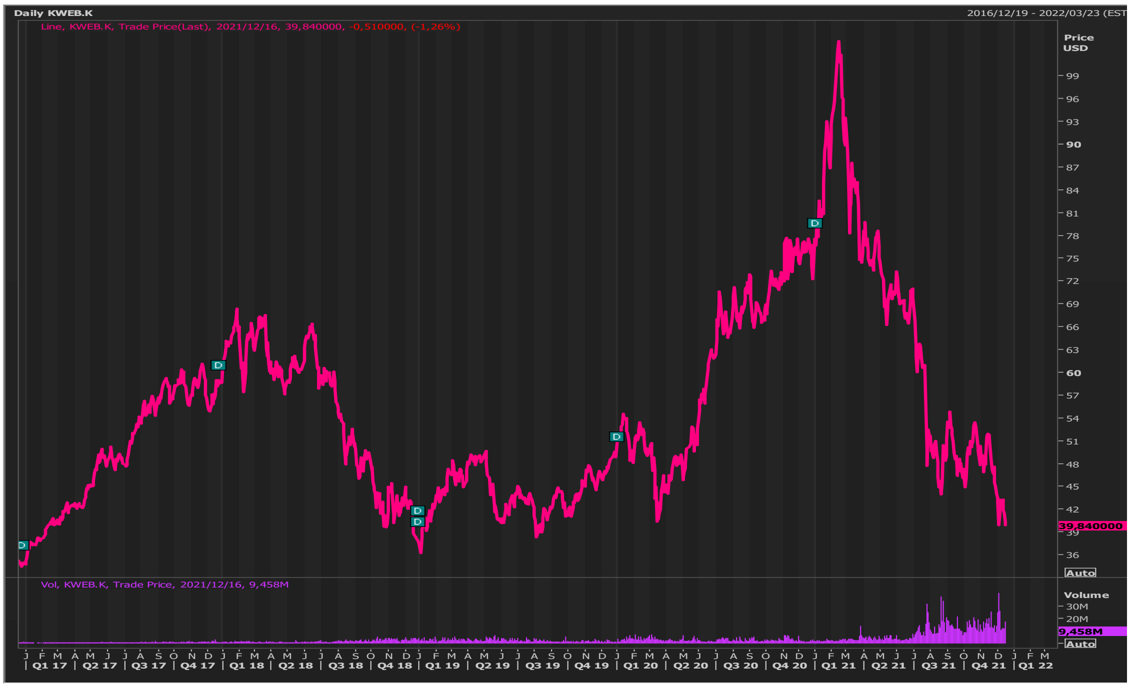
Huge Hidden Risks in Some ETF's

Perspectives: December 16th, 2021

Chart 1: KraneShares CSI China Internet ETF, 2017 to 2021



Exchange Traded Funds ("ETF's") are offshoots of a very good idea - the valid notion that investors can also invest their savings in the markets by purchasing a passively constructed basket of securities on a low-cost basis.

As with many things in life, a very good idea taken to extremes can often turn into very bad ideas. We pop the hood on the US$8bn Kraneshares CSI China Internet ETF. In Chart 1, you can see it has had a rough 2021, down 60% from its peak. Ouch.

This ETF is listed in the United States, which interests us because it means they had to file an unusually detailed prospectus, including a lengthy disclosure of all risks. Bearing in mind this is a *passive* product, here are some of our findings.

- Fund **management fees** of 0,70% per year.
- A fund **turnover rate** of 89% in the past year.
- **Redemption fees** of 2%.
- Transacting in this (and any) ETF involves paying **both brokerage commissions** and crossing the **bid-offer spread** in whatever market it is listed on.

But it is in their detailed **risk** disclosures where it gets *interesting...*

- **Investment Strategy**: The Fund may invest up to 20% of its assets in derivative instruments and other investment companies. The other investment companies may be advised, sponsored, or otherwise serviced by Krane and/or its affiliates. Krane is subject to conflicts of interest in allocating Fund assets to related investment companies.
- **China Risks**: Although China has begun the process of privatizing certain sectors of its economy, privatized entities may lose money and/or be re-nationalized.
- In recent years, Chinese entities have incurred significant levels of debt and Chinese financial institutions currently hold relatively large amounts of non-performing debt. Thus, there exists a possibility that widespread defaults could occur, which could trigger a financial crisis, freeze Chinese debt and finance markets, and make Chinese securities illiquid.
- **Custody Risks**: China A-Shares will be held in the joint names of the Fund and Krane. The Fund's assets may not be as well protected as they would be if it were possible for them to be registered and held solely in the name of the Fund. There is a risk that creditors of Krane may assert that the securities are owned by Krane, and the regulatory actions taken against Krane may affect the Fund. The risk is particularly acute in the case of cash deposited with a People's Republic of China ("PRC") sub-custodian because it may not be segregated, and it may be treated as a debt owing from the PRC custodian to the Fund as a depositor. Thus, in the event of a PRC Custodian bankruptcy, liquidation, or similar event, the Fund may face difficulties and/or encounter delays in recovering its cash.

- **Tax Risks**: The Fund is temporarily exempt from the Chinese tax on capital gains on trading in A-Shares. There is no indication as to how long the temporary exemption will remain in effect.
- **Capital Controls Risk**: There is no assurance that repatriation restrictions will not be (re-)imposed in the future.
- **Stock Connect Program Risk**: Investments in China A-Shares may not be covered by the securities investor protection programs of either exchange and, without the protection of such programs, will be subject to the risk of default by the broker.
- **Authorized Participants Concentration Risk**: The Fund has a limited number of financial institutions that may act as Authorized Participants. To the extent they exit the business or are otherwise unable to proceed in creation and redemption transactions with the Fund, shares of the Fund may be more likely to trade at a discount to NAV and possibly face trading halts or delisting.
- **Discount Risk**: In periods of heightened market volatility or steep market declines, market or stop-loss orders to sell Fund shares may be executed at prices well below Fund NAV.
- **Secondary Market Trading Risk**: There can be no assurance that an active trading market for shares will develop or be maintained or that the Fund's shares will continue to be listed.
- **Valuation Risk**: Independent market quotations for certain investments held by the Fund may not be readily available. There is a risk that the Fund may not be able to sell an investment at the price assigned to the investment by the Fund.

Our work continues...

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