THE CHINA FUND

INVESTMENT MANAGER'S REPORT

Performance

The China Fund's net asset value per share decreased 6.3% in the six months to 30 September, 2004. This compares with a 6.2% decrease in the CLSA China World Index in the same period.

Due to the uncertainty in the impact of credit tightening on the macro economy, the Company has been focusing on stocks with good earnings visibility, strong cash flows, and less policy risk. These include energy, telecom, transportation and selective consumer stocks, which are much less affected by the tightening measures taken by the government. The Company's overweight position in the above sectors has contributed positively to the performance of the portfolio during the period.

The Company received no subscription of shares and repurchases of 61,000 shares during this period.

Economic Review

China's economy maintained strong growth momentum in 2004. GDP went up by 9.6% and 9.1% in the first and second quarter respectively. Due to concerns on economic overheating, the government introduced austerity program in the second quarter. Measures taken include raising banks' required reserve ratio with central bank as well as restricting new loans to the overheated industries namely steel, cement, aluminum, property and auto. As a result, growth in fixed-asset investments slowed to 30% in August from over 50% in the first quarter of the year. Money supply (M2) also dropped from a high level of over 19% in the beginning of this year, to below 14% in the third quarter. Prices for basic materials such as steel, aluminum, cement retreated from their peaks in the first quarter of this year.

The Consumer Price Index (CPI) has been trending upwards from 3.5% in January to 5.3% in July and August, mainly driven by rising food prices. This has prompted government to consider raising interest rate as a tool to reverse negative real interest rates. Whilst the economy is showing signs of cooling down after the administrative control, the government intends to use more market-based tools to adjust economic activities.

Whilst investments are slowing, growth in consumption has been accelerating. Retail sales growth reached 14% in September from around 11% in the first quarter.

Stock Market Review

China shares were under severe profit-taking pressure during the second quarter. The sell-off was triggered by concerns over a potential hard-landing for the economy after government adopted austerity measures. The H-share index fell sharply by 30% in April and May. Sell-off was indiscriminative towards all sectors except energy and telecom stocks due to their relative defensiveness. Cyclical stocks were especially hard hit after their stellar performances in 2003. In addition, selling which had fuelled by the unwinding of the dollar carry trade also resulted in massive capital outflows from Asia during the period.

In the third quarter, China shares were range-bound after recovering from the sell-off in the second quarter. Despite the macro tightening, corporate earnings remained strong momentum. Most Chinese companies announced satisfactory interim results and upstream raw material producers surprised the market with their stronger than expected results. Resources and materials stocks posted a rebound as commodity prices recovered from the correction in the second quarter. At the same time, transportation sector, especially port operators, also performed strongly due to their robust earnings outlook as well as their resilience to change in government policy.

The A and B share markets performed poorly during the period, both declining sharply by around 20%. Whilst macro tightening and falling commodity prices were the main triggers for the sell-off, the efforts by the government to clear irregularities at local securities houses also had a negative impact on market liquidity and sentiment.

Outlook

In October 2004, the People's Bank of China (PBOC) raised 1-year benchmark lending and deposit rates by 27bps to 5.58% and 2.25% respectively. The magnitude of the increase was relatively small and more rate hikes are expected in the next 12 months. The Chinese government is targeting a CPI of 3% in 2005 which is hoped to be achieved by lower food prices after the autumn harvest. Under this scenario, PBOC would need to raise at least another 75bps to neutralize the negative real interest rate. Although China has entered into an up-cycle for interest rates, the Company believes that the government is unlikely to raise rates aggressively in the near term and monetary policy will remain relatively expansionary. The government is targeting 7-8% GDP growth for 2005.

Despite the positive outlook for China, the Company is aware that various problems, including infrastructure bottleneck and over-investment in certain areas, have yet to be resolved. Moreover, rising raw material costs would eat into the margins of many downstream manufacturers. As real interest rates remains negative in the short term, investments will continue to be fuelled by money from various channels that are outside the banking system. This would potentially result in more over-investment, which may trigger more stringent austerity programs by the government at a later stage.

There have been a lot of discussions regarding the revaluation of Renminbi (Rmb). Whilst the government has committed to a more flexible currency regime, the progress is slow with slight widening of the trading band likely to be the first step. Substantial work needs to be done before a new currency system can be established, including introducing a market-making system and more products for the foreign exchange market as well as loosening capital controls. Although the timing of revaluation is unclear, the anticipation of Rmb appreciation in the long run will continue to be an important driving force for overseas funds flowing into China in the coming years.

The Company remains very positive on upstream resources stocks. The fourth quarter is traditionally the high season of the year for industrial production in China. Resources and raw materials are expected to remain in tight supply, supporting strong commodity prices. After slower economic data were reported in July and August, the government eased some of the credit controls in September and resumed many infrastructure projects which were suspended in the second quarter. Materials prices rebounded on revived construction activities. The Company will focus its investment on upstream energy and material stocks, which should continue to enjoy strong earnings momentum. At the same time, it will be cautious on downstream manufacturers which are likely to be under increasing margin pressure in the near term.

The Company believes that the intention of the policy-makers in China is to guide the economy towards a healthier growth rather than to apply the brakes. The Company continues to believe that macro tightening is unlikely to derail China's long-term growth prospects, although short-term volatility is inevitable during the process of policy adjustment.

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