



Investment Product Guide- Exchange Traded Funds and Warrants

I have read the Investment Product Guide of the above product,
and I acknowledge that I understand its features and risks.

Signature: _____

Print Name: _____

Date: _____



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What is an Exchange Traded Funds (ETFs)?

- ❖ The ETFs is to track the performance of an underlying index. Some ETFs gain exposure to the underlying index by investing in shares, bonds, futures, commodities or other assets that make up the index
- ❖ Synthetic ETFs adopt a different replication strategy by investing in derivative instruments designed to replicate the performance of index

Key features of ETFs

- ❖ *Exchange trading* - An ETF is structured as a mutual fund or a unit trust but its units, like a stock, are also tradable on the Stock Exchange
- ❖ *Index tracking* - To achieve the index tracking objective, a fund manager may adopt one or more of the following strategies:
 - full replication by investing in a portfolio of securities that replicates the composition of the underlying index;
 - representative sampling by investing in a portfolio of securities featuring a high correlation with the underlying index, but is not exactly the same as those in the index; or
 - synthetic replication through the use of financial derivative instruments to replicate the index performance.
- ❖ *Synthetic replication* is sometimes used by an ETF to raise efficiency and reduce cost. Where an ETF tracks a market (or an index in a market) that has restricted access, it has no other choice but to adopt synthetic replication through the use of financial derivative instruments.
- ❖ *Trading price vs. Net Asset Value (NAV)* - Each ETF has an NAV that is calculated with reference to the market value of the investments held by it.
- ❖ *Dividend entitlement* - An ETF may or may not distribute dividends, depending on its dividend policy.

Risk Factors:

ETFs

- ❖ Product is NOT principal protected.
- ❖ Investors are exposed to Market risk such as economic, political, currency, legal and other risks of a specific sector or market related to the index and the market that it is tracking.
- ❖ Liquidity risk exists when a particular instrument is difficult to purchase or sell
- ❖ There may be disparity between the performance of the ETF and the performance of the underlying index due to, for instance, failure of tracking strategy, currency differences, fees and expenses.
- ❖ Since the trading price of an ETF is typically determined by the supply and demand of the market, the ETF may trade at a price higher or lower than its NAV.

Synthetic ETFs

- ❖ Product is NOT principal protected.
- ❖ Investors are exposed to Market risk such as political, economic, currency and other risks related to the synthetic ETF's underlying index.
- ❖ Investors are subject to the credit risk of the counterparties who issued the derivatives and knock-on effect:
 - Once a derivatives issuing counterparty defaults, a synthetic ETF may suffer losses.
 - If a replacing counterparty cannot be found, the ETF may no longer be able to track the benchmark index. In case the ETF is forced to liquidate the underlying assets, investors may suffer significant losses.
 - One derivatives counterparty goes bankrupt may have a knock-on effect on other derivatives counterparties. Some synthetic ETFs have collateral to reduce the counterparty risk, but there may be a risk that the market value of the collateral has fallen substantially when the synthetic ETF seeks to realize the collateral. Investors may trade a synthetic ETF at a discount or premium to its Net Asset Value (NAV). Where the index/market that the synthetic ETF tracks is subject to restricted access, the efficiency in unit creation or redemption to keep the price of the synthetic ETF in line with its NAV may be disrupted, causing the synthetic ETF to trade at a higher premium or discount to its NAV. Investors who buy a synthetic ETF at a premium may not be able to recover the premium in the event of termination.
- ❖ A higher liquidity risk is involved if a synthetic ETF involves derivatives which do not have an active secondary market. Wider bid-offer spreads in the price of the derivatives may result in losses.
- ❖ There may be disparity between the performance of the synthetic ETF and the performance of the underlying index due to, for instance, failure of tracking strategy, currency differences, fees and expenses.

What are Warrants?

- ❖ Warrants are an instrument which gives investors the right - but not the obligation - to buy or sell the underlying asset (e.g. a stock) at a pre-set price on or before a specified date.

Key features of Warrants

- ❖ Compared with stocks, warrants have more attributes which include:
 - *Issuer:* A warrant can be issued by a listed company (i.e. subscription warrant) or a third party such as a financial institution (i.e. derivative warrant).
 - *Underlying asset:* It can be a single stock, a basket of stocks, an index, a currency, a commodity, a futures contract (e.g. oil futures) etc.
 - *Types of embedded rights:* Don't mix up a call warrant with a put warrant. A call warrant gives you the right to buy whereas a put warrant gives you the right to sell the underlying asset.
 - *Exercise price:* The price at which you buy or sell the underlying asset in exercising a warrant.
 - *Conversion ratio:* This refers to the number of units of the underlying asset exchanged when exercising a unit of a warrant. Normally, in Hong Kong a derivative warrant on shares has the ratio of 1 (i.e. one warrant for one share) or 10 (i.e. 10 warrants for one share).
 - *Expiry date:* The date on which a warrant will expire and become worthless if the warrant is not exercised.
 - *Exercise style:* With an American warrant, you can exercise to buy/sell the underlying asset on or before the expiry date. Whereas a European warrant allows exercise on the expiry date only.
 - *Settlement:* A warrant can be settled by cash or physical delivery upon exercise.

Warrants

- **Derivative warrants** are issued by financial institutions. Unlike subscription warrants which must be call warrants, derivative warrants can be call or put warrants. Most of the derivative warrants in the market have a shorter life, ranging from 6 months to 2 years normally, although the current Listing Rules allow a maximum life of 5 years.
- Derivative warrants can be linked with a single stock, a basket of stocks, an index, a currency, a commodity or a futures contract (e.g. oil futures). They can be settled by cash or physical delivery, which must be specified by the issuers at launch.
- In exercising a call derivative warrant on a single stock with physical settlement, the issuer will deliver the underlying shares to the warrant holder. This does not involve the issuance of new shares by the underlying listed company as in the case of subscription warrants.
- Furthermore, every derivative warrant has a designated liquidity provider to help improve the liquidity of the instrument in the market. Such a requirement does not apply to subscription warrants.

Warrants



Risk Factors:

Warrants

- ❖ Product is NOT principal protected.
- ❖ Gearing risk: Although warrants often cost less than the price of the underlying assets, a warrant may change in value to a much greater extent than the underlying assets. Although potential return on warrants may be higher than that on the underlying assets, it should be noted that in the worst case the value of warrants may fall to zero and holders may lose their entire investment amount.
- ❖ Limited life: Unlike stocks, derivative warrants have an expiry date and therefore a limited life. Unless the warrants are in-the-money, they become worthless at expiration.

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Derivative warrants

- ❖ Product is NOT principal protected.
- ❖ Issuer risk: Derivative warrant holders are unsecured creditors of the issuer and they have no preferential claim to any assets an issuer may hold.
- ❖ Gearing risk: Although derivative warrants often cost less than the price of the underlying assets, a derivative warrant may change in value to a much greater extent than the underlying assets. Although potential return on derivative warrants may be higher than that on the underlying assets, it should be noted that in the worst case the value of derivative warrants may fall to zero and holders may lose their entire investment amount.
- ❖ Limited life: Unlike stocks, derivative warrants have an expiry date and therefore a limited life. Unless the derivative warrants are in-the-money, they become worthless at expiration.
- ❖ Time decay: So long as other factors remain unchanged, the value of derivative warrants will decrease over time. Therefore, derivative warrants should never be viewed as products that are bought and held as long term investments.
- ❖ Market forces: In addition to the basic factors that determine the theoretical price of a derivative warrant, derivative warrant prices are also affected by the demand for and supply of the derivative warrants. This is particularly the case when a derivative warrant issue is almost sold out and when there are further issues of an existing derivative warrant.
- ❖ Turnover: High turnover should not be regarded as an indication that a derivative warrant's price will go up. The price of a derivative warrant is affected by a number of factors in addition to market forces, such as the price of the underlying assets and its volatility, the time remaining to expiry, interest rates and the expected dividend on the underlying assets.

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