THE CHINA FUND

INVESTMENT MANAGER'S REPORT

PERFORMANCE

Despite a difficult year for global equities last year, The China Fund rose 4.6%, outperforming the CLSA China World Index, which declined 2.5%. Being underweight in the telecommunication sector and overweight in cyclical stocks contributed to the Fund's out-performance.

In the period under review, Red Chips underperformed, declining 24.2%, dragged down by the performance of the telecommunication stocks and the conglomerates. H shares however, rose 9.2%. B shares were also down despite the initial excitement of allowing local Chinese access to the market.

At the end of the period, the Fund was 43.1% invested in Red Chips, 35.3% in H shares, 5.9% in B shares, 11.5% in Hong Kong companies engaged in China business, and cash was at 4.2%.

ECONOMIC REVIEW

Fixed asset investments contributed to 60% of 2001's economic growth and it will continue to sustain growth in the coming year. In the first two months of 2002, State fixed asset investments shot up 24.5%, compared to 13.7% growth in 2001. To fund State spending, the fiscal deficit is expected to rise to 2.9% of GDP in 2002 from 2.6% in 2001.

Exports dropped off in the 4th quarter of 2001, but recovered in 2002. For the first two months of 2002, exports rose 14.1%. This should be substainable given the surge in The Organisation for Economic Corporation and Development (OECD) leading indicator and China's increasing market share after its entry into the World Trade Organisation (WTO) this year.

After remaining fairly resilient in 2001, consumer spending slowed in the last few months. Retail sales rose only 8.5% in the first two months of 2002 compared to a stable growth of around 10% in 2001. This was particularly evident in the cities, where retail sales growth has moderated to 9.3% from above 11% in the past two years. This could be attributed to the lackluster stock market performance, and rising concern on unemployment due to China's entry into the WTO.

MARKET REVIEW

China shares were quite stable in the year under review. Unlike the rest of the global markets that plunged after 11th September last year, China shares were not sold off as they were relatively more insulated from the US. As such, when other markets, anticipating economic recovery, rallied in the last few months, the rise in the China shares was less substantial.

Most of the larger index stocks did not perform well in the year, as their earnings momentum had slowed and valuations were not cheap. Power and infrastructure stocks, which offer predictable earnings growth, outperformed. Upstream oil stocks also held up well due to the rise in oil price in the last few months.

OUTLOOK

Given the sustained strength in fixed asset investments and the recovery in exports, we expect China's GDP to grow 7.5% in 2002. While consumer spending has slackened in recent months, we believe that exports recovery will have a spillover effect on domestic consumption. As such, retail sales should pick up later in the year.

Indeed, the entry into the WTO has brought in new competitors and pricing pressure has intensified in the industries that were previously protected. Passenger cars, for example, saw an increase in imports after a 15% reduction in import tariffs. Although domestic producers had to reduce their prices accordingly, auto sales boomed, rising 21% in the first two months of 2002. Clearly pricing pressure is unlikely to be eased, but the efficient companies will eventually benefit from a bigger market as foreign competitors help to expand the number of consumers.

Although several companies that have committed to restructuring have been diligently delivering their promises in the past year, we do not expect there to be major government policies on reforms in the near term. Due to the sensitivity in political handover this year, social stability is expected to be a high priority and drastic changes are unlikely to occur.

We welcome the reduced volatility in China shares as a sign of a maturing equity market. Despite concerns on competition brought by WTO and the slow down in retail sales, we are sanguine that domestic consumption will recover and we have therefore increased exposure to the consumer stocks. We also maintain our weighting in cyclical stocks, which will benefit from the global economic recovery. With our balanced portfolio, we look forward to another good year for The China Fund.

Deutsche Asset Management (Asia) Limited
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