

INVESTING THROUGH INVESTMENT CERTIFICATES

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One of the features of financial markets today is the continuous innovation in the instruments used. This is particularly facilitated by the informatization and globalization of financial markets. The financial markets are attracted not just to large institutional investors, but also small investors, which in the banking sector are identified as retail clients. The logical consequence of this interest is the innovation of instruments and products tailored to small investors.

As a result of the substantial decline in interest rates over recent years, the popularity of financial investment has risen. Mutual funds are already quite widespread in Slovakia and the amount of money invested through such funds is constantly increasing. Yet investments continue to be made predominantly in conservative funds, especially of the money market and bond types. Because of the sharp fall in interest rates, these funds have recently been reporting relatively high yields. The scope for further rate cuts is, however, all but exhausted and there is no longer an assumption that conservative funds will deliver high returns. Another aspect of mutual funds is that, as they are demanding to manage, part of the gains are swallowed up in fees and this reduces the overall yield.

Investment certificates offer an alternative to mutual funds. In Slovakia at present they are almost unknown. The aim of this article is to describe investment certificates in general and to look in more detail at the so-called linear certificates.

Characteristics of investment certificates

The certificate is a security, the value of which is derived from the value of an underlying asset in a stipulated way. The underlying asset is usually a share in a company, a basket of shares, or an entire index. Index certificates in particular are increasingly tradable worldwide.

An index certificate is like an imitation share index. In order to be accessible to small investors, it represents a proportional sample, typically 1:100, which means that if the share index has a value of, for example, 2000 points, the certificate will have a value of EUR 20. Since an optional number of such certificates may be purchased, this instrument is also suitable for all investors.

The strategy of bank is simple. It buys an underlying asset and using investment certificate, it "changes" it into small parts and sells them to the investors. So the bank buys, for example, one index CECE at the price of 2240 EUR and sells it to investors by 100 investment certificates.

Investment certificates mostly have a precisely stipulated maturity period. There is, however, an indefinite term for open-end certificates. The issuers of these certificates may terminate them as of a stipulated date, though notice of termination must be given far in advance (at least one year and a day before-

hand). The investor will be paid the value of the certificate as at this date, provided that he has not already sold the certificate.

The issuers of investment certificates are financial institutions. The issuer is obliged at all times to sell or repurchase the certificate for a price that is transparently derived from the price of the underlying asset.

Because of these characteristics, investing through investment certificates has the following advantages:

- **Transparency** – the purchase price and sale price of the certificate, as well as the underlying asset, are known at any time.
- **Liquidity** – there is the option to buy or sell at any time, since the issuer is required always to set a sale price and purchase price (market making). The issuer is therefore a trading partner, whether for a purchase or a sale.
- **Accessibility** – certificate prices are typically in tens of euros and it is possible to buy an optional number of certificates.
- **Low costs** – since the underlying asset is stipulated and does not change, there is "passive management" not incurring any costs. The issuer earns its commission in the spread between the purchase price and sale price.

The most substantial risk is the risk attached to the issuer. With certificates, the investor is in effect len-



ding money to the issuer and receiving as countervalue the security/investment certificate. That is why particularly close attention should be paid to the choice of issuer.

Trading with investment certificates is growing significantly in recent years. The largest market still remains in Germany, in which more than one half of all investment certificates traded are emitted. Table 1 shows the number of certificates emitted in Germany during 2001 – 2003:

Table 1 The total number of certificates emitted in Germany during 2001-2003

	2001	2002	2003
Total number of certificates emitted	3 400	6 191	10 553

Types of certificates

Investing through investment certificates shows a growing trend, involving as it does instruments from the financial derivatives group. Several types have been developed, enabling investments to cover different assumed scenarios for the development of the underlying asset, while respecting the different relationship between the investor and risk.

The most well-known types of investment certificates are:

- Linear certificates,
- Guaranteed certificates,
- Airbag certificates,
- Discount certificates,
- Bonus certificates,
- Sprint certificates,
- Outperformance certificates.

Each type differs in construction, and therefore also in the profit function for the same underlying asset. With knowledge of them, it is possible to select the most advantageous certificate in regard to the assumed scenario for the underlying asset and depending on acceptance of the risk relationship and projected yield.

Investment certificates are a new phenomenon (especially in Slovakia), and it should be noted that innovations are continually springing up in this field. It is therefore quite possible and probable that the different literature on this subject will employ different terminology. It is therefore important to define the given certificate and find the profit function. It is best, though not essential, to know the basis for the creation of the investment certificate.

Linear certificates will be analysed in the next part of the article, and the other types in subsequent contributions.

Linear certificates

The simplest type of investment certificate, linear certificates closely follow the development of the underlying asset. If the price of the underlying asset increases, so will the price of the certificate, and, conversely, if the underlying asset declines in price, the certificate price will go up too. Since this is a linear profile, further knowledge is not necessary. If we think that the value of the underlying asset, e.g. an index, is relatively low and the index value is expected to rise, then we will buy a linear certificate for this index. When the value of the index rises, the price of this certificate will also go up. The certificate may be sold, while the profit function is expressed as:

$$P(S) = n(S - x_I), \quad (1)$$

where x_I is the purchase price of the certificate, S is its sale price, and n is the number of certificates. In the event that $S > x_I$, then the investment earns a profit, and the profit for the given period may be calculated as a percentage using the following formula:

$$\frac{S - x_I}{X_I} \cdot 100 \% \quad (2)$$

If $S < x_I$, the investment has made a loss.

At present there are tens of thousands of investment certificates on world financial markets.

The Austrian bank Raiffeisen Centrobank has issued 37 linear investment certificates, details of which may be found on its website at www.rcb.at.

Let's assume that for 2005 we considered three suitable objects of investments, namely, shares in the biggest companies in Europe, in companies in Poland, Hungary and the Czech Republic, and in Russian companies.

The investment in the 50 most important European companies could be made through a certificate for

Table 2 Certificate for the DJ EURO STOXX 50

Certificate	Underlying asset	Date of purchase	Date of sale	Profit in %	Profit in % p.a.
AT0000340146	DJ EURO STOXX 50	7. 2. 2005	7. 2. 2006	20,3	20,3
		7. 2. 2005	7. 4. 2006	25	21,43
		7. 2. 2005	26.7. 2006	19,2	12,32

the index DJ EURO STOXX 50. In fact, Raiffeisen Centrobank issued the investment certificate AT0000340146 for this index. Table 2 shows the gain on this investment.

The investment in shares in Polish, Hungarian and Czech companies could be made through the investment certificate AT000489034 for the CECE index. Table 3 shows the gain on this investment according to the date of sale.

Table 3 Certificate for the CECE index

Certificate	Underlying asset	Date of purchase	Date of sale	Profit v %	Profit in % p.a.
AT000489034	CECE	5. 1. 2005	5. 1. 2006	53,10	53,10
		5. 1. 2005	5. 2. 2006	49,70	45,87
		5. 1. 2005	26. 7. 2006	47,10	30,22

The investment in Russian firms could be made through the certificate AT0000481221 for the RDX index. Table 4 shows the gain on this investment according to the date of sale.

Table 4 Certificate for the RDX index

Certificate	Underlying asset	Date of purchase	Date of sale	Profit v %	Profit in % p.a.
AT0000481221	RDX	7. 2. 2005	7. 2. 2006	125	125
		7. 2. 2005	7. 4. 2006	168	144
		7. 2. 2005	26. 7. 2006	153	98,18

As the tables make clear, all the investments were successful. The best performer was the investment in the RDX index with the date of purchase 7 February 2005 and the date of sale 7 April 2006, which produced a yield of 168%, or 144% per annum. That is a quite unbelievable return and we can only regret not having taken advantage of it.

But it should be stressed that the success of a linear certificate investment is contingent upon an increase in the price of the underlying asset. Every investor should know that share price growth is not always linear, but rather includes corrections, stagnation and even decline.

In mentioning the possible negative side of investment in linear certificates, let us consider an investment in one of the above-mentioned certificates, i.e. a certificate for the RDX index but one with less favourable dates of purchase and sale. Table 4 shows

Table 5 Certificate for the RDX index in 2006

Certificate	Underlying asset	Date of purchase	Date of sale	Profit in %	Profit in % p.a.
AT0000481221	RDX	8. 5. 2006	24. 5. 2006	- 25,70	- 616,8
		8. 5. 2006	9. 6. 2006	- 27,80	- 333,6

the gain, or more strictly the loss, according to the dates of purchase and sale.

As is apparent from Tables 3 and 4, an investor who invested in a certificate for the RDX index on 7 February 2005 and sold it on 7 April 2006 made an outstandingly successful investment (a profit of 168%), while the investor who invested in the same certificate on 8 May 2006 and sold it on 9 June 2006 had a particularly unsuccessful investment (a loss of 27.80%).

When investing through investment certificates, it is therefore important to select the right certificate and the right time of investment. The price volatility of underlying assets is large, which is logical given that the expected profit is great.

Conclusion

Linear certificates are suitable where the price of the underlying asset is growing. The greater the growth, the higher the gain on the linear certificate investment. Their drawback is that when the price of the underlying asset remains flat, there is zero gain, and especially that when the underlying asset price falls, the loss on the investment increases in proportion. For scenarios featuring constant or declining markets, other investment certificates are more suitable and will be looked at more closely in subsequent articles.

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