Citadele

DESCRIPTION OF FINANCIAL INSTRUMENTS AND RELATED RISKS

The objective of each investor is to *receive a positive return on investment and to maximize it to the extent possible.* However, there always exists a risk of negative investment returns which translates into investment loss. Every type of financial instruments entails different risk of loss because profit forecasts are usually associated with a risk of incurring losses. It is usually considered to be a safer option to diversify your investments by acquiring a variety of financial instruments rather than investing in just more or more than one financial instruments. This enables the investor to diversify investment risk and avoid concentrating risk factors which can occur all at the same time.

SHARES AND RELATED RISKS

Shares. Shares are securities that represent an ownership. All corporate shares are registered shares and are classified into ordinary shares and preference shares based on the rights that they confer upon their holders.

Ordinary registered shares grant certain entitlements to their holders, e. g. the right to receive dividends as well as other rights. Preference registered shares give the holder the right to certain dividends but do not entitle them to vote in general shareholders' meetings. In the event of the company's insolvency, the holders of preference or ordinary registered shares are entitled to the assets of the company after the company makes payments to bond holders and holders of other debt instruments. However, in this case preference shares give their holders preferential treatment in respect of the owners of ordinary registered shares. A company can issue different classes of shares. These classes can be marked with a letter, starting with A. Classes of shares are often associated with voting rights granted by such shares. Class A shares grants more votes to their holders than class B shares, etc. When issuing different classes of shares, attempts are usually made to retain the influence of the company's founders by granting a higher number of votes to them than to the shareholders who have purchased the shares from later issues and of different classes.

Based on the degree of risk, shares bear a higher risk than bonds, deposits or funds. However, they are more secure than derivative instruments. The degree of risk is reflected in the fluctuation of share prices. An unfavorable global, regional, national or sector situation may result in the decrease of share prices. The share risk encompasses capital, credit, country, currency, liquidity, legal and regulatory risks. In case of a high turnover, the difference between financial intermediaries' bid/ask prices for a particular share will decrease. A share with high turnover is often of high liquidity and is therefore easy to buy and sell. Large positions can be bought and sold in such shares without affecting their price. Shares may experience price changes during the course of a day or a longer period of time, if we look at the share volatility, e. g. the magnitude and frequency of changes in the share price in relation to its average price over the period. The company's shares can have more than one listing and in more than one country. In this case, the share price in one market will have an impact on the price of shares sold in another market, if trade is conducted via financial intermediaries. The share price may vary due to fluctuations in the share prices of other companies, regardless of whether these shares belong to the same sector or not, whether they are listed on the same exchange or not, and whether they are traded in the same country or abroad.

Debt securities (bonds) and related risks

Bonds. Bonds are a type of securities whereby the issuer becomes the debtor of the holder of debt securities and is obliged to repay the principal amount (par value) and interest if such were foreseen in the issue conditions of debt securities, at pre-defined terms. Interest can be paid in different ways subject to the defined conditions. Interest may be paid all at once at the time of repaying loan (repaying the bond), or, in case of a long maturity term, it can be paid in certain intervals, depending on the defined conditions. While it is one of the most safe investment instruments, it offers a moderate potential return.

Bonds are known as fixed-income securities because investors know the exact amount of cash their will get back. However, a company may be entitled to repay the bond before the maturity date which can result in loss due to the decreased bond market price. The bond's market price depends on the market interest rate effective on a given date. An increase in interest rates will drive down the price of a bond. Alternatively, a decline in interest rates will result in the increase of bond prices. Since the bond is a loan and the holder of the bond is a lender, investment in bonds is associated with the issuer's bankruptcy risk. The price fluctuation range of debt securities is smaller than that of the ownership securities. The repurchase of debt securities and interest payment is warranted by their issuer, thus the investor assumes the bankruptcy risk of the issuer. If debt securities are sold before the maturity date, the investor can incur loss as a result of the decrease in market price. Bonds can have different maturities (from 1 to 30 years), currencies and profitability levels. Debt securities can be sold before their maturity date and make additional profit from positive changes in the prices in case of a favorable market situation. Interest income received by natural persons is not subject to income tax. Profitability ranges between low to moderate. Liquidity depends on market conditions. Government debt securities offer high levels of liquidity.

Structured bonds. Structured bonds are securities linked to other financial instruments. The repurchase amount of structured bonds directly depends on the changes in a financial instrument to which a structured note is linked. Structured bonds are risky in that they are linked to shares, raw materials or other highest-risk assets. Unlike direct investments in shares, index funds or mutual funds, investments in structured bonds are insured. The issuer guarantees that, even in the event of the decline in the value of the financial instrument to which bonds are related, the amount to be paid to the holders of the bonds upon repurchase will not be lower than the nominal value of the bonds. If you are planning to purchase structured bonds, you may expect an investment return typically expected from the stock market which is often greater than the return you get from investments in fixed-rate bonds. However, before acquiring this type of bonds, one should assess the risk inherent in these financial instruments (yield risk, liquidity risk, risk of frozen funds, cancellation risk, etc.). Another relevant short term risk is loss of purchase commissions which are usually higher than those of bonds or shares.

Investment funds and related risks

Mutual funds. Mutual funds are assets owned by many investors under the common partial property right the management of which is entrusted to the fund management company. These are money pooled in by a large number of investors to invest in shares, bonds, money market instruments, other financial instruments or their combinations.

The level of risk in a mutual fund depends on the type of the fund. There exist several different types of mutual funds (shares, bonds, mixed, money markets, etc.), each bearing a different degree of risk. Money market mutual funds are the lowest risk type of mutual funds. Highest-risk mutual funds invest in the shares of developing markets. Investment fund rules and investment strategies also vary from fund to fund, thus the investor faces different investment costs and different purchase and sale procedures. In the long run, the prospects of the country or market in which the mutual fund invests experience changes, thus it is advisable to regularly reassess the existing situation. If you choose to invest in a mutual fund, you do not need to track the changes in the stock market and worry about the buying and selling of corporate shares as this task is delegated to the fund manager.

Repurchase and reverse repurchase agreements and related risks

Repurchase (REPO) agreement. A repurchase agreement is a credit granting transaction whereby one party who borrows money sells his securities to another party who lends him money. These securities are repurchased on the date agreed on the basis of the repurchase agreement. The different between the sale and repurchase prices is interest paid for the loan granted. With the help of this agreement, the seller of securities borrows money to satisfy temporary liquidity need, whereas the buyer of these securities safely invests his free cash. A distinctive characteristic of repurchase agreements is that they increase the liquidity of securities and in this way make a positive impact on the secondary market activity. For the person who sells securities it is a repurchase agreement, whereas for the one who purchase securities it is a reverse repurchase agreement.

Repo transactions expose investors to the highest level of risk. Besides regular risks associated with investing in shares, there exists the risk of interest rate fluctuations. Also, there is a risk of losing borrowed money as well. Meanwhile, there are no limits on losses if you purchase securities.

Derivative financial instruments and related risks

Derivative financial instruments. These include options, futures, swaps, forward rate agreements, contracts for difference and any other derivative contracts and derivative instruments relating to securities, currencies, interest rates and yields, exchange products or financial indices which may be settled in cash.
The following are the main types of derivative financial instruments:

1. Forward contracts;
2. Options;
3. Swaps.

A forward contract is an agreement between two parties to buy or sell an asset in future at a pre-agreed price.

An option is an agreement under which the issuer is obliged to buy or sell specified assets for a pre- agreed price.

A swap agreement is an agreement whereby parties agree to periodically exchange interest payments or currencies, such as fixed interest rate for a floating interest rate payments or where parties swap different currencies.

The decision to invest in derivative instrument is made based on expectations related to the changes in the value of assets or other indices over a specified period of time. A derivative instrument can offer a high return but in the event of adverse market conditions the investor can incur high losses including total loss of invested money. The investor should have a clearly defined investment objective and be aware of the degree of risk, and be ready to take actions to avoid losses in the event of adverse or rapid changes in the market.

RISKS INHERENT IN FINANCIAL INSTRUMENTS

Capital risk. The risk that investors will lose a large portion of their invested money and will not get back their invested money at all or will not get back a full amount invested.

Inflation risk. The risk that the purchasing power of money might drop as a result of the increase in the prices of commodities and services, which means that you can buy less for a specified amount of money.

Timing risk. This type of risk is related to the best timing to enter or leave the market. There always remains a risk of receiving a lower return on investment due to error in timing.

Market risk. This type of risk is related to a variety of market factors that may have an impact on the decrease of the investment value. These may include instability of the national currency rate, decrease in share price, instability of interest rate, decrease in prices of certain products and other factors. This type of risk, as in the case of the above-mentioned capital risk, is not directly related to the issuer but rather more dependent on macroeconomic indices.

Liquidity risk. This type of risk arises due to the fact that invested money cannot be recovered at a desirable moment, e. g. trading of shares may fail due to the lack of buyers. From this perspective, it is important to invest in a liquid market.

Currency risk. This type of risk stems from investments in securities in a foreign country where rate of exchange is instable which may lead to significant decrease in the returns of investment due to exchange fluctuations.

Legal regulation. Before investing in the stock market of a remote or little known country, it is important to examine the legal regulation of this country. Also, besides taxes and other aspects directly relating to investments, it is important to look into such factors as political stability and perspectives of the country. Our expert team of specialists are ready to offer you advice on any issue related to legal regulation.