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By Dan Weiskopf
Access ETF Solutions
Portfolios

Interview series: Investment Factors that drive ETF performance

May 29,2015

In this interview I am pleased to be speaking to Brendan Ahern, the Chief Investment Officer of Kraneshares. Index methodologies in emerging markets equities are highly differentiated with meaningful results that are driven by factors that result in varying allocations to countries, market cap size, industries and fiscal policies. We hope that readers appreciate, if only for educational purposes, that exploring alternative allocation methodologies should be constructive for any investor as it leads to a deeper understanding of what drives returns.

Dan Weiskopf: KraneShares is primarily known for it's China focus. What primary factors have led to the underperformance of the Emerging markets over the US markets since 2008? Has China been the driving issue?

Brendan Ahern: We recognized the onshore equities represented by the world's fourth and seventh largest stock exchanges, the Shanghai and Shenzhen Stock Exchanges, were excluded from broad emerging market indices. We believe a complete China allocation should go beyond Chinese companies listed in Hong Kong and include the onshore equities as well. Since the end of the financial crisis, emerging market equities have not kept pace with U.S equities. We identified three factors that we believe negatively effected emerging market performance and could continue to do so. Working with FTSE, we found a GDP weighted emerging market country allocation reduces exposure to these factors versus traditional market cap weighted allocations. This lead to the development of the KraneShares FTSE Emerging Market Plus ETF (ticker KEMP).

Dan Weiskopf: Let's start with the factors you believe investors should be focused on.

Brendan Ahern: The first factor is **U.S Dollar Strength & The Potential Federal Reserve Rate Hike.** Since its five year low on July 26, 2011 through April 30, 2015, the Bloomberg Dollar Spot Index returned 28.95%. While the dollar has strengthened, some individual emerging market (EM) currencies have depreciated significantly as illustrated by the second chart below. This foreign exchange exposure hurt market cap weighted EM indices due to their overweight to several of the worst performing currencies. The specter of a potential rate hike from the Federal Reserve could exacerbate this situation because when rates rise in the U.S. the dollar typically strengthens.

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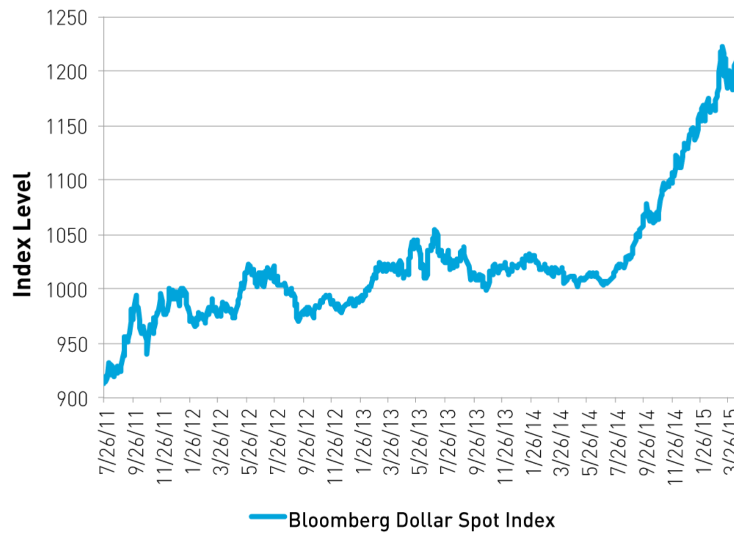
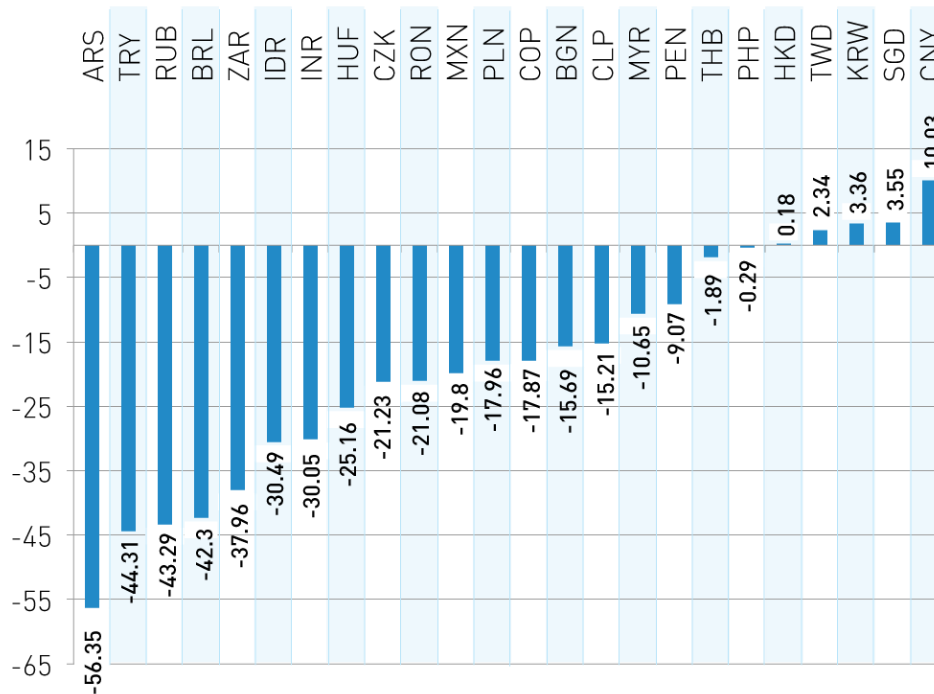
Bloomberg Dollar Spot Index
(7/26/2011 – 4/30/2015)



Source Bloomberg as of 4/30/2015

Total Spot Return
of Emerging Market Currencies vs. USD
(4/30/2010 – 4/30/2015)



KEY	Argentine Peso	Turkish Lira	Russian Ruble	Brazilian Real
	ARS	TRY	RUB	BRL
South African Rand	Indonesian Rupiah	Indian Rupee	Hungarian Forint	Czech Koruna
ZAR	IDR	INR	HUF	CZK
Romanian Leu	Mexican Peso	Polish Zloty	Colombian Peso	Bulgarian Lev
RON	MXN	PLN	COP	BGN
Chilean Peso	Malaysian Ringgit	Peruvian New Sol	Thai Baht	Philippine Peso
CLP	MYR	PEN	THB	PHP
Hong Kong Dollar	Taiwanese Dollar	South Korean Won	Singapore Dollar	Chinese Renminbi
HKD	TWD	KRW	SGD	CNY

Source Bloomberg as of 4/30/2015

The second factor is **Increased U.S. Energy Production.** Increased U.S. energy production is a contributor to the collapse in global oil prices. Lower oil prices hurt the economies and stock markets of many emerging market exporters such as Brazil, Mexico and Qatar. The trickle down effect of lower prices on these economies has been severe. Market cap weighted emerging market indices have high weights to these countries.

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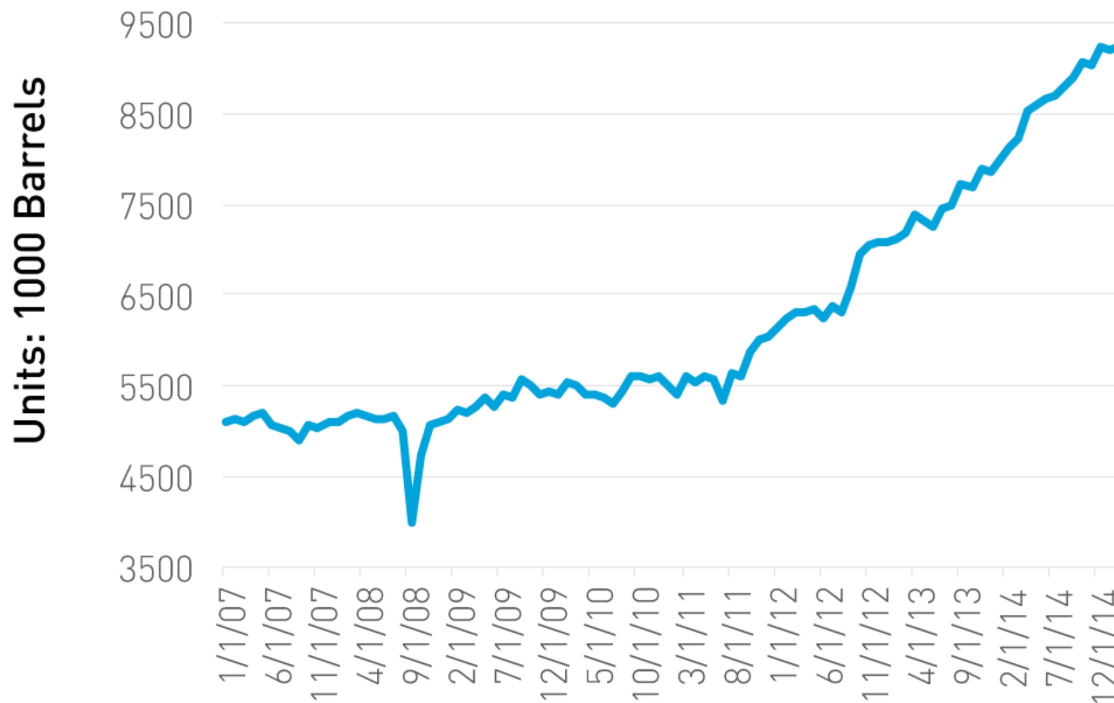
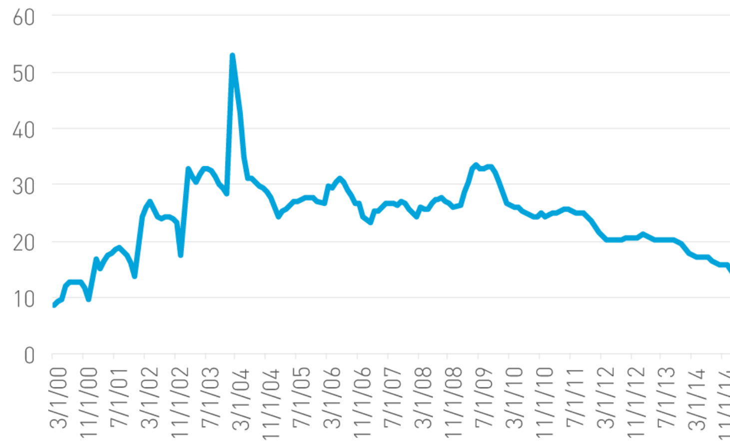


Source Bloomberg
as of 2/28/2015

The third factor is **China's Slowing Fixed Asset Investment**. China's rate of fixed asset investment growth has been slowing in recent years. Fixed asset investment (FAI) is an economist's term for building assets that are held for ten years or more. If China is building at a slower rate, less commodity inputs are needed. China is the largest trading partner for many emerging market countries that rely on it to buy their commodity and natural resource exports. If China's FAI continues to slow, investors can expect a negative knock on effect for these countries. Market cap weighted indices have large exposures to emerging market countries that depend on China to buy their resources.

China Fixed Asset Investment (Excluding Rural Households) Year over Year Percent Change
(3/31/2000 – 3/31/2015)



Source Bloomberg
as of 3/31/2015

Individual Country Total Exports to China
as of Q3 2014

Country	Total Exports (billions)	China's rank as trading partner:
Brazil	$16,343	1
Chile	$4,536	1
South Africa	$4,138	1
Argentina	$2,817	2
Colombia	$2,256	2
Peru	$2,063	1
Venezuela	$1,836	4
Ecuador	$459	4

Data from the International Monetary Fund as of Q3 2014.
Retrieved from Bloomberg on 4/30/2015

Dan Weiskopf: Will these factors contribute to a new investment paradigm with new winners and losers?

Brendan Ahern: While we believe these factors have taken some of the luster out of emerging market investing, savvy investors can still find plenty of potential opportunities within emerging markets. We don't know when these factors will reverse from their long term trend, but one can make the argument that we might be in a new paradigm. If this paradigm persists we believe the GDP weighting scheme overweights the beneficiaries such as India and underweights those hurt by it such as Brazil.

Dan Weiskopf You mention that the GDP weighting methodology is a more complete emerging market strategy. Can you elaborate?

Brendan Ahern: We recently launched a new EM ETF (KEMP) based upon the FTSE emerging plus index. One of the key benefits is that it adds a trillion in market capitalization over the their traditional FTSE EM index. This makes this index very liquid. Currently the definition of China within country, regional and global indices is Chinese companies listed in Hong Kong. US listed Chinese companies like Alibaba are excluded due to their US listing. The Shanghai and Shenzhen Stock Exchanges, the world's fourth and seventh largest stock exchanges, are also excluded despite they comprising 10% of the world's market cap. We have added these exposures in advance of traditional indices. GDP weighting also raises India's exposure. We believe the GDP weighting scheme more accurately reflects the economic relevancy of countries. It also provides a glimpse of what EM indices are apt to look like in the future.

Dan Weiskopf : How frequently do you review these factors and potentially re-allocate or tweak the portfolio?

Brendan Ahern: The GDP weighted methodology uses the International Monetary Fund's five year forecast to determine country weights which is reviewed and rebalanced annually. Currently, for example, we are overweighted to China and India at about 43.4% and 17.8%, respectively which is about 18% and 5.6% above the FTSE comparable EM index. As the GDP growth engine of the EM region we see these 2 countries positioned to outperform and the methodology underweights those countries like Taiwan, Brazil and Mexico which are forecasted to show much less GDP growth. We also believe that this methodology puts investors in a relatively defensive position as any slowdown in EM growth that is driven by less imports from China could also add economic pressure to countries who are also dependent upon China's success. Given that the rebalancing is only once a year we see the portfolio remaining current with the long term GDP outlook of the region.

The GDP weighting methodology uses the IMF's five year forecast to determine country weights which is reviewed and rebalanced annually. I think it is important that even if investors don't agree with our views on the US dollar, US oil production and slowing Chinese FAI, the GDP weighting approach provides a look at how EM indices are apt to look in the years to come. I believe the GDP weighting methodology provides an overweight to India and China for tactical investors who want to maintain broad EM exposure and for strategic investors who want to proactively adjust for future index changes such as the inclusion on China's US listed and onshore markets.

Dan Weiskopf: What factors do you believe GDP weighting highlights versus market cap weighting?

Brendan Ahern: We believe GDP weighting is a better representation of countries' economic importance than market cap weighting. Market cap weighting is indictative of a country's capital market development as opposed to GDP weighting being an indictation of economic development and importance within the global economy. The largest and arguably the most important emerging market economies, India and China, are underrepresented in market cap indices while many countries are overweighted. We created KEMP as a more sophisticated tool for investors to capture the most important economies within the emerging market space.

Disclosure: **For Institutional Investors Only.**

Dan Weiskopf is a portfolio manager of Access ETF Solutions LLC, whose third-party ETF strategies are offered through IPI Wealth Management, Inc. (IPI). IPI is an SEC-registered investment adviser, with its principal office located at 226 W. Eldorado St., Decatur, IL 62522, 217-425-6340. Access ETF Solutions LLC was established in 2013 with a focus that structure matters in selecting ETFs. Access ETF Solutions LLC is not affiliated with IPI.

References to specific securities or market indexes are not intended as specific investment advice. The manager may directly or indirectly hold a position in the KraneShares (KEMP) ETF. This interview should be viewed as an educational piece and not a recommendation.

Carefully consider the Funds' investment objectives, risk factors, charges and expenses before investing. This and additional information can be found in the Funds' prospectus, which may be obtained by visiting www.kraneshares.com Read the prospectus carefully before investing.

Investing involves risk, including possible loss of principal. The Funds focus their investments primarily with Chinese issuers and issuers with economic ties to China. The Funds are subject to political, social or economic instability within China which may cause a decline in value. Fluctuations in currency of foreign countries may have an adverse effect on domestic currency values. Emerging markets involve heightened risk related to the same factors as well as increased volatility and lower trading volume. Current and future holdings are subject to risk.

The ability of the KraneShares FTSE Emerging Markets Plus ETF to achieve its investment objective is dependent, in part, on the continuous availability of A Shares through the Fund's investment in the KraneShares Bosera MSCI China A Share ETF and that fund's continued access to the China A Shares market. If such access is lost or becomes inadequate to meet its investment needs, it may have a material adverse effect on the ability of the Fund to achieve its investment objective because shares of the KraneShares Bosera MSCI China A Share ETF may no longer be available for investment by the Fund, may trade at a premium to NAV, or may no longer be a suitable investment for the Fund.

The KraneShares FTSE Emerging Markets Plus ETF and KraneShares Bosera MSCI China A Share ETF may be concentrated in the financial services sector. Those companies may be adversely impacted by many factors, including, government regulations, economic conditions, credit rating downgrades, changes in interest rates, and decreased liquidity in credit markets. This sector has experienced significant losses in the recent past, and the impact of more stringent capital requirements and of recent or future regulation on any individual financial company or on the sector as a whole cannot be predicted. These ETFs may also invest in derivatives. Investments in derivatives, including swap contracts and index futures in particular, may pose risks in addition to those associated with investing directly in securities or other investments, including illiquidity of the derivatives, imperfect correlations with underlying investments, lack of availability and counterparty risk. The use of swap agreements entails certain risks, which may be different from, and possibly greater than, the risks associated with investing directly in the underlying asset.

The KraneShares ETFs are distributed by SEI Investments Distribution Company, which is not affiliated with Krane Funds Advisors, LLC, the Investment Adviser for the Fund.

KEMP invests in variable-interest entities (VIEs), which are investments in foreign-domiciled American Depository Receipts (ADRs). Rather than owning Chinese-domiciled entities, the VIEs have contractual arrangements designed to provide the economic benefits related to certain Chinese-domiciled companies. The structure of VIEs presents some unique risks that should be considered.

VIE structures do not give investors ownership in the operating company, as stock does. With a VIE, an investor has no direct claim on the core, restricted business assets of the VIE operating company. As a result, investors may not exert as much influence over the subject company as they could if they were owners of common stock. Often, the voting rights in

the VIE operating company, especially in matters of corporate governance, are controlled by the principals who established the VIE operating company.

In addition, there is no guarantee as to the enforceability of the VIE structure, as it has never received explicit approval from the Chinese government and is recognized as a structure put in place principally to work around Chinese restrictions on foreign investment.