

Dim Sum Bond Primer

The Economic/Political Backdrop

In order to understand the significance of the dim sum bond market, investors must first have a basic understanding of the currency regime in China.

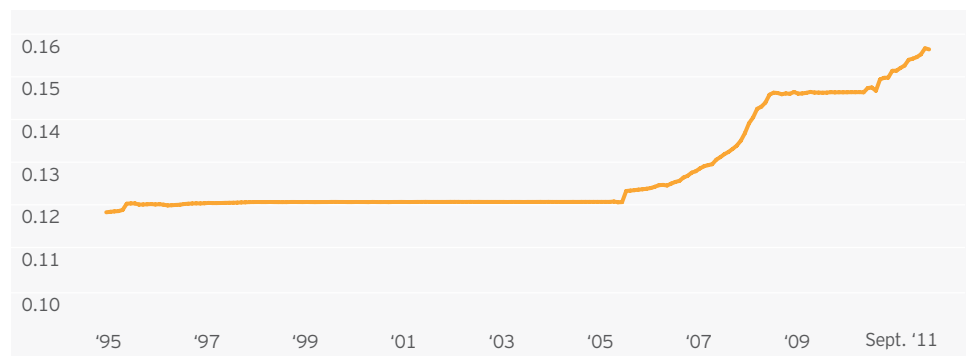
The Chinese government has maintained tight controls on the value of its currency for decades, keeping its value artificially low and thereby supporting economic growth through exports. Only recently has China begun to show signs of interest in letting the market play more of a role in determining the currency's value. This change has been part of China's broader efforts to internationalize its currency and establish it as a global reserve.

Renminbi (RMB) is the official currency of China; its primary unit is the yuan (CNY). For most of its recent history, RMB has only been allowed to circulate within mainland China. This meant all trade with China was settled in non-RMB currencies (mostly U.S. dollars), with the People's Bank of China (PBoC) keeping tight controls on the pegged rate at which it exchanged RMB for U.S. dollars.

Liberalization¹

This all began to change in 2003, when Hong Kong banks were permitted to begin conducting retail RMB business; in 2004 Hong Kong became the first jurisdiction to be allowed limited accumulation of RMB outside mainland China. The following year, China began to allow the RMB to float within a managed range against a basket of currencies and the RMB began to rise against the USD:

\$/¥

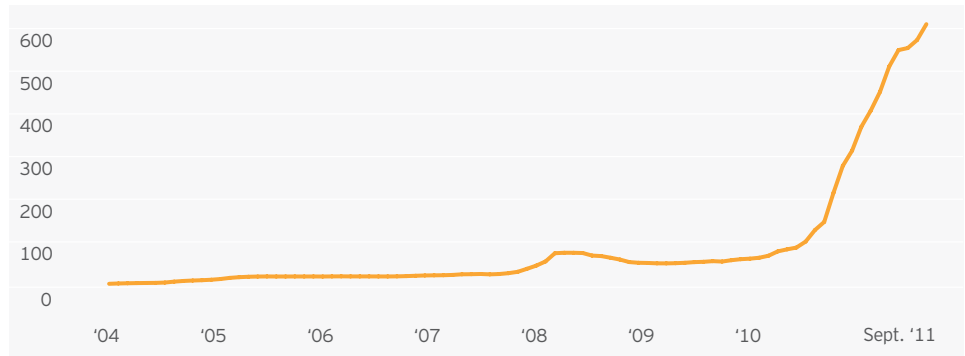


Source: Bloomberg L.P., as of Sept. 30, 2011

Prior to July 2009, all cross-border trade with China had to be settled in non-RMB currencies (mostly U.S. dollars). Up to that point, a very small portion of China's cross-border trade was settled in RMB, which meant there was very little of it circulating outside of China, particularly relative to China's significant proportion of global trade.

This changed in July 2009 when China began to permit a limited number of foreign trade partners to be paid in RMB and then expanded that list in 2010. When this happened, RMB deposits began to rapidly accumulate in Hong Kong:

RMB Deposits with Hong Kong Licensed Banks (¥ billion)



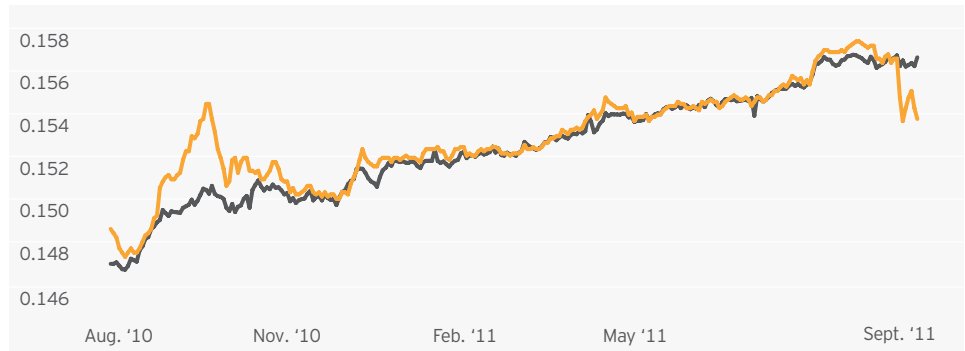
Source: Bloomberg L.P., as of Sept. 30, 2011

Offshore vs. Onshore

Outside of mainland China, the RMB is not managed, but rather is allowed to float freely. Not surprisingly, it exhibits characteristics of being its own separate currency. As such, RMB outside mainland China (offshore) is labeled CNH while the onshore version maintains its designation of CNY.

China allows some mainland entities to simultaneously access both the CNH and CNY markets, but maintains controls on the extent to which they may do so. So while there is some market pressure to keep CNH and CNY in parity, there is not unlimited permission to arbitrage them, which means at times there can be some divergence:

\$/¥ ■ Offshore ■ Onshore



Source: Bloomberg L.P., as of Sept. 30, 2011

Offshore bonds: As CNH deposits grow, depositors are increasingly looking for ways to earn returns on those deposits. The offshore bond market has developed in response to this demand.

Dim sum bonds are yuan denominated and generally issued in Hong Kong by a variety of issuers ranging from governments to corporations. These bonds get their name from the Chinese cuisine that is especially popular in Hong Kong.

The dim sum bond market was introduced in 2007 when People's Republic of China-Incorporated-Financial-Institutions were first allowed to issue RMB-denominated bonds offshore. In 2010, the regulatory environment for offshore RMB bonds was eased and additional entities became eligible to both issue and invest in dim sum bonds. Since 2007, total issuance is over ¥200 billion, with ¥140 billion issued year to date by mid-September 2011.¹

Investing in Dim Sum Bonds

Dim sum bonds may offer investors a new means of accomplishing a variety of portfolio objectives, including *currency exposure*, *alternative investment exposure*, and *diversifying a fixed-income portfolio*.

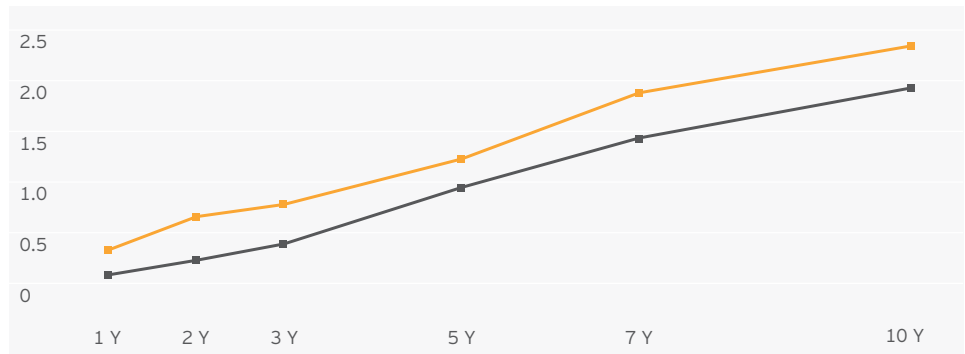
In September 2011, Chinese officials stated their intention to gradually move away from their managed-range CNY policy and toward allowing the yuan to float freely, letting it achieve full convertibility by 2015.¹ In a globalized economy, foreign currency exposure can be an important piece of a portfolio's construction, offering the potential to protect against a weakening U.S. dollar.

Dim sum bonds are issued and settled in offshore Chinese renminbi (CNH) and offer investors exposure to both its appreciation potential against the dollar as well as its reserve-currency trajectory. Additionally, using bonds to gain this exposure may help to offset some currency-related volatility through their coupon payments.

As a relatively new investment vehicle, dim sum bonds can also be thought of as an alternative investment, offering previously unobtainable exposure to both the Chinese yuan and to issuers in mainland China. Until recently, investors were limited largely to equity investments for their exposure to China's rapid economic growth. Dim sum bonds offer an alternative to equity for investors looking for exposure to China's rapidly expanding role in the global economy.

Dim sum bonds may also offer a means of diversifying a fixed-income portfolio. In addition to foreign currency exposure, dim sum bonds also offer exposure to a different yield curve:

Yield Curves (%) ■ China Sovereign Offshore Curve ■ U.S. Treasury Curve



Source: Bloomberg L.P., as of Sept. 30, 2011

To the extent that China's path of economic growth diverges from that of the U.S. and as it continues to liberalize its currency regime, its interest rate term structure may be significantly different from that of the U.S. This may offer investors a new way to diversify their fixed-income portfolios and a vehicle for shielding their portfolios in a rising U.S. rate environment.

To learn more about dim sum bonds, call 800 983 0903 or email info@powershares.com.

Arbitrage is risk-free profit.

Fixed-income securities, such as notes and bonds, carry interest rate and credit risk. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. Credit risk is the risk of loss on an investment due to the deterioration of an issuer's financial health.

Adverse economic conditions, such as unfavorable or volatile currency exchange rates and interest rates, political events or other conditions may cause the Chinese government to intervene and impose "capital controls," including the prohibition of, or restrictions on, the ability to transfer currency, securities or other assets.

There are special risks associated with investing in securities designed to provide exposure to Chinese Yuan, such as Yuan-denominated bonds in which the Fund will invest. The Chinese government maintains strict currency controls and regularly intervenes in the currency market. As a result, the value of the Yuan, and the value of Yuan-denominated securities, may change quickly and arbitrarily, potentially impacting the availability, liquidity, and pricing of securities designed to provide offshore investors with exposure to Chinese markets.

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