PERSPECTIVES

AUGUST 2014

FIDELITY FUNDS CHINA CONSUMER FUND

Eye on long-term secular growth stories

Raymond Ma remains positive on the long-term outlook for "New China" sectors, even though these stocks have underperformed since March 2014. In particular, he focuses on six key underpenetrated sectors that should offer ample room for growth in the next 3–5 years.

WHAT IS YOUR ECONOMIC OUTLOOK FOR CHINA FOR THE REST OF 2014?

I believe that the Chinese government will focus on cyclical easing measures to sustain growth in the foreseeable future.

In the first quarter of 2014, Chinese Premier Li Keqiang said that a GDP growth rate of 6.8% was acceptable for the next few years. However, in the second quarter, Premier Li stated that the government would adjust its policy measures to ensure that the country reaches its 7.5% GDP target. This change in tone within such a short period of time indicates that the government is keen on maintaining a growth rate of above 7%.

Given that China's labour market remains resilient – the unemployment rate is at around 4% and wage growth is around 10% – the government's eagerness to propel growth is not related to employment. Rather, in view of the ongoing property market correction and rising non-performing loans in the banking sector, the government is trying to increase liquidity in the economy and keep its monetary and credit conditions accommodative.

As China's interest rates and reserve requirement ratio remain high and inflation stays benign, there is ample room for the government to implement targeted easing measures to increase money supply and drive growth in the near term. As such, growth is likely to rebound in the second half of the year, and GDP growth of 7.3–7.5% is expected in 2014.

WHAT ACCOUNTS FOR THE FUND'S RECENT UNDERPERFORMANCE?

A rotation from "New China" to "Old China" sectors, specifically banks and real estate developers, began in March 2014 after authorities announced a reduction in the reserve requirement ratio for some qualified banks and several Chinese cities relaxed home purchase restrictions. As a result, the fund's underweight stance in these segments weighed on relative returns.

Meanwhile, security selection in the consumer sectors detracted from performance. Holdings in casino operators Sands China and Galaxy Entertainment hurt returns after making a noteworthy contribution in the previous quarters. The Chinese government's efforts to curb high-end spending led to concerns about a decline in revenue growth at these casinos. Moreover, an overweight stance in consumer staples, particularly food producers, held back gains. For instance, worries over slower growth weighed on holdings in China Modern Dairy and China Mengniu Dairy.

On a positive note, an underweight stance in energy supported relative returns. In particular, the lack of exposure to CNOOC added relative value amid expectations that rising production costs could offset benefits from higher output and strong oil and gas prices.

RAYMOND MA is the portfolio manager of Fidelity Funds China Consumer Fund.

Raymond joined Fidelity International (Hong Kong) Ltd. in 2006 as an Investment Analyst and has covered China Telecoms, Financials and Consumer stocks. Raymond was made the Consumer Sector Leader in 2009. He was promoted to Director of Research in 2010 and then Portfolio Manager in 2011.

Raymond has over 13 years of experience in researching companies in the China market. His extensive research experience in the consumer universe gives him an edge in understanding regulations, industry trends and competition within the region.

Raymond graduated from Fudan University, Shanghai, with a Bachelor of Law. He also holds a Master of Law degree from the same university.

Fidelity™ WORLDWIDE INVESTMENT

WOULD YOU CONSIDER RAISING THE EXPOSURE TO CHINESE BANKING STOCKS IN VIEW OF THEIR CHEAP VALUATIONS?

The fund has remained significantly underweight or has avoided Chinese banks since inception. Despite their cheap valuations, I am concerned about the asset quality and rising leverage in the banking sector.

Chinese banks face liquidity issues stemming from the significant bank lending witnessed since 2009 to stimulate the economy through massive infrastructure projects. This resulted in a mismatch in short-term demand deposits (around half of the total deposits) vis-a-vis the huge long-term loan book. Although I do not expect a liquidity crunch in the banking system in the near-term as the deep-pocketed Chinese government should be able to avoid this problem, the margins and profitability of Chinese banks are likely to be undermined in the medium term. In addition, the interest rate liberalisation that took place in the Chinese banking sector could lead to a compression of net interest margins (NIMs) and falling profitability. As such, I see limited growth potential in the banking sector for the foreseeable future.

Instead, I maintain an overweight stance in Chinese insurers and brokerage companies as they are the key beneficiaries of China's financial reforms. Chinese insurers are expected to benefit from pension reforms and the resulting increase in sales of life insurance products. Brokerage firms should benefit both from an improvement in trading volumes in the near-term and an increase in direct financing and broadening of capital markets in the long term.

DO "NEW CHINA" STOCKS LOOK EXPENSIVE?

While valuations of "New China" stocks may appear expensive compared to "Old China" stocks, the valuation premium is justified as it is supported by solid fundamentals.

First, the outperformance of "New China" stocks over recent years has been largely driven by superior earnings growth of 20–40% per annum on average. Meanwhile, "Old China" companies have only been able to deliver an annual earnings growth of less than 10% in recent years. Second, "New China" stocks have much better earnings quality (in terms of margins, profitability, cashflow and leverage) than "Old China" stocks. Third, valuations of "New China" stocks look reasonable on a price-to-earnings-growth (PEG) basis given their strong earnings growth potential.

Indeed, the process of rebalancing the economy (less credit intensive, investment-led), correcting structural issues (e.g. high leverage and shadow banking) and pursuing reforms, has suppressed growth somewhat and put operating pressure on "Old China" industries, which mainly compete on volume. On the other hand, "New China" companies, which are less sensitive to macro cyclicality and short-term policy shifts, have experienced very strong growth due to technology advancement, changes in consumer behaviour and flexible business strategies.

All of the above factors suggest that the valuation premium of "New China" stocks is justified.

WHAT CHANGES HAVE YOU MADE TO THE PORTFOLIO RECENTLY?

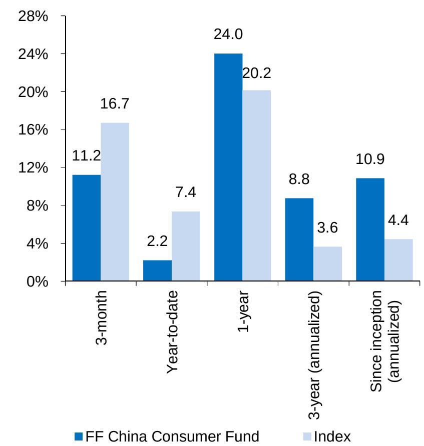
I raised the exposure to a number of Chinese insurance companies and securities brokers as they are expected to be the key beneficiaries of China's financial reforms. I also increased the allocation to selected Chinese property developers as ongoing policy easing should support property demand.

Conversely, the overweight exposure to internet and software stocks was reduced over the past quarter as their valuations were getting stretched. Moreover, I believe that this segment may experience some volatility ahead of the listing of Alibaba. However, as the Chinese internet industry continues to offer long-term secular growth, I will accumulate quality internet stocks on weakness.

Elsewhere, the allocation to Macau gaming stocks was reduced as these companies are facing heightened regulatory risks and their valuations appear to be stretched following the strong run over the previous quarters.

CUMULATIVE RETURNS (%)

as at 31.07.14



Source: Morningstar, NAV-NAV, gross income reinvested excluding initial charge in USD.

Index is the MSCI China Index. The fund was launched on 23 February 2011.

TOP 10 OVERWEIGHT HOLDINGS (%)

as at 31.07.14

	Fund	Index
AIA Group Ltd	8.7	0.0
Sands China Ltd	5.2	0.0
Galaxy Ent Group Ltd	3.8	0.0
Cathay Financial Hldg Co Ltd	3.6	0.0
Ping An Ins Group Co China Ltd	5.1	2.2
China Pac Ins Group Co Ltd	3.8	1.3
China Life Insurance Co Ltd	4.4	2.8
President Chain Store Corp	1.4	0.0
Uni-President Enterprises Corp	1.3	0.0
Li & Fung Ltd	1.2	0.0

Source: FIL Limited.
Index: MSCI China Index

Top overweights and underweights are those securities that had the largest active positions relative to the index. Holdings in different securities issued by the same company are aggregated, along with any exposure achieved by derivatives.

HOW DO YOU POSITION YOUR PORTFOLIO UNDER THE CURRENT MARKET CONDITIONS?

Rather than chasing stocks that are only expected to outperform in the next two to three quarters, I will maintain an overweight stance in “New China” sectors and will continue to identify long-term secular growth stories. In particular, I will focus on the following six areas to attain secular growth as they are generally underpenetrated and should have ample room for growth in the next three to five years:

1. **Insurance:** The sector is expected to benefit from pension reforms and the subsequent increase in sales of life insurance products.
2. **Brokerage:** Chinese brokers should benefit both from an improvement in trading volumes in the near term and an increase in direct financing and broadening of capital markets in the long term.
3. **Environmental protection:** Green energy (e.g. solar, wind and gas) and environmental protection (e.g. waste water treatment) development should continue to benefit from the government’s emphasis on environmental protection.
4. **Pharmaceuticals:** An ageing population, widening insurance coverage, stronger health care affordability and improving innovation capabilities should support strong growth in the sector in the coming years.
5. **Internet:** As of June 2014, China had 632 million internet users and a penetration rate of 46.9%. The country now has the largest number of e-commerce transactions in the world and is expected to witness superior growth in coming years.
6. **Consumer-related services:** Consumer-related services such as education, tourism and plastic surgery are among the fastest-growing industries in China, due to consumers’ changing lifestyles and the continuous increase in discretionary expenditure.

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