Understanding Exchange Traded Funds

Exchange Traded Funds (ETFs) are passively-managed and open-ended funds, which are traded on the securities market of Hong Kong Exchanges and Clearing Limited (HKEx). All listed ETFs are authorised by the Securities and Futures Commission (SFC) as collective investment schemes.

ETFs are designed to track the performance of their underlying benchmarks (eg an index, a commodity such as gold, etc) and offer investors an efficient way to obtain cost-effective exposure to a wide range of underlying market themes. Similar to other securities, investors can buy or sell ETFs through their brokers anytime during the securities market's trading hours.

Key Features

Benchmark tracking

ETFs are passively managed funds which aim to track closely the performance of the underlying benchmarks.

Transparency

Each ETF has its own website operated by its ETF manager (a list of ETFs' websites can be found on the HKEx website). ETFs' websites provide key information such as the underlying benchmarks and the benchmarks' constituents, the ETF's Net Asset Value (NAV), the counterparty exposure and details of collateral from counterparties. The NAV of an ETF is the sum of marked-to-market values of the individual portfolio holdings plus the portion of the assets held in cash and cash equivalents, less all the accrued ETF expenses. The NAVs of ETFs are calculated intra-day during the trading hours and at the end of the trading day. The intra-day estimated NAVs, or iNAVs, are also known as RUPVs (Reference Underlying Portfolio Valuations) or IOPVs (Indicative Optimised Portfolio Values). The end-of-day NAV information may also be obtained on the HKExnews website, in addition to the ETF's website. Real-time or delayed price quotes for ETFs are disseminated by information vendors and are available on the HKEx website.

Low transaction costs

Unlike unlisted funds, ETFs do not charge any subscription fees. The transaction costs for trading ETFs at HKEx are the same as those for trading other securities, which include brokerage commission, transaction levy, investor compensation levy (currently suspended), trading fee, trading tariff and stamp duty[1].

Low minimum investment

ETFs are traded in board lots and the minimum initial investment is usually set at an affordable level.

Liquidity

ETFs can be traded any time during the trading hours of the securities market. Listed ETFs usually have market makers, which are known as Securities Market Makers, to provide some liquidity. However, market making for the ETFs is available only during the Continuous Trading Session.

[1]Some ETFs are exempted from stamp duty. Details are on the HKEx website at http://www.hkex.com.hk/eng/etfrc/etfta/etftradingarrangement.htm

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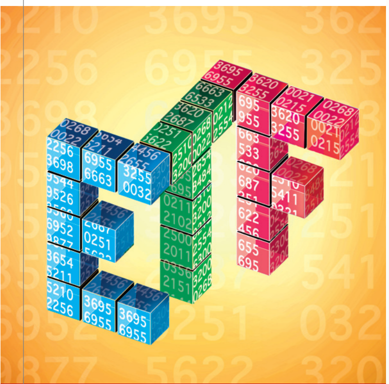
October 2011



Convenience

ETFs are traded through brokers in the same way as other securities and the settlement arrangements are the same.

Diversification

Most ETFs track a portfolio of assets to provide diversified exposure to selected market themes. However, ETFs may also track a single underlying asset such as gold.

Market exposure

While some ETFs provide Hong Kong investors access to a basket of Hong Kong securities, others provide the investors access to overseas markets or other asset classes.

Types of ETFs

ETFs can be broadly grouped into two types:

1. Physical ETFs (ie traditional or in-specie ETFs)

Many of these ETFs directly buy all the assets needed to replicate the composition and weighting of their benchmark (eg constituents of a stock index). However, some only buy a portion of the assets needed to replicate the benchmark or assets which have a high degree of correlation with the underlying benchmark but are not part of it.

Some physical ETFs with underlying equity-based indices may also invest partially in futures and options contracts. Lending the shares they own is another strategy used by some physical ETFs. Investors should read the ETF prospectus carefully to ensure they understand how the fund operates.

2. Synthetic ETFs

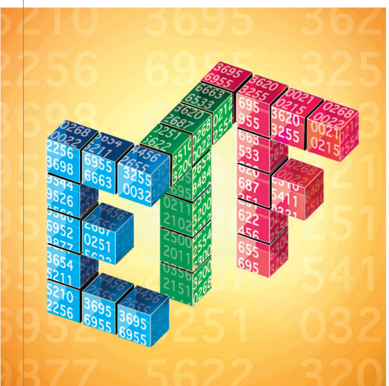
These ETFs do not buy the assets in their benchmark. Instead, they typically invest in financial derivative instruments to replicate the benchmark's performance. The ETFs are required to have collateral when investing in derivatives (details of the net and gross counterparty exposure and types and composition of the collateral are published on the ETF's website). An ETF's net risk exposure to any single counterparty (ie net of the value of any collateral provided) cannot be more than 10 per cent of its NAV. Investors should read the ETF prospectus carefully to ensure they understand how the fund operates.

> Aside from referring to the ETFs' prospectus and related publications, investors can also identify synthetic ETFs by the marker X at the beginning of their stock short name to denote their synthetic structure. The complete list of synthetic ETFs can be found in the ETF section of the HKEx website.

Risks Associated with ETFs

Counterparty risk

Synthetic ETFs are subject to counterparty risk associated with the derivatives issuers and may suffer losses if the derivatives issuers default or fail to honour their contractual commitments. Further, potential contagion and concentration risks of the derivative issuers should be taken into account (eg since derivative issuers are predominantly international financial institutions, the failure of one derivative counterparty of a synthetic ETF may have a "knock-on" effect on the other derivative counterparties of the synthetic ETF). Although synthetic ETFs have collateral from their counterparties, it may not completely remove the counterparty risk so they are still subject to the collateral providers fulfilling their obligations. There is a further risk when the right against the collateral is exercised because the market value of the collateral could be substantially less than the amount secured, resulting in significant losses to the ETF.



Market risk

ETFs are exposed to the economic, political, currency, legal and other risks of a specific sector or market related to the index that it is tracking. ETF managers do not have the discretion to take defensive positions in declining markets. Investors must be prepared to bear the risk of loss and volatility associated with the underlying benchmarks.

Tracking error risk

Tracking error is the difference between the performance of an ETF and its underlying benchmark. Tracking error can arise due to factors such as the impact of the Total Expense Ratio (TER), changes in the composition of the underlying benchmark and type of ETF (e physical vs synthetic). The TER of an ETF may include management fee and other fees and costs (eg transaction costs, stamp duties, costs for preparing financial reports and other prescribed documentation, legal and auditing fees, insurance costs, fees for custody services, etc) – there is no universal definition. An ETF's estimated TER is stated in the prospectus. The estimated TER of an ETF does not necessarily represent the fund's tracking error because the fund's NAV may be affected by other factors, eg dividends and other income from the portfolio, and in the case of a synthetic ETF, the indirect costs borne by the fund may only be reflected in the market value of the derivatives it holds.

Risk in trading at discount or premium to NAV

The market price of an ETF may be at a discount or premium to its NAV. This price discrepancy is caused by supply and demand factors and may be more likely to emerge during periods of high market volatility and uncertainty. This phenomenon may also be observed in ETFs tracking specific markets or sectors that are subject to direct investment restrictions. As a result, investors who buy at a premium may suffer losses even if the NAV is higher when they sell and they may not fully recover their investment in the event of termination of the ETF.

Liquidity risk

Although ETFs usually have market makers (known as Securities Marker Makers, or SMMs) to help provide liquidity, there is no assurance that active trading will be maintained at all times. In the event that the SMMs are unable to fulfil their obligations, investors may not be able to buy or sell the ETF or may find the market price of the ETF is at a discount or premium to its NAV.

Stock lending risk

Physical ETFs which engage in stock lending face the risk of the borrower not returning the ETF's securities as agreed and thus may experience some losses due to their stock lending.

Frequently Asked Questions about ETFs

1. Where can I obtain information on each ETF?

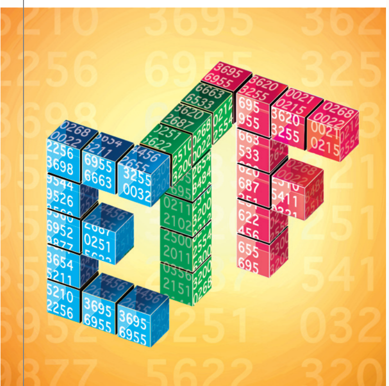
You can refer to the individual ETF's website which shows detailed information about the ETF, including its prospectus, annual reports, fund fact sheet, NAVs, underlying benchmark values, holdings, historical performance, etc. The hyperlink to an individual ETF's website can be found on the ETF section of the HKEx website. ETF information submitted by the respective ETF managers can also be obtained from the HKExnews website.

2. What is the benchmark used by the ETF?

You can refer to the ETF's prospectus and website for the benchmark of the ETF. HKEx also publishes the benchmarks in the ETF section of the HKEx website.

3. How can I identify an ETF adopting synthetic replication?

You should read the ETF's prospectus and related publications to understand whether it is a synthetic ETF and the risks involved. In addition, a synthetic ETF can be identified by the market X at the beginning of its stock short name. The ETF section on the HKEx website has a full list of physical and synthetic ETFs.



4. Where can I buy or sell ETFs?

You can buy or sell ETFs through your broker the same way as you buy or sell other securities. There is no need to open a separate trading account for ETFs.

5. What is the minimum initial investment?

ETFs are traded in board lots and the board lot size is set by the ETF managers.

6. What transaction fees do I need to pay when I buy or sell ETFs?

Similar to buying and selling other securities, you need to pay brokerage commission, transaction levy, investor compensation levy (currently suspended), trading fee, trading tariff and stamp duty. Certain ETFs are exempted from stamp duty.

7. How much in management fees do ETFs charge?

You can find the details of the management fees as well as other expenses for individual ETFs in their prospectuses.

8. How long do I need to hold ETFs before I can sell?

Like other securities, ETFs can be bought and sold on the same day.

9. Do ETFs pay dividends?

Most ETFs pay dividends to their unit holders. The frequency and timing of dividend distribution are determined by the ETF managers. You are advised to read the distribution policies specified in the prospectuses of the ETFs.

10. Do ETFs have market makers?

Yes, listed ETFs usually have market makers, known as Securities Market Makers, or SMMs, to help provide liquidity. SMMs are subject to a set of obligations prescribed by HKEx with respect to the maximum bid/ask spread, quote size, response time, etc. The names of the SMMs as well as their obligations for each ETF can be found in the ETF section of the HKEx website.

Hyperlinks to Useful Websites

ETF section of the HKEx website:
www.hkex.com.hk/eng/prod/secprod/etf/etfmain.htm

HKExnews website:
www.hkexnews.hk

SFC's InvestEd website ETF product:
www.invested.hk/invested/en/html/section/products/funds/ETF/etf_key.html