INVESTMENT MANAGER'S REPORT

PERFORMANCE

The China Fund's net asset value per share decreased 3.1% (as adjusted for dividends) during the year. This compares with a 10.1% decrease in the CLSA China World Index in the same period.

The Fund identified the transportation sector as the major beneficiary of China's strong export growth and was overweight in stocks such as Cosco Pacific and Zhejiang Expressway. The Fund's out-performance was also attributable to the overweight position in the power sector which has benefited from higher demand for power driven by stronger economic growth. The Fund's underweight position in telecommunications and private-enterprise stocks also helped performance.

At the end of the year, the Fund was 40.0% invested in Red Chips, 40.7% in 'H' shares, 5.4% in 'B' shares and 7.0% in Hong Kong companies engaged in business in China. Cash accounted for 6.9% of the portfolio.

ECONOMIC REVIEW

China's GDP was up 8% in 2002. Fixed asset investments (FAI) continued to be the growth driver and contributed about 45% to the GDP growth. However, the growth decelerated from an average of 24.4% in the first half of 2002 to 17.4% for the full year. This is partly a reflection of government's intention to control FAI due to the increasing fiscal deficit.

China's economy was also fuelled by a stronger-than-expected export growth of 22.3% during the year. The strong exports indicated that China is becoming increasingly important as the manufacturing base for multi-national companies after its entry into the World Trade Organization (WTO). Export growth accelerated from 10.0% in the first quarter of 2002 to a remarkable 30.5% in the fourth quarter. In the first quarter of 2003, export growth achieved a record high of 33.5%. Exports contributed about 30% to GDP growth in 2003. Although growth is likely to cool down in 2003, exports will remain important to China's economic growth in future.

Industrial production accelerated during the year and recorded a growth of 12.6% in 2002. The growth was mainly due to strong production growth in the electronics and auto sectors as well as higher demand for basic materials due to the construction boom. Total profits in the industrial sector increased by 20.6%, with turnaround improvement in the materials sector. At the same time, concerns regarding over-capacity have emerged as the sales-to-output ratio declined from 98.9% in the fourth quarter of 2002 to 96.6% in the first quarter of 2003.

Domestic consumption was unexciting but remained resilient. Retail sales increased by 8.8% on the back of strong urban consumption which went up by 10%. However, pricing pressure has increased and both CPI (Consumer Price Index) and RPI (Retail Price Index) declined by 0.8% and 1.3%, respectively. Prices were also weak at producers' levels, decreasing by 2.3%.

After the new generation of leaders came on board, no significant changes in the regulatory framework are expected. Reform and restructuring will continue to be the main focus of policy making. However, the speed of implementation in particular areas, such as disposing of some state assets, could be slowed during the transitional period.

MARKET REVIEW

China shares were quite volatile during the year. Whilst investors were excited about its supreme economic growth and the remarkable export engine, concerns over a slower economic growth started to emerge towards the end of the year. Over the course of the year, three main investment themes stood out, namely power, consumer and export-related sectors. Power stocks had outperformed on expectation of restructuring, which will drive significant asset growth in future, as well as on better production growth due to power shortage in China. As exports consistently posted robust growth, companies that benefited from increasing trade flows, such as Cosco Pacific, were favored. Moreover, consumer companies with leading market positions, such as Denway, also performed strongly.

On the other hand, telecommunications and technology stocks continued to be under-performers. Regulatory risk remained high in the telecommunications industry and the regulator is in favor of more competition in the marketplace. Technology companies faced difficulties as government and major telecommunications companies cut their IT expenditures. Moreover, the performance of private enterprises was hurt by some accounting scandals which kept investors away from these companies.

Both Shanghai and Shenzhen B shares headed lower during the year as there was no clear driver for performance. The launch of the Qualified Foreign Institutional Investor (QFII) system, which gives overseas investors access to the local A-share market, added additional pressure to B shares. However, as the securities authority recently expressed its intention to allow local institutional investors to enter the B share market, positive liquidity flows are likely to support share price performance as most B shares are still trading at over a 50% discount to their A-share counterparts.

OUTLOOK

GDP growth in the first quarter of 2003 was exceptionally strong at 9.9%, driven by strong exports (up 33.5%) and fixed asset investments (up 31.6%). Manufacturing and construction were major growth drivers. Contracted foreign direct investment (FDI) surged by 60% whilst utilized FDI jumped by 57%. There are some signs that the economy may be overheating as capacity utilization started to decline in the first quarter of 2003 and overall supply has clearly outpaced demand by a large margin. As a result, inventory is on the rise. Since strong exports have been absorbing a substantial part of excess capacity, any slow down in exports would worsen the over-capacity problem in China. The government is clearly aware of a potential bubble in the economy and has taken some measures to cool down over-investment in some areas such as the property market. It has also made efforts to control fiscal spending on fixed asset investments.

The outbreak of severe acute respiratory syndrome (SARS) in China will have a profound impact on China's economy in the long term. It could cost about 0.5% of China's GDP growth this year as estimated by some economists. The immediate impact is on tourism and consumption. Whilst consumption and tourist arrivals are likely to recover as the fear of an epidemic fades away, SARS could have a more profound impact on China's exports and FDI in the longer term as multi-national companies may diversify their outsourcing orders to other countries as a precautionary measure going forward. This would in turn have an adverse impact on domestic consumption going forward.

Whilst it is hoped that the severe measures taken by the government would be effective in containing the virus in the near term, volatility is likely to increase in China shares due to the uncertainty in the development of SARS as well as the perceived higher country risk by investors. Regulatory risk may also rise during the political transitional period as the implementation of some policies may be delayed. This could affect companies that have plans for acquiring state assets, such as the red chip conglomerates.

During the past year, most China companies delivered satisfactory results. Dividend pay-out has been raised by a number of companies, indicating better financial positions. Management quality has also been improving. In 2003, growth may slow down in some areas such as consumer and telecommunications as competition heats up. Export-related businesses including transportation and OEM manufacturers would also be affected by the likely moderation of export growth this year. However, there are some sectors that are more resilient to the impact of SARS, such as power and oil companies. The Fund will be cautious in stock selection and focus its investment on companies that are in better positions to weather the potential difficulties in the operating environment going forward.

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