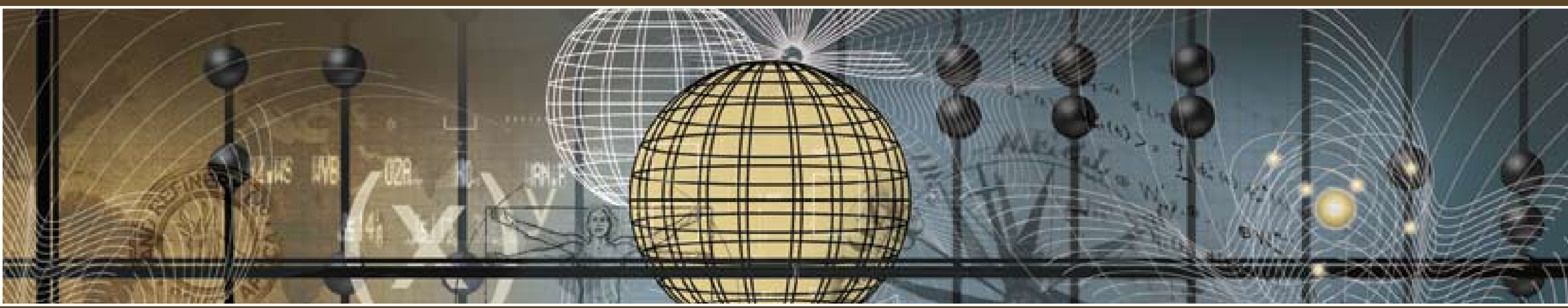
Standard Bank

Global Markets Knockout! Warrants



Content

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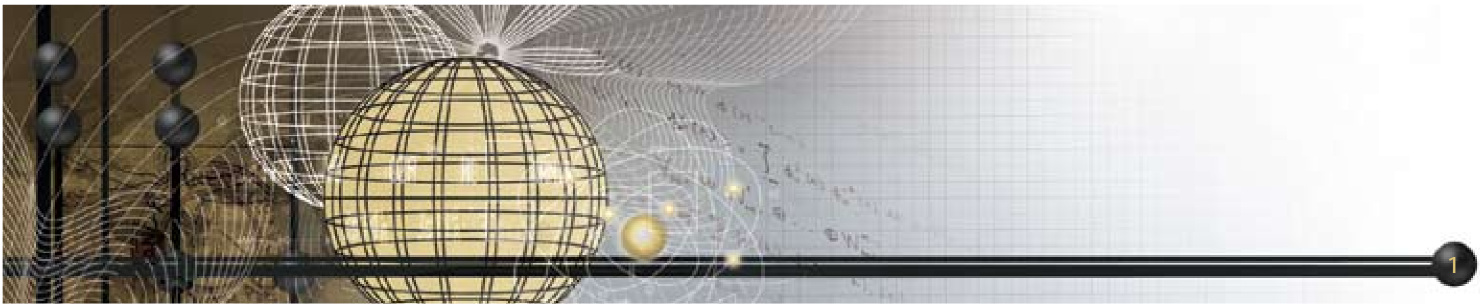

Increased gearing for experienced traders

With the growing popularity of geared trading instruments in South Africa, Standard Bank launches Knockout! Warrants, a super-charged warrant for experienced traders.

What are Knockout! Warrants?

Knockout! Warrants are warrants listed over individual indices or shares traded on the Johannesburg Stock Exchange. Investors can trade them in the same manner as vanilla warrants.

Standard Bank acts as a market maker for Knockouts providing liquidity to the market and ensuring that warrant traders are able to efficiently enter and exit positions.

The performance of Knockouts is linked to the value of the underlying index or share over which it is listed. As the price of the underlying increases, all other things being equal:

- Knockout! Call Warrants will increase in value; and
- Knockout! Put Warrants will decrease in value, and vice versa.

How do Knockout! Warrants differ from Vanilla Warrants?

Knockout Level

Knockout! Warrants have a Knockout Level. This Knockout Level is equivalent to the Strike Price. If the price of the underlying crosses the Knockout Level (Strike Price), the warrant lapses, that is, it terminates and gives the holder no further rights.

Greater gearing/leverage

Knockout! Warrants offer greater gearing (leverage) than Vanilla Warrants. This means that, all other things being equal, for a given percentage move in the price of the underlying, that the percentage move in the price of a Knockout! Warrant will be greater than for a Vanilla Warrant.

Delta

Knockout! Warrants almost replicate "Delta 1 Exposure" to the underlying. Investors will receive close to the same price movement (up or down) as that of the underlying. Technically Knockouts have a higher delta than Vanilla Warrants.

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Knockout! Call Warrants

Knockout! Call Warrants resemble Vanilla Call Warrants in that they allow the investor to profit if the underlying index rises. When the underlying index is trading far away from the Knockout Level, the warrant will behave like a Vanilla Warrant:

Example

Knockout level	Index level	Knockout! Warrant price
17 000	21 000	R4,44
	21 500	R4,95
	22 000	R5,41
	Conversion ratio	1 000: 1

Assume Trader A purchases the above Knockout Call at R4,44 when the index is trading at 21 000. The index then rises to 22 000 and she sells her Knockout at R5,41. She has made a 22% return [(5,41- 4,44) / 4,44], while the index increased by 4,7% [(22 000-21 000) / 21 000]. The Knockout! Warrant has gained 4,7 times the movement of the index, a similar movement to Vanilla Index Warrants.

However, should the underlying index trade near the Knockout Level, the gearing offered by the warrant increases dramatically. It is important to note that should the underlying index trade at or below the Knockout Level, the warrant automatically terminates:

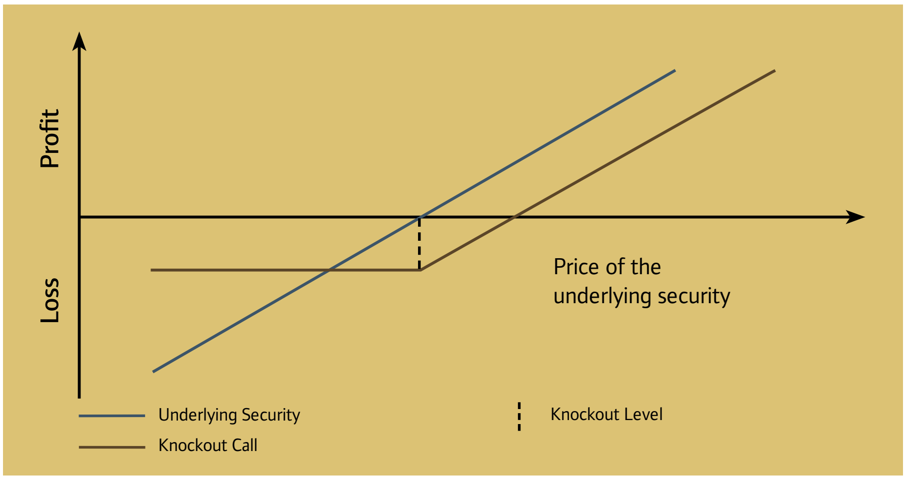
Example

Knockout Level	Index Level	Knockout! Warrant price
17 000	16 500	Lapsed
	17 000	Lapsed
	17 100	R0,15
	17 500	R0,57
	18 000	R1,08
	18 500	R1,59
	Conversion ratio	1 000: 1

Assume Trader B purchases the above Knockout Call at R0,57 when the index is trading at 17 500. The index then rises to 18 500 and she sells her Knockout at R1,59. She has made a 179% return [(1,59-0,57) / 0,57], while the index only increased by 5,7% [(18 500-17 500) / 17 500]. This strong price movement is due to the very high gearing of the Knockout! Warrant when the underlying index is trading near the Knockout Level.

But remember that there can also be a complete loss of investment when trading Knockouts:
Assume Trader C purchases his Knockout Call at R1,08 when the index was trading at 18 000. The index then falls to 17 000 and he is unable to sell his Knockout! Warrant as the index has traded at the Knockout Level. He loses 100% of his cash invested, while the index only decreased by 5,5% [(17 000-18 000) / 18 000].

Payoff profile of Knockout! Call Warrant vs Underlying Security



How do you calculate the gearing on your Knockout! Warrant?

The gearing indicates the extent to which the warrant will rise and fall if the index moves 1%.

= [Price of Underlying Index / (Price of Knockout x Conversion Ratio)]		
[21 000 / (4,44 x 1 000)]	[17 500 / (0,57 x 1 000)]	[17 100 / (0,15 x 1 000)]
4,73	30,70	114

It is important to note how the gearing increases as the underlying index approaches the Knockout Level. As the gearing increases, so does the risk!!

What happens on expiry date?

If the index closes at 18 500 on expiry date, investors will receive a cash payout of

= [(Index Level at expiry – Knockout Level / Conversion Ratio]

= [(18 500 – 17 000) / 1 000]

= R1,50

Is there a Premium over the intrinsic value?

The premium relates to the Standard Bank's financing costs, which are necessary for hedging. The premium decreases constantly through the life of the Knockout. Investors receive a portion of the premium back, if they close their Knockout! Warrant before expiry, so long it has not been knocked out.

Premium of Knockout Call =

Price of Knockout – [(Underlying Price – Knockout Level) / Conv. Ratio]

= R1,08 – [(18 000 -17 000) / 1 000]

= R1,08 – R1,00

= R0,08

Knockout! Put Warrants

Knockout! Put Warrants resemble Vanilla Put Warrants in that they allow the investor to profit if the underlying index falls. When the underlying index is trading far away from the Knockout Level, the Knockout! will behave like a Vanilla Warrant:

Example

Knockout Level	Index Level	Knockout! Warrant price
26 000	23 000	R3,32
	23 500	R2,85
	24 000	R2,29
	Conversion ratio	1 000: 1

Assume Trader D purchases the above Knockout Put at R2,29 when the index was trading at 24 000. The index then falls to 23 000 and she sells her Knockout at R3,32. She has made a 45% return [(3,32 -2,29) / 2,29], while the index only decreased by 4,2% [(23 000-24 000) / 24 000].

However, should the underlying index trade near the Knockout Level, the gearing offered by the warrant increases dramatically. It is important to note that should the underlying index trade at or above the Knockout Level, the warrant automatically terminates:

Example

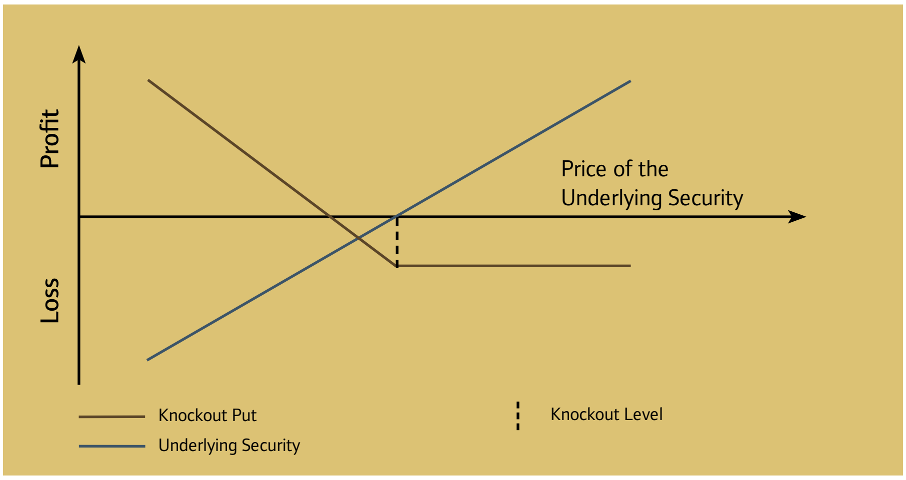
Knockout Level	Index Level	Knockout! Warrant price
26 000	24 500	R1,61
	25 000	R1,10
	25 500	R0,59
	25 900	R0,19
	26 000	Lapsed
	26 500	Lapsed

Assume Trader E purchases his Knockout Put at R0,59 when the index was trading at 25 500. The index then drops to 24 500 and he sells her Knockout! at R1,61. She has made a 173% return [(1,61-0,59)/0,59], while the index only decreased by 3,9% [(24 500-25 500) / 25 500]. This strong price movement is due to the very high gearing of the Knockouts when the underlying index is trading near the Knockout Level.

But remember that there can also be a complete loss of investment when trading knockouts:

Assume Trader F purchases his Knockout Call at R1,10 when the index was trading at 25 000. The index then rises to 26 000 and he is unable to sell his Knockouts as the index has traded at the Knockout Level. He loses 100% of his cash invested, while the index only increased by 4% [(26 000-25 000) / 25 000].

Payoff profile: Underlying Security versus Knockout Put



... investors must realise that if they knockout, they lose 100% of their investment. On this basis, only invest the amount of cash you can afford to lose.

How do you calculate the gearing on your Knockout?

The gearing indicates the extent to which the warrant will rise and fall if the index moves 1%.

= [Price of Underlying Index / (Price of Knockout x Conversion Ratio)] x 10		
[23 000/(3,32 x 1 000)]	[25 500/(0,59 x 1 000)]	[25 900/(0,19 x 1 000)]
6,93	43,2	136,3

It is important to note how the gearing increases as the underlying index approaches the Knockout Level. As the gearing increases, so does the risk!!

What happens on expiry date?

If the index closes at 24 500 on expiry date, investors will receive a cash payout of

= [(Knockout Level – expiring Index Level)/Conversion Ratio]

= [(26 000 – 24 500)/1 000]

= R1,50

Is there a premium over the intrinsic value?

The premium relates to Standard Bank's financing costs, which are necessary for hedging. The premium decreases constantly through the life of the Knockout. Investors receive a portion of the premium back, if they close their Knockout! Warrant before expiry, so long it has not been knocked out.

Premium of Knockout Put

= Price of Knockout! – [(Knockout Level – Underlying Price)/Conversion Ratio]

= R1,10 – [(26 000 – 25 000) / 1 000]

= R1,10 – R1,00

= R0,10

Advantages of trading Knockout! Warrants

- Greater Gearing / Leverage
- Liquidity provided by Standard Bank, ensuring that traders are able to efficiently enter and exit positions.
- Ability to trade both the long and short sides of the market.
- Knockout Level provides traders' protection from unlimited losses, that is, your maximum potential loss is your initial premium paid – be aware that this is still a 100% loss on your investment.
- Delta 1 Exposure, allows traders to replicate the index's performance on an almost one-for-one basis.

Risks associated when trading Knockout! Warrants

- Knockout! Warrants lose 100% of their value, if at any time during the life, the underlying equals or breaches the Knockout Level.
- Knockout! Warrants are highly leveraged investments.

Knockout! Warrants are to be considered more risky than trading in Vanilla Warrants. Potential traders therefore need to ask themselves the following questions:

Do I have the time available to trade Knockout! Warrants?

Due to the amplified moves that can occur in these instruments, investors are required to constantly monitor both the Knockout and the underlying over which they have invested. This becomes even more important when the Knockout is trading near its knockout level.

Can I afford to lose the cash I have invested?

Due to the high risk – high reward nature of Knockout! Warrants, traders must realise that if they knockout, that they lose 100% of their investment. On this basis, only invest the amount of cash you can afford to lose.

- **When trading Knockouts bear in mind the following:**
  - The greater the gearing; the greater the risk
  - Keep a close eye on the underlying, as well as market activity.
  - Never buy a Knockout when the underlying is close to the Knockout Level.
  - Use a strict stop loss with constant monitoring of positions throughout the trading day.

When choosing your Knockout! Warrant

- Ensure you understand the product properly, and have experience in trading derivatives.
- If you are an inexperienced trader don't trade Knockout! Warrants.
- Once the index or share has been chosen, buy Knockout Calls if you are bullish, buy Knockout Puts if you are bearish.
- Keep in mind that different Knockout! Warrants will have different Knockout Levels.
- With every investment, one needs to have a time horizon. Don't buy a Knockout Put listed on an index that you feel might fall in the next three months, if the Knockout Put expires in one month.
- Once you have entered the position, keep a close watch of the Current Index Level and your Knockout Level.
- Manage the Knockout Level. If the index approaches the Knockout Level, we recommend you exit that Knockout while it still has value.
- Please note Standard Bank will not be a seller of the Knockout! Warrants close to the Knockout Level.

Authorised financial services and registered credit provider (NCRCP15)

The Standard Bank of South Africa Limited. Reg. No. 1962/000738/06 SBSA 803216

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