Enabling investors to benefit from both bull and bear markets

JSE

EQUITY MARKET

Warrants

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Johannesburg
Stock Exchange

A warrant is an exchange listed contractual agreement which entitles the holder to the right (but not obligation) to enter a transaction involving an underlying security at a predetermined price on a predetermined future date.

Warrants can be divided into two basic categories namely call and put warrants. A call warrant gives the holder the right (but not the obligation) to purchase an underlying security at an agreed price while a put warrant gives the holder the right (but not the obligation) to sell an underlying security at an agreed price.

Warrants can also be categorised according to their 'style' which can either be "American" or "European". American style warrants allow the holder to exercise the warrant at any time between listing and the expiry date whereas with European style the warrant may only be exercised on the date of expiration.

How to invest in warrants

Warrants are bought and sold via a broker as they are traded in the same manner as any other security listed on the JSE.

Investing through a stockbroker requires opening a trading account with a stockbroker (refer to the JSE website for a list of brokers).

All transactions will be subject to:

- Brokerage fees
- Settlement fees (Strate)
- Investor Protection Levies
- Custodian or administrative fees (where applicable)
- VAT (where applicable)

Benefits of investing in warrants

- **Advantageous in bull and bear markets**
  If investors speculate on a price increase in a specific security they will purchase call warrants. On the contrary if investors speculate on a price decrease they will buy put warrants as the value of the put warrant increases as the market drops.
- **Very liquid market**
  The presence of a market maker ensures liquidity at all times
- **Unlimited upside, but limited downside**
  The worst case scenario for investors is losing the initial premium (deposit) they paid.
- **Reduced cost**
  The cost of trading warrants is generally lower than the cost of trading directly in the underlying security of the warrants.
- **Leverage**
  Investors can gain full exposure to the price movement of the underlying securities by investing a small amount.

Types of warrants

- **Single equity warrants (vanilla warrants)**
  These warrants are issued on the shares of a single company listed on the JSE or a particular asset class. The underlying could be a variety of securities including currencies, commodities etc. They are currently the most popular type of warrant traded.
  Settlement is in cash terms or by delivery of the underlying security.
- **Index warrants**
  These warrants are issued on a particular index and are settled by way of a cash payment.
- **Bond warrants**
  The underlying security is a bond.
- **Basket warrants**
  These are similar to single equity warrants except the underlying security is a basket of securities rather than a single security. The basket generally includes companies within a particular industry.
- **Barrier warrants**
  These are single equity warrants that have a barrier level to which the price of the underlying is confined. If this level is breached by the underlying security the warrant lapses and becomes worthless.
- **Discount warrants**
  A discount warrant has a structure that allows investors to purchase the underlying at a discount to the current market price. The investor forfeits participation in some of the upside movement of the security for this benefit.
- **Capital protection warrants**
  Capital protection warrants give the holder a guaranteed return on the underlying security. The investor is guaranteed a specific return, but he/she will also benefit if the underlying security's value increases beyond the capital protection level.

List of warrant issuers

- ABSA Capital
- Deutsche Bank AG
- Investec Bank Limited
- Nedbank Limited
- Standard Bank of South Africa

In a nutshell

Warrants can offer an excellent addition to an investor's portfolio, but due to their risky nature, warrant investors need to be attentive to market movements as well as other risks applicable to these instruments.

Warrant investment example

An investor has R1 000 to invest. Share A is selling at R100 and the investor believes that the share will gain value in 3 months' time. He considers the following options to gain exposure to this share's movement:

At purchase	
Scenario 1	Buy 10 shares at R100 each.
Scenario 2	Buy 250 vanilla call warrants at R4 per warrant. Buying 1 warrant does not necessarily entitle the investor to the right to 1 share. Warrants have "cover ratios"* which stipulate how many warrants give you exposure to 1 share. In the example the cover ratio is 20, i.e. buying 250 warrants gives the investor exposure to 12.5 shares.
Scenario 3	For the investor who wants the option of benefiting from his speculation on the price movement of the share, but who is not willing to lose his initial capital, a combination strategy can be used. Purchasing a capital protection warrant with a portion of his R1 000 will guarantee that in 3 months time the investor receives R1 000. With the rest of his money the investor can invest in vanilla call warrants. For the purposes of this example, we will assume a risk free rate of 15%. Discounting R1 000 back for 3 months we get R960, which means if the investor invests R960 today in a capital protection warrant, in three months he will receive R1 000. This leaves R40 to invest in call warrants now and hence using the same cover ratio as in Scenario 2, he has exposure to 1.5 shares.
In 3 months' time if Share A is now trading at R130 per share	
Scenario 1	The investor makes a profit of R300. The investor can sell each share for R30 more than he bought it thus creating a profit of 10 shares x R30 profit per share, i.e. 30% profit
Scenario 2	Investor makes a profit of R625. Similar to the explanation in Scenario 1, the investor can sell his shares for R30 more but since he has 12.5 shares instead of just 10 his profit increases to 12.5 shares x R30 profit per share,i.e.62.5%profit
Scenario 3	Investor makes a profit of R15. The gain to the investor in this scenario is substantially less than the other two(1.5 shares x R30 profit per share, i.e. 1.5% profit) but here the investor has the added advantage of capital protection which will benefit the investor in the case of the share price moving in an unfavourable direction as illustrated next.
In 3 months' time if Share A is now trading at R70 per share	
Scenario 1	The investor makes a loss of R300 (10 shares x R30 per share, i.e. 30% loss) if he/she decides to sell his/her sharesatthis point. The investor may retain the shares in hope that the share price will recover.
Scenario 2	Investor makes a loss of R1000 (250 warrantsxR10,i.e.100%loss). The warrant has reached its expiry and since the investor's belief thatthe share price would appreciate was wrong, he/she cannot benefit from the warrants. He therefore loses his initial invest ment of R1000.
Scenario 3	Investor incurs no profit or loss. The investor loses the R40 which he spent on the call warrants. This is however offset by the return on the risk free investment, i.e. 0% loss and 0% gain.

**Cover Rations are determined by the warrants issuer and will vary for different warrants.*

Some considerations

- **Effect of changes in variables**
  The value of a warrant is primarily affected by changes in the price of the underlying security. Any adverse movement in the underlying security's price may have a negative impact on the price of a warrant.
- **Credit risk**
  Credit risk relates to the non-fulfilment of the warrant issuer's obligations especially upon the exercise of the warrant. One needs to assess the credit risk associated with the warrant issuer.
- **Limited life of warrants**
  Since warrants have an expiry date and therefore a limited life span, it is possible that they may expire without the holder's expectations being realised.
- **Extraordinary event**
  In certain circumstances the warrant issuer has the right to declare an extraordinary event, resulting in expiry of the warrant, prior to the specified expiry date.
- **Limitation of rights**
  Warrant holders are limited in that they only have the right to buy or sell the underlying securities at the terms stipulated.
  Equity warrants do not form part of a company's issued share capital until they are exercised. For this reason, warrant holders do not have the right to attend or vote at a shareholders meeting.

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