It's a big, big world

FCSS provides exposure to China's thriving technological innovation.

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Investors are really spoilt for choice in this vast world: there are roughly 4,200 companies in the FTSE All-World Index, while bonds, commodities, property and infrastructure, to name just a few, provide a whole host of alternatives. Yet, sometimes, investors can be myopic, focusing on a very narrow part of this investable universe and eschewing diversification. We are currently living through one of these periods, as artificial intelligence (AI) conquers all.

Now, we're not downplaying the profound impact AI is going to have; we think it will be revolutionary, powering productivity gains and helping new stock market winners emerge. However, we're at the point where the haves (those stock markets with significant AI exposure) are beating the havenots disproportionately.

Take Asia, a continent of almost five billion with a total GDP of $40bn. As AI has dazzled, investor attention has been firmly focused on Taiwan and South Korea, supported by strong demand for semiconductors, AI infrastructure and advanced hardware.

This time last year, the MSCI Korea Index was trading on a cyclically adjusted price to earnings (CAPE) ratio of just under 15×; today it's climbed to c. 45×, higher even than the MSCI USA Index's c. 40×. Taiwan's CAPE is higher still, at c. 56×.

We fully believe that the boom for both these countries' stock markets is warranted. The booming demand for products made by the likes of Korea's SK Hynix and Taiwan's TSMC will no doubt drive future earnings for their respective country indices higher than ever before, making them look cheaper on a forward earnings basis.

Innovation nation

We do, though, think things have gotten slightly carried away. Investors' myopic focus on the AI powerhouses of the US, Korea and Taiwan means they are at risk of missing a whole world of opportunity to add diversification away from the increasingly pricey-looking AI trade.

The UK small-cap segment certainly stands out from a valuation perspective, but it must be acknowledged that it's hardly a bastion of technological innovation. For those seeking both above, we think China should be seriously considered. China is not only cheap on a forward price-to-earnings basis, trading at c. 10×, but the CAPE ratio is a lowly c. 14× to boot.

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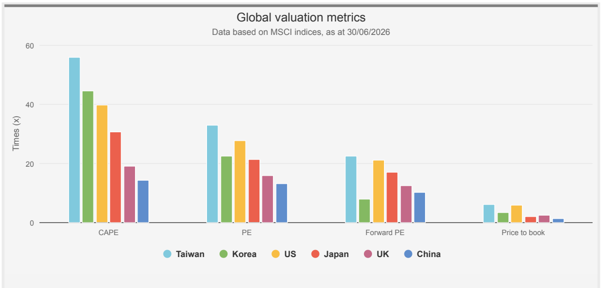
Fig.1: China Screens As Cheap



Source: MSCI, Barclays

Innovation and progress in China are thriving, encompassing not only AI (which people seem to have overlooked), but other exciting areas such as robotics, automation, advanced manufacturing and what is often referred to as "physical AI" – the application of artificial intelligence in the real world.

The fact that valuations ascribed to the Chinese are not only low in absolute terms, but also relative to many emerging market peers (the MSCI China Index trades at a c. 30% PE discount to the broad MSCI Emerging Markets Index).

This shows, in our view, that the market is underappreciating the global competitiveness and innovation capabilities of many Chinese industrial companies, particularly those moving up the value chain in the areas we've already mentioned.

Hyperfocus on semiconductors and memory chips is all well and good, but the expansion of AI infrastructure also requires substantial investment in power generation, energy management and electrical equipment – areas in which China is increasingly leading.

Companies across solar, batteries, inverters and power electronics are participating in this supply chain, leveraging manufacturing scale, engineering expertise and vertically integrated operations to capture new sources of demand. This adaptability is often underappreciated.

A broad opportunity set

At a time when the AI boom seems to be becoming narrower and focused on fewer companies, China's innovation story is becoming increasingly broad-based. Somewhat counter-intuitively, we think **this makes stock selection even more important**, since there will be winners and losers along the way.

Fidelity China Special Situations (FCSS) provides exactly that. Dale Nicholls has been managing FCSS for over 12 years now, having worked with the trust's first portfolio manager, Anthony Bolton, for a few years before taking over full management responsibilities.

Dale also manages the open-ended Fidelity Funds Pacific Fund, giving him a regional perspective on markets. We think the trust benefits from this as it helps to build a picture of the competitive position of companies in China.

Based in Hong Kong and Singapore, Dale spends a lot of time speaking with management teams and competitors of companies in which he invests or may choose to invest, engaging with hundreds each year. He also draws on the work of 16 dedicated Greater China analysts based in Shanghai and Hong Kong.

FCSS has a flexible, all-encompassing investment process that offers multiple sources of alpha, from not only capturing the opportunities in listed markets, but also picking from the best of the privately owned universe, offering an all-round differentiated option for investors.

This process has delivered substantial outperformance over long periods of time and, as investors' focus starts to become less myopic and broaden out their search for sources of innovation, we see considerable scope for future returns, enhanced by the current discount, which currently sits at c. 7%.

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