THE CHINA FUND

INVESTMENT MANAGER'S REPORT

PERFORMANCE

The China Fund's net asset value per share increased 104.9% during the year. This compares with a 77.8% increase in the CLSA China World Index in the same period. The strong outperformance was due mainly to our focus on stocks with substantial cyclical earnings growth such as metal stocks, as well as stocks that benefit from a shortage of resources and energy, such as oil and coal stocks. Moreover, our shift from cyclical stocks to consumer sector in the first quarter of 2004 also contributed significantly to the performance.

At the end of the period, the Fund was 41.1% invested in Red Chips, 34.3% in H shares, 7.0% in 'B' shares and the remainder in Hong Kong companies engaged in China business. Cash accounted for 4.6% of the portfolio.

ECONOMIC REVIEW

China economy grew strongly in 2003 by 9.1% with growth accelerated in the fourth quarter to 9.9%. In the first quarter of 2004, GDP continued strong momentum and went up by 9.7%. The robust economic growth was mainly driven by strong fixed-asset investments and industrial production due to China's increasing market share in the export market as well as steady growth in domestic consumption.

The strong economic growth however triggered concerns on the economy overheating. The government has adopted some tightening measures. These include raising banks' required reserve ratio with central bank and lifting entry barriers for overheated industries such as steel, cement, aluminum, property and auto. Banks were required to tighten their lending policies especially to the above-mentioned areas. As a result, commodity prices started to soften and fixed asset investments have declined from over 50% in the first two months of 2004 to 18.3% in May 2004. Money supply also moderated with the money supply M2 growth dropping from 19.6% in 2003 to 17.5% in May, close to the 17% target set by the government.

At the same time, the government focused on domestic consumption with an emphasis on rural areas. A series of reforms were introduced to reduce various fees and levies on agricultural products and to improve income of farmers. Retail sales growth accelerated from 9.1% in 2003 to 17.8% in May 2004 with rural consumption recovering strongly from a sluggish 3% growth in May 2003 to 13.5% in the same period of 2004. The strong pick-up in consumer spending was encouraging.

After the Consumer Price Index (CPI) turned positive for the first time in two years in January 2003, inflation was gradually returning. Both CPI and the Producer Price Index (PPI) hit five-year high of 4.4% and 5.7% respectively in May 2004. If CPI exceeds the 5% tolerance level set by the government, more monetary tightening is likely to be implemented.

In 2003, growth in external trades continued to accelerate as China became an important production base of many multi-national companies. Exports and imports grew by 34.7% and 40% respectively in 2003. In the first five months of 2004, the growth momentum was maintained with exports up by 33.3% and imports by 40.9%. Huge trade surplus increased China's foreign exchange reserve substantially from US$304bn in January 2003 to US$440bn in March. Renminbi (RMB) was under increasing pressure to appreciate. Although the government considered various options or a revaluation of the currency for changing the currency regime, including pegging the RMB to a basket of currencies, no decision has been made.

The new generation Chinese leaders have been remarkably proactive in tackling problems in the economy. In an attempt to pre-empt the overheating situation during the 1990s, they took action as early as in mid-2003 to curb over-investment in certain areas such as steel, auto and the property sectors. They also accelerated reforms on SOEs state-owned enterprises (SOE) and the banking sector to further improve their operating efficiency and financial strength. Moreover, the control on over-investment were focused on selective industries and were conducted in a manner so as to direct the economy towards a more balanced growth rather than to dampen investment sentiment.

MARKET REVIEW

After weak performance in April 2003 due to the Severe Acute Respiratory Syndrome (SARS), China stocks posted a strong rally in the later part of the year. The strong performance was mainly driven by the upturn in the prices of basic material such as petrochemical, steel and cement as surging fixed asset investments resulted in tight supply of these basic materials. Earnings recovered strongly mainly driven by production 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 on RMB appreciation have also helped attract huge liquidity flows into China stocks during the period.

In the first quarter of 2004, the strong market momentum was maintained, driven by stronger-than-expected 2003 earnings. However, concerns on economic overheating as well as a potential hard-landing of the economy have triggered substantial profit-taking in April. The H-share index fell sharply by 30% in April and May. Cyclical stocks were especially hard hit after their stellar performances in 2003. Whilst the sell-off was mainly due to concerns on the economic slow-down, the unwinding of the dollar carry trade also played a role which resulted in massive capital outflows from Asia during the period.

The Chinese securities authority opened domestic A share markets to foreign investors in the second half of 2003 through Qualified Foreign Institutional Investors (QFII) system. A flux of funds went into the local markets for large-capitalization, good-quality stocks. As the valuation gap between A and H shares have narrowed over the past year, some A shares are now trading at comparable valuations and they offer more investment alternatives to investors.

OUTLOOK

We believe the strong economic growth in China is not likely to be derailed by the tightening measures taken by the government. Whilst the economic slow-down may overshoot in the short to medium term, we remain confident about the sustainability of China's strong growth in the longer term. We believe China will continue to gain market share in the global out-sourcing market. The Chinese leaders' competence should help to lead the economy towards a more balanced and healthy growth.

Despite our positive outlook, there are various problems that China economy is facing. The infrastructure bottleneck as well as shortage of energy and raw materials could defer the inflow of foreign direct investments. Moreover, the tightening on bank credits, especially short-term financing, may result in deterioration of corporate balance sheets and cash flow positions. We would not rule out the possibility that the economy slow-down may be more drastic than market expectation in the short term.

Corporate earnings are likely to maintain their strong momentum this year. However, due to expectations on earnings have already been high, we are not surprised to see earnings downgrades in coming months. Nonetheless, most Chinese companies are still able to deliver strong earnings growth this year. Moreover, sectors such as telecommunications, oil, infrastructure and transportation would continue to grow steadily due to strong consumer spending or a persistent shortage/bottleneck in their particular industries. These companies are relatively less affected by the macro tightening which we will focus our investments on.

Going forward, the market will be observing both investment momentum and inflation in the coming months. Recently, the government softened its stance on tightening as economic data are showing signs of slowing down. It will monitor economic data in the next few months carefully before deciding on whether further tightening is needed. The main goal of government policy is a soft-landing of the economy and we have confidence that it can be achieved.

Deutsche Asset Management (Asia) Limited
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