



## The Dangers of Trading Knockout Warrants

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Standard Bank Knockout! Warrants (KW's), are a highly geared instrument that are specifically designed for the more experienced trader. This article investigates two very important aspects of trading these instruments.

### 1. Why trading in KW's is more difficult than trading in vanilla warrants?

- KW's are listed with a Knockout Level. If the price of the underlying index trades at that Knockout Level at any time on or before the expiry date of that KW, the warrant terminates immediately. This Knockout Level is unique to KW's. Vanilla warrants have no Knockout Level.
- KW's offer greater gearing than vanilla warrants. This means that, all other things being equal, the KW will have a greater percentage gain or loss than a vanilla warrant would when the underlying index over which they are listed moves.

This brings us to the second very important aspect:

### 2. The Dangers of trading KW's when the index is trading near the Knockout Level

When the underlying index is trading far from the Knockout Level, the KW will behave like a vanilla warrant but with a higher gearing. This is best illustrated by the following example:

**Example:**

Knockout Level	Index Level	KW Price
21,000	23,000	42c
	23,500	50c
	24,000	58c

Assume a trader purchases the above Knockout Call Warrant at 42c when the index was trading at 23,000. The index then rises to 24,000 and she sells this KW at 58c. She has made a 38% return  $[(58c - 42c) / 42c]$ , while the index only increased by 4.3%  $[(24,000 - 23,000) / 23,000]$ . This KW has moved 8.8 times more than the index (ie. it has an effective gearing of 8.8).

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, this Knockout Call Warrant automatically terminates.

**Example:**

Knockout Level	Index Level	KW Price
21,000	21,000	Lapsed
	21,200	13c
	21,500	19c
	22,000	28c

Another trader purchases his Knockout Call Warrant at 13c when the index was trading at 21,200. The index then rises to 22,000 and he sells this KW at 28c. He has made a 115% return  $[(28c-13c) / 13c]$ , while the index only increased by 3.8%  $[(22,000-21,200) / 21,200]$ .

Whilst most traders would be happy to make a 115% return when the underlying index only moves 3.8%, in practice not many achieve this when the index is trading near the Knockout Level. Unfortunately, most traders that buy at 13c (and hold the position) end up losing 100% of the money invested, when the underlying index trades at or below the Knockout Level. This is a function of the extreme gearing of the instrument which results in the KW being knocked out if the market moves slightly down.

In the example above, the trader that buys at 13c off a level of 21,200 loses 100% of his money when the index trades at or below 21,000. Thus, the index has moved under 1%, and the trader has lost 100% of his funds.

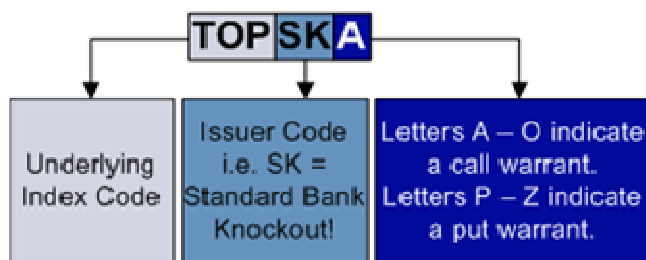
### Things to Consider Before and During Trading Knockout! Warrants

- Ensure you understand the product properly.
- If you are an inexperienced trader in derivatives, don't trade KW's.
- Always keep the Knockout Level fresh in your mind.
- Try and avoid trading KW's where the index is within 300 - 500 points of the Knockout level.
- **The gearing when trading near the Knockout Level is extreme.**
- **Remember very few traders can handle the amount gearing on offer when the index is near the Knockout Level.**
- Manage the Knockout level. If the index approaches the Knockout Level, you may choose to exit that KW while it still has value, and enter another KW with a more desirable Knockout Level.
- Please note that Standard Bank will not be active sellers of KW's close to the Knockout Level.

### How to identify Knockout! Warrants

Knockout! Warrants Have a Unique Coding that distinguishes them from vanilla warrants:

- KW's have been assigned a unique JSE code.
- Vanilla Standard Bank Warrants 4<sup>th</sup> and 5<sup>th</sup> letter of the code will always be 'SB' (ie Standard Bank).
- **Knockout! Standard Bank Warrants 4<sup>th</sup> and 5<sup>th</sup> letter of the code will always be 'SK' (ie Standard Bank Knockout!).**
- **An understanding of this coding is critical.**
- **Please make sure that if you want to trade a vanilla warrant, that the 4<sup>th</sup> and 5<sup>th</sup> letter of the code is not 'SK'.**



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