

**From The Desk – HSBC GIF Euroland Equity** Quarterly ReviewOctober 9th, 2009**How did the markets perform?**

The Euroland Equity is up 20% over the quarter. Leading indicators were expansionary for the first time pointing to an official end of the recession in Q3. The earnings cycle also has probably finally turned after a 47% fall in earnings since the cyclical peak at end 2007, the biggest decline in since WWII. Moreover the market consensus has posted net positive earnings upgrades for the first time in two years.

Within this context cyclicals generally outperformed defensives particularly in the first half of the quarter. The top performers were real estate (+45%), banks(+35%), semis(+34%), insurance (+28.2%) and the weakest were tech hardware (+2%), food & staples(3.2%), energy(9.0%), Food & Beverage(13.5%) and healthcare including pharma(+15.5%).

The recovery in stocks became increasingly broad based and some cyclicals started to lag their growth counterparts. For example valuation factors such as low price to book were highly positive return contributors in August but practically neutral in September.

The size factor has also been a world of contrast, with the flow in liquidity benefiting the smaller cap segment of the market. With little new money entering the euroland equity market, investors shifted out of mega caps into the mid and small cap companies, thus creating a huge gap in relative performance. Mega caps are up only 15% year to date versus 66% for mid caps.

Performance Analysis**Fund Performance**

Note to returns: the gross arithmetic outperformance was 1.46% over the month and 9.62% year to date ².

	Month %	3 Months %	2009 YTD %	12 Months %	3 Years %	Since Inception %
Fund return	6.68	24.93	35.28	8.23	-6.65	45.83
Benchmark return	4.35	20.67	23.99	-2.19	-20.63	22.47
Difference	2.33	4.27	11.29	10.42	13.98	23.36

[All returns in the table above are provided by HSBC Global Asset Management France]

Returns calculated before deduction of management fees and operating expenses TER: 1.85% ("A", retail share)

¹ Inception of Strategy on October 1st, 2004

²After adjusting for timing differences between publication of the fund NAV at 11:00 am CET and the Benchmark at the market close, the real gross arithmetic outperformance over the month is 1.46% and 9.62% year to date.

Benchmark: MSCI EMU (NR) index.

The performance shown refers to the past and should not be seen as an indication of future performance.



Q3 review

Over the quarter outperformance of close to 4% was purely a result of stock exposure. The impact of sector allocation was slightly negative because of higher than average exposures to defensive economic models such as Telecoms, Food & Staples and Pharmaceuticals.

The long and gradual shift over the last 18 months of the portfolio to companies that would stand to benefit the most from economic normalisation has paid off. However, some of the low profitability companies are starting to be priced at mid cycle valuations: this is probably not justifiable at this point in the economic recovery. We have started to pare back on stocks where further big gains seem unlikely. Instead we have already refocused on companies combining relatively attractive valuations with clear growth initiatives or restructuring potential.

The height of our bias in the low profitability, recovering stocks was reached at end June where this segment reached about one-third of the overall portfolio versus 18% in September 2008. The current level is still high at around 29% but this will probably gradually diminish as we see more attractive value opportunities in the medium to rising and high and stable profitability segment of the market. Our recently initiated position in Unilever is a recent example of this gradual shift.

Performance Drivers

Stock level over the quarter

The table below shows the top positive and negative stock contributions to performance for the quarter.

Positive Stock	Return %	Relative Weight %	Impact %	Negative Stock	Return %	Relative Weight %	Impact %
VOLKSWAGEN	-53.42%	-0.80%	0.85%	DELHAIZE LE LION E	-5.38%	1.15%	-0.34%
CINTRA	79.98%	1.48%	0.75%	REED ELSEVIER	-1.72%	1.15%	-0.29%
SAINT-GOBAIN	49.62%	1.75%	0.46%	HELLENIC TELECOM	3.67%	1.53%	-0.29%
ING GROEP	70.68%	1.06%	0.45%	BBVA	36.84%	-1.89%	-0.27%
TOTAL SA	5.26%	-2.31%	0.38%	FRESENIUS MED CARE	6.62%	1.55%	-0.23%

[HSBC Global Asset Management – 30 June 2009 to 31 September 2009]
Benchmark: MSCI EMU (NR) index.

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Developments in investments

Best contributors over the month

- **Volkswagen** : Our absence from this holding was the best contributor over the month. We have never invested in the stock because of unjustified valuations and the opacity of the holding structure. The latest news is that Volkswagen will own Porsche, but the price has not been set yet. As a result, the stock price is now converging rapidly to the valuation of its peers.
- **Cintra** : Cintra rose on the news that the terms of its impending merger with Ferrovial would be more generous than expected. Moreover, the improvement in traffic data and the receding risk of deflation combined with the opening up of the credit markets for infrastructure companies has been highly positive. Finally, lower interest rates benefited interest rate sensitive utilities such as Cintra.
- **Saint Gobain** : The whole construction and materials sectors have outperformed in the rally since March lows. As St. Gobain is mainly exposed to a relatively resilient European market, it was a late entrant into the global sector rally occurring in Q2. Saint Gobain also benefited from government stimulus plans to public works programs throughout Europe. Finally, Saint Gobain enjoyed a deep discount because of a 30% stake by Wendel, a holding company which looked at one point as if it were going to have to sell its stake in the open market. We favor St. Gobain because it has consistently proven it can meet its cost cutting targets. And the company is very much exposed to different segments of the Alternative energy space which is also being supported by government subsidies and stimulus packages.
- **ING Groep** : ING surged as it played a valuation catch up to its peers subsequent to its bail out by the Dutch government. Specifically, the Dutch government bought most of its toxic exposure to Alt A exposure at a price which it could have achieved in the market.
- **Total** : Our underweight position in Total has contributed positively to relative returns because of a disappointing earnings report and the fact that it continued to miss its targets for volume growth. We continue to prefer smaller alternative energy companies such as OMV and Repsol because of their greater nimbleness and growth potential.

Worst contributors over the quarter

- **Delhaize le Lion** : The stock experienced profit taking because of strong price appreciation year to date and the fact that two of its competitors (Safeway and Super Value) in the US have recently reported profit warnings due to food disinflation and aggressive price cutting from Walmart. However, the stock price should be supported by the fact that Delhaize is taking market share away from Carrefour and Colruyt in its home market of Belgium.
- **Reed Elsevier** : There were two reasons for the drop in the share price: The results confirmed that the business which were not supposed to be cyclical were in fact somewhat cyclical such as professional publishing, legal, medical and hospitals. The second issue has been its failure to find a buyer for its professional trade journal (RBI). The proceeds from the sale of RBI was supposed to offset the price of recent acquisitions. Moreover, the recent right's issue to boost its capital position



has pressured the stock price. We still like Reed because its businesses remain relatively defensive but are leveraged to an economic recovery. And valuation is very attractive.

- **Hellenic Telecom** : The overhang on the Greek market, weighing on Hellenic Telecom are the upcoming general elections which the Leftist opposition has a good chance of winning. This could lead to re-regulation for Telecoms. Moreover, Q2 results indicated intensifying competition is pressuring Hellenic's revenues.
- **BBVA**: Our underweight position in BBVA has been negative given the ongoing rally of the entire banking sector over the month. Within Spanish banks, we prefer Santander to BBVA because of the former's higher quality management and higher quality exposure to the Brazilian market relative to BBVA's exposure to the Mexican market.
- **Fresenius Medical Care**: Fresenius is suffering along with the entire Healthcare industry as a result of the market's preference for cyclicals and from the controversy concerning the impact of Obama's Healthcare reform bill on private healthcare. However, none of the proposals so far would seem to have a direct adverse impact on Fresenius's dialysis and diagnostic business.

Sector Level over the month

The table below shows the major sector contributions to performance for the month. The sector weightings and corresponding contributions result entirely from our stock selection approach.

Positive	Return %	Relative weight %	Impact %	Negative	Return %	Relative weight %	Impact %
Sector				Sector			
Utilities	15.40%	-5.44%	0.29%	Banks	34.34%	-1.83%	-0.20%
Autos & Components	8.41%	-2.05%	0.24%	Health Care Equip. Serv.	9.37%	1.71%	-0.20%
Tech Hardware	3.13%	-1.00%	0.21%	Food & Retailing	3.87%	1.03%	-0.19%
Transportation	28.54%	2.52%	0.19%	Real Estate	40.33%	-0.89%	-0.16%
Insurance	27.15%	2.02%	0.12%	Telecommunication Services	16.28%	2.09%	-0.08%

[HSBC Global Asset Management – 30 June 2009 to 31 September 2009

Benchmark: MSCI EMU (NR) index.

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Significant portfolio activity over the month

Unilever : We initiated a new position of about 1.2% because of its refocusing efforts on fewer but higher growth products across all markets and ability to expand margins through cost efficiencies, cheaper raw materials and high margin brands. It will be investing the proceeds in marketing initiatives in order to upgrade its overall profitability profile.



Total : We added about 0.4% to the position because of a more attractive valuation profile and the fact that that CAPEX outlays will be lower than expected due to its ability to obtain hefty discounts of up to 20% from their contractors.

Fortis: We sold the remaining position because our target price of 3 euros had been reached, implying limited further upside potential for a business with a highly uncertain future.

Repsol: We reduced 0.6% from the position because its big discount to peers has now gone away. This discount was justified in part due to the risks associated with the development of its Brazilian discoveries but the upside for growth still remains intact.

Fund positioning

The table below shows the largest five positions at the end of the month:

Top positions	Weight %	Relative weight %
TELEFONICA	5.3%	1.8%
BANCO SANTANDER	5.2%	1.3%
SANOFI-AVENTIS	4.1%	1.8%
REPSOL YPF	3.2%	2.6%
UNICREDIT	3.1%	1.5%

[HSBC Global Asset Management – 30 September 2009]
Benchmark: MSCI EMU (NR) index.

Telefonica: A significantly higher growth profile than the sector thanks to the strength of its domestic market, its accretive acquisition policy and a growing exposure to international markets. Telefonica is second to none in its ability to wring efficiencies out of its asset base.

Banco Santander : A well managed Spanish bank with a fairly equal retail exposure to both Europe and LATAM. It has one of the highest levels of generic provisions in order to protect itself from the cyclical downturn in its home market. Moreover Santander just raised €5.5 billion from an IPO of 15% of its Brazilian subsidiary. This will place it in an even strong capital position relative to its peers.

Sanofi: Sanofi faces the major challenges affecting the Pharma industry. However, Sanofi benefits from a very low valuation relative to its peers, an above average dividend yield, extremely strong balance sheet and high and stable margins. There is ample room to improve profitability by reducing its bloated cost structure. In fact, recent profitability and revenue trends indicate that the turn around is bearing fruit both in terms of new product growth and cost reductions.

Repsol: It Repsol benefits from resilience in its domestic refining business in Spain and is one of the fastest growing energy and exploration companies thanks to its major discoveries off the coast of Brazil and in the Gulf of Mexico. It is also in the process of floating 20% of its partially regulated Argentinean subsidiary. This will free up capital to develop its deep water discoveries off the coast of Brazil and Mexico.



Unicredit: Unicredit is one of the highest profitability banks in Italy thanks to oligopolistic position in its home market and exposure to the best economies of Eastern Europe. Poland, its biggest single country exposure outside of Italy is a very attractive market for banks thanks to its strong and stable economy and potential for growth. Its position in Turkey was boosted by huge interest rate cuts by the central bank. Unicredit is resolving solvability concerns on its own by raising 4 billion euros instead of exercising its option to use government aid.

Sector

The table below shows the largest overweight and underweight sector positions at the end of the month:

Overweights	Weight %	Relative weight %	Underweights	Weight %	Relative weight %
Consumer Services	4.2	3.3	Utilities	4.3%	-6.0%
Pharma & Biotech	7.9	3.2	Banks	15.0%	-2.9%
Transportation	4.8	3.1	Materials	4.9%	-2.7%
Telecom Services	11.4	2.4	Autos & Components	2.2%	-1.8%
Insurance	8.6	2.4	Cons. Durables	0.0%	-1.6%

[HSBC Global Asset Management – 30 September 2009]

Benchmark: MSCI EMU (NR) index.

Although our approach resides purely in stock selection, the strategy does not seek sector neutrality. Sector fundamentals sometimes contribute to our selection of specific stock holdings.

- **Consumer services:** a mix of companies with resilient business models that thrive during economic downturns (budget hotels, budget food outlets).
- **Healthcare:** resilient profitability based on rising margins (operational leverage and cost cutting), improving asset turnover (sales growth and R&D efficiency), limited financial leverage and good cash flow transformation.
- **Telecom Services:** strong cash flows and falling CAPEX. Stable leverage through high dividend distribution. Attractive valuation.
- **Utilities:** uncertain commodity-driven and highly regulated cash-flows. Ballooning debt-financed capital employed and relatively unattractive valuations. However, low interest rates are starting to be somewhat positive for the sector.
- **Banks:** Caution is required as valuations have stopped discriminating between the good and bad banks.
- **Consumer Durables:** expensively valued profitability with only partial defensive characteristics.
- **Materials/Autos:** transitory profitability with limited valuation attractiveness.



Risk and risk-adjusted performance

Fund metric	Value	Target range/number/limit
Tracking error*	4.5%	(3 –6)
Stock specific risk (% of active risk)	87%	> 50%
Number of positions	57	Target 50 -60
Active Industry exposure (% of active risk)	37.6%	< 50%
Beta (ex ante)	1.03	(0.9 -1.1)
Information ratio** (3 years rolling)	1.2	0.5 – 1.5

[HSBC Global Asset Management – 30 September 2009]

* ex-ante tracking error at 30 September 2009

** calculated using annualised excess return over 3 years divided by average monthly ex-ante tracking error over 3 years

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Economic backdrop

Industrial production improved in all Euro area countries. Italy led the pack with a jump of +7% (m/m) after +2.4% (m/m). Germany and France were respectively up +1.7% and +1.8%. On a quarterly basis, industrial activity is likely to rise significantly in the 3rd quarter for the first time since Q1 2008.

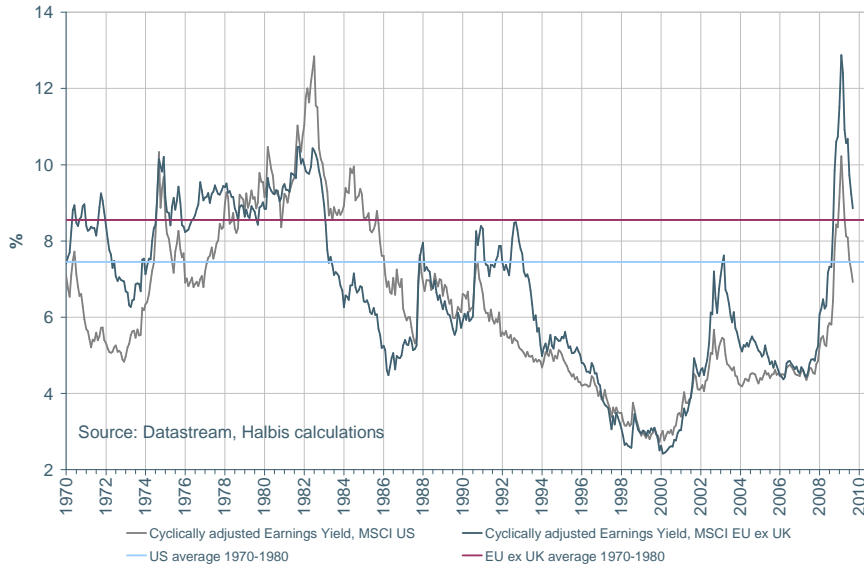
Outlook for investments

Now that the earnings cycle has just turned, the question remains, “What will the amplitude and duration of the earnings recovery be after the 47% decline since end 2007” ? In Europe, the average earnings decline from peak to trough has been about 35%. The average subsequent recovery in earnings has posted growth of 27% in the first year and 24% in the second year. In general sharper declines are followed by stronger recoveries: the strongest earnings recovery during the first year was 45% in the early 2000's. Currently the consensus forecast is for 25% earnings growth in Europe over the next 12 months. Moreover, 25% growth implies a 12 month PE of only 12.9x which is still very attractive. In fact, Europe is the cheapest of the developed markets.

In the below, we have established that Europe ex UK still offers very attractive cyclically adjusted earnings yields (green line), much higher than that of the US (gray) line. In fact, the current yield is higher than the average that prevailed during the average of the 1970 to 1980 periods when valuations were low and inflation was rampant in contrast to the low interest rates of today.

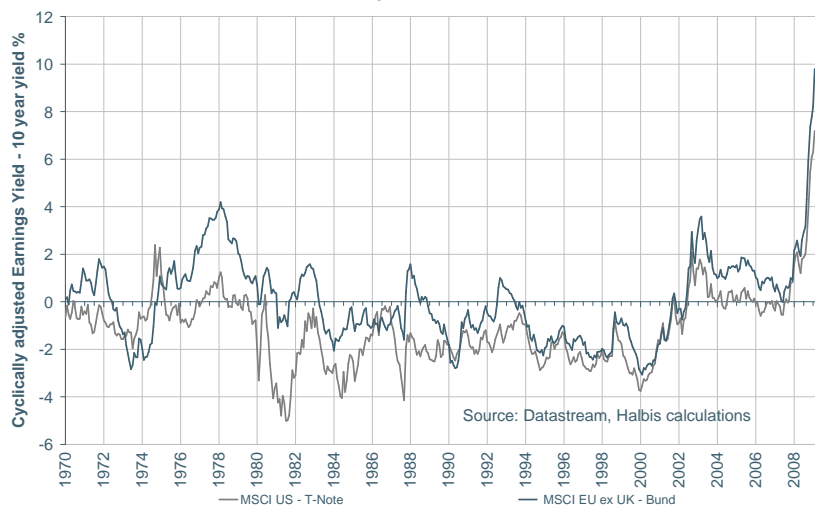


Cyclically adjusted Earnings Yields - US and Europe ex UK



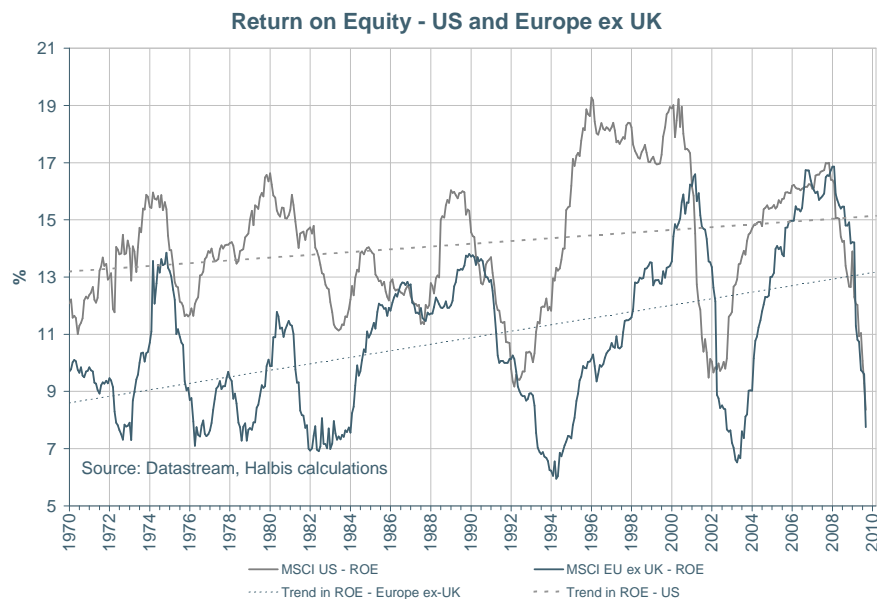
If you look at the famous fed model which takes the current level of low interest rates into account, equities look even more attractive compared to history.

US and Europe ex UK : FED Model





Finally, now that we have established that the European market is attractively valued in absolute terms and versus the US, we want to know whether Europe deserves this “value” status. We’ve seen in the past the trend profitability in Europe was lower than the US, particularly in the 1970’s. In the last decade profitability levels have practically converged. European companies have made great strides in improving their competitiveness, undistinguishable from their US counterparts. We believe this convergence in profitability levels is here to stay.



In conclusion, the current valuation discount in Europe should eventually go away. Stock market levels should be boosted by PE re-rating as well as an earnings recovery that could very well surprise the consensus on the upside. Liquidity has remained on the sidelines as few investors have really had the opportunity to participate in the rally. These flows should return so long as market valuations remain intrinsically and relatively attractive, and no major crisis erupts on the short term horizon.

Two major risks that we see is a faltering earnings recovery or else a further big decline in the US dollar which would adversely impact the world’s stock markets.



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