UWEALTH

GUIDE TO UNDERSTANDING ASSET CLASSES :

OVER-THE-COUNTER (OTC) DERIVATIVES

U Wealth : Your partner in mastering financial instruments.

We want you to feel comfortable making suitable investment decisions based on knowledge of the opportunities and risks of given financial instruments.

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FINANCIAL INSTRUMENTS: OPPORTUNITIES AND RISKS

The higher the complexity of a financial instrument, the higher its potential risk – but the higher, too, the opportunities for returns.

WHAT ARE DERIVATIVES?

A derivative is a **security whose price is dependent on**, or derived from, one or more **underlying asset**. **The derivative itself is merely a contract** between two or more parties.

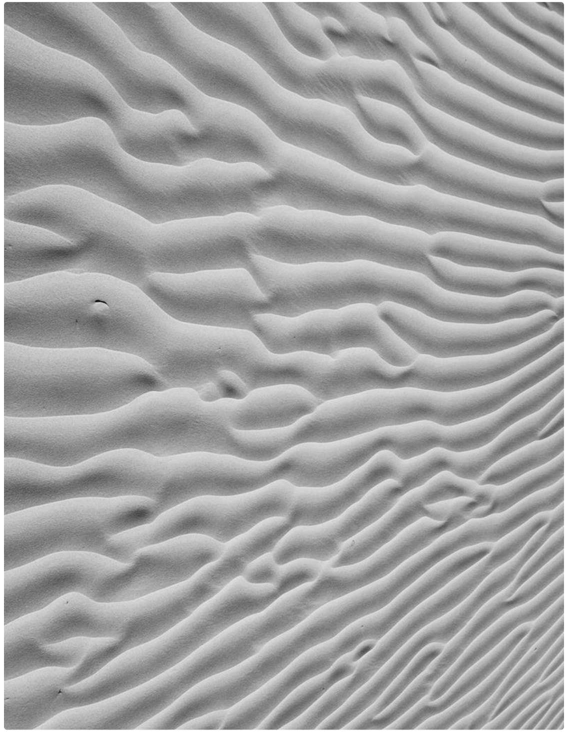
There is a crucial difference between a direct investment and an investment in a derivative:

- when **directly investing** in a financial instrument such as a stock or a bond, the investor **participates directly** in its risks, gains, and losses.
- when investing in a **derivative**, the investor invests **in a contract, note, unit, or certificate**. This **adds specific characteristics**, risks, obligations, and/or rights to the assets on which the derivative is based.

An **underlying can consist of a single asset or multiple assets**. The most common underlying assets include stocks, bonds, commodities, currencies, interest rates, and market indices.

The value of the derivative depends in a non-linear way on the price of its underlying.

A derivative may be traded over the counter (unlisted) or be standardised and traded on public exchanges.



ADVANTAGES/DISADVANTAGES

Advantages	Disadvantages
Cost efficiency by leverage: the gross amount invested is smaller than trading the individual underlyings.	Options have a 'time decay'; the time value of the option decreases over the investment period.
Hedging instruments: losses can be limited by long options (buying a right).	They can have higher spreads and commissions per dollar invested.
Flexibility: ability to trade a wide range of underlyings and to lock in prices.	If used with a speculative intention, strategies such as **leverage and short selling** bear the risk of overproportional or even unlimited losses.
	Over-the-counter derivatives **carry additional risks such as counterparty risk and higher liquidity risks** that do not apply to standardised exchangetraded options.

IMPORTANT RISKS TO CONSIDER OTC DERIVATIVES

Price risks

The price of the underlying, the volatility of the price, and the time to expiration of the option. These are the most important ones.

Market risks

The price of the underlying, a major factor influencing the price and pay-off of the option, is subject to market risks.

Leverage

When investing in derivatives, minor investment amounts can control much larger volumes. This is called 'leverage'. If the market falls, leverage maximises risks, as well as gains, from the investments.

Over-the-counter derivatives

Over-the-counter traded derivatives may carry additional risks such as counterparty risk and higher liquidity risks than exchange-traded standardised options.

The following two pages explain a number of common OTC options and a selection of option strategies.

- Investing in such options and option strategies requires a very good understanding of options and the related risks in order to select the most appropriate instrument or option strategy depending on market outlook and intended investment purpose.
- The basics of investing in derivatives and how options work can be found in the separate educational material on exchange-traded derivatives.

OTC DERIVATIVES, EXAMPLES OF OTC OPTIONS

Vanilla OTC option	The term ‘vanilla’ refers to normal OTC options without any kind of special features such as barriers. In contrast to exchange-traded options, vanilla OTC options are not standardised when it comes to underlyings, strike prices, contract sizes, or expiry dates.
Barrier option	Barrier options are path-dependent options. On top of the strike price, they contain a barrier price. There are two different kinds of barrier options: knock-in and knock-out options. **Knock-in option:** the option only becomes active once the barrier price is breached. **Knock-out option:** the option becomes invalid as soon as the barrier price is breached.
Transatlantic barrier option (knock-in/knock-out)	A transatlantic barrier option contains two barriers. The first is a European-style barrier which is above the strike (in case of a call option; “up and in”). The second one is an American-style barrier which is equal to or below the strike price (in case of a call option; “down and out”). In the case of a put option, the American-style barrier is above and the European-style one is below the strike.
Digital-at-expiry option	Compared with a vanilla option, the digital-at-expiry option pays off the same amount, – independent of how far above the strike price the underlying asset closes (call option), or – independent of how far below the strike price the underlying asset closes (put option).
One touch/no touch	Compared with vanilla options, one-touch options allow to profit from a simple yes-or-no outcome. There are only two possible scenarios: – The strike price is reached → the investor receives the premium plus a defined payout; or – The strike price is not reached → the investor loses the option premium.

OTC DERIVATIVES, SELECTED OPTION STRATEGIES

The following blocks describe different option strategies.
Options strategies are combined buys and/or sells of call/put options at the same time on the same underlying.

Stradel / Strangle

A stradel is a strategy in which a call and a put are bought with the same expiration date and strike price. It can be used in case of high volatility but uncertain direction.

A strangle is a strategy in which a call and a put are bought with the same expiration date but different strike prices. It can be used if the investor has a clear view of the direction in which the underlying price moves but wants to be protected anyway.

Call/put spread

A call spread is a strategy in which a call at a specific strike price is bought and a call of a higher strike price is sold. It can be used in case a moderate rise in underlying asset price is expected.

A put spread uses the same strategy using puts in case of moderate declining asset prices.

Butterfly spread

A butterfly spread combines two call spreads. It involves four call options: a buy of a call option with a strike price below the current price; a buy of a call option with a strike price above the current price; and a sell of two call options with a strike price equal to the current price.

It can be used if the investor thinks the underlying asset will not move much.

FOR FURTHER INFORMATION ON RISKS OR ON OTHER AVAILABLE FINANCIAL INSTRUMENTS, PLEASE REQUEST TO YOUR RELATIONSHIP MANAGER ON U WEALTH EDUCATIONAL MATERIAL.

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