VP Bank (Luxembourg) SA · Valid from November 2018

Opportunities and risks inherent in **securities transactions**

VP BANK

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Due to the growing importance of security investments on the financial markets, we have issued this brochure entitled "Opportunities and risks inherent in securities transactions". On the occasion of account opening, all clients of VP Bank (Luxembourg) SA will receive this brochure.

Despite the fact that we consider our clients familiar with the essential characteristics of the popular types of securities, this brochure contains at the beginning a general survey of the most important risks inherent in securities transactions, as well as a brief description of the different types of securities.

Thereafter we have compiled information on the characteristics and special risks of certain types of transactions. The transactions in question are linked to derivative instruments and consequently involve a substantial profit and loss potential. We have based our descriptions on the customary classification of such transactions into options and forward transactions as well as structured and synthetic products.

Since investments in certain markets may also be susceptible to larger-than-normal risks, this brochure also provides information on the risks associated with investments in the emerging markets.

Securities transactions – especially in derivative financial instruments – may cause substantial losses. Investors should therefore engage in such transactions only after having assessed their economic situation.

The ongoing evolution in the field of securities makes it impossible to give a full and final view on the financial products that are now and will be traded on the markets. Thus, this brochure does not explain all the risks involved but concentrates on the main aspects.

In any event, no securities transactions should be carried out without first ascertaining the precise risks associated with such transactions and the ability to absorb the substantial loss potential. Readers who require further information or clarification concerning the subject matter of this brochure or the individual transactions and products described should not hesitate to contact us.

Risks inherent in securities transactions

Risks which must be considered when investing are described briefly below. They are assigned to the individual types of securities listed in the table commencing on page 5.

Credit risk: a deterioration in the solvency – or worse still, the bankruptcy – of a borrower means at least a partial loss of the capital invested.

Monetary risk: Inflation can reduce the value of an investment. The purchasing power of the invested capital declines if the rate of inflation is higher than the return generated by the securities.

Market risk: If the market value of an investment declines, assets are reduced. Credit, country and interest-rate risks in particular have an impact in the form of price fluctuations. All investments are exposed to this risk.

Country risk: Investments in countries where political conditions are unstable are exposed to special risks. These can very quickly result in wide price fluctuations. Those risks include, for example, foreign exchange restrictions, transfer risks or standstill agreements.

Liquidity risk: In the case of securities issued by small companies (second-tier stocks), occasional illiquidity of the market is to be expected. This can mean that securities cannot be traded at the desired time and/or in the desired quantity and/or at the desired price.

Currency risk: Declining exchange rates reduce the value of investments in foreign currencies. However, the foreign exchange market also offers opportunities for profits. Currency risk can be eliminated by investing only in the client's domestic currency. However, companies operating on an international scale are exposed to exchange-rate trends to some degree. Such trends can therefore also exercise an indirect influence on the price movements of securities.

Interest-rate risk: Changes in interest-rate levels on the money and capital markets have a direct impact on the prices of fixed-interest securities. Rising interest rates usually have a negative impact on the market prices of equities and bonds. By contrast, falling interest rates have a positive impact on prices.

No category of investment excludes all risks. It is therefore important to diversify investments and thus spread the risks. Shrewd investors incur a number of individual risks in diversification because they can thus substantially reduce the overall risk for their assets.

One-sided investments result in a bulk risk, i. e. the capital invested can decline considerably in value, for example, as a result of the insolvency of a single borrower or the weakness of a certain currency.

Credit risk must not be underestimated in the field of derivative financial instruments. This is particularly the case for non-standardised products. Credit risk includes the danger that a counterparty will no longer be able to fulfil his or her obligations. In this context, the size of the credit risk depends substantially on the type of transaction performed.

Type of security	Opportunities	Risks
Shares (domestic and foreign; bearer, registered, ordinary, preference, priority, voting share)	Equity instruments embodying a share in a public limited company, thus entitling the holder to participate directly in the success of the company, e.g. in the form of capital gains. (Property and membership rights)	• credit risk • market risk • country risk • liquidity risk • currency risk • interest-rate risk (indirect)
Participation certificates (non-voting shares)	see shares (without membership rights)	see shares
Dividend-right certificates (non-voting, no par value)	see shares (without membership rights)	see shares
(Ordinary) shares in a co-operative	Equity instruments embodying a share in a co-operative, thus entitling the holder to participate directly in the success of the company. (Property and membership rights)	• credit risk • market risk • liquidity risk • interest-rate risk (indirect) • depending on the articles of association, members of the co-operative are obliged to make further capital contributions
Rights	Embody the shareholders' right to subscribe to new securities in the event of an increase in capital. (Protection against dilution)	limited to the duration of the subscription period: • market risk • liquidity risk • currency risk
Mutual fund units (bond, equity, money market, mixed securities, precious metal, commodities, real-estate funds)	Embody a share in the assets of a mutual fund and therefore enable the holder to participate directly in the success of the fund.	vary depending on the investments made (fund rules and regulations): • credit risk • monetary risk • market risk • country risk • liquidity risk • currency risk • interest-rate risk
Debenture bonds	Embody a money claim on the issuer (borrower).	• credit risk • monetary risk • market risk • country risk • liquidity risk • currency risk (in the case of foreign currency bonds) • interest-rate risk
Eurobonds	see debenture bonds	see debenture bonds
Notes	Embody a medium-term money claim on the issuer (borrower).	see debenture bonds
Medium-term notes	Embody a medium-term money claim on a domestic issuer (borrower).	• credit risk • monetary risk • market risk • liquidity risk • interest-rate risk
Mortgage bonds	Embody a money claim on a mortgage bank.	• monetary risk • market risk • liquidity risk • interest-rate risk
Medium-term, bank-issued bonds	Embody a medium-term money claim on public authorities.	• credit risk • monetary risk • market risk • liquidity risk • interest-rate risk
Perpetual bonds	Embody a non-expiring money claim on the issuer (borrower).	see debenture bonds

Type of security	Opportunities	Risks
Book-entry bonds	Embody a book-entry money claim on the public authorities.	• monetary risk • market risk • liquidity risk • interest-rate risk
Treasury bonds	Embody a long-term money claim on a government (especially that of the US).	• monetary risk • market risk • liquidity risk • interest-rate risk
Treasury bills	Embody a short-term money claim on a government (especially that of the US, Canada, or the UK).	• monetary risk • market risk • liquidity risk • interest-rate risk
Certificates of deposit (CD)	Embody a short-term money claim on a US or UK bank.	• credit risk • monetary risk • market risk • liquidity risk • interest-rate risk
Banker's acceptance	Embody a short-term money claim in the form of a trade bill guaranteed by an American bank. Depending on the market situation, they offer a higher return than other forms of fixed-interest investment.	see certificates of deposit
Commercial paper	Embodies a short-term money claim in the form of a promissory note issued by an industrial or financial company.	see certificates of deposit
Convertible bonds	Embody a money claim on the issuer (borrower). Depending on the market situation, convertible bonds can offer a higher return than other forms of fixed-interest investment. The conversion right offers the opportunity of participating directly in the success of the company.	• credit risk • monetary risk • market risk • country risk • liquidity risk • currency risk • interest-rate risk
Warrant-linked bonds, with warrants	Embodies a money claim on the issuer (borrower). Depending on the market situation, these warrant-linked bonds can offer a higher return than other forms of fixed-interest investment. The warrant offers the opportunity of participating directly in the success of the company.	see convertible bonds
Warrant-linked bonds, without warrants	see debenture bonds	see debenture bonds
Warrants (stock options)	Embody a precisely defined right for the holder to purchase or sell other assets during the exercise period. However, leverage makes the potential for capital gains considerably greater than for a corresponding direct investment.	• credit risk • monetary risk (partial) • high market risk due to leverage • country risk • liquidity risk • currency risk • interest-rate risk (indirect)
Calls (standardised purchase options; i.e. Eurex)	**for the purchaser:** see warrants **for the writer:** possibility of earning an additional return or improved yield on an existing holding	**for the purchaser:** see warrants **for the writer:** (in uncovered trading) • credit risk • high market risk due to leverage • country risk • liquidity risk • currency risk • interest-rate risk (indirect) • risk of having to sell the instruments underlying the call at less than the current market value

Type of security	Opportunities	Risks
Puts (standardised selling options; i.e. Eurex)	**for the purchaser:** see warrants possibility of hedging existing holdings **for the writer:** possibility of earning an additional return or improved yield on an existing holding	**for the purchaser:** see warrants **for the writer:** • credit risk • high market risk due to leverage • country risk • liquidity risk • currency risk • interest-rate risk (indirect) • risk of having to purchase the instruments underlying the put at more than the current market value
Futures (standardised forward contract; i.e. Eurex)	High potential for capital gains on the underlying instruments due to the small commitment of capital (leverage); possibility of hedging existing holdings	• high market risk due to leverage • country risk • currency risk • other risks depending on underlying instruments
Over-the-counter derivative instruments (non-standardised options and forward transactions)	see calls, puts, futures	see calls, puts, futures but with increased liquidity risk

Characteristic features and risks of forward transactions

Forward transactions can involve major risks and should therefore only be entered into by investors who are familiar with this type of transaction, have sufficient liquid resources at their disposal and are able to absorb potential losses.

Characteristic features

Definition

Forward transactions embody the obligation to accept or deliver a certain quantity of a certain underlying instrument on a certain date in the future (expiry date) at a price agreed upon when concluding the contract.

The following may serve as underlying instruments:
- Physical assets (equities, warrants, options, commodities, precious metals)
- Benchmarks (currencies, interest rates, indices)

Categories

Futures are forward transactions whose contract sizes and expiry dates are standardised and which are traded on an exchange. Contracts of this nature are traded on exchanges organised specially, e.g. Eurex.

Over-the-counter (OTC) forward transactions (so-called forwards) are contracts with standardised contractual terms or contract specifications agreed upon individually between purchasers and vendors. Forwards are not traded on an exchange.

Margin requirement / margin cover

An initial margin is stipulated for both purchases and forward short sales of underlying instruments when a contract is concluded. A variation margin is also calculated periodically during the entire life of the contract. The variation margin corresponds to the book gain or book loss arising by virtue of the change in value of the contract, i.e. the underlying instrument. In the process, the variation margin can rapidly amount to a multiple of the initial margin. In the case of futures, these margins and their calculation are subject to the guidelines laid down by the exchange in question and are debited or credited daily. The banks are entitled to request higher margins than the required minimum rates. In the case of forwards, the banks can set the margins at their discretion.

Investors must maintain the required margin cover with the bank during the entire life of the contract. A margin shortfall usually results in the liquidation of the position in question by the bank.

Closing out / settlement

Contracts can be closed out at any time prior to their expiry date. Depending on the type of contract and customary practice on the exchange in question, contracts are closed out either by means of an identical counter transaction or by concluding an offsetting transaction in respect of the obligation, with otherwise identical specifications. In the latter case, the delivery and acceptance obligations resulting from the two open contracts cancel each other out.

Contracts which are not closed out must be settled on their expiry date. In the case of contracts based on physical assets, this usually takes the form of a delivery of the underlying instrument. In the case of contracts based on benchmarks, a corresponding cash consideration is paid in lieu of physical delivery.

The relevant contract specifications determine the further terms and conditions of settlement, especially for stipulating the place of performance.

Risks

Changes in the value of the contract / underlying instrument

Every investor has certain expectations in respect of the change in value of the contract, i.e. the corresponding underlying instrument, in the relevant period. If the actual change in value does not correspond to these expectations, the investor is exposed to the following risks:
- If the value of the contract / underlying instrument rises, the seller for forward delivery must deliver the underlying instrument at the price originally agreed upon. That can be substantially lower than the current market value.
- If the value of the contract / underlying instrument falls, the purchaser for forward delivery must accept the underlying instrument at the price originally agreed upon. That can be substantially higher than the current market value.

In both cases, the risk lies in the difference between the price agreed upon when the contract was concluded and the actual market value on the expiry date. The extent of this risk cannot be defined in advance.

Purchase of the underlying instrument in the case of short sales

Anyone selling an underlying instrument for forward delivery without already being in possession of it when concluding the contract (short sale) is exposed to the risk of having to purchase the underlying instrument at an unfavourable – i.e. high – market value, in order to be able to meet his or her delivery obligations on the expiry date. In this case, the risk is especially high, indeed it is theoretically unlimited.

Difficulty or impossibility of closing out positions

In order to limit excessive price fluctuations, an exchange can fix price limits for certain contracts. The investor must be aware that when the price limit is reached, closing out is considerably more difficult or even temporarily impos-sible. Every investor should therefore make enquiries about any existing price limits before concluding forward transactions.

Physical delivery / cash settlement

Investors are exposed to greater risks with contracts which have to be fulfilled by physical delivery than with those which are fulfilled by cash settlement. In the case of physical delivery, the full contract value must be paid, whereas in the case of cash settlement, only the difference between the price agreed upon when concluding the contract and the current market value on settlement date must be paid. Investors must therefore have greater liquid resources at their disposal for contracts with physical delivery than for contracts with cash settlement.

Special risks of OTC forward transactions

As a rule, the market for standardised OTC forward transactions is transparent and liquid. Closing out is usually possible without any significant problems.

By contrast, there is no market as such for OTC forward transactions with individual contract specifications. Closing out is therefore only possible if a counterparty is found who is prepared to conclude an offsetting contract.

In forward foreign exchange transactions, the bank will act as a so-called systematic internaliser. This simplifies the close out of transactions, but bundles the counterparty risk, since all transactions are carried out with VP Bank.

Combined transactions

These transactions are understood to refer to various combinations of forward, spot and options transactions. Due to the diversity of possible variations, the risk structures arising in a specific instance cannot be dealt with in detail within the scope of this brochure. Note that closing out individual elements of a combined transaction substantially alters the risk profile of the position as a whole, i.e. of the elements remaining open. Before investors conclude a transaction of this nature or close out individual elements of it, they should therefore make detailed enquiries about the specific risks involved.

Characteristic features and risks of options transactions

Options transactions can involve major financial risks and should only be entered into by investors who are familiar with this type of transaction, have sufficient liquid resources at their disposal and are able to absorb potential losses.

Characteristic features

Definition

With an option, the purchaser acquires the right, against immediate payment of the option premium, to purchase (call option) or sell (put option) a certain quantity of the underlying instrument at a price stipulated in advance, either at any time during the life of the contract (US option) or on the expiry date (European option).

By contrast, the writer of an option undertakes to deliver (call option) or accept (put option) the corresponding underlying instrument at the agreed price (striking price) if the option is exercised. Depending on the contract specifications, cash settlement can also be accepted in lieu of physical delivery.

The following may serve as underlying instruments:
- Physical assets (equities, futures, bonds, commodities, precious metals)
- Benchmarks (currencies, interest rates, indices)

"In the money", "out of the money" and "at the money" options

A call option is "in the money", i.e. has an inherent value, if the current market value of the underlying instrument is higher than the striking price. A put option is "in the money" if the current market value of the underlying instrument is lower than the striking price.

A call option is "out of the money" if the current market value of the underlying instrument is lower than the striking price. A put option is "out of the money" if the current market value of the underlying instrument is higher than the striking price.

Call and put options are "at the money" if the current market value of the underlying instrument and the striking price are the same.

Categories

Traded options are financial instruments whose contract sizes, striking prices and expiry dates are standardised and which are traded on exchanges. Contracts of this nature are traded on specially organised exchanges, i.e. Eurex. OTC options transactions are contracts with standardised contractual terms or contract specifications agreed upon individually between purchasers and vendors. OTC options transactions are not traded on an exchange.

Warrants are non-standardised financial instruments. Some of them are traded on exchanges, but many are traded over the counter.

Margin requirement / margin cover

A margin is fixed for sales of puts and short sales of calls when the contract is concluded. This margin is recalculated periodically during the entire life of the contract and may result in equivalent margin calls. Future-styled options, such as options on Eurex interest-rate futures, are an exception. In this case, a margin requirement always exists on both purchases and sales. As in the case of future contracts, this is made up of an initial margin and a periodically calculated variation margin. In every instance, the margin on options may rapidly rise to many times the initial margin because of the leverage effect. In the case of traded options, these margins and their calculation are subject to the guidelines laid down by the exchange in question and are debited or credited daily. The banks are entitled to request higher margins than the required minimum rates. In the case of all other options transactions, the banks can set the margins at their discretion.

Investors must maintain the required margin cover with the bank during the entire life of the contract. A margin shortfall usually results in the liquidation of the position in question by the bank.

Closing out / settlement

Contracts can be closed out at any time prior to their expiry date. Depending on the type of contract and customary practice on the exchange in question, contracts are closed out either by means of an identical counter transaction or by concluding an offsetting transaction in respect of the obligation, with otherwise identical specifications. In the latter case, the delivery and acceptance obligations resulting from the two open contracts cancel each other out.

Obligations arising from the sale of options which are not closed out must always be settled on the expiry date. In the case of contracts based on physical assets, settlement usually takes the form of a delivery of the underlying instrument. In the case of contracts based on benchmarks, a corresponding cash consideration is paid in lieu of physical delivery.

Risks

Changes in the value of the contract / underlying instrument

Every investor has certain expectations in respect of the change in value of the contract, i.e. the corresponding underlying instrument, in the relevant period. If the actual change in value does not correspond to these expectations, the investor is exposed to the following risks:

The purchaser of a call or put loses the option premium already paid, either partially or entirely. His or her risk is thus clearly limited at all times:

- If the value of the contract / underlying instrument rises, the writer of a call must deliver the underlying instrument at the price originally agreed upon. That price can be substantially lower than the current market value.
- If the value of the contract rises, i.e. the value of the underlying instrument falls, the writer of a put must accept the underlying instrument at the price originally agreed upon. That price can be substantially higher than the current market value.

In both cases, the risk lies in the difference between the price agreed upon when the contract was concluded and the current market value on the expiry date. The extent of this risk cannot be defined in advance.

Purchase of the underlying instrument in the case of short sales of call options

Anyone writing call options without already being in possession of the underlying instrument when concluding the contract (short sale) is exposed to the risk of having to purchase the underlying instrument at an unfavourable – i.e. high – market value in order to be able to meet his or her delivery obligations on the expiry date. In this case, the risk is especially high, indeed it is theoretically unlimited.

Difficulty or impossibility of closing out positions

In order to limit excessive price fluctuations, an exchange can fix price limits for certain contracts. The investor must be aware that when the price limit is reached, closing out is considerably more difficult or even temporarily impossible. Every investor should therefore make enquiries about any existing price limits before concluding options transactions.

Physical delivery / cash settlement

Investors are exposed to greater risks with contracts which have to be fulfilled by physical delivery than with those which are fulfilled by cash settlement. In the case of physical delivery, the full contract value must be paid, whereas in the case of cash settlement, only the difference between the price agreed upon when concluding the contract and the current market value on the settlement date must be paid. Investors must therefore have greater liquid resources at their disposal for contracts with physical delivery than for contracts with cash settlement.

Special risks of OTC options transactions and transactions with warrants and stock options

As a rule, the market for standardised OTC options transactions and for transactions in warrants and stock options listed on an exchange is transparent and liquid. Closing out is therefore usually possible without any significant problems.

By contrast, there is no market as such for OTC options transactions with individual contract specifications and for transactions in warrants and stock options which are not listed on an exchange. Closing out is therefore only possible if a counterparty is found who is prepared to conclude an offsetting contract.

Combined transactions

Combined transactions are understood to mean the conclusion of two or more options transactions on the same underlying instrument. In such cases, the options differ at least in respect of type (call or put), quantity, striking price, expiry date and/or the position taken (long, short).

Due to the diversity of possible combinations, the risks arising in a specific instance cannot be dealt with in detail within the scope of this brochure. They can also be altered substantially by closing out individual elements of a combined transaction. Before concluding a combined transaction, investors should therefore make detailed enquiries about its specific risks.

"Exotic" options

Compared with the types already described above, options of this nature involve additional conditions or agreements. They therefore feature structures which cannot be created by any combinations of standard options alone or together with underlying instruments. "Exotic" options occur both as OTC options and also in the form of warrants.

The virtually unlimited possibilities for structuring "exotic" options mean that the risks arising in individual instances cannot be described within the scope of this brochure. Investors should therefore seek detailed information about the risks involved before purchasing or selling instruments of this nature.

Characteristic features and risks of hybrid financial instruments

Hybrid financial instruments are securities consisting of combinations of two or more investment products. However, the combination is not structured by investors themselves, but by the issuer prior to market launch (issue). The diverse possibilities for combination mean that each hybrid has its own risk profile, since the specific risks of the individual elements are either entirely or partially eliminated or intensified. It is therefore of the greatest importance for the client to seek detailed information about the risk characteristics of a hybrid before purchasing such an instrument.

At present, hybrids offering capital preservation (e.g. GROI, PIP, PEP, IGLU, VIU, etc.) predominate on the market. The following comments therefore deal exclusively with these types of transaction.

Characteristic features and risks

Hybrids of this nature enable investors to participate in the development of one or more underlying instruments (physical assets, benchmarks) and at the same time limit the potential loss (capital preservation). The capital preservation component and the participation component can be separated (split), depending on the hybrid. This enables the purchaser to retain or dispose of the individual components independently of each other. Note that splitting or sale of individual components can materially alter the risk profile of the combined instrument.

Capital preservation component

Independently of the price trend at expiry, the capital preservation component determines the extent to which the face value of the hybrid instrument and, if appropriate, what minimum return on the face value is paid out to the purchaser. The capital protection component refers to the face value and not to the issue or purchase price on any secondary market. It therefore falls/rises as a percentage of the invested capital if the purchase or issue price is higher/lower than the face value.

Participation component

The participation component defines the manner and extent of participation in the development of the underlying instrument. It thus defines the potential for profit over and above the capital preservation component. As a rule, participation is provided via a derivative or a combination of various derivatives. The risk behaviour of the participation component therefore corresponds to that of the relevant derivative or combination of derivatives. Hence the participation component can expire worthless, depending upon the price trend of the underlying instrument.

The following examples show several possible forms of participation. For the sake of simplicity, they only illustrate scenarios in which a hybrid is retained to maturity:

Hybrids with unlimited profit potential: In this case, the purchaser participates in proportion to the price trend of the underlying instruments. His or her percentage share in this development depends, inter alia, on the extent of hedging of the invested capital. Participation can be linear, progressive or degressive in relation to the trend of the underlying instrument.

Hybrids with limited profit potential: In this case, the purchaser participates in the development of the underlying instruments up to a certain limit. If the underlying instruments develop beyond this, he or she no longer participates. However, participation up to this limit will usually £be greater than in the case of a hybrid with unlimited profit potential.

Hybrids with fixed profit potential: These offer the purchaser a specific payment in addition to the hedged capital if
- the underlying instruments reach, exceed or fail to reach previously specified thresholds on expiry date or certain record dates; or
- the underlying instruments move within a defined range on the expiry date, on certain record dates or during the entire life of the contract.

This means that the purchaser of these products must have expectations not only in respect of the price trend of the underlying instruments, but also in respect of the potential price fluctuations during the term in question.

Characteristic features and risks of hedge funds

Positions in hedge funds may carry financial risk of a special kind and should only be taken up by investors who have sufficient knowledge of the particular hedge fund, substantial liquid resources and are able to carry potential losses.

Characteristic features and risks

No precise definition can be given of the term "hedge fund". As a general rule, these are foreign funds, which seek exceptional profit growth. With that end in view, high risks are taken deliberately. They are basically free to choose the instruments used. Cash, future and option business is possible, together with combinations in all kinds of underlying securities. Short selling and credit-based transactions are also habitually performed. A hedge fund may pursue several different investment strategies simultaneously.

Hedge funds are often only accessible to institutional investors and/or big customers. It is not unusual for minimum investments running into millions to be stipulated. In most cases, the possibilities or participation and withdrawal of capital are strictly limited. A minimum investment period is often stipulated.

As domiciles in offshore centres such as the British Virgin Islands, Gibraltar or the Cayman Islands are generally used, hedge funds are much less stringently regulated than traditional forms of investment. As a result, they also enjoy substantial tax advantages.

In addition to the normal investment risks already described in this publication (creditworthiness risk, currency risk, interest-rate risk), hedge funds carry further risks for the reasons indicated. These include the size risk (optimum size), operational risks (e.g. human risk, organisational risks) or strategy change risks. It is difficult for the investor to detect asses and control all these different aspects, as the information policy of hedge funds is generally rather sparse and lacking in transparency.

Characteristic features and risks of investments in emerging markets

Emerging markets are securities markets in countries characterised by, among other things, a certain degree of political instability and relatively unpredictable financial markets and economic growth patterns. Emerging markets include countries whose stock markets are still in the process of becoming properly established, whose economies are weak or which may be regarded as less developed countries. Thus the list of countries deemed to be emerging markets is constantly changing. Essentially, however, the term may be said to refer to all countries with the exception of Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States of America. These countries are referred to below as "established markets".

Investments in emerging markets should be carried out exclusively by those persons who have an in-depth knowledge of the markets in question and are thus in a position to assess the various risk factors.

Characteristic features

All types of investment in emerging markets are bound up with specific risks which are not present in established markets. The same applies when the issuer or seller of a product is either based in an emerging market or conducts the bulk of its activities there. Of course, investments in emerging markets may also carry other risks, including those described in previous chapters of this brochure.

Investments in instruments offered by these issuers and providers are frequently speculative in character.

Risks

The primary (though not only) additional risks associated with investments in emerging markets are as follows:

Political risk

A lack of political experience in a government or the instability of a political system mean that there is a greater risk that the economy or the political system will undergo radical change in the short term. For the investor, this can mean, among other things, that assets are confiscated without compensation, the investor's powers to dispose of his or her own property are restricted, state interventions in certain industries might seriously undermine the asset's value or the investment is subject to the state monitoring and control mechanisms.

Economic risk

The economy of an emerging-market country is more susceptible to the effects of changes in interest rates or inflation rates, which themselves are considerably more volatile than in established markets. Emerging economies also tend to be far less broadly based, with the result that isolated developments can have a much greater impact on the fortunes of the economy as a whole or of individual sectors. In addition, emerging economies will tend to have a smaller capital base and are frequently characterised by inadequate financial market organisation and monitoring.

Credit risk

Investments in debt securities (e.g. bonds, notes) issued by the governments of emerging economies or companies in emerging markets tend to carry greater risks than their counterparts in established markets. This is due to poorer credit standing, high levels of state indebtedness, debt reschedulings, a lack of market transparency or inadequate information on the markets or companies concerned. Moreover, different valuation standards and the absence of reliable ratings make credit risk assessment a much more difficult undertaking.

Exchange-rate risk

The currencies of emerging-market countries are more susceptible to pronounced and unpredictable fluctuations. It should also be noted that certain countries impose currency export controls or are liable to introduce them at short notice. Although hedging can minimise losses caused by exchange-rate fluctuations, such losses cannot always be entirely excluded.

Market risk

Because of their underdeveloped financial market monitoring mechanisms, emerging markets often suffer from insufficient transparency and liquidity as well as poor regulation and inefficiency. These markets are relatively volatile and display wide price variations. With regulation poor or absent altogether, there is a heightened danger of market manipulation and insider dealing.

Liquidity risk

Liquidity levels will depend on supply and demand. The supply and demand situation in emerging markets will tend to change much more rapidly and lastingly in response to social, economic or political developments or natural disasters. In an extreme case, an emerging market might become illiquid, preventing the investor from disposing of his or her other investment.

Regulatory and legal risk

If financial market supervision is inadequate or non-existent, legal claims might be difficult or impossible to assert. In addition, where the judiciary lacks the requisite experience, legal uncertainty may be widespread.

Settlement risk

Certain emerging markets have an array of different clearing and settlement systems or none at all. Such systems are generally outdated and prone to commit processing errors or cause long delays in settlement and delivery.

Shareholder / creditor risk

Legislation to protect shareholders and creditors (e.g. reporting duty, ban on insider trading, prescribed management responsibilities, protection of minority shareholders) is frequently inadequate or even non-existent.

Your contact – wherever you may be

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