香港交易所 HKEX

# UNDERSTANDING RISKS OF EXCHANGE TRADED PRODUCTS

## Market risk

- The value of an Exchange Traded Product (ETP) represents the value of its underlying assets including but not limited to stocks, bonds, or commodities. ETP issuers may use different strategies to construct the portfolios, but in general they 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 index/assets.

## Tracking error

- Tracking error refers to the disparity in performance between an ETP and its underlying index/assets. For ETPs adopting a passive strategy, tracking error can arise due to factors such as the impact of transaction fees and expenses incurred to the ETP, changes in composition of the underlying index/assets, and the ETP issuer's replication strategy. (The common replication strategies include full replication/representative sampling and synthetic replication which are discussed in more detail below.) For ETPs adopting an active strategy, tracking error will normally higher due to the ETP issuer's objective to outperform its underlying index/assets. Investors should be aware of this active risk when considering to invest in actively managed ETPs.

## Trading at premium or discount

- An ETP may be traded at a premium or discount to its Net Asset Value (NAV). This price discrepancy is caused by supply and demand factors, and may be particularly likely to emerge during periods of high market volatility and uncertainty. This phenomenon may also be observed for ETPs tracking specific markets or sectors that are subject to direct investment restrictions.

## Foreign exchange risk

- Investors trading ETPs with underlying assets not denominated in Hong Kong dollars are also exposed to exchange rate risk. Currency rate fluctuations can adversely affect the underlying asset value, also affecting the ETP price.

## Liquidity risk

- Market Makers provide liquidity to facilitate trading in ETPs. Although most ETPs are supported by one or more market makers, there is no assurance that active trading will be maintained. In the event that the market makers default or cease to fulfill their role, investors may not be able to buy or sell the product.

## Counterparty risk involved in ETPs with different replication strategies

- Full replication and representative sampling strategies
    - An ETP using a full replication strategy generally aims to invest in all constituent stocks/assets in the same weightings as its benchmark. ETPs adopting a representative sampling strategy will invest in some, but not all of the relevant constituent stocks/assets. For ETPs that invest directly in the underlying assets rather than through synthetic instruments issued by third parties, counterparty risk tends to be less of concern.
- Synthetic replication strategies
    - ETPs utilising a synthetic replication strategy use swaps or other derivative instruments to gain exposure to a benchmark. Currently, synthetic replication ETPs can be further categorized into two forms:
        - Swap-based ETPs
            - Total return swaps allow ETP issuers to replicate the benchmark performance of ETPs without purchasing the underlying assets.
            - Swap-based ETPs are exposed to counterparty risk of the swap dealers and may suffer losses if such dealers default or fail to honor their contractual commitments.
        - Derivative embedded ETPs
            - ETP issuers may also use other derivative instruments to synthetically replicate the economic benefit of the relevant benchmark. The derivative instruments may be issued by one or multiple issuers.
            - Derivative embedded ETPs are subject to counterparty risk of the derivative instruments' issuers and may suffer losses if such issuers default or fail to honour their contractual commitments.

Even where collateral is obtained by an ETP, it is subject to the collateral provider fulfilling its obligations. There is a further risk that when the right against the collateral is exercised, the market value of the collateral could be substantially less than the amount secured resulting in significant loss to the ETP.

It is important that investors understand and critically assess the implications arising due to different ETP structures and characteristics.

## Delayed Settlement Risk

Market makers may short sell units of an ETF listed on SEHK in market making trades and may apply for one extra day for settlement to cover such short positions. Therefore, the affected buyer(s) would receive the ETP units one day later than normal settlement date without prior notice, but the affected buyer(s) retain the right to sell the bought shares before the completion of settlement. Furthermore, a Participating Dealer may have their redemption settlement process affected by the delayed settlement.




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