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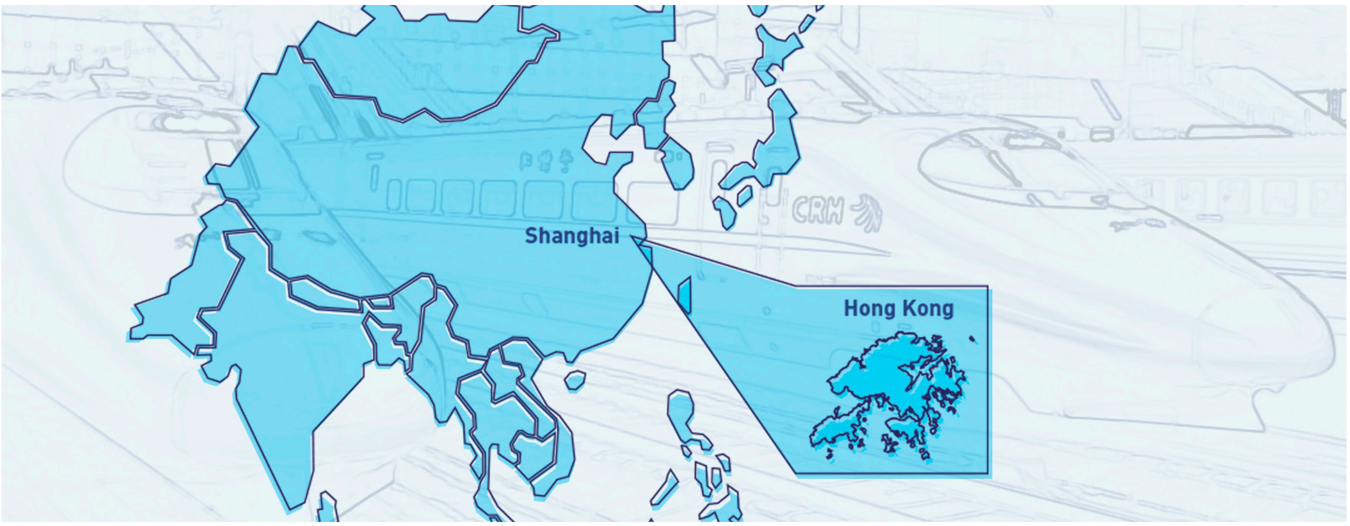
Mainland Chinese Equities' Benefit to Strategic Asset Allocation



Abstract:

Headlines have lamented the poor returns of the "lost decade". The rise of correlations across global indices is an equally serious issue for investors. Historically US investors allocating to international markets benefited from their positive, non-correlated returns. The benefit of international investing has diminished due to a multitude of factors including globalized fund flows, orchestrated central bank policy and the rise of major market participants. Market moving events or the actions of major market players ripple across the globe. This paper will quantify the change in correlations that has taken place. The mainland Chinese equity market offers investors one market that has not been fully integrated into globalized fund flows. Using the MSCI China A Index as a proxy, we will quantify the inclusion of this market within strategic asset allocation. The MSCI China A Index captures large and mid cap representation across China securities listed on the Shanghai and Shenzhen exchanges.

The Rising Tide of Correlations

The three legs of the Modern Portfolio Theory (MPT) stool are return, standard deviation and correlation. Per the theory, packaging asset classes that act differently together rewards an investor with a smoother ride and better risk adjusted return. Historically within MPT international investing offered US investors non-correlated positive returns that raised their risk adjusted returns. On the next page is a graphical representation of the S&P 500's correlation to the MSCI All World Index Ex-US.

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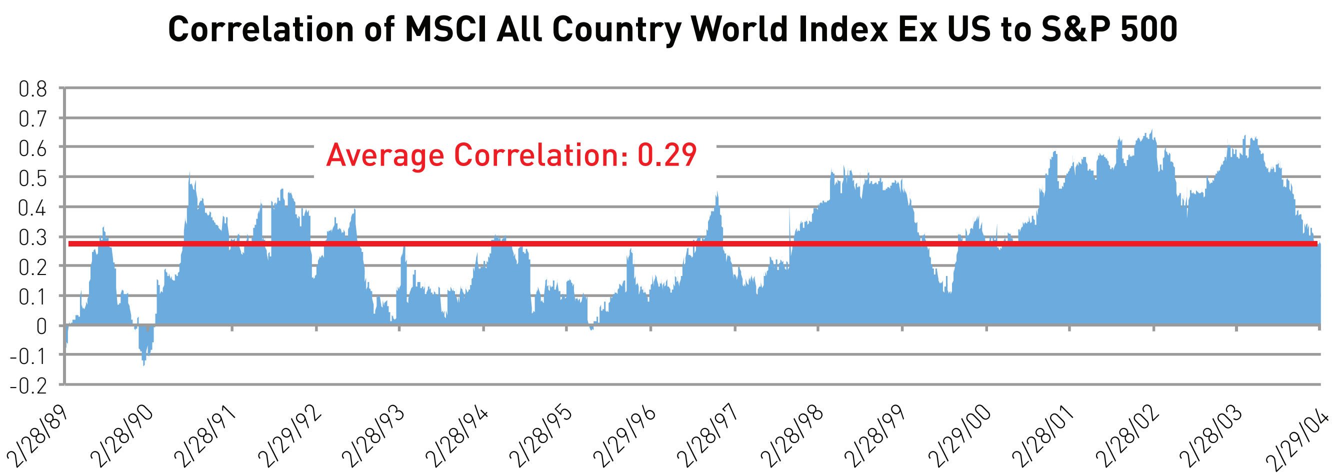
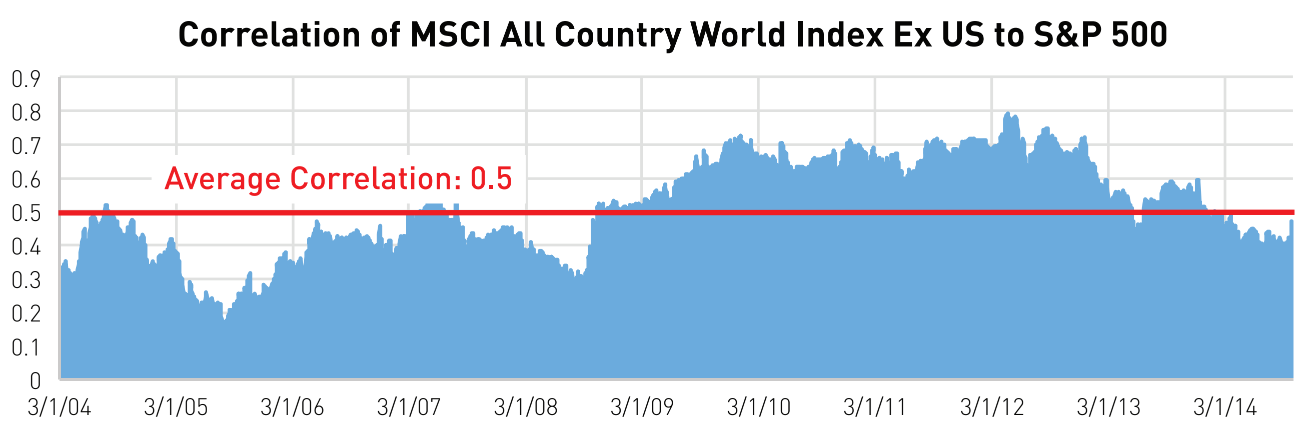


In the 1990's and into the early 2000's the average correlation between the MSCI All Country World Ex US index to the S&P 500 index remained relatively low at 0.29

The era of easily accessible risk adjusted returns is ending as global markets have become increasingly correlated with one another. Over the past ten years correlation between the S&P 500 and the MSCI All World Index Ex-US has increased steadily. It is difficult to say exactly why or when this occurred though the globalization and interconnectedness of markets and economies are likely key contributors. Below is an updated chart of the correlation between the two indices over the past decade.



Over the past decade the average correlation between the MSCI All Country World Ex US index to the S&P 500 index saw a substantial increase to 0.5

What investors do with this information runs from doing nothing and hoping the current high correlation regime dissipates to David Garff's recommendation of becoming more tactical in their country allocations. The opening of the mainland Chinese equity markets provides investors with an additional option.

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The Case for MSCI China A In Strategic Asset Allocation

The Chinese mainland markets have been largely ringfenced from foreign investors. With a market capitalization of nearly one trillion US dollars, non-Chinese investors make up a de minimis percentage of equity ownership estimated between 1-2%. The mainland equity markets are unique in this regard. The below chart highlights the lack of correlation to global benchmarks.

Correlation of MSCI China A Index to Major MSCI Asset Allocation Benchmarks

Tickers	ACWI	EAFE	EM	USA	China	Frontier	China A
ACWI	1						
EAFE	0.96	1					
EM	0.88	0.86	1				
USA	0.94	0.83	0.74	1			
China	0.67	0.67	0.83	0.53	1		
Frontier	0.38	0.39	0.36	0.32	0.31	1	
China A	0.16	0.17	0.28	0.08	0.43	0.15	1

Source: Bloomberg, weekly correlation from September 30, 2003 to September 30, 2014

ACWI - All Country World Index

EAFE - Europe, Australasia, Israel and Far East

EM - Emerging Markets

USA - Companies listed in the United States

China - Chinese companies listed in Hong Kong

Frontier - Frontier Markets

China A - Chinese companies listed on Shanghai and Shenzhen Stock Exchanges

Correlation of 1 means two securities move together, correlation of 0 means the securities are independent of one another. Correlation of -1 means securities' movements are inverse to one another. Correlations above 0.7 are considered significant.

An interesting data point to highlight is the lack of correlation the China A market has to other Chinese markets. 11% of the names in MSCI China A are dually listed on the Hong Kong Stock Exchange (Chinese stocks listed on the Hong Kong exchange are commonly referred to as H-Shares). In looking at periods of market stress we find the disconnect between the H-Share and A-Share market noteworthy. What's the cause of this disparity?

The H-Share market is widely held by both active and passive investors globally due to its inclusion in broad market indices, conversely the A-Share market is not included in such benchmarks. If investors sold their emerging market investments, that selling pressure would directly affect the H-Share market but not the A-Share market. There have been several examples of periods when the H share market declined while the A share market did not. The chart on the next page is a graphical representation of the A Share/H Share premium discount. When values are above 100, the A share stock is a premium to its H share equivalent.

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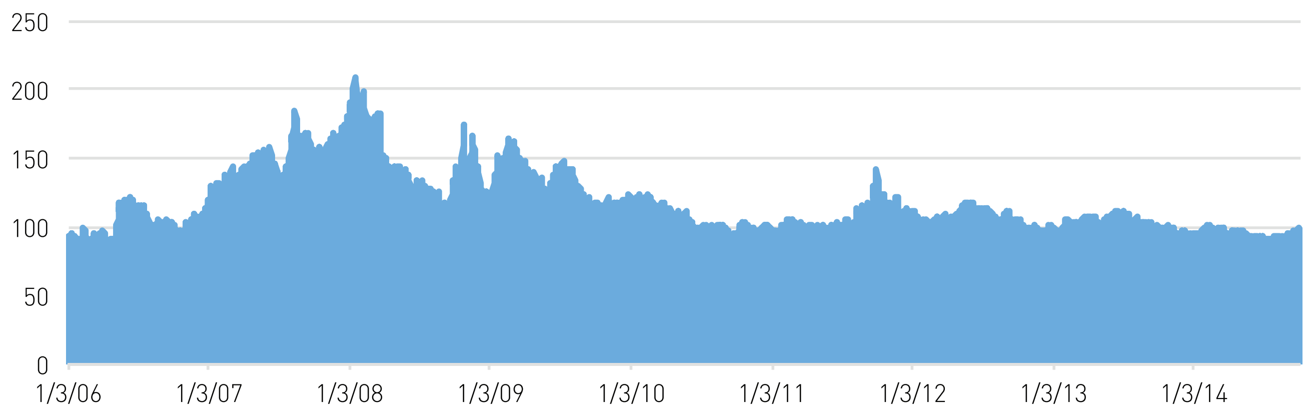
	03/31/2014 – 09/30/2014	12/27/13 – 02/05/14	02/06/12 – 05/23/12	05/27/11 – 10/4/11	01/26/10 – 10/06/10
A/H Premium Discount	7.23%	9.29%	15.31%	46.48%	-24.99%
MSCI China A	19.73%	-3.17%	5.11%	-10.69%	-2.94%
MSCI China	7.31%	-9.99%	-10.65%	-32.95%	17.24%
S&P 500	6.42%	-4.73%	- 1.23%	-14.96%	7.77%

A Share / H Share Premium Discount Change



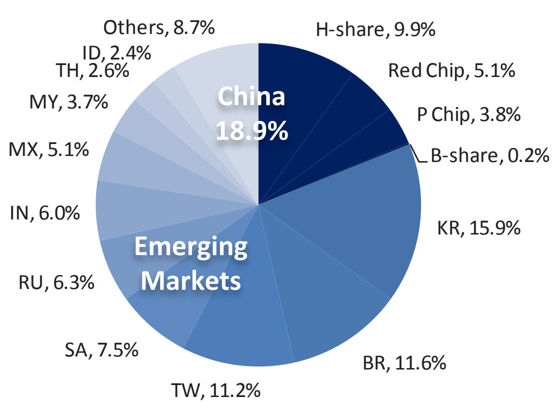
The MSCI China A Index offers investors the potential to recapture the the risk adjusted returns typically associated with international investing due to the de minimis level of foreign ownership and insulation from foreign ownership driven flows.

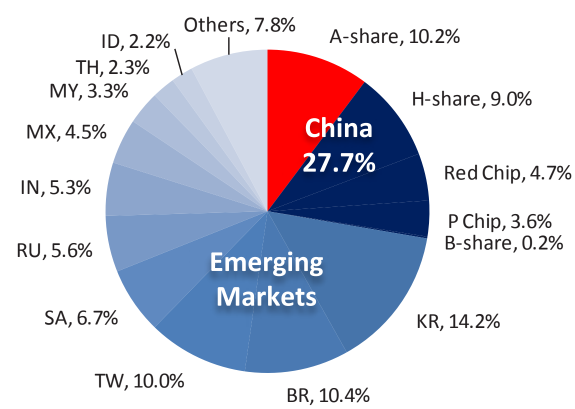
Full inclusion of the mainland markets within MSCI Emerging Markets would raise China from a 18.9% to 27.7% allocation.

Current Status (as of 6/30/2014)

Full Inclusion*

KR = South Korea
BR = Brazil
TW = Taiwan
SA = South Africa
RU = Russia
In = India
MX = Mexico
MY = Malaysia
TH = Thailand
ID = Indonesia





*Source: MSCI, data as of October 18, 2013 based on pro forma results of November 2013 SAIR (Semi- Annual Index Review)

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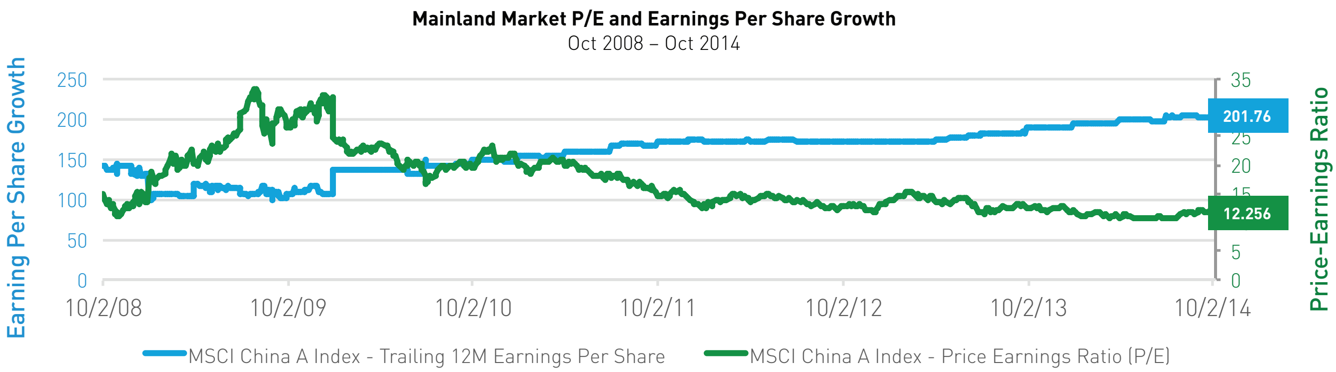
MSCI China A offers compelling valuations to other global markets. The low valuations appear to be partially driven by the increasing earnings per share growth.

As of September 30, 2014	P/E	P/E Forward	P/BV
MSCI China A	12.56	9.7	1.7
MSCI ACWI IMI	17.83	14.4	2.02
MSCI Emerging Markets	12.67	10.3	1.52
MSCI USA	18.91	15.64	2.72

Source: MSCI as of September 30, 2014

The mainland market's low P/E (green line) has been driven by strong Earnings Per Share growth (blue line).



Source: Bloomberg as of October 2, 2014

In addition to the portfolio benefits of MSCI China A, we believe there are several catalysts for the mainland markets after several years of flat returns:

- A new reform minded President and Premier assumed leadership in March of last year and will serve a term of ten years. Since their appointment they have instituted a multitude of reforms including liberalizing lending interest rates, cracking down on corruption, addressing pollution concerns, establishing the Shanghai Free Trade Zone, and reforming State Owned Enterprises.

- Beginning in late October 2014 the Shanghai-Hong Kong Stock Connect Program will allow foreign investors to invest directly into the mainland markets without pre-approval. In the short term, this may rectify the discounts exhibited by the mainland markets. In the long run, it could allow index providers to include the mainland indices in their broader benchmarks. Full inclusion of the mainland markets within MSCI Emerging Markets would raise China from a 18.9% to 27.7% allocation.

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About KraneShares:

KraneShares is a product of Krane Fund Advisors, a boutique asset management firm delivering China-focused exchange traded funds to US investors.

Our local presence and Chinese partners position us to provide ETF strategies from a Chinese perspective.

KraneShares is China focused and partnered with local Chinese professionals.

What sets KraneShares apart:

New paradigms in China-focused investment products

KraneShares ETFs offer US investors innovative ways to invest into China, allowing them to capture the drivers of China's long-term economic growth. Our products are developed from a Chinese perspective and provide a simple, yet differentiated, medium to invest into the second largest economy in the world.

Helping US investors understand the China opportunity

China has 2000 years of history, 1.3 billion people and is growing at exponential speeds. Understanding China requires more than simply reading the newspaper. KraneShares provides transparency into China's capital markets, people, society and culture to help US investors decode the China investment opportunity.

Focused on China and partnered with local Chinese professional expertise

KraneShares has "boots on the ground" in China. Our team and partnership network includes Chinese nationals and seasoned US investment professionals. We provide the local Chinese perspective to US investors.

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