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NEW MARKET FOR COVERED WARRANTS

READY FOR RAPID GROWTH AFTER FIVE STEADY MONTHS

The pace of development of London's fledgling covered warrants market has attracted some comment recently. The advantages should appeal to sophisticated investors over the long term however

There are signs that UK investors may be getting to grips with the newly launched covered warrant market. Both the number of trades and the volumes traded have risen steadily, if not spectacularly, since covered warrants were introduced by the London Stock Exchange (LSE) at the end of October last year. In March 2003, the LSE reported record trading in covered warrants, an 84 per cent increase on February 2003 (2708 trades in March 2003, compared with 1472 trades in February 2003).

The pace of growth has disappointed some commentators, but this is a market that was always going to build over time, as sophisticated investors become familiar with the advantages that these derivatives have to offer. (See chart on page 40.)

Covered warrants give investors the right, but not the obligation, to buy an underlying asset at a specified price at a specified time. Buying a "call" warrant means that investors are hoping that the price of the underlying asset (and hence the warrant) will rise over time, while a "put" warrant rises in value when the price of the underlying asset on which it is based falls. Clearly the ability to effectively "short" the underlying asset is, like other derivatives, a key advantage of covered warrants.

The other key advantage is the gearing inherent in a covered warrant, which means that the purchase price (or premium) is typically less than the price of the underlying asset. The gearing therefore allows exposure to an underlying share, index or commodity with less financial outlay than trading the share itself. Similarly the gain (or loss) can be greater than actual movements in the underlying investment. However, unlike other derivatives, the maximum loss from the investment is limited to the premium paid.

GEARED RETURNS

One might assume that the ability to make money from falling markets would, in the current environment, have led to a far greater degree of trading than has been seen to date. The reality though is that investors, for mainly psychological reasons, always prefer – and trust themselves – to go long rather than short.

This is the case with all derivatives. Even in bear markets, the number of calls always vastly exceeds the puts, whether it be spread betting, options or covered warrants.

Almost every other covered warrant market in the world launched in the midst of a bull market, a time in which investors were much more likely to experiment in a new form of derivative.

So to compare the first five months of covered warrant trading on the LSE with current trading statistics from covered warrant markets around the world is to compare apples with pears. What is more interesting is to

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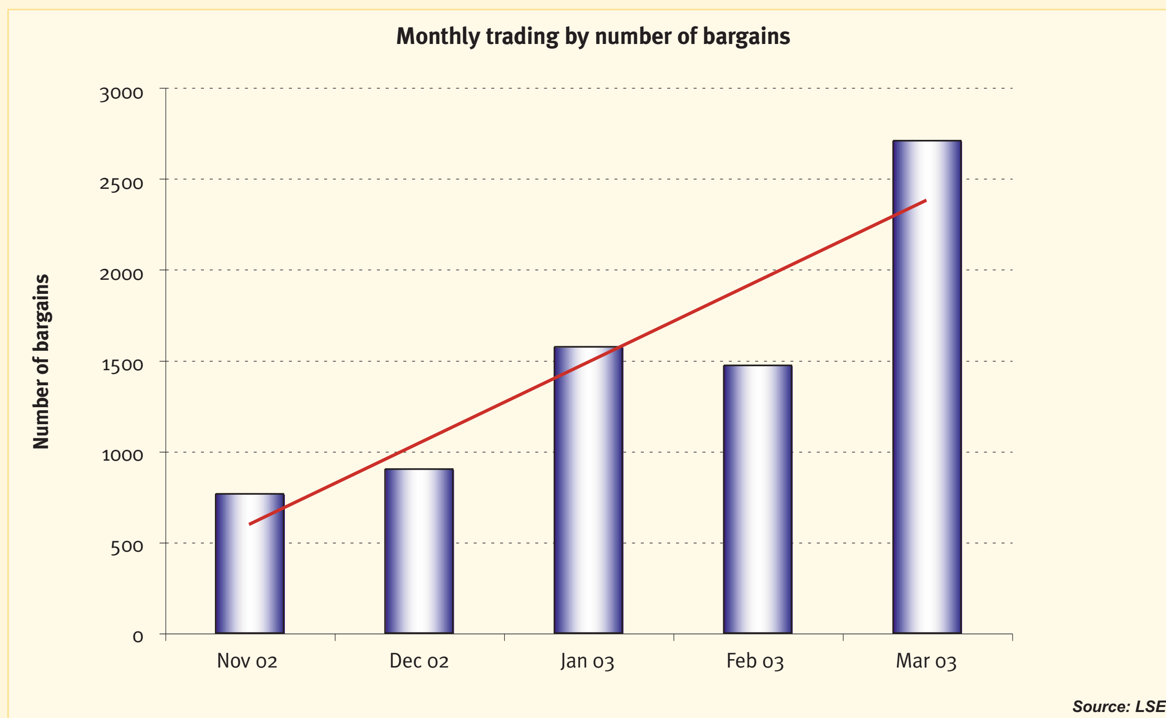
Chris Broad, LSE



compare the launch of the London market with the launch of other covered warrant markets.

In almost every case, trading has built slowly. For example, the Spanish and Australian markets took three to four years to reach the trading levels that the LSE has witnessed after just five months. The German market, which is now the largest covered warrant market in the world, began with just one issuer and only a handful of trades. Even the huge Italian market only began with 300 trades a day, and this was after five years of off exchange trading.

Each of these markets started slowly and exploded only when they had been established for some time and investors had been educated sufficiently for them to have the confidence to trade regularly. The London covered warrant market will surely develop in the same way, a point not lost on the LSE and the four issuers.

FOUR ISSUERS

Since the launch of the covered warrant market, the four issuers, Goldman Sachs International, JPMorgan, SG and TradingLab have launched a total of 448 warrants (29 have since expired). The underlying assets on which they are based range from individual equities, to indices such as the FTSE 100 and commodities such as gold and oil. Unlike some other derivatives, they have the advantage of being exchange-traded, meaning that prices can be accessed easily at all times, and traded through an investors' normal stockbroker.

Covered warrants can be exercised at any time, but only profitably when the warrant is "in the money". This is where the price of the underlying asset is greater (call) or less (put) than the strike price, otherwise known as the exercise price.

They are particularly useful to sophisticated investors as part of an overall portfolio. They are often successfully used to hedge exposure to existing investments. For example, a covered warrant can be easily used to offset the risk of holding an individual equity – a useful tactic when markets are as unpredictable as they currently are.

They do carry risk though. A covered warrant that expires "out of the money" – where the price of the underlying is less than (call) or greater than (put) the exercise price – can often mean the loss of the entire investment.

So, while covered warrants should appeal only to a niche audience, they do hold significant advantages for the investor. These advantages will almost certainly mean that the trading will continue to grow steadily and will undoubtedly take off just as soon as the market does. Precedents from other covered warrant markets around the world point to a period of slow growth before exploding.

Should the London market follow this trend, it is likely to become one of the biggest covered warrant markets in the world.

EXAMPLES

BUYING A CALL COVERED WARRANT

Investors who anticipate an increase in the price of an underlying share can buy a call covered warrant instead of the underlying share at a fraction of the price.

Here is an example of a call covered warrant:

Covered warrant type	call
Issue date	March
Issuer	XYZ Bank
Underlying asset	ABC plc (current share price 200p)
Conversion ratio	1:1
Exercise style	American

BUYING A 200p SEPTEMBER CALL COVERED WARRANT AT 50p

An investor is interested in buying a September call covered warrant, based on the expectation that the share price will rise in the future from its current level today (April) of 200p.

If the investor buys the call covered warrant with the exercise price of 200 today (April), it will cost him 50p to own the right, but not the obligation to buy the underlying asset. Being American style, exercise can take place at the pre-agreed price (exercise price) of 200p at any time between now and expiry day (September).

EXPIRY OF THE CALL COVERED WARRANT

To illustrate the various outcomes at the final expiry day under different market conditions we can refer to the following table:

POSSIBLE OUTCOMES

Asset price at expiry	Net profit/loss	Value of 200p call at expiry
100	–50	0
150	–50	0
200	–50	0
250	0	+50
300	+50	+100
350	+100	+150

If the share price of ABC plc is at or below 200p at expiry in September, the holder of the call covered warrant is under no obligation to exercise the call.

After all, why buy the asset at 200p via the call, if it is currently only worth 100p in the underlying market at expiry? The holder of the call in this situation would abandon the covered warrant, as it would be worthless (due to the option of abandonment, a covered warrant cannot have a negative value).

This illustrates an important point about buying covered warrants, ie, the maximum loss to the holder of a covered warrant (call or put) is the premium, in this case 50p and no more.

If the ABC plc share price is above 200p at expiry, the buyer of the call covered warrant could exercise his right to buy the shares at 200p from the issuer and in doing so he would be in a net profit position.

NET PROFIT OF A CALL COVERED WARRANT

To work out the net profit of a call we can use the following calculation:

Asset price at expiry – (exercise price + premium paid) = net profit

Suppose the asset at expiry was 300p, net profit would be: **300p – (200p+50p) = 50p profit**.

HOLDER'S RIGHTS

EXERCISE, CLOSE OUT OR ABANDON

The holder of the 200p call covered warrant can exercise the right to take delivery of the share at 200p, even though the share may be worth 300p in the open market.

The issuer of the call covered warrant is obliged to deliver the share at the price of 200p. The 200p call covered warrant premium at expiry therefore, should now be worth 100p (originally 50p).

This can be illustrated another way by saying that the holder of the call covered warrant, having taken delivery of the shares at 200p could now sell the shares immediately back in the open market at 300p at expiry, and make 100p profit (for this reason the covered warrant premium at expiry should be 100p).

Let's not forget, however, that the covered warrant originally cost 50p, so the true net profit on the exercise is 100p – 50p = 50p.

Realising a profit or loss therefore can be generated in several ways. The first is to exercise the covered warrant and then trade the stock back in the underlying market. Or, simply sell the covered warrant back to the issuer in order to close out the original purchase of the covered warrant.

Most users will close out their positions prior to expiry. Another method is to let the covered warrant lapse worthless at expiry, ie, abandon it.

Chris Broad,
London Stock Exchange

CORPORATE STATEMENT

The London Stock Exchange is one of the world's leading equity exchanges and a leading provider of services that facilitate the raising of capital and the trading of shares. The most international equities exchange, it trades in the world and Europe's largest pool of liquidity. By the end of 2002, the market capitalisation of UK and international companies on its markets amounted to £3100bn, with £4600bn of equity business transacted over the year.

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