



# **OVERVIEW OF THE MAIN RISKS AND FEATURES OF FINANCIAL INSTRUMENTS**

This document does not attempt to describe all the risks associated with investments in financial instruments. Its aim is rather to provide some basic information to teach our clients about the existence of risks inherent in any investment in the main financial instruments. All clients are advised against carrying out an investment before being certain they fully understand all the associated risks. They are also advised to adapt their investments to their individual financial situation, needs and investment objectives.

For investment funds, the risk factors to which clients are liable to be exposed are defined and described in the fund prospectus.



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# 1. General risks

The risks addressed in this chapter are potential risks most often incurred by investors holding a financial instrument or a portfolio of financial instruments (held directly or through a portfolio management mandate or advisory investment services or investment fund).

## 1.1. Risk of Capital loss

Except when explicitly mentioned otherwise, there is no guarantee for investors relating to the capital invested in a financial instrument, meaning that investors may not receive back the full amount invested. This risk may be driven by the other risks mentioned here below.

## 1.2. Interest Rate risk

A change in interest rates, resulting notably from inflation, may cause a risk of losses and reduce the investment value (particularly in the event of a rate increase if the investment has positive rate sensitivity and in the event of a rate decline if the investment has a negative rate sensitivity). Long term bonds (and related derivatives) are more sensitive to interest rate variations. A change in inflation, in other words a general rise or fall in the cost of living, is one of the factors potentially affecting interest rates and consequently the investment value.

## 1.3. Inflation risk

Inflation risk is predominantly caused by sudden changes in supply and demand for goods and products in the economy, by rises in commodities prices and by excessive wage hikes. It is the risk of receiving payment in a depreciated currency and obtaining a rate of return lower than the inflation rate. This risk is prevalent, for example, with long-dated and fixed-rate bonds. Investors are therefore advised to base their investments on real interest, i.e. the difference between the interest rate and the inflation rate.

## 1.4. Credit risk

Risk that an issuer or counterparty defaults. This risk includes the risk of changes in credit spreads and default risk.

Some investments may be exposed to the credit market and/or specific issuers in particular whose prices will change based on the expectations of the market as regards their ability to repay their debt. These investments may also be exposed to the risk that a selected issuer will default, i.e. will be unable to honour its debt repayment, in the form of coupons and/or principal. Depending on whether the investment is positively or negatively positioned on the credit market and/or some issuers in particular, an upward or downward movement respectively of the credit spreads, or a default, may negatively impact the investment value.

The level of credit risk is usually evaluated by using "ratings" representing a comparative assessment of the credit quality (solvency level) of an issuer, issue or portfolio. "High yield" investments present the lowest rating levels and therefore a higher credit risk.

An issuer's solvency can change subsequent to general economic developments or changes affecting the issuer's business and/or sector of operation over the term of the debt. Such developments can include changes in the economic climate, changes relative to the business, sector and/or country concerned, and political events generating major economic consequences.

A decline in the issuer's solvency also has adverse impacts on the prices of the securities concerned. The term "spread risk" refers to the fact that, without the issuer even defaulting, the price of a security



can increase or decrease according to changing investor expectations concerning the likelihood of the issuer's (in)solvency.

For a portfolio, the portfolio manager may be permitted to set up positive or negative exposure to the credit market and/or specific issuers. As a result, an increase or decrease in credit spreads, or even a default, can adversely impact the value of the portfolio.

## **1.5. Equity risk**

Some financial instruments may be exposed to equity market risk, meaning submitted to the positive or negative evolution of stock exchanges. These evolutions can be huge and be mainly driven by expectations relative to macro-economy and company results, speculation and irrational factors (including trends, opinions or rumours).

A fund or a portfolio management mandate may own long or short exposures to equity markets. A variation in the equities market in the reverse direction to the positions can lead to the risk of substantial losses and may cause the investment value to fall.

## **1.6. Commodity risk**

Trends on commodity markets may differ significantly from those of traditional transferable securities markets (equities, bonds). Climatic and geo-political factors can also affect the supply and demand levels of the respective underlying product, in other words altering the expected scarcity of the product on the market. Commodities namely energy or metals could have closely correlated trends. Unfavourable trends on these markets may cause the investment value to fall.

## **1.7. Real Estate risk**

The main risk of real estate-related securities is that the value of the underlying real estate may go down. Many factors may affect real estate values. These factors include both the general and local economies, vacancy rates, tenant bankruptcies, the ability to re-lease space under expiring leases on attractive terms, the amount of new construction in a particular area, the laws and regulations (including zoning, environmental and tax laws) affecting real estate and the costs of owning, maintaining and improving real estate.

The availability of mortgage financing and changes in interest rates may also affect real estate values.

## **1.8. Foreign exchange risk**

Foreign exchange risk derives from an exposure to a currency other than its investor reference currency. Changes in the exchange rate of this currency in relation to that of investor may affect the investment value, by providing an additional loss or gain compared to the return of the investment calculated in its own currency.

## **1.9. Emerging Country risk**

Market movements can be stronger and faster on emerging markets than on “developed markets”, which can lead to a substantial decline in the investment value in the event of the adverse movements relative to the positions taken. Some foreign governments do not supervise and regulate stock exchanges, brokers and the sale of securities to the same extent as on “developed markets”.

Sector concentration risks can also prevail on some emerging markets. Emerging countries can be subject to serious political, social, legal and tax-related uncertainties and also other events that can adversely impact the investment on these markets. The governments of certain countries may prohibit or impose substantial restrictions on foreign investments in their capital markets or in certain industries.



For securities issued in a foreign currency, investors may receive payments in a currency that cannot be converted due to foreign exchange limitations. In some circumstances, emerging currencies can be submitted to sudden and substantial devaluation affecting the investment value converted in the investor currency.

## 1.10. Counterparty risk

When investors carry out over-the-counter transactions (i.e. not involving instruments listed on the markets), they are also exposed to the risk of default by the counterparty to the transaction, i.e. the risk that said counterparty will not be able to make the financial payments associated with these transactions.

To mitigate this risk, collateral exchange agreements are set-up: at regular intervals, the counterparty currently indebted to the other due to changes in the value of the transaction in progress, delivers cash or securities to the other counterparty in order to provide financial collateral that could then be used if the counterparty defaulted.

## 1.11. Liquidity risk

Liquidity risk is defined as the risk that a position in a financial instrument cannot be sold, liquidated or closed for a limited cost and within a sufficiently short time.

On some markets (particularly emerging and high-yield markets, small cap equities markets, etc.), price differences can increase under less favourable market conditions, which can generate an impact on investment value when they are bought or sold. In the event of a crisis on these markets, the securities can also become harder to trade.

For an investment fund, this can compromise the fund's ability to meet its obligations to redeem units at its investors' request at all times.

## 1.12. Concentration risk

Risk related to a significant concentration of investments in a specific asset class or certain markets. This means that changes in these assets or these markets have a significant impact on the investment value. The greater the diversification of the investments, the lesser the concentration risk is. This risk is also greater for instance on more specific markets (certain regions, sectors or themes) than on broadly diversified markets (worldwide distribution).

## 1.13. Leverage risk

Some financial products and investment strategies may subject the investor to leverage. Such products and strategies tend to magnify returns on underlying assets, both on the upside and downside. Consequently, a minor trend on the market can lead to substantial gains or losses. In some cases, the entire investment can be wiped out.

## 1.14. Sustainability risk

The sustainability risk refers to any environmental, social or governance-related event or situation that might affect the performance and/or reputation of issuers in a portfolio.

Sustainability risks may be subdivided into three categories:

- Environmental: environmental events may create physical risks for the companies in the portfolio. For example, such events could arise from the consequences of climate change, loss of biodiversity, changes in ocean chemistry, etc. Apart from these physical risks, the companies could be negatively impacted by steps taken by governments to address environmental risks (such as a carbon tax).



These mitigation risks could affect companies depending on their exposure to the above risks and how well they adapt to them.

- Social: refers to the risk factors linked to human capital, the supply chain and the way companies manage their impact on society. Issues around gender equality, remuneration policies, health and safety and the risks associated with working conditions in general all fall within the social dimension. The social dimension also includes risks of violation of human rights or labour rights in the supply chain.

- Governance: these aspects are linked to governance structures, for example the independence of the board of directors, management structures, labour relations, remuneration and compliance, or tax practices. The thing that governance risks have in common is that they are due to inadequate oversight of the company and/or the lack of incentive for the company to move towards higher governance standards.

The sustainability risk may be specific to the issuer (such as a strike), depending on its activities and practices, but may also be due to external factors (such as an environmental disaster) and have a negative impact on a portfolio performance. In addition, issuers which adapt their activities and/or policies may be less exposed to the sustainability risk.

## 2. Specific risks associated with certain types of investments

### 2.1. Financial instrument characteristics

#### 2.1.1. Bonds

Bonds are negotiable instruments, in registered or bearer form, issued by a given issuer (commercial company, local authority, regional government entity, sovereign or supranational authority, etc.) to investors that lend it capital. The nominal value of bonds at issuance comprises a fraction of the overall amount of the debt. Bonds can be issued at a fixed rate, variable rate or a combination of the two. The maturity (from a few months to a few decades) and the repayment method are pre-established. The buyer of a bond (the creditor) holds a claim on the issuer (the debtor).

#### 2.1.2. Equities

Equities, or stocks, are securities delivered to shareholders to acknowledge their ownership rights in a company. Stocks can be in registered or bearer form. They represent a fraction of the company's share capital. Its price quoted on the stock markets may raise and fall, based on investors' assessment of the company's ability to generate profits in the future.

#### 2.1.3. Commodities

Several types of financial instruments - including certificates, ETFs (exchange traded funds), investment funds and derivatives - offer exposure to commodities. The most common types of commodities include precious metals (gold, silver, platinum, palladium, etc.), ore and metals (copper, zinc, nickel, lead, etc.), agricultural commodities (wheat, coffee, cotton, etc.) and energy commodities (oil, coal, gas, etc.).



## 2.1.4. Real Estate Investments

Real estate investments mostly fall into two categories: physical real estate investments like land, residential and commercial properties, and real estate securities that don't require directly owning physical property, such as real estate certificates, REITs (Real Estate Investment Trusts) or mortgage-backed securities.

## 2.1.5. Derivatives

A derivative is a financial instrument whose value evolves according to the changes in the underlying asset. This asset can be, among others, a market index, an interest rate, a currency, a commodity price or even another derivative. The main derivatives are options, futures, IRS (interest rate swaps), CDS (credit default swaps) and performance swaps.

### 2.1.5.1. Options

Options are derivatives whose value evolves according to the changes in the underlying. The party purchasing the option receives the right to buy (call option) or sell (put option) the underlying asset on a given date or over a given period, for a given exercise price, against payment of a premium to the counterparty (the seller of the option).

#### Features

- Term: the term of an option is the period from its subscription to the date of its expiry.
- Relationship between the option and the underlying: this relationship underscores the number of units of the underlying instrument that the option holder can buy (call) or sell (put) in exercising the options.
- Base price: the base price is the previously agreed-upon price at which the option holder can buy or sell the underlying instrument when exercising the option.
- Leverage: in principle, any change in the price of the underlying instrument generates a proportionately more significant change in the exercise price.
  - Buying a call or a put: the buyer of a call option hopes that, over the term of the option, the price of the underlying instrument will increase, causing the value of the option to increase. Conversely, the buyer of a put option can make a profit if the price of the underlying instrument falls.
  - Selling a call or a put: the seller of a call option hopes that the value of the underlying instrument will fall, while the seller of a put option can make a profit if the value of the underlying instrument increases.

#### Buying an option

Buying an option is a highly volatile investment. The probability of the option expiring without any value is very high. In such case, the investor will have lost the entire amount used to purchase the premium, plus commissions. After buying an option, investors can hold the position to maturity or set up the opposite position, or for US-style options, they can exercise them prior to expiry. Exercising an option may call for the cash settlement of a differential or the purchase or delivery of the underlying.

#### Selling an option

Selling an option usually involves taking a greater risk than buying one. This is because, even if the price obtained for the option is fixed, the seller is exposed to potentially unlimited losses.

If the market price of the underlying evolves unfavourably, the seller of the option will be forced to adjust the margin on the option in order to maintain the position. If the option sold is a US-style option, the seller can be called on to settle the transaction in cash or to buy or deliver the underlying. If the option sold has futures as its underlying, the seller can take a position in futures and will be subject to the obligations concerning the adjustment of the margins.

The seller's risk exposure can be reduced by taking a position in the same type of underlying (securities, index or other) as that of the option sold.



### **2.1.5.2. Futures**

Futures are commitments entered into by two counterparties for the purchase or sale of a given quantity of an underlying asset at a predetermined date and at a price agreed upon in advance. More often than not, this underlying is an interest rate, equity index or commodity.

Futures are generally standard products traded on a regulated market. They can be bought or sold over their entire lifespan.

It is possible to open a position by buying or selling a future. To this end, a guarantee deposit - often representing less than 10% of the commitment taken through the contract - is necessary to reduce the risk of default at expiry. Investors are therefore subject to leverage, which can either play in their favour or against them (potential for a much greater loss than the initial amount invested). This guarantee deposit is subject to daily "margin calls" (= decreases or increases of deposits) stemming from the change in the value of the commitment for each counterparty.

To close the position, the same future can be sold prior to expiry. In practice most open positions are closed before expiry.

### **2.1.5.3. Forward Forex contracts**

A currency forward is a contract in the foreign exchange market that locks in the exchange rate for the purchase or sale of a currency on a future date. A currency forward is essentially a customizable tool that does not involve an upfront margin payment.

### **2.1.5.4. Forex swaps**

A foreign exchange swap is a simultaneous purchase and sale of identical amounts of one currency for another with two different value dates (one at short term and the other in the future).

### **2.1.5.5. Interest rate swaps**

Through these contracts, counterparty agrees to pay a given interest rate over a given period on an initially agreed-upon amount to another counterparty, which in turn agrees to pay another interest rate on this same amount. In general, counterparty pays a fixed rate and the other a variable rate. These transactions can be used, for example, to exchange the fixed income on an asset (a bond) for variable income, creating the opportunity to take advantage of any interest rate rises.

### **2.1.5.6. Credit default swaps ('CDS')**

In a CDS, Counterparty A agrees to pay a given interest rate over a given period on an initially agreed-upon amount ("nominal") to Counterparty B, which in turn agrees to deliver the equivalent of the nominal amount (in cash or shares) in the event a specific issuer defaults. If Counterparty A is afraid that Issuer X of a bond that it holds will default, instead of selling the bond, it can decide to enter into a credit default swap with Counterparty B, which then agrees - against payment - to compensate Counterparty A in the event Issuer X defaults.

The value of the CDS may increase or decrease according to changes in the probability of default of the hedged issuer (X in this example), given that this hedge will end up being more or less relevant.



## 2.1.6. Structured Products

Structured products are pre-packaged investments that are issued by an issuer and whose performance is linked to pay-off determined by one or several underlying assets. These underlying assets may be plain-vanilla securities such as an investment-grade bond or equity, a basket of several ones or more complex strategies on different assets.

## 2.1.7. Investment funds

An investment fund (general term covering in particular collective investment vehicles and open-ended mutual funds) is a company or joint ownership that collects money from a certain number of investors with the aim of investing it in various assets according to the principle of risk distribution and having their shareholders or participants benefit from the resulting management of their assets. The main benefits of an investment fund are diversification (regardless of the amount of the individual investment), professional management and possible exposure to market segments that are sometimes more complex for individual investors to handle.

- In an open-ended fund, the number of units, and therefore participants, cannot be determined at first glance. The fund can issue new units or redeem existing units. The fund is obligated to redeem an investor's units, at the fund's expense, at the agreed-upon redemption price and in accordance with contractual provisions.
- In a closed fund, the issuance is limited to a given number of units. Unlike open funds, a closed fund is not obligated to redeem units. Units can only be sold to third parties or, where applicable, to the market. The price obtained for the units is determined according to supply and demand.

ETFs (exchange traded funds) or trackers are special investment funds, listed on the market like stocks, and reflecting the performance of a given market segment ("passive" management, as opposed to "active" management by a fund manager aiming to outperform a benchmark index).

Some investment funds which take the form of undertakings for collective investments (UCI) are qualified as "illiquid assets" (such as private equity funds, real estate funds, private debt funds,...). Such UCIs have the following specific risks :

- Liquidity risks: investors of such funds must have the financial capacity and the willingness to accept the risks and the lack of liquidity associated with such investments over a very long term. Unitholders may not request the redemption of their units before the expiry of the term of these UCIs. There is currently no organized or public market for trading these UCIs. It is therefore possible that the unitholders will not be able to sell their units during the life of the UCIs.
- Risks inherent in calls for capital and potential investments: an investment in this type of asset is an irrevocable and high-risk commitment, with no guarantee of capital or profitability. As the selected UCIs may only make a limited number of investments, the poor performance or even the default of part of the portfolio can affect the performance of the UCIs. Their management company may not identify a sufficient number of attractive investment opportunities at reasonable economic conditions to meet the diversification objectives of the UCIs. The amounts committed may not be fully called by the UCI management company. Conversely, the Client is required to honour the commitments resulting from his subscriptions throughout the life of the UCIs.
- Valuation risks: The liquidation value of units in such UCIs may not reflect the exact value of their portfolio due to difficulties in valuing their assets, which are by nature illiquid. There is no guarantee that the final proceeds from the sale of the assets of such UCIs will



reflect the valuation made thereof in the periodic valuations made available to unitholders. The valuation of the investments of these mutual funds can change significantly over time. In addition, the timing of cash distributions to Unitholders is uncertain and cannot be planned. It is probable that Unitholders will not receive any distributions in the near term. The repayment of the invested capital and the realization of profits, if any, will only take place on the occasion of the sale by the UCIs of all or part of their portfolio investments.

- Risks of limited supervision: such UCIs are generally less regulated than so-called “traditional” UCIs, the regulators not necessarily subjecting them to prior approval or to the same level of control.

## 2.2. Risks relative to financial instruments

Financial Instrument Type	Main Risks (1)									
	Capital Loss	Interest Rate	Inflation	Credit	Equity	Commodities	Real Estate	Foreign Exchange	Emerging Countries	Counterparty
Money Market Instruments	X	X	X	X				(2)		
Bonds	X	X	X	X				(2)	(3)	
Equities	X				X			(2)	(3)	
Commodity investments	X					X		(2)	(3)	
Real Estate Investments	X						X	(2)	(3)	
Interest Rate Options	X	X	X					(2)	(3)	(4)
Single Stock Options	X				X			(2)	(3)	(4)
Equity Index Options	X				X			(2)	(3)	(4)
Currency Options	X							X	(3)	(4)
Interest Rate Futures	X	X	X					(2)	(3)	
Equity Index Futures	X				X			(2)	(3)	
Currency Futures	X							X	(3)	
Forward Forex contracts	X							X	(3)	X
Forex Swaps	X							X	(3)	X
Interest rate Swaps	X	X	X					(2)	(3)	X
(Options on) Credit default swaps	X			X				(2)	(3)	X
Structured Products	X	May be exposed to some of these risks, depending on the underlying								
Investment funds	X	May be exposed to some of these risks, depending on the underlying								

- (1) These instruments may however be exposed to risks not flagged in the table to a less extent or indirectly.  
 (2) If exposed directly or via the underlying to another currency than the investor one  
 (3) if relative to country/issuer/currency of emerging markets  
 (4) if over the counter instruments (not quoted ones)



### 3. Risks associated with the discretionary portfolio management or advisory investment services

When investing in a discretionary or advisory investment agreement, the client supports the intrinsic risks of the financial instruments chosen by the portfolio manager (cfr previous chapter) but is also likely to support some risks considered at the level of the portfolio:

Portfolio potential risks	Types of portfolio management the most exposed to these risks
Concentration risk	Portfolios concentrated on a single or a limited list of market segments (ie equity sector(s) and/or geographical area(s), specific rating or duration bucket) and/or on a more limited number of issuers/securities.
Liquidity risk	Portfolios investing in securities with less intrinsic liquidity (such as for example stocks with a small market capitalization, bonds with a small issue size or securities issued tailor made and not easily tradable on the market) and/or owning a high percentage of the total amount issued via a same security (cfr proportion of market capitalization, bond issued amount, fund assets). It also concerns portfolios substantially invested on some asset classes considered as less liquid by nature (such as high yield bonds or "illiquid assets").
Leverage risk	Portfolios implementing strategies using derivatives, especially to be invested on the market for a higher exposure level than the invested amount.
Modelling risk	Portfolios for which the asset selection is partially or completely based on the results of a financial model (usually developed by the management company itself) or for which the portfolio level of exposure is mainly driven by a specific risk model.
Sustainability risk	Portfolios that do not put in place some filter such as the following ones : <ul style="list-style-type: none"> <li>- exclusion of controversial activities or issuers,</li> <li>- exclusion of issuers based on sustainability criteria,</li> <li>- inclusion of sustainability risks when issuers are selected or given weightings in the portfolio,</li> <li>- engagement and sound management of the issuers.</li> </ul>
Performance risk	<p>Usually, using asset classes with higher risks can provide a higher return but it depends on the market circumstances and the past performances may never be considered as a certainty for the future.</p> <p>A type of passive management will provide a return closer to the one of a benchmark representative of the relevant market segment, when a more active management should deliver a performance that could be more different, higher or lower depending on the management quality.</p> <p>The quality of the choices done by the portfolio manager in terms of asset selection and allocation directly impacts the performance of a portfolio. In particular, some types of management include, voluntarily or not, some biases (such as - without limitation - growth/value trends, size or contrarian style) that can have a direct impact on the portfolio return.</p>