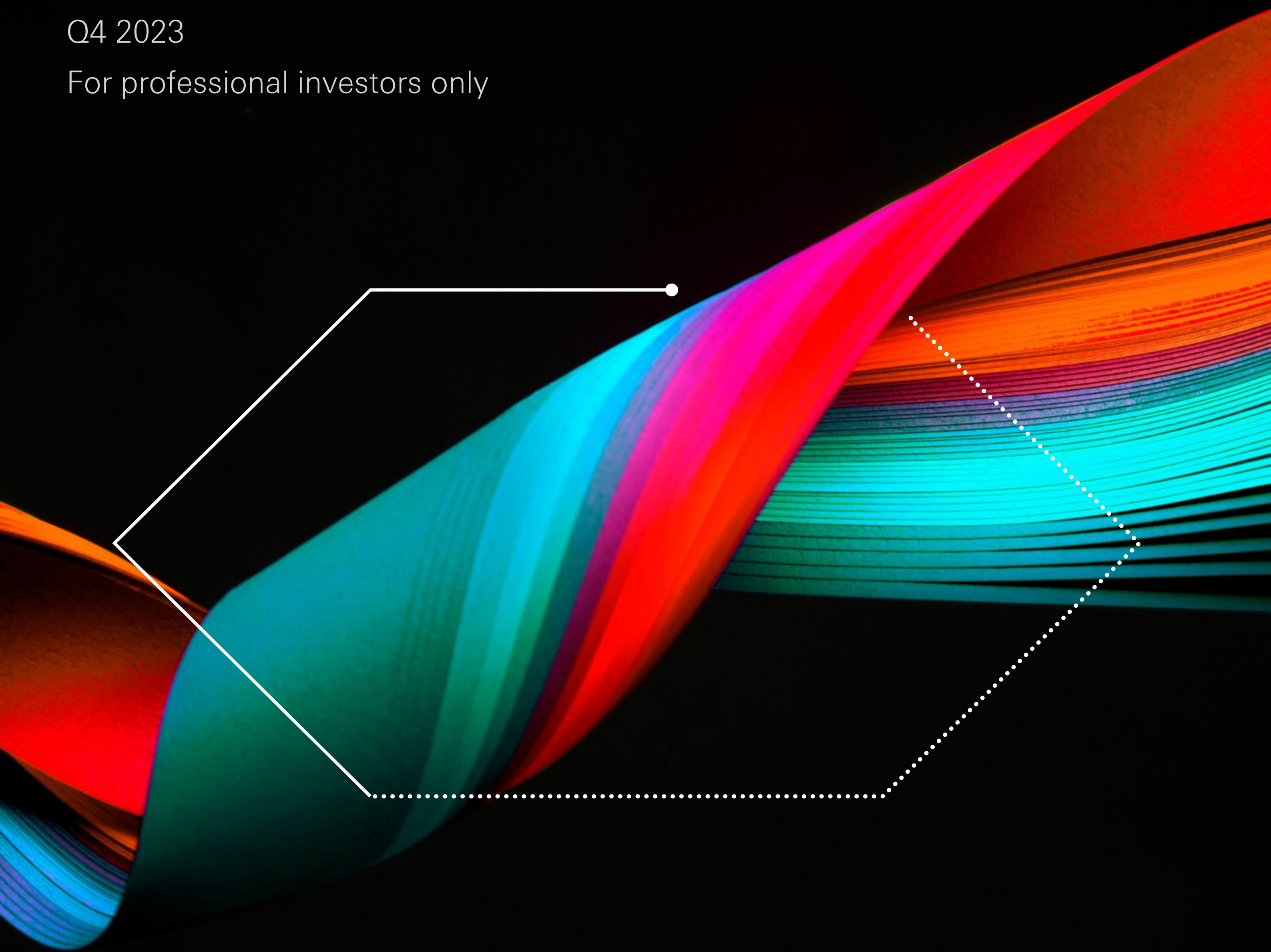
Multi-Asset Insights

Q4 2023

For professional investors only



HSBC Asset Management

Table of contents

Foreword	3
In a nutshell	4
Intelligent diversification through thematics	5
Tactical allocation in Asia: Using a systemic approach	11
Important information	18

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Foreword

We are entering a new regime that changes risk and return dynamics. Both in the near and longer term, we expect asset allocators will need to explore more granular considerations to generate returns.

Jean Charles Bertrand
Global CIO, Multi-Asset
HSBC Asset Management

Welcome to the latest edition of our quarterly Multi-Asset Insights series, where we present the findings of our Strategic Forum.

Despite market valuations seeming to price a soft landing in developed economies, our central scenario remains somewhat less optimistic. The rapid tightening of monetary and credit conditions has created a problem of interest, in our view. In other words, markets may not be fully prepared for adverse growth outcomes likely to materialise next year.

As we are transitioning to a new paradigm – which is likely to be one of inflation around 2%, with higher interest rates around 3% and bond yields around 4% – a defensive investment approach is still our preferred option.

In practice, we think that current yield levels represent an opportunity and 'bonds are back'. But we also see 'defensive growth' opportunities. This is especially true across emerging markets and Asia, which cannot be solely appreciated through a 'China versus India' lens. The region offers a very heterogeneous universe, which means little chance to benefit from major directional trends as a whole. We think that only a more granular approach can generate the desired exposure to relevant opportunities. Empirical evidence indicates that adopting a rules-based tactical asset allocation strategy can support accessing those opportunities on a systematic basis – while maintaining portfolio risk-budgets.

Amidst the new paradigm that we expect to pose challenges to both equity returns and the reliability of traditional diversifiers, we see thematic investing as another idiosyncrasy to exploit within portfolios. However, thematic allocations come with well-known risks that must be accounted for to generate suitable risk-adjusted returns. Again, this requires a structured approach that incorporates fundamentals alongside thoughtful portfolio construction to diversify risks, and signal-based tactical considerations.

I trust you will find this publication and its exploration of these topics to be an interesting and useful resource.

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In a nutshell

Intelligent diversification through thematics

- We think sources of intelligent diversification will be needed as part of a new investment paradigm that looks very different to the secular stagnation of the 2010s.
- Allocating to thematic investments may support the goal of delivering returns while providing diversification benefits through a unique return profile, if approached in a structured manner that reduces downside risks.
- Our analysis shows alpha delivered in the past performance of themes that cannot be fully explained by inherent style factor, sector or country biases. Outperformance is inconsistent across themes but demonstrates that theme exposure is more than simply a factor or sector play.
- Implemented in a thoughtful way, thematics can provide intelligent diversification both for the cyclical investment horizon and medium-term regime change underway.

Tactical allocation in Asia: Using a systematic approach

- Empirical evidence indicates that adopting a rules-based tactical asset allocation strategy can allow investors to take advantage of market situations within a well-defined risk budget, on a systematic basis.
- Our research shows that an equally weighted composite signal can effectively mitigate the drawbacks of using individual signals while generating higher alpha.
- Implementing a tactical allocation strategy can also improve risk-adjusted return profiles against a buy and hold strategy.
- Furthermore, a disciplined, multi-signal based framework for both directional asset allocation and relative value ideas enables asset allocators to cover a broad and granular investment universe.

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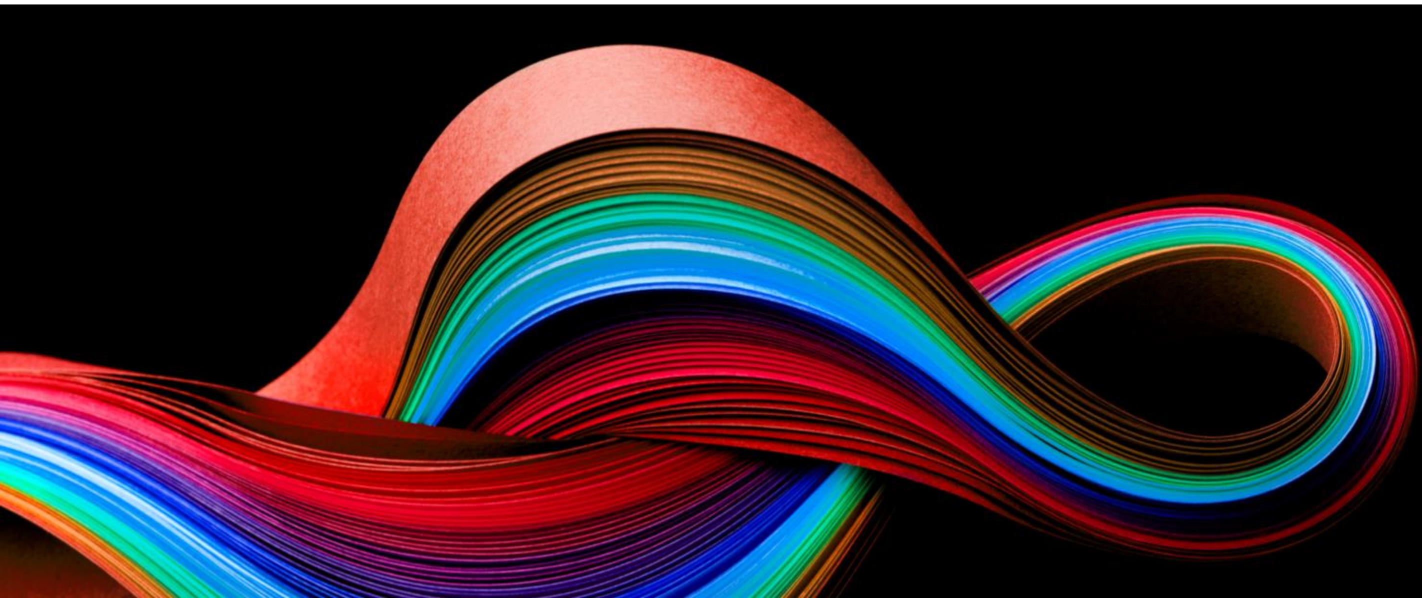


Intelligent diversification through thematics

Thematic investing, while containing an array of risks and challenges that can only be overcome via a disciplined and systematic approach, offers access to individual sources of returns that may prove useful in a new investment paradigm.

Arthur Swain
Head of UK Discretionary Portfolio Management

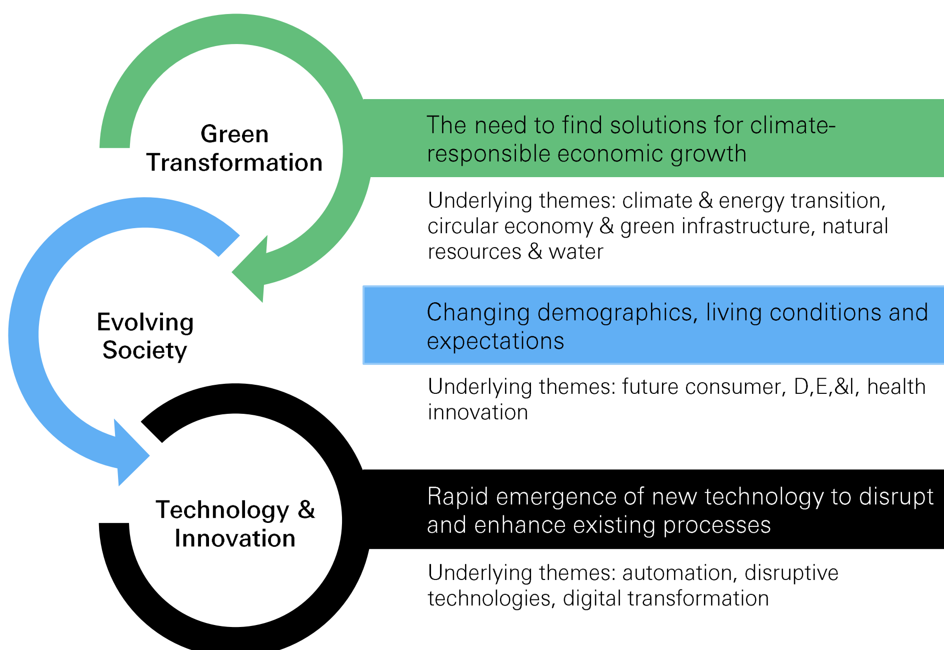
Hugo Thompson
Multi-asset Investment Specialist

We expect a new paradigm that looks very different to the secular stagnation of the 2010s, with the introduction of higher interest rates, higher average inflation and looser fiscal policy. This poses challenges to both equity returns and the role of traditional diversifiers, with a negative stock/bond correlation no longer as reliable. New sources of intelligent diversification will be needed. Accordingly, select thematic allocations may warrant a role in diversifying traditional beta exposures.

It is important to note that we are not referring to classic, cyclical investment themes such as 'higher for longer' interest rates, which can be expressed within portfolios using traditional allocation levers. Thematic allocations are distinct from traditional equity allocations and cut across typical dimensions such as geographies, sectors and style factors.

Previously in this publication[1] we explored thematic allocations, examining the benefits and pitfalls. Understanding the potential advantages and the need for a systematic approach to avoid pitfalls, we now address the topic of how best to gain thematic exposure.

Figure 1: Our thematic taxonomy framework



Source: HSBC AM, November 2023. For illustrative purpose only.

1. https://www.assetmanagement.hsbc.co.uk/en/institutional-investor/news-and-insights/multi-asset-insights-june-2023

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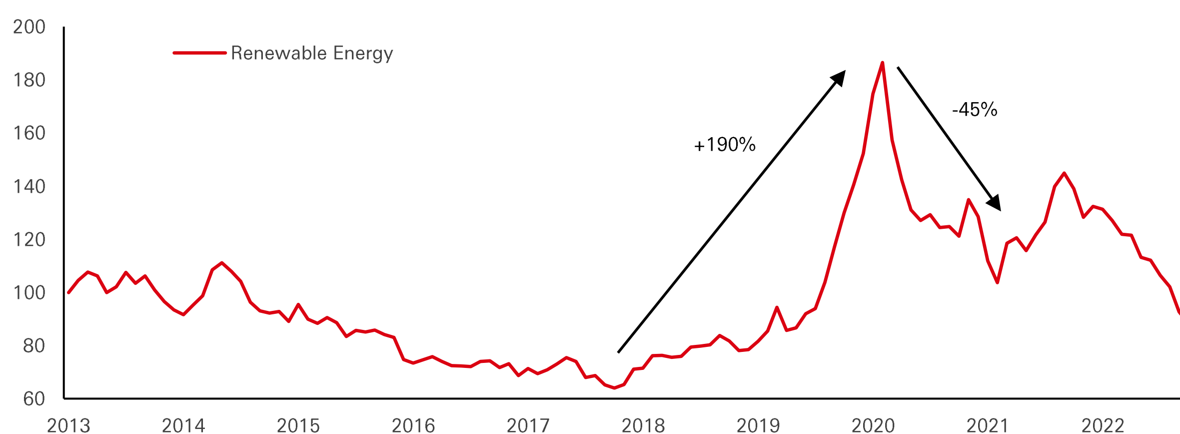
Shaping a thematic allocation

Going forward, we expect higher interest rates, elevated political risks, and a lower profit share of GDP to end the golden period for equity market returns experienced during the 2010s. Allocating to thematic investments may support the goal of delivering returns while providing diversification benefits, if approached in a structured manner that reduces downside risks.

Thematic investing often falls victim to the Gartner Hype Cycle, which typically sees inflated expectations after an innovation trigger for a theme, subsequently leading to deflated prices and negative returns before the longer-term benefits to productivity and earnings are realised. This cycle is illustrated by the performance of renewable energy over the last few years. Being a necessity to longer term economic and societal development globally, clean energy is clearly not a fad or short-term technology which will not endure over the long run. Nonetheless, returns from the sector have followed this cycle.

Figure 2: Time series of excess returns vs ACWI



Source: HSBC AM, Bloomberg data, November 2023. **Past performance is no guarantee of future returns.**

Given the notorious volatility, we posit that diversification should be of primary importance in shaping a thematic allocation. Some investors have questioned whether effective diversification is in fact possible in thematics, suggesting that all themes share a narrow set of return drivers, and as such meaningful diversification becomes impossible.

While it is certainly true that trends often targeted by thematic investments are overlapping, the broad thematic investment universe is surprisingly heterogonous. As illustrated in figure 1, we have divided the thematic universe into three categories or 'transformational trends'. Within each category theme correlation is high, as expected, but between categories correlations are low.

This insight is the key to effective diversification. Over the long term, an allocation across all three transformational trends will benefit from meaningful diversity and volatility reduction versus single theme investing.

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Figure 3: Correlation of excess returns (versus global equity) between select themes and Transformational Trends

	Green Transformation	Technology & Innovation	Evolving Society
Climate & Energy Transition	0.25	0.22	0.15
Circular Economy & Green Infrastructure	0.26	-0.17	0.13
Natural Resources & Water	0.34	-0.16	0.00
Automation & Robotics	-0.04	0.46	0.00
Disruptive Technologies	-0.11	0.57	0.29
Digitalisation	0.05	0.59	0.26
Future Consumer	-0.04	0.56	0.00
Diversity, Equity and Inclusion	0.22	-0.23	0.21
Healthcare Innovation	0.10	0.22	0.43

Source: HSBC AM, Bloomberg data, April 2013 to September 2023. **Past performance is no guarantee of future returns.**

Understanding and adjusting to factor biases

Of course, given the disruptive nature of most transformational trends or their underlying themes, and the opportunity for the underlying companies driving them to challenge incumbents, exposure to these themes creates inherent style factor biases - typically growth over value, and emphasis on smaller companies with less profitability. Nonetheless, our analysis shows alpha delivered in the past performance of themes that cannot be fully explained by inherent style factor, sector or country biases. Outperformance is inconsistent across themes but demonstrates that theme exposure is more than simply a factor or sector play.

Below we show the factor biases for two very relevant but different themes in today's environment.

Figure 4: Artificial intelligence and big data factor relatives (vs ACWI)

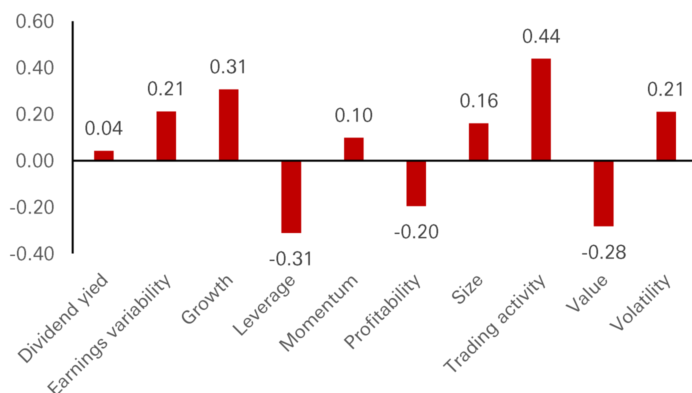
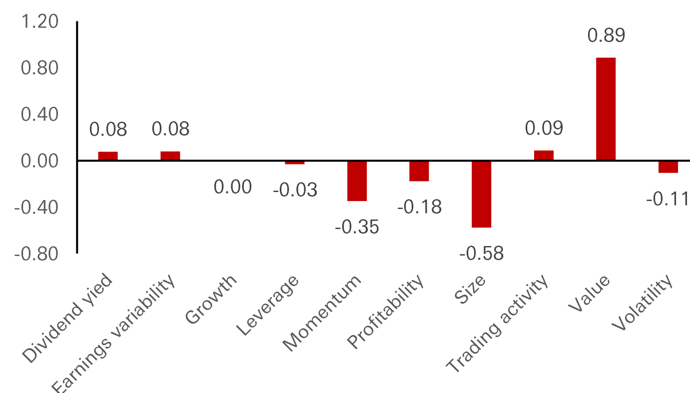


Figure 5: Agribusiness factor relatives (vs ACWI)



Source: HSBC AM, Bloomberg data, November 2023. **Past performance is no guarantee of future returns.**

Inherent differences between the exposures captured within each theme reiterate the diversification benefit of a multi-theme approach. Today, the artificial intelligence theme has qualities that position it favourably in the short-term environment given exposure to positive momentum, along with size and growth which continue to outperform. However, longer term headwinds, such as higher rates that would remove the tailwinds growth benefited from under secular stagnation in the 2010s, leave question marks over the ability to extend outperformance further out. To the contrary, agribusiness should be well placed under a new paradigm that benefits value and cyclicals over growth, particularly given its positive exposure to commodities, energy and other factors connected to the higher average inflation regime we expect to see in the years ahead.

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As a further example of the differences in exposures across underlying themes, below we show the sector exposures captured by the battery value chain and ageing population themes, part of the green transformation and evolving society transformational trends, respectively. Again, each displays very different qualities that could prove useful in balancing a thematic allocation, while offering particular exposures that could appeal in a new investment paradigm, such as materials and healthcare.

Figure 6: Battery value chain sector relatives (vs ACWI)

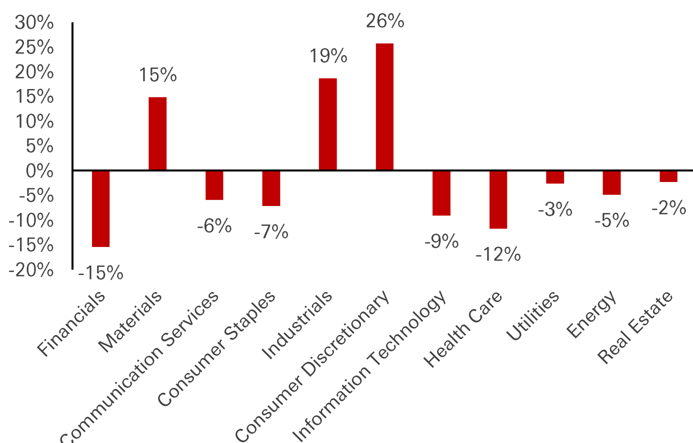
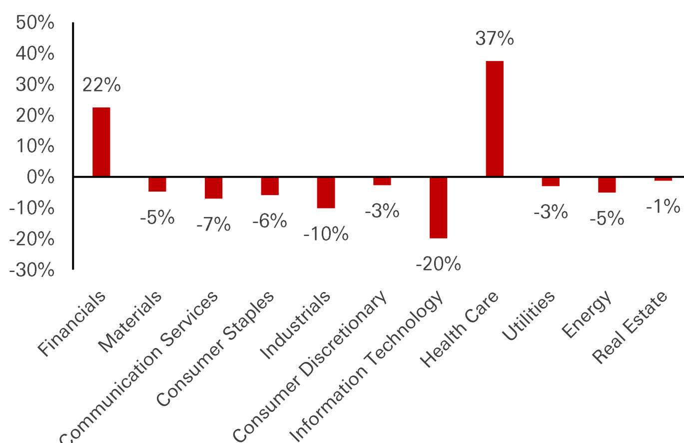


Figure 7: Ageing population sector relatives (vs ACWI)



Source: HSBC AM, Bloomberg data, November 2023. **Past performance is no guarantee of future returns.**

The advantage of spreading a portfolio's allocation across the transformational trends is clear. However, determining the most appropriate long-term split across the trends requires further analysis. Below we show the historical outcomes of four potential approaches to building a long-term allocation across trends: equal weighting, risk parity, tracking error[1] targeting (4%), and tracking error minimisation.

Figure 8: Ten-year performance analysis of allocation techniques

	Equal Weighting	Risk Parity	4% Tracking Error	Min Tracking Error
Return	10.3%	9.3%	9.6%	9.3%
Volatility	17.4%	16.6%	16.9%	16.8%
Risk/Return	0.59	0.56	0.56	0.56
Excess Return	2.1%	1.2%	1.4%	1.2%
Tracking Error	4.9%	3.6%	4.0%	3.8%
Information Ratio	0.43	0.32	0.35	0.31
Diversification Ratio	1.24	1.21	1.21	1.20

Source: April 2013 to September 2023. MSCI ACWI index used as benchmark. Diversification ratio = weighted average of the volatilities relative to the portfolio volatility. Minimum TE portfolio includes a minimum allocation of 5% to each theme. The risk parity portfolio has no such constraint and therefore some exposures are less than 5%. **Past performance is no guarantee of future returns.**

The analysis suggests that an equal weighting methodology across the underlying themes is the most appealing approach, generating the strongest returns and highest information ratio. Although those returns come with increased volatility and tracking error, the risk-adjusted performance remains compelling.

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While our research provides useful historical context, we must be mindful not to build allocations based on historic performance data alone. An equally weighted allocation holds several additional advantages outside of the strong returns it has delivered historically:

- **Portfolio simplicity**: equal weighting is an objective, rules based, high diversification approach to long term allocations
- **Theoretical robustness**: over the long term, there is no theoretical justification for the persistent outperformance of one Transformational Trend versus another. As such, an agnostic view on trends is intuitively appealing
- **Allocation neutrality**: an equally weighted starting point provides a neutral platform from which active asset allocation can be conducted

Since individual themes tend to deliver inconsistent performance cycles impacted by the 'hype cycle', there is a strong case to be made for conducting short-term adjustments around a portfolio's long term thematic allocation.

Active asset allocation should leverage objective, systematic signals, rather than relying on narrative. In addition to quantitative signals, bottom-up, fundamental research adds a useful second dimension when making active decisions, especially in the less well covered areas of the investment markets where thematic investment strategies are often focused.

Finally, it is imperative that any potential active position is considered in the aggregate context of the wider thematic allocation and its inherent exposures. This can be accomplished by conducting a review of the aggregate impact of all active positions on the allocation's macroeconomic, factor, and market sensitivities.

Preparing for a new regime

Following a 24-month period during which government bonds delivered some of their worst returns in history, the current handwringing about fixed income allocations within portfolios is understandable. However, as is often the case in markets, we believe that the real emerging risk is gestating in anonymity.

With bond yields sitting close to 25-year highs, fixed income investors are all but guaranteed a strong decade ahead. Yet, looking at current price-to-earnings ratios, the reverse might be true for equity markets. Moreover, a combination of secular headwinds approach. Climate change policies and a reversal or slowdown in globalisation are both likely to be contributors to continued inflation. Separately, demographic and other constraints are set to be a drag on growth. These issues also point to a likely lower profit share of GDP after peaking in recent years. In short, the golden age of equity market returns might be drawing to a close.

Are thematics a solution? They offer promise given thematic allocations look to invest in, and profit from, the very disruptive forces that spell trouble for the equity market. From spending on climate change, to solutions for an aging population, the broad equity market's loss should be a thematic investment's gain.

However, as always, the investment case is not clear cut. The factor and macroeconomic sensitivities of thematic allocations suggest they are highly sensitive to GDP growth, demonstrate limited profitability, and tend to be concentrated in smaller companies. These attributions will not be supportive during a higher interest rate, low growth environment.

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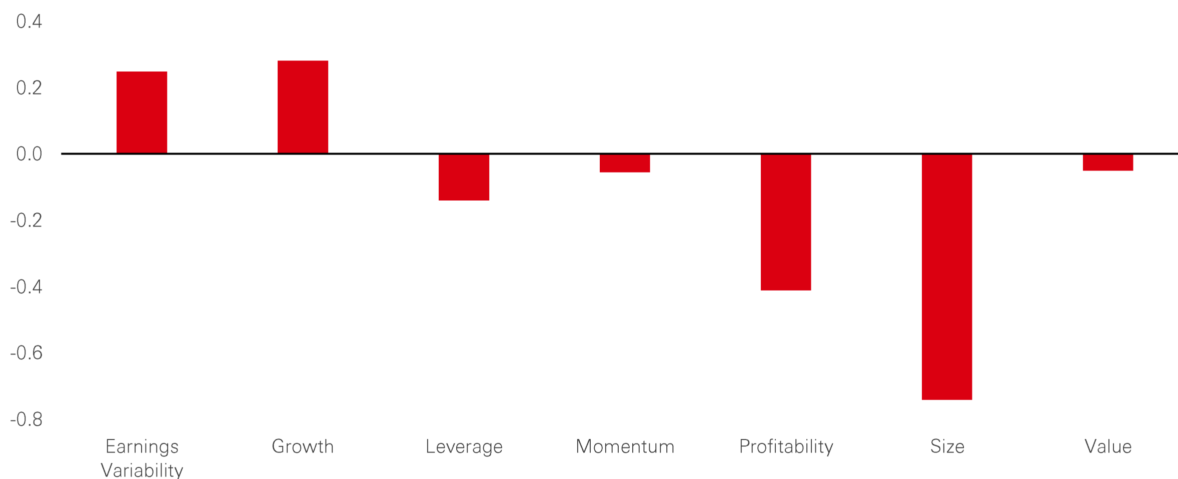
Figure 9: Equally weighted thematic portfolio factor biases versus Global Equities



Source: HSBC AM, Bloomberg data, November 2023. **Past performance is no guarantee of future returns.**

Thus, while there is potential for superior returns, as demonstrated by the performance of the artificial intelligence theme this year, a balanced scorecard approach to thematic investing is needed to build a holistic investment case. This includes establishing fundamental views along with systematic inputs and robust portfolio construction. Implemented in a thoughtful way, thematics can provide intelligent diversification both for the cyclical investment horizon and medium-term regime change underway.

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Tactical allocation in Asia: Using a systemic approach

A disciplined multi-signal based framework for both directional asset allocation and relative-value arbitrages can allow us to take advantage of market developments within a well-defined risk budget, while exploiting a broad and granular investment universe.

Yiğit Onat
Head of Multi Asset, Asia

Gloria Jing
Multi Asset Senior Portfolio Manager

Structurally, Asian assets are undervalued and underrepresented in world indices and consequently in global investors' portfolios. Such under-positioning in global portfolios is partially due to a period of weak returns. It is possibly exacerbated by the suboptimal construction of traditional market-cap benchmarks which may not reflect the fundamentals of the underlying economies, as researched by many market participants, such as Davis et al (2022)[1]. Yet, most global asset allocators now have a structural exposure to Asia. But here again, this exposure is often too static to take advantage of the dynamic in this very heterogeneous region. Similarly, tactical asset allocation for broad Asian assets is relatively understudied by academic or practitioner research.

A typical multi-asset investment process involves various stages of portfolio construction starting with establishing a risk profiled long-term asset allocation (equilibrium portfolio), which is dynamically optimised based on a mean-variance optimization framework reflecting asset class risk premia relative to their fair value levels. Tactical asset allocation seeks to add value above that of the dynamic allocation by focusing on shorter time horizons, typically one to three months. Over this time horizon, long-term valuations are less powerful indicators for future asset class performance.

The underlying question we try to address here is whether we can rely on a systematic approach to generate Asia asset allocation calls that would add value to performance. To answer this question, we looked at a range of market, fundamental and macro-related variables to capture directional asset allocation bets and relative-value opportunities across Asia.

Capturing directional opportunities using a tactical composite score

To develop directional views on asset classes, we combine medium-term (over five years) views based on our asset class expected returns framework and shorter-term tactical views, considered in a disciplined, multi-signal based framework.

1. Davis et al (2022). Emerging Market Investing: A Multi-Asset, Granular, and Dynamic Portfolio Approach.

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Following the approach of Schnetzer (2020)[2], the core set of indicators used for tactical views can be narrowed down to 'momentum', 'short term reversal', 'risk', and 'macro'.

These four indicators demonstrate higher predictability, efficiency, and low or negative correlations when tested for the longest available historical data across equity, fixed income and currency markets in Asia.

Momentum investing is one of the most popular strategies that consists of buying past winners while selling past losers based on returns of the past twelve months[3]. Despite being explored extensively, evidence supports momentum being a viable trading signal as the market continues to exhibit positive serial correlation due to human behavior of under-reaction and over-reaction at different timescales.

Short-term reversal strategy, on the other hand, consists of buying recent losers while selling recent winners based on prior one-month returns, and is also found to be profitable according to academic research[4]. In this framework, we only apply short-term reversal to momentum winners to avoid the double dip scenario where momentum losers could continue to underperform over the shorter term – e.g. a fire sale situation.

Risk signals assess the current risk environment and whether it is conducive to market performance by comparing recent and longer-term volatility. The higher recent volatility, the lower our conviction in the market. Historically, higher volatility tends to persist due to a clustering phenomenon. Similarly, higher volatility periods tend to negatively correlate with market performance.

Macro-economic data is important information, next to price and fundamental indicators. Many academic publications have demonstrated how macro data – including growth forecasts, inflation surprises, and PMI surveys – can be good indicators of the evolution of equity risk premium[5]. In particular, PMI levels are notable as early indicators measured consistently across countries and sectors, including in Asian equity markets.

We aggregate these indicators to define a composite score for tactical opportunity assessment. Equal weighting is applied to each of the factors with the intention to be free of any past data bias.

2. Schnetzer, M. (2020). How Good is Tactical Asset Allocation Using Standard Indicators.

3. Jegadeesh and Titman (1993). Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency.

4. Hong and Stein (1999). A Unified Theory of Underreaction, Momentum Trading, and Overreaction in Asset Markets.

5. Cochrane, J. H. (2011). Presidential address: Discount rates.

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We have tested this directional composite across 11 Asian equity markets, 5 bond markets and 5 Asian currencies over the past 15 years[6]. Each month, the composite signal has been generated for all markets, and its strength has determined the directional position for the asset class.

Over the period, the tactical strategy[7] using the composite score exhibits, on average, a better Sharpe ratio against a traditional buy and hold strategy for each asset group (Figure 1).

In formulating a final view for each asset class, we integrate the tactical composite signal with medium-to-long-term valuation metrics to mitigate setback due to overvaluation.

Figure 1: Directional composite versus buy & hold strategy (Sharpe ratio)

Source: HSBC AM, Bloomberg data, August 2009 to April 2023.

The performance figures displayed in the document relate to the past and past performance should not be seen as an indication of future returns

6. Equity markets indices are MSCI India, MSCI Taiwan, MSCI Korea, MSCI AC Asia ex Japan, MSCI AC Asia ex Japan IT, MSCI AC ASEAN, MSCI China Small, MSCI China A 50, MSCI China, Hang Seng China; bond markets indices are J.P. Morgan JACI Investment Grade, J.P. Morgan JACI Non-Investment Grade, ABF Pan-Asia USD ex-CN, China Treasury + Policy Bank, J.P. Morgan GBI-EM India Unhedged; currencies are CNH, INR, THB, IDR, JPY.

7. The strategy assumes monthly rebalancing, with 1-month lag of implementation and 0.20% p.a. transaction cost.

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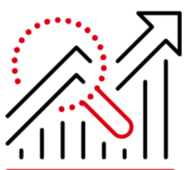
Capturing cross sectional relative-value opportunities

Usually, relative-value positions are mainly implemented across equity (countries and sectors), sovereign bond and currency markets, based on a multi-factor approach that combines valuation, momentum, quality, and growth (with potential asset-class specific signals) without taking any directional equity, duration or volatility risk. Qualitative inputs can also be reflected when building final relative-value views.

In the context of Asia tactical opportunities, we use a cross sectional framework to identify relative value opportunities among Asian equities, including 10 major markets in the MSCI Asia ex Japan Index: China, India, Indonesia, Hong Kong, Malaysia, Philippines, South Korea, Taiwan, Thailand, and Singapore.

This framework captures four indicators: 'valuation', momentum', 'quality' and 'earnings growth'.



Valuation is one of the most important determinants of market returns over long horizons and is commonly used in factor-based investing solutions. Historically, it may not have been the strongest market-timing indicator over shorter horizons, but it remains a crucial indicator for downside risk management.

Momentum signal is similar to what we described for directional signals but focuses on recent asset performance only relative to other assets. In other words, both time series and cross-sectional momentum signals can bring value. As evidenced in academic research[8], combining cross-sectional momentum and time-series signals tends to lead to improved Sharpe ratios.

Quality can be measured by many traits including high margins, low earnings volatility, or low financial leverage. In our own research, we have found return on equity, free cash flow generation, and dividend yield to be the most reliable factors for Asian equity indices. Return on equity, which measures a company's efficiency in generating profits, has proven to be a stabiliser among different indicators, incurring the least turnover in our strategy.

Earnings growth is the last pillar of this cross-sectional ranking framework. It is a key input into equity valuation – and a major focus point for most investors. Earnings momentum, which measures earnings revisions, could be another valid indicator – that we are currently investigating to assess its potential relevance in such a framework.

8. Clare, A., J. Seaton, P. N. Smith, and S. Thomas. 2013. "The Trend Is Our Friend: Risk Parity, Momentum and Trend Following in Global Asset Allocation.

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Indeed, a single factor cannot be a perfect indicator of future returns, and each factor reacts to market information in its own way. Consequently, using a blend of factors to identify relative value opportunities across individual markets makes more sense in our view – since it can capture diverse exposure to technical and fundamental aspects of the markets.

To illustrate this, the table below shows the correlation between four different long-short portfolios where we are long 100% of the top-ranked cohort, short 100% of the bottom-ranked market, long 50% of the 2nd top-ranked market and short 50% of 2nd bottom-ranked market, based on valuation, momentum, quality, and growth indicators separately. As shown in Figure 2, their average correlation[9] with each other is 0.09 since 2010.

Figure 2: Historical correlation between indicators

	Valuation	Quality	Growth	Momentum
Valuation	1	0.4	-0.08	0.10
Quality	0.41	1	0.08	0.19
Growth	-0.08	0.08	1	-0.15
Momentum	0.10	0.19	-0.15	1

Source: HSBC AM, Bloomberg data, October 2010 to April 2023.

By combining the four factors with equal weighting attached to each of them, we can determine a composite score which is used to rank the ten equity markets in scope (Figure 3).

Figure 3: Determination of a composite score

	Valuation	Quality	Growth	Momentum	Score
China	0.0	0.0	0.0	-1.0	**-0.2**
Hong Kong	1.0	0.5	0.0	-0.5	**0.3**
Taiwan	-0.5	0.0	0.0	1.0	**0.1**
Korea	-0.5	-0.5	0.0	0.0	**-0.2**
India	-0.5	1.0	0.0	0.5	**0.2**
Singapore	0.5	1.0	0.0	0.0	**0.4**
Indonesia	0.5	1.0	0.5	0.5	**0.6**
Thailand	0.0	0.0	0.0	-0.5	**-0.1**
Malaysia	1.0	0.5	0.0	0.5	**0.5**
Philippines	1.0	1.0	0.0	-1.0	**0.2**

Source: HSBC AM, Bloomberg data, October 2010 to April 2023.

9. The portfolios rebalance monthly with 1-month lag of signal timing

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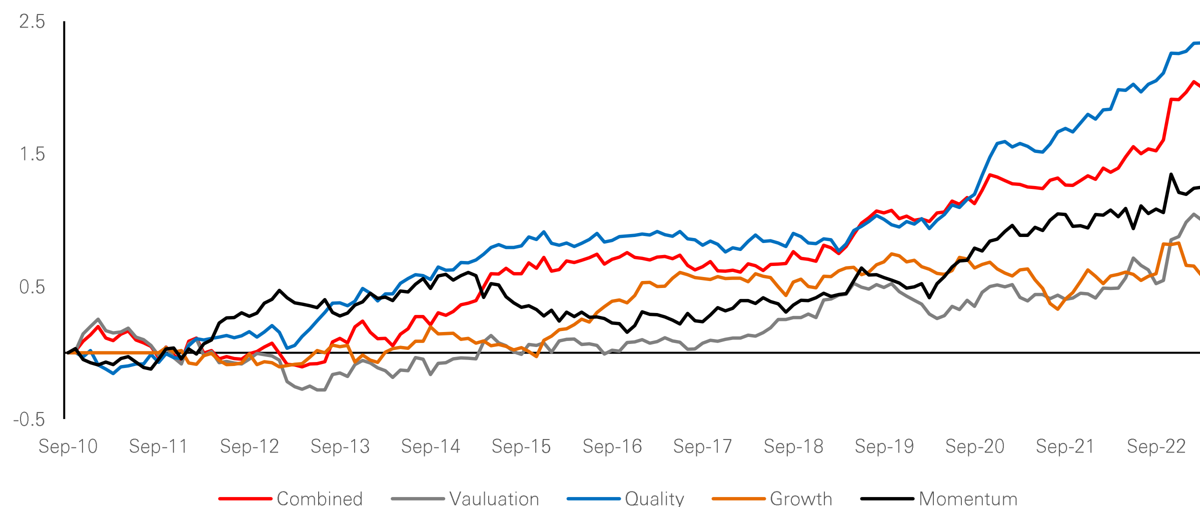
In practice

Based on this ranking, we can constitute a long-short strategy made of long positions in the top two markets and short positions in the bottom two markets. Historically, this strategy would have delivered a Sharpe ratio of 0.56.

Figure 4: Historical performance of a relative value composite



Source: HSBC AM, Bloomberg data, August 2023.
The performance figures displayed in the document relate to the past and past performance should not be seen as an indication of future returns

More recently, the recovery of Korea is a good illustration of what tactical signals can provide. Despite a declining earnings outlook for the year, tactical signals for South Korean equities turned positive in February 2023, driven by momentum and short-term reversal after a prolonged slump in 2022. Over the following months, signals pointed to the strongest end of the range (Figure 5).

Figure 5: Tactical signals and composite score range for South Korea equity as of July 2023

Tactical score

	Momentum	Risk	Valuation	Macro	Score
Korea	0.5	0.5	0.0	1.0	0.9

Market performance (total return index, %)

	YTD	QTD	MTD
Korea	22.0	2.8	2.8

2023 score range

6-Jan	13-Jan	20-Jan	27-Jan	3-Feb	17-Feb	3-Mar	17-Mar	31-Mar	14-Apr	28-Apr	12-May	26-May	9-Jun	23-Jun	7-Jul
-0.6	-0.4	-0.6	-0.4	0.1	0.1	-0.1	-0.1	-0.1	0.6	0.9	0.9	1.2	0.8	0.8	0.8

Source: HSBC AM, Bloomberg data, August 2023. **Past performance is no guarantee of future returns.**

From a fundamental standpoint, this recovery takes its roots in South Korea's heavily discounted valuations and favorable macroeconomic outlook (including favorable growth and inflation trends). It makes this positive tactical signal an obvious candidate for implementation within a broader strategy – that would have benefited materially from a risk-adjusted return perspective.

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To be fair, it is also important to note that given the weak scores generated by the signals in the beginning of 2023, the strategy wouldn't have benefited from the strong performance starting in January 2023. One of the reasons why the signals have failed to pick this up is due to weak momentum in the first few months, which is measured with a relatively longer time lag, while the South Korea stock market tends to trade forward earnings much earlier and faster than peers.

Despite their ability to generate value by flagging opportunities across a wide range of assets, signals should be balanced against discretionary views to mitigate model risk, overfitting, or changes in the market.

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