TALKING **POINT**

A PERSONAL PERSPECTIVE FROM FIDELITY

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FIDELITY JAPAN FUND

JAPAN: IS THERE LIGHT AT THE END OF THE TUNNEL?

Rob Rowland

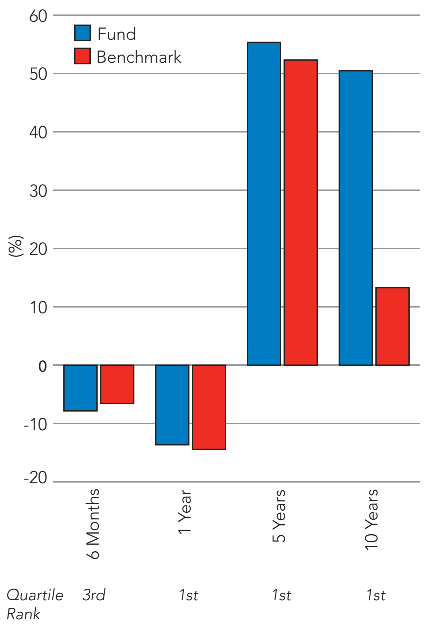
Portfolio Manager

Rob Rowland joined Fidelity as an equity Analyst in 1995, covering the semiconductors, semiconductor equipment, precision equipment and auto sectors. Robert became a Portfolio Manager in 1999 and has managed the Fidelity Japan Fund since August 2003.

Prior to joining Fidelity he spent 2 years with Barclays de Zoette Wedd in Tokyo as a Japanese Equity Analyst. Robert has an M.A. in International Business from Waseda University.

CUMULATIVE PERFORMANCE

as at 29.02.08



Source: Morningstar as at 29.02.08 on a bid to bid basis with net income reinvested.

Investor sentiment towards Japan has become almost universally negative. While downside risks remain, many companies are beginning to offer very attractive value on both a relative and an historic basis. Despite challenging stock market conditions for all Japanese equity funds that have meant negative absolute returns, the Fidelity Japan Fund outperformed its benchmark (Tokyo Stock Exchange TOPIX Total Return Index) and placed in the first quartile of the (IMA) Japan sector over the 12 months to February 29, 2008. Here, portfolio manager, Rob Rowland provides his outlook on the market and explains why sees good opportunities to buy quality blue chips at reasonable valuations.

HOW ARE YOU POSITIONING THE PORTFOLIO IN THE LIGHT OF RECENT VOLATILITY?

Despite the market turbulence, I have made very little change to the portfolio positioning since last summer. I am maintaining a highly concentrated portfolio with around 70-75 holdings where I have strong conviction in their earnings and share price growth potential. The focus remains on stocks with greater than expected earnings growth potential that are trading on multiples that are less than expected.

As the earnings outlook becomes increasingly uncertain, the market becomes overly sensitive to near-term growth momentum, However, I find a lot of attractive opportunities in stocks whose ability to create shareholder value over time remains intact.

In this environment, I continue to focus on large-cap blue chip companies, with good management, healthy balance sheets, and the ability to generate strong free cashflows. The Fund has overweight positions in internationally-competitive companies that command dominant positions in their respective markets. Usually large caps have a much lower implied discount rate than smaller companies by virtue of their better liquidity and stronger balance sheets. At the moment, implied discount rates are similar and this is a reason to be bullish on large caps as we can expect the discount advantage to reassert itself, to the benefit of large cap share prices.

In terms of style, the fund's style bias is currently neutral, with exposure to value and growth factors almost equally-weighted. This is largely a function of the market environment, where a number of quality blue chips have been sold down to a level below their book value.

WHAT THEMES ARE YOU PLAYING WITHIN THE FUND?

My positive outlook is reflected in the underweight exposure to traditional defensive sectors. Currently, I see attractive opportunities in oversold, quality blue chip companies on the basis of a medium to long term view. Exporters tend to be hit disproportionately when the yen appreciates and I see this as a good opportunity to pick up the stocks that I like at reasonable valuations.

Good examples can be found among auto makers, office equipment makers, industrial machinery, and materials makers, which are represented in the fund's current top overweight positions. As the yen has strengthened in recent months, the share prices of many blue chip exporting stocks have declined by a greater percentage than the overall market. However, if we take a two to three-year view, it appears that some leading exporters look very cheap relative to their growth potential. Many of these companies are actually generating strong free cash flows and their dividend payout ratio is higher than the market average. Because I have conviction in the long-term growth of exporters' core profitability, I do not hesitate to buy more shares on this kind of weakness.

I also favour companies that are benefiting from secular, rather than cyclical, growth that is driven by strong pricing power in highly value added products. For example, Konica Minolta has multiple growth drivers including LCD materials, copiers, and Blu-Ray components, while its strong cashflow suggests that there is a greater scope for dividend growth. Another example is Asahi Glass, an LCD glass maker that commands a large global market share In the glass substrate market where barriers to entry are high.

TOP TEN HOLDINGS (%)

as at 29.02.08

	Fund	Benchmark
CANON	**8.1**	1.8
TOYOTA MOTOR	**7.4**	4.5
SUMITOMO MITSUI FINANCIAL GROUP	**3.6**	1.8
HONDA MOTOR	**3.3**	1.6
MITSUBISHI UFJ FINANCIAL GROUP	**3.0**	3.2
KONICA MINOLTA HOLDINGS	**2.9**	0.2
MITSUBISHI	**2.7**	1.4
SUMITOMO ELECTRIC INDUSTRIES	**2.5**	0.3
NOMURA HOLDINGS	**2.2**	1.0
MITSUI	**2.2**	1.1

Source: Fidelity.

"It's critical to take a long term view at this point. Although downside risks remain, Japanese stocks now trade on historically low valuations and, in many cases, appear undervalued relative to their global peers. In this environment, I believe the key to successful investment is to avoid the 'value trap' and focus on 'growth' stocks at attractive valuations."

Rob Rowland, Portfolio Manager

The fund remains underweight in defensive sectors such as utilities, food and pharmaceuticals because I believe their valuations are very expensive relative to the rest of the market.

WHAT HAVE BEEN THE MAIN CONTRIBUTORS TO PERFOMANCE?

Over the last 12 months, the Fund has outperformed its benchmark and peer group. Most of the active return was made during the first five months, while the performance since last summer has markedly deteriorated amid the heightened global market turbulence. During the five months to the end of July 2007, holdings in automobile, technology and commodity-related large caps added significant value.

On the other hand, the fund's underperformance over the last seven months (to the end of February 2008) was primarily due to holdings in electronics parts and material makers. Investor sentiment towards these stocks was adversely affected by a continued downtrend in the ISM index and sharp yen appreciation. In addition, the fund's underweight exposure to defensive stocks such as foods, railways, pharmaceuticals, which come in to favour at a time of heightened uncertainty, detracted further from performance.

WHAT IS YOUR VIEW ON EXISTING VALUATION LEVELS?

While it is difficult to be optimistic at this point, we think the current market is significantly undervalued based on a discounted cash flow model and a dividend discount model. The market compares favourably with other developed markets in terms of both price-to-earnings and EV/EBITDA ratios, suggesting that the Japanese market is full of cash-rich under-geared companies. After a series of sharp corrections in recent months, the dividend yield for large companies listed on the Tokyo Stock Exchange First Section has risen well above Japan's long bond yield. This has tended to provide downside support for the market in the past. The current environment therefore offers opportunities to buy on weakness and build positions where long-term value exists.

ARE JAPANESE COMPANIES BECOMING MORE SHAREHOLDER FRIENDLY?

Japanese companies are increasingly bowing to pressure to raise shareholder value and dividend payouts have increased in each of the last two calendar years. Historically, the dividend payout ratio has been low in Japan and remains so relative to Europe and the US at around 23.8%. The respective figures for the US and Europe are closer to 36.1% and 35.7% respectively[1]. For Japan to enter this range, we need to see the dividend payout ratio increasing by 10 - 15%pa for the next three years. This improving focus on shareholder value is another reason for investors to be more positive.

WHAT IS THE OUTLOOK FOR JAPAN?

The Japanese stock market faces multiple headwinds and investor sentiment has become almost universally gloomy. The most prominent downside risks include an outright global recession, heightened pressure on profit margins from higher input costs and a stronger yen, a delayed recovery in housing starts and a lack of reform-oriented political leadership. Potential upside catalysts remain elusive for the time being although good news is likely to trade at a premium.

The recent trade data shows that export growth in terms of both volume and value is losing momentum, with a marked deceleration for exports to China. The latest quarterly survey of business sentiment, known as the Tankan also suggests that Japanese companies are expecting slower export growth and deterioration in export profit margins due to yen appreciation.

However, much of the negative news is now priced into company valuations, so there is potential for the market to make good advances even in the face of what may look like bad news. And on a two to three year view, the picture is even more compelling.

Notes: 1. DIR, as at December 2007.

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