

# Warrants and Covered Warrants

## Fact Sheet

A warrant gives the holder the right, but not the obligation, to buy or sell an underlying equity, or index, at a specified price (the strike price), on or before a specified date. They offer private investors the opportunity to benefit from falling as well as rising markets; if you believe the price of the underlying security is going to rise then you would buy

a 'Call' warrant, alternatively if you believe the underlying price is going to fall then you would buy a 'Put' warrant. They also offer the potential to protect existing portfolios against adverse movements in the market and the possibility of higher returns through gearing.

There are two types of warrant: 1) A warrant issued by company 'A' and the underlying security is company 'A', and 2) a covered warrant which is issued by a financial institution, company 'B', and the underlying security is company 'A'. Warrants have traded on the stock market for many years, but covered warrants were only launched by the London Stock Exchange in 2002. The term 'covered' refers to the fact that the financial institution offering the warrant will cover their position with the actual underlying stock.

Warrants carry very few rights. Holders are not entitled to any dividends and have no voting rights. In addition, if you do not exercise your subscription right by the expiry date then your warrants will expire and you could lose what you paid for them.

### HOW DO I BUY WARRANTS?

You can buy them in the same way as any other quoted security. You will receive a certificate (which will set out the terms in which you can exercise your subscription rights) or they can be held within a Nominee or an ISA.

Warrants can be issued as a bonus to shareholders or as an incentive to encourage shareholders to partake in a rights issue or open offer.

**Because of the gearing, warrants are very speculative; therefore a *Complex Instruments: Appropriateness Assessment Form* must be understood and completed before dealing.**

### WHY BUY A WARRANT?

A warrant can provide an opportunity to buy the underlying security, in the case of a 'Call' warrant, at a discounted price to the share price. In order to calculate the discount we need

to take into account the warrant strike price and price paid for the warrants (the premium).

Let us consider the following example. Company XYZ shares are trading at £1.00 per share and the company issues warrants as a bonus to existing shareholders. Each warrant is exercisable into one ordinary share at a strike price of £1.50. If the underlying share price was to increase to £2.00 per share the investor may decide to exercise his warrants at £1.50. In this instance the investor is paying 50p less to buy the shares than if he were to buy them directly in the market.

*Of course, in this example the investor received the warrants free of charge. If the investor had bought the warrants, the premium paid for them would have to be taken into account when calculating the discount. For example: underlying share price - (premium + strike price) = discount; underlying share price £2.00 - (premium 20p + strike price £1.50) = discount of 30p.*

Warrants can also be used to hedge an investment. For example, 'Put' warrants work against a falling share price, therefore potential losses are offset by an increase in the value of the warrant. It can be viewed as taking out insurance, which you may not need to use if the price of the underlying investment increases but is taken out just in case it does not.

Another advantage is the gearing element, to speculate on the movement of the underlying share price of an asset. The premium paid (price paid for a warrant made up of so-called intrinsic value and/or time value - see below) is a fraction of the value of the underlying asset, but the movement of the price of the warrant is exaggerated, therefore allowing the potential to maximise returns from favorable price movements. See the table below:

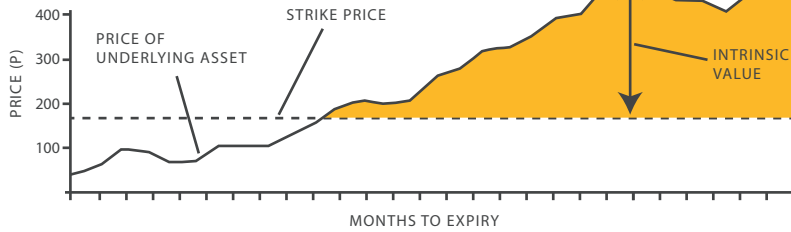
SHARE/ WARRANT	AVAILABLE FUNDS TO SPEND	PRICE WHEN PURCHASED	NUMBER OF UNITS PURCHASED	PRICE INCREASED TO	VALUE OF FUNDS (£)
Share	£1000	1.00	1000	1.20	1200
Warrant	£1000	0.10	10000	0.30	3000

The table shows that if the share price moves up 20p then the profit on the shares is 20%, while the same movement in price on the warrant results in a profit of 300%. A relatively small movement in the underlying security results in a disproportionate move in the warrant price. Of course, this can work for you as well as against you. This all contributes to the volatility of warrant prices.

## TIME VALUE



## INTRINSIC VALUE



## GLOSSARY OF TERMS

**CALL:** A covered warrant that gives the holder the right, but not the obligation, to BUY the underlying at a future date and specified price.

**PUT:** A covered warrant that gives the holder the right, but not the obligation, to SELL the underlying at a future date and specified price.

**PREMIUM:** The price paid for a warrant - this is made up of Intrinsic & Time Value.

**STRIKE PRICE:** The price at which the investor may buy or sell the underlying investment up until the expiry date.

**TIME VALUE:** The longer the life of a warrant, the more expensive it will be.

**INTRINSIC VALUE:** The difference between strike price & the market price of the underlying investment.

**EXPIRY DATE:** The day on which the warrant may no longer be exercised or traded.

For further information, please contact your local **Redmayne Bentley office** or call **0113 243 6941**.

Investments and income arising from them can fall as well as rise in value and you may lose some or all of the amount you have invested.