



# INFORMATION NOTICE ON RISKS ASSOCIATED WITH FINANCIAL INSTRUMENTS

**NIRF**

Ed. 02/2023

This document provides additional information on the features of financial instruments in which Clients are likely to invest and the associated risks. Should Clients wish to obtain more extensive information on a given instrument, we recommend that they contact their advisor at Edmond de Rothschild (Middle East) Limited (the "Company"). The Company is regulated by the Dubai Financial Services Authority ("DFSA") under Reference no. F007577.

This document does not deal with the tax and legal implications of transactions in financial instruments.

Clients wishing to obtain individual guidance on these aspects should contact a specialist advisor.

## I. BASIC INVESTMENT RISKS

Any investment involves risk and investors should consider their own attitude to such risk before they decide to invest and in selecting the type of investments to place their money into. These risks apply to all types of investments. However, some financial instruments may carry a combination of the risks set out below, which increases the overall risk exposure.

### 1) Economic risk

Changes in the activity of a market economy always affect the prices of financial instruments and exchange rates. Prices fluctuate roughly in line with phases of economic decline or growth. The duration and extent of economic upward and downward cycles vary, as do their repercussions on different business sectors. In addition, economic cycles can differ from one country to another.

Clients who misjudge economic developments or overlook them when making investment decisions can sustain losses. It is particularly important to consider the impact of the economic cycle on investment prices.

In view of the above, a financial instrument's past performances are not indicative of future results. Reductions in the investment's value, and hence losses to the investor, are always possible. Investors must thus ensure at all times that their investments are appropriate in the light of the economic climate and, if required, make any necessary changes to their portfolios.

### 2) Inflation risk

Investors may sustain financial losses on their investments due to a fall in the purchasing power of a monetary unit. This can affect both the actual value of the assets concerned and the investment's actual yield. Investors should therefore consider the actual yield, i.e. the difference between the interest rate and inflation rate for fixed-rate products.

Investors will therefore sustain a loss in the purchasing power of the capital invested if the inflation rate exceeds the yield generated by the financial instruments (capital gains and interests).

### 3) Price volatility risk

Volatility risk is the likelihood of a variable-income investment being subject to price fluctuations of varying degrees, generating a capital gain or loss. Investors will sustain a capital loss if the price falls and a capital gain if it rises.

Overall price performances may be affected by irrational factors, such as trends, opinions or rumours that can cause securities prices to drop substantially, even if there is no deterioration in the financial situation and prospects of the companies concerned.

In addition, changes in the activity of a market economy always affect the prices of transferable securities. Prices fluctuate in line with phases of economic decline or growth. The duration and extent of economic upward and downward cycles vary, as do their repercussions on different business sectors. Moreover, economic cycles can differ from one country to another. Clients who misjudge economic developments or overlook them when making investment decisions can sustain losses. It is particularly important to consider the impact of the economic cycle on security prices.

### 4) Country risk

A foreign debtor, although solvent, may be unable to make interest or debt payments on time or at all due to foreign currency being unavailable or non-transferable in the country concerned because of factors such as economic, political or social instability.



The ensuing unavailability or non-transferability of foreign currency may trigger defaults on payments due to investors. When dealing with financial instruments issued in a foreign currency, investors could receive payments in a currency which can no longer be converted due to exchange controls. Even if there is no crisis, state intervention in some business sectors (e.g. nationalisation) can affect the value of investors' assets. In extreme cases, investors' assets can be confiscated or frozen by the local authorities or investors' rights can be restricted. In principle, there is no way of hedging against this type of risk. However, the country ratings published in the financial press are a useful guide for investors. More generally, instability in the political and/or economic and/or social situation of certain countries can trigger sudden price fluctuations.

#### 5) Exchange rate risk

Since currency exchange rates fluctuate, investors are exposed to exchange rate risk whenever they hold financial instruments denominated in a foreign currency. Depending on the exchange rate, a given investment can generate a profit or a loss. Moreover, since companies' operations are affected to varying degrees by exchange rates, fluctuations in these rates are likely to affect the prices of the financial instruments they issue. Key factors affecting a country's exchange rate include its inflation rate, the spread between domestic and foreign interest rates, the evolution of the economic conditions, government debt, recession, the global political situation and investment security in general. In addition, psychological factors, such as a lack of confidence in its political leaders, can weaken a country's currency.

#### 6) Liquidity risk

An investor's ability to sell financial instruments at market value at any time is described as liquidity.

A lack of market liquidity can prevent an investor from selling financial instruments at market prices. A basic distinction has to be drawn between liquidity shortages due to supply and demand in the market and those due to the nature of the financial instrument concerned or market practices.

A liquidity shortage due to supply and demand arises when there is scant or no supply of, or demand for, a financial instrument at a given price. In such cases, it may be impossible to execute buy or sell orders immediately and/or in full (in the case of partial execution) and/or on favourable terms. Moreover, higher transaction costs may apply.

A liquidity shortage due to the features of the financial instrument concerned or market practice may arise, for example, due to a lengthy transcription procedure for a transaction on registered shares, long execution times caused by market practices or other trading restrictions, short-term liquidity needs that cannot be covered by the sale of financial instruments or long closed periods before trades can be executed, in particular for alternative investment funds.

#### 7) Psychological risk

Irrational factors may affect overall price performances, such as trends, opinions or rumours that can cause securities prices to drop substantially, even if there is no deterioration in the financial situation and prospects of the companies concerned.

#### 8) Risk of not obtaining returns or repayments

This risk reflects the likelihood of an investor being unable to withdraw income from an investment. It leads to an absolute loss due to inflation and a relative loss versus an income-generating investment (the "opportunity cost"). Repayment risk is the likelihood that an investor may not recover the full amount of the initial investment at maturity or upon exiting the investment (fluctuation in the financial markets). Investors thus run the risk of not recovering the full amount of their original investment.

#### 9) Credit risk

Credit-financed purchases of financial instruments carry a number of additional risks. Firstly, additional collateral may be required - sometimes at very short notice - if the credit limit is overrun due to movements in the prices of assets pledged as collateral. If an investor is unable to provide such collateral, the custodian bank may be forced to sell the financial instruments pledged at a time when conditions are unfavourable. In addition, losses incurred if prices move against the investor can exceed the initial investment amount. Fluctuations in the prices of financial instruments pledged as collateral can undermine an investor's ability to repay any associated loan.

It must be borne in mind that the leverage effect generated by credit-financed purchases of financial instruments amplifies their sensitivity to price fluctuations. As a result, the chances of obtaining higher gains increase, but so do the risks of incurring higher losses. The risks associated with this kind of purchase increase with the amount of leverage. Investors' obligations to repay their loan apply irrespective of changes in the value of the credit-financed assets. Therefore, the Client not only risks losing the capital originally invested but could also be required to repay the remainder of the loan using other assets not held with the custodian bank.

Finally, returns on credit-financed assets can be lower than the interest rate payable on the loan. In other words, the charges can be higher than the income generated.

#### 10) Interest rate risk

Fluctuations in short- or long-term interest rates can have substantial adverse impacts on the valuation of financial instruments.



### 11) Risk of insolvency of the issuer or the clearing/settlement system

The insolvency of the issuer of the financial instruments or of the clearing/settlement system in which the instruments are traded could lead to the loss of some or all of the funds invested for the investor.

### 12) Additional risks associated with emerging markets

Emerging markets are those of countries in which per capita income based on the World Bank's definition is average or low. More specifically, these are generally countries showing a degree of political instability, relatively uncertain financial markets and economic growth, financial markets still at the development stage and weak economies. Emerging markets include many markets in South America and Eastern Europe, as well as the markets of some Asian countries.

In these markets, the risks set out below are generally amplified.

For instance, political and economic changes (e.g. inflation, exchange rates) have a greater impact on investment values in emerging markets than in other countries. Likewise, in emerging markets the impacts of natural disasters or war are often stronger and longer-lasting.

Moreover, emerging markets often have less sophisticated rules for transaction clearance and settlement, which makes processing errors and settlement fails more likely.

Finally, regulatory supervision in these markets and the rules in place to protect investors are often weak.

### 13) Other basic investment risks

#### a) Information risk

Information risk is the risk of an investor making poor investment decisions due to information that is lacking, incomplete or inaccurate. This can in turn be due to unreliable sources, the misinterpretation of originally accurate information or communication errors.

#### b) Information transmission risk

When placing an order, investors must provide certain details (financial instrument, type of order, volume, execution date, etc.) necessary for its execution by the custodian bank or other domestic or foreign intermediaries (e.g. brokers). The more accurate the order, the smaller the risk of a transmission error.

#### c) Risks associated with transaction costs

The custodian bank, as well as other domestic or foreign intermediaries (e.g. brokers), may be involved in executing an order, in which case the fees and commissions of these parties will be passed on to the investor. An investment only becomes profitable once all these costs have been covered.

## II. SPECIFIC INVESTMENT RISKS

### 1) Term deposits

Term deposits are cash deposits remunerated on a specified date at a fixed rate, determined in advance. Depending on market conditions, these products may provide a higher return than other fixed-income products.

However, these products are mainly subject to inflation risk, exchange and interest rate risk and counterparty risk, as described in part I above.

Characteristics:

- Returns: interest payments;
- Duration: short term (< 4 years), medium term (4 – 8 years) or long term (> 8 years);
- Interest: interest depends on the terms and conditions of each deposit; e.g. fixed interest for the entire duration or variable interest often linked to financial market rates (e.g. LIBOR or EURIBOR).

Risks associated with term deposits:

These products are mainly subject to inflation risk, exchange and interest rate risk and counterparty risk, as described in part I above.

### 2) Bonds

Bonds are marketable securities, in bearer or registered form, issued by a company or governmental body to its lenders. Bonds value will depend on the yield or interest rate payable, the credit worthiness of the issuer of the bond comparative to the general economic conditions and the value and outlook of alternative investments, such as equities and cash deposits. At issuance, the par value of one bond represents a fraction of the total amount of the loan. The interest payments on bonds may be either fixed or variable. The duration of the loan as well as the terms and conditions of repayment are determined in advance. Some structured products can take the legal form of a bond. The purchaser of a bond (the creditor) has a claim against the issuer (the debtor).

Characteristics:

- Returns: interest payments, possible increase in value;
- Duration: short term (< 4 years), medium term (4 – 8 years) or long term (> 8 years);



- Currency: national currency of the investor or foreign currency. It can be provided for capital repayments and interest payments to be made in different currencies. In such cases, an option can be attached to the bond to limit the associated exchange rate risk;
- Form: individual certificates with specific nominal values (which can be delivered to the investor) or values collectively represented by a global certificate, which is deposited with a custodian bank;
- Issue value: at par (100 % of the nominal value), below par (issue price lower than the nominal value) or above par (issue price higher than the nominal value);
- Place of issuance: this can be the investor's domestic market or a foreign market;
- Payment: can be predetermined – unless otherwise provided for, the debt is repaid on the maturity date, through annual instalments, or at different dates determined by drawing lots – or no set repayment date may be given;
- Interest: interest depends on the terms and conditions of each bond; e.g. fixed interest for the entire duration or variable interest often linked to financial market rates (e.g. LIBOR or EURIBOR);
- Subordination: if the issuer defaults, subordinated bonds will only be redeemed after repayment of regular and senior bonds, depending on the remaining funds available. In exchange for this, the yield on this type of bond is higher than those on regular and senior bonds.

Risks associated with bonds:

a) *Issuer default risk*

The issuer could become temporarily or permanently insolvent and thus be unable to pay interest and/or the principal of the loan. Should this happen, the creditor could not only lose income (non-payment of interests) but also part of the invested capital. An issuer's solvency can change due to general economic developments or factors specific to the issuing company and/or its business sector during the life of the bond. The level of risk varies depending on whether a bond is issued by a government or a company. The lower a company's credit rating, the higher the associated risk. Ratings reflect economic developments, changes affecting the company, its business sector and/or the country concerned, and political developments with significant economic impacts.

This type of risk varies depending on whether the bond is issued by a government body or private institution. It also depends on the nationality of the government body and the type/business sector of the private institution concerned, as well as its financial robustness. A decline in the issuer's creditworthiness has a negative impact on the price of the securities concerned.

b) *Interest rate risk*

Given the relative uncertainty surrounding interest rate trends, buyers of fixed-rate securities could see the price of their securities drop if interest rates increase. A bond's sensitivity to interest rate fluctuations depends particularly on its residual maturity and the nominal interest rate.

c) *Early redemption risk*

A bond issuer may provide for early redemption of its debt securities, usually in falling interest rate markets. Such early redemptions can affect the anticipated returns on the debt securities concerned.

d) *Risk associated with lottery bonds*

The maturity date of lottery bonds is difficult to determine and these bonds can experience unexpected changes in their anticipated yield.

e) *Risk associated with the country of issuance*

If a bond is issued on a foreign market, it will, in principle, be governed by the law of the country of issue. Investors must therefore ascertain how enforcement of the foreign law could affect their rights.

f) *Risks specific to certain types of bond*

Some types of bond may carry additional risks: e.g. floating rate notes, reverse floating rate notes, zero coupon bonds, bonds denominated in a foreign currency, convertible bonds, index or option-linked bonds, subordinated bonds, etc. With these types of bonds, investors should enquire about the risks described in the issue prospectus and should not invest until they are certain that they have understood all the risks involved.

Investors must obtain information on the specific risks associated with each bond by consulting the relevant prospectus, which is made available to the public without charge, as described in the prospectus.

The points below provide only a brief overview of the additional risks carried by these specific types of bond.

Floating rate bonds come in various forms, such as:

- Floor floater bonds, which pay a guaranteed minimum level of interest. If the sum of the reference rate and the spread is below a specific level, the investor will receive interest at the pre-determined minimum rate. Conversely, with cap floater bonds, the rate of interest paid to the investor is capped in advance. With these bonds, at the time of issue it is impossible to anticipate the actual yield on the investment, as it varies with fluctuations in market rates.

Under the terms of some variable-interest bonds, the interest rate moves in the opposite direction to market rates (i.e. reverse floating rate bonds). With these medium or long-term bonds, the interest rate payable to the investor is calculated based on the spread between a fixed rate of interest and a reference rate (e.g. 16 % minus LIBOR). Therefore, the interest paid to the investor rises when the reference rate falls. The prices of these bonds are usually subject to higher market volatility than fixed-rate bonds with the same maturity. There are also



convertible floating rate bonds, which entitle the investor or issuer (depending on the bond's terms and conditions) to convert them into regular fixed-rate bonds. If only the issuer has this right, the bond yield may be lower than anticipated by the investor.

- Zero coupon bonds do not have coupons attached. Instead of periodic interest payments, investors receive the difference between the redemption price and the issue price (in addition to repayment of the principal amount). These bonds are usually issued at a discount to their par value and redeemed at par. The size of the discount depends on the bond's maturity, the borrower's creditworthiness and prevailing market interest rates. Hence, these bonds provide investors with a single lump-sum payment at a future date if they are held to maturity (which may have tax implications in some countries). However, if they are sold prior to maturity, the investor will only receive the proceeds from the sale. Therefore, if market interest rates increase, the price of these bonds falls more sharply than those of identical bonds with the same maturity. When considering subordinated bonds, investors should find out how they rank compared to the issuer's other bonds since, if the issuer goes bankrupt, subordinated bonds will only be redeemed once all higher ranked creditors (preferential and *pari passu* bondholders) have been repaid.
- Convertible/warrant bonds: These bonds give investors the right to exchange them for shares in the issuer, on a given date or within a specific period, based on a predetermined ratio. There is usually a minimum lock-up period, during which an investor cannot exercise his conversion right. If the conversion right is not exercised, the bonds remain fixed-interest notes, redeemable at par on maturity. Because they offer a conversion right, these bonds usually pay lower interest rates than regular bonds. Their value is essentially determined by the price of the underlying shares. Thus, if the share price drops, so does the value of the bond. There is thus a greater risk of a drop in the value of these bonds than for bonds without conversion rights (but the risk is usually lower than that associated with a direct investment in the underlying shares). There are also bonds that entitle the investor to subscribe for shares in addition to the bond, rather than as an alternative. This subscription right takes the form of a certificate (warrant), which is detachable from the bond and can be traded separately. The investor can purchase shares in the issuer upon surrender of the warrant, on terms agreed in advance, and continue to hold the bond to maturity. As with bonds with conversion rights, periodic interest payments are usually low. In addition, the price of these bonds, with the warrant attached, also tracks the price of the underlying shares. If the bonds do not have the warrant attached, they behave like traditional bonds and, as such, their price is mainly determined by market rates.

g) *Liquidity risk*

The vast majority of bonds trade on over-the-counter (OTC) markets. The size of the issue provides an initial indication of the security's liquidity, which can also be affected by factors such as country of issue, subordination, rating, etc. During periods of market stress, liquidity can temporarily drop in the bond market, causing the bid/ask spread to widen.

h) *Risk of losing the entire investment*

If an issuer defaults, coupons may not be paid and the amount invested may not be reimbursed.

i) *Functioning and performance*

Bond prices fluctuate with interest rate movements. When interest rates drop, bond prices increase and vice versa. The longer a bond's maturity, the greater its sensitivity to rises/falls in interest rates. For example, for a 10-year bond issued by the German government:

- A 100 bp rise in interest rates would in theory cause the bond price to fall by 9.10 %;
- A 100 bp reduction in interest rates would in theory cause the bond price to increase by 9.97 %.

Alongside the interest rate factor, credit spreads also come into play with corporate bond issuers. The credit spread is the difference in yield between a corporate bond and a "risk free" bond with the same maturity. Issuers deemed "risk free" include Germany for bonds denominated in EUR and the United States for those in USD. As well as interest rate risk, corporate bond prices are affected by changes in credit spreads. If credit spreads widen, corporate bond prices fall, and vice versa.

### 3) Shares

Shares are certificates delivered to shareholders, representing their rights in a company. They can be in bearer or registered form. One share represents a fraction of a joint stock company's share capital. .

Characteristics:

- Returns: dividends and price increases are possible;
- Shareholder's rights: financial and ownership rights, determined by law and by the issuing company's articles of association;
- Transfer of shares: unless otherwise provided by law, bearer shares can generally be transferred without particular formalities. Conversely, there are often restrictions on the transfer of registered shares;

Risks associated with shares:

a) *Business risk*

Shareholders are not creditors of a company, but contribute to its capital and, as such, become co-owners. Consequently, they participate in the company's development, and the associated opportunities and risks, which can cause unexpected fluctuations in the investment's value. In a worst-case scenario, the issuing company could



go bankrupt and the entire amount invested could be lost.

b) *Share price risk*

Whilst there is the opportunity for the price of shares to increase over time, producing capital growth, share prices can fluctuate unpredictably, sometimes over the course of a day or even less, generating a risk of losses being incurred. Prices rise and fall over the short, medium and long term and it is impossible to predict the duration of these cycles.

A distinction must be drawn between general market risk and company-specific risk, both of which affect share price performances.

c) *Dividend risk*

The dividend on a share depends chiefly on the issuing company's earnings. If earnings are low, or the company reports a loss, dividend payments may be reduced or there may be no pay-out at all.

d) *Liquidity risk*

The liquidity risk associated with shares depends on trading volumes and the proportion of the company's capital that is not held by strategic investors. In general, the higher the company's market capitalisation, the more liquid the market for its shares. Markets can become illiquid due to a major supply/demand imbalance: if supply drops, prices rise, and vice versa.

e) *Risk of losing the entire investment*

If the company goes bankrupt, shareholders participate in its losses and can lose part or all of their investment.

f) *Functioning and performance*

Share prices are affected by internal and external factors: reported and anticipated earnings, news on the company and its sector, dividend and share buyback policy, political events, legal developments and irrational factors that can cause stock prices to fluctuate.

If prices move in their favour, shareholders stand to benefit from the rise in the share price and the possible distribution of profits.

In an adverse scenario, the share price can fall and the company may decide to reduce its dividend distribution.

#### 4) Participating bonds

Participating bonds represent property rights as defined in the terms and conditions of issue. They generally take the form of par value debt instruments that entitle the holder to participate in the company's profit.

A distinction must be drawn between fixed/variable distribution participating bonds and those with option or conversion rights.

Risks:

a) *Non-distribution or reduction in repayment*

If the issuing company incurs losses, interest payments may be stopped if there is no minimum interest payment provided for in the terms and conditions. The repayment of the principal amount may also be reduced.

b) *Issuer default risk*

If the issuing company defaults, the entire amount invested could be lost.

#### 5) Pooled investments or collective investment funds (Funds)

Collective investment funds or pooled investments offer an alternative to buying shares directly. A pooled investment allows an investor to participate in buying the shares of many different companies by combining with other investors. In such pooled investments the money of all the investors is aggregated and invested by a fund or investment manager. This allows the investment manager to spread the money invested across a range of different company shares or assets and may even allow investors access to different global markets within a single investment product.

Characteristics:

- Open-ended funds: means a Fund where investors have a right (generally, on request, or at a specified frequency) to have their Units<sup>1</sup> redeemed or repurchased at a value calculated based on the net asset value of the Fund Property. In an open-ended fund, the number of shares/units and, hence, of participants cannot, in principle, be determined. The fund can issue new shares/units or redeem existing shares/units. The fund undertakes to redeem investors' shares/units, at its own expense, at the agreed redemption price in accordance with the terms of the contract.
- Closed-end funds: means a Fund where investors have no right of redemption or repurchase of their Units. In a closed-end fund, the shares/units issued are limited to a set number. As opposed to open-ended funds, these funds are not obliged to repurchase investors' shares/units. Shares/units may only be sold to third-party buyers or, in some cases, on the stock exchange. The price obtained is determined by supply and demand.

<sup>1</sup> a Unit is a unit in or a share representing the rights or interests of a Unitholder in a Fund



#### Risks associated with Funds:

Pooled investments are generally thought of as lower risk than direct equity or share investment because of this ability to diversify (spread) the risk. However, the value of the underlying investments is still dependent on the fluctuating market values of the investments held and may fall. Investors must obtain information on the risks specific to each Investment Fund, namely by consulting the relevant prospectus and any key investor information documents (KIID). The prospectus and investment fund's KIID are made available to the public free of charge as described in the prospectuses of the investment funds concerned. Pooled investments are generally thought of as lower risk than direct equity or share investment because of the ability to diversify (spread) the risk. However, the value of the underlying investments is still dependent on the fluctuating market values of the investments held and may fall.

a) *Fund management risk*

The returns on investments made by a fund depend, among other factors, on its managers' expertise and sound decision-making. Errors of judgement in the fund's management can result in losses or capital losses being sustained

b) *Risk of a fall in share/unit prices*

There is a risk that the price of the investment fund share/unit could drop, due to a fall in the value of the securities or currencies held in the fund's portfolio, all else remaining equal. The more diversified the fund's investments, the lower the risk of losses being incurred. Conversely, the risk is higher if the fund focuses on more specialised, less diversified investments. It is therefore important for investors to consider the general and specific risks attached to the financial instruments and currencies in the fund's portfolio. Investors must enquire about the risks specific to each fund, namely by consulting the relevant prospectus.

The prospectus and KIID of investment funds are made available to the public free of charge, as described in the prospectuses of the funds concerned.

c) *Risk of losing the entire investment*

Investment funds are exposed to a price risk associated with the underlying investments and diversification. If the market comes under stress, depending on the fund's diversification, investors could lose the portion of their funds invested in failed or defaulted assets.

d) *Liquidity risk*

Open-ended funds can buy or sell assets at any time. The liquidity of their shares/units depends chiefly on the liquidity of the underlying investments. Closed-end funds do not offer this flexibility. With these funds, the number of outstanding shares/units is fixed and prices depend on supply and demand for the fund concerned.

e) *Functioning and performance*

The returns on investments made by a fund depend, among other factors, on the managers' expertise and sound decision-making. Errors of judgement or market downturns can generate capital losses.

Before investing in a fund, investors must consult its prospectus, KIID, and annual, half-yearly and monthly reports. These documents present the fund's key characteristics and risks, as well as its management fees, which will also affect the returns obtained.

## 6) Derivative instruments

Derivatives are financial instruments whose value fluctuates in line with that of an underlying asset, such as a share, market index, interest rate, currency, commodity or even another derivative.

When considering derivative products, a distinction must be drawn between:

- i. Option transactions, entered into by Professional Clients and Market Counterparties, where one of the parties acquires the right, but not the obligation, to execute a trade. One party (the option writer) makes a firm commitment, while the other (the option buyer) can choose whether to exercise their option;
- ii. Futures transactions, where the parties enter into a contract which must be executed at a set time in the future. In futures transactions, both parties make firm commitments to execute the agreed transaction at the agreed time.

Transactions involving these products carry higher risks of losses and the full amount invested could be lost. Since margin calls can be made throughout the life of these products, investors must ensure that they have sufficient liquid assets at their disposal before entering into this type of transaction.

### i. Option transactions

Options are derivative instruments whose value tracks that of their underlying assets. The buyer of an option pays a premium to the seller (writer) to acquire the right to purchase (call option) or sell (put option) the underlying asset at a specified time or during a specified period at a predetermined strike price.

An option's characteristics can be standardised or defined on a case-by-case basis.

Exercise date: options that can be exercised at any time up to their expiry date are called "American style" options, while those that can only be exercised on the expiry date are called "European style" options. The latter can nonetheless be traded freely on the secondary market prior to expiry if the market is liquid;

Terms of exercise: an option can be subject to physical settlement, in which case the buyer of a call option can demand physical delivery of the underlying asset against payment of the strike price or the buyer of a put option has the right to deliver the underlying asset to the seller against payment of the strike price by the seller. The option can also be cash-



settled, in which case the difference between the strike price and the market value of the underlying asset is payable, provided that the option is “in the money”; “In-the-money”, “at-the-money” and “out-of-the-money” options: An option to buy (call option) is said to be “in the money” when the market value of the underlying asset is higher than the strike price. An option to sell (put option) is said to be “in the money” when the market value of the underlying asset is lower than the strike price. Conversely, a call option is said to be “out of the money” when the underlying’s market value is lower than the strike price and a put option is “out of the money” when the underlying’s market value is higher than the strike price. When the current market value of the underlying asset is the same as the strike price, the option is said to be “at the money”;

Initial and additional (“variation”) margin: during an option’s lifetime, the seller must provide collateral in the form of a sufficient quantity of the underlying asset or another eligible form of asset. The margin is determined by the custodian bank. Stock exchanges require a minimum margin for listed options. If an investor’s position becomes under-margined, the Bank is entitled to call for additional margin from the seller, sometimes at very short notice;

Duration: this is the period from the date of subscription to the date on which the option right expires;

Relationship between the option and the underlying asset: this relationship reflects the number of units of the underlying asset that the option holder can buy (call) or sell (put) by exercising the option;

Strike price: the agreed price at which an option holder can purchase or sell the underlying asset when exercising the option;

Leverage: a change in the price of the underlying triggers a proportionately higher change in the option price;

Purchasing a call or put option: the buyer of a call option anticipates an increase in the underlying asset’s price over the life of the option, triggering an increase in the value of the option. Conversely, the buyer of a put option can profit from a drop in the price of the underlying asset;

Writing a call or put option: the writer of a call option anticipates a drop in the value of the underlying asset, whereas the writer of a put option can benefit from an increase in the value of the underlying asset;

Value of the option: an option’s price depends on its intrinsic value, as well as a number of other factors (time value), in particular the option’s remaining life and the volatility of the underlying asset. The time value reflects the probability of the option being “in the money”. Therefore, it is higher for options with long remaining lives and highly volatile underlying assets.

Form:

Option certificates (warrants, listed options): the rights and obligations attached to the option are guaranteed by the issuer. These certificates are sometimes listed on the stock exchange;

Traded options: these are standardised options for which the rights and obligations are not guaranteed and which are traded only on specific stock exchanges;

Over-the-counter (OTC) options: these are options traded off-exchange or agreed “over-the-counter” between the parties. Their level of standardisation depends on market practices. They can also be tailored to meet investors’ needs. This type of option is not listed and rarely takes the form of a certificate;

“Exotic” or “synthetic” options: compared to the plain-vanilla call and put options presented above, “exotic” or “synthetic” options involve additional conditions or clauses.

Their payment structures cannot be obtained using a combination of conventional transactions, with or without underlying assets. Exotic options can take the form of “tailor-made” OTC options or warrants. As there is a virtually infinite range of possible exotic or synthetic options, it is impossible to present the risks specific to each one. The points below therefore deal only with the additional risks associated with the most common exotic and synthetic options. Before buying or selling exotic or synthetic options, investors must obtain full details of the associated risks. Generally speaking, the price performance of an exotic or synthetic option can differ significantly from that of a plain-vanilla option over its lifetime, due to the special arrangements involved.

Information documents:

Investors are advised to consult documents providing information on option trading, published by the various markets in which options are traded, particularly the following:

- “Characteristics and Risks of Standardized Options”, on options traded on the Chicago Board Options Exchange, available on request from the Company and on the website [www.cboe.com](http://www.cboe.com);
- The information document, “*Note d’information*” (COB visa no. 00-1228 of 4 July 2000) on options traded on the Euronext MONEP market (Paris options market), available on request from the Company and on the website [www.monep.fr](http://www.monep.fr);
- The document “*Officieel bericht opties en futures*”, on options and futures traded on the AEX, available on request from the Company.

Investors must obtain information on the specific risks associated with each derivative instrument, namely by consulting the prospectus made available to the public free of charge, as described in the prospectus concerned.

Risks:

a) *Price risk*

Options can be traded on stock exchanges or over the counter and are subject to supply and demand. Key factors determining an option’s price are market liquidity for the option concerned and the actual or expected price performance of the underlying asset. A call option loses value when the price of the underlying asset decreases,





whereas the opposite is true for put options.

The price of an option does not depend solely on fluctuations in the price of the underlying asset. A number of other factors come into play, such as the option's duration and the frequency and depth of fluctuations in the underlying asset's value (volatility). This means that the option's value may decrease, even if the price of the underlying asset remains unchanged.

b) *Leverage risk*

The leverage effect causes movements in an option's value to be proportionately higher than those in the underlying asset price. Thus, during the option's lifetime, the option holder stands to benefit from larger gains, but also runs the risk of incurring steeper losses. The risk associated with buying an option increases in line with the strength of the leverage effect involved.

c) *Risk of losing the entire investment*

Investors risk losing the full amount of their investment.

In an option purchase, the option is worthless after its exercise period. Buyers could lose their entire investment if they do not exercise their option right.

In an option sale, the seller receives a premium but could sustain a loss greater than the proceeds from the sale if the underlying asset price moves in the buyer's favour.

d) *Issuer default risk*

This risk represents the likelihood of the issuer being unable to meet its financial obligations. The issuer's credit quality is very important, as the issuer is responsible for repaying the initial capital. The weaker the issuer's financial and business situation, the higher the risk of non-repayment. One way of addressing this problem is by considering the rating, or risk assessment, determined by an independent rating agency. Such ratings are not static but can change over the product's life.

e) *Purchase of an option*

An option purchase is a highly volatile investment and the likelihood of an option expiring worthless is very high. In such cases, investors lose all the funds used to pay the initial premium, plus any commission. After buying an option, the investor can hold the position until the option expires or enter into an offsetting transaction. "American-style" options, however, can be exercised up to the expiry date.

Exercising an option can involve settling the difference between the strike price and market price in cash or taking/making delivery of the underlying asset. When options on futures contracts are exercised, the investor takes a position in futures and must accept the associated margining obligations.

f) *Writing of an option*

Writing an option is generally riskier than buying one.

Although the price obtained for an option is fixed, the losses that the seller may sustain are potentially unlimited.

If the price of the underlying asset moves against him, the option seller has to adjust his margin cover in order to maintain his position. If the option sold is "American-style", the seller may at any time be required to settle the transaction in cash or to purchase or deliver the underlying asset. If the underlying assets are futures contracts, the seller takes a position in futures and must comply with any margining obligations. The seller's risk exposure can be reduced by holding an offsetting position in the underlying asset (securities, index or other).

g) *Purchase of the underlying asset in a short sale*

The seller of an uncovered call option does not hold the relevant quantity of the underlying asset when entering into the contract (short sale). With physically settled options, the potential loss for the investor is the difference between the strike price received against delivery of the underlying assets if the option is exercised and the price the seller will have to pay to acquire the underlying assets. With cash-settled options, the potential loss is the difference between the strike price and the market value of the underlying asset.

As the market value of the underlying can be significantly above the strike price when the option is exercised, the potential loss for the option writer cannot be determined in advance and is, at least in theory, unlimited.

This risk is greater for "American-style" options, which can be exercised at any time, including when conditions are very unfavourable for the option writer.

An option writer also carries the risk that, when the option is exercised, he may be unable to acquire the underlying asset or may only be able to do so on very unfavourable terms (especially as regards the cost) due to market conditions.

In this context, it should be borne in mind that the potential loss can be higher than the value of the margin cover provided by the investor.

h) *Specific risks associated with over-the-counter (OTC) options*

A position arising from the purchase or sale of an OTC option can only be closed with the counterparty's agreement.

i) *Specific risks associated with option combinations*

Option combinations comprise two or more option contracts which have the same underlying, but confer different rights or have different features.



Given the large number of possible combinations, the risks involved in each case cannot be covered in this document. Investors must therefore enquire about the specific risks associated with the combination they are considering.

It is important to bear in mind that, with any combination, if one or more options are cancelled at any time, the investor's risk position may change considerably.

*j) Specific risks associated with exotic options*

Compared to the plain-vanilla call and put options presented above, exotic or synthetic options involve additional conditions or clauses. Their payment structures cannot be obtained using a combination of plain-vanilla options, with or without underlying assets. Exotic options can take the form of "tailor-made" OTC options or warrants. As there is a virtually infinite range of possible combinations of exotic options, it is impossible to provide details of the risks specific to each one. Before buying or selling exotic options, investors must obtain full details of the risks associated with them. The price performance of an exotic option can differ significantly from that of a plain-vanilla option over its lifetime due to the special arrangements involved.

*k) Functioning and performance*

An option contract can be sold prior to expiry, generating a capital gain or loss, depending on the characteristics of the underlying and its performance over time (volatility, price, etc.). If an option is exercised, the return will depend on the strike price, the price of the underlying asset and the premium initially paid to the seller. An option buyer can also hold the option until it expires, in which case the loss incurred will be equal to the premium paid.

## ii. Futures transactions

Futures transactions involve the obligation to make, or take, delivery of a specified quantity of the underlying asset on a future date (the settlement date) at a price agreed when entering into the contract.

The underlying can be securities (shares, bonds, commodities, precious metals) or reference rates (exchange rates, interest rates, indices). Futures are exchange-traded contracts standardised in terms of the quantity of the underlying asset and the delivery date. Forward contracts traded over-the-counter (OTC) and their specifications can be standardised or agreed on a case-by-case basis between the buyer and seller.

Characteristics:

- **Initial margin requirement:** when entering into a futures contract to buy or sell an underlying asset, an initial margin is determined, usually expressed as a percentage of the contract's value.
- **Variation margin:** throughout the term of a contract, a variation margin is periodically determined and required from the investor. It represents the accounting profit or loss resulting from changes in the contract's value or the price of the underlying asset. The variation margin can be many times higher than the initial margin. The variation margin is calculated, during the term of the contract or upon settlement, based on stock exchange rules and the specific provisions of each contract. The investor must provide variation margin cover immediately when asked to do so by the custodian bank.
- **Liquidation:** in principle, the investor may, at any time during the term of the contract, settle or liquidate his position prior to maturity, either by selling it or offsetting it with an opposing contract. Liquidation closes out the risk positions taken: any accumulated gains and losses are realised.
- **Settlement:** contracts held to maturity must be honoured by the parties concerned. If the underlying are tangible assets, the contract can be settled by physically delivering the assets or via cash settlement. If the underlying are reference rates (except currencies), physical delivery is not possible. In the case of physical delivery, the contract must be honoured in full, whereas for cash settlement, only the difference between the initially agreed price and the market value on the settlement date is payable. Therefore, investors need more available funds for contracts requiring physical delivery of the underlying asset than for cash-settled contracts.

Risks associated with futures:

*a) Change in the value of the contract or of the underlying asset*

There is a risk that the effective value of the contract or underlying asset could fail to perform as the investor anticipated when entering into the contract.

If the price of the contract or underlying asset rises, a futures seller must still deliver the underlying asset at the price initially agreed on, which could be significantly below the current price. The seller's risk is therefore the difference between the initially agreed price and the market value on the maturity date. In theory, there is no limit as to how far the market value can rise, so the seller's potential loss is also unlimited and could considerably exceed the required margin.

If the value of the contract or underlying asset drops, a futures purchaser must still take delivery of the underlying asset at the price initially agreed upon, which could be significantly above the current market value. The buyer's risk is therefore the difference between the price initially agreed on and the market value on the maturity date. The most the buyer can lose is therefore the initially agreed price, but this amount could be significantly higher than the required margin.

- b) Transactions are regularly market to market and investors must have sufficient margin cover available at all times. If a contract becomes under-margined at any time, the investor must provide additional margin cover at very short notice, failing which the contract will be subject to early termination, generally at loss. Risk of liquidation being difficult or impossible*



To limit excessive price fluctuations, a stock exchange can set price limits for certain contracts. In such cases, investors must bear in mind that, when the price limit is reached, it may be very difficult, or momentarily impossible, to settle the contract. Therefore, investors should always find out whether such limits are in place before entering into a futures contract.

It will not always be possible (depending on the market and the contract terms and conditions) to execute trades intended to avert or reduce the risks of an ongoing transaction.

Stop-loss trades, if they are possible at all, can only be executed during the custodian bank's office hours. They do not limit losses to the specified level but are executed once the threshold is reached in the market. At that time, they are treated as "at best" market orders.

Options can be traded on a secondary market. An option also gives the buyer a right: if the buyer wishes to execute a transaction, the seller is obliged to comply.

c) *Purchase of the underlying in a short sale*

Short-selling an underlying asset (i.e. without owning it when entering into the contract) exposes the seller to the additional risk of being forced to buy the underlying asset at an extremely unfavourable price in order to meet the obligation to deliver the underlying upon maturity.

d) *Specific risks associated with OTC transactions*

For standardised OTC futures transactions, the market is generally transparent and liquid, so contracts can be readily settled. However, there is no market for OTC futures transactions whose specifications are determined individually by the purchaser and the seller. That is why these contracts can only be settled with the agreement of the other party.

e) *Risk of losing the entire investment*

For the buyer of a futures contract, potential losses are limited to the purchase amount if the value of the underlying falls. However, for the short seller of a futures position i.e. when the seller does not possess the underlying instrument, the potential loss is, in theory, unlimited.

f) *Issuer default risk*

Issuer default risk is the likelihood that the issuer may be unable to meet its financial obligations. The issuer's credit quality is very important, since the issuer is responsible for repaying the initial capital. The weaker the issuer's financial and business situation, the higher the risk of non-repayment. One way of addressing this problem is by considering the rating, or risk assessment, determined by an independent rating agency. The rating is not static but can change over the product's lifetime.

g) *Risks specific to forward exchange products*

A forward exchange transaction involves the sale or purchase of a currency on a future date at a price set when entering into the contract. This type of investment may be used to protect the investor against exchange risk. Moreover, no premium is paid when entering into the contract. The main risk for the investor is that of losing profit if exchange rates perform more favourably than anticipated when concluding the contract.

h) *Functioning and performance*

Investors must deposit collateral to meet the initial margin requirement. This margin is intended to cover potential losses on the transaction. Throughout the contract's life, a variation margin is calculated and required from the investor. It represents the accounting profit or loss resulting from changes in the value of the contract or the underlying.

## 7) Structured products or EMTN

Structured products are combinations of two or more financial instruments to form a new product. Such products can often be complex in nature and they involve different levels of risk. At least one of the instruments must be a derivative. The most frequently traded structured products are those with capital protection, which can be traded on the stock exchange or over the counter. Given the large number of possible combinations, each structured product carries specific risks, since the risks associated with each component instrument can be reduced, eliminated or increased due to the combination. Investors must therefore secure details of the specific risks associated with the structured product they are considering. This information is available in the brochures and term sheets describing the product, for example.

### i. Specific case of structured products with capital protection

In the specific case of structured products with capital protection, investors are guaranteed to recover their investment on the maturity date. However, this protection can affect investors' returns since, as is the case with all investments, the lower the risk, the lower the return is likely to be. Protection is only guaranteed at the structured product's maturity; it does not apply in the event of an early exit or issuer default.

Characteristics:

Two components: these products generally have two components, a fixed-income product (e.g. bond or money market instrument) and an option or combination of options. This enables the investor to benefit from price movements in one or more underlying assets while at the same time limiting potential losses. The capital protection component may, in some cases, cover only a portion of the capital invested. Moreover, the protection and participation components can be split into two separate elements to ensure that they remain independent of each other or enable them to be sold separately;



**Capital:** fully or partially guaranteed (upon maturity). The capital protection component determines how much of the nominal value of the structured product will be paid out to the investor at maturity, irrespective of any price movements in the participation component;

**Return:** the option component or direct investment in a risky underlying asset determines how and to what extent the investor can benefit from price movements in the underlying. As such, this component makes it possible to determine the potential return over and above the capital protection component;

**Flexibility:** these products can be tailored to the needs of each Client and all types of underlying.

**Advantages:**

These products make it possible to invest in a market while reducing the risk of losing capital to which investors would be exposed had they invested directly in the same market. Returns may be higher than those of money market or bond investments with an equivalent level of protection.

**Risks associated with structured products:**

*a) Risks at the level of the capital protection component*

The capital protection offered relates to the product's nominal value rather than its issue price or purchase price on a secondary market. Therefore, the investor's guarantee only covers amounts up to the product's nominal value. Hence, "capital protection" does not necessarily mean that 100 % of the capital invested will be repaid.

The protection decreases if the issue/purchase price is higher than the nominal value and, conversely, increases if the issue/purchase price is lower than the nominal value, in particular if the product was purchased at a price other than par or after the original issue. The level of protection depends on the issuer's creditworthiness. The investor's capital is only protected if the issuer can meet its obligations.

The maximum potential loss is thus the difference between the purchase price and the amount of capital protection at maturity. However, over the life of the product, its price can fall below the capital protection amount, which increases the risk of loss if the product is sold prior to expiry. Capital protection is only guaranteed if the investor holds the product to maturity; it is not ensured if early repayment is requested.

At maturity, if the capital is not 100 % guaranteed, the investor may not recover the full amount originally invested.

*b) Risks at the level of the option/direct investment component*

Due to price performances in the financial markets, this component can be worthless at maturity. The risks associated with this component are the same as those associated with the option, option combination or direct investment involved. In return for capital protection, investors' returns may be lower than if they had invested directly in the underlying asset.

*c) Liquidity risk*

The investment's liquidity is, in principle, ensured only above a certain amount, usually through a bid/ask spread and/or a penalty if the product is not held to maturity.

**ii. Specific case of structured products without capital protection, e.g. reverse convertibles or discount certificates**

**Characteristics:**

- Investors must obtain information on the specific risks associated with each instrument, namely by consulting the relevant prospectus, which is made available to the public free of charge as set out in the prospectus concerned.
- Term product: the investor receives a guaranteed coupon in a given currency but accepts a risk on his capital on maturity;
- Underlying: shares, indices, baskets, etc.;
- Capital: protected if the market value of the underlying is not lower than the strike price on maturity;
- Settlement: in cash or by delivery of the underlying, at a strike price determined in advance, if this price has fallen or increased. On the maturity date, if the price of the underlying is higher than the strike price, the investor receives the guaranteed coupon plus 100 % of the capital initially invested (in cash). If the price of the underlying is lower than the strike price, the investor receives the guaranteed coupon plus the underlying asset at the strike price;
- Flexibility: these products can be adapted to all types of underlyings. With discount certificates, the investor receives the coupon only at maturity but initially buys the product at a discount.

**Advantages:**

Returns are higher than those of investments in money market products. In principle, these are short-term investments, which makes it easier to determine the potential returns.

**Risks:**

*a) Risk at the level of the capital*

Capital protection is not guaranteed if the investor receives the underlying asset instead of the capital invested upon maturity.

At this level, the risk is very closely related to changes in the underlying's market value.

*b) Liquidity risk*

In principle, the investment's liquidity is only guaranteed above a certain amount.



c) *Exchange risk*

With products denominated in currencies other than that of the underlying asset, the investor is exposed to an additional exchange risk.

d) *Risk of losing the entire investment*

Due to the many possible combinations involved, each structured product has its own specific mechanisms. Investors must find out how the structured product they are considering works. This information is available in the term sheet describing the product.

e) *Functioning and performance*

Due to the many possible combinations involved, each structured product has its own specific mechanisms. Investors must find out how the structured product concerned works. This information is available in the term sheet describing the product.

## 8) Synthetic products

Synthetic products – essentially passive investments and certificates – are characterised by the fact that their profit and loss structures are identical or similar to those of certain conventional financial instruments (shares or bonds). Synthetic products are formed by combining two or more financial instruments into one product. Basket certificates, which incorporate a given number of specified shares, are one typical example.

Synthetic products can be traded either on a stock exchange or over the counter.

Given the large number of possible structures, each synthetic product has its own risks. However, investors must generally bear in mind that the risks associated with synthetic products are not necessarily the same as those associated with the financial instruments they contain. Before investing in these products, investors must obtain full details of their specific risks, for instance by consulting the product description.

Investors must obtain details of the risks specific to each instrument, namely by consulting the prospectus, which is made available to the public free of charge as set out in the prospectus.

Passive investments (e.g. BLOC warrants, DOCU, GOAL) Characteristics:

- Limited potential loss: when making a passive investment, the investor purchases an underlying asset (share, bond or currency) and, at the same time, writes a call option on that same asset. In return, the investor is paid a premium. This limits the investor's loss if the price of the underlying falls;
- Limited potential gain: potential returns from capital gains on the underlying asset are limited to the option's strike price;
- Collateral: for a traditional passive investment, the investor must lodge the underlying asset as collateral, thus becoming a passive investor;
- Synthetic passive investment: this type of investment is based on the idea of duplicating or reproducing traditional passive investments, but by means of a single transaction. Both the purchase of the underlying asset and the writing of the call option are carried out synthetically using derivatives. The purchase price for this type of product is the price of the underlying minus the premium received for selling the call option. Hence, the synthetic product is sold more cheaply than its underlying;
- Settlement: at maturity, the contract is settled either in cash or by physically delivering the underlying asset. If the underlying's price is above the strike price, the investor receives a specified cash amount as settlement. If, however, it is lower than the strike price, the investor receives physical delivery of the underlying asset.

Advantages:

Writing a call option (traditional passive investment) or having proceeds from the sale of a call option built into the product price (synthetic passive investment) means that any losses incurred due to a drop in the underlying's price are lower than they would have been on a direct investment in the underlying asset.

Risks:

Unlike structured products with capital protection, synthetic passive investments do not provide protection against capital losses on the underlying asset.

Therefore, if the underlying's price increases and is higher than the option's strike price at maturity, the investor receives the price originally agreed upon in the form of a cash payment. If, at maturity, the price of the underlying is lower than anticipated by the investor when purchasing the product, the return on the product may be lower than that on a money market investment with the same maturity.

If, at maturity, the price of the underlying is equal to or lower than the option's strike price, the investor receives the underlying. The investor's potential loss therefore relates to a possible drop in the market value of the underlying asset before maturity. Hence, the potential loss is unlimited, as if the investor had invested directly in the underlying asset.

However, the option premium offsets the impact of a potential capital loss on the underlying.

## 9) Certificates/EMTN (e.g. PERLES)

Characteristics:

- Diversification: a certificate entitles the investor to purchase a claim based on several underlyings or whose value results from several indicators;



- Common types of certificate:
  - Index certificates: these reflect a whole market, being based on an official index (e.g. DAX, CAC, etc.);
  - Region certificates: these are based on a number of indices or companies in a given region (e.g. Eastern Europe, Pacific area, etc.);
  - Basket certificates: these are based on a selection of national or international companies operating in the same sector (e.g. biotech, telecoms, etc.), indices, bonds or other underlyings;
- Guarantee: these certificates are guaranteed;
- Maturity and tradability: the maturity of these certificates usually ranges between one and three years. However, they can be traded at any time;
- Limited duration: these certificates are embedded in securities and thus have limited duration;
- Investor's rights: no voting rights or rights to dividends/interest on the underlying assets;
- Redemption: the certificates are redeemed at maturity, as follows:
  - a set amount per index point for an index certificate;
  - the difference between the market value at maturity and the strike price for a region or basket certificate.

#### Advantages:

Even if they invest only a modest amount, investors can diversify their investment across a range of instruments and risk factors, which minimises the risk involved.

This type of product offers the same potential gains or losses as a comparable direct investment in the underlying assets. However, by diversifying across the index, the risks specific to the index's component companies are limited or even totally eliminated, thus limiting the risk of losing the full amount invested.

They are usually low-cost products (in particular as they have no rights to dividends/interest or voting attached).

#### Risks:

##### a) *Transfer of risk*

Investments in index, region or basket certificates carry the same risk of potential loss as direct investments in the underlying shares. However, with certificates the risks are diversified. The risks do not disappear completely but can be transferred to the market or sector underlying the certificate.

##### b) *Absence of rights*

As opposed to direct investments, certificates do not offer voting rights or entitle the investor to dividends or interest on the underlying assets.

Thus, a drop in the certificate price cannot be offset by dividend or interest payments.

##### c) *Issuer default risk*

In addition to the risk of default by the companies underlying the certificate, the investor is also exposed to issuer risk, i.e. the risk of the banking institution that issued the certificate going bankrupt.

##### d) *Leverage risk*

The leverage effect causes movements in a certificate's value to be proportionately higher than those in the underlying product's price. Thus, during the certificate's lifetime, the holder stands to benefit from stronger gains, but also runs the risk of incurring steeper losses. The risk associated with buying a certificate increases in line with the strength of the certificate's leverage effect. These types of certificate in principle exhibit greater volatility than traditional certificates and can become worthless very quickly.

##### e) *Risk of losing the entire investment*

The risks carried by certificates are in principle the same as those of the underlying. If the underlying exposes investors to a risk of losing their entire investment, then so does the certificate.

##### f) *Functioning and performance*

Certificates track the price performance of the underlying and generate the same return. Investors should therefore consult the information on the underlying's functioning and performance.

## 10) Alternative investments and off-shore funds

Alternative investments are investments in, for example, a domestic or foreign investment fund which differs from traditional investments in shares and bonds due to its investment style. Hedge funds are the best-known alternative investment funds. Their active investment style usually involves short selling, engaging in leverage and using derivatives and they enjoy more freedom when determining their investment methods. Investments in private equity funds (venture capital, acquisition finance) also come under this category. Off-shore funds are investment funds domiciled in off-shore centres, such as the Bahamas, Bermuda, the Cayman Islands, Panama and the Dutch Antilles.

Alternative investment funds can also invest their assets directly in financial instruments (shares, fixed or floating rate bonds, zero coupon bonds, convertible bonds and money market instruments). They are not subject to limitations on the industries, sectors and regions in which they invest, the instruments and securities they trade, the currencies in which these are denominated or the index-tracking financial instruments they use.



Generally, alternative investment funds do not compare their performances with an index or benchmark: their aim is to obtain a strong absolute performance. Alternative investment managers use a vast range of investment strategies, which can only be classified in a relatively arbitrary manner. Moreover, many funds combine several management styles in their day-to-day management or practice management methods incorporating features of more than one of the main styles set out below. Each of these styles has its own risk, return and correlation (or market risk) profile.

## 11) Hedge funds

Hedge funds have free rein to choose the products and markets in which they invest (including emerging markets), as well as their trading methods. They usually require a high minimum investment from investors. Their managers' remuneration is often linked to the fund's performance.

Their basic strategy aims to reduce the risk on a long position in a securities portfolio by short-selling other securities. Having thus reduced their exposure to market risk, managers use leverage to boost returns. They often take long positions in securities they feel are undervalued and short positions in those deemed to be of poorer quality. Their short positions may also include positions on indices. Below are some more detailed examples:

- Long/short equities or bonds: this is a pure style as described above. Stock picking is the main source of performance for this type of fund, usually based on fundamental analysis.
- Aggressive growth funds invest in stocks expected to generate strong earnings growth and as such often show a bias towards small caps. Funds specialising in a specific sector (technology, medias, telecoms, etc.) often fall into this category.
- Value funds invest in securities deemed highly undervalued, for various reasons, relative to their intrinsic value.
- Market neutral funds invest equally in long and short positions with the aim of minimising exposure to market fluctuations. This strategy relies heavily on sound fundamental analysis and stock picking, and to an even greater extent on in-depth risk analysis. The short positions generally comprise positions in equities.
- Short sellers: these are funds which only practise short selling. They focus on stocks that they feel are overvalued and poised for a downturn. Their key selection criterion is a deterioration in the issuer's fundamentals.
- Event-driven funds: the benefit from specific events in the course of a company's corporate activity, such as restructuring, mergers or spin-offs. This type of strategy is not highly exposed to market trends.
- Opportunistic funds profit from IPOs, takeover bids, earnings surprises and other events affecting the issuer.
- Distressed securities funds invest in securities - mainly bond debt or bank claims - that are highly undervalued due to bankruptcies or rescue packages being in place. This type of strategy is used chiefly in the United States, where the applicable legislation is favourable.
- Arbitrage funds: these funds capitalise on imperfect market valuations to generate returns. They seek to identify differentials in the market prices or yields which are not justified by the issuer's financial situation. They take positions in the market when they feel strongly that the mismatch is set to disappear. Some of these funds are called "relative value funds".

They include:

- Fixed-income arbitrage: these funds exploit pricing discrepancies in the bond markets.
- Convertible bond arbitrage: funds which carry out arbitrage between a convertible bond, usually long, and the associated equity, usually shorted.
- Mortgage-backed securities: these funds exploit discrepancies in the mortgage-backed securities market (and its derivatives) in the United States.
- Merger arbitrage: these funds focus on takeovers and mergers.
- Traders/CTA (commodity trading advisors): these funds take highly leveraged directional positions in the markets (equities, bonds, futures, commodities, currencies). Generally, they do not take long-term positions in advance. They endeavour to capture excessive price fluctuations in the short term, or to follow trends. They have low correlation with the equity and bond markets. Therefore:
- Systematic funds base their investments on quantitative analysis using IT models.
- Discretionary funds rely more on fundamental market analysis.
- Macro players: these funds exploit broad macroeconomic trends, implementing opportunistic strategies. They base their decisions on fundamental macroeconomic analysis and predict the markets' reactions to changes in economic policy (interest rates, exchange rates, etc.). They invest in all types of financial assets and all markets, as and when opportunities arise. They also take leveraged positions.
- Special situations: these funds exploit highly specific situations, which they can even create themselves, e.g. by forcing a company's management to invalidate its own strategy. They are also known as niche players.
- Opportunist funds have no set strategy. They simply profit from opportunities that they identify.
- Funds of Funds invest in other alternative investment funds, operating in one or more of the segments described above. All these strategies can also be subject to geographical or sectorial classification, in the same way as traditional funds.

Each fund has its own risks, so the risks associated with investments in these products can only be dealt with briefly in this document, without going into detail. Before investing in these products, investors are therefore advised to enquire about the



specific risks of each instrument, namely by consulting the fund prospectus, which is made available to the public free of charge as described in the prospectus.

Risks:

a) *Leverage effect*

Investment strategies of this nature can carry significant risks. For example, when taking leveraged positions, a slight movement in the market can generate significant gains, but also heavy losses. In some cases, the entire investment may be lost.

b) *Short Sales*

The mutual funds in which the Company invests on its Clients' behalf may take short positions in securities, which could expose that portion of the mutual fund's assets to unlimited risk, as there is no cap on the price that the securities concerned could reach. However, any losses would be limited to the amount invested in the mutual fund in question.

c) *Lack of transparency*

The net asset value of such investment instruments is usually not known when the investor decides to make or liquidate the investment. This is due to the fact that a notice period is generally required before such a transaction can be performed. Consequently, the net asset value can only be calculated once the investment has been made or liquidated.

In addition, investors in alternative investment funds often have access to only very limited information. The strategies employed by these funds can be extremely complex and frequently lack transparency for investors. Changes in strategy, which can significantly inflate the risk involved, are often poorly understood or misinterpreted by investors.

d) *Potential lack of liquidity*

The liquidity of alternative investments varies significantly and can be very low. Most of these investments are subject to lock-up periods or incur penalties if they are sold before the end of a given period. This is due to the relatively illiquid nature of the investments involved in these instruments, which are intended to be held long-term.

Moreover, many of the techniques used in alternative investments involve financial instruments that are illiquid or subject to legal, transfer or other restrictions. It is therefore possible that alternative investment positions may only be sold periodically or on certain dates after a notice period of several weeks, e.g. four times a year on specific dates. Depending on bid/ask spreads, proceeds from the sale may not be equal to the position's net asset value. Positions in hedge funds can only be redeemed monthly, quarterly or annually. With private equity funds, the lock-up period can be more than 10 years.

e) *Valuation of mutual funds*

The net asset value of units/shares in funds in which investments are made is not audited (except for the value calculated at the financial year end). Therefore, to evaluate these funds, the Company uses unaudited financial information provided by the funds concerned, administrative officers and/or market makers. If the financial information used by the funds to determine their own net asset value per unit/share is incomplete or inaccurate, or does not reflect the true value of the investments made by the funds, the valuation of these assets will be incorrect.

f) *Absence of custodian banks*

For certain mutual funds in which assets are invested, the role of custodian is assumed by a broker rather than a bank. Such brokers do not necessarily have the same credit rating as a bank. Moreover, unlike custodian banks, which operate in a regulated environment, these brokers provide custody of the assets but do not have to meet any regulatory requirements in terms of supervision.

g) *Performance fee*

h) Due to the specialised nature of these funds, a number (or even most) of them charge performance fees. *Minimal regulation*

Many funds in this sector are domiciled in off-shore centres ("off-shore" funds), where the applicable regulations are often minimal. Numerous problems or delays may occur during the execution of orders to buy or sell units in these funds, for which the Company or the custodian bank cannot be held liable. The enforceability of investors' rights is not systematically guaranteed.

i) *Additional risks associated with private equity funds*

Private equity investments typically carry the following additional risks:

No guarantee that investors will obtain returns:

Investors may not be able to recoup the full amount invested and may even lose it entirely. The past performance of these investments is no guarantee of their future performance, particularly as the investment environment is constantly changing (new geographical regions, new specialised areas, etc.).

For example, an economic upturn often creates strong competition when it comes to investing in companies, and it is difficult to exit such investments during a downturn.

Low liquidity:

These funds usually have a term of seven to fifteen years. There is no recognised secondary market for this type of investment. As a result, the penalty for exiting a private equity fund (which can require payments over several years) can be very severe and can even require investors to forfeit their rights to amounts already invested in the fund.

As regards their financial commitments to a fund, investors should pay particular attention to notice periods, which are usually very short (sometimes only seven days), and ensure that they have sufficient liquid assets that can be mobilised





at short notice to meet any calls for capital.

This document is not intended to describe all the risks associated with financial instruments. It aims to provide basic information and draw Clients' attention to the risks associated with all investments in financial instruments. Additional information, including details of specific products, can be obtained from the Company. Clients are advised not to make any investment until they are sure that they understand all the risks involved. They should ensure that their investments are appropriate, in the light of their financial position and needs.

*j) Risk of losing the entire investment*

Investment funds are exposed to a price risk relating to their underlying investments and diversification.

During times of market stress, depending on the fund's diversification, investors could lose the portion of their funds invested in failed or defaulted assets.

*k) Functioning and performance*

The returns on investments made by a fund depend, among other factors, on the managers' expertise and sound decision-making. Errors of judgement or market downturns can generate capital losses.

Before investing in a fund, investors must consult its prospectus, KIID, and annual, half-yearly and monthly reports. These documents present the fund's key characteristics and risks, as well as its management fees, which also have an impact on the returns obtained.