WHAT ARE DERIVATIVE PRODUCTS (SUCH AS OPTIONS, WARRANTS AND TURBOS)?

Derivatives are complex financial instruments whose properties and whose value are determined by the properties and the values of the underlying assets, usually a commodity, bond, share, currency or index.

Listed derivatives have a published price and so can be traded on the financial markets.

All these products share the characteristic of **leverage**. Leverage ensures that a limited increase or decline in the underlying value results in a relatively larger change in the value of the derivative product. The price fluctuations for products of this type can therefore be very significant.

Characteristics

The most common forms of derivatives are options, warrants and turbos.

OPTIONS

Anyone who buys an option is acquiring the right (but not the obligation) to buy (**call option**) or sell (**put option**) an underlying value on a given date, or during a defined time period, at a price that is fixed in advance (**the strike price**).

The underlying value is the security or goods to which the option relates. These may be shares or a stock index, but can also be currencies, commodities, bonds, etc.

The holder of the option can exercise their right up to the expiration date. For this right, they pay an **option premium** to a counterparty, the option writer (issuer). This writer is another investor who undertakes, in return for the option premium, to buy or to sell the underlying value at the established price, if the holder decides to exercise their right.

You can use options for all kinds of purposes: to cover yourself against a risk, to earn an extra return, to speculate on the rise or fall in value of all kinds of assets such as commodities, interest rates, exchange rates, shares, indices, etc.

Options are traded on an exchange exclusively for options. The holder can resell their option to someone else on this exchange.

WARRANTS

A warrant has some features in common with an option. A warrant gives the right to trade shares, other securities and more at a fixed point in the future for a fixed price. Warrants that give the right to buy a specific underlying value, are known as **call warrants**; Warrants that give the right to sell a specific underlying value, are known as **put warrants**.

But there are also key differences:

- Unlike an option, that is traded on an exchange exclusively for options (**options exchange**), warrants are listed on the classic stock exchanges (such as Euronext).
- Warrants are issued by a company or a financial institution that trades in warrants on specific shares, while options are issued by the options exchange.
- The **exercise period** for a warrant (the period during which the investor can exercise their right) is usually longer than that for an option.
- The conditions for options are defined by the options exchange and are very standardised. The conditions for a warrant are defined by the issuing financial institution.

TURBOS

A turbo (also known as a **speeder** or **sprinter** depending on the issuing financial institution) has some common features with an option. A turbo is also an exchange-listed security where you can use leverage to profit rapidly from a rise or fall in a given underlying value, such as shares, exchange indices, commodities, etc. If you want to profit from an increase in the underlying value, you buy a **turbo long**. If you buy a **turbo short**, you are expecting a fall in the underlying value.

An important difference to options is the way in which the leverage effect is created. In the case of a turbo, it is possible because you only invest in a limited part of the underlying value. The remaining amount is lent out by the financial institution that issues this turbo on the market (**financing level**). Therefore, with a turbo you receive the whole of the rise or fall in the underlying value, but you only buy a fraction of the underlying value. The leverage indicates how much more steeply the price of the turbo will change for each step change in the underlying value. A turbo on the BEL20 with a leverage of 5 means that if the BEL20 rises by 1%, the value of the turbo rises by 5%.

Unlike options, turbos do not have an expiration date. However, to avoid a customer losing more than they invested, there is always a stop loss level. When the price of the underlying value hits this **stop loss level**, the turbo ceases to exist.

Because of the high **leverage**, these are very risky products, where a small rise or fall in the underlying value can quickly lead to enormous losses.

Risks

Derivatives are always associated with high risks. They are therefore intended for experienced investors. Retail investors would be well advised to learn about these products in practical terms before starting to use them.

- **Options** increase the upwards and downwards fluctuations of the underlying assets; this is the so-called leverage effect. They therefore involve a high risk, which can lead to a substantial, and in theory, even unlimited loss of capital.
- **Warrants** offer strong leverage and are therefore very volatile and risky financial instruments. If the expected result does not occur, the whole of the amount invested can be lost.
- **Turbos** also carry a high level of risk. In the best case, with a turbo you can achieve many times the profit on the underlying value; in the worst case you lose your entire stake.

Costs and taxes

When you buy derivative products, it is in your best interest to take the costs and taxes that you will have to pay into account. This is because they will affect the return.

COSTS

Brokers' fees: banks will charge costs to execute your orders on the market.

Custody fee: most banks will charge you fees to hold your derivatives on a custody account.

TAXES

Stamp duty on stock exchange transactions (TOB): if you buy listed derivatives on the market, you need to pay the exchange stamp duty.

Speculation tax: from 1 January 2016, you will pay a speculation tax on certain derivatives if you sell listed derivative products within a six-month period of buying them. Speculation tax does not apply to all derivatives; if the underlying value for a turbo, for example, is a stock index, then no speculation tax is collected.

Do you want to find out more about derivative products ?

Read our *Financial instruments information sheet* on our website at www.bnpparibasfortis.be.

Responsible editor: A Moenaert - BNP Paribas Fortis SA/NV, Montagne du Parc/Warandeberg 3, 1000 Brussels, RPM/RPR Brussels, VAT BE0403.199.702 – june 2016

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