High-income bonds could fare well amid current market volatility

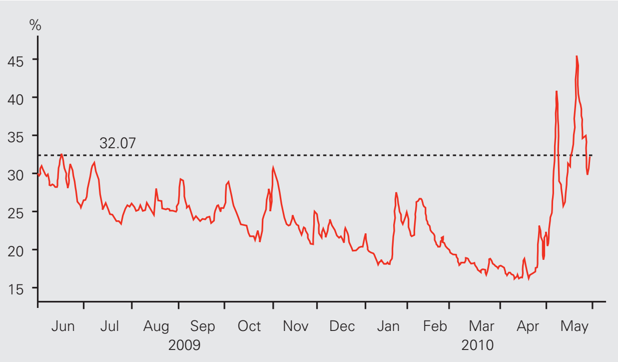
Q3 2010

Summary

- In times of volatility, investors tend to invest in lower risk assets
- Income seekers may consider re-allocating their capital to a bond portfolio that could offer stable income
- Seasoned bond fund managers with consistent and outstanding track records could help generate decent risk-adjusted returns under the current market condition

The European sovereign debt risk and the renewed tension between North-South Korea hurt market sentiment in May. Global equities fell sharply by nearly 10% and volatility spiked. The VIX Index, a measure of expected market volatility, rose to the highest level in more than a year as investors' appetite for risk continued to fade (Chart 1). In contrast, government bonds in the G7 have benefited from the shift to a safe haven.

Chart 1: The VIX Index



Source: Bloomberg. Data as at 31 May 2010.

Bonds should continue to outperform

While the events in May did play a role in raising the level of nervousness, they were not the key reason behind the equity market sell-off. The more fundamental factor driving the markets' weakness is that there are still concerns about global growth, given the elevated levels of unemployment and weak consumption.

As concerns over growth remain and markets are likely to be volatile, investors are likely to opt for stability and income. As such, flight to safety could prolong investors' preference for low-risk assets. However, as interest rates are not expected to rise sharply in the near future given the weak economic outlook, close to zero money-market rates make cash deposits an unrewarding alternative for risk-averse investors.

In an environment where growth could be subdued, income seekers may consider re-allocating their capital to bonds that could offer higher yields than cash in the medium term.

Corporate bonds offer better value than government bonds

While bonds in general could continue to perform well for the rest of 2010, investors have to be selective as global markets could remain volatile. Though economic recovery is underway, the macroeconomic outlook for 2010 remains challenging, especially in developed markets as structural problems persist. Hence, bond segments with stronger fundamentals, a brighter outlook and potential to offer respectable risk-adjusted returns are likely to outperform in the second half of 2010.

HSBC Global Asset Management

Government bonds of developed markets offer relatively little value at the current levels. The run up in investment-grade government bonds like US Treasuries, and their expensive valuations and low yields, make them considerably unattractive as a medium-term investment. Moreover, other European sovereign bonds like those in PIIGS (Portugal, Ireland, Italy, Greece and Spain) are subject to potential default and political risk.

On the contrary, corporate bond markets present more value after some correction in April amid the European sovereign debt crisis. Although market sentiment has improved after the European Union and the IMF approved rescue packages, market volatility remains high and credit spreads continue to be wide compared with the historic average. Given that corporate profitability has largely recovered over the past year as a result of the timely stimulus measures by governments and central banks around the world, this paves the way for a quick turnaround as the European situation stabilises and economic uncertainty clears.

To strike a balance between yields and quality

Under the current market conditions, a stable income stream and capital preservation are equally important. While income seekers are chasing for higher yields, they should also keep an eye on the potential risks.

Although bonds in general are less volatile than equities, bondholders are subject to various types of risks, such as interest rate risk, liquidity risk, reinvestment risk, credit risk, default risk, currency risk, etc. Amid the current market uncertainties, closer attention should be paid to the credit quality of the bonds and their potential default risk.

Default risk is the possibility that a bond issuer will default, by failing to repay principal and interests in a timely manner. Default risk has a significant impact on the value of a bond: if a borrower's ability to repay debt is impaired, default risk is higher and the value of the bond will decline.

Table 1: Credit rating and the potential default risk

Credit rating	Classification	Default risks	Average yields
AAA	Investment grade	0 - 0.1%	2.7%
AA			3.0%
A			4.1%
BBB		0.3%	5.0%
BB	Non-Investment grade	0.8%	7.8%
B	Speculative	3.5%	9.0%
CCC and below	Extremely speculative	26.4%	13.2%

Source: Moody's Investor Services, Merrill Lynch Broad Market Corporate and Merrill Lynch High Yield bond indices. Data as at 30 April 2010. Default risk refers to global issuer weighted default risk.

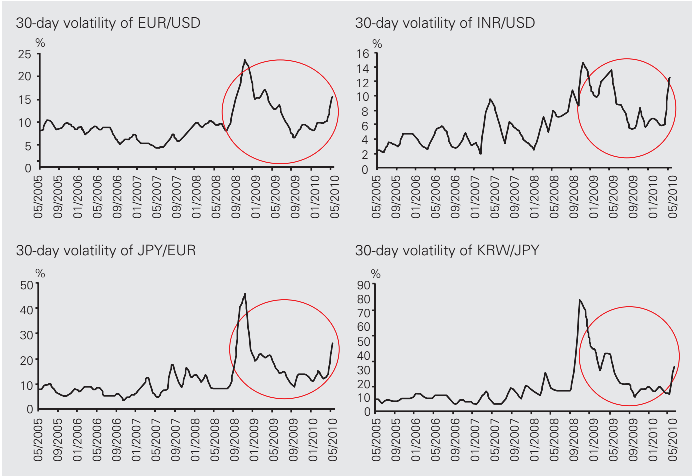
Although high-yield bonds in general offer higher yields than investment-grade bonds, they are more at risk of default than the latter, especially in times of recession or credit crunch. To contain risk, one should avoid investing in highly speculative bonds.

Given the breadth and depth of the global bond universe, it might not be necessary for investors to trade-off substantial risk by picking highly speculative bonds to obtain higher yields. Indeed, investors may take advantage of the market inconsistencies and add value by capturing opportunities at issuer and sector levels. Based on the risk-return profile of bond segments, one can see that bonds rated BBB/BB present the solid risk-adjusted return potential today.

Minimise the FX exposure to reduce risk

Aside from potential default risk, the currency risk should not be overlooked either. Currency volatility has risen significantly since the global financial crisis, and sharp volatility across the board makes currency bets hard to get right (Chart 2).

Chart 2: Currency volatility has escalated since the credit crisis



Source: Bloomberg. Data from 31 May 2005 to 31 May 2010.

To generate alpha, you have to know where to look

Challenging conditions in the capital markets have created unprecedented dislocations and selective opportunities for investors. However, as the risk-return profile within the bond universe is diverse, one must possess in-depth market knowledge and must know where to look to unearth hidden opportunities and to generate alpha (excess return).

While the excess return can be generated through a prudent credit-selection strategy, it is not easy for ordinary retail investors to construct a diversified and high-income bond portfolio given their limited capital and market knowledge. As such, retail investors may consider investing in a professionally-managed global high-income bond fund to seek decent income stream and risk diversification.

Seasoned bond experts with long-term track records can help you actively manage the portfolio during different market cycles to unlock returns, manage risk and quick response to unprecedented market events. They may also provide access to bonds that were normally only available to institutional investors, but not the retail public.

Important information:

- The Fund may invest more extensively in futures, forwards, options, swaps (such as credit default swaps and total return swaps) and other financial derivative instruments which may involve embedded leverage.
- The Fund may have exposure to emerging markets, non-investment grade bonds, mortgage backed securities and asset backed securities which are subject to higher risks and volatility.
- The Fund's investments may involve substantial credit/counterparty, market, currency, volatility, liquidity, regulatory, downgrading and political risks. If the issuers default, or the relevant securities or their underlying assets cannot be realised or perform badly, investors may suffer total loss of their investments.
- The investment decision is yours but you should not invest unless the intermediary which sells you the Fund has advised you that the Fund is suitable for you and has explained why, including how investing in the Fund will be consistent with your investment objectives.

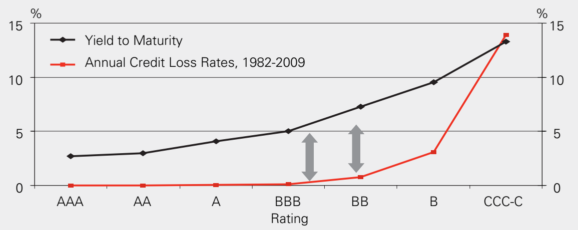
4 reasons to invest in the **HSBC Global Investment Funds – Global High Income Bond** (the "Fund")

1 High income potential[1]

- In an era of volatility, a steady income stream offers some certainty to investors. The Fund aims to deliver high income through stable monthly dividends[1]. This monthly income payment will be periodically reviewed

2 Stringent credit risk control[2]

- Amid current market condition, the Fund aims to invest mostly in corporate bonds with an average credit rating of BBB-/BB+, which have a historically attractive risk-return profile compared to much higher risk bonds. The Fund will actively manage credit and default risk, aiming for significantly lower volatility than the average high yield bond fund



	3-year annualised volatility[3]
Benchmark composite	8.6%
High yield bond fund average	18.8%

3 Seek minimisation of currency risk

- Currently, the Fund seeks to minimise currency volatility by investing 90% in USD bonds, but will maintain 10% exposure to foreign currencies. It may primarily play its foreign currency exposure through emerging-market currencies, where stronger fundamentals indicate more visible opportunities for currency appreciation

4 Managed and supported by award-winning fixed income team[4]

- Having an established investment team, with a proven track record, is critical to unearthing the right investment opportunities. The Fund will be managed and supported by an award-winning team that has gained industry recognition for its Asian, European and global emerging markets fixed-income expertise

- **Asian fixed income**
  - "The Best of the Best Asian Bond House"
  - Lipper Fund Awards Hong Kong 2009 & 2010
  - Morningstar 2009 Fund Awards (Hong Kong)
  - Asia Asset Management Best-of-Best Awards 2009
- **Global emerging markets fixed income**
  - "The Best Emerging Market Debt House"
  - Lipper Fund Awards Japan 2010
  - Morningstar 2008 Fund Awards (Hong Kong)
- **European fixed income**
  - Lipper Fund Awards Italy 2010
  - Lipper Fund Awards France 2010
  - Morningstar 2010 Fund Awards (France)

[1]Applicable to Class AM only. Dividend of the Fund is not guaranteed. It is subject to the Fund manager's discretion and the dividend may be paid out of capital. Payment of dividends from capital will result in capital erosion and consequently constrain further capital growth. A positive distribution yield does not imply a positive return. [2]Source: Yield data - Bloomberg, Merrill Lynch (ML) indices as at June 2010; loss data - Moody's Corporate Default and Recovery Rates, 1920-2009. AAA = AAA-rated, ML Global Fixed Income Market Index; AA = AA-rated, ML Global Fixed Income Market Index; A = A-rated, ML Global Fixed Income Market Index; BBB = BBB-rated, ML Global Fixed Income Market Index; BB = BB-rated, ML Global Fixed Income Market Index; B = B-rated, ML Global Fixed Income Market Index; CCC or lower = CCC-rated or lower, ML Global Fixed Income Market Index. [3]Source: HSBC and Morningstar. Data as at 31 May 2010. Peer average refers to the category of Morningstar fixed income global high yield. Benchmark refers to 35% EMD Barclays Emerging Markets USD Index + 20% Barcap U.S credit Baa + 15% Barcap US High Yield Ba + 15% BarCap EuroAgg Corporate Baa USD Hedged + 15% BarCap Euro HY BB Rating Only USD Hedged. Benchmark does not represent the performance of the Fund. These results are not indicative of future performance. [4]Source: Lipper Fund Awards 2009 and 2010, data as at 31 December 2008 and 2009 respectively. Morningstar 2008, 2009 and 2010 Fund Awards, data as at 31 December 2007, 2008 and 2009 respectively. Asia Asset Management Best of the Best Awards 2008 and 2009, data as at 31 December 2008 and 2009. "Best Emerging Market Debt House" by Pension and Investment Provider Awards 2010, data as at 2010.

HSBC Global Investment Funds – Global High Income Bond

The Fund seeks to provide stable income by investing in a diversified portfolio of higher yielding fixed income bonds, including investment grade, high yield, Asian and emerging markets bonds.

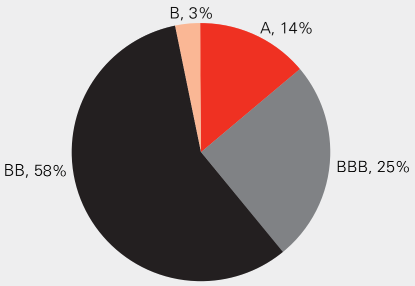
Initial offer period until 28 July

Key features

- Targets stable monthly dividend distribution[1]
- Provides flexible dealing currency options – available in HK$/US$
- Current average credit rating of BBB-/BB+[#] and NO exposure to highly speculative bonds

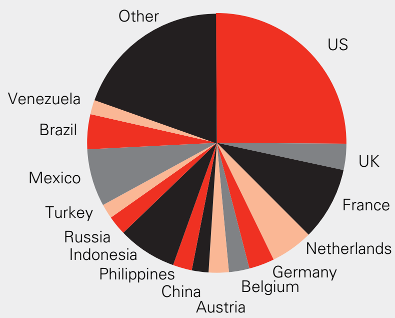
Indicative portfolio (as at 31 May 2010)*

Credit rating



	Characteristics
Average credit rating	BBB-/BB+
Indicative duration	5.5 years

Country breakdown



No exposure to PIIGs!

Fund details

Class of shares	Class AM
Currency	US$ / HK$
Launch date	28 July 2010
Minimum investment	US$1,000 / HK$10,000
Initial offer price^	US$10.309 (includes a sales charge of 3% of the initial offer price)
Management fee	1.25%
Switching fee	1%
Redemption fee	Nil
First dealing date	29 July 2010
Financial year-end	31 March
Dividend policy	Monthly, targeted first ex-dividend date in end September 2010[1]
Fund manager	Azim Meghji
Investment manager	Halbis Capital Management (UK)

Suitable investors

- The Fund may be suitable for investors who seek:
  - high income and regular dividend distribution
  - lower-risk exposure than equity amid the current market volatility
  - access to bond portfolio managed by well recognised bond experts
  - to participate in bond markets and are willing to accept bond investment risks, such as interest-rate risk, default risk and liquidity risk, etc.

Potential risks

- The investment may involve bond market, foreign exchange, interest rate, credit, liquidity, default and political risks, currency risks and any combination of these and other risks
  - Bonds are more susceptible to fluctuation in interest rate movement
  - Credit risk : an issuer suffering an adverse change in its financial condition could lower the credit quality of a security, leading to greater price volatility of the security
  - Default risk: an issuer suffering an adverse change in its financial condition may not pay interests or repay the principal, leading to greater price volatility of the security greater price volatility of the security

Customer Hotline 2284 1118 www.assetmanagement.hsbc.com/hk

*[1]Applicable to Class AM only. Dividend of the Fund is not guaranteed. It is subject to the Fund manager's discretion and the dividend may be paid out of capital. Payment of dividends from capital will result in capital erosion and consequently constrain further capital growth. A positive distribution yield does not imply a positive return. #Represents the average portfolio rating of the current indicative portfolio, and may be changed from time to time subject to investment strategy. *The figures and information are for illustrative purposes only and does not represent the Fund's actual composition. Actual asset allocation and characteristics may differ. ^The equivalent amount in HKD will be calculated based on the exchange rate on the IPO closing date*

Issued by HSBC Global Asset Management (Hong Kong) Limited