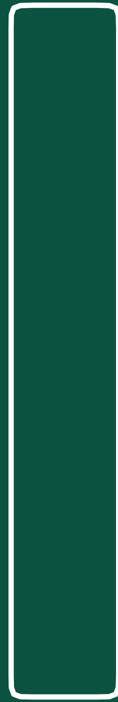

# Your risk when investing

## Investment Categories and Risk Warnings

This booklet gives information to help investors understand the nature and risks associated with some of the more common investment categories that may be included in an investment portfolio, thereby enabling them to make informed investment decisions.

It should not be viewed as a comprehensive disclosure of all the possible investment categories that may be contained within a portfolio, nor of all the risks and features associated with the investments described.

All investments will pose a degree of risk of some kind. Investment prices/values and investment income may fall as well as rise, and you may get back less than you invested. Indeed, you may risk losing your entire investment. Note that past performance is no guarantee of future performance.

# 1. Bonds

In principle, a bond is a loan made to the issuer of the bond, who in return for the loan pays interest to the bondholder. The interest on the loan is repaid at an agreed date(s). In the event that the issuer experiences financial difficulties, there is a risk that it will not be possible to make the interest payments when they fall due or not be able to repay some, or all, of the loan at its maturity.

Bonds have a nominal value, which is the amount that must be repaid to the lender at maturity, and a market price, at which the bond can be bought and sold for in the bond market. The market value may be higher or lower than the nominal value. The market value can fall as well as rise and can be influenced by a number of factors. These factors include:

- the issuer's credit rating (which can go up and down depending upon the perceived financial strength of the bond issuer)
- inflation rates - in times of rising inflation an investment in some bonds may look less attractive, and this can cause their market value to fall
- general market interest rates (when market interest rates are lower than the interest rate offered on a particular bond, then that bond can be an attractive investment and demand a higher price than in times when the market interest rates are higher than the particular bond interest rate)

Bonds as an investment category are generally considered a relatively reliable investment, posing relatively lower risk and a more stable return when compared to investments in shares (equities). In certain circumstances, however, the general bond market can become more volatile (particularly when interest rates are fluctuating), and depending on the individual bond's characteristics and credit rating, it can represent a high investment risk, so certain bonds can be even more risky than some equities. There is no guarantee you would get all, or even some, of your money back when investing in bonds (see risks described below).

You can buy bonds issued by sovereign states, corporations, or mortgage credit institutes. Bonds can be either fixed rate bonds, paying you a fixed interest income, or floating rate bonds paying you variable interest income.

Bonds issued by governments of stable countries or by large financially secure corporations are generally considered to pose lower risk than those issued by issuers based in emerging markets or by smaller companies, but ultimately bonds do not guarantee a return and there is always some degree of risk that you may not get back the money invested.

Some bonds, (most commonly some corporate bonds), can have special conditions attached to them that you should be aware of, and that can affect the level of risk related to a particular bond. For example, there may be a clause that allows the bond issuer to redeem (pay back) the bond early (see early redemption risk described below).

- **Government bonds:** Government bonds are issued by sovereign states or state-guaranteed undertakings. Bonds issued by sovereign states which benefit from political stability and have a high credit rating are generally considered low risk investments since the probability of default is minimal. Some states, however, may have low credit ratings and thereby carry a higher risk of default. You should therefore consider the rating of the bond.

- **Corporate bonds:** Corporate bonds are issued by corporations and are typically used to finance a company's investment and operations. When purchasing these bonds, you must consider the company's credit rating, which is often lower than the credit rating of sovereign states and mortgage credit institutes. The credit rating will vary highly from company to company. Generally, the lower a company's credit rating the higher the investment risk. In return for the higher risk, you are likely to receive a higher investment yield to maturity (assuming the issuer does not default).

- **Mortgage bonds:** Mortgage bonds issued by mortgage credit institutes are typically used to finance home purchases. These institutes often have a high credit rating. If you buy mortgage bonds, you should be aware that you may risk early redemption (repayment) of your bond, since some bonds can always be redeemed at 100 (par) even at times when the bond may be trading above 100 (par) on the bond market. As a compensation for this risk, you are likely to receive higher interest than you would receive on a corresponding bond that cannot be redeemed at 100 (par).

## Return

The total return depends on both the price and the nominal interest on your bonds. If you have purchased a bond with a fixed interest rate, you can expect a fixed interest income which is paid on the nominal amount of the bond (not the amount that you paid for the bond).

When you buy the bond, you pay a price which is determined by the market. This price may be more (above par) or less (below par) than the nominal value of the bond. The nominal value of the bond is repaid to you at maturity, and not the amount that you paid when you bought the bond.

The return you can expect on your bond is normally expressed as the yield to maturity. This amount is dependent upon you holding the bond to maturity (rather than selling it in the market prior to maturity). The return considers the price that you pay for the bond and the interest that you will receive on the nominal value of the bond over its remaining term (up until maturity). The yield to maturity calculation will also assume that the interest received on the bond is reinvested at the same interest rate during the bond's lifetime (which may not always be the case).

The bond's price in the market will vary over time and can go down as well as up, so selling a bond before maturity may get you a lower price than you paid for it. The bond's value in the market will therefore influence your total return if you sell it before maturity.

If you purchase a bond with a floating interest rate, the interest income will fluctuate while the market price on the bond is likely to be more stable.

## Risks

Risks associated with bonds include:

- **Default risk:** A bond may become worthless if the issuer defaults. Credit rating agencies such as Standard & Poor's, Moody's and Fitch grant credit ratings to bond issuers and these can help an investor assess the risk of default. Typically, there is a correlation between the credit rating of the issuer and the risk/return. The lower the credit rating, the higher the risk and potential for return. Even if the bond issuer does not default, a downgrading of a bond's credit rating by a rating agency can lead to a drop in its market value, which can affect the return on a bond investment if sold in the market before maturity.

- **Interest rate risk:** The risk that bond prices may fall as market interest rates rise (market interest rates fluctuate and are influenced by outside factors such as the strength of the economy, inflation rates and government fiscal policy). The price on your bonds may fluctuate in step with changes in the market interest rate level. The longer to maturity of your bond, the more sensitive it will be to changes in the interest rate level. Since floating rate bonds are mostly linked to short term rates, the price on these bonds tend to have very low sensitivity to changes in the market interest rate level.

- **Inflation risk:** The risk that the rate of inflation in the economy reduces the value of the bond proceeds in real terms. If the inflation rate rises significantly and at a faster rate than the income received on the investment, then the purchasing power of the bond proceeds when the bond is sold or at maturity can be reduced.

- **Early redemption risk:** Some bonds can be redeemed by the issuer before maturity. These are known as callable or redeemable bonds. The bond issuer might typically use his right to redeem the bond early in times when interest rates have fallen since the bond was first issued. When a bond is redeemed, the bondholder will receive the nominal value of the bond. Bond issuers typically take advantage of this option when the market value of the bond is above par.

- **Liquidity risk:** The liquidity of bonds may vary greatly and so the possibility of selling the bond before maturity also varies. Under normal market conditions, government bonds and bonds issued by large, stable, mainstream companies are readily tradable, but in times of instability and extraordinary market conditions, buyers and sellers can be hard to find. In these circumstances, the bondholder may be forced to accept a lower price than expected to sell the bond or may not even be able to find a buyer at all in the short term.

- **Currency risk:** If you buy a bond denominated in another currency than your base currency, you assume an exchange rate risk. (See more on currency/exchange rate risk described under point 5 below).

- **Concentration risk:** (see more on concentration risk described under point 6 below).

# 2. Shares (Equities)

A share is a stake in a company. When buying shares, you become co-owner of the company (a shareholder). This means that your investment is dependent on the performance of the company.

Shares are traded in a stock market and are generally purchased in the expectation that the share price will increase as the company grows and makes profit. The strength of the company and its ability to make money influence the market price of your shares.

## Return

A company may choose to pass on a share of its profits to its shareholders by paying them a dividend. A company will usually decide annually whether to pay a dividend to its shareholders. Whether or not it does so will usually depend on whether or not there are any distributable profits available within the company and whether or not it is thought to be in the best interests of the company to pay a dividend, or alternatively to retain profits in order to strengthen or grow. There is therefore no guarantee that a dividend will be paid.

Unlike bonds, there is usually no requirement on the company to eventually return the capital to the shareholder unless it chooses to do so, or the shares include redemption rights (which typically they do not). The only way for a shareholder to redeem his/her investment is to sell the shares in the market and any return on the investment is therefore largely dependent upon the price achieved when the shares are sold.

## Risks

- **Fluctuations in the share price:** Share prices can fall as well as rise and they can fluctuate widely, therefore shares are best suited for investors with a long investment horizon. If you invest with a short-term horizon, hoping to see quick gains, then you must be aware that typically this can be highly speculative and involves great risk. There are many factors that can influence the price of a share, including the company's perceived financial strength, its historic performance and its growth prospects. Growth prospects can be influenced by many factors both internal and external, including general conditions in the economy and the economic outlook, the markets in which the company operates, its competition and the demand for its products or services.

- **Market risk:** The possibility that share prices (and thus the value of your investment in shares) fall due to a general poor economic climate levels or negative sentiment prevailing in the financial markets generally or in a particular market segment. Shares as an investment category tend to follow the overall trends and cycles in the market, and often the market sentiment will move almost all shares up or down together as a group.

- **Liquidation or bankruptcy:** The company in which you hold shares could go into liquidation or declare bankruptcy in which case the value of your shares could fall to zero and you could lose all the money invested.

- **Liquidity risk:** Shares listed on major stock exchanges generally enjoy good liquidity but, depending on market conditions, the liquidity of some listed shares may be depressed in certain market conditions. Shares listed in secondary or alternative investment markets may prove harder to value and be prone to less liquidity.

- **Currency risk:** If you buy a share denominated in another currency than your base currency, you assume an exchange rate risk (see more on currency/exchange rate risk described under point 5 below).

- **Concentration risk:** Please see concentration risk described under point 6 below.

- Investments in shares of very low value (sometimes known as penny shares) tend to involve higher risk than mainstream, listed shares.

# 3. Collective Investment Schemes (often referred to as funds)

When you invest in mutual fund units, you become a member of a mutual fund. This means that your money is ‘pooled’ together with other investors, and in doing so you get assistance from professional fund managers who monitor the market and select the underlying investments held within the fund.

An investment in a mutual fund generally enables a small capital investment to be spread across different securities/assets and, depending upon the nature of the fund, different market sectors, with a view to reducing concentration risk. Your overall return is therefore unlikely to be affected to the same extent, should one of the issuers of an individual security or (if not a sector-specific fund) a particular market sector, held within the fund underperform or default. However, you would need to carefully consider the type of diversification that the fund offers, since some funds can be set up to invest in a single market sector. For example, an investment into an IT equity fund would spread your risk across many IT companies but would be exposed solely to the IT sector. The performance of the fund is therefore closely linked to the development in the IT sector. See below under point 6 for more information about using diversification to reduce concentration risk.

Investments held in funds commonly include quoted equities (shares), corporate bonds and government issued bonds, but depending upon the type of fund may also include investments in real estate, unquoted securities, derivatives, structured products, and other high-risk investments.

An investment in a fund should generally be regarded as long term, and you should not invest money that may be needed in the short term.

## Return

The fact that a fund has performed well in the past is no guarantee that it will continue to do so in the future.

When you invest in a fund, you buy fund units with the expectation that the unit value will increase over time. Whether or not it does so depend upon the performance of the underlying investments held within the fund. The value of the fund units (and thus your investment) can decrease as well as increase and you could get back less than you originally invested.

Some funds (Distributing Funds) will periodically pay a dividend to their members, whereas others do not pay dividends (Accumulating Funds).

**Distributing funds**
Your return consists of a possible dividend payment (usually considered annually) and the performance of the fund. The performance of the fund is based upon an increase or decline in the net value of the underlying investments, (i.e. the aggregated value of the fund’s portfolio of securities/assets) and is reflected in the unit price.

**Cumulative funds**
Cumulative funds do not pay dividends. Instead, any income generated by the fund is re-invested in the fund’s assets. The re-investment is reflected in the fund value/ price and therefore your return depends solely on the performance, and any return is only realised on the day you sell your units.

## Risks

Before investing in any fund, you should make sure that you understand its nature and the risks that it poses. To help you do this, you should read and understand the fund's Factsheet and Key Investor Information Document (KIID), which will give you important information about the fund's objectives, risk and costs related to the investment.

Different funds will involve different levels of risk, depending upon several factors including:

- **Market risk:** The market sectors and geographic areas in which they can choose to invest. For example, investments in emerging markets, where there may be more political and economic volatility and less financial regulation would generally carry higher risk than investments in an established and more stable market.

- **Diversification risk:** The levels of diversification within the fund. For example a fund which is set up to invest in one particular sector (for example Information Technology), or a specific region (for example Africa), would carry more risk than a fund set up to invest across a wide range of sectors or geographic regions.

- **Liquidity risk:** Funds that invest in real estate and other illiquid assets can themselves be illiquid particularly at times when the underlying market is depressed, and as such, there may be times when investors in property funds and some other funds are unable to sell their units.

- **Currency/ Foreign exchange risk:** If you invest in a fund denominated in another currency than your base currency, you assume a currency risk.

  Similarly, if the underlying assets held in a fund are in a currency or currencies other than those in which the fund is denominated, then investors will be indirectly exposed to currency risk.

  Please see below under point 5 for more about currency risk.

  **Gearing:** Some funds have the power to borrow money to make further investments. This is commonly known as 'gearing'. In a rising market, gearing has the potential to increase the level of return on the fund's investments, however, when markets are falling, losses on a geared investment can also be significantly increased, and as such gearing can greatly increase the level of risk associated with a fund (and ultimately the risk of capital loss). (See more on currency/exchange rate risk described under point 5 below).

  Some funds may not be regulated, meaning that they are free to invest and impose restrictions on when units can be sold as they see fit. Amongst others, hedge funds, property funds, and private equity funds are often unregulated.

# 4. Exchange Traded Funds (ETF)

An ETF is an investment fund, the shares of which are traded on an exchange. They may be of interest to investors wanting good diversification of their investment and who are interested in a return and risk that closely match that of a specific reference portfolio (also known as a benchmark).

The benchmark can be a broad equity index, such as FTSE 100 or the S&P 500, or it can be linked to an index of bonds, commodities, or currencies, or represents a specific market sector or commodity.

An ETF is similar to a mutual fund, the main difference being that most ETFs tend to have no active portfolio management or personal evaluation and assessment of the potential of the individual assets in which they invest. ETFs are subject to passive management in that they are solely intended to track the

specified benchmark as closely as possible. The costs associated with ETFS are generally lower than those associated with traditional mutual funds since management expenses are typically lower.

With a small amount of capital, you can spread your risk across many different securities by purchasing an ETF. Your return is therefore not as exposed to negative events that might affect an individual company or asset relevant to that index. This is because the fund tracks the benchmark index. On the downside, however, there is little opportunity to take advantage of the potential for high returns offered by investments in individual assets or actively managed mutual funds.

ETFs are listed and tradable throughout the trading day just like equities. The benchmark indices often comprise very many equities, and it would be costly for the ETF to invest in all equities included in the benchmark. Therefore, some ETFs select a portfolio intended to approximately track the benchmark. The deviation between the assets of the ETF and the benchmark is called the tracking error. It is worth noting that ETFs differ from each other in expenses and tracking error, but also in management, benchmark and structure. Hence, some ETFs may be actively managed, and some ETFs may invest in the benchmark by means of swap contracts instead of a direct investment in the physical equities. You will be able to find out more from the relevant ETF Factsheet.

## Return

Your return is the sum of any dividends distributed by the fund (if any) and the change in the value of your shares in the fund (plus or minus) upon sale. Note that not all ETFs pay dividends.

The development of the net asset value of the fund will see an increase or decline in the price, i.e. the value of the underlying securities/assets. Your contribution to the operating expenses of an ETF will lower your return. The expenses will appear from the Factsheet on the ETF.

## Risk

Before investing in an ETF, you should make sure that you understand the nature of the fund, the index that it tracks and the risks that they pose. To help you do this, you should read and understand the fund's Factsheet and Key Investor Information Document (KIID), which will give you important information about the fund.

In addition to the risks associated with an investment into any type of collective investment scheme (described under point 3 above) you should also consider:

- **Index risk:** You will need to consider the specific risks posed by the underlying index. The performance of an investment in an ETF will be largely dependent upon the performance of the underlying index. It is therefore very important for an investor to understand how the index is made up and which assets can enter or exit it to assess the risks posed by that index. For example, an ETF that tracks a bond index would generally pose lower risk than an ETF tracking a real estate index and an ETF tracking a major stock index, such as the FTSE 100, would pose a lower risk than one tracking an emerging markets index.

  The value of an Exchange Traded Fund will move in line with the index that it is designed to track. Because ETFs are generally not actively managed, the ETF will not sell a security that is underperforming or whose issuer is in financial difficulty, neither will it purchase securities that it anticipates will increase more in value than the average.

  At worst, you may lose your entire amount invested.

- **Counterparty risk:** Not all Exchange Traded Funds/Commodities hold the physical assets and instead use complex financial derivatives such as swaps to track the specified index. To do this, the ETF will need to enter into arrangements with a counterparty (usually a bank) and the investor's return is therefore dependent on the counterparty's ability to meet its obligations under these agreements. If the investment bank providing the derivative fails, the ETF, and ultimately you as an investor in the fund, could lose part or all the money invested.

- **Currency/ Foreign exchange risk:** If you invest in an ETF denominated in another currency than your base currency, you assume a currency risk.

  Similarly, if the underlying index is exposed to currencies which are different to that in which the ETF is denominated, then investors will have an indirect currency risk.

  Please see below under point 5 for more about currency risk.

# 5. More about Currency/Foreign Exchange Risk

Any investments denominated in a currency other than the currency in the country in which you live (your base currency) will pose a currency (exchange rate) risk.

Currency markets can be volatile and if the funds you have available to invest have to be converted into another currency in order to make a particular investment, then any changes in the currency exchange rate will impact either positively or negatively on the investment's value in real terms. If the investment is sold at a time when the foreign exchange rate has moved against you, and the investment proceeds are converted back into your base currency at a less favourable rate than that for which they were originally purchased, then this will have a negative impact on your investment return.

In some circumstances foreign exchange risk can be 'hedged' to protect from currency market fluctuations and reduce the currency risk. This can be done using a Foreign Exchange (FX) Forward Contract. An FX Forward Contract is an agreement to sell one currency and buy another, but at an agreed point in the future. The rate of exchange to be used is fixed and 'locked in' when the contract is made, so you are insulated from the risk posed by any subsequent adverse movements in the exchange rate up to the agreed settlement date.

Forward exchange contracts can also be used for speculative purposes but in these circumstances the contract will expose you to additional risk.

In certain circumstances, Stop Loss Orders can also be used to limit foreign exchange risk. A Stop Loss Order is an instruction given by the client to close a trade when the market moves against you by a specific amount. It is important to note, however, that when you place a Stop Loss Order the maximum amount of your exposure to losses is not guaranteed. This is because the Stop Loss Order is only activated once the limit price has been reached. The bank will then make the trade at the first available price thereafter, and your actual loss/risk could therefore be higher should the market price move rapidly beyond the limit price that you set. Also, remember that once your limit order has been executed, you are no longer able to enjoy any possible recovery in the exchange rate and recover any of your loss.

# 6. More about Concentration Risk

In general, the level of risk associated with an investment portfolio can be lowered by ensuring that the portfolio is well-diversified (spread across a good number of individual securities, regions and sectors). For example, if you have GBP 200,000 to invest, and you buy two bonds investing GBP 100,000 in each bond, and if one of the issuers of the bonds fails, you will lose 50% of your investment. On the other hand, if you spread your GBP 200,000 investment across four bonds, investing GBP 50,000 in each bond, one of which was issued by that same failed company, then you will only lose 25% of your investment.

Diversification can be achieved not only by spreading your investment across several securities or different assets but also by spreading it across different markets. In that way you can reduce your exposure to market risk. For example, if you were to invest in 10 bonds, all of which are issued by IT companies, and if there is a general downturn in the demand for IT services or products, then it is likely that the value of all your IT investments will suffer. On the other hand, if only part of your investment had been exposed to the IT sector, then it is less likely that you would be affected to the same extent.

# 7. More about Gearing (Leveraging)

When you leverage, you borrow funds to increase the amount you have available to invest. The amount that you borrow when compared against the amount of your own capital is known as the gearing ratio. For example, if you have EUR 100,000 to invest and you borrow EUR 200,000, the gearing ratio is 2:1. In other words, your capital is two times geared.

By increasing the amount available to invest you can increase the potential gains. However, you also magnify any investment losses and as such leveraging gearing can be a very high-risk investment strategy with the potential to inflict large losses very quickly. In a worst-case scenario, you could not only lose all your investment capital but also the investments made with the borrowed funds and as such, be left with a debt. The higher the gearing/leverage ratio (i.e. the more you borrow compared to the amount of your own funds available to invest), the higher the risk.

To illustrate the impact of gearing, consider a scenario where you have EUR 100,000 available to invest:

- Let us assume that your unleveraged EUR 100,000 investment gives you a 10% return and you sell after one year. That means that you get back EUR 110,000 and have made a profit of EUR 10,000. If, however, the investment was to lose 10% in the year, then you get back EUR 90,000 and have made a loss of EUR 10,000.

- If you gear your EUR 100,000 investment by two times, you will borrow EUR 200,000. You now have a total of EUR 300,000 available to invest (your own investment of EUR 100,000 plus the EUR 200,000 that you have borrowed).
- Now let us assume that you pay interest on the EUR 200,000 loan at the rate of 5% pa and that as in the first 'unleveraged' scenario, the total investment of EUR 300,000 gives a similar 10% return after one year.

  The 10% return on the EUR 300,000 invested (i.e. your EUR 100,000 investment capital plus the loan proceeds of EUR 200,000) will amount to EUR 30,000 (300,000 x 10%).

  You will pay interest on the EUR 200,000 loan of EUR 10,000 (200,000 X 5%).

  This means that after you repay the EUR 200,000 loan plus the loan interest of EUR 10,000, you will get back a total of EUR 120,000 (being your initial EUR 100,000 investment plus the return net of loan interest).

You have now made a 20% profit (EUR 20,000) on your initial EUR 100,000 investment which is double the return you achieved without any gearing.

- **However:** If the EUR 300,000 gives a 10% loss, then you now have a loss of EUR 30,000 plus the interest of EUR 10,000 payable on the EUR 200,000 loan.

  This gives you a total loss of EUR 40,000. The initial 10% loss is magnified to an effective 40% loss, and you would get back just EUR 60,000 of your initial EUR 100,000 investment (this compares to a 10% loss had you not geared your initial investment).

  Had you decided to gear three times rather than two times, then your loss would be even higher (55%).

In addition to the gearing risk described above, you are also exposed to the interest rate risk on the loan, and that, depending on what you chose to invest the borrowed money in, your underlying investments are likely to be exposed to some of the other investment risks mentioned above (including foreign exchange risk). This causes a geared investment strategy to contain very high risk. As such, gearing is generally only suitable for sophisticated investors with a high-risk appetite and who are both willing to accept large fluctuations in the portfolio value and able to absorb high levels of potential losses.

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**Trusted Novus Bank**
76, Main Street
P.O. Box 143
Gibraltar
www.trustednovusbank.gi