



AUGUST 2007

Martha Wang

Portfolio Manager

Martha Wang joined Fidelity International in mid-2005 and took over management of the fund in May 2006. Martha has nearly 13 years' experience researching Chinese companies, having worked with Indosuez WI Carr Securities, HSBC Asset Management and most recently with First State Investments. In addition to her research responsibilities, Martha provided portfolio management assistance at both First State Investments and HSBC Asset Management.

TOP TEN HOLDINGS (%)

as at 30.06.07

	Fund	BM
CHINA MOBILE	9.2	14.5
PETROCHINA	7.7	7.6
CHINA LIFE INSURANCE	7.6	6.9
PING AN INSURANC	5.9	2.7
CNOOC	4.9	4.7
CHINA CONSTRUCTION BANK	3.6	4.6
CHINA MERCHANTS BANK	2.5	-
SINA.COM	2.0	-
INDUSTRIAL & COMMERCIAL BANK	2.0	4.4
NINE DRAGONS PAPER	1.8	0.8

Benchmark: MSCI China Index

FIDELITY FUNDS CHINA FOCUS FUND

VALUATIONS KEY FOR CHINA STOCKPICKING

In May 2006, Martha Wang took over the management of the Fidelity Funds China Focus Fund. China's recent outperformance has naturally generated attention from investors as well as prompting government action. However, whilst some investors have used this outperformance to take profits, Martha continues to find attractively priced opportunities. Here Martha discusses her investment style, the outlook for Chinese equities and portfolio positioning over the first half of 2007.

WHAT IS YOUR OUTLOOK FOR CHINESE EQUITIES?

Strong economic growth and healthy corporate performance has seen Chinese equities perform strongly over the last year. In July, despite recent volatility, domestic Chinese equity indices have been robust. From an offshore perspective, MSCI China has re-rated in the last 18 months and is now trading close to 20x 2007 earnings compared to 12x as at 31 December 2005. This valuation may not seem cheap but is still reasonable for offshore Chinese equity.

The investment universe has expanded on the back of strong IPO activity both in Hong Kong and increasingly on the mainland, as the government encourages more companies to list on the A-share market. I take a positive view towards IPOs, as long as the quality is controlled. Essentially, the universe in A-shares is not representative of the underlying economy, but with more listings, this universe becomes more diverse and investors get more choice.

Looking ahead over the next 12 months, the September/October congress election is expected to extend the current party's tenure, offering stability, and, of course, the 2008 Olympics should see increased levels of consumption. Despite liquidity controls implemented by the government, the overall macro environment is benign, displays good fundamentals, and continues to provide good stockpicking opportunities.

HOW HAS THE FUND PERFORMED RECENTLY?

Over the last 12 months, the fund has returned 74.24%, compared to the benchmark return of 79.75%. Sector allocation has been the biggest detractor. Following 2006's strong performance, many sectors are now experiencing mean reversion. For example, utilities, which underperformed last year, began to catch up with the market. Stock selection continues to drive positive fund performance and I remain willing to invest in strong companies operating in what may otherwise be underperforming or unfashionable sectors. A good example is the financials sector, which has underperformed following profit-taking from investors. Nevertheless, I am willing to hold a number of banking stocks in which I have high conviction and which have outperformed the market. For instance, recent monetary tightening measures could reduce credit growth and constrain banks' operating margins, yet the fund's non-benchmark position in China Merchants Bank had a positive influence, owing to its strong presence in the fast-growing retail finance segment.

WHAT TRENDS DO YOU SEE SHAPING THE CHINESE MARKET GOING FORWARD?

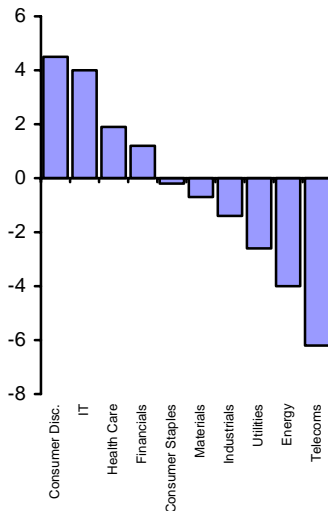
Strong global demand for Chinese goods continues to push the economy forward but the growth in domestic consumption is also a significant factor in the country's economic strength. In 2006, Chinese workers saw nominal wage growth of 8.0% and a 10% jump in personal disposable income¹. This compares to nominal wage growth of 4.6% for the US and 2.7% for Europe². So, I'm very keen on those companies which will be affected by lifestyle changes as Chinese consumers become wealthier. Currently, many companies that are positioned to benefit from this trend are mid-cap companies and are at the early stages of their earning cycle.

¹Source: Source: JP Morgan, June 2007

²Source: CLSA Asia-Pacific Markets, "Chain Reaction", February 2007

TALKING POINT

RELATIVE SECTOR WEIGHTINGS (%)
as at 30.06.07



Benchmark: MSCI China Index

"I'M VERY KEEN ON THOSE COMPANIES WHICH WILL BE AFFECTED BY LIFESTYLE CHANGES AS CHINESE CONSUMERS BECOME WEALTHIER"

A PERSONAL PERSPECTIVE FROM FIDELITY

For example, wine currently comprises only around 1% of the alcohol market but I expect this to increase as disposable income grows; wine companies should therefore benefit. Similarly credit card consumption is currently around 15% of GDP but this is expected to grow significantly over the longer term. Credit card companies like China Merchants Bank are well-positioned to capitalise on this trend.

HOW WOULD YOU DESCRIBE YOUR INVESTMENT STYLE?

I prefer stocks that can offer growth at reasonable valuations. Valuations are particularly important in view of the cyclical nature of the Chinese stock market. As such, I am keen to emphasise valuation criteria, such as price-to-book ratios, as part of the stock selection process. I look for companies which are industry leaders, with high entry barriers and low costs of production. I also favour companies where senior management has a flexible mindset and strategy. I regard these as essential requirements for capturing market share and driving earnings growth in China's rapidly changing environment. As a bottom-up stock picker I am free to invest outside the benchmark and am willing to invest across the market cap spectrum. I run a relatively concentrated portfolio and take large positions when conviction permits, so the top ten will see a number of positions that deviate from the benchmark.

WHAT ARE YOUR THOUGHTS ON THE A- AND H-SHARE MARKETS?

The H-share market's better valuations are proving more rewarding at present. Nonetheless, about 6% of the portfolio is invested in mainland or domestic Chinese equities and the market is attractive from a bottom-up stock picking perspective, especially as it is relatively under researched. We continue to look at investment opportunities within this structure, and, in fact, we are hiring a new investment analyst with considerable experience in domestic Chinese equities, dedicated to the A-share market.

Overall, the A-share market has performed very well, driven by strong economic fundamentals, liquidity and market sentiment. This has attracted government attention and led to moves to dampen liquidity levels with reserve and interest rate increases. Going forward it is likely there will be continued efforts to address excess liquidity and encourage greater capital outflow (a QDII quota expansion is imminent), as well as encouraging more Hong Kong-listed companies to list on the A-share market, thus increasing the supply of equities.

The risk profile for the A-share market has been increasing, given the potential for further tightening. However, it is important to note that the fund primarily invests in the offshore Chinese equity universe, limiting any potential impact on the fund. Stocks listed on both the A-share and H-share markets face a valuation gap of around 50%, with H-share stocks providing a better risk/return profile. Historically the two markets have been negatively correlated, due to different investor bases and liquidity flow. However, I believe that we should see an increasing correlation between the two markets given the greater number of dual-listed companies and the QDII/QFII expansions. Initially, I expect these expansions to primarily benefit the Hong Kong market as more capital flows from the mainland. Indeed, China's decision to relax restrictions on overseas portfolio investments has buoyed the Taiwan and Hong Kong markets. Over the long term, we should continue to see a net outflow of capital largely driven by China's strong FX reserves, but with Chinese investors willing to invest more widely. The QDII is one outflow channel and its expansion should facilitate further flows. Other outflows are taking the form of overseas acquisitions by Chinese companies and the government. For example, China Mobile, the country's largest mobile phone operator, recently acquired a Pakistan telecommunications provider. This activity adds a new dimension and interesting opportunities for investors in Chinese stocks.

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