

# INVESTING IN WARRANTS

What you need to know before you start.



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# About this booklet

This booklet provides an overview of warrant types and the key risks associated with investing in warrants. However, this booklet should not be used as a substitute for your own research and, in particular, reading the relevant product disclosure statement (PDS) for any warrant you are considering.



# What is a warrant?

Warrants are financial instruments that provide the holder with exposure to the value of another asset such as a security, an index, a commodity, a currency or an interest rate (the underlying asset).

In Australia, warrants are traded on regulated markets and warrant Issuers must meet minimum requirements before they are eligible to issue the warrants that are traded on those markets. A warrant that is able to be traded on a regulated market is “quoted” on that market.

Depending on the warrant, exercise/settlement may involve physical delivery of the underlying or it may involve cash settlement.

Warrants are often geared or leveraged instruments which means that you can obtain exposure to the underlying asset for a smaller portion of capital than buying the underlying asset outright. The price of a warrant typically moves proportionally more than the underlying asset which can have a positive or negative impact for an investor. As geared or leveraged instruments, warrants may expose investors to higher risk than outright purchase of the underlying asset.

New warrant types are developed periodically – the Issuer’s product disclosure statement (PDS) will include comprehensive information on the product.

# The Chi-X warrant market

There are two regulated markets in Australia that quote and trade warrants - Chi-X Australia (Chi-X) and ASX Limited (ASX).

Chi-X is a regulated market that is able to quote and offer trading in the complete range of warrants. Investors can purchase warrants quoted by Chi-X direct from the Issuer or its agent or they can purchase warrants on the secondary market operated by Chi-X.

The actual warrants series available on Chi-X and ASX may differ but the types of warrants are common to both markets. The trading mechanism and the clearing and settlement of warrants are the same irrespective of the market you trade on.

**If you buy a warrant on one market you must sell it on the same market.**

However, it is important to note that warrants are not fungible between regulated markets - a warrant quoted on Chi-X will not be able to be traded on ASX.

# Why do people invest in warrants?

Warrants can appeal to investors looking for the potential to increase their profits.

## Gearing can provide greater exposure than an outright purchase

Gearing can provide greater exposure than an outright purchase of the asset underlying a warrant.

Some investors prefer to invest in instalment warrants that receive dividends and franking credits paid by the underlying asset. Having not paid the

full price of the underlying asset at the outset the holder hopes to achieve an enhanced income stream.

Some investors use instalment warrants as a way to release cash from an investment they hold but still keeping their exposure to that asset's capital growth and income. This is referred to as "cash extraction". Cash extraction is not a strategy available to self-managed superannuation funds (SMSFs).

Some trading warrants which appreciate in value as the underlying asset falls in value, may be used to either profit from a negative view or to protect the value of a holding in that underlying asset, should the price of that asset fall.

SMSFs are limited in their ability to obtain geared exposure to investment assets. Warrants are instruments that some SMSFs invest in to obtain geared investment exposure provided appropriate arrangements are in place. Advice should be sought before investing in warrants on behalf of a SMSF.

# Are you suited to investing in warrants?

Warrant investing involves many considerations - the choice of underlying asset, the warrant type, and the choice of warrant series within that type. Understanding pricing variables and knowing how to manage the key risks are necessary skills for prudent investing in warrants. Warrants do not suit all investors. As a generalisation, experience in investing and some familiarity with leveraged investing can be beneficial to the prospective warrant investor.

**Warrant investors will often be experienced investors**

A psychological element often overlooked is the matter of decision-making. There are a lot of decisions to make, on an ongoing basis, and people who prefer to make few decisions, who prefer to be hands off may be less suited to investing in warrants. Prudently managing investments in warrants requires a high level of engagement.

You should read the Product Disclosure Statement in its entirety before investing in a warrant.



# What are the main risks?

Warrants have a range of risks which vary between warrant types

Warrant holders are exposed to the *risk of adverse change in the value of the asset underlying the warrant*. This might be due to general market conditions or the sector relevant to the underlying asset. In addition there is specific risk to do with the performance of the underlying asset itself.

Leverage is an advantage of warrants in that it offers the possibility of magnified returns. But it is also a risk as an adverse movement in the price of the underlying asset can result in a magnified adverse movement in the price of the warrant. Some warrants include features intended to mitigate this risk. As the holder of a warrant you need to manage the risk of leverage and/or geared exposure to any adverse change in its value.

Some warrants, but not all warrants, have a *limited life* and, of those that have an expiry date, some are shorter dated and some are issued with longer dated expiries. You will need to take account of the *timing for your particular market view* as it will be of no benefit if your market view proves to be correct after the warrant has expired.

All exchange traded instruments are subject to *liquidity risk* in that the *market price* may be affected by supply and demand at any given time. In the case of warrants, this liquidity risk applies not only to the market for a warrant but also the market for the underlying instrument and other instruments used by market makers to hedge their exposure.

Some warrants, but not all warrants, with expiry dates are regarded as wasting assets because the *“time value” component* in their price declines as the instrument approaches expiry. This can be a significant influence on the price of an affected warrant. You should read the relevant PDS.

The price of some warrants, but not all warrants, is affected by *volatility*, both general market volatility and volatility relating to the price of the asset underlying that warrant. Again, please read the relevant PDS.

Some warrants include a *stop loss feature* that can mitigate loss but if the underlying asset's price hits the stop loss level the warrant will expire and, depending on the level of the stop loss, investors may be left with an investment with zero value. Furthermore the stop loss level may change over the life of the warrant.

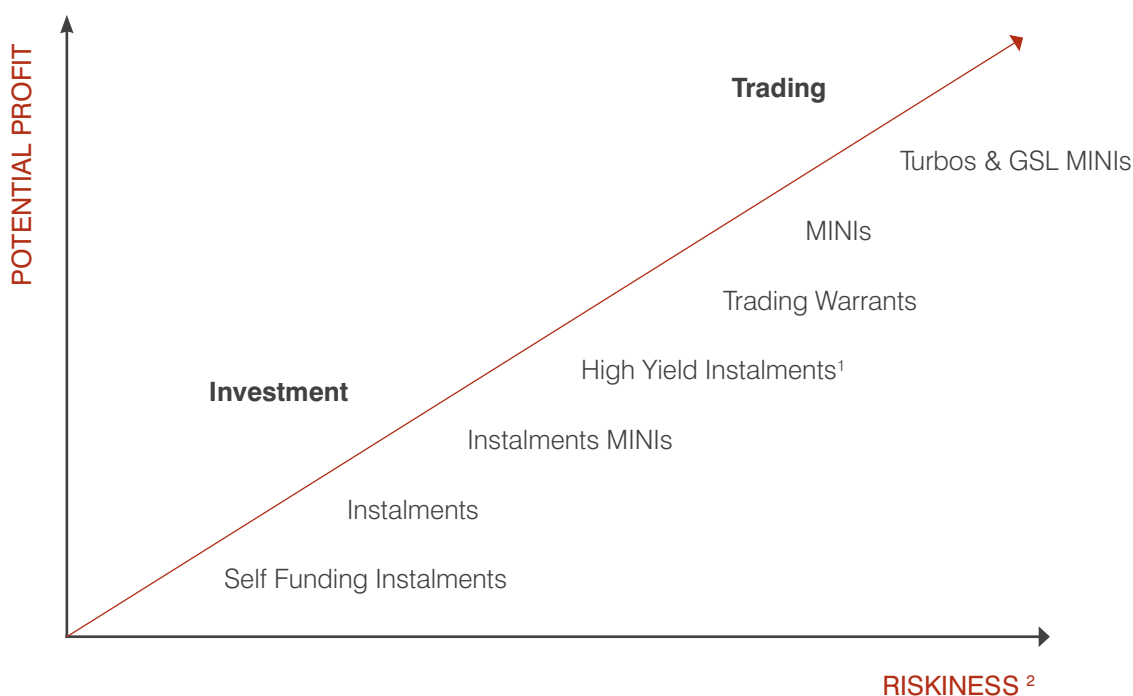
*Currency risk* can apply to your warrant if it is based on an overseas asset. For example a warrant over an American share price index is likely to use a contract multiplier

denominated in US dollars. Your currency risk arises when the US dollar value is converted into local currency.

Warrants are issued by financial service providers who contract to meet certain obligations under the terms of the warrant. This means there is a risk associated with the ability of the Issuer or its Guarantor to fulfil its obligations at expiry of the warrant. It follows that part of your investment decision should be an assessment of the *creditworthiness of the Issuer* and/or its Guarantor.

Some warrants have a feature that causes the warrant to lapse in certain circumstances. Others have a maximum pay out and there is a range of *extraordinary event* scenarios that, if triggered, can affect your investment. Given this, it is essential that you have a full understanding of the terms of a warrant before investing and you should not assume that the terms of one warrant are identical to those of another warrant. The full terms of a warrant including extraordinary event scenarios will be set out in the warrant's product disclosure statement (PDS). These can be accessed from the Chi-X website and the relevant Issuer's website.

As a broad rule of thumb, the relative potential for profit and "riskiness"<sup>2</sup> of each type of warrant is outlined below.



<sup>1</sup> A high-yield instalment is one with a gearing over 70%

<sup>2</sup> Riskiness as measured by the likelihood and magnitude of loss. Specific terms pertaining to each warrant – such as time to maturity, volatility, strike levels etc. – should be evaluated by individual investors prior to making an investment decision.

# What warrants can I invest in?

At any given time a range of different warrants will be available. You can check on the Chi-X website for the current list of warrants available on Chi-X.

You should not assume the terms of one warrant are the same as another

There are 2 broad categories of warrants. **Trading style warrants** have features that better lend themselves to shorter term trading. **Investment style warrants** are typically held for longer although they can also be traded actively.

Before we look into the types of warrants you can invest in, here are some high level features.

- All warrants have an underlying asset - it can be a security, a share price index or an instrument based on an index, a foreign exchange rate, a commodity or other asset.
- Trading warrants are typically cash settled and investment style warrants are typically deliverable which means you have the right to purchase/sell the underlying asset.
- Some warrants have an expiry date which is the last day that a warrant can be exercised.
- Warrants have a conversion ratio which tells you how many warrants you must hold if you want to buy/sell the underlying by exercising your warrants.
- Index warrants and warrants over commodities or foreign exchange rates have a contract multiplier which is used to calculate the value of the warrant. The multiplier may be denominated in a foreign currency.

# Trading style warrants

If you are looking to make a leveraged profit based on your view on the future price of an asset you could consider the various types of trading warrants. Geared exposure can be achieved because you pay only a proportion of the price of the underlying asset to gain exposure to that asset.

The price of the warrant will change as the price of the underlying fluctuates.

## MINIs

MINIs have no expiry date - you can exit your position by selling on-market. Options pricing does not apply so the price of MINIs is not subject to time decay.

MINIs are cash-settled, leveraged instruments that typically track movement in the price of the underlying asset on a one-for-one basis.

MINI longs (sometimes shown as MINI calls) benefit from a rise in the price of the underlying and MINI shorts (MINI puts) benefit from a fall in the price of the underlying.

The value of a MINI will generally be the difference between the share price and the strike price. The exercise price (strike price) changes every day, it is not fixed.

Single stock MINI Long = share price – strike price.

Single stock MINI Short = strike price – share price.

A range of MINIs is available with differing levels of leverage. You can work out how much leverage a MINI offers by comparing the strike price of the MINI with the price of the underlying. Issuer websites usually have the current leverage for all their MINIs.

MINIs held overnight incur a funding cost effected by an adjustment to the strike price of the MINI. For MINI longs the funding cost is *added* to the strike price and, in a low interest rate environment, for MINI shorts it is *subtracted* from the strike price. Should interest rates rise, there would come a point where the funding cost gets added to MINI shorts.

**MINIs have no  
expiry date**

**MINIs longs  
provide exposure  
to a rising market,  
MINI shorts to  
falling markets**

MINIs include a built-in stop loss feature that is set above the strike price for MINI longs and below the strike price for MINI shorts. The stop loss trigger level is adjusted each month to take account of funding accruals. Stop loss levels are also updated for any corporate actions events or the roll of underlying futures contracts for index and commodity MINIs.

If a stop loss is triggered, your MINI will be suspended. The remaining value of the MINI will be determined and a bid price will be established for those wanting to exit their position from 2pm the next trading day and all day the following trading day.

**Stop loss trigger levels are adjusted each month**

Following is an example of a MINI over a share in XYZ Company. If the MINI was over an index, currency or commodity or foreign exchange rate a multiplier would be applied to establish contract value.

Example: ABC stock trading at \$20.00

MINI long over company XYZ, current strike \$15.00 stop loss \$17.00

*Expiry:* there is no expiry, to liquidate your holding you must sell on market.

*MINI long price:* \$5.00 (current share price – current strike price)

*Stop loss:* if the underlying drops to \$17.00 or lower, trading in the MINI is halted and a bid price will be established at the remaining value of the MINI. You can trade out on-market but, if you don't, the remaining value is paid to you by the Issuer

## Guaranteed stop loss (GSL) MINIs

A variant on the MINI is the guaranteed stop loss (GSL) MINI.

GSL MINIs are more highly geared than MINIs and appeal to active traders. With GSL MINIs the stop loss is set at the strike price so, if the share price drops below the strike, the MINI will terminate automatically. GSL MINIs terminate at zero value because the stop loss is set at the strike price.

GSL MINIs are more highly geared

As with all stop losses, once you are “stopped out” you have no opportunity to participate in any recovery. Also the guaranteed stop loss comes at a cost - the Issuer includes a “gap premium” based on the Issuer’s assessment of the risk taken in providing the guaranteed stop loss. The gap premium is added to the cost of the GSL MINI.

### Examples of pricing for MINIs and GSL MINIs

#### MINI long over company ABC

The cost of your guaranteed stop loss is paid via the gap premium reflected in the price of the GSL MINI

ABC trading at \$45.00

MINI long strike \$35.00

MINI long price \$10.00 (current share price – strike price)

#### MINI short over company ABC

ABC trading at \$45.00

MINI short strike: \$55.00

MINI long price: \$10.00 (strike price – current share price)

### GSL MINI long over company XYZ

XYZ trading at \$3.00

GSL MINI long strike \$2.80

\*Gap premium \$0.06

GSL MINI long price - \$0.26 (current share price – strike price) + gap premium

### GSL MINI short over company XYZ

XYZ trading at \$3.00

GSL MINI long strike \$3.20

\*Gap premium \$0.06

GSL MINI long price - \$0.26 (strike price – current share price) + gap premium

\*The gap premium is for illustrative purposes only. Gap premium will vary according to the Issuer's assessment of the risk associated with providing a guaranteed stop loss.

## **Turbo warrants**

A product that preceded the MINI and the GSL MINI is the Turbo warrant – another product aimed at confident traders seeking enhanced leverage. Turbos can be characterised as high risk / high reward.

Turbos have a barrier (or knock-out) feature which, if triggered, terminates the product rendering the investment worthless. Given the knock out feature, investors in turbos are typically active and confident traders willing to quickly adjust their positions.

## **Call and put warrants**

Call and put warrants have an options structure and options pricing applies.

Options pricing applies to call and put warrants

Call warrants give the holder the right to buy the underlying asset at a specified price. Put warrants give the holder the right to sell the underlying at a specified price. The specified price is referred to as the exercise price or the strike price. If the exercise price of a call warrant is low then the intrinsic value of the warrant will be higher and this will be reflected in its market price. The opposite applies to put warrants.

If you hold a bullish view it could be acted on with call warrants which give you the right to buy the underlying. If you hold a bearish view or you are looking to hedge an asset you might consider using put warrants which give you the right to sell the underlying.

Call and put warrants have a conversion ratio which determines how many securities the warrant entitles you to buy/sell. The conversion ratio could be 1 for 1 or more commonly a fraction of a share. A warrant with a higher conversion ratio will usually make the market price of these warrants cheaper. This is because a holder wanting to physically buy or sell the underlying will need enough warrants to convert into whole units of the underlying. Conversion ratios can be found on Issuer websites or on the Chi-X website.

Call and put warrants may be deliverable (on payment of the exercise price you can physically buy/sell the underlying) or they may be cash settled (the difference between the exercise price and the settlement price is exchanged). Index call and put warrants are cash settled whereas call and put warrants over securities in listed companies are usually deliverable.

Call and put warrants have expiry dates and their price has two components. The intrinsic value in a call or a put reflects the difference between the strike price of the warrant and the current market price of the underlying asset.

Time value reflects the potential for a warrant to become more or less valuable in the time remaining until the warrant's expiry. The time value component in call and put warrants declines over time. As expiry approaches the time value in the warrant diminishes. Generally speaking, the time decay of a warrant will result in a put or a call warrant losing two thirds of its value during the last third of its life.

After expiry, call and put warrants lapse.

## Investment style warrants

Investment style warrants tend to be longer dated and traded less actively than trading style warrants. This is because holders often employ strategies associated with the accumulation of dividend income, so the investment style warrants need to be held for long enough to qualify for dividend payments.

### Instalment warrants

Instalments are often referred to as simply "instalments". Although also traded for profit, a popular strategy for using instalments is to maximise dividend income. There are also variants such as instalment MINIs, rolling instalments and self-funding instalments.

Instalments involve 2 payments. The first instalment is the market price. It is a variable amount depending on a range of pricing considerations. The first instalment can represent 20 - 60% of the price of the underlying security.

**A popular strategy  
with instalments  
is to enhance  
dividend income**



The final instalment is also referred to as the loan amount. This amount may be fixed for the term of the warrant. As a holder you can pay this second amount any time up until maturity of the instalment.

When instalments are issued, the underlying securities are purchased and placed in a trust or an equivalent structure. This enables dividends and franking income to be passed through to the instalment holder. The first instalment is less than the cost of buying the securities outright (varying with the leverage offered by the instalment). This means the Issuer must pay the residual amount so the securities can be purchased. It follows that the first payment and loan amount combined can be expected to be at least equal to the price of the underlying security. If interest rates are higher, the funding cost will be higher and vice versa.

**Instalments have a funding cost which is included in the variable first payment**

Instalments are often compared to margin loans because they can be regarded as a securitised loan to buy securities. You get the right to dividends and franking credits applying to those underlying securities as well as any capital appreciation on those securities and interest charges can be tax deductible. However, a significant difference between the instalment and the margin loan is that with a margin loan you are liable for margin calls in the event of an adverse price movement that triggers the buffer level for that loan. Instalments do not have margin calls. In the event of adverse market movement you do not need to make the final payment. You will have lost what you invested but your exposure is limited to that amount.

Instalments are popular with investors looking to maximise dividend income. This is because, for a given amount, you can derive more income and franking credits by purchasing instalments than if that amount had been applied to an outright purchase of the underlying securities.

If you are investing on behalf of a self-managed superannuation fund, instalments are a means by which your fund can gain leverage in the portfolio. But seek your own advice before you do.

Pricing Factor	Change in Pricing Factor	Change in Instalment Price
Underlying Parcel Price	↑	↑
Time to Maturity	↓	↓
Interest Rate	↑	↑
Volatility of Share	↑	↑
Dividends	↓	↓

Variants on instalment warrants are available. Rolling instalments are “rolled “every 12 to 18 months typically though there may be warrants which roll at longer time periods. These allow you to get longer term exposure but your final payment (which includes funding and protection fees) only has to cover the period up to the roll date. You can make tax deductions for the interest incurred in the period up to the roll. When rolling, you will be liable for the next period of funding, which can be done by a cash payment or by a reduction in your existing holding to cover that cost.

As the price of the underlying asset changes, the gearing of an instalment may change – it may be higher or lower than the level you prefer. Reset instalments provide the opportunity to return the instalment to the preferred level of gearing. Reset dates occur at regular intervals, typically 12 months or longer.

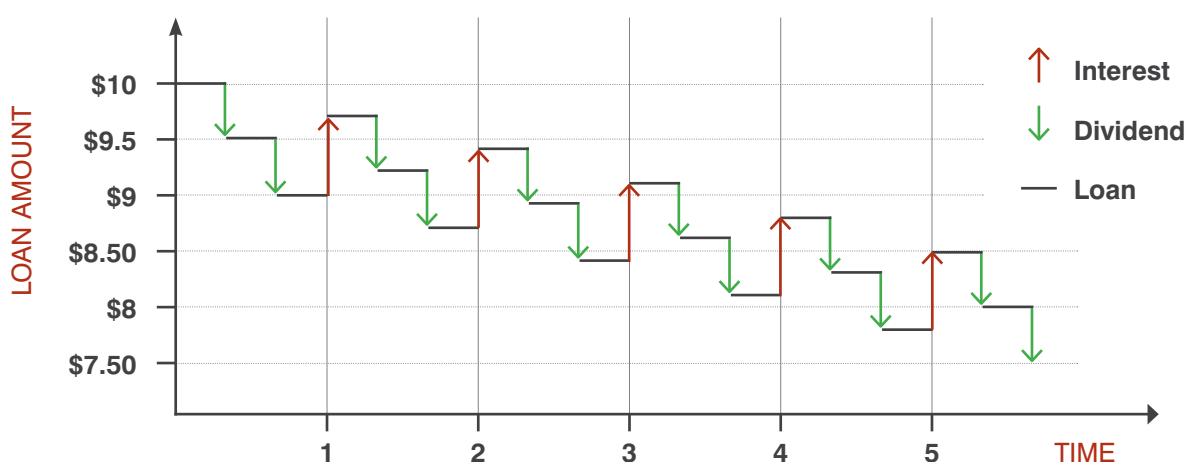
The interest amount is paid up to the reset date and the Issuer will then ask you to pay the interest and fees applying until the next reset date. An adjustment to the exercise price (if needed) will be made to restore the preferred gearing level. This could require an additional payment to be made to the Issuer or, if the exercise price is increased, a payment from the Issuer to you. Rolling instalments can also incorporate a reset feature.

## Self-funding Instalments

Self-funding Instalments are called this because dividends paid by the underlying security are applied to reduce the final instalment rather than being paid to you as income.

The final instalment also includes interest payments so the extent that the instrument will be “self-funding” depends on the level of dividend income and interest payments, and the duration of the warrants. In the event that dividends exceed interest payments, the self-funding effect can be shown as follows.

This diagram is intended as an illustration only.



## Instalment MINIs

A variant on the Instalment is the Instalment MINI. Since their launch these instruments have grown in popularity with investors looking for:

- medium to long term exposure to the stock market
- enhanced dividend yields and franking credits
- gearing without the risk of a margin call (depending on the warrant the gearing may range from 20 to 80%)

Unlike vanilla MINIs, instalments MINIs have an expiry / maturity date. At maturity you can pay the final instalment and receive the underlying securities, roll into another series of instalment MINIs, or walk away and receive any value remaining in the investment.

An attraction for traders is a more highly leveraged instrument that includes eligibility for dividends and franking credits. Instalment MINIs are available which provide dividends and franking credits to the holder and there are instalment MINIs which apply dividends to paying off the loan amount, effectively a self-funding instalment MINI. Instalment MINIs have a stop loss feature which comes at no additional cost and works in the same way as described for MINIs. The stop loss is set above the final instalment and the stop loss trigger level is amended as the final instalment increases due to funding costs. If you hold an instalment MINI overnight you will incur funding costs.

As with other warrants you may be able to include instalment MINIs in your SMSF portfolio but, again, seek your own advice.

**Instalment MINIs  
have an expiry date**

**Like MINIs,  
Instalment MINIs  
include a stop loss**

# Buying and selling warrants on Chi-X

The process of buying and selling on Chi-X is similar to trading in other securities. Warrants are allocated a trading code, bids and offers are entered and orders matched in the manner that you will be familiar with when buying securities on-market.

The volume visible on screen is not necessarily reflective of the total volume available to buy and sell at a price. This is because Issuers act as, or contract the services of, market makers to provide liquidity. The arrangements between Issuers and market makers require liquidity to be maintained so that investors can have confidence that, barring an extraordinary event, reasonable prices may be available for the purpose of liquidating existing positions.

Warrants are settled through CHESS and appear on your CHESS statements. Warrants are included on a register just like other securities and you will receive correspondence from the Issuer's appointed registry.

Clearing and settlement of warrants is the same irrespective of the market you trade on.

## Trading codes/symbols

All instruments traded on Chi-X have a code that uniquely identifies them. As there are many different series of warrants it is important that you have the right code for the warrant series you are interested in.

The same coding convention is employed for warrants traded on the Chi-X warrants market and the ASX warrants market.

Warrants are given a 6 character code.

The *first 3 characters* identify the underlying asset.

A warrant over BHP shares will use the stock symbol BHP for the first 3 characters.

An index warrant over the S&P/ASX 200 share price index will use the code XJO as this is the code used for this index.

The *fourth character* identifies the type of warrant

I, J – instalments and instalment MINIs

S – self-funding instalments

K, Q, M – MINIs

L – GSL MINIs

T, U, V, W - put and call trading warrants

X, Y, Z – others which includes barrier and knockout warrants / turbo warrants

The *fifth character* of the code identifies the Issuer. Chi-X and ASX use different characters for Issuers.

The *sixth and final character* uniquely identifies a particular warrant. The sixth character is also used to differentiate put and call trading warrants: A – O = Call / Long Warrant P – Z = Put / Short Warrant

A full list of the warrant series currently quoted and traded on Chi-X and their trading codes is available on the Chi-X website.

# What happens when my warrant is exercised or reaches maturity?

The Issuer will advise you of the impending expiry of the warrant. The expiry notice will advise you of any choices you might have including making a final payment to purchase the underlying, receiving a cash payment for the sale of the underlying, receiving a cash payment or rolling over into another series of warrants.

If an Issuer does not fulfil its obligations within 20 business days following the valid exercise of a warrant, you may ask for the payment of liquidated damages under the Chi-X rules that apply to warrant issuers. You may also pursue other legal remedies against the Issuer.

# What must I do before I can trade warrants?

Before trading in warrants, you need to consider whether you are an experienced and attentive investor with a good understanding of leveraged and/or geared investment products and the risks they pose.

## Consider whether warrants suit your investment style and your investment needs

Before you can place an order for a warrant you must sign a client agreement with your broker. Included in this agreement will be a statement that you have been provided with and read an explanatory booklet on warrants.

For investors who have already been approved for investing in warrants, a new client agreement is not required. However, your broker is required

to provide you with a copy of the Chi-X explanatory booklet. This can be emailed to you. Hard copies are available if you do not have email. You are not required to acknowledge receipt of the booklet.

In the case of Chi-X warrants the explanatory booklet is this document.

# Make sure your adviser is accredited

You can buy and sell warrants through Chi-X trading participants.

However, if you are receiving advice on investing in warrants by an adviser employed by a Chi-X Trading Participant your adviser must be accredited before they can advise clients on Chi-X traded warrants. The required level of accreditation is Accredited Derivatives Adviser level 1, which is also known as ADA1. Ask your adviser if they hold ADA1.

For other advisers different types of accreditation are available.

## Compensation arrangements

The Chi-X market operates a compensation regime that provides protection for retail investors in circumstances that are outlined in the Corporations Act. The compensation arrangements cover losses arising from defalcation or fraudulent misuse of client money, property or authority by a Chi-X participant, subject to certain exceptions. This compensation regime is different to the compensation regime applying to ASX traded warrants.

This compensation does not extend to the performance obligations of the warrant Issuer or its Guarantor including their obligations arising from the exercise or lapse of the warrants.

## Issuer information

Warrant Issuers provide information on their own websites.

Information includes the product disclosure statement for every warrant series they issue, operational information and records of announcements made to the market about particular warrant series and may include educational resources for investors.

You should visit an Issuer's warrant website before you purchase a warrant. It can be helpful to also visit the Issuer's website as a warrant approaches expiry to make sure you know what your options are and the key dates associated with expiry.

## About Chi-X<sup>®</sup> Australia

Chi-X Australia offers a valuable alternative to trading on ASX using its low latency, high performance, proven trading system. Chi-X Australia provides innovative new order types, price improvement opportunities, the potential for lower costs and a more efficient way to trade.

## About Chi-X Global

Chi-X Global is driven to be an industry leader in operating trading venues and generating innovative products and services for the benefit of financial markets and the global trading community. The company believes that competition from technology-driven markets increases overall market volumes and improves investor performance, providing benefits to all participants.

Owned by a consortium of major financial institutions, Chi-X Global operates market centers in Australia, Canada and Japan. Its Chi-Tech<sup>TM</sup> technology services unit provides technology to its business lines and its Chi-FXTM platform powers BM&FBOVESPA's BEI service.

## The Chi-X Name

The name Chi-X is derived from the Greek letter Chi, written "X", symbolising the crossing of the two sides of a trade. Along with the "X" from the English alphabet, the name signifies a combination of the old world and modern world, or traditional securities trading techniques married with cutting-edge technology.

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