THE CHINA FUND

INVESTMENT MANAGER'S REPORT

Performance

The China Fund's net asset value per share increased 43.05% in the six months to 30 September 2003. This compares with a 36.5% increase in the CLSA China World Index in the same period.

The Company focused on companies which enjoyed cyclical recoveries in earnings such as Shanghai Petrochemical and Anhui Conch. It also benefited from an overweight position in the oil sector as well as stocks with a strong position in the domestic consumer market such as Denway. Moreover, it identified a number of undervalued private enterprises with strong growth potential such as Comba, a telecom equipment producer and Zhejiang Glass, a glass manufacturer which contributed substantially to the out-performance. At the end of the period, the Company was 44.2% invested in Red Chips, 37.5% in H shares, 5.6% in 'B' shares and the remainder in Hong Kong companies with substantial business in China. Cash accounted for 4.6% of the portfolio.

The Company received no subscriptions and repurchased 50,638 shares during this period.

Economic Review

China GDP growth slowed to 6.7% in the second quarter of the calendar year 2003 due to Severe Acute Respiratory Syndrome (SARS) but subsequently rebounded to a much stronger 9.1% in the third quarter. The economy was mainly driven by accelerated growth in fixed asset investments and exports. Both increased more than 30% in the first nine months of 2003. Industrial output has been growing at around 16% mainly due to strong growth in electronic appliances and the steel and automobile sectors. It was also a strong year for basic materials prices due to much stronger than expected demand.

Growth in broad money M2 growth accelerated to around 21%, above the 18% target set by the government. In the second quarter of this year, People's Bank of China raised the Reserve Ratio of commercial banks with the Central Bank by 1%. Other measures were also taken to control loan growth, including tightening mortgages on high-end properties in an attempt to avoid overheating in the property market. Whilst the effects of these measures have yet to be seen, the government is unlikely to introduce aggressive austerity measures given the relatively low Consumer Price Index inflation of around 1%.

The government is under increasing pressure to appreciate the Renminbi (RMB). Value Added Tax rebates on imports were reduced to lower the huge trade surplus as well as to smooth out China's trade relationship with western countries. The government also encouraged Chinese companies to invest overseas to ease some pressure on the currency.

Last but not least, the private sector is playing an increasingly important role in China's economy. Private enterprises are now actively involved in fixed asset investments such as large infrastructure projects as well as production of basic materials. More importantly, the rise of the private sector has forced state-owned enterprises (SOEs) to speed up reform and become more efficient in an increasingly competitive operating environment.

Stock Market Review

After a weak performance in April due to SARS, China stocks posted a strong rally in the months that followed. The strong performance was mainly driven by a cyclical recovery in basic materials such as petrochemicals, steel and cement with surging fixed asset investments resulting in tight supply of these basic materials. Earnings recovered strongly mainly driven by capacity expansion as well as rising product prices. Transportation and export-related stocks rallied due to increasing trade flows between China and the rest of the world. Other sectors that outperformed were the power and auto stocks that are geared to the strong industrial growth and domestic demand. Apart from increasing earnings momentum, expectations of RMB appreciation have also helped attract huge liquidity flows into China stocks during the period.

There have been remarkable improvements in management of Chinese companies in the past one to two years. This is mainly due to the Chinese management's higher awareness of shareholders' value after constant interaction with international investors. Investors are generally pleased with the increasing focus on shareholders' returns. Chinese managements have also been making sensible expansion plans and attractive acquisitions. The financial positions of most Chinese companies have improved significantly in the past 12 months and higher dividends have been distributed.

Another important trend during the period was a substantial narrowing of the valuation gap between Hong Kong listed China stocks and domestic A and B shares. After sluggish performance in the past two years, some A and B shares are now trading at attractive valuations or even at discounts to H shares. The establishment of limited Qualified Foreign Institutional Investor (QFII) system has provided foreign investors with access to the vast domestic equity market and increasing investment choices. However, due to the constraints on capital withdrawal, the access is still limited.

Outlook

China's GDP growth is expected to remain robust at least for the next one to two quarters before showing any sign of slowing down. The government indicated its maximum tolerance on inflation to be 3%, which implies no drastic changes in its monetary policy in the foreseeable future. At the same time, the government will try to provide more guidance on the direction of new loans in order to control investments in certain areas. The government is aware of the risk of overheating and has implemented measures to boost domestic consumption, especially for the less developed rural areas.

The rally in share prices of China stocks this year has been well supported by strong recovery in earnings. Valuations remain attractive even after the strong performance. Whilst growth momentum of cyclical sectors, especially commodity stocks, is likely to peak, the out-sourcing story, as well as the pick-up in domestic consumption, will remain key investment themes going forward. China will continue to attract foreign direct investments and increase its importance as the production base for the world and this is a structural change that has long-term implications on the sustainability of growth. The strong economic growth should also filter through to private consumption, which has yet to take off. Moreover, industry restructuring and reform on SOEs, will continue to make Chinese companies more efficient and competitive.

The Company will focus on stocks that have leading positions in domestic consumer markets as well as those that benefit from industry consolidation or restructuring. It also favors stocks that can withstand increasing competition from foreign companies as the Chinese market gradually opens up. The fast growing second- and third-tier cities as well as a potential up-trend in rural consumption will also be an important investment theme to explore.

The opening of domestic A share market has substantially increased investment exposure for foreign investors which the Company will be actively tapping into. Moreover, the Company also identified good stock ideas in B shares which, after being neglected for a long time, have become more attractive as they are now trading at a discount to their A and H share counterparts.

Deutsche Asset Management (Asia) Limited

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