DESCRIPTION OF FINANCIAL INSTRUMENTS AND THEIR RISKS

Financial instruments are shares, bonds, treasury bills, investment fund units, depository receipts and other financial instruments traded in financial instruments markets.

Financial instruments generally provide a certain return on investment: dividends are paid on shares, interest for bonds, and, moreover, the market value of financial instruments may increase or decrease. An investor always wants a higher return, but there is always a risk that the return may be negative. As a rule, the higher is the expected return on investment, the greater is the risk assumed. In the event of an unfavourable market situation, the investment loss in this case may also be significant. Investments in financial instruments are inevitably related to certain specific risks that investors have to take into account.

INVESTMENT RISKS

Inflationary risk

This risk is otherwise called the risk of falling purchasing power. With inflation, prices for various consumer goods and services arise, which reduces the purchasing power of money, which means that less goods can be bought for the same amount of money. This risk is particularly relevant to non-invested funds, or in the event that the selected investment has a lower profitability than inflation.

Capital Risk

It is a risk that investors will lose all or part of the funds invested. This risk is directly related to the characteristics of the market in a particular financial instrument.

Market risk

This risk applies to the entire capital market when the value of the investment can decrease by changing market factors such as interest rate, exchange rate, country's economic situation, prices of financial instruments and others. This risk, like capital risk, is not directly related to the issuer, it depends more on macroeconomic indicators.

Liquidity risk

This is the risk that it will not be possible to recover funds invested without significant losses. When investing in illiquid financial instruments, a situation may arise that you will not be able to sell them at the desired time or you will have to sell them at a significantly lower price due low demand or lack of it.

Interest rate risk

It is a risk that the change in the market interest rate will reduce the value of investment in bonds and other fixed income financial instruments. The overall interest rate increase has a negative impact on fixed income investments.

Currency/exchange rate risk

It is a risk that the return on investments in non-national currency financial instruments may fall significantly due to the volatility of the foreign exchange rate change.

Risk of choice

It is a risk that a reasonable decision to invest in the relevant financial instrument will eventually prove to be unfortunate or fails to meet expectations.

Investment timing risk

This risk is related to the wrongly selected investment time. It is a risk of reducing the return on investment due to the wrong timing of investing in financial instruments.

Reinvestment risk

Investments in bonds and other fixed income financial instruments aim at steady income over a period of time, but there is always a risk that at that time there will be no opportunity to reinvest the proceeds into financial instruments of the same profitability. This is especially true if the coupon is paid at a time when there is a downturn in the debt market and the funds received can no longer be invested with the same return on investment.

Credit risk

It is the risk of losing part or all of the invested funds due to a deterioration in the issuer's financial position or even bankruptcy. This risk is directly related to the issuer and is especially relevant to investing in debt securities. Credit risk always grows heavily if invested in long-term bonds because it is difficult to predict the issuer's financial position in the long run.

Legislative risk

This risk means that a change in legal regulation in a country in whose market it has been invested will reduce the return on investment or losses will arise. It involves changes to the laws and trade rules, which may change not only property, billing regulations, but also investment taxation.

Systematic risk

This risk implies that the inability of one institution (credit institution, brokerage firm) to timely fulfil its obligations could jeopardize the stability of the entire financial market.

Tax risk

This is the risk that changes in investment tax legislation will result in lower return on investment or loss incurred. The Bank does not advise on tax issues (even if it specifies specific tax aspects in the information provided) and does not have the ability to manage these risks, so the Client must independently assess any tax-related circumstances that may affect the outcome of its investment decisions.

Counterparty risk

This is the risk of incurring losses as a result of the counterparty's failure to fulfil its obligations arising from the execution of a financial instrument transaction. In order to minimize counterparty risk, the Bank mainly enters into transactions with reputable credit or financial institutions.

FINANCIAL INSTRUMENTS AND ACTUAL RISKS

Shares

Shares are equity securities that certify the part of ownership of the owner (shareholder) in the company and confer the following rights: the right to participate in the management of the company, the right to receive dividends, the right to get a part of the company's assets remaining after the liquidation of the company and other statutory rights.

Shares may be ordinary or preference. Holders of ordinary shares are entitled to vote, but no dividends are guaranteed. On the contrary, preference nominal shares grant their owners the right to receive a fixed dividend by paying them before ordinary shareholders, but usually do not give voting rights in the general meeting of shareholders. In the event of a bankruptcy or liquidation of a company, the owners of preference shares shall prevail over the ordinary shareholder's interest in the share capital of the company after the company settles with holders of bonds and other debt instruments.

The stock market price shows how financial markets value the company's ability to earn a profit. As a result, the price of shares is influenced by changes in the market, economic trends, technologies, legislation, competition and other factors on which the company's performance and prospects depend. The macroeconomic situation of the country, its perspectives, and trends in global markets also strongly influence the dynamics of the stock price. Price fluctuations are also driven by stock liquidity. In most cases, shares with high turnover on the stock exchange are liquid, i.e. there is a sufficient number of participants in the market, so that its price changes without significant fluctuations.

Because of the high number of factors affecting the company's share price, shares are generally considered to be more risky financial instruments than deposits, bonds or investment funds, and therefore, if choosing a conservative investment strategy, part of the shares in the total investment portfolio should make a small part.

Bonds

Bonds are non-equity securities under which their issuer undertakes to pay interest to their holders at the terms set in advance and to pay the principal amount of the debt, the par value, at the end of the bond validity. Interest can be paid at a fixed frequency throughout the term of the bond or at the end of its validity. Interest may be fixed or variable. Bonds that do not pay interest and are distributed at a lower than par value but are redeemed at a nominal price are called "zero coupon" or "discount". Bonds can be issued by governments, banks, companies.

Bonds issued by governments or municipalities are considered safer than those of the companies, as the latter are more likely to face insolvency problems. The issuer's risk is further increased by investing in long-term corporate bonds, because in the long run, companies' financial position and ability to pay off debts are more difficult to predict. Therefore, it is very important to pay attention to the credit ratings of bonds and their issuers, which show a higher degree of credit risk.

The market value of the bonds is influenced by the market interest rate. As the interest rate increases, the price of the bond decreases and vice versa. The general interest rate level is influenced by the monetary policy pursued by central banks, the general market situation, and the expectations of its participants. Therefore, willing to sell bonds before maturity, there is a risk of experiencing an impairment loss, or even a loss, if the market interest rate is increased and, as a result, the price of bonds significant decreases. The interest rate swap also involves a reinvestment risk that could lead to a disadvantage in the market for reinvestment of received bond yield payments, i.e. due to the market downturn it will not be able to invest money with the same return on investment.

Money market instruments

Money market instruments are instruments that are traded on the money market and can be easily converted into money. These are deposits in banks, treasury bills, short-term government bonds (up to 1 year), money market fund units.
Money market instruments are short-term investments and therefore have a low risk that within a short investment period there will be a significant fluctuation in the market value of such instruments which will result in significant losses to the investor. However, given that the return on investment in money market instruments is not high, the investor faces the risk that the earnings may be lower than inflation and that the invested capital will depreciate.

Investors in money market instruments also face the risk of credit (default): the risk of non-receipt of a deposit due to the potential insolvency of the financial institution that accepts it.

Investment funds

Investment funds are collective investment undertakings. These are the property on common partial ownership belonging to the investors, invested by the fund management company according to the investment strategy chosen. The assets of the fund are segregated from the assets of the management company. As a general rule, the fund's documents (prospectus, regulations) are confirmed and are required to be familiarized with before it is invested.

The main types of investment funds are equity funds, bond funds, mixed funds, money market funds, index funds and fund funds. The funds are also divided into open and closed-ended funds. The liquidity of open-ended funds is higher as the management company undertakes to redeem them under the conditions provided for in the prospectus, and the redemption of closed-ended funds may be restricted.

Benefits of investment funds:
Professional management: the funds invested are managed by professional fund managers.
Diversification: the funds of the fund participants are invested

in different classes of assets, thus reducing the risk of investment.
Simplicity: buying and selling investment funds is easy and the minimum investment amount is not high.
Liquidity: an investor can at any time sell units of investment funds available to the management company for a net asset value.

The fund consists of a large number of financial instruments, fluctuations of each of which influence the value of the fund's investment portfolio. Therefore, the risk of a fund depends on how risky its financial instruments are. Even the lowest-risk investment funds, under changing market conditions, may lose a part of their value, so there is a risk of receiving less than it was invested. On the other hand, investment in funds is safer and less vulnerable to changes in individual financial instruments; when one of the securities market value falls, while others may mitigate or even offset the decline.

The risk of the funds also depends on the reliability of the management company and the professionalism of the manager, so when choosing a fund, it is necessary to look into the history of its activities.

There are many types of funds, some investing in highly risky instruments or selecting one sector or region, which leads to a significant narrowing of diversification.

Exchange Traded Funds

Exchange Traded Funds or ETFs are exchange traded funds that make it easier to buy and sell them than ordinary investment funds. These funds are usually not actively managed, and their value is often associated with a certain index (energy resources, technologies, other commodities or raw materials, precious metals, etc.), and therefore their price varies accordingly. These funds are becoming more and more popular in financial markets.

The exchange traded funds are primarily beneficial to the investor in that they are easy to acquire and their acquisition costs are usually lower. The liquidity of these funds is usually large, and their trading on the market takes place in real time. However, it is also necessary to pay attention to the risks inherent for these funds. First of all, this is an instrument made up of individual financial instruments, therefore the market price of a fund unit depends on the overall change in the price level in the market.

If the ETF is linked to the index, the investor faces the risk that the ETF unit price may inaccurately reproduce the selected index. This is especially true in the case of raw material indices. There is also a risk that the unit value of the fund may differ from its net asset value.

Some ETFs use derivatives, therefore, such funds may have a leverage of a certain size, the effect of which may be directly dependent on the change in the price of the relevant asset or index, or be inversely proportional to the change in the value of such assets. These features make it possible to earn not only from getting more expensive but also getting cheaper financial instruments, also to get multiplied return on investment, i.e. the return on the fund may change at a higher rate than the index with which the fund is linked. Due to the high risk inherent in such types of funds, it is necessary to familiarize with their investment strategy and composition before making an investment decision.

Derivative financial instruments

Derivative financial instruments are transactions or arrangements resulting from, or linked to, certain financial instruments or assets. The most commonly used are option, forward, futures and other transactions for stocks, bonds, raw materials, precious metals, currency or interest rates, or other commodities. The term of these financial instruments may range from several days to several years.

Derivative financial instruments can be standard and non-standard. Standardized derivatives are traded on regulated markets but the parties agree with each other for the non-standard transaction terms and such transactions are made on non-regulated markets.

Derivative financial instruments are generally used to protect against unfavourable changes in asset prices. When derivatives are used for trading purposes, there are high volatility conditions, as derivative prices tend to fluctuate more. Price fluctuations are intensifying even more closer to the end of the transaction validity.

Derivative financial instruments are characterized by a leverage, so changes in the price of the related asset lead to a larger change in the derivative's price. Therefore, investments in financial derivatives may yield a higher return than direct investment in the assets that resulted in such a transaction.

Options allow you to earn both from positive and negative changes in the base asset price. Call options are generally considered to be lower risk transactions than put options, because when buying an option, only the paid bonus is risked. Call options are often used to protect against unfavourable asset price changes. When selling an option, there is a risk that the loss due to a possible unfavourable change in the underlying asset price will be higher than the premium paid. An option seller may incur almost unlimited losses in this case, as there is no maximum price limit for him. This risk corresponds to the risk that an investor faces in short selling.

Repurchase agreement

Repurchase agreement is an agreement whereby one of the parties lends money for a fixed period for receiving a deposit - financial instruments, while another undertakes to pay interest and repurchase financial instruments on an agreed date. For the party selling the financial instruments, this will be a repurchase transaction, and for the purchasing party this is a reverse repurchase transaction. The difference between the price of sale of financial instruments and the repurchase price is an agreed interest.

This is a convenient way to lend (sell) to a bank or another party the financial instruments available and receive a short-term loan. However, if the investor uses these funds for the purchase of new financial instruments and repeats this process several times, he can create a financial scheme, where even small changes in financial instrument collateral may lead to a loss of all invested assets.

Risks arising from repurchase transactions are highly dependent on the collateral - the type of financial instruments and their price sensitivity. The more fluctuating is the price of collateral - financial instruments, the more likely it is that another party will require an additional collateral or unilaterally terminates the contract if this collateral is not provided or the collateral market value falls sharply.

An investor must be aware that the interest payable on a repurchase transaction reduces the benefits of the transaction. This is especially true when the money received from the transferred financial instruments is reinvested and the return on investment received is lower than the interest payable.

An investor may be exposed to risk also in the case of bankruptcy of the issuer whose financial instruments are transferred as collateral. The lender then can redirect recovery of the debtor's obligations under the repurchase agreement to his other property.

In this type of contract with banks, a liability is usually provided for the client to monitor the value of his collateral and, upon its drop, without the bank's separate warning, to supplement the margin call account in cash or financial instruments within the set time limit. Otherwise, the bank reserves the right to sell the financial instruments that are collateral and/or terminate the repurchase agreement.

Before investing in a repurchase agreement, it is recommended that the investor very well familiarizes with the terms of the transaction and evaluates his ability to maintain the transaction security and assume all risks of such a transaction.

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