCSS stock selection

FCSS has positioned its portfolio to benefit from all aspects of these trends and the modernisation of the economy (especially online usage). Some may appear rather obscure beneficiaries, e.g. the paint industry. However, it is through detailed research and scale that Fidelity can identify such companies, which it believes offer better returns on urbanisation than real estate (or developers) for whom regulatory risk is much more uncertain.

Why China (3): other positives

Further de-regulation in capital markets

China looking to further de-regulate capital markets, which should increase investment opportunities

As we noted above, the five-year plan communique emphasised the strategic intent for more openness. Capital market reforms in China include the following: i) the loosening of short-selling restrictions; ii) lowering of foreign investment restrictions; iii) the implementation of a registration-based IPO mechanism launched in July 2020 on the STAR Board, and now being employed on ChiNext; iv) more flexible listing criteria (for example, we note that the listing requirement of profitability for the HK Stock Exchange has been waived for bio-tech companies); and v) the May 2020 removal of the Qualified Foreign Institutional Investor (QFII) investment quota, where QFIIs used to be required to apply for any investment quotas from the State

Administration of Foreign Exchange[3]. We also note the 2 September 2021 statements announcing the establishment of a stock exchange in Beijing targeted at FCSS's sweet spot of small and medium-sized companies.

Control of pandemic

Chinese control of pandemic was reflected in dip in February but then strong PMI all throughout 2020 and real GDP growth in the year

One measure of how the pandemic affected the country is to look at the Purchasing Managers' Indices where a reading of below 50 is indicative of a downturn and above 50 of favourable trading conditions. This measure collapsed in February 2020, but there was an immediate bounce-back and the overall measure did not dip below 50 in any other month of the year. The GDP chart in the section above showed that China saw real growth in GDP in 2020, performing much better than other economies. Apart from the short-term economic gain, we believe the important consideration is that it shows the Chinese authorities have levers, which they can rapidly deploy to control downside scenarios.

Stock market anomalies

Chinese exchange trading dominated by retail investors, even though they hold 23% of shares. Creates opportunities for mis-pricing and so value creation by fundamental research-led houses.

The FT, in a 26 February 2021 article, highlighted three key issues: i) a Goldman Sachs report noting retail trading at the end of 2019 accounted for more than 80% of turnover on the Shanghai and Shenzhen exchanges against 16% on the Hong Kong exchange; ii) China made up a quarter of equity turnover against 12% of worldwide capitalisation; and iii) China Renaissance analysis, which indicated that retail investors accounted for 23% of China's stock market holdings (against 50% in 2015). The market today is very different from 2015, when retail investors borrowed heavily to finance their positions, but the report above clearly indicates considerable retail trading activity. When such participants exhibit herd-like investment mentalities, with holding periods measured in days not years, this creates significant opportunities for more research-driven investors to sell at above fair value and to buy below. FCSS balances these valuation opportunities with the risks they create.

Underweight in global funds

.

Relative to GDP and market capitalisation, international investors are underweight China. As China becomes an increasing part of global indices, it is likely to see an increasing number of buyers.

In addition to demand from domestic savers (as the Chinese population becomes wealthier, it should have more savings), there appears to be the opportunity for material demand from foreign investors. Historically, there were the regulatory constraints on foreign ownership (e.g. only a carefully chosen few such as FCSS could invest in China "A" shares), but as the economy shows greater openness, this is likely to include wider share ownership. We note the following as illustrative of the opportunity: i) while China accounts for between a sixth and fifth of the global purchasing power, and global market capitalisation, it only accounts for 2.5% of allocation in global funds;[4] ii) the 2Q'20 global study from Greenwich Associates and Matthews Asia, *Crafting the Optimal China Allocation Strategy The Asset Owner's Perspective,* reported that, at that time, almost half of asset owners are not yet satisfied with their China investment plans, and almost 20% planned to increase or significantly increase their dedicated allocation to China's equity markets in the next three to five years; iii) in the Willis Towers Watson review, *The merits of a standalone equity allocation to China*, foreign holders accounted for just 2.4% of the Chinese stock markets against ca.16%-17% in India or Japan and 33%-37% in Korea and the US; and iv) the same report noted, on a full market capitalisation basis, China would account for 20% of global indices against ca.5% now. The trend to higher index weightings has started (it was only 2% in 2010) but has a long way to go.

[3] https://www.safe.gov.cn/en/2020/0507/1677.html
[4] Baillie Gifford September 2020 article RE-FOCUSING ON THE FUTURE: CHINA https://www.bailliegifford.com/en/uk/individual-investors/funds/baillie-gifford-china-growth-trust/ic-article/2020-q3-re-focusing-on-the-future-china-ind-we-1770?p=24349

Investment-neutral issues

1) Discount control mechanisms

Policy is to target buybacks to limit discount within single-digit range – on current rating, unlikely to see buybacks

The board has a discount control policy in place whereby it seeks to maintain the discount in single digits in normal market conditions and will, subject to market conditions, repurchase shares with the objective of stabilising the share price discount within that level. As the discount is well within the range set by this policy, no buybacks would currently appear to be likely.

2) Gearing

Unlike most peers, FCSS can and does use gearing, with net exposure in recent years ca.20% in excess of NAV

FCSS may borrow up to 25% of NAV and the gross asset exposure (whether from borrowing or the use of derivatives) may not exceed the NAV by more than 30%. This appears to be a very different policy from peers, who do not borrow except for settlement purposes. The manager varies the level of gearing by the market opportunity and so it will typically be higher when investment opportunities are perceived as good and lower when prices are high. As at end-July, the company's gross gearing was 29% (30 September 2020, 26.0%, 31 March 2020: 25.2%, March 2019: 26.1%) close to the policy cap of 30%. Net gearing, which nets off short positions, was 20.2% (September 2020: 21.8%, 31 March 2020: 23.2%).

By introducing gearing, FCSS:

Over long term, FCSS has added value – 2010-20 +1.6% p.a. to NAV and 11.1% in FY'21…

- Increases the compounding long-term return in rising markets and where the manager is adding value (both present here). Taking the attribution analysis provided in the Report and Accounts, on average, gearing has added 1.6% to annual returns between 2010 and 2020, roughly half the value added by stock selection. In FY'21, gearing added 11.1% to the already exceptional returns from the rising market and stock selection.

…but also increases volatility in returns

- However, it also introduces further volatility in markets that are already volatile (see section below). We note gearing added 8.3% to performance in FY'18 when the index rose 40% but made a negative contribution in each of FY'12 (-1.8%), FY'16 (-1.8%), FY'19 (-0.7%) and FY'20 (-1.0%).

3) ESG: FCSS good, China less so

As with many companies, FCSS now makes extensive disclosure on its ESG policies and procedures – *inter alia*, pages 4, 13 and 36-37 of the 2021 Report and Accounts.

Fidelity uses proprietary model, dedicated teams and external consultants, and has been signatory to UNPRI since 2012. On internal ratings, FCSS has over 3x proportion in highest-rated category of MSCI China Index.

Fidelity has been a signatory to the United Nations Principles for Responsible Investment (UNPRI) since 2012 and submits an annual report detailing how it incorporates ESG into its investment analysis. In practice:

- Fidelity employs a proprietary sustainability rating process (established in 2019), leveraging its internal research and interactions with corporates. Analysts assign an overall A to E rating on a sector-relative basis. FCSS's portfolio has 10% A-rated compared with the MSCI China Index proportion of 3%.
- It has a dedicated "Sustainable Investing team", which has 13 research specialists – nearly a tenth of the global analyst team.
- It subscribes to an external ESG research provider and rating agency to supplement its organic analysis.

- It receives, from the external research vendor, controversy alerts that include information on companies that have been identified to have been involved in a high-risk controversy that may have a material impact on the company's business or its reputation.

We note FCSS's comments regarding good governance being not only socially responsible but also good for shareholders returns.

While improving strongly, China starts from lower base of ESG compliance

We have classified ESG as a neutral issue given the overall state of ESG in the Chinese market. To measure how China adheres to ESG principles, we note that the UN reports signatories to its *Principles for Responsible Investment (PRI) by region*. There were 39 new Chinese signatories in FY'19-20, compared with 510 in the UK/Ireland alone. The good news is that the rate of growth in China (77%) is nearly 3x the global growth rate (28%). At the 2021 AGM, FCSS highlighted that the average improvement in MSCI ESG rating in China is one of world's highest. In September 2020, Xi Jinping announced at the UN General Assembly that China would seek to reduce emissions to net zero by 2060. Market commentators suggest that, given the underlying growth in China, this means that emissions must start to turn down within a couple of years.

4) Other neutral issues

Currency movements

Currency exposure is complex. FCSS's policy is not to hedge. FY'11-20 saw a small net gain, but FY'21 saw 18.3% NAV hit from FX. Over whole period, net accounting cost 1.1% p.a., but FCSS has avoided real cash cost of hedging.

FCSS's currency exposure is complex with i) its investee companies predominantly having exposure to China markets and most of their revenue and profit is Yuan denominated (on average, less than 10% of revenue to global exports and just 3% to the US), ii) FCSS having a $100m US dollar facility, which it could be argued matches its underlying companies' direct US exposure, iii) the investments being listed across the world with the listing being denominated in Yuan, Hong Kong dollars and US dollars, and iv) FCSS being a sterling-listed and reporting business.

It is FCSS's policy not to hedge the underlying currencies of the holdings in the portfolio but rather to take the currency risk into consideration when making investment decisions. This can see some return volatility – on the attribution analysis in the report and accounts, FY'17 saw a 16.9% NAV gain (driven by sterling weakness post Brexit) while FY'18 saw a 15.2% hit. In FY'21, the adverse effect of currency was 18.3% of NAV. Overall, FY'11-21, the attribution analysis shows an average 1.1% p.a. adverse currency impact on NAV, which suggests the company has been right to avoid incurring the real cost that hedging would incur.

FCSS: correlation with benchmark

FCSS's share price not closely correlated to indices

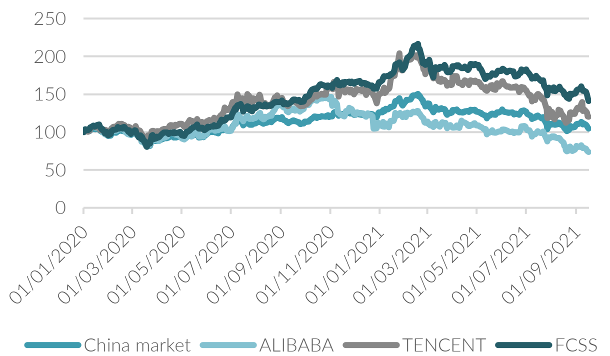
We believe that some UK investors may look at some of the headline indices in Greater China, but this would be erroneous for, as may be expected given FCSS's bottom-up stock selection, there is not a statistically valid correlation between its share price movement and changes in such indices.

Regulation risk

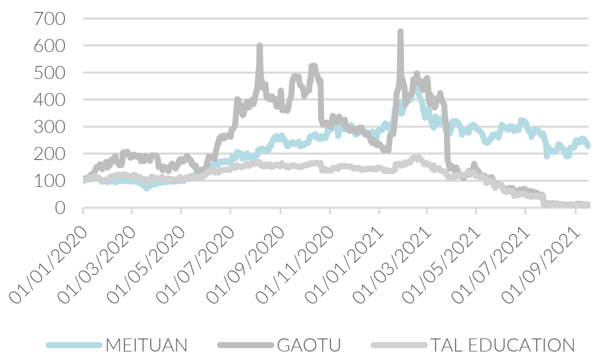
Series of announcements from November 2020 have hit a range of large-cap Chinese companies

In early November 2020, after unexpected Chinese regulatory pressure, Alibaba was forced to pull the IPO of its fintech business, Ant Group. Alibaba's shares fell by nearly 8%. This was the start of a series of announcements, which have led to the dramatic falls in Chinese markets and especially in some of the biggest names illustrated in the charts below. The latest was the 3 September announcement that Beijing City was proposing that Didi be taken under state control.

Market and selected stock indexed to Jan 2020 at 100



Meituan, Tal Education and Gaotu (Jan 2020 at 100)



Source: Refinitiv, Hardman & Co Research

What are the Chinese objectives?

Understanding why regulations are changing helps appreciate where future risks may lie

Three key drivers, including: i) concerns on social inequality – most impact on largest companies and those with poor consumer/worker protections; ii) data protection and related national security – mainly affecting technology and tech-enabled businesses; and iii) preservation of Communist Party power by limited development of potential domestic and international rivals – impact on largest companies with wealthiest investors

Understanding why the regulations are changing helps appreciate where future risks may lie. We have identified three key themes, each of which will have a dramatically different impact on specific stocks. The three themes we have identified are:

- Concerns about social inequality – in China, the top 10% share of national income has risen from just over 30% in 1990 to an estimated 42% now while its share of wealth has increased from just over 40% to nearly 70%.[5] For a communist country, it is not surprising that such a trend may be a cause for concern and we note Chairman Xi's recent slogan of "common prosperity" appears to have been gaining increasing traction. This theme has seen:
  - The moves on private education, which were seen as being advantageous to only those who could afford it. Similarly, while bio-tech continues to see strong government support, big drug manufacturers are under pressure to cut prices for mass medication.
  - As part of the common prosperity, worker protection was enhanced by the end-July 2021 Supreme People's Court and Ministry of Human Resources joint announcement that the "996" overtime policy (i.e working 9am to 9pm six days a week) was illegal. Market commentary is that this poses a particular threat to the technology industry.[6]
  - Competition and consumer rights appear to be the driver behind the Ant Group restructuring, which saw a new holding company established so that it would be regulated more like a bank, has a new personal credit reporting

[5] World Inequality Database https://wid.world/country/china/
[6] https://www.ft.com/content/a794faf1-2ee9-4d19-abc6-72620227396c or https://edition.cnn.com/2021/08/27/tech/china-supreme-court-996-intl-hnk/index.html

company to prevent abuse of data and the links between Alipay and its credit card and consumer businesses were cut.

- Data protection and national security, including the 17 August State Council passing of "*regulation to strengthen protection over critical information infrastructure*".[7] This covered a very broad range of "*network infrastructure and information systems in public telecommunications, information services, energy sources, transportation and other critical industries and domains, in which any destruction or data leakage will have severe impact on national security, the nation's welfare, the people's living and public interests*" and the July 2021 investigation of the ride-hailing app Didi, the share price of which halved that month. The focus is on access to data rather than infrastructure and systems and it is companies with such access that would appear most at risk.

- In our view, Chinese authorities have a long-term focus, and they may have seen a threat to the Communist Party control, if money and power are concentrated in just a few private or overseas hands. In a "Real Politik" move, the rug has been pulled from under the feet of potential rivals. This is part of a wider trend to ensure autonomy/independence in supply chains with, for example, a strong push to build semi-conductor capacity to reduce dependence on overseas supplies.

Why was the effect on share prices so dramatic?

Effect has been dramatic because i) China can take action more rapidly than many other countries, ii) announcements were not expected; and iii) were poorly communicated, creating uncertainty as to what will be affected next

The reasons why the market reaction was so dramatic include:

- As a one-party regime, China could act rapidly. US/European/UK debates on data protection, were and continue to be a very extracted process. From the European Data Protection Supervisor, publishing its approach in June 2011, GDPR regulations were not adopted until 2016 and did not actually get applied until May 2018.[8] In contrast, China, to a degree, caught up with data protection, by implementing new policies within months. The market did not have time to adjust to new policies.

- The moves were unexpected. While FCSS's Report and Accounts "Principal Risks" section noted legal and regulatory risks within the market, economic and geopolitical risk sub-section, and there is comment on p4 about domestic and foreign investor sentiment risk, we do not believe that the market anticipated the specific proposals that have emerged.

- Several commentators have observed that communication of the policies left the markets feeling extremely uncertain as to how wide regulatory changes may be, driving a more general sell-off. Education was seen as one of the "Three Big Mountains" (the other two are medical services and housing). The use of "Three Big Mountains" carries extra significance given its similarity to Chairman Mao's 1948 term "Three Great Mountains" (imperialism, feudalism and crony capitalism). We believe this raised concerns as to how far regulatory changes may go. At the end of July, Fang Xinghai (China Securities Regulatory Commission Vice Chairman) was reported to have called brokers advising them

[7] http://english.www.gov.cn/policies/latestreleases/202108/17/content_WS611b8062c6d0df57f98de907.html

[8] https://edps.europa.eu/data-protection/data-protection/legislation/history-general-data-protection-regulation_en

that the message was that other industries would not be targeted,[9] as an attempt to moderate what the authorities considered to be an over-reaction to their previous announcements.

Will there be more?

Expect more regulations as Chinese economy matures into a developed market, but impact on markets will vary

Yes, is the simple answer. Increasing degrees of regulation is a global phenomenon and, given China is evolving into a more modern economy, further regulations appear probable. FCSS's manager's recent comment was "*We see regulation around these three areas becoming more prominent - obviously something we are very focused on as investors. Given our weighting in healthcare we are watching developments closely, but my sense is that policy moves are already quite progressed (for example, most price cuts are focused on generic drugs versus the government's goal of developing home-grown innovative drugs)*".[10] At present, we believe that the "noise" around regulatory risk is high, outweighing long-term growth prospects. Over time, we expect sentiment to the issue to go through cycles, potentially falling from its current peak of intensity.

Secondary costs

Investors should focus not only on direct costs but also secondary ones like compliance. Some companies trying to head off changes with their own "common prosperity" initiatives, but this will come at a cost.

Investors need to consider the secondary costs of the recent wave of regulatory news. It is likely that, over time, increased regulation will be an administrative burden on companies. While these can, at times, act as a barrier to new entrants, there is the risk of higher costs. Additionally, we think that some companies may try to head off future changes by compromising now. Alibaba, for example, said, on 3 September 2021, it will give away RMB100bn ($15.5bn, two thirds of 2020 net income) across 10 key initiatives to promote common prosperity in China. This followed Tencent's April announcement of RMB50bn to "*fund initiatives in areas including basic science, education innovation, rural revitalisation, carbon neutrality, food/energy/water provision, assisting with public emergencies, technology for senior citizens and public welfare*". The FT reports that this figure has subsequently been doubled.

Putting it into historical and international perspective

Tencent share price nearly double level it fell to post regulatory concerns in 2018. China not unique in regulatory risk.

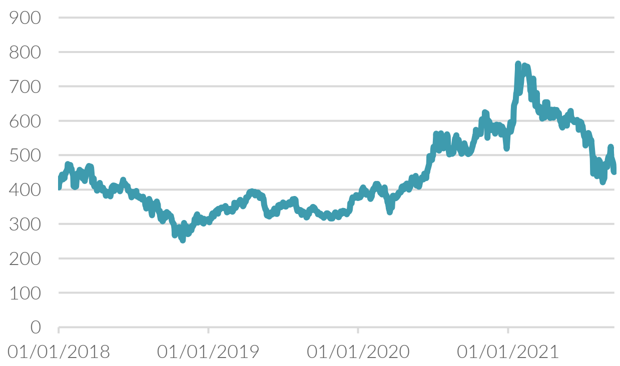
In his review of regulation,[11] Dale Nicholls, FCSS's portfolio manager, highlighted the example of Tencent, which suffered a near 50% fall in 2018 when the government halted new gaming licences. The left-hand chart below shows the Tencent share price rally since then. It shows that long-term growth factors outweigh short-term noise over time. The objectives behind regulation that we outlined above are far from unique to China. One only has to look to the collapse of large parts of the listed UK non-standard finance market to see social equality and consumer rights having dramatic effects there. Plus500 suffered a sharp fall in mid-2015 when it was forced to close to new business to enhance its compliance controls.

[9] Bloomberg 28 July 2021, *https://www.bloomberg.com/news/articles/2021-07-28/china-convenes-banks-in-bid-to-restore-market-calm-after-rout or Reuters 29 Jul'21* https://www.reuters.com/world/asia-pacific/china-regulator-talks-investment-banks-calm-market-jitters-sources-2021-07-29/

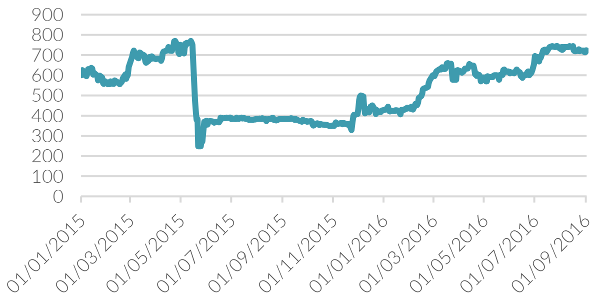
[10] https://investment-trusts.fidelity.co.uk/news-and-insights/china-special-situations/dale-nicholls-thoughts-on-chinas-evolving-regulatory-landscape/

[11] https://investment-trusts.fidelity.co.uk/news-and-insights/china-special-situations/dale-nicholls-thoughts-on-chinas-evolving-regulatory-landscape/

Tencent share price (HKD) 1 Jan 2018 to date



Plus500 share price 1 Jan 2015 to 1 Sep 2016 (p)



Source: Refinitiv, Hardman & Co Research

Opportunities for FCSS

Opportunities for FCSS include: i) general market sell-off creates value opportunities in unaffected businesses; ii) ESG regulations will create new markets, like EV, where Fidelity's global research can help identify local opportunities; iii) research and active management better identify real risks; iv) long-term Chinese growth driver of domestic demand unaffected; v) FCSS's bias to small/medium cap less affected by government targeting largest players; and vi) more domestic listings play to Fidelity's local analytical resources

We see a range of opportunities for FCSS from the regulatory changes and investor sentiment to them.

- First, sentiment may affect all share prices even when the regulatory risk is concentrated in specific names and sectors. This general market sell-off creates value opportunities and we note FCSS, in recent months, has increased its gross gearing to take advantage of such opportunities.

- Looking at the ESG plans, China is likely to see a rapid growth in electric vehicles (EV). The target is 20% of new sales by 2025, meaning it will be the biggest and fastest-growing EV market in the world. Fidelity's global analyst network helps it identify the best opportunities across the whole supply chain.

- FCSS's research means it can take an informed view of the risks, and avoid areas where either risk is known to be high or there is uncertainty. FCSS has a small exposure to one education sector company, having exited most after-school tutoring positions in 1H'21. Playing urbanisation through paint companies, not real estate ones, is a further example of the value of research in practice. The NAV outperformance seen YTD is at least indicative that it is less exposed to regulatory risk than the market as a whole.

- Stock market concerns and sentiment to Chinese stocks have a very limited impact on the key fundamental macro drivers we identified above – the rise of middle-class discretionary spending and a modernising economy, including online delivery. The main themes in which FCSS is investing remain robust.

- With the main risks appearing to be sector-specific and targeted at big-cap. companies, FCSS's bias to small-cap companies may further benefit from sentiment swinging it its favour. Furthermore, growth in such companies is a counter-balance to the largest companies and may be welcome by the authorities as an alternative to further regulation of large-cap names.

- It appears likely that some companies, which might previously have listed on overseas markets, will now choose to have their quotes on Mainland China or Hong Kong exchanges (we also note the new Beijing exchange targeting small and medium-sized enterprises). Given Fidelity's long-term local presence and large analyst team, such a move may see it have more mis-valuation opportunities than companies open to the broader scrutiny on global exchanges.

Other investment risks

Investor appetite for FCSS's approach

FCSS style of investing can be out of favour and, in such times, it faces a headwind compared with benchmarks

The chart below shows the performance from launch to FY'21. The average annual outperformance up to FY'20 was 3.7%, with six years of relative outperformance and four of underperformance. The FY'21 performance has since seen the annual average outperformance double. We highlight the pre-'21 period as it shows that, long term, FCSS was an outperformer even before the exceptional year. Within this long-term trend, there were three sequential years of underperformance in FY'18-20. This is primarily driven by the market's preference for large-cap tech stocks while FCSS has been more focused on smaller-cap names. We note the Chair's comments in the FY'19 Report and Accounts, "*The year was adversely affected by the general underperformance of small and mid-cap stocks*," and Dale's comments in FY'20 "*smaller market capitalisation stocks experienced substantial declines compared to larger market capitalisation stocks*".

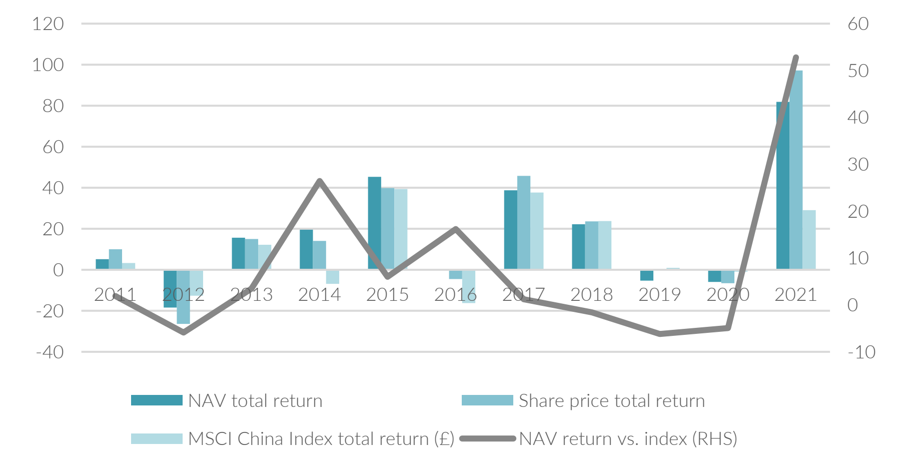
Gearing may compound issue in short term, but, in long term, approach has led to outperformance

In explaining the 6% underperformance against benchmark in the year to 2012, the Chairman commented "*The exposure to small and medium cap stocks was the largest detractor from performance as these experienced an unprecedented level of volatility during the year under review. The Company's decision to use bank borrowings to increase exposure to the market while valuations remain attractive detracted further from relative performance. Both of these factors are expected to enhance the performance of the Company relative to the market in more favourable conditions.*"

New China vs. old China

As a general rule, in addition to its small-cap bias, the portfolio is generally skewed to new China and underweight segments like banks, real estate, utilities. The latter can outperform when there is a style rotation into purer "value" and away from growth themes. Some also see volatility around regulatory news and can outperform when this noise is low.

Annual NAV, share price and MSCI Index total return and FCSS's relative performance (%)



Norte: 2011 from launch on 19 April 2010 to 31 March 2011. Source: FCSS Report and Accounts, Hardman & Co Research

Volatility of returns

FCSS investment style likely to generate incremental volatility in an already volatile market

FCSS has achieved long-term outperformance, but it is operating in markets that have volatility. The chart above shows the volatility of returns FY'11-21. Even before FY'21, the NAV average return was 11.7%, but this ranged from -19% to +45%. We note that FCSS's investment approach compounds the market volatility (even with some hedging derivatives). In eight of the years, FY'11-20, it showed more volatility than the benchmark index and in one year moved in the opposite direction. FY'21 was an even more extreme example, fortunately on the upside.

China: stock market trends and volatility

Chinese markets have been volatile

Historically, the Shanghai stock market has been characterised by periods of rapid appreciation and sharp declines.

October 2007 - October 2008, 72% correction – a speculative bubble led to sharp correction triggered by government action to control the bubble. We have not seen a rise of that kind in recent years.

- Between October 2007 and October 2008, the index fell from 6,124 to 1,728. Part of this reflected the spectacular bubble that had built from mid-2005 (the index rose more than 6x in a little over two years). As the market started to rise, there were announcements as the government tried to cool the bubble (e.g. a fall of 8% on 10 June 2008 as the central banks raised reserve requirements). Looking at the market in 2021, there simply was neither the same bubble built-in in advance nor the same degree of authority concern over a bubble.

From late 2009, concerns about a hard landing saw a four-year decline. Different now as there is a clear path to superior domestic demand fuelled by rising consumer spending.

- The Shanghai composite index fell from a level of 3,408 in July 2009 to 1,992 in July 2013. We believe, for much of this period, there was a debate about whether China faced a hard landing with forecasts of slowing growth (albeit still well above developed markets). We believe that, at the time, there was limited confidence in how China could revert to a long-term superior growth model. While many of the structural risks today are the same, what is different is that there is a clear path through domestic demand and modernisation.

June 2015 to March 2016 – 46% correction. In 2015, again, index saw a speculative bubble not present today not least as it was partially fuelled by retail investors borrowing to take positions. FCSS's NAV rose in year to March 2016,

- The index fell by 46% between June 2015 and March 2016. This correction followed a 2.5x rise in the year before the fall. The sharp correction appears to have been driven by a number of factors. China's Purchasing Managers' Index (PMI) declined steadily from August 2015 through to December, in that month falling below 50, i.e. indicting a potential recession in the core manufacturing activity. FCSS's March 2016 Report and Accounts also noted "*Negative sentiment towards China, led by concerns over its economic growth, movements in RMB and capital market policy have caused volatility since May 2015.*" This was compounded by inexperienced retail investors funding part of their investments through gearing. Once stocks started to fall, margin calls lead to forced selling and so further downward pressure. Again, we note that there simply has not been such a bubble, which would precede such a fall. We do not believe the market is currently concerned about the currency and, if anything, capital markets policies are favourable (see section above). The stock exchange trading is still dominated by retail investors, but changes since 2016 mean borrowing to fund positions should not be a material factor. It is worth noting that, in the year to March 2016, FCSS's stock selection growth in NAV in HK$ (19%) more than outweighed the market fall (16%).

China: geopolitical risk

We concur with FCSS and the likes of SMT in believing tensions between US and China likely to be embedded for many years

FCSS, like several other funds heavily invested in China (e.g. SMT), has the same view as us that high, and variable, levels of tensions between the US and China are likely to feature for the long term. There are simply too many points of friction (including Hong Kong, trade deficit, intellectual property, Uyghur) for relations to be "normal". It is probable that, as these issues evolve, tension, and perceptions of its impact, will be a factor for FCSS.

Direct portfolio risk limited with just 3% of investee company revenue coming from US…

In analysing the direct impact of US/China trade tension, FCSS's interim 2021 reported the disclosure on investee company sources of revenue. It highlights that the US is a very small percentage of revenue (3%) and FCSS has invested in businesses that will be driven by Chinese revenue streams.

…but there could be indirect effects through supply chains and US regulations on Chinese companies (20% of TNA in US exchange-listed companies)

Supply chains and end customers may also be affected by trade wars, but the effect is hard to quantify. Additionally, on 15 December 2020, MSCI removed 10 Chinese securities from its indices following similar moves by Dow Jones Indices, and FTSE Russell. In its release, MSCI noted "*Based on feedback from more than 100 U.S. and non-U.S. market participants, the Order may have a significant impact on the investment processes of global investors… In particular, non-U.S. market participants noted that the extensive presence of U.S. entities, such as commercial banks, broker-dealers, and custodians, within their chain of financial intermediaries would significantly limit their ability to transact in the impacted securities*." It is indicative of a risk that investment decisions could be affected by unilateral US action and 20% of July 2021 TNA is in companies listed on US exchanges.

FCSS showed no share price reaction on days of US announcements in 2020

FCSS had the following (table below) share price reactions on the days when specific sanctions were announced. We do not regard any as being significant, which is indicative that the market was not unduly concerned that FCSS would be affected by any of these announcements or potential fallout from them.

Share price reaction to sanction announcements

Date	Sanction announced	S/P move
9 July 2020	Sanctions and visa restrictions against senior Chinese officials, including CCP Politburo member Chen Quanguo, Zhu Hailun, Wang Mingshan and Huo Liujun	+2.5p
12 November 2020	President Donald Trump signed Executive Order 13959, titled "Addressing the Threat From Securities Investments That Finance Communist Chinese Military Companies". The executive order prohibits all US investors from purchasing or investing in securities of companies identified by the US Department of Defense as "Communist Chinese military companies".	+5.5p
7 December 2020	Sanctions on entire 14 Vice Chairpersons of the National People's Congress of China	+2.0p

Source: LSE, Hardman & Co Research

Wide range of other geopolitical risks, to date not slowed China growth materially

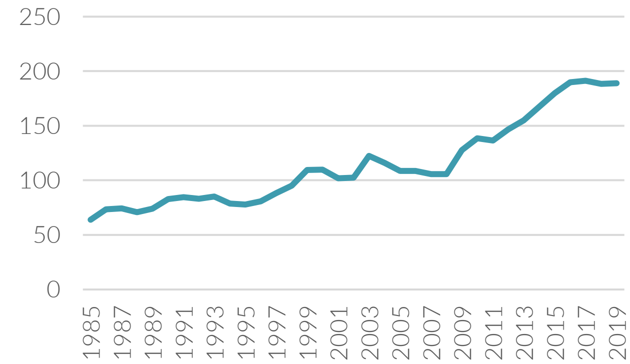
With a range of sensitive touch points, including Hong Kong security, human rights, intellectual capital, military presence in South China Sea, border rows with India, Taiwan, etc., there are multiple countries where the relationship may be strained/be perceived to be strained.

China: other economic risks

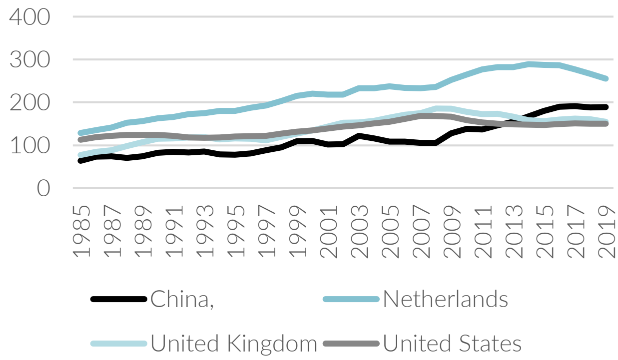
Government debt rising sharply, albeit well below many global peers. Private debt risen sharply and above international peers.

China's debt to GDP has been on a rising trend and was 53% of GDP in 2019 against 34% in 2009. China's private debt, loans and debt securities (as % of GDP), at 189%, is high by international standards (e.g. US: 150%, UK: 155%) and much of the debt has been issued by state-owned, non-financial corporations, which may struggle with inefficiencies, over-capacity and the debt burden (see section on zombie companies below).

China's private debt, loans and debt securities (as % of GDP)



International comparisons of same measure



Source: IMF Global; debt database, Hardman & Co Research

2020 central bank Financial Stability Review stress test scenarios indicate nearly a quarter of banking system would fail a stress test scenario where non-performing loans double

We note from the People's Bank of China (central bank) Financial Stability Review[12] (p34) published in November 2020 that commercial banks' capital ratios were rising (end-2019 core equity tier 1, 10.92%), liquidity was "*reasonably sufficient*" and that "*Non-performing loans (NPLs) increased slightly and the downward pressure on asset quality increased*." At end-2019, NPLs of banking institutions totalled RMB3.19tr, an increase of RMB349.8bn YoY. Pages 43-49 of the report go on to detail the stress tests covering 1,550 banks (78% of the banking sector). In the stress test on the risk of overall credit assets, the 30 large and medium-sized banks could meet the 10.5% total CAR regulatory requirement, showing a strong resilience to credit risk. For the 1,520 small and medium-sized banks, if their NPL ratio rises by 100%, 200% and 400%, their overall CAR would drop to 11.54%, 9.51% and 5.16%, respectively, in which case 589, 786 and 977 banks would fail the test, accounting for 23.55%, 40.30% and 62.56% of the total assets of tested small and medium-sized banks, respectively.

Loos-making, state-owned enterprises a potential drag, but government now open about need for their reform and likely to be supportive

One specific area of concern is zombie, state-owned enterprises where the businesses had been driven by non-financial considerations and many were/are inefficient. The table below shows the growing trend in the number of these loss-making businesses. The government has been taking action to address the problem (including allowing some high-profile failures like YongCheng Coal and Electricity or Huachen Automotive Group, a debt-for-equity swap in 2016), but has generally continued to support the businesses, either directly or through infrastructure projects from which they benefit.

Number of loss-making, state-owned enterprises (000s)

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
41.2	39.9	47.7	52.2	55.2	58.1	62.1	64.6	69.0	76.1

Source: Peterson Institute for International economics citing Ministry of Finance of China, 2019 China Fiscal Yearbook , IMF, Hardman & Co Research

Government increasing regulation of shadow-banking market (e.g. peer to peer), but was an important funder of SMEs and those unable to access mainstream credit

In November 2020, *S&P Global Market Intelligence*[13] reported that shadow-banking assets (including things like peer-to-peer lenders) totalled RMB22tr (down 3% YoY). In August 2020, China's Supreme Court slashed the legally protected ceiling of informal, lending which may see further pressure on the sector. By way of comparison, the article also reported that total outstanding RMB loans at Chinese financial institutions hit a record high of RMB169tr. We highlight shadow banking as a risk because it was a major provider to the SME sector, and it is unclear whether

[12] http://www.pbc.gov.cn/en/3688235/3688414/3710021/3982927/4154143/202101251735 2186067.pdf

[13] https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/china-s-shadow-banking-sector-may-shrink-further-as-economy-rebounds-61048109

mainstream lenders will pick up the slack. It was also important to borrowers who may have difficulties accessing traditional finance.

Rapid house price appreciation introduces risk of correction and we note government already taking preventative action to mitigate this

The FT reported on 5 April that China's central bank asked lenders to rein in 1Q'21 lending to the same levels as 1Q'20. Debt helped fuel the property sector with Chinese new home sales up 133% in January and February and property investment by 38%. In August 2020, the government unveiled its "three red lines" policy targeting balance sheet leverage among property developers and new rules restricted lending to developers and capped the percentage of total loans that could be mortgages.

Long term, narrowing current account surplus reflects transition to more developed economy rather than a reason for concern

The World Bank reports that China's current account balance as a percentage of GDP has fallen from the heady 10% in 2007 to ca.1% in 2019[14] with provisional data suggesting 2020 was back up to $310bn, just over 2%.[15] Rather than the fall being a concerning trend, we believe it reflects the transition of China from a low-cost, manufacturing centre into a more developed economy.

China faces same ageing populations as many other countries but has more time to adapt and learn lessons from other countries. In short term, it is boosting discretionary spending power.

Reuters reports[16] that the number of Chinese aged over 60 will rise from 254m in 2019 (18% of population) to 300m by 2025 and 400m by 2035 with the same report highlighting the number of people of working age could decline by 200m by 2050. This demography reflects the one-child policy introduced in 1978. Despite a relaxation of the policy, the World Bank,[17] citing UN World Population Prospects highlights that the birth rate has continued to decline. In 2018, it was just 10.9 births per 1,000 population against 11.9 in 2010 and 18.2 in 1980. In due course, China will face many of the same issues constraining GDP growth that say Japan is facing today. China has already started to address the issues – it is one factor driving the focus on modernisation and technology – and it has the advantage of being able to learn lessons from those countries that have had to face the problem earlier.

Sustained period of unemployment, which government clearly trying to avoid, could undermine some of the positive points about consumer demand

While, by international standards, Chinese unemployment is very low, the official data only covers part of the market – urban workers. It does not cover 149m self-employed business owners of nearly 300m migrant workers[18] and some historical analysis has indicated that the real rate is twice as high[19] as the reported rate.

China is not unique in many of these risks. What 2020 showed, though, is that the authorities can react quickly and very effectively and it has a number of tools to manage them. From an FCSS perspective, the detailed research it conducts on each company includes reviewing such factors as these. Indeed, the portfolio is positioned to take advantage of long-term growth opportunities (such as healthcare), which are emerging from them.

---

[14] https://data.worldbank.org/indicator/BN.CAB.XOKA.GD.ZS?locations=CN
[15] https://www.reuters.com/article/us-germany-trade-ifo-idUSKBN29Q332
[16] https://www.reuters.com/article/us-china-population/china-planning-new-policies-to-take-on-ageing-population-state-media-idUKKBN28300Y
[17] https://data.worldbank.org/indicator/SP.DYN.CBRT.IN?locations=CN
[18] https://www.scmp.com/economy/china-economy/article/3110193/china-unemployment-rate-how-it-measured-and-why-it-important
[19] National Bureau of Economic Research (US) https://www.nber.org/digest/oct15/official-statistics-understate-chinese-unemployment-rate

Portfolio

Sector trends over time

The table below shows how the portfolio has evolved by sector since March 2018. Of note: i) Consumer Discretionary overweight – this position is consistent with the rising middle classes and their ability to spend on discretionary items rather than necessities; ii) IT and Healthcare heavily overweight; and iii) Financials are overweight insurance but underweight banks; and iv) underweight in Materials, Consumer Staples, Real Estate and Utilities.

Portfolio sector summary (as % net assets as at end-March 2021 and July 2021 factsheet)

Sector	2018		2019		2020		2021		July 2021	
	FCSS	Bnchmk	FCSS	Bnchmk	FCSS	Bnchmk	FCSS	Bnchmk	FCSS	Bnchmk
Consumer Discretionary	32.3	9.2	35.5	22.5	47.5	27.5	36.4	33.9	32.6	33.4
Communication Services	1.5	4.3	22.2	26.0	21.0	22.0	26.1	20.5	20.5	17.9
Information Technology	42.1	40.8	20.6	3.0	18.0	4.4	14.5	6.0	16.2	7.1
Financials	14.5	23.0	18.7	22.1	15.7	19.4	15.7	14.4	11.1	13.4
Healthcare	7.8	2.7	9.6	3.0	12.8	4.6	13.5	6.7	15.9	8.2
Industrials	15.4	3.9	12.5	5.3	7.2	5.5	13.9	4.7	16.4	5.4
Materials	0.8	1.5	2.6	2.0	5.8	2.3	8.0	2.2	10.1	3.1
Consumer Staples	8.6	2.2	6.3	2.6	5.8	3.9	3.7	4.4	3.0	4.5
Energy	3.0	4.8	1.8	4.9	3.1	2.8	2.2	1.2	2.1	1.3
Real Estate	1.8	5.3	1.0	5.9	0.8	5.2	0.8	2.0	0.9	3.5
Utilities	1.9	2.3	0.4	2.7	0.0	2.4	0.8	4.0	1.1	2.3
Total gross asset exposure	129.7	100.0	131.2	100.0	137.7	100.0	135.6	100.0	130.0	100.0
Derivatives	-9.5		-5.1		-12.5		-9.4		-9.9	
Total inc. derivatives	120.2	100.0	126.1	100.0	125.2	100.0	126.2	100.0	120.2	100.0

Source: FCSS Report and Accounts, July Factsheet, Hardman & Co Research

Listing trends over time

Selected portfolio listings summary (as % net assets as at end-March 2021)

	2018		2019		2020		2021		July 2021	
	FCSS	Bnchmk	FCSS	Bnchmk	FCSS	Bnchmk	FCSS	Bnchmk	FCSS	Bnchmk
Listing										
HK	48.0	30.1	43.9	27.3	47.2	25.5	42.7	35.2	42.9	47.7
US	31.6	25.4	29.1	25.4	31.7	22.5	25.4	31.0	19.7	16.4
China "H" shares	19.3	32.3	21.8	30.8	19.0	27.4	20.2	17.6	17.4	18.1
China "A" shares	11.4	0.0	11.8	2.5	10.7	13.9	20.5	11.9	24.9	13.6
Red Chips	8.3	12.1	6.8	13.4	5.9	10.6	5.1	4.2	4.9	4.1

Source: FCSS Report and Accounts, July Factsheet, Hardman & Co Research

Market capitalisation trends over time

Portfolio summary (as % net assets as at end-March 2021)

	2018		2019		2020		2021		July 2021	
	FCSS	Bnchmk	FCSS	Bnchmk	FCSS	Bnchmk	FCSS	Bnchmk	FCSS	Bnchmk
Size (market cap)										
> £5bn	59.5	87.4	52.6	89.5	52.3	89.3	52.3	91.7	47.7	84.4
£1-£5bn	32.5	12.3	38.7	10.5	38.3	10.7	38.7	8.3	31.3	9.5
<£1bn	33.4	0.3	30.0	0.0	28.2	0.0	27.4	0.0	33.0	0.3
Unlisted	4.3	0.0	4.8	0.0	6.4	0.0	7.6	0.0	8.1	5.9
Total	129.7	100.0	126.1	100.0	125.2	100.0	126.2	100.0	120.2	100.0

Source: FCSS Report and Accounts, July Factsheet, Hardman & Co Research

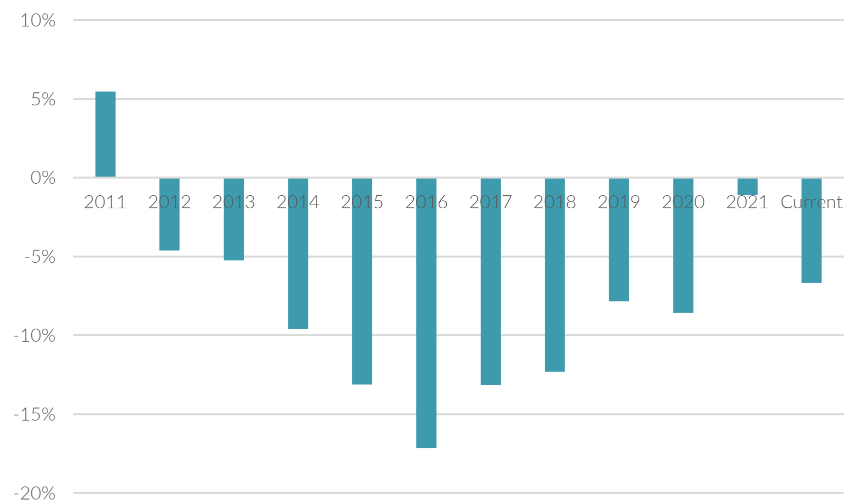
Valuation

Historical trend

Strong performance in 2017-18 saw discount to NAV reduce. With relative performance through COVID-19, this became a modest premium before sentiment to regulatory risk drove it back to small discount.

As can be seen for 2015-18, FCSS typically traded at a double-digit discount, reflecting both the political uncertainty at the time and the weak performance of the benchmark index (2016 total return -16% against FCSS's flat). This changed with the strong performance of the trust and index. The strong relative performance of China through the pandemic saw it rise to a modest premium before more recently falling back on regulatory concerns (and the small effect of lagging unlisted valuations).

Historical discount to NAV at end-March 2021 and 17 September 2021

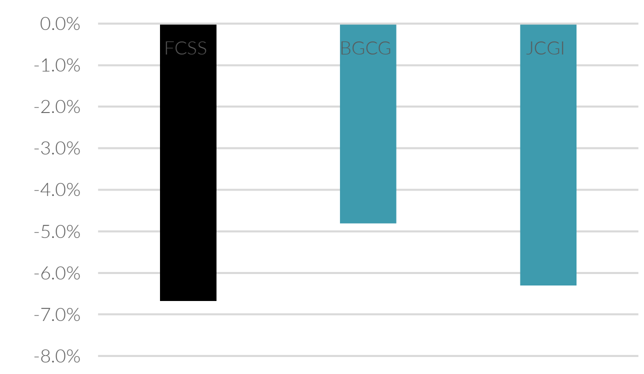


Source: FCSS Report and Accounts, FY ended March, LSE NAV announcement and share price dated 17 September 2021, Hardman & Co Research

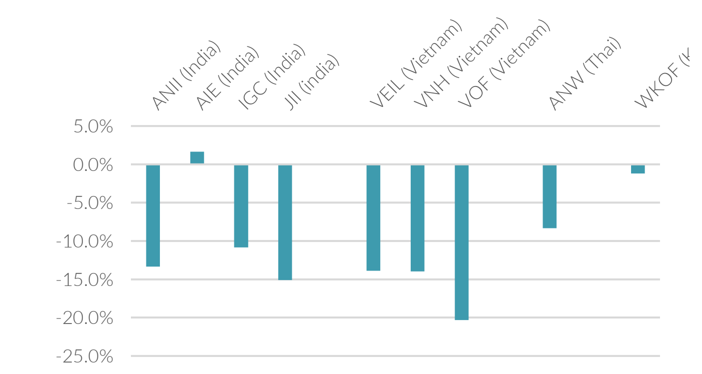
Peer comparisons

FCSS's discount to NAV is slightly above average for Chinese specific investment trusts (see left hand chart), but it is a lower discount than most Asian country-specific players. The yield of 1.4% is lower than Chinese or country-specific investments.

Immediate peers' premium/discount to NAV (%)



Wider peer premium/discount to NAV (%)



Source: LSE priced on 17 September 2021, Hardman & Co Research

Financials

Income statement (£000)

Year-end Mar	2021 Revenue	2021 Capital	2021 Total	2022E Revenue	2022E Capital	2022E Total	2023E Revenue	2023E Capital	2023E Total
Investment income	21,012		21,012	34,676		34,676	33,689		33,689
Derivative income	11,689		11,689	11,689		11,689	11,689		11,689
Other income	80		80	1,500		1,500	1,500		1,500
Total income	32,781		32,781	47,865		47,865	46,878		46,878
Gains/losses on inv. at FV through P/L		**725,388**	**725,388**		**-86,691**	**-86,691**		**210,558**	**210,558**
Losses on derivative instruments		**266,752**	**266,752**		**40,593**	**40,593**		**40,593**	**40,593**
Foreign exchange gains on other net assets		-12,401	-12,401		0	0		0	0
Foreign exchange losses on bank loans		7,825	7,825		0	0		0	0
Total income and losses	**32,781**	**987,564**	**1,020,345**	**47,865**	**-46,098**	**1,768**	**46,878**	**251,152**	**298,030**
Expenses									
Investment management fees	-4,119	-14,472	-18,591	-4,810	-15,486	-20,296	-5,006	-16,116	-21,122
Other expenses	-1,260	-108	-1,368	-1,300		-1,300	-1,350		-1,350
Profit/(loss) before finance costs and taxation	27,402	972,984	1,000,386	41,755	-61,584	-19,828	40,522	235,036	275,558
Finance costs	-2,253	-6,758	-9,011	-2,253	-6,758	-9,011	-2,253	-6,758	-9,011
Profit/(loss) before taxation	25,149	966,226	991,375	39,502	-68,342	-28,839	38,269	228,278	266,547
Taxation	-760		-760	-790		-790	-765		-765
Profit/(loss) after taxation for the year	24,389	966,226	990,615	38,712	-68,342	-29,629	37,504	228,278	265,782
Earnings/(loss) per ordinary share	**4.70**	**186.11**	**190.81**	**7.51**	**-13.26**	**-5.75**	**7.28**	**44.29**	**51.56**

Source: FCSS Report and Accounts, Hardman & Co Research

Balance sheet

@ 31 March (£000)	2015	2016	2017	2018	2019	2020	2021	2022E	2023E
Investments	1,001,043	987,878	1,295,266	1,495,818	1,423,161	1,289,807	2,167,275	2,105,584	2,341,142
Current assets									
Derivative instruments	43,907	20,275	48,639	37,518	19,235	39,152	33,296	33,296	33,296
Amounts held at futures clearing houses and brokers	1,383	12,740	2,069	30,247	81,451	39,495	19,872	19,872	19,872
Other receivables	3,388	3,531	13,154	10,714	737	1,407	22,749	22,749	22,749
Cash and cash equivalents	14,932	30,266	47,722	80,439	86,963	38,523	66,404	67,660	64,537
Total current assets	63,610	66,812	111,584	158,918	188,386	118,577	142,321	143,577	140,454
Total assets	1,064,653	1,054,690	1,406,850	1,654,736	1,611,547	1,408,384	2,309,596	2,249,161	2,481,597
Current liabilities									
Derivative instruments	-2,134	-28,082	-33,458	-34,841	-90,161	-45,183	-22,208	-22,208	-22,208
Bank loans	-101,014	-104,315	0	0	-115,331	0	0	0	0
Other payables	-17,370	-13,815	-9,933	-10,054	-4,467	-9,855	-31,937	-26,905	-21,909
Total current liabilities	-120,518	-146,212	-43,391	-44,895	-209,959	-55,038	-54,145	-49,113	-44,117
Net current assets	944,135	908,478	1,363,459	1,609,841	1,401,588	1,353,346	2,255,451	2,200,048	2,437,480
Long-term liabilities									
Bank Loans	0	0	-119,665	-106,975	0	-80,299	-72,474	-72,474	-72,474
Net assets	944,135	908,478	1,243,794	1,502,866	1,401,588	1,273,047	2,182,977	2,127,574	2,365,006
NAV per share	1.653	1.642	2.254	2.725	2.550	2.363	4.235	4.127	4.588

Source: FCSS Report and Accounts, Hardman & Co Research

Disclaimer

Hardman & Co provides professional independent research services and all information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable. However, no guarantee, warranty or representation, express or implied, can be given by Hardman & Co as to the accuracy, adequacy or completeness of the information contained in this research and they are not responsible for any errors or omissions or results obtained from use of such information. Neither Hardman & Co, nor any affiliates, officers, directors or employees accept any liability or responsibility in respect of the information which is subject to change without notice and may only be correct at the stated date of their issue, except in the case of gross negligence, fraud or wilful misconduct. In no event will Hardman & Co, its affiliates or any such parties be liable to you for any direct, special, indirect, consequential, incidental damages or any other damages of any kind even if Hardman & Co has been advised of the possibility thereof.

This research has been prepared purely for information purposes, and nothing in this report should be construed as an offer, or the solicitation of an offer, to buy or sell any security, product, service or investment. The research reflects the objective views of the analyst(s) named on the front page and does not constitute investment advice. However, the companies or legal entities covered in this research may pay us a fixed fee in order for this research to be made available. A full list of companies or legal entities that have paid us for coverage within the past 12 months can be viewed at http://www.hardmanandco.com/legals/research-disclosures. *Hardman may provide other investment banking services to the companies or legal entities mentioned in this report.*

Hardman & Co has a personal dealing policy which restricts staff and consultants' dealing in shares, bonds or other related instruments of companies or legal entities which pay Hardman & Co for any services, including research. No Hardman & Co staff, consultants or officers are employed or engaged by the companies or legal entities covered by this document in any capacity other than through Hardman & Co.

Hardman & Co does not buy or sell shares, either for their own account or for other parties and neither do they undertake investment business. We may provide investment banking services to corporate clients. Hardman & Co does not make recommendations. Accordingly, they do not publish records of their past recommendations. Where a Fair Value price is given in a research note, such as a DCF or peer comparison, this is the theoretical result of a study of a range of possible outcomes, and not a forecast of a likely share price. Hardman & Co may publish further notes on these securities, companies and legal entities but has no scheduled commitment and may cease to follow these securities, companies and legal entities without notice.

The information provided in this document 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 Hardman & Co or its affiliates to any registration requirement within such jurisdiction or country.

Some or all alternative investments may not be suitable for certain investors. Investments in small and mid-cap corporations and foreign entities are speculative and involve a high degree of risk. An investor could lose all or a substantial amount of his or her investment. Investments may be leveraged and performance may be volatile; they may have high fees and expenses that reduce returns. Securities or legal entities mentioned in this document may not be suitable or appropriate for all investors. Where this document refers to a particular tax treatment, the tax treatment will depend on each investor's particular circumstances and may be subject to future change. Each investor's particular needs, investment objectives and financial situation were not taken into account in the preparation of this document and the material contained herein. Each investor must make his or her own independent decisions and obtain their own independent advice regarding any information, projects, securities, tax treatment or financial instruments mentioned herein. The fact that Hardman & Co has made available through this document various information constitutes neither a recommendation to enter into a particular transaction nor a representation that any financial instrument is suitable or appropriate for you. Each investor should consider whether an investment strategy of the purchase or sale of any product or security is appropriate for them in the light of their investment needs, objectives and financial circumstances.

This document constitutes a 'financial promotion' for the purposes of section 21 Financial Services and Markets Act 2000 (United Kingdom) ('FSMA') and accordingly has been approved by Capital Markets Strategy Ltd which is authorised and regulated by the Financial Conduct Authority (FCA).

(Disclaimer Version 8 – Effective from August 2018)

Status of Hardman & Co's research under MiFID II

Some professional investors, who are subject to the new MiFID II rules from 3rd January 2018, may be unclear about the status of Hardman & Co research and, specifically, whether it can be accepted without a commercial arrangement. Hardman & Co's research is paid for by the companies, legal entities and issuers about which we write and, as such, falls within the scope of 'minor non-monetary benefits', as defined in the Markets in Financial Instruments Directive II.

In particular, Article 12(3) of the Directive states: 'The following benefits shall qualify as acceptable minor non-monetary benefits only if they are: (b) 'written material from a third party that is commissioned and paid for by a corporate issuer or potential issuer to promote a new issuance by the company, or where the third party firm is contractually engaged and paid by the issuer to produce such material on an ongoing basis, provided that the relationship is clearly disclosed in the material and that the material is made available at the same time to any investment firms wishing to receive it or to the general public…'

The fact that Hardman & Co is commissioned to write the research is disclosed in the disclaimer, and the research is widely available.

The full detail is on page 26 of the full directive, which can be accessed here: https://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-2031-EN-F1-1.PDF

In addition, it should be noted that MiFID II's main aim is to ensure transparency in the relationship between fund managers and brokers/suppliers, and eliminate what is termed 'inducement', whereby free research is provided to fund managers to encourage them to deal with the broker. Hardman & Co is not inducing the reader of our research to trade through us, since we do not deal in any security or legal entity.

research@hardmanandco.com

1 Frederick's Place
London
EC2R 8AE

+44(0)20 3693 7075

www.hardmanandco.com