UWEALTH

GUIDE TO UNDERSTANDING ASSET CLASSES :

FOREIGN EXCHANGE

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 IS FOREIGN EXCHANGE?

Foreign exchange involves the **exchange of two different currencies**.

Certain precious metals (e.g. gold) share similar properties to currencies (e.g. availability of forward and derivative contracts), and are included in foreign exchange markets and traded in the same way.

ADVANTAGES/DISADVANTAGES

Advantages

Liquidity and availability

The foreign exchange market is the biggest liquid market in the world; it is open 24 hours a day.

Volumes

High volumes can be traded without influencing prices.

Low costs/spreads

Low margin

It has low margin requirements and fewer quantitative limitations compared to futures.

Hedging

Forward markets may be used to hedge against currency risk.

Disadvantages

Constant attention

Due to availability and dynamics, constant attention is needed.

Leverage risks

Leverage and margin (optional) maximise profits but also potential losses.

Different costs

There are different costs/spreads for retail and wholesale clients.

Central bank intervention

Central banks can intervene in the market.

Volatility

Foreign exchange rates can be volatile.

Currencies are **not only traded on spot markets.** Exchange rates **serve as underlyings for a wide variety of other financial instruments,** such as mutual funds, futures, and derivatives.
Such instruments bear risks above and beyond the direct buying/selling of currencies and require corresponding investor knowledge.
Please consult the relevant U Wealth educational material for details on these instruments.

IMPORTANT RISKS TO CONSIDER

Spot and outright transactions

Market risks : Foreign Exchange Rates may change as a result of many factors. These include: forces of supply and demand, political and economic changes in the currency's home country (including changes in monetary policy).

Credit and liquidity risks

Foreign exchange trading is 'over the counter', based on the fulfillment of agreements about a currency rate in the future. This introduces counterparty risks.

Counterparty credit risk: the ability of the counterparty to fulfill its obligations is an important consideration. For example, in foreign exchange transactions on U Wealth, U Wealth is the relevant counterparty and not a third-party bank.

Liquidity risk: your rights might be closed out before the settlement date using a counter-deal. The liquidity of foreign exchange contracts with longer maturities is lower than with shorter ones. During the life of the contract, the collateral will be blocked on the account.

WHAT TO EXPECT FROM SPOT AND OUTRIGHT TRANSACTIONS?

Investment horizon

- Short term (up to 12 months)

Income expectation

- Capital gain

Market expectation

- Increasing
- Decreasing
- High volatility
- Sideways

IMPORTANT TO KNOW BEFORE MAKING SPOT AND OUTRIGHT

Maximum gain

Unlimited –
the difference between market value at buying/selling

Maximum loss

There is a risk of unlimited loss.

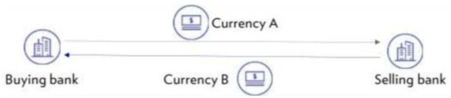
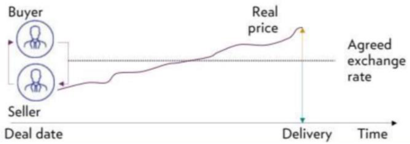
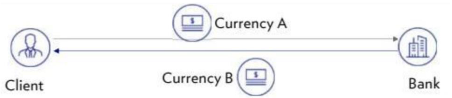
Profit/loss

Profit and loss are not predictable. The return behaves linearly with the changing exchange rates (adjusted for interest rates over time). When investing, the following points should be taken into consideration.

- Foreign exchange rates can behighly volatile and markets are directly exposed to country risk. Corresponding knowledge of the political and economic situation of the currency's home country is helpful.
- Trading can involve significant leverage. This should be weighed against one's financial abilities. A clear idea of the risks one is willing to take is indispensable.
- Depending on the investment objectives, spot markets/outrights are only one way of entering foreign exchange markets. There are other investment products too.

A CLOSER LOOK AT FOREIGN EXCHANGE

HOW FOREIGN EXCHANGE WORKS

Example	Characteristics	Motivation
Interbank market  	• Spot trades are usually settled within two working days.	• Direct need for currency
Forward market  	• Agreement to buy/sell in the future at a price fixed today	• Speculation
Banking retail business  	• Retail quantities • Other margins apply than on the interbank market.	• Direct need for currency • Hedging • Speculation

GENERAL TYPES OF FOREIGN EXCHANGE TRANSACTIONS

There are two major types of foreign exchange transactions.

Spot transactions

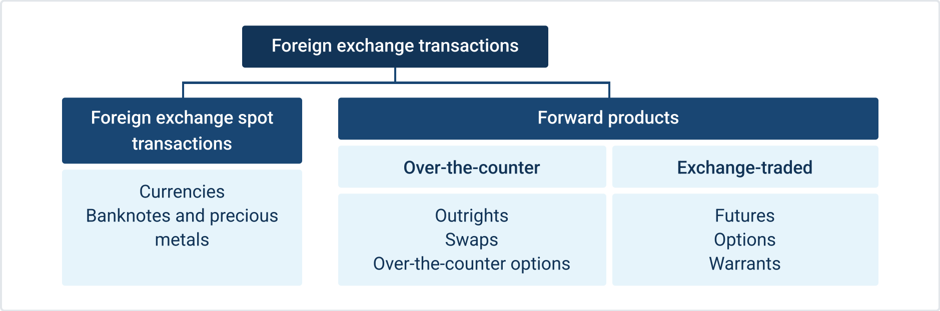
Spot transactions are transactions based on the foreign exchange rates currently available.
These include:

- currencies
- precious metals

Forward products

Forward products are transactions that are settled in the future.
These include:

- outright
- other forward products, such as options



PROPERTIES OF FOREIGN EXCHANGE MARKETS

The foreign exchange market

Is the largest available financial market worldwide.

- Liquidity and traded volumes are extremely high.
- Volatility can be substantial.
- The only market in the world that is open 24 hours a day. Recently, however, the market in cryptocurrencies has grown dramatically and is open 24 hours a day, as well as seven days a week.
- For reasons of demand, liquidity, and availability, precious metals and precious metal accounts are included in the foreign exchange market.

The foreign exchange trades

- Foreign exchange trades presuppose that currencies are freely tradeable. This is not the case for all currencies. The currency traffic is regulated by the authorities, and the way they manage exchange rates is called a 'regime'. Examples of exchange rate regimes are: free float: the exchange rate is determined by supply and demand, and may be managed by the central banks to avoid excessive appreciation/depreciation. pegged: fixed to a specific value or floating within a band.

For the investor, this may mean that certain currencies are not freely available or are traded at exchange rates that do not reflect actual market conditions.
Policies may be changed by the authorities at any time.

FOREIGN EXCHANGE RATES AND FOREIGN EXCHANGE FORWARD RATES

An exchange rate ('forex' rate) is the rate at which one currency can be converted into another.

This depends on a **variety of factors,** including:

- interest and inflation rates
- political stability
- transparency of the country's economic and political decisions
- general economic welfare.

In foreign exchange transactions, there are **two types of exchange rates.**

Spot rates

The exchange rate for immediate settlement of the transaction.

Forward rates

The exchange rate applicable at a certain date in the future. Forward rates are based on the spot rate, adjusted by the difference in interest rates between the two currencies involved.

SPOT AND OUTRIGHT TRANSACTIONS

Spot and outright transactions are two important types of foreign exchange transactions. The following table shows their most important characteristics.

Spot transactions	Outright transactions (forward transactions)
A spot transaction is the purchase or sale of a foreign currency at the current today available rate (spot rate).	An outright rate is an agreement for a currency exchange with a maturity in the future.
Settlement is done on the second or third working day after conclusion of the trade.	Foreign currency can be bought or sold through outright.
	The amount can be fixed beforehand.
	The maturity may be from three working days in the future to any date up to five years (commonly one-, two-, three-, six-, or twelve-month maturities).
	The rate is negotiated directly between the client and the bank at the deal date. The bank executes the trade on its own account.
	The contract may not be terminated early. However, a transaction can be cleared by settling a counter-transaction on the same maturity date.
	Banks demand a margin as a collateral.

RETURNS, LEVERAGE, MARGINS, AND SPREADS

Returns

Returns on the foreign exchange market are realised by fluctuations in the exchange rate with time, adjusted for interest-rate differentials.

Costs

The **costs of the trade** are mainly the bid/ask spread. This spread is typically lower for foreign exchange than for other financial instruments and may depend on the volume of the trade.

Bid/ask spread: orders (interests) to buy or to sell are left in the market and investors can trade on them. The best bid will be the highest available price at which an investor can sell. The best offer will be the lowest price that buyers can find among orders (interests) left in the market by sellers. The difference is called the 'bid/ask spread'.

Margins and Leverage

Currencies on the spot market require full coverage of the nominal value. Outright transactions are usually not exchanged at the face value; instead, so-called **margins and financial leverage** apply.

- When executing a trade, an initial deposit (a margin) is required that is usually lower than the nominal value of the trade.
- The margin can be as low as 10% of the face value. The possibility to trade high volumes based on a minimum initial amount is called **financial leverage**. For less liquid or more volatile currency (or precious metal) pairs, higher margins will be applied. Most of the liquidity is available for tenors of up to one year; less liquid currency or precious metal pairs might be available for shorter tenors only.
- Margin requirements may change according to exchange rate fluctuations. This may generate the need for further collateral to be added to the initial margin provided (a so-called **'margin call'**).
- Leverage maximises not only potential profits but also potential losses. It contributes very significantly to the risks involved.

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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