Guide to Index Tracker Funds
What is an Index Tracker Fund?

An index tracker fund aims to replicate the returns of a given index as closely as possible, by investing in financial instruments that will closely replicate the characteristics of the given index.

Why invest in Index Tracker Funds?

Traditional or active fund managers invest with the aim of outperforming a given benchmark. An index tracker fund does not seek to outperform its benchmark index. Rather index tracker funds aim to replicate the exposure of a benchmark. The approach is popular because it reduces the variability in results and is also not vulnerable to losing a ‘star fund manager’ in the same way that a fund manager using an active fundamental approach can be.

Why use an Index Tracker Fund instead of buying the individual stocks of a given index?

First and foremost, an investor would need a large amount of capital to buy individual stocks as well as the knowledge as to when to buy and sell the right amount of the right securities at the right time.

Using the FTSE All-Share index as an example, if a client were to hold every stock within the index, they would need to buy approximately 650* stocks and continuously re-weight them. This would incur large trading costs and the client would be unlikely to keep up with changes in the constituent weightings, due to, for example, liquidity and trading costs issues. Failing to manage these issues and track the index effectively would ultimately impact on results.

Why is there a difference in performance of an Index Tracker Fund compared to the index it tracks?

All replication methods incur some dealing and trading fees as portfolios need to be periodically re-weighted to ensure they accurately reflect the composition of the index being tracked. These costs are deducted from fund performance.

What are the different methodologies used for replication?

The below table is an overview of the main replication strategies used by index tracker funds:

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| Full replication | Where a basket of stocks are held in the same proportionate weight as represented in the benchmark index | ➤ Cash flow management  
➤ Very low tracking error  
➤ Fits Institutional needs          | ➤ Custody costs  
➤ Transaction costs  
➤ Withholding tax  
➤ Broad indices               |
| Optimisation     | Attempts to minimise tracking error in an index portfolio, given that all of the stocks in the benchmark cannot be held | ➤ Works well for small funds  
➤ Efficient in illiquid markets  
➤ Lower custody costs | ➤ High tracking error  
➤ Volatility risk  
➤ Re-optimisation costs       |
| Synthetic        | Seamless blend of index derivative products                                  | ➤ Low custody costs  
➤ Minimum transaction costs | ➤ Basis risk  
➤ Pricing                   |
| Blended/Pragmatic| A blend of the most desirable attributes of full replication and optimisation strategies | ➤ Cash flow management  
➤ Flexible/adaptable style  
➤ Controls trading cost | ➤ More complex structure       |

*This figure is subject to change as the constituents of the index fluctuate.
What are the potential benefits of investing in Index Tracking Funds?

Index tracking funds are generally regarded as good value. To manage an Index fund requires an expert fund management team but it does not require large teams of fund managers and company research analysts that you would typically expect in many active fund management businesses. The general efficiency in the costs of running an index fund management business translate into lower annual management charges than would be typical of an active investment approach in the same financial market.

Index trackers help to avoid variability in results. The performance of active fund managers in a peer group will vary widely from the best to the worst performing fund while even the best active fund managers can pursue an individual style that is out of favour and under-perform an Index for a very long time. You not only have to pick the right market, you also have to invest with the right active manager at the right time to out-perform with an active approach. If you get it wrong you will still pay the costs associated with active fund management. Investing in index funds helps to remove the variability of performance versus the market index. It is favoured by investors who would rather control the costs and the risk of underperformance than they would pay more and deal with the probabilities associated with trying to beat the index over the long run.

The holdings in index trackers are very transparent to investors. Because a fully replicated index fund essentially matches the companies in an index and their weighting within that index it is very clear what an index fund manager is investing in and how they are achieving their results. As well as being able to look at the companies which the manager is investing in, it is also easy to follow the risk and return characteristics of an index fund by looking at the data that is typically available on the index being matched. At the simplest level it is possible to gain access to the level of financial market indices through the media where they are widely and frequently reported on.

Index funds achieve diversified exposure to the whole stock market. Compared to accessing the returns of the stock market by buying individual shares or bonds, an index tracking fund is a quick and efficient way for investors to gain diversified exposure to the whole of a particular financial market. In a single investment an investor can gain exposure to all of the companies in a given market through an Index fund. Active fund managers might pick the wrong companies and/or hold them in different proportions but they may also miss out on the performance of the companies that they choose not to own. An index fund simply seeks to replicate the characteristics of the whole market represented by the Index.

Some investors choose to combine active funds and index funds together, allowing the two approaches to play complementary roles within a broad portfolio. This is often done by using index funds to gain exposure to markets which are deemed to be relatively efficient and therefore the additional costs of active management are not necessary. Conversely, the focus is placed on active fund management for parts of the portfolio where the markets being invested in are still developing and where the knowledge and expertise of an active fund manager is more likely to deliver results. Another common approach is to change approach from Indexation to active fund management in light of market conditions and/or market characteristics. This is because it is generally true that active management is more successful if markets are falling and, for example, the performance of stocks within sectors and volatility from one industry to another gives rise to anomalies and therefore opportunities for stock pickers to add value. If the market is rising sharply and investors are not discerning about which companies that they choose to own the index tracker is a potentially attractive option.

What are the predominant risks when investing in Index Tracking Funds?

An index fund will seek to replicate as closely as possible the Index that it is seeking to match. This works when the market is rising and also when it is falling. As a result, investors should understand and be ready to accept the risk of the market that the Index is replicating. The index fund manager works on the basis that the investor has made an allocation to the market and that the investor is looking to replicate the results, good or bad.

In the process of replicating the market an Index Fund will provide exposure to individual companies and their industries in the proportions in which they are reflected in the Index. If there are specific issues that impact on those firms then this specific risk and the effect of it will be reflected directly in the performance of the Index fund. The fund manager will not vary the weights and will not make a decision to, for example, increase exposure to cash if the market is expected to fall.

If the risk inherent in the Index itself increases as a result of a concentration of securities or industries within it, or a concentration of risks affecting the market as a whole, an Index fund manager will not seek to manage these exposures. As the risk of the Index increase the risk in the Index Fund will rise by the same magnitude.
An index fund manager is not seeking to reflect opinion of views associated with macro-economic developments or stock specific research or information and will not make a value judgement around whether the index that they are tracking represents the best place to invest at a given point in time.

Index funds that invest in international stock markets will typically not hedge exchange rate movements between the currency of the fund and that of the securities held in the Index.

The value of investments and the income from them can go down as well as up, and investors may not get back the amount originally invested. Past performance of an index or an individual company is not a guide to future returns.

**Who should consider investing in Index Tracker Funds?**

Investors who are:

- Investors who are looking to control the total amount that they pay
- Investors who think the index that we are tracking will rise over five years or more
- Investors who want exposure to the market and to have transparency around what we are investing in
- Investors who are prepared to take the risk of the market in order to grow their wealth
- Investors who would like to diversify their portfolio in a particular market relative to a more concentrated portfolio of directly held stocks
- Investors who don’t like picking funds and the variability of outcomes that comes with doing this

**Summary**

- Index tracker funds represent a cost-effective way of achieving diversification across companies and sectors
- Index tracker funds can be effective in delivering a return that is closely correlated to the market in which they seek to replicate
- Index tracker funds are relatively easy to understand and represent a transparent investment strategy from an investor point of view
- Index tracker funds have grown in popularity over recent years because of their relative simplicity and potential ability to deliver market-driven returns

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