Share Warrants- *the good the bad and the ugly*

“Excuse me Sir, What is a Warrant?”

A small time investor asked me this question not too long ago. I was clearly surprised by the question since he never looked the type to even be bothered about what an EPS or a P/E ratio was. Then he completed the query with the reason behind it. “I lost half my money in the “ABCD Warrant”. Warrants are very bad”.

Whilst growing in activity and complexity, we are bound to see more trading instruments being introduced to our relatively simple and straightforward Colombo Stock Exchange. Before you judge a trading instrument “good’ or ‘bad’, the first thing you should know is the value of the instrument (Warrant in this case) depends almost entirely on the underlying security. In this issue, lets discuss answer the question of my favorite small time investor.

In simple language, Warrants are securities issued by a company, which give their owners the right to purchase shares in the company at a specific price at a future date.

Share Warrants are usually given as ‘sweeteners’ (issue of free Warrants with a rights issues) to make the offer more attractive. For instance, in 2011 People’s Finance PLC (former Nation Lanka Finance Company) issued free Warrants to those shareholders who subscribed for its rights issue.

Warrants trade separately and usually its price movements occur in relation to the price movement of the respective shares. If investors are confident that value of the underlying stock will increase overtime, the value of the respective Warrant will see a rise. Warrants have no dividend and voting rights, therefore the price is largely correlated to the relationship between the exercise price and the share price of the company.

A Warrant will carry an exercise price (strike price) which is the amount that has to be paid to buy or sell a Warrant. In 2007, Nations Trust Bank (NTB) issued Warrants subsequent to its rights issue and second tranche of the Warrants were converted to shares in March 2011 at an exercise price of Rs.35. By this time, the NTB share was trading at Rs.75 at the Colombo Stock Exchange.

The conversion ratio is the number of Warrants that needed to buy or sell the underlying security. For example, if the Warrant conversion ratio is four for a particular stock, this means that four Warrants will have to be bought to acquire a one stock.

Types of Warrants

There are two main types of Warrants – ***Call Warrants and Put Warrants***. A Put Warrant gives the rights to sell on or before a specified date on an agreed price. In contrary, a Call Warrant gives the right to buy the underlying instrument on or before a specified date for an agreed price. However, currently CSE does not allow Put Warrants in operation as short selling is not allowed.

How to pick a suitable Warrant?

You should consider about two main factors before investing in Warrants. First, investors should have a clear understanding whether the underlying asset is likely to go up or down in value. The decision will direct you to decide whether to select Put or Call Warrants. Say for an instance, that the Government of Sri Lanka has announced a new construction project and the likelihood of a listed blue chip company is getting the project is very high. If this is deemed to be good for the listed company's future earnings prospects, investors will expect the share price to rise. Then you should consider buying Call Warrants.

Secondly, an investor will have to take the time factor in to attention. What this means is, it is important that the underlying asset price to reach to the investor's target price expectations at the same time the Warrant matures. For example, in case of Call Warrant, longer the time to mature, there is more time for the underlying asset to appreciate in value – this will in turn increase the price of the Call Warrant.

Why invest in Warrants?

Gearing effect

The biggest advantage Warrants trading have over stocks trading is the gearing effect. This means that an investor can make a relatively large from a modest investment. For example, say the stock A is currently trading at Rs.20, thereby it will cost you Rs.20,000 to buy 1,000 shares of stock A. A 1% increase of your portfolio invested in stock A will give you a return of Rs.200. But if you buy stock A's Warrants with an effective gearing of 10 times, it should approximately give you same profit of Rs.200. The effective gearing indicates how many percent a Warrant price will move if the underlying stock changes by 1 percent. In this case, trading in stock A's Warrants cost just Rs.2,000 but gives the same return of Rs.200.

This means that if the share price moves in to a favourable direction, an investor can get higher returns with a higher level of gearing. ***But at the same time, if you get your view wrong, losses will also mount.*** However, since Warrants are cheaper than the underlying shares, it frees up investors' cash for other purposes.

A hedging tool

In a market where short calls can be made, buying a Put Warrant gives you the right to sell the underlying asset. This can be even viewed like buying an insurance policy for your portfolio, as it protects you from falls in the market.

For example, one can hold A stock's shares and buy A stock's Put Warrants. If the A's share price keeps falling, losses will be partially offset by the gain in the Put Warrant price. As Warrants can be used to capture both the upside (Call Warrants) and the downside (Put Warrants), they can be used as a tool for risk management in a stock portfolio.

Risks of investing in Warrants

There are risks that investors in Warrants need to manage if they're to succeed in this asset class. All investments have risks, but as a geared investment Warrants are riskier than ordinary equities.

The first risk that an owner of a Warrant faces is that it may expire worthless if the share price is below the strike price for a Call Warrant (and above for a Put Warrant) on the exercise date. Technically, a Warrant holder can still exercise his right to buy or sell an underlying share but there's no point in paying more for a share than it costs on the Stock Exchange.

Warrants have an expiry date – and so a limited life. If the Warrant expires out-of-the-money it will be worthless.

Other risks relate to the underlying share or index over which the instrument is listed, as the Warrant ultimately derives its value from that source. For example, if the underlying share price goes down then the price of a Call Warrant will also fall (or rise in the case of a Put Warrant).

In short,

A Warrant is as good as any other simpler equity investment, just with a leveraged effect. First make sure the company in question has a fundamental upside. If the value of the share is less than the exercise price, the Warrant becomes worthless.

Warrants also have neither right to dividends nor voting rights, so their value is tied entirely to the relationship between their exercise price and the share price of the company. If the share price is below the exercise price, the Warrants are said to be 'out of the money' and they are worthless. If the share price rises above the exercise price, they are 'in the money' and worth something.

Note Warrants are 'geared'. This means that a small rise in the price of the share price results in a large rise in the value of the Warrants, and a fall in the share price has an equally dramatic downward effect on the value of the Warrant.

Note that the owner of a Warrant does not have to buy the shares. He has a right, not an obligation. Note too that the value of a Warrant can quite easily drop to zero (if the exercise price is higher than the share price) and that it will definitely be zero once the time for exercise has passed. So Warrants are risky. Riskier than the simpler equity investments. The age-old investment wisdom "higher risk, higher reward" holds true here.

Remember that irrespective of the investment instrument of your choice, there is no substitute to doing your homework on the investment. Warren Buffet did not accumulate a US$ 40bn fortune by acting on rumours or betting on junk stocks. In the long run- knowledge, patience and hard work always outsmart riding your luck at the roulette table.

Source:

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