

**HSBC CHINA DRAGON FUND**  
Annual Report 2008



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# Investment Advisor's Report

**Period from 20 June 2007 (date of inception) to 31 March 2008**

## **Review**

The HSBC China Dragon Fund's Net Asset Value fell 6.3% since listing on 20 July 2007 in a volatile market environment during this period. China shares initially surged to record highs from July to October with the release of strong economic data, impressive interim earnings results and abundant liquidity inflow. China A-share companies posted an average interim earnings growth of 75% which triggered a further market rise.

China shares listed in Hong Kong, such as H-shares and red chip stocks, were boosted by the announcement that domestic insurance companies will be allowed to invest 15% of their total assets in overseas markets in July 2007. In August, H-share and red chips experienced massive sell-offs triggered by the US sub-prime crisis. However, the market quickly reversed this downward trend following the announcement on 20 August by the State Administration of Foreign Exchange that mainland citizens would be allowed to invest directly into the Hong Kong stock market. This new policy caused some jitters in the A-share market, but it did not stop the A-shares from rising as both the economic and corporate earnings growth remained strong.

China shares rose further in September and October on expectations that both QDII and Chinese individual money will soon bring additional liquidity into the market. During the 17th Party Congress in October, government highlighted key economic objectives for the next five years. This included quadrupling China's GDP per capita by 2020 (starting from 2000), improving the competitiveness of Chinese companies, and promoting energy saving and pollution control in China's manufacturing industries.

However, November and December brought news of a delay in the launch of the PRC individual investment scheme; expectations of additional credit tightening policies; and renewed concern over the worsening US sub-prime crisis. The market weakened further in January 2008 due to the high inflation rate in China, the impact of the severe winter in central China, and the increasing potential of slower global economic growth. Several initial public offerings scheduled for January were postponed due to poor market sentiment.

Financial and property stocks recovered in February on the back of rebounding loan growth and market speculation of imminent credit relaxation. During the National People's Congress in March, Premier Wen Jiabao affirmed that combating inflation will be the government's top priority in 2008 with a CPI target of 4.8% for the year.

China's CPI reached an 11-year high of 8.7% in February before easing to 8.3% in March, largely influenced by rising food prices. Economic growth remained strong going into 2008 with GDP in first quarter 2008 registering 11.6% year-on-year growth. Retail sales accelerated to 21.4% year-on-year from 16.8% in 2007. Fixed asset investment rose 24.6% year-on-year during the period. China's foreign exchange reserve surged to a new high of USD1.68 trillion by March 2008 on the back of a 21.4% rise in exports during the first three months of 2008.

## **Market outlook**

We believe market sentiment will remain cautious over the coming months due to concerns of further government tightening to curb inflation in China and the increased likelihood of slower global economic growth in 2008. However, we expect inflation to ease in the second half of 2008 as food prices ease. The Chinese government will likely maintain an overall tight credit policy over the coming months to curb inflation, and may also accelerate currency appreciation to reduce the cost pressure from imported raw materials. Corporate earnings growth will likely remain strong in 2008 on the back of continuing robust domestic consumption and investment growth in China.

**For and on behalf of  
Halbis Capital Management (Hong Kong) Limited**

24 July 2008

## Trustee's report to the unitholders of HSBC China Dragon Fund

We hereby confirm that, in our opinion, the Manager has in all material respects, managed HSBC China Dragon Fund ("the Fund") in accordance with the provisions of the Trust Deed dated 20 June 2007, as amended, for the period from 20 June 2007 (date of inception) to 31 March 2008.

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	)	
CHEUNG, Keith	)	For and on behalf of
LEUNG, Gary	)	HSBC Institutional Trust Services (Asia) Limited, Trustee
	)	
	)	

24 July 2008

## Independent auditor's report to the unitholders of HSBC China Dragon Fund

We have audited the financial statements of HSBC China Dragon Fund ("the Fund") set out on pages 4 to 21, which comprise the statement of assets and liabilities as at 31 March 2008, and the income statement, statement of changes in net assets attributable to unitholders and the cash flow statement for the period from 20 June 2007 (date of inception) to 31 March 2008, and a summary of significant accounting policies and other explanatory notes.

### **Trustee's and Manager's responsibilities for the financial statements**

The Trustee and the Manager are responsible for the preparation and the true and fair presentation of these financial statements in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants, and for ensuring that the financial statements comply with the relevant disclosure provisions of the Trust Deed dated 20 June 2007, as amended, and the relevant disclosure requirements set out in Appendix E to the Hong Kong Code on United Trusts and Mutual Funds issued by the Hong Kong Securities and Futures Commission ("the Code"). This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

### **Auditor's responsibility**

Our responsibility is to express an opinion on these financial statements based on our audit. This report is made solely to you, as a body, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and true and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Trustee and the Manager, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### **Opinion**

In our opinion, the financial statements give a true and fair view of the financial position of the Fund as at 31 March 2008 and of their transactions and cash flows for the period from 20 June 2007 (date of inception) to 31 March 2008 in accordance with Hong Kong Financial Reporting Standards, and have been properly prepared in accordance with the relevant disclosure provisions of the Trust Deed dated 20 June 2007, as amended, and the relevant disclosure requirements of the Code.

### **KPMG**

Certified Public Accountants  
8th Floor, Prince's Building  
10 Chater Road  
Central, Hong Kong  
24 July 2008

## Statement of assets and liabilities

As at 31 March 2008

	Note	HK\$
<b>Assets</b>		
Investments	8	3,228,821,569
Interest and other receivables		2,420,309
Cash and cash equivalents		169,925,839
		<hr/>
<b>Total assets</b>		3,401,167,717
		<hr style="border-top: 1px dashed black;"/>
<b>Liabilities</b>		
Taxation	7	24,554,349
Amounts payable on purchases of investments		715,846
Accrued expenses and other payables		5,705,128
		<hr/>
<b>Total liabilities (excluding net assets attributable to unitholders)</b>		30,975,323
		<hr style="border-top: 1px dashed black;"/>
<b>Net assets attributable to unitholders</b>		3,370,192,394
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<b>Number of units in issue</b>	11	371,910,000
		<hr style="border-top: 3px double black;"/>
<b>Net asset value per unit</b>		9.06
		<hr style="border-top: 3px double black;"/>

Approved and authorised for issue by the Trustee and the Manager on 24 July 2008

	)	
CHEUNG, Keith	)	For and on behalf of
LEUNG, Gary	)	HSBC Institutional Trust Services (Asia)
	)	Limited, Trustee
	)	
	)	
STOKES, Edmund Richard	)	For and on behalf of
LAM, Po Yee	)	HSBC Global Asset Management
	)	(Hong Kong) Limited (formerly
	)	known as HSBC Investments
	)	(Hong Kong) Limited), Manager
	)	

## Income statement

For the period 20 June 2007 (date of inception) to 31 March 2008

	Note	HK\$
Dividend income		5,813,643
Interest income on deposits	4	8,963,725
Gains on investments	5	692,352,817
Losses on investments	5	(802,587,490)
Net foreign exchange gain		392,564
		<hr/>
<b>Net investment income</b>		(95,064,741)
		- - - - -
<b>Expenses</b>		
Auditors' remuneration		(260,000)
Management fee	9(a)	(44,779,670)
Trustee's fee	9(b)	(3,156,109)
Transaction costs		(51,037,753)
Preliminary expenses	6, 9(e)	(128,385,708)
Custodian fee	9(c)	(1,703,654)
Other operating expenses		(1,344,265)
		<hr/>
<b>Operating expenses</b>		(230,667,159)
		- - - - -
<b>Loss attributable to unitholders before taxation</b>		(325,731,900)
Taxation	7	(23,175,706)
		<hr/>
<b>Loss attributable to unitholders after taxation</b>		(348,907,606)
		<hr/> <hr/>

## Statement of changes in net assets attributable to unitholders

**For the period from 20 June 2007 (date of inception) to 31 March 2008**

	<b>HK\$</b>
Subscriptions received from units issued	3,719,100,000
Loss attributable to unitholders after taxation	<u>(348,907,606)</u>
	3,370,192,394
Net assets attributable to unitholders, beginning of period	<u>–</u>
Net assets attributable to unitholders, end of period	<u><u>3,370,192,394</u></u>



## Cash flow statement

For the period from 20 June 2007 (date of inception) to 31 March 2008

	<b>HK\$</b>
<b>Operating activities</b>	
Management fee	(40,272,950)
Trustee fee	(2,783,534)
Transaction costs on investment	(51,037,753)
Preliminary expenses	(128,385,708)
Other operating expenses	(2,482,086)
	<hr/>
<b>Net cash used in operating activities</b>	(224,962,031)
	- - - - -
<b>Investing activities</b>	
Interest received	8,888,602
Dividend income received	5,813,643
QFII custodian deposit placed	(2,345,186)
Proceeds from sales of investments	3,770,576,212
Purchases of investments	(7,108,916,608)
	<hr/>
<b>Net cash used in investing activities</b>	(3,325,983,337)
	- - - - -
<b>Financing activities</b>	
Proceeds from issue of units	3,719,100,000
	<hr/>
<b>Net cash generated from financing activities</b>	3,719,100,000
	- - - - -
<b>Net increase in cash and cash equivalents</b>	168,154,632
<b>Cash and cash equivalents at the beginning of the period</b>	-
<b>Effect of foreign exchange rates changes</b>	1,771,207
	<hr/>
<b>Cash and cash equivalents at the end of the period</b>	169,925,839
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# Notes on the financial statements

**For the period from 20 June 2007 (date of inception) to 31 March 2008**

## **1. Background**

HSBC China Dragon Fund ("the Fund") is a closed-end unit trust governed by its Trust Deed dated 20 June 2007 ("the Trust Deed"), as amended. The Fund is authorized by the Hong Kong Securities and Futures Commission ("the SFC") under Section 104 of the Hong Kong Securities and Futures Ordinance. The Fund is also listed on The Stock Exchange of Hong Kong Limited ("the Stock Exchange") (a subsidiary of the Hong Kong Exchanges and Clearing Limited). The period fixed for the duration of the Fund is eighty years after the date of inception.

The investment objective of the Fund is to achieve long-term capital growth by investing primarily in listed companies established or operating in the People's Republic of China (PRC) or listed companies that are positioned to benefit from the strong economic growth potential and promising investment opportunities in the PRC, including but not limited to A Shares, B Shares, H Shares and shares issued by Red Chip Companies and other companies which carry out a significant proportion of their business activities in the PRC.

Under the prevailing regulations in the PRC, foreign investors can invest in the PRC A-Share market through institutions that have obtained qualified foreign institutional investor (QFII) status in the PRC. The Fund itself is not a QFII, but may invest directly in A Shares via the US\$200 million QFII investment quota obtained by the Manager.

## **2. Significant accounting policies**

### **(a) Statement of compliance**

The financial statements of the Fund have been prepared in accordance with all applicable Hong Kong Financial Reporting Standards ("HKFRSs"), which collective term includes all applicable individual Hong Kong Financial Reporting Standards, Hong Kong Accounting Standards ("HKASs") and Interpretations issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), accounting principles generally accepted in Hong Kong, the relevant disclosure provisions of the Trust Deed, as amended, and the relevant disclosure requirements of the Hong Kong Code on Unit Trusts and Mutual Funds issued by the Hong Kong Securities and Futures Commission. A summary of the significant accounting policies adopted by the Fund is set out below.

The HKICPA has issued certain new and revised HKFRSs that are first effective or available for early adoption for the current accounting period of the Fund. Note 3 provides information on the changes in accounting policies resulting from initial application of these developments to the extent that they are relevant to the Fund for the current accounting period reflected in these financial statements.

### **(b) Basis of preparation of the financial statements**

The functional and presentation currency of the Fund is Hong Kong dollars reflecting the fact that the units of the Fund are issued in Hong Kong dollars.

The measurement basis used in the preparation of the financial statements is the historical cost basis except that investments are stated at their fair value as explained in the accounting policies set out below.

## Notes on the financial statements

### For the period from 20 June 2007 (date of inception) to 31 March 2008

The preparation of financial statements in conformity with HKFRSs requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period or in the period of the revision and future periods if the revision affects both current and future periods.

Judgements made by management in the application of HKFRSs that have significant effect on the financial statements and estimates with a significant risk of material adjustment in the next year are discussed in note 13.

#### **(c) Financial instruments**

##### (i) Classification

The Fund designated all its equity investments into the financial assets at fair value through profit or loss category upon initial recognition.

Financial instruments are designated at fair value through profit or loss upon initial recognition when:

- the assets or liabilities are managed, evaluated and reported internally on a fair value basis;
- the designation eliminates or significantly reduces on accounting mismatch which would otherwise arise;
- the asset or liability contains an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract; or
- the separation of the embedded derivative(s) from the financial instrument is not prohibited.

Financial assets that are classified as receivables include interest receivables and other receivables.

Financial liabilities that are not at fair value through profit or loss include amounts payable on purchases of investments, accrued expenses and other payables.

##### (ii) Recognition

The Fund recognises financial assets and financial liabilities on the date it becomes a party to the contractual provisions of the instruments.

A regular way purchase or sale of financial assets and financial liabilities is recognised using trade date accounting. From this date any gains and losses arising from changes in fair value of the financial assets or financial liabilities are recorded.

Financial liabilities are not recognised unless one of the parties has performed their obligation under the contract or the contract is a derivative contract not exempted from the scope of HKAS 39.

## Notes on the financial statements

### For the period from 20 June 2007 (date of inception) to 31 March 2008

#### (iii) Measurement

Financial instruments are measured initially at fair value (transaction price). Transaction costs on financial assets and financial liabilities at fair value through profit or loss are expensed immediately, while on other financial instruments they are amortised.

Subsequent to initial recognition, all instruments classified at fair value through profit or loss are measured at fair value with changes in their fair values recognised in the income statement.

Financial assets classified as receivables are carried at amortised cost using the effective interest rate method less impairment loss, if any.

Financial liabilities, other than those at fair value through profit or loss, are measured at amortised cost using the effective interest rate method.

Upon termination of the Fund, a share of all net cash proceeds derived from the sale or realisation of the assets of the Fund less any liabilities, in accordance with their proportionate interest in the Fund at the date of termination. The unitholders' funds are therefore classified as a financial liability rather than equity in accordance with HKAS 32. It is shown on the statement of assets and liabilities as the "net assets attributable to unitholders".

#### (iv) Fair value measurement principles

The fair value of financial instruments is based on their quoted market prices at the date of the statement of assets and liabilities without any deduction for estimated future selling costs. Financial assets are priced at current bid prices, while financial liabilities are priced at current asking prices.

If a quoted market price is not available on a recognised stock exchange or from a broker/dealer for non-exchange-traded financial instruments, the fair value of the instrument is estimated using valuation techniques, including use of recent arm's length market transactions, reference to the current fair value of another instrument that is substantially the same, discounted cash flow techniques, option pricing models or any other valuation technique that provides a reliable estimate of prices obtained in actual market transactions.

Where pricing models are used, inputs are based on market data at the date of the statement of assets and liabilities. Fair values for unquoted equity instruments are estimated, if possible, using applicable price/ratios for similar listed companies adjusted to reflect the specific circumstances of the issuer.

Gains and losses on investments are included in the income statement. Realised gains and losses include net gains or losses on contracts which have been settled or for which offsetting contracts have been entered into.

#### (v) Impairment

Financial assets that are stated at cost or amortised cost are reviewed at each date of the statement of assets and liabilities to determine whether there is objective evidence of impairment. If any such indication exists, an impairment loss is recognised in the income statement as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate.

## Notes on the financial statements

### For the period from 20 June 2007 (date of inception) to 31 March 2008

If in a subsequent period the amount of an impairment loss recognised on a financial asset carried at amortised cost decreases and the decrease can be linked objectively to an event occurring after the write-down, the write-down is reversed through the income statement.

#### (vi) Derecognition

A financial asset is derecognised when the contractual rights to receive the cash flows from the financial asset expire, or where the financial asset together with substantially all the risks and rewards of ownership have been transferred.

Assets held for trading that are sold are derecognised and corresponding receivables from the brokers are recognised as of the date the Fund commit to sell the assets.

A financial liability is derecognised when the obligation specified in the contract is discharged, cancelled or expires.

The Fund use the weighted average method to determine realised gains and losses to be recognised in profit or loss on derecognition.

#### (vii) Offsetting

Financial assets and liabilities are offset and the net amount is reported in the statement of assets and liabilities when there is a legally enforceable right to set off the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

#### (viii) Cash and cash equivalents

Cash and cash equivalents comprise current deposits with banks. Cash equivalents are short-term highly liquid investments that are readily convertible to known amounts of cash, are subject to an insignificant risk of changes in value, and are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes.

### **(d) Revenue recognition**

Provided it is probable that the economic benefits will flow to the Fund and the revenue and costs if applicable, can be measured reliably, revenue is recognised in the income statement as follows:

#### *Interest income*

Interest income is recognised in the income statement as it accrues, using the original effective interest rate method.

#### *Dividend income*

Dividend income from listed investments is recognised when the share price of the investment goes ex-dividend. Dividends from other investments are recognised in the income statement as dividend income when declared.

## Notes on the financial statements

### For the period from 20 June 2007 (date of inception) to 31 March 2008

In some cases, the Fund may receive or choose to receive dividends in the form of additional shares rather than cash. In such cases, the Fund recognises the dividend income for the amount of the equivalent cash dividend with the corresponding debit treated as an additional investment.

#### **(e) Preliminary expenses**

Preliminary expenses of the Fund are charged to the income statement as incurred.

#### **(f) Expenses**

All expenses are recognised in the income statement on an accruals basis.

#### **(g) Taxation**

Taxation comprises current tax and deferred tax. Current tax and movements in deferred tax assets and liabilities are recognised in the income statement.

Current tax is the expected tax payable on the taxable income for the period, using tax rates enacted or substantively enacted at the date of statement of assets and liabilities.

Deferred tax is provided using the balance sheet method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes.

Apart from certain limited exceptions, all deferred tax liabilities, and all deferred tax assets to the extent that is probable that future taxable profits will be available against which the asset can be utilised, are recognised.

#### **(h) Translation of foreign currency**

Foreign currency transactions during the period are translated into Hong Kong dollars at the foreign exchange rates ruling at the transaction dates. Monetary assets and liabilities denominated in foreign currencies are translated into Hong Kong dollars at the foreign exchange rates ruling at the date of statement of assets and liabilities. Exchange gains and losses are recognised in the income statement.

#### **(i) Related parties**

For the purposes of these financial statements, a party is considered to be related to the Fund if:

- (i) the party has the ability, directly or indirectly, through one or more intermediaries, to control the Fund or exercise significant influence over the Fund in making financial and operating policy decisions, or has joint control over the Fund;
- (ii) the Fund and the party are subject to common control;
- (iii) the party is an associate of the Fund;
- (iv) the party is a member of key management personnel of the Fund or the Fund's parent, or a close family member of such an individual, or is an entity under the control, joint control or significant influence of such individuals;

## Notes on the financial statements

### For the period from 20 June 2007 (date of inception) to 31 March 2008

- (v) the party is a close family member of a party referred to in (i) or is an entity under the control, joint control or significant influence of such individuals; or
- (vi) the party is a post-employment benefit plan which is for the benefit of employees of the Fund or of any entity that is a related party of the Fund.

Close family members of an individual are those family members who may be expected to influence, or be influenced by, that individual in their dealings with the Fund.

#### **(j) Subscriptions**

The Fund recognises unitholders' subscriptions and allots units upon receipt of a valid subscription application.

#### **(k) Foreign exchange gains and losses**

Foreign exchange gains and losses on financial assets and financial liabilities at fair value through profit or loss are recognised together with other changes in the fair value. Included in the profit or loss line item *Net foreign exchange gain* are net foreign exchange gains and losses on monetary financial assets and financial liabilities other than those classified at fair value through profit or loss.

### **3. Changes in accounting policies**

The HKICPA has issued a number of new and revised HKFRSs and Interpretations that are first effective or available for early adoption for the current accounting period of the Fund.

The Fund has not applied any new standard or interpretation that is not yet effective for the current accounting period (see note 14).

### **4. Interest income**

During the period, the Fund earned all its interest income from cash and cash equivalents.

## Notes on the financial statements

For the period from 20 June 2007 (date of inception) to 31 March 2008

### 5. Gains and losses on investments

	<b>Period from 20 June 2007 (date of inception) to 31 March 2008 HK\$</b>
Realised gains	601,010,413
Unrealised gains	91,342,404
	<hr/>
Total gains on investments	692,352,817
	<hr style="border-top: 1px dashed black;"/>
Realised losses	(247,120,846)
Unrealised losses	(555,466,644)
	<hr/>
Total losses on investments	(802,587,490)
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Net losses on investments in equity instruments	(110,234,673)
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Gains and losses presented above exclude dividend income.

### 6. Preliminary expenses

The preliminary establishment expenses of the Fund, including the Stock Exchange initial listing fees, legal and other professional fees, underwriting commission, the SFC application fee, the SFC authorisation fee and printing and other expenses relating to the Global Offering and establishment of the Fund, which amounted to HK\$128 million, were borne by the Fund and were written off immediately on the first Valuation Day of the Fund.

### 7. Taxation

No provision for Hong Kong Profits Tax has been made in the financial statements as the Fund is exempted from taxation under section 26A (1A) of the Hong Kong Inland Revenue Ordinance.

Under current tax law in the PRC, as a foreign company which does not have an establishment in the PRC, the Fund is subject to PRC withholding tax at the rate of 10% in respect of its receipt of PRC-sourced income, including capital gains, dividend income and interest income.

Pursuant to Article 13 of the Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income ("PRC-HK DTA"), the taxing right in respect of gains derived by a Hong Kong tax resident from the alienation of shares of a PRC company, in which the assets of the PRC company comprised less than 50% of immovable property within three years prior to the transfer and the Hong Kong tax resident directly or indirectly holds less than 25% interest in the PRC company within a year prior to the transfer, are allocated to Hong Kong.



## Notes on the financial statements

### For the period from 20 June 2007 (date of inception) to 31 March 2008

Pursuant to the tax notice *Guo Shui Fa [1993] No. 45* ("Notice 45"), effective prior to 1 January 2008, a foreign company was exempt from withholding tax in respect of realised capital gains and dividend income derived from investment in B shares and H shares.

The PRC-HK DTA provides withholding tax rate for interest income derived from deposit with the custodians in the PRC to be reduced to 7%.

The Offering Circular of the Fund gives the Manager the right to provide for withholding tax on such gains or income and withhold the tax for the account of the Fund. In the absence of any precedent on the actual tax treatment of such gains to holders of QFII quota, but on the basis of the available information, the Manager has determined that it is appropriate to provide for realised gains on A-shares at the rate of 10% in the financial statements.

### 8. Investments

	HK\$
Listed equity securities	
– in Hong Kong	1,644,646,984
– outside Hong Kong	1,584,174,585
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	3,228,821,569
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### 9. Transactions with the Manager and its Connected Persons

Connected Persons of the Manager are those as defined in the Code on Unit Trusts and Mutual Funds established by the Hong Kong Securities & Futures Commission ("the Code"). All transactions entered into during the period between the Fund and the Manager and its Connected Persons were carried out in the normal course of business and on normal commercial terms. To the best of the Manager's knowledge, the Fund does not have any other transactions with Connected Persons except for what is disclosed below.

#### (a) Management fee

The fee payable to the Manager is calculated at the rate of 1.5% per annum of the net asset value of the Fund payable monthly in arrears. Any fees payable to the Investment Adviser should be borne by the Manager. The management fee charged by the Fund in respect of the period and payable at the end of the period amounted to HK\$44,779,670 and HK\$4,506,720 respectively.

The Fund has invested directly in A Shares via the US\$200 million QFII investment quota obtained by the Manager.

#### (b) Trustee's fee

The fee payable to the Trustee is calculated at the rate of 0.125% per annum for the first HK\$390 million of the net asset value, and 0.1% per annum thereafter. The trustee fee is accrued daily and payable in arrears on a monthly basis. The trustee fee charged by the Fund in respect of the period and payable at the end of the period amounted to HK\$3,156,109 and HK\$372,575 respectively.

## Notes on the financial statements

**For the period from 20 June 2007 (date of inception) to 31 March 2008**

**(c) Custodian fee**

The custodian fee is calculated at the rate of 0.1% per annum of the net asset value of the assets held by the QFII custodian as determined by the QFII custodian (based on the actual number of calendar days in a year). The custodian fee charged by the Fund in respect of the period and payable at the end of the period amounted to HK\$1,703,654 and HK\$61,884 respectively.

**(d) Bank balances**

Bank balances are maintained with the Trustee. The bank balances held with the Trustee as at 31 March 2008 amounted to HK\$169,925,839. During the period, interest earned on the above bank balances was HK\$8,963,725.

**(e) Underwriting fee and commission and fee of the Receiving Banker**

The Hongkong and Shanghai Banking Corporation Limited was one of the Underwriters of the Global Offering of the Fund. The Underwriters in total received underwriting commission of HK\$111,573,000 (HK\$0.30 for each unit) in relation to the units offered under the Placing and the Hong Kong Public Offering and the units issued pursuant to the exercise of the Over-allotment Option, out of which they might share part or all of the underwriting commission with intermediaries which introduced investors to subscribe for units under the Global Offering. In addition, The Hongkong and Shanghai Banking Corporation Limited also acted as the Receiving Banker under the Hong Kong Public Offering, and received a fee of HK\$658,293.

**(f)** In its purchases and sales of investments, the Fund utilises the brokerage services of The Hongkong and Shanghai Banking Corporation Limited. Details of transactions effected through this company are as follows:

	<b>The Hongkong and Shanghai Banking Corporation Limited HK\$</b>
Commission paid for the period	569,452
Average rate of commission	0.13%
Total aggregate value of such transactions for the period	452,844,440
Percentage of such transactions in value to total transactions for the period	4.09%

### 10. Soft dollar practices

The Manager, the Investment Adviser or any of its connected persons may effect transactions by or through the agency of another person (or person connected with him) with whom it has an arrangement under which that party will from time to time provide it with or procure for it goods, services or other benefits (such as research and advisory services, portfolio analysis or computer hardware and software incidental to such goods or services) the nature of which is such that their provision is of demonstrable benefit to the unitholders as a whole and for which no direct payment is made but instead the Manager, the Investment Adviser or any of its connected persons undertake to place business with that party. For the avoidance of doubt, such goods and services do not include travel, accommodation, entertainment, general administrative goods or services, general office equipment or premises, membership fees, employee salaries or direct money payments.

## Notes on the financial statements

**For the period from 20 June 2007 (date of inception) to 31 March 2008**

### 11. Units in issue

Units issued during the period	371,910,000
Number of units in issue carried forward	371,910,000

The Fund is a closed-end unit trust. There was no redemption of units during the period.

### 12. Financial instruments and associated risks

The Fund maintains investment portfolio in a variety of listed financial instruments as dictated by its investment management strategy. The investment objective of the Fund is to achieve long-term capital growth by investing primarily in listed companies established or operating in the PRC or listed companies that are positioned to benefit from the strong economic growth potential and promising investment opportunities in the PRC, including but not limited to A Shares, B Shares, H Shares and shares issued by Red Chip Companies and other companies which carry out a significant proportion of their business activities in the PRC. The risk exposures inherent in the Fund as at 31 March 2008 are summarised below. Details of such investments held as at 31 March 2008 are shown in the investment portfolio.

The Fund's investing activities expose it to various types of risks that are associated with the financial instruments and markets in which it invests. The Manager and the Trustee have set out below the most important types of financial risks inherent in each type of financial instruments. The Manager and the Trustee would like to highlight that the following list of associated risks only sets out some of the risks but does not purport to constitute an exhaustive list of all the risks inherent in an investment in the Fund. Investors should note that additional information in respect of risks associated with investment in the Fund can be found in the Fund's offering document.

During the period, the Manager invested in financial instruments which the Manager considered are commensurate with the risk level of the Fund in accordance with its investment objective.

The nature and extent of the financial instruments outstanding at the balance sheet date and the risk management policies employed by the Fund are discussed below.

#### **(a) Market risk**

##### (i) Price risk

Price risk is the risk that value of the instrument will fluctuate as a result of changes in market prices, whether caused by factors specific to an individual investment, its issuer or all factors affecting all instruments traded in the market.

The Fund is exposed to price risk arising from changes in market price of equity instruments. Price risk is managed by a diversified portfolio of investments across different industries in accordance with the investment objective of the Fund.

##### *Price Sensitivity*

All of the Fund's equity investments are listed on stock exchanges in Hong Kong or the PRC. A 5% stock increase in stock prices at 31 March 2008 would have increased the net assets attributable to unitholders by HK\$161,441,078; an equal change in the opposite direction would have decreased the net assets attributable to unitholders by an equal but opposite amount.

## Notes on the financial statements

For the period from 20 June 2007 (date of inception) to 31 March 2008

<b>Investment assets</b>	<b>31 March 2008 % of total assets</b>	<b>Change in equity price 2008 %</b>	<b>Effect on net assets attributable to the unitholders 2008 HK\$</b>
Listed equity investments:			
– in Hong Kong	48.36	5	82,232,349
– outside Hong Kong	46.57	5	79,208,729
	<u>94.93</u>		<u>161,441,078</u>

(ii) Interest rate risk

The majority of the Fund's financial assets are non-interest bearing. Interest-bearing financial assets are cash and cash equivalents. Changes in interest rates will not significantly change the net asset value of the Fund.

The following table indicates the effective interest rates for the relevant period and the expected next repricing dates (or maturity dates whichever are earlier) for interest bearing assets and liabilities at the date of statement of assets and liabilities.

	<b>2008</b>			<b>Total HK\$</b>
	<b>Less than 3 months HK\$</b>	<b>3 months to 1 year HK\$</b>	<b>Non-interest bearing HK\$</b>	
<b>Assets</b>				
Investments	–	–	3,228,821,569	3,228,821,569
Interest and other receivables	75,123	–	2,345,186	2,420,309
Cash and cash equivalents	91,602,582	–	78,323,257	169,925,839
<b>Total assets</b>	<u>91,677,705</u>	<u>–</u>	<u>3,309,490,012</u>	<u>3,401,167,717</u>
<b>Liabilities</b>				
Taxation	–	–	(24,554,349)	(24,554,349)
Amounts payable on purchases of investments	–	–	(715,846)	(715,846)
Accrued expenses and other payables	–	–	(5,705,128)	(5,705,128)
<b>Total liabilities</b>	<u>–</u>	<u>–</u>	<u>(30,975,323)</u>	<u>(30,975,323)</u>
<b>Total interest sensitivity gap</b>	<u>91,677,705</u>	<u>–</u>		

## Notes on the financial statements

### For the period from 20 June 2007 (date of inception) to 31 March 2008

(iii) Currency risk

The Fund invests in securities denominated in Renminbi and Hong Kong dollar. Consequently, the Fund is exposed to risks that the exchange rate of the Renminbi relative to the Hong Kong dollar may change in a manner that has an adverse effect on the value of the investments.

At the reporting date the Fund had the following exposure:

	<b>Assets HK\$</b>	<b>Liabilities HK\$</b>	<b>Net exposure HK\$</b>
<b>31 March 2008</b>			
Renminbi	<u>1,550,836,171</u>	<u>(24,776,308)</u>	<u>1,526,059,863</u>

Amounts in the above table are based on the carrying value of the assets and liabilities.

*Currency sensitivity*

At 31 March 2008, had the HKD strengthened by 5% in relation to all currencies, with all other variables held constant, net assets attributable to unitholders would have decreased by the amounts shown below.

**31 March 2008**

	<b>HK\$</b>
Renminbi	<u>76,302,993</u>
<b>Total</b>	<u><u>76,302,993</u></u>

A 5% weakening of the HKD against the above currencies would have resulted in an equal but opposite effect on the above financial statement amounts to the amounts shown above, on the basis that all other variables remain constant.

**(b) Credit risk**

Credit risk is the risk that a counterparty to a financial instrument will fail to discharge an obligation or commitment that it has entered into with the Fund.

At the reporting date, the Fund's financial assets exposed to credit risk amounted to the following:

	<b>HK\$</b>
Interest and other receivables	2,420,309
Cash and cash equivalents	<u>169,925,839</u>
<b>Total</b>	<u><u>172,346,148</u></u>

## Notes on the financial statements

### For the period from 20 June 2007 (date of inception) to 31 March 2008

Amounts in the above table are based on the carrying value of assets.

Credit risk arising on transactions with brokers relates to transactions awaiting settlement. Risk relating to unsettled transactions is considered small due to the short settlement period involved and the high credit quality of the brokers used.

Substantially all of the assets of the Fund are held by the Trustee or Bank of Communications Co., Ltd (the "QFII Custodian"). Bankruptcy or insolvency of the Trustee or the QFII Custodian may cause the Fund's rights with respect to securities held by the Trustee or the QFII Custodian to be delayed or limited.

The majority of the cash held by the Fund is deposited with Bank of Communications Co., Ltd and The Hongkong and Shanghai Banking Corporation Limited (the "banks"). Bankruptcy or insolvency of the banks may cause the Fund's rights with respect to the cash held by the banks to be delayed or limited. The Fund monitors the credit rating of the banks on an ongoing basis.

#### (c) *Liquidity risk*

The Fund's policy is to regularly monitor current and expected liquidity requirements to ensure that it maintains sufficient reserves of cash and readily realisable marketable securities to meet its liquidity requirements in the short and longer term.

The Fund's equity investments are considered to be readily realisable as they are all listed on stock exchanges in Hong Kong or the PRC.

#### *Residual contractual maturities of financial liabilities*

	<b>Less than 3 months HK\$</b>	<b>3 months to 1 year HK\$</b>	<b>No stated maturity HK\$</b>
<b>31 March 2008</b>			
Taxation	–	–	24,554,349
Amounts payable on purchases of investments	715,846	–	–
Accrued expenses and other payables	4,941,180	–	763,949
	<hr/>	<hr/>	<hr/>
Total liabilities	5,657,026	–	25,318,298
	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>

### 13. Fair value information

The Fund's financial instruments are measured at fair value on the date of statement of assets and liabilities. Fair value estimates are made at a specified point in time, based on market conditions and information about the financial instruments. Usually, fair values can be reliably determined within a reasonable range of estimates. For certain other financial instruments, including interest receivable, amounts receivable from sale of investments, provision for tax, deferred tax liabilities, amounts payable on purchase of investments, accrued expenses and other payables, the carrying amounts approximate fair value due to the immediate or short-term nature of these financial instruments.

## Notes on the financial statements

### For the period from 20 June 2007 (date of inception) to 31 March 2008

The carrying amounts of all the Fund's financial assets and financial liabilities at the date of statement of assets and liabilities approximated their fair values as at 31 March 2008.

#### **(a) Estimation of fair values**

The major methods and assumptions used in estimating the fair values of financial instruments were disclosed in note (c) of the significant accounting policies section.

At 31 March 2008, the carrying amounts of equity investments which fair values were determined directly by reference to published price quotations amounted to HK\$3,228,821,569. There is no equity investments for which fair values were determined using valuation techniques.

Quoted market prices are readily available for all the Fund's financial instruments.

Fair value estimates are made at a specific point in time, based on market conditions and information about the financial instrument. These estimates are subjective in nature and involve uncertainties and matters of significant judgement (e.g., interest rates, volatility, estimated cash flows etc.) and therefore, cannot be determined with precision.

#### **(b) Fair value**

All financial instruments are stated at fair value or carried at amounts not materially different from their fair values as at 31 March 2008.

### **14. Possible impact of amendments, new standards and interpretations issued but not yet effective for the annual accounting period ended 31 March 2008**

Up to the date of issue of these financial statements, the HKICPA has issued a number of amendments, new standards and interpretations which are not yet effective for the period ended 31 March 2008 and which have not been adopted in these financial statements.

The Fund is in the process of making an assessment of what the impact of these amendments, new standards and new interpretations is expected to be in the period of initial application. So far it has concluded that the adoption of them is unlikely to have a significant impact on the Fund's results of operations and financial position.

In addition, revised HKAS 1 "Presentation of financial statements" which is effective for accounting periods beginning on or after 1 January 2009, may result in new or amended disclosures in the financial statements.

## Investment portfolio

As at 31 March 2008

### HSBC China Dragon Fund

Holdings	Market value HK\$	% of total net assets attributable to	
		Market value HK\$	unitholders
<b>Listed investments</b>			
<b>PRC equities</b>			
Baoding Tianwei Baobian Electric	1,000,832	58,590,524	1.74
Baoshan Iron and Steel Co Ltd	5,183,459	71,447,166	2.12
Beijing Zhongke Sanhuan High-Tech	2,568,659	33,039,513	0.98
Chengdu B-Ray Media Co Ltd	2,544,156	75,105,046	2.23
China Enterprise Co Ltd	301,600	5,017,377	0.15
China Merchants Bank Co Ltd	1,957,500	69,778,407	2.07
China Southern Airlines Co Ltd	5,281,754	86,928,676	2.58
China United Telecommunications Corp	3,501,597	34,469,384	1.02
China Vanke Co Ltd	4,100,000	116,438,844	3.45
Chongqing Changan Automobile Co Ltd	6,934,395	74,495,095	2.21
East China Engineering Science & Tech Co Ltd	195,677	21,607,604	0.64
Fujian Septwolves Industry Inc	1,219,791	34,736,481	1.03
Fuzhou Tianyu Electric Co Ltd	2,635,271	81,772,296	2.43
Guangzhou Shipyard Int'l Co Ltd	590,000	28,319,258	0.84
Hangzhou Steam Turbine Co	2,729,991	32,759,892	0.97
Huadong Medicine Co Ltd	2,789,059	44,231,704	1.31
Huangshan Tourism Development	2,227,415	62,046,688	1.84
Jiaozuo Wanfang Aluminum Mfg Co Ltd	679,979	20,209,232	0.60
Kingdream Public Limited Co	2,566,608	43,352,878	1.29
Offshore Oil Engineering Co Ltd	2,101,654	105,891,430	3.14
Ping An Insurance Group Co	456,400	26,789,397	0.80
Shandong Gold Mining Co Ltd	567,858	89,016,794	2.64
Shanghai Int'l Airport Co Ltd	1,768,500	47,653,795	1.41
Shanghai Pudong Development Bank Co	3,789,000	148,605,503	4.41
TBEA Co Ltd	1,097,870	28,510,873	0.85
Tsingtao Brewery Co Ltd	1,040,000	29,547,249	0.88
Yantai Changyu Pioneer Wine Co Ltd	1,688,775	81,246,965	2.41
ZTE Corp	498,379	32,566,514	0.97
		1,584,174,585	47.01
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## Investment portfolio

As at 31 March 2008

### HSBC China Dragon Fund

<b>Holdings</b>	<b>Market value HK\$</b>	<b>% of total net assets attributable to unitholders</b>
<b>Listed investments</b>		
<b>Hong Kong equities</b>		
Anhui Conch Cement Co Ltd	730,000	1.15
Belle International Holdings Ltd	4,555,000	1.09
Catic International Holdings Ltd	50,992,000	0.41
China Bluechemical Ltd	12,000,000	1.46
China Comm Construction Co Ltd	2,100,000	1.07
China Construction Bank	9,000,000	1.54
China Life Insurance Co Ltd	5,440,000	4.33
China Mobile Ltd	1,750,000	6.01
China National Building Material	1,646,000	0.89
China Oilfield Services Ltd	10,700,000	4.04
China Overseas Land & Investment Limited	4,833,001	2.04
China Petroleum & Chemical Corp	9,008,000	1.78
China Railway Construction Corp	2,369,000	0.75
China Shipping Development Co Ltd	3,000,000	2.17
China Travel Int'l Inv Hong Kong Ltd	12,134,000	1.13
China Unicom Ltd	4,222,000	2.05
China Yurun Food Group Limited	3,575,000	1.04
CNOOC Ltd	11,800,000	4.01
Gome Electrical Appliances Hldgs Ltd	1,300,000	0.68
Industrial and Comm Bank of China	25,000,000	4.00
Parkson Retail Group Ltd	685,500	1.33
Petrochina Co Ltd	7,068,000	2.03
Ping An Insurance (Grp) Co of China	1,000,000	1.63
Sinotruk Hong Kong Ltd	3,000,000	0.66
Want Want China Holdings Ltd	4,804,000	0.41
Zhaojin Mining Industry Co Ltd	800,000	0.60
Zijin Mining Group Co Ltd	2,278,000	0.50
	1,644,646,984	48.80
	3,228,821,569	95.81
<b>Total investments</b>		
(Total cost of investments: HK\$3,717,085,041)		
<b>Other net assets</b>	141,370,825	4.19
<b>Total net assets</b>	3,370,192,394	100.00

## Statement of movements in portfolio holdings

For the period from 20 June 2007 (date of inception) to 31 March 2008

	<i><b>% of total net assets attributable to unitholders</b></i>
Equities	95.81
<b>Total investments</b>	95.81
<b>Other net assets</b>	4.19
<b>Total net assets attributable to unitholders</b>	100.00

## Performance table

**For the period from 20 June 2007 (date of inception) to 31 March 2008**

**(a) Total net asset value**

Total net asset value HK\$3,370,192,394

**(b) Total net asset value per unit**

Net asset value per unit HK\$9.06

**(c) Price record**

The Fund is a closed-end fund listed on The Stock Exchange of Hong Kong Limited and no unitholders may demand redemption of their units. In general, closed-end funds may trade on the exchange at a discount or at a premium to their net asset value. There is no assurance that the units will be traded at a price that is equal to the Net Asset Value. As the market price of the units may be determined by factors such as the Net Asset Value and market supply and demand for the units, there is a risk that the units will be traded at a discount to its Net Asset Value. In times of market disruption or when there is an insufficient number of buyers and/or sellers of the units, the bid/ask spread of the market price of the units may widen significantly.

Year	Net asset value per unit	
	Lowest HK\$	Highest HK\$
2008 (since inception)	8.62	13.94

## Administration and management

### **Directors of the Manager**

Executive Directors:

APENBRINK, Rudolf Eduard Walter

AU, King Lun

LAM, Po Yee

STOKES, Edmund Richard

LOUIE, Ngar Yee (resigned on 5 May 2008)

Non-Executive Directors:

CHENG, Hoi Chuen Vincent

CHEANG, Wai Wan Louisa

ENGEL, Conrado

FRIED, David Lawrence

LEECH, Paul Ernest

LEUNG, Ko May Yee Margaret

LEUNG, Wing Cheung William

MCCOMBE, Mark Seumas

AMANDINI, Peter James (appointed on 5 May 2008)

### **Trustee**

HSBC Institutional Trust Services (Asia) Limited

HSBC Main Building

1 Queen's Road Central

Hong Kong

### **Registrar and Processing Agent**

Computershare Hong Kong Investor Services Limited

Shops 1712-1716, 17th Floor

Hopewell Centre

183 Queen's Road East

Wanchai

Hong Kong

### **Manager**

HSBC Global Asset Management (Hong Kong) Limited

(formerly known as HSBC Investments (Hong Kong) Limited)

HSBC Main Building

1 Queen's Road Central

Hong Kong

### **Investment Adviser**

Halbis Capital Management (Hong Kong) Limited

HSBC Main Building

1 Queen's Road Central

Hong Kong

### **QFII Custodian**

Bank of Communications Co., Ltd

188, Yin Cheng Zhong Road

Shanghai 200120

The People's Republic of China

### **Auditors**

KPMG

Certified Public Accountants

8th Floor, Prince's Building

10 Chater Road

Central

Hong Kong

