

Fund Perspective

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China's Consumer Sectors set to Outperform in Times of Volatility

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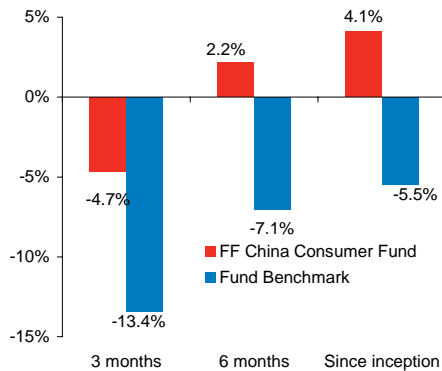
Raymond joined Fidelity International (Hong Kong) Ltd. in 2006 as an Investment Analyst and has covered China Telecoms, Financials and Consumer stocks. Raymond was made the Consumer Sector Leader in 2009. He was promoted to Director of Research in 2010 and then Portfolio Manager in 2011.

Raymond has over 10 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.

RETURNS (%)

as at 31.08.11



Net of initial 5% sales charge

-9.4% -2.9% -1.1%

Source: Fidelity, NAV-NAV, gross income reinvested. Since inception return is calculated from 23 February 2011. Benchmark is the MSCI China Index.

Past performance is not indicative of future performance.

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Raymond Ma, the portfolio manager of Fidelity Funds China Consumer Fund, believes that China is better positioned to withstand the global economic downturn nowadays. Given the lack of exposure to overseas markets, the impact from the global economic downturn on China's consumer sectors should be limited. Consumer stocks are set to outperform in the medium term on the back of solid consumption growth and potential margin expansion.

HOW DID THE FUND PERFORM IN THE RECENT MARKET VOLATILITY?

Chinese equity markets witnessed significant volatility in August 2011 amid concerns over the European debt crisis and the risk of a US recession. Despite the market fluctuations, the Fund still managed to outperform its benchmark by 3.3% in August. Timely sector rotation and prudent security selection were the key drivers of the fund's outperformance:

- **Timely rotation between consumer discretionary and consumer staples sectors.** I turned more defensive in August by reducing exposure to consumer discretionary plays such as automobiles and department stores. Instead, I added exposure to selected consumer staples names, namely China Mengniu and China Food, which proved beneficial as these stocks outperformed in times of volatility.
- **Reduced underweight in the telecom sector.** When the fund was launched in February 2011, I was significantly underweight in telecom plays. However, over the recent months, I have added exposure to stocks like China Mobile, China Unicom and Taiwan's Chunghwa Telecom as the rising popularity of smartphones and the rising demand for 3G and data plans should drive the revenue of these telecom plays. This strategy has worked well as investors' flight to safety led to the outperformance of defensive stocks during the volatile period.
- **Increased exposure to Hong Kong and Taiwan.** In view of China's higher inflation and credit tightening measures, I raised exposure to selected Hong Kong retailers like Luk Fook and Lifestyle International and Taiwan's Far Eastern Department Stores. The overweight in these retailers proved rewarding, as the Renminbi appreciation drives the spending of Chinese visitors in Hong Kong and Taiwan.

Favourable stock selection within the insurance industry. While I remain underweight in life insurance stocks in China, I maintain overweight in PICC Property & Casualty and AIA. Within Taiwan insurers, I trimmed exposure Fubon Financial Holding and used the proceeds to China Life Insurance (Taiwan). The stock selection has been successful as the selected insurers have significantly outperformed during the period.

WHAT IS YOUR VIEW ON THE GLOBAL ECONOMIC DOWNTURN? CAN CHINA WITHSTAND THE ECONOMIC SLUMP?

I turn more bearish over the global economic outlook for the next 12 months, in light of the deteriorating European debt crisis. In the near term, fundamental downtrend and market expectations for further economic stimulus are likely to keep the global markets in volatility.

However, I do believe that China is in a better position to withstand the global economic downturn nowadays. First, China is less dependent on exports than before thanks to a shift towards domestic demand. Meanwhile, over half of its exports are either going within the Asian region or to other emerging markets at present. As long as the US and Europe can avoid a recession, China's exports should hold up well due to resilient intra-Asia and intra-EM trades.

Second, despite the aggressive monetary tightening over the past year, economic data releases through to July 2011 showed that China's economic growth momentum remained healthy. Fixed asset investment in particular, continued to positively surprise (rose by 25.4% in the past seven months of the year from a year ago) on the back of sizeable investments in social housing projects.

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Even with the current sequential slowness in manufacturing, China's output is 50% above the pre-2008 crisis level and industrial production has remained at healthy mid-teen level. Retail sales growth and wage growth have remained resilient as well.

Third, solid fiscal and financial position is likely to keep China in a good shape. Government debt levels appear to be manageable when examined in the context of global debt levels. China's low consumer debt level is another factor supporting its financial system, with very high deposit levels at many leading Chinese commercial banks.

More importantly, the global economic downturn should accelerate the peaking out of China's inflation. Accordingly, China's inflation should start to decline in the 4Q11 and further monetary tightening is unlikely. The Chinese authority may also start to loosen its monetary policy by then.

WOULD CHINA'S CONSUMER SECTORS BE HAMPERED BY THE GLOBAL ECONOMIC DOWNTURN?

China's consumption momentum should remain strong in the foreseeable future. To a large extent, domestic department stores, supermarkets, retailers, and food and beverage manufacturers operate in China only and do not have operations overseas. Thus, the impact from the global economic downturn on China's consumer sectors should be quite limited.

Robust wage growth will be the key driver of stronger consumption in the foreseeable future. In 1Q11, 13 provinces and cities in China raised their minimum-wage levels by 14-28%. Household incomes in China are set to double during the period covered by the 12th Five-Year Plan (2011-15).

Meanwhile, consumer staples companies are expected to be potential beneficiaries of the global economic downturn, as the retreat of commodities prices on slowing global demand could lead to their margin expansion.

WHAT IS YOUR CHINESE MARKET OUTLOOK?

Although China is not insulated from the global economic downturn, resilient domestic demand driving the long-term growth should provide ample grounds for funds to flow back into China once the initial flight to safety abates.

Currently, China is trading at a forward P/E of 9.3x, which is at a significant discount to its 5-year average of 13.5x. Both China's 'A' and 'H' share markets are very attractive compared to regional peers and relative to history, trading near their minus one standard deviation from the historical average P/E level. We are definitely seeing more attractive buying ideas in China.

Given China's relatively solid fundamentals and Chinese market has been leading the global markets over the past few years, we believe Chinese equities would be among the first ones to come out from the market correction and would be the market outperformers in 2011, similar to what had happened in 2009. Among all, consumer sectors are set to outperform in the medium term due to solid consumption growth and their lack of exposure to the chaotic overseas markets.

GIVEN THAT CORPORATE GOVERNANCE ISSUES TEND TO BE EXAGGERATED IN A CAUTIOUS MARKET ENVIRONMENT, HOW DO YOU SELECT COMPANIES TO MITIGATE CORPORATE GOVERNANCE RISK?

First of all, I don't consider corporate governance issue as a unique Chinese phenomenon. From time to time, accounting frauds have been found among the US and the UK companies as well. Indeed, corporate governance of Chinese companies has significantly improved over the past decade, and the recently reported accounting scandals are only company-specific issues.

In order to avoid corporate governance risk, I undergo a stringent due diligence process before investing in a company. I favour listed companies with market capitalization of US\$1 billion or above. Amid the current credit-tightening cycle, larger companies tend to have better access to capital markets and their costs of capital are relatively lower than that of the small and medium enterprises (SMEs). On the contrary, SMEs that are short of cash may have to borrow from underground sources at interest rates of 20% or above. Hence, accounting frauds are found more commonly among SMEs as they have to cook the books to raise funds.

More importantly, I pay close attention to the cash flow statement of a company. While it is relatively easy for a company to manipulate its balance sheet and income statement, cash flow statement is an area that is difficult for one to conceal the frauds. Therefore, companies with strong cash flow generating capability, consistent earnings growth, solid management track records and sound fundamentals fit my stock selection criteria.

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HOW WOULD YOU POSITION YOUR PORTFOLIO UNDER THE CURRENT MARKET CONDITION?

In light of the slowing global economy, I favour domestic-oriented companies with increasing business focus on China's lower-tier cities. With the government's policy of urbanisation and development of inland provinces, both income and consumption growth in the rural and lower-tier cities in China is expected to grow faster than the Tier 1 cities in the years ahead.

Input costs remain high despite signs of easing. Hence, I prefer companies with market leadership, superior pricing power, strong margin sustainability and operating cost efficiency so that they can pass through the higher costs to end users or absorb part of them without a significant margin hit.

In view of China's monetary tightening policy, companies with strong balance sheets and low gearing are my top picks as solid financial position helps them to survive under a credit tightening environment.

Given the valuations of China's consumer stocks (especially for defensive consumer staples plays) remain high, I am looking to invest in selected oversold stocks. In general, I prefer large caps and avoid stocks that lack liquidity.

While I will maintain a defensive stance in times of volatility, I may increase exposure to certain oversold growth stocks by reducing exposure to defensive ones. Moreover, I may increase bets in China by reducing exposure to Taiwan in light of the former's solid fundamentals.



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