BNP PARIBAS
FORTIS

complex investment products (options, warrants, futures)

Derivative products are complex financial instruments of which the characteristics and value depend on those of an underlying asset, this generally being a commodity, bond, equity, currency or index.

When purchasing a derivative product, an investor benefits from a **leverage effect**. Indeed, he can make as much of a profit as investing directly in the underlying asset but using much less capital, since the value of a derivative product is only a fraction of the value of its underlying asset. Derivative products therefore allow much larger gains to be made in proportion to the amounts invested.

Another feature of derivative products is that they have an **expiry date**. This means that if the underlying asset does not perform as anticipated by the expiry date of the derivative product, it could lose its entire value.

The main types of derivative products are options, warrants and futures.

An **option** is an investment instrument that can be used for different purposes: to hedge oneself against a risk, obtain an additional return or speculate on gains or losses in such varied assets as commodities, interest rates, foreign exchange prices, equities, benchmarks, etc. A negotiable option is a right that confers on its purchaser the possibility, but not a commitment, to buy (call) or sell (put) a determined quantity of an underlying asset at a price set in advance (exercise price) over a given period, at an expiry date (European option) or at any time (American option). The 'option' or 'premium' represents the price paid by the buyer of the option to the seller. Sellers of options associated with the buyers' decisions must fulfil the requirements related to their contract. The buyer and seller of a negotiable option may independently resell or rebuy the option before its due date (closure of the position). If it is kept without being exercised, the option no longer has a value at the due date.

A **warrant** is a financial instrument that gives its holder the right to negotiate underlying assets at a rate set at the outset (exercise price) during a specific period. The underlying assets of a warrant may be equities, an index, a basket of equities, foreign exchange prices, interest rates, etc. There is a difference between 'call warrants' which give the right to buy underlying assets (in anticipation of a rise) and 'put warrants' which give the right to sell underlying assets (in anticipation of a fall).
When an investor has purchased a warrant, two possibilities are open to them: to resell the warrant on the stock exchange or exercise it, that is to say, purchase (a call warrant) or sell (put warrant) the underlying asset. In practice, cash in hand redemption (the issuer directly pays the difference between the price at the due date and the exercise price) is given preference over physical delivery of the securities.

A **future** is a forward contract by which two parties commit, one to buy, the other to sell, to a specific amount of financial products at a rate set at the moment of concluding the contract. Delivery against the settlement associated with the corresponding capital happens at a pre-established later date. Any forward transaction is thus characterised by the fact that a time interval occurs between the conclusion of the contract and its execution.
At the expiry date, the future may be settled either by physical delivery of the underlying asset or by settlement in cash corresponding to the difference between the price at which the contract was concluded and the rate at which the trade is liquidated. Fixed future contracts mainly involve financial instruments: stock market indices, baskets of securities, currencies, interest rates and returns, as well as commodities and goods purchased for resale.

Advantages

- Derivative products offer investors the possibility of **covering in full or in part** some or all of their portfolio assets when these assets are liable to experience significant unfavourable performance.
- Due to their leverage effect, derivative products enable **speculation on significant short-term gains**.
- Derivative products allow **very dynamic management** of portfolio positions.

Disadvantages

- Derivative products listed on markets are generally **standardised** to allow the existence of an efficient market. The underlying asset therefore does not always correspond fully to the investment the investor would like to hedge. Hedging can be tailor-made, but **at the expense of the product's liquidity**.
- Considering the significant risks with which they are associated, derivative products are meant for **experienced investors** who fully understand the functioning of these financial instruments and who follow changes in the markets very closely.
- Trading in derivative products may entail **burdensome administrative monitoring**.

Risks

Derivative products generally come with **significant risks**. As a result, they are better **left to experienced investors** and it is advisable for the non-professional user to obtain a certain degree of practical knowledge on these products before using them.

Options greatly magnify the rise and fall of variations in the underlying assets; this is what is referred to as the leverage effect. Options therefore present a higher risk of significant losses of capital that, in certain cases, can theoretically be unlimited.

Warrants procure an important leverage effect and are therefore highly volatile financial instruments, involving high risks. If the anticipated movement does not occur, it is possible to lose the total sum invested.

As with options, **futures** present high risks of loss, which can be greater than the capital invested initially.

Test your knowledge of complex investment products

Did you know...?

- A call option gives you the right to buy a security during a specific period at a specified price.
- A put option gives you the right to sell a security during a specific period at a specified price.
- Options, futures and other derivative products allow you to achieve higher returns than by investing directly in the underlying, and to do this with much lower costs (leverage effect).
- You risk losing your entire investment if the expected evolution of the underlying does not occur during the investment period.
- These solutions are aimed at informed investors who follow market developments very closely.

Like to know more about complex investment products?

Consult our Financial Instruments Information Brochure on our website
www.bnpparibasfortis.be/saveandinvest > MiFID > Like to know more about MiFID?