The Dangers of trading in 10-cent warrants

Global markets are trapped in a cycle of fear with equities having their worst year since the 1930's. The rout has left investors battered and bruised with many scrambling for cover. The severity of the downturn has also resulted in many call warrants falling well below their strike price, in many instances to a delta of 0.1 and below.

At times such as these it's worth readdressing the merits or rather "de-merits" of trading in 10-cent warrants. For many investors who have taken a long position in a call warrant (higher-up) there is a temptation to do some rand-cost-averaging and buy some lower down. The logic at first seems rock solid, "I had some at 20 cents, now its 10 cents if I double up on my position then my average price is 15 cents and if the stock rallies I can make up all my losses".

This logic works fine when trading in underlying shares, that don't have an expiry date, however, when one is trading in warrants one has to be a little more careful. Remember that warrants have a set expiry date and if the underlying does not close above it (in the case of call warrants) the warrants will expire at zero. In essence one could quite easily be averaging towards zero!

One also needs to consider what the circumstances result in a warrant falling to 10 cents and below. Ultimately it's because the share price has fallen extremely far from the warrants strike price. The delta of the warrant (think of delta as the probability of share price rising to the warrants strike price by expiry) also falls dramatically in many cases to 0.1 and below, meaning that in all probability (baring a massive rally in the underlying) that the warrant will expire at zero.

It is for this reason that we advise clients refrain from:

1. Rand-cost-averaging into warrants, rather make use of a stop loss.
2. Avoid warrants that have very low delta's (0.1 and below)

It is also important to note that when warrants fall to very low delta's (0.1 and below) that Standard Bank is no longer an active seller of the warrant and becomes what is known as "Bid only". By "Bid only" we mean that the bank will only be buyers of the warrant according to the warrant matrix and no longer active sellers. The fact that it is "Bid only" does not compromise existing holders of the warrant as the bank remains a buyer (bid) to enable them to exit their positions.

Please be cautious when purchasing these instruments as there may be other sellers in the market (not Standard Bank) at prices higher than the matrix price. Standard Bank publishes a full matrix (bid and offer) for all its warrants daily on the website www.warrants.co.za always consult the matrix before trading to avoid paying above the fair value or matrix offer price for “bid only” warrants.