HSBC Asset Management

Understanding Tracking Difference and Tracking Error

For Professional Clients only

Two sides of the same coin – total return vs performance consistency

Tracking difference shows how a product's performance compares with that of its benchmark over a certain period of time.

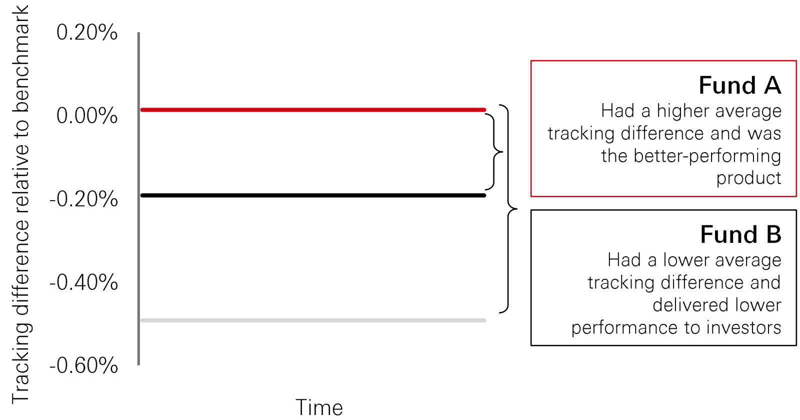
- Can be positive or negative
- Calculated as the NAV (a fund's Net Asset Value) total return minus the benchmark's total return
- Includes the annual management charges, the administration costs (depositary fees, custody fee, index license fees), rebalancing costs (such as index changes or corporate actions) and the impact of any security misweight due to optimisation or stock exclusions

Tracking error shows the consistency of an ETF's tracking difference during the same period of time.

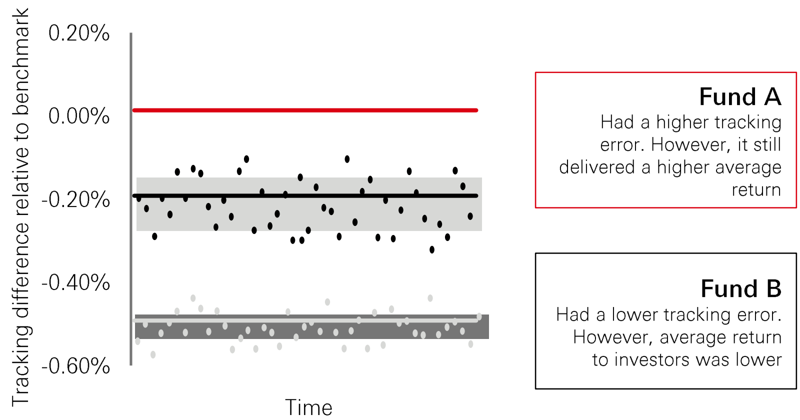
- Being a volatility measure, it is always positive
- Calculated as the annualised standard deviation of tracking difference data points
- Typically affected by trading and management costs, and the method used by the ETF to replicate the benchmark performance

When evaluating ETFs it is important to look at both tracking difference and tracking error, but they are only two of the many measures that investors may want to consider while selecting products

Investors with a primary focus on total return may see Fund A as the better choice due to the higher average return



Investors that place high importance on performance consistency, however, may prefer Fund B due to the lower tracking error



Past performance should not be seen as an indication of future returns.
For illustrative purposes only.
Source: HSBC Asset Management.

Main factors affecting Tracking Difference and Tracking Error

Total Expense Ratio (TER)

- Higher management fees may cause a higher Tracking Difference

Replication Methodology

- Holding a representative sample of an index rather than every constituent may result in outperforming or underperforming ETFs

Taxation

- The underlying stocks of an investment tracker fund will distribute dividends throughout the year
- Funds will suffer withholding tax (WHT) on those dividends, with the rate depending on the structure and domiciliation of the fund

Key risks

The value of an investment in the portfolios and any income from them can go down as well as up and as with any investment you may not receive back the amount originally invested.

- **Concentration Risk:** The Fund may be concentrated in a limited number of securities, economic sectors and/or countries. As a result, it may be more volatile and have a greater risk of loss than more broadly diversified funds
- **Counterparty Risk:** The possibility that the counterparty to a transaction may be unwilling or unable to meet its obligations
- **Derivatives Risk:** Derivatives can behave unexpectedly. The pricing and volatility of many derivatives may diverge from strictly reflecting the pricing or volatility of their underlying reference(s), instrument or asset
- **Emerging Markets Risk:** Emerging markets are less established, and often more volatile, than developed markets and involve higher risks, particularly market, liquidity and currency risks
- **Exchange Rate Risk:** Changes in currency exchange rates could reduce or increase investment gains or investment losses, in some cases significantly
- **Index Tracking Risk:** To the extent that the Fund seeks to replicate index performance by holding individual securities, there is no guarantee that its composition or performance will exactly match that of the target index at any given time ("tracking error")
- **Investment Fund Risk:** Investing in other funds involves certain risks an investor would not face if investing in markets directly. Governance of underlying assets can be the responsibility of third-party managers
- **Investment Leverage Risk:** Investment Leverage occurs when the economic exposure is greater than the amount invested, such as when derivatives are used. A Fund that employs leverage may experience greater gains and/or losses due to the amplification effect from a movement in the price of the reference source
- **Liquidity Risk:** Liquidity Risk is the risk that a Fund may encounter difficulties meeting its obligations in respect of financial liabilities that are settled by delivering cash or other financial assets, thereby compromising existing or remaining investors
- **Operational Risk:** Operational risks may subject the Fund to errors affecting transactions, valuation, accounting, and financial reporting, among other things
- **Real Estate Investments Risk:** Real estate and related investments can be negatively impacted by any factor that makes an area or individual property less valuable

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