14 IDEAS FOR TRADING COVERED WARRANTS

BY ANDREW MCHATTIE

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"When trading beyond the very short term you need two things; control of your risk, and the flexibility to ride out a short term move against you. Covered Warrants enable you to amplify your exposure and potentially boost your returns from the rising or falling price of a single stock, index, commodity or currency pair without ever risking more than you invested".

In this guide, Andrew McHattie introduces 14 different trading techniques that could be useful in different market conditions, incorporating some of the basics of Covered Warrants investing along the way. Examples from the current range of SG Covered Warrants are included for illustration, but please bear in mind their prices and technical characteristics will have changed and that you should always check the latest data before investing.

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The Covered Warrant strategies described in this guide are provided by Andrew McHattie, an investment adviser at The McHattie Group. The strategies expressed in this guide are those of Andrew McHattie only, and Societe Generale takes no responsibility for his strategies. The strategies expressed are Andrew McHattie's views as of the date of publication only. Neither Andrew McHattie nor Societe Generale accepts any liability arising from investment decisions you may make for your own account. This material is intended to give general information only and the investments mentioned may not be suitable for everybody. You should seek professional advice if any of the content of this document is unclear.

KEY TERMS THAT YOU WILL COME ACROSS IN THIS GUIDE

TERM	DESCRIPTION
At the Money	The Covered Warrant's Strike Price is the same as the Underlying Asset price.
Call Warrant	A Covered Warrant designed for rising market trends.
Delta	The sensitivity of the Covered Warrant price to the Underlying Asset price.
EPIC Code	The unique identifier used to quote to your broker.
Effective Gearing	The ratio between a percentage change in the Underlying Asset price and the resulting percentage change in the Covered Warrant price.
Gearing	The ratio between the cost of the Covered Warrant and the cost of purchasing the Underlying Asset directly.
In the Money	The current price of the Underlying Asset is above (Call) or below (Put) the Covered Warrant's Strike Price.
Intrinsic Value	The amount by which the Underlying Asset's price is above (Call) or below (Put) the Covered Warrant's Strike Price.
Out of the Money	The current price of the Underlying Asset is below (Call) or above (Put) the Covered Warrant's Strike Price.
Parity	Number of Covered Warrants required to get exposure to one unit of the Underlying Asset.
Put Warrant	A Covered Warrant designed for falling market trends.
Strike Date	The date that the Covered Warrant expires.
Strike Price	The level at which the Underlying Asset's price must be above (Call) or below (Put) in order to create a payout upon expiry.
Premium	Generally considered to be the price you pay for the chance of the product expiring In the Money. You can calculate it by subtracting the Intrinsic Value from the current price of the Covered Warrant.
Time Value	A component of the Premium which is directly related to the amount of time remaining until expiry.
Time Decay	The erosion of Time Value as a Covered Warrant approaches its Strike Date.
Underlying Asset	The single stock, index, commodity or currency pair that the product is linked to.

WHAT ARE COVERED WARRANTS?

Covered Warrants are similar to options in that there are two types: Call Warrants for rising markets, and Put Warrants for falling markets. They are also very similar in that they provide the right to purchase (Call) or sell (Put) a specific Underlying Asset at a specific price (the Strike Price), on a specific date in the future (the Strike Date). That Underlying Asset could be an index, a stock, a currency pair or a commodity so there really is a world of choice.

What this means in practise is that if you hold your Covered Warrant to expiry, your potential profit is based on how far above (Call) or below (Put) that Strike Price your chosen Underlying Asset finishes on the Strike Date. You don't actually have to purchase or sell your Underlying Asset, and you won't ever receive a barrel of oil delivered to your door. Covered Warrants are cash settled, which means that any profit due will be automatically paid in cash after the Covered Warrant expires. The amount that you receive would be determined by the following formulas:

Call Warrant payout = Underlying Asset's price – Strike Price

Put Warrant payout = Strike Price – Underlying Asset's price

If the market is against you at expiry, your Covered Warrant expires worthless and your investment is lost. However, unlike a CFD or spread bet, you can never lose more than you invested.

Gearing up your potential returns

A key benefit of trading Covered Warrants is the leverage that they provide. For example, a Covered Warrant with Effective Gearing of 10x will move 10 times faster than the Underlying Asset. This means that your profits and losses can be 10x greater than investing directly in the Underlying Asset. You can check the Effective Gearing of any Covered Warrant on our website www.sglistedproducts.co.uk.

Trading prior to expiry

You don't have to hold Covered Warrants until expiry, and indeed, many investors sell back their position long before the Strike Date. Prior to expiry, a Covered Warrant's price will move throughout the trading day according to three main variables; the Underlying Asset price, the time to expiry and the implied volatility level (how erratically the price is expected to move). Typically as time and volatility fall the Covered Warrant price will fall because there is less chance of the Underlying Asset price moving significantly, and changing the potential payout at expiry.

A brief history of Covered Warrant trading

For more than a decade now, Covered Warrants have been listed and traded on the London Stock Exchange, mainly by private investors but also professionals. In the UK they can be purchased via a stockbroker and trade on the London Stock Exchange in a similar way to buying or selling shares.

Issued by banks, Covered Warrants have actually existed for far longer in continental Europe, where they remain popular. They are also traded actively in other markets such as Hong Kong.

More ways to trade

Societe Generale has the largest range of Covered Warrants in the UK, covering a huge variety of single stocks, indices, commodities and currencies. There are typically a number of Covered Warrants for each Underlying Asset with different Strike Dates and Strike Prices, giving you the flexibility to decide the direction you think the Underlying Asset will take, how far it will go, and how long it will take to get there.

Selecting a Covered Warrant

Every Covered Warrant has a unique identifier called a TIDM or EPIC code, which is a four digit code such as 'SG99'. The full product name will include this TIDM, the type of Covered Warrant (Call or Put), the Underlying Asset name, the Strike Price and the Strike Date. For example the SG99 FTSE 100 6,800 June 16th, 2015 Calls are a Call Warrant linked to the performance of the FTSE 100 Index, which will generate a payout on the 16th June 2015 based on how far the FTSE 100 Index is above 6,800. You can select a Covered Warrant according to the name and then use the TIDM to trade it with your stockbroker.

WHAT RISKS SHOULD I BE AWARE OF?

Underlying Risk
The value of the product will depend on the value of the underlying, which may be volatile. Covered Warrants are not suitable for all investors, we recommend that potential investors study the Final Terms and consult their own independent professional advisors before making any decision.

Leverage risk
The Underlying Assets may be volatile and both gains and losses could be greater than those incurred by the Underlying Asset itself.

Time Decay
Covered Warrants have a limited life, as denoted by the Strike Date of each issue. After this date, Covered Warrants can no longer be traded or exercised. Investors should note that Covered Warrants experience Time Decay (erosion of their Time Value) throughout their life. The rate of this decay accelerates as Covered Warrants near expiry and Covered Warrants may expire worthless. You should not buy a Covered Warrants unless you are prepared to lose all of the money you have invested plus any commission on transaction charges.

Price sensitivity
It is important to note that while changes in the underlying price are generally the most important factor for Covered Warrants, other variables - such as market volatility, interest rates, exchange rates and dividends - may lead to a change in the price of a Covered Warrants even if the underlying itself is unchanged. For example, Call Warrants on a single stock can decrease in value due to falls in volatility even if the single stock price increases.

Counterparty Risk
Covered Warrants are issued by Societe Generale Acceptance, a member of the SOCIETE GENERALE group of companies. At any point during the life of the investment, any failure of Societe Generale Acceptance to perform obligations when due may result in the loss of all or part of an investment. Investors should note that holdings in these products will not be covered by the provisions of the Financial Services Compensation Scheme, nor by any similar scheme.

Liquidity Risk
Societe Generale is the only market-maker and therefore the only liquidity provider for Societe Generale's Covered Warrants. Liquidity will only be available in normal market conditions. See page 23 for more information on the Secondary Market.

Currency Risk
For a Covered Warrant whose underlying asset is quoted in a currency other than GBP, exchange rate fluctuations can impact both positively and negatively upon the price of the Covered Warrant.

STRATEGY 1:
CHOOSING CALL WARRANTS

The majority of investors use Covered Warrants quite simply, to gain geared exposure to an Underlying Asset. If you are bullish on UK stocks you might buy a Call Warrant on the FTSE 100 Index for example; or if you are bearish on gold you might buy a Put Warrant on gold. These simple 'directional' trades are the foundation for many active portfolios.

Even with this simple strategy though, to maximize your potential profits it is essential to choose an appropriate Covered Warrant from the range available. One common mistake is for investors to select low-priced Covered Warrants with apparently high Effective Gearing. These can seem enticing – and could provide excellent returns in the right conditions - but they frequently have a very high risk of expiring worthless. Balancing the potential risk and reward is important.

In the Money Covered Warrants

For Call Warrants, a warrant where the current asset price exceeds the Strike Price is said to be 'In the Money' or to have positive Intrinsic Value. The Intrinsic Value is the theoretical value it would have if it were to be exercised immediately. For example, with the FTSE 100 Index at 6,750, the SA20 FTSE 100 6,500 19-Dec-14 Calls (SA20 Call Warrants) are In the Money. Their Strike Price of 6,500 implies 250 points of Intrinsic Value, and with a parity of 1,000 that translates to £0.25 (250/1,000). By Parity, we simply mean a scaling factor which is used by issuers to describe how many units of a Covered Warrant you would need to buy to gain exposure to one unit of the Underlying Asset. It allows Covered Warrants to be created in smaller sizes. Without the Parity adjustment, the Intrinsic Value of SA20 would be £250 and the market price significantly more. Instead, changes in the value of the FTSE 100 Index are scaled down by a factor of 1,000.

The actual market price of SA20 Call Warrants is more than £0.25 because it includes Premium, which is generally considered to be the price you pay for the chance of the product generating a profit at expiry. You can calculate it by subtracting the Intrinsic Value from the current price of the Covered Warrant. In this example, if the SA20 Call Warrant is priced at £0.52, and the Intrinsic Value is £0.25, then it will have a Premium of £0.27 (£0.52-£0.25). The SA20 Call Warrants offer just over 7 times Effective Gearing. This means that any rise or fall of the FTSE 100 Index is amplified 7 times, i.e. a 1% rise in the FTSE 100 Index would create a 7% rise in the value of the Call Warrant all other factors being equal.

You can simply look up the Effective Gearing value for each Covered Warrant on our website, or you can calculate it yourself.

Calulating the Effective Gearing

To calculate Effective Gearing we first divide the price of the Underlying Asset (6,750) by the price of the Covered Warrant (£0.52), and divide the result by Parity (1,000). We take this figure (12.98) and multiply it by the Delta (67.69%) to give us the Effective Gearing (8.79). Don't be put off by the new term 'Delta', it is an indicator used to describe how sensitive the Covered Warrant is to a 1% change in the Underlying Asset. At the time of writing on June 12th, 2014, the Delta value for SA20 Call Warrants for example is 67.69%. This means that the Covered Warrant price moves by just under 0.68% for every 1% change in the Underlying Asset all other factors being equal. Like Effective Gearing, you can find the Delta on our website (www.sglistedproducts.co.uk).

Out of the Money Covered Warrants

For comparison, with the FTSE 100 Index at 6,750, the SC44 FTSE 100 7250 19-Dec-14 Calls (SC44 Call Warrants) have no Intrinsic Value – they are said to be 'Out of the Money' because the current Underlying Asset price is below the Strike Price. These Covered Warrants have a lower price and offer higher Effective Gearing of 10.9 times, and those factors may make them appear more exciting. They could be if the market rallies very strongly, but if there is a gentle rise in the market, the SA20 Call Warrants could actually do better due to the lower Strike Price.

A 50-point rise in the market, for example, is meaningful for the In the Money SA20 Call Warrants because it creates another 50 points or £0.05 of Intrinsic Value, but it is not especially meaningful for the SC44 Call Warrants, which would remain well Out of the Money.

There is a 'pricing' calculator on the SG website for each warrant, enabling you to see what might happen under different scenarios, and it will help your choice if you have a good idea about the time and scale of any movement, plus the strength of your conviction and your own personal risk tolerance. Even better is the 'multipricer' tool that allows you to compare the possible returns from a range of Covered Warrants for a given market scenario.

For more information on the risks involved in trading Covered Warrants, please refer to page 6.

The different states of Intrinsic Value

DESCRIPTION	CALL WARRANT	PUT WARRANT	INTRINSIC VALUE	PAYOUT AT EXPIRY
In the Money	Underlying Asset > Strike	Underlying Asset < Strike	Yes	Yes
At the Money	Underlying Asset = Strike	Underlying Asset = Strike	No	No
Out of the Money	Underlying Asset < Strike	Underlying Asset > Strike	No	No

STRATEGY 2:
CHOOSING PUT WARRANTS

Some new investors struggle to understand Put Warrants, but often this is because the concept is less familiar. You can think of a Put Warrant as a 'reverse' Call Warrant. It carries the theoretical right to sell an asset at a fixed Strike Price, which should mean the warrant gains in value when the Underlying Asset falls.

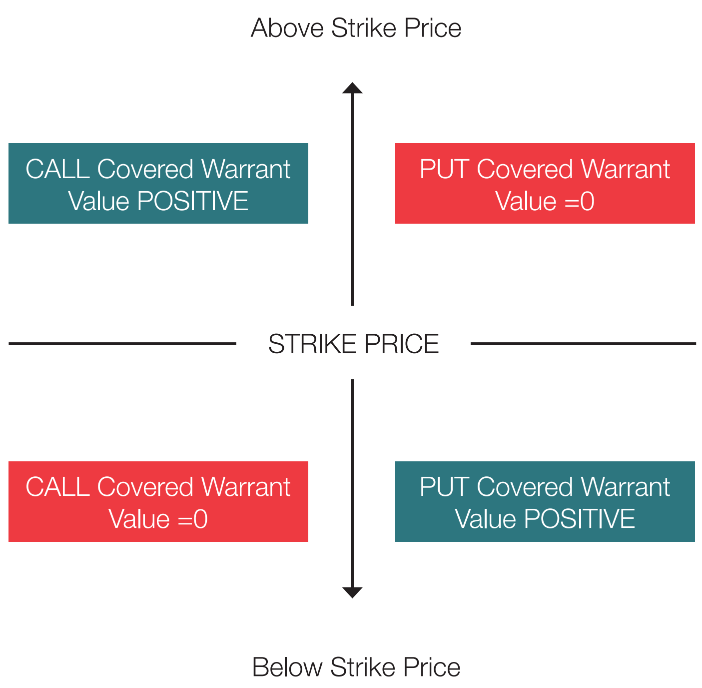
When evaluating Put Warrants, many of the sums are reversed. For a Put Warrant to be 'In the Money', for example, the asset price must be below the Strike Price. Thus, for example, with Standard Chartered shares currently at £12.86, the SB99 Standard Chartered £13.00 20-Jun-14 Put Warrants are just 'In the Money.'

The number of trades in Put Warrants is much lower than for Call Warrants – perhaps because many investors are optimists – and as a result there are fewer Put Warrants available. This means that it is important to be even more careful to ensure those on offer are likely to meet your requirements.

If you are wondering where to begin, the most popular Covered Warrants are typically those on the FTSE 100 Index. This is the most widely-followed measure of stockmarket performance in the UK, and you will usually find a very good range of Covered Warrants available in both Call and Put varieties. There is one further attraction to Covered Warrants on market indices too – because volatility is an important part of the pricing matrix, and indices generally exhibit less volatility than single stocks, index Covered Warrants are generally priced more cheaply.

For more information on the risks involved in trading Covered Warrants, please refer to page 6.

Underlying Asset Price Vs Strike Price



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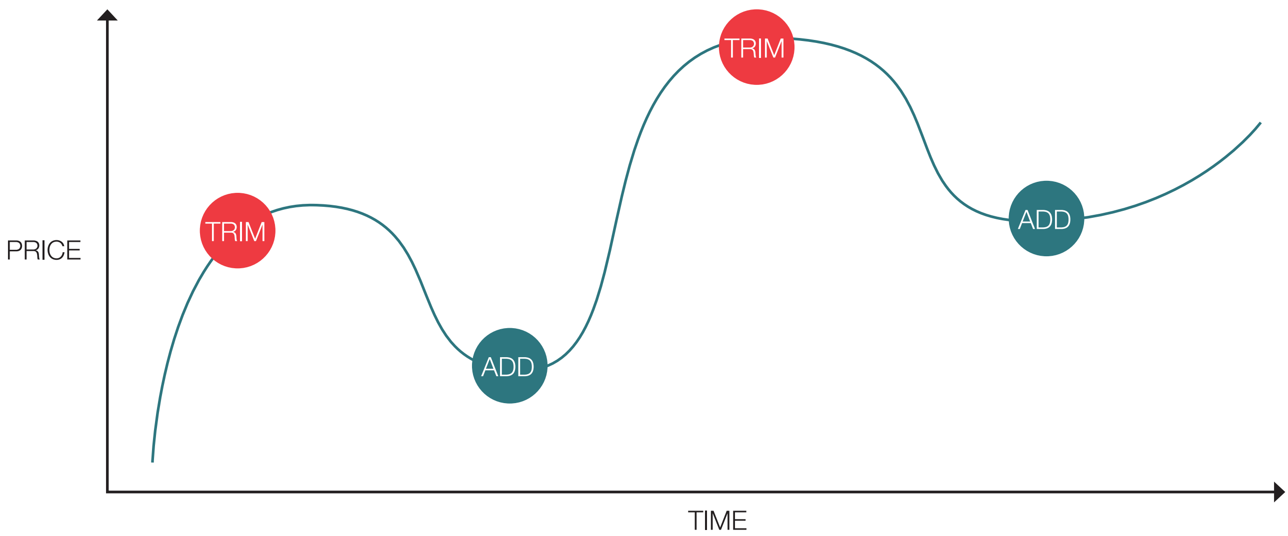
STRATEGY 3:
BUILDING A POSITION

Market timing is not an easy skill, and of course with volatile instruments, a small error in timing can quickly result in significant losses. For this reason, if you are reasonably confident about your medium-term market view, and able to commit a certain amount of capital, then it might make sense to build a position over time. This can make particular sense if you anticipate a sizeable change in price.

Let's say, for example, you believe the US market is going to rise, and you want to establish a bullish position by buying Call Covered Warrants on the S&P 500 Index. Taking a full position on day one is risky, because your entry position may subsequently prove to be a relatively high point. An alternative might be to use the 'pound-cost averaging' approach. This works by investing, say, a quarter of your full investment initially, adding to the position on market dips, and possibly trimming the position if the market rises. Taking advantage of the process of 'pound-cost averaging' is worth considering for assets that move in a non-linear fashion.

One objection to this approach is the cost of dealing. Covered Warrants are fully listed on the London Stock Exchange, just like ordinary shares, and the dealing costs are almost the same. Stockbrokers levy the same dealing charges, typically £5-15 per trade, but there is no stamp duty chargeable on trades in Covered Warrants, which is a small benefit*. The minimum dealing size in Covered Warrants is just one warrant, but because of those fixed dealing charges, a more realistic minimum is perhaps between £500 and £1,000, to avoid costs taking up too large a proportion of your investment. You can invest less, but your investment will need to work harder to overcome the charges. It is also possible that the market continually falls over the course of the investment and has not recovered by the time the Covered Warrant expires. In this case you would lose money on your investment.

For more information on the risks involved in trading Covered Warrants, please refer to page 6.



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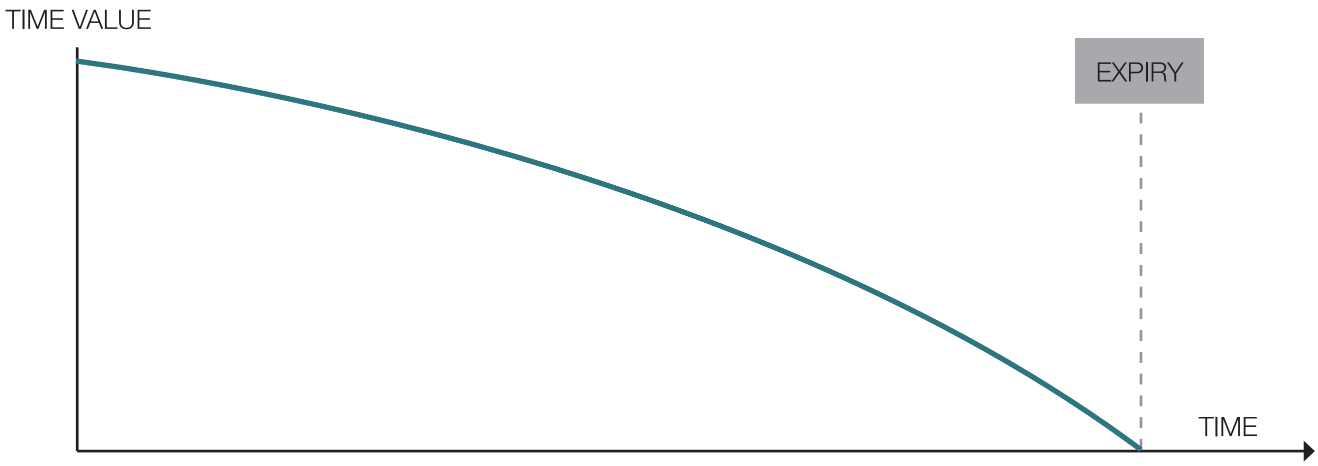
STRATEGY 4:
LONG-DATED WARRANTS

Many investors assume that Covered Warrants are solely for short-term trading. They are of course used frequently in that manner, but the existence of comparatively long-dated Covered Warrants means they can be used for medium-term investment as well. With long-dated warrants you can adopt a more relaxed time-frame if you wish, using warrants that last well beyond this calendar year. This can be very useful if you are expecting a trend to persist for some time, or again if you are uncertain about timing. Some Covered Warrants have longer maturities than traditional investment trust warrants.

Amongst the Covered Warrants in issue, for example, there is the SI34 Nikkei 225 40,000 11-Dec-20 series of Call Warrants, and there are a number that last until the end of 2018. This means you can take a medium-term view if you wish, although of course you can always decide to sell out of a position at any time during normal market trading hours (8.05am to 4.30pm).

You should be aware that if you hold a Covered Warrants position for any length of time, you will probably notice that the warrant loses Time Value. Time Value erodes as warrants approach their final expiry date, which means that if the Underlying Asset stands still, the associated warrants will likely fall in value, whether they are Calls or Puts. Stable markets are not welcome. The good news, though, for holders of long-dated warrants is that this loss of Time Value, known as Time Decay, is spread over a long period, happening very gradually. Time Decay is non-linear, tending to accelerate as warrants become shorter-dated.

For more information on the risks involved in trading Covered Warrants, please refer to page 6.



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STRATEGY 5:
OUT OF THE MONEY WARRANTS

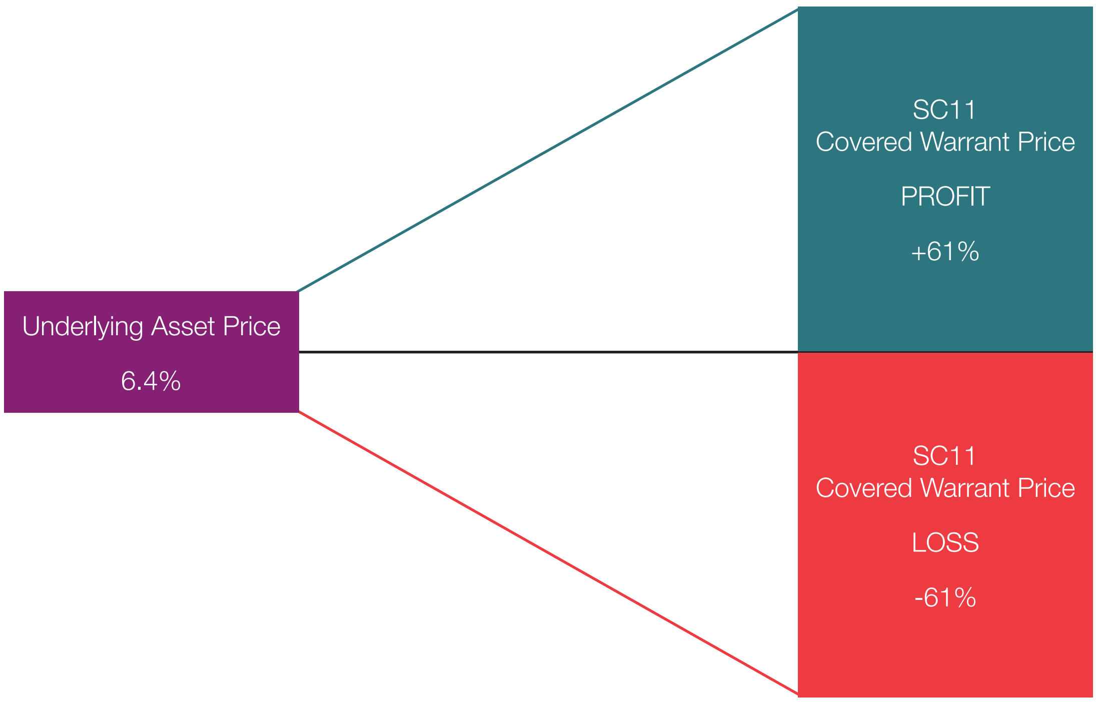
For those occasions when you have a strong view held with high conviction, it may pay to consider the more speculative end of the Covered Warrants market. Out of the Money warrants are typically low-priced, with high Effective Gearing, and can provide big returns if there is a sizeable asset price movement in the right direction.

If you check the largest price gainers on any given day, these will be Out of the Money warrants most of the time. On January 13th, 2014 when this guide was written, for example, the largest riser was the SC11 William Morrison £3.00 20-Jun-14 Calls, which have responded to a 6.4% share price rise with a 61% jump. The Strike Price of £3.00 is significantly above the current share price of £2.51. This demonstrates that an Out of the Money Covered Warrant can be profitable even if the asset price is not particularly close to the Strike Price, as long as it has some time remaining for that to be a reasonable possibility. The biggest riser over the last month, as at 13th January 2014, was the SC64 IBEX 35 Index 11,000 20-Jun-14 Calls, up by 163% in reaction to an 11.8% rise in the index over the same period. Again, these were Out of the Money with the index at 10,363.

Although such warrants offer the chance of a large payoff in response to a big asset price movement, much of the time they may not respond to small moves, and they may lose value if the loss of Time Value outweighs small gains from a changing asset price. Don't forget, if a warrant is Out of the Money, then by definition its entire value is composed of Time Value, and without a positive asset price movement the warrant will expire worthless. This high risk is the corollary to those potential high returns, but for a proportion of your trades where you have a high level of confidence you may be able to justify a move up the risk scale.

For more information on the risks involved in trading Covered Warrants, please refer to page 6.

An example OTM Covered Warrant



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STRATEGY 6:
SHORT-DATED WARRANTS

As Covered Warrants approach expiry, so they reach the dazzling end of the risk and reward spectrum, where price movements can be sudden and dramatic. For nimble investors who are looking for the real excitement, there is nothing like a big expiry period for market action. For more conservative investors, there are good reasons to close positions beforehand and to avoid the late drama. Prices tend to exhibit much more volatility as time grows short and there is less time for any corrective price movements. This can be unnerving if you are not expecting it. Covered Warrants with significant Time Value will also tend to lose it more rapidly as the final expiry date approaches, so this adds to the risk.

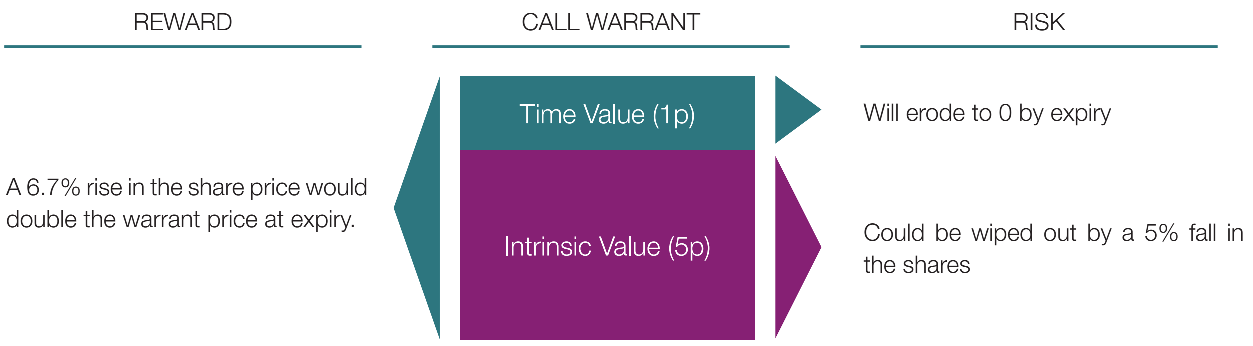
For speculative investors there is no better or more compelling time to look for great opportunities. Hunting for short-dated Covered Warrants that are close to being 'At the Money' – where the Underlying Asset price is close to the Strike Price – can be a particularly rewarding challenge.

If we construct a theoretical example of a Covered Warrant with just a few days to run, we would not expect it to have significant 'Time Value' at this point, but just a little remaining. If we consider an Underlying Asset priced at 105p and some Call Warrants with a Strike Price of 100p, we can consider a theoretical a warrant price of perhaps 6p, of which we can assume 5p to be Intrinsic Value and 1p of Time Value that will disappear. If we consider the risk, first of all, it is extremely high. A 5% fall in the shares would wipe out all of the value, and if the shares remain unchanged then the Covered Warrants will lose that penny of Time Value, equating to 16.7% ((1/6) x 100)). On the upside though, a 6.7% rise in the share price to 112p would imply a 100% rise for the Covered Warrants at expiry.

If the early life of Covered Warrants, soon after issue, is all about probabilities, then the final days of a Covered Warrant is all about absolutes, and those can be both powerful and unforgiving.

If you do decide to deal in short-dated Covered Warrants, or to maintain existing holdings, there is also the question of whether to sell out at the very end, or whether you leave your Covered Warrants to expire. If you do leave them to expire, the investor protection built into the regulations means you will have the Intrinsic Value credited to your broking account, but it is valid to ask whether the actions of the issuing bank in closing its hedging positions can count against you at this time. If the bank winds down its position, perhaps just before expiry, will this move the Underlying Asset price adversely, thereby reducing your return? The answer should be no. Banks only issue Covered Warrants on the most liquid of Underlying Assets, where their activities represent only a tiny proportion of normal trading volumes.

For more information on the risks involved in trading Covered Warrants, please refer to page 6.



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STRATEGY 7:
CASH EXTRACTION

Whilst the majority of market participants think of Covered Warrants as an aggressive way to 'gear up' and gain extra exposure, there is an alternative mindset that is far more defensive. Covered Warrants can in fact be used to lower the overall risk of a portfolio. A strategy called cash extraction can be very sensible in uncertain markets as a way of potentially boosting your returns and reducing your potential maximum loss at the same time.

This strategy draws on the possibility of 'gearing down' by using Covered Warrants to achieve an equivalent exposure to a direct investment with far less capital. This can be a prudent policy to maintain an interest in the stockmarket with a lower overall investment.

Here's how it works

Let's say an investor has a portfolio of FTSE 100 stocks. The portfolio ties up a lot of capital – let's say £50,000 for this example – and the investor is worried about losing this sum if the UK equity market crashes. It would also be useful to have some of that cash for other purposes, but the investor is reluctant to sell and miss out on the potential for future gains. One solution is cash extraction. The idea here is to sell the shares and loosely replicate the portfolio by buying FTSE 100 Index Call Warrants, obtaining a similar level of exposure for far less money and releasing the balance for other uses.

Calculating your trade

There is one calculation to work out how many Call Warrants are needed to provide similarly equivalent exposure to the share portfolio. The formula is to divide the number of shares held by the 'Delta' of the Covered Warrants, and then to multiply that answer by the Parity ratio. Now, you might have a problem with this formula. We are talking about a strategy here to replace a basket of shares with an index warrant, so the number of shares needs to be adjusted first.

Returning to our practical example, we need to think of our £50,000 basket of shares as units of the FTSE 100 Index instead. If we assume the index is 6,750, then our £50,000 might buy 7.4 indices (simply 50,000/6,750). That is the first part of the calculation complete. Next, we need to choose a Call Warrant, preferably one with a reasonable amount of time to run and a good chance of finishing with value at the end of its life. In this case we might choose the SY45 FTSE 100 6,000 18-Dec-15 Calls. The calculation now becomes 7.4 divided by the Delta of 64.2%, and then multiplied by the Parity of 1,000. We arrive at a figure of 11,526, which is the number of Covered Warrants required in this case to replicate the £50,000 basket of shares. At 13th January 2014 the SY45 Covered Warrants could be bought for approximately £0.94, meaning that the investment required in the Covered Warrants was £10,834. This is much less than the £50,000 invested in the shares, allowing £39,166 to be taken out. This is the all-important 'cash extraction' which can now be used for other purposes. The money can be kept safe, it can be used for other investments, it can be used to generate income, to pay off debt, or simply to meet other expenditure requirements.

For more information on the risks involved in trading Covered Warrants, please refer to page 6.

Does it work?

Does this much smaller investment really work to generate similar returns? We can test it with a scenario. If we assume the market rises by 10%, then we would assume the £50,000 share basket would generate a profit of £5,000 in response. The level of the FTSE 100 Index, meanwhile, might rise by 10%, so 675 points, multiplied by the Delta of 64.2% and divided by the Parity of 1000, working out at £0.434p. This would take the price of the Covered Warrants to £1.374, making the holding of 11,526 Covered Warrants worth a total of £15,837, or £5,003 more than the purchase price. That is an equivalent gain, in theory, from a 'geared down' position with much less capital at risk.

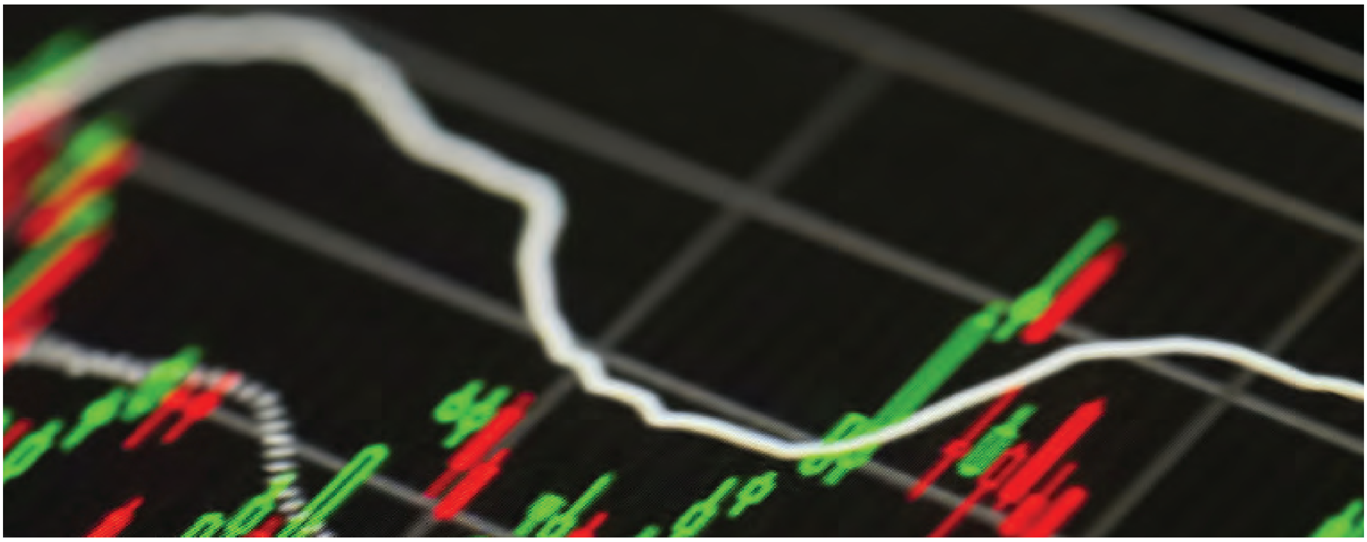
Draw backs to the strategy

In practise, there are some complications. First of all, Covered Warrants are not eligible for any dividend payments declared by underlying investments, so if the income stream from an asset is important, this will need to be factored into any calculations. This need not be a great problem though, as the cash extracted can of course be used to generate an income – perhaps even a higher income if it is used in a focused way. Second, there is one scenario under which the cash extraction strategy fails to work at all successfully. If prices do not move, cash extraction will reduce your returns. Direct holdings would not fall in value, but a Covered Warrant holding would fall due to the loss of Time Value. For this reason, the cash extraction strategy is best used when some movement is expected – and this seems a decent assumption in normal markets. Third, in practise this policy is unlikely to work as neatly and perfectly as the calculations suggest. One problem is that the Delta is not a static indicator. It is always changing, and this means that unless the holding is rebalanced frequently – incurring extra dealing charges each time – then it will likely be less accurate at replicating the movements of an Underlying Asset as time passes. There are caveats then, but even so, a margin of inaccuracy seems a small price to pay in many respects for the benefits.

Taking more specific risk with a Covered Warrant holding can be a way of reducing your overall risk. In the example we have used, the potential loss in the event of a market crash is reduced from £50,000 to a maximum of £10,834. And whereas once upon a time, investors may have scoffed at the idea of blue-chip investments losing all of their value, there have been a sufficient number of high-profile disasters over recent years to remove any such complacency.

Cash extraction may be an approximate methodology at best, but it seems entirely legitimate to consider using the Effective Gearing defensively so that less capital is deployed for an equivalent exposure if market conditions are uncertain. This is a process known as 'gearing down'. As all car drivers will know, gears are intended not just for acceleration, but to help you put the brakes on as well.

For more information on the risks involved in trading Covered Warrants, please refer to page 6.



STRATEGY 8:

STRADDLES AND STRANGLES

Not a method for the high jump, nor a clever kind of knot, straddles and strangles are options strategies that can equally be used for Covered Warrants. These are techniques used to benefit from uncertainty, employed when you expect a move in an asset price, but you do not know the direction. This situation can occur frequently, and it is not difficult to think of a few examples.

Just think about market indices before an election, or before the announcement of an interest rate decision; think about company shares just before they announce their results; think of retailers around Christmas; think of pharmaceutical stocks before drug trials or litigation news – there are numerous occasions where we might expect something to happen, but we do not know whether we will profit from a Call or a Put.

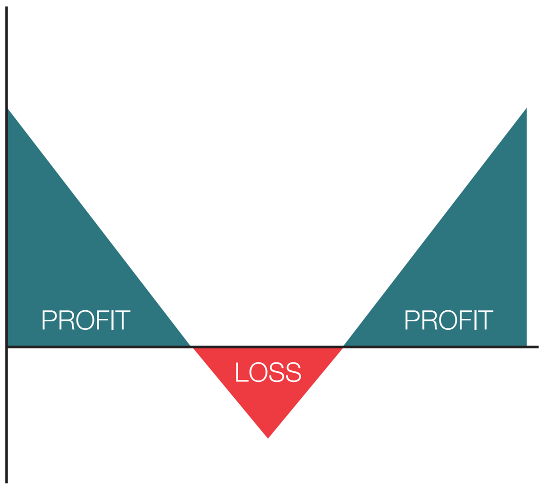
For both straddles and strangles you buy a Call Warrant and a Put Warrant simultaneously on the same Underlying Asset. This might sound fatuous, but actually is it reasonable to expect that the gain on one side might outweigh the loss on the other. This takes advantage of the 'unlimited potential, limited loss' aspect of Covered Warrants, their asymmetric returns profile. It is possible to achieve a profit that multiplies your investment many times over, yet at no point can you lose more than the amount you have invested.

Starting with a straddle, this is where a Call and a Put Warrant are both purchased with the same Strike Price, typically one that is close to being 'At the Money'. With a large enough movement in the asset price, in either direction, the gain on one warrant can outweigh the loss on the other, creating a net profit. The amount of profit will vary with the degree of leverage, the loss of Time Value, and the level of volatility, so it is essential to use the pricing tools available to postulate various scenarios and the possible outcomes. What you will find is that there is a 'valley of loss' in the centre, where a small movement in the asset price does not generate a sufficiently large return on the profitable side to overcome the loss on the other warrant. The larger the movement, and the more quickly it happens, the better the chance you have of utilising this strategy successfully.

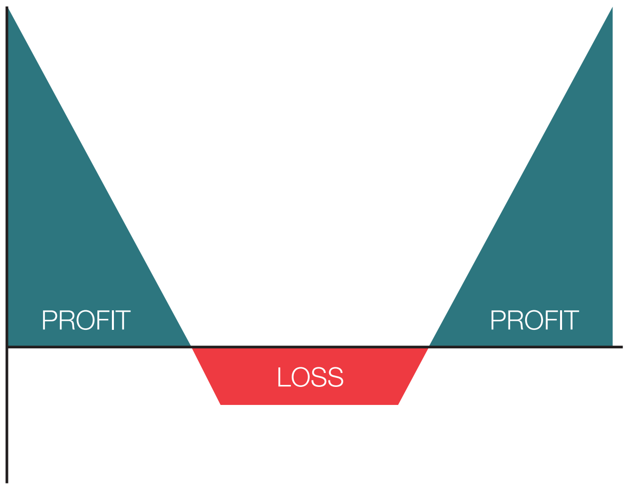
A strangle is very similar, but is used when you have an even firmer conviction there will shortly be a substantial price movement. With a strangle, cheaper Out of the Money Calls and Puts with different Strike Prices are purchased. This can generate superior profits, but at the cost of a wider 'valley of loss'. Strangles can offer greater rewards, but at a higher risk than straddles.

For more information on the risks involved in trading Covered Warrants, please refer to page 6.

An example of a straddle



An example of a strangle



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STRATEGY 9:
PAIRS

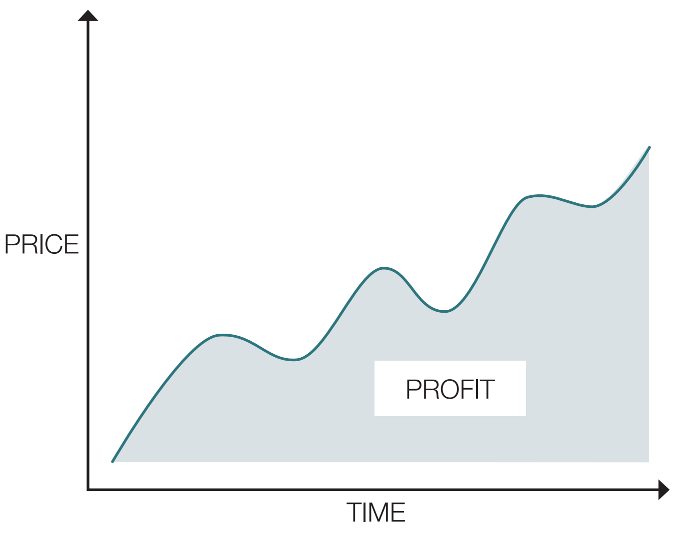
It is sometimes much easier to make sense of the world in relative rather than in absolute terms. You may not be able to judge which cricket team will win the next World Cup, but you may be able to judge that Australia are better than England. The same applies in the financial realm, where stockbrokers often use relative ratings (hence 'outperform' rather than 'buy'), and where you might well form opinions about the merits of Royal Dutch Shell against BP, or Barclays against Lloyds Banking, or the FTSE 100 Index against the FTSE 250 Index. There is a way to create trades that can enable you to benefit from a differential, regardless of the underlying market direction. This is called a pairs trade.

A pairs trade is just what the name suggests – you buy two Covered Warrants at the same time in the expectation that the profits on one will outweigh losses on the other. Let's say, for example, that you prefer gold over silver, you can buy a Call Warrant on gold and a Put Warrant on silver. Of course the two prices move somewhat in tandem, but if you have forecast the differential correctly, you could make more on your Call Warrants than you lose on the Put Warrants (if prices rise), or alternatively lose less on the Call Warrants than you make on the Put Warrants (if prices fall).

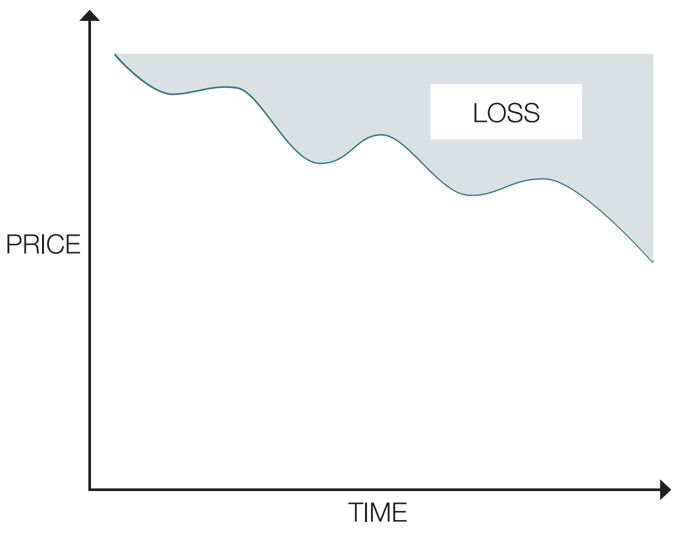
Pairs trades have the merit of being able to isolate a relative position, enabling a potential profit regardless of market direction. Their drawbacks are that they are slightly complicated to set up – as you need to find two suitable Covered Warrants and decide how much to invest in each (as their Effective Gearing may differ), and also that the loss of Time Value on both Covered Warrants can outweigh the potential gain if the difference in performance is not sufficiently marked.

For more information on the risks involved in trading Covered Warrants, please refer to page 6.

Trade 1: Gold Call Warrant



Trade 2: Silver Put Warrant



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STRATEGY 10:

HEDGING

Hedging is rather like insurance. It can be used to protect your portfolio against loss, and is relevant for shareholders who are reluctant to sell out of existing holdings (where there may, for example, be tax considerations), but fear a short-term setback in prices. Where it might be advantageous to offset some of the downside risk, a hedge can be put in place. This involves the purchase of relevant Put Warrants.

Static Hedging

There are two main types of hedging, static hedging and dynamic or Delta hedging. A static hedge is the simplest form, and is quite easy to implement. Once you have found a suitable Put Warrant (which does not have to be on the same stock – it could be a proxy, such as an index warrant), you will need to calculate how many Put Warrants to buy.

To calculate the number of Put Warrants required for a static hedge, the formula is as follows:

Number of Covered Warrants = (value of holding / Strike Price of warrant) x Parity ratio

A shareholder wanting to protect a £10,000 holding in Standard Chartered, for example, might consider buying the SB99 Standard Chartered £13.00 20-Jun-14 Puts.

Holder owns 775 Standard Chartered shares at £12.91 = £10,005.

STANDARD CHARTERED PUT WARRANTS

Strike Price	£13.00
Covered Warrant Price	£0.14
Parity	10
No. Put Warrants required	7,696 ((10,005 / 13) x 10)
Cost of trade	£1,077 (7,696 x £0.14)

Scenario A: Standard Chartered shares fall by 15% to £10.97; loss of £1,501 in share value.

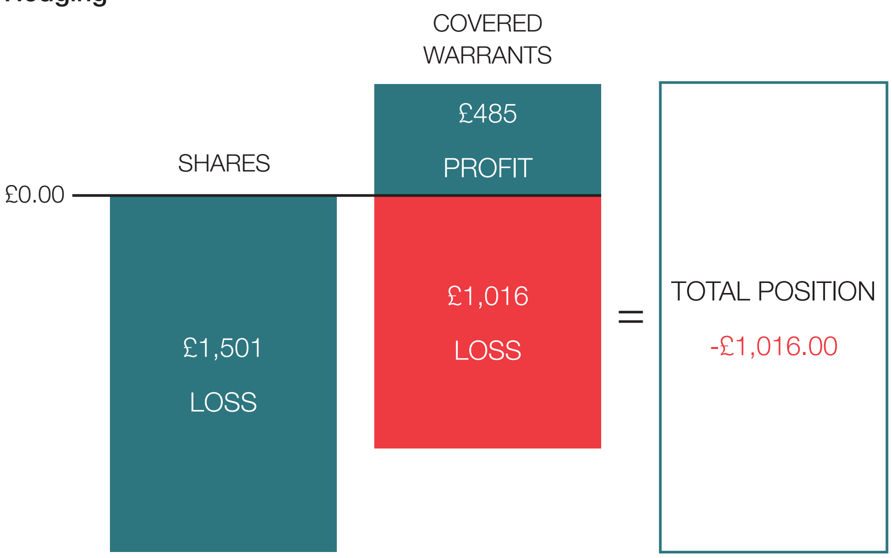
On expiry, Covered Warrants are worth (£13.00-£10.97)/10 = £0.203; gain on Covered Warrants is £485.

This still leaves a net loss of £1,016.

You will see immediately that this static hedge has provided only partial protection, which is a normal outcome here. The loss of Time Value on the Covered Warrants – which for simplicity we have assumed were held until expiry – means that the value of the hedge is eroded. The hedge still has some beneficial effect, but it is not efficient.

For more information on the risks involved in trading Covered Warrants, please refer to page 6.

Example trade; Static Hedging



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Delta hedging

A better strategy is Delta hedging, although it is more complex and also more expensive in terms of the amount of capital required. Here the formula includes reference to the 'Delta' of the Covered Warrants. For Put Warrants the Delta will lie between 0 and -100%, and because this figure indicates how the Covered Warrants should move relative to the asset, we should be able to hedge accurately. One issue here is that the Delta is always changing, and for this reason an accurate hedge requires regular rebalancing (as the number of Covered Warrants you need will change). This is why Delta hedging is also called dynamic hedging.

The formula here is simple, it is the (number of shares x Parity ratio) / Delta

Let's revisit the Standard Chartered example, but this time we will assume the time-frame is short so that the Delta does not change:

Holder owns 775 Standard Chartered shares at £12.91 = £10,005.

STANDARD CHARTERED PUT WARRANTS

Strike Price	£13.00
Covered Warrant Price	£0.14
Delta	-50%
Parity	10
No. Put Warrants required	15,500 ((775 x 10)/0.5)
Cost of trade	£2,170 (15,500 x £0.14)

Scenario A: Standard Chartered shares fall by 15% to £10.97; loss of £1,501 in share value.

Change in Covered Warrants is (change in share price x Delta) /Parity

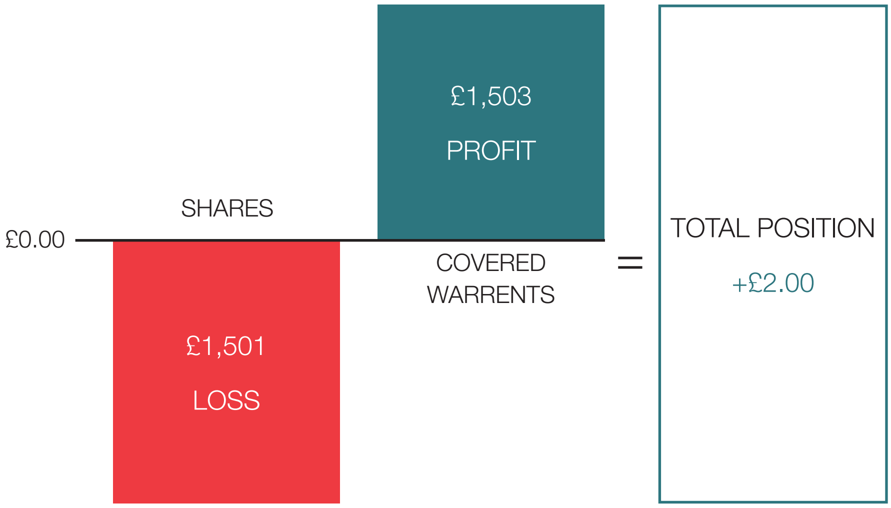
This = (£1.94 x 50%) / 10 = £0.097

So, Covered Warrants rise by £0.097 from £0.14 to £0.237, generating a profit of (15,500 x 0.097) £1,503, offsetting the entire loss on the shares.

We can ignore the negative sign on the Delta here. As long as the Delta is accurate, this hedge should work perfectly, but it comes at a higher cost, and with more effort to maintain its accuracy over time. As is true in other areas of life, good insurance costs more.

For more information on the risks involved in trading Covered Warrants, please refer to page 6.

Example trade; Delta Hedging



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STRATEGY 11:
DIVERSIFYING

When most investors think about gearing, they are really thinking about the ability to generate larger percentage gains and losses using Covered Warrants. Simple Gearing though really means the ability to gain exposure with less money, and that leads on to the strategy of diversification.

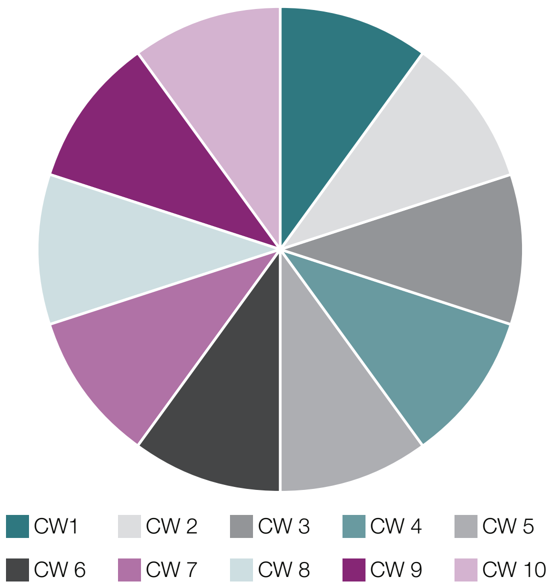
Any book on investment theory will tell you that diversifying your investments is a good way to reduce unsystematic risk, and that spreading your money around is a sensible precaution against sudden and dramatic losses in value. That's fine in principle, but most investors have limited capital to invest, and it may not be realistic to create a broadly-based portfolio with the cash available.

Consider, for example, an investor with capital of £5,000 to invest in equities. He or she may determine that £1,000 is the minimum efficient investment in view of stockbrokers' dealing charges, but the resulting portfolio of five shares will necessarily be concentrated and vulnerable to poor performance if the selections prove unfavourable. Using Covered Warrants, and the benefit of Gearing, the same exposure to those five shares could perhaps be achieved by an investment of £2,500 in total, releasing a balance of £2,500 that can be used for further purchases to broaden the sector or geographical base of the portfolio, reducing the dependence of individual stock performance and dampening overall portfolio volatility.

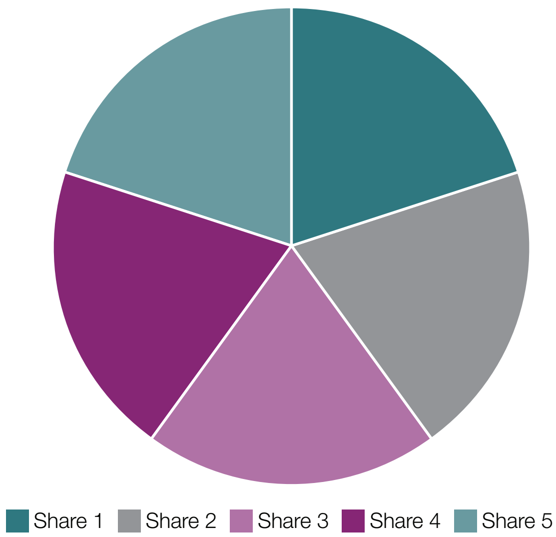
Effective diversification, though, is not quite that simple. If you initially own Barclays shares and you buy further shares in RBS and Lloyds Banking, you are not really reducing your sector-specific risk. It is better to buy non-correlated assets – assets that do not move together – and the wide range offered by the Covered Warrants market is very useful for that. The fact that you can buy Covered Warrants on assets as varied as copper, Google, the pound-euro exchange rate and the Nikkei 225 Index, all in sterling and with standard dealing charges, means that you can more easily and effectively diversify your portfolio.

For more information on the risks involved in trading Covered Warrants, please refer to page 6.

Covered Warrants Portfolio



Share Portfolio



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STRATEGY 12:

LONG-SHOT INVESTING

Even if Covered Warrants are not central to your investment approach, there are many ways of using them as an effective peripheral instrument. One interesting technique for maintaining participation in risky assets even if you want to keep you core capital relatively safe is to try long-shot investing. This strategy involves investing your core capital in gilts, or bonds, or in an interest-bearing account, and then using the interest payments you receive to take highly leveraged Covered Warrant positions.

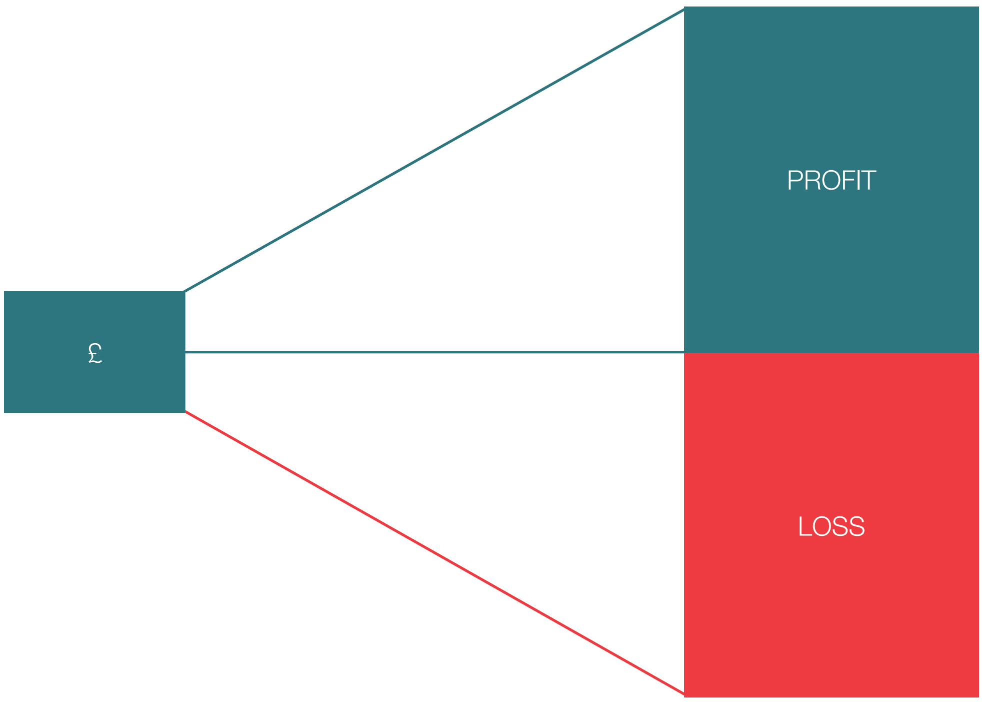
The benefit of this technique is that the leverage can allow you to have some meaningful market participation without too much money at risk. You would probably target Out of the Money Covered Warrants where the potential returns are large, even from a relatively small stake.

The current low interest rate environment is not helpful for this strategy, but it may be that you can generate enough interest on your capital to invest in Covered Warrants occasionally, or you may have some other regular income that could be earmarked for this use.

A quick trawl through the list of Covered Warrants presently available reveals a number of index Covered Warrants with Effective Gearing in excess of 20 times, share and commodity Covered Warrants with Effective Gearing of more than 10 times, and currency Covered Warrants with much higher figures still.

For more information on the risks involved in trading Covered Warrants, please refer to page 6.

Covered Warrants Amplify Profits and Losses



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STRATEGY 13:
CURRENCY WARRANTS

Possibly one of the least appreciated corners of the Covered Warrants market, currency Covered Warrants allow you to participate in the foreign exchange markets, the most active in the world. Whether you have a view on the pound, the US dollar, the euro, or the yen, you can participate with comparative ease, dealing in sterling, on the London Stock Exchange, using your normal stockbroking account.

At first, currency Covered Warrants can seem difficult to understand. In part this is because the Underlying Asset is not just one variable, but the rate of exchange between two variables; it is not always clear whether to buy a Call or a Put; and the figures such as the Intrinsic Value and premium which allow you to consider the valuation are more complex to calculate. It makes sense to learn as much as you can about currency Covered Warrants before you begin trading.

Watching currency Covered Warrants in action can be highly instructive too. Exchange rates are constantly flickering and changing, making these markets extremely interesting for active investors. There are no quiet moments in the currency markets; no stale prices or flat-line graphs. Seeing the markets in action should help you understand the way in which prices move and assist in absorbing the basic naming conventions and whether to use Calls or Puts.

Let's say, for example, you think the pound is likely to strengthen against the US dollar. Clearly the GBP/USD exchange rate is the one to consider, but do you buy a Call or a Put? The first step is to understand the conventional methods of quotation. When expressing currency rates the convention is that the rate is expressed as the amount of the second-named currency you can exchange for one unit of the first-named (the 'base' currency). If GBP/USD is trading at 1.65, this means that you can obtain 1.65 US dollars for one pound.

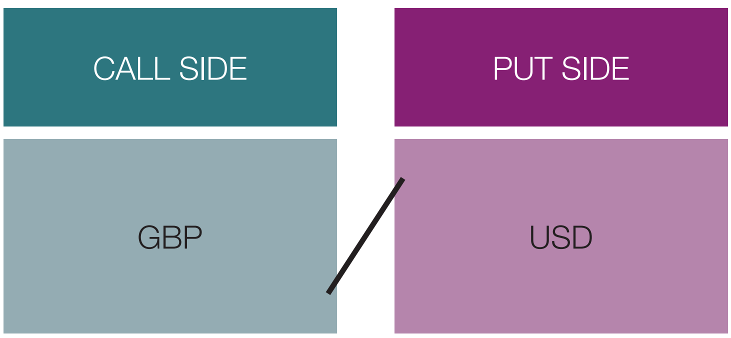
The second step is to recognise that Covered Warrants use the same convention, so their value is determined by the value of the base currency in terms of the second-named currency. Thus, when you are considering whether you need to buy a Call or a Put, it is the first-named currency which matters. If you think sterling will rise, you might buy GBP/USD Calls.

There is a sense in which all currency Covered Warrants are at once both Calls and Puts, since if one side of the ratio rises, the other must fall. Thus a GBP/USD Call is at once a Call on sterling and a Put on the US dollar. The warrant should gain in value if sterling strengthens against the dollar, or if the dollar weakens against the pound. The result is the same.

Different investors use currency Covered Warrants in different ways. You may have a developed a view on the likely future movement of any exchange rate – and there is definitely a wealth of information and analysis widely available on major FX rates - and you want to speculate for profit on this view being correct. Alternatively, you may wish to hedge against an existing position, effectively insuring against an adverse currency movement.

For more information on the risks involved in trading Covered Warrants, please refer to page 6.

Reading Currency Pairs



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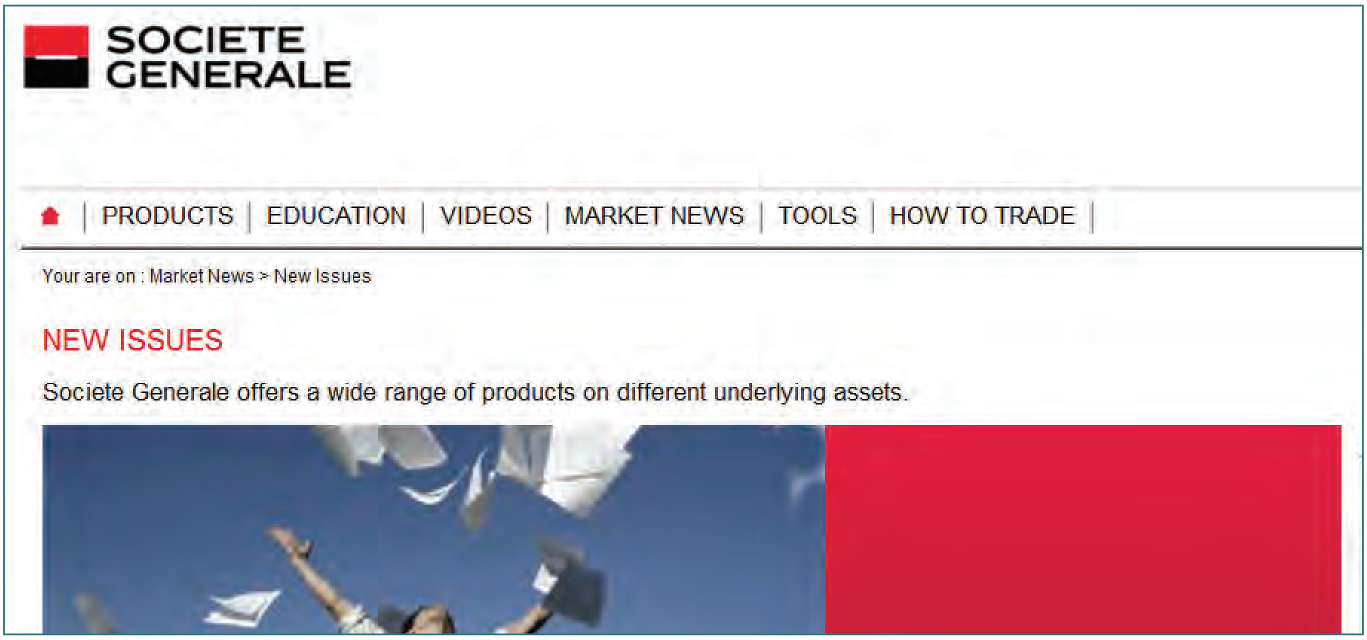
STRATEGY 14:
NEW ISSUES

It is worth keeping an eye on the SG website for new issues, as these can often be interesting. Of course, the time-limited nature of Covered Warrants means there is a regular cycle of expiries and replacement issues, but there are two reasons why new issues can be especially worthy of attention.

The first reason is that they will generally have reasonable Strike Prices that make the new Covered Warrants of immediate practical use for various scenarios. Sometimes, once an Underlying Asset price has moved sharply in one direction or another, this can leave fixed Strike Prices looking too far 'Out of the Money' to be of realistic use, or perhaps too far 'In the Money' to offer much leverage. In this way certain Covered Warrants can become stale, but clearly this is not a problem when they are freshly issued.

The second reason is that Covered Warrant issues are sometimes topical. Thus, at the time of the flotation of Royal Mail last year, new Covered Warrants were issued on the stock, allowing investors to benefit from some of the initial price movements.

For more information on the risks involved in trading Covered Warrants, please refer to page 6.



CONCLUSIONS

With hundreds of different Covered Warrants available, on a swathe of assets of different types, in Call and Put varieties, with short-term and longer-term expiry dates and Strike Prices that pitch the Covered Warrants In the Money or Out of the Money, there is a great deal to explore in this market.

This tremendous variety means that you can be quite creative in how you use these versatile instruments, adapting your strategies to meet your own specific needs. This short guide may give you a few ideas, but ultimately it is your own choice. What we can argue is that Covered Warrants can be used in all market conditions, no matter how your own risk preferences or views might change.

Hear more from Andrew McHattie
Andrew McHattie is the author behind the Societe Generale Traders Blog, an independent commentary which follows his trading strategy across Societe Generale's range of Listed Products. Andrew regularly updates his Blog as he buys and sells products from our range of Covered Warrants, Turbos and Daily Leverage. Each trade will be explained and evaluated so that you can see what he is thinking, and whether each trade is a winner or loser.

You can catch up with Andrew's latest thinking online at www.sglistedproducts.co.uk. Or you can sign up to Market Daily to make sure you hear about any changes in his strategy first.

IMPORTANT INFORMATION

Secondary Market

You can buy or sell these products at any time on the secondary market prior to the Strike Date on any regular trading day from 8.05am to 4.30pm. The value of the product will vary on an intraday daily basis.

- Societe Generale is the only market-maker and therefore the only liquidity provider for all SG Listed Products. Societe Generale will provide live prices throughout the trading day in accordance with LSE rules. The liquidity provided is monitored by the LSE monitoring team, in terms of both spreads and sizes.
- Cases in which there is no guarantee that liquidity or live prices will be available on the secondary market include where:
  - the Underlying Asset is suspended or not tradable;
  - there is a failure in the LSE or Societe Generale systems;
  - abnormal trading situations e.g. sudden and sharp volatility increase or lack of liquidity in the underlying.

This means that you may find it difficult or impossible in certain circumstances to sell the Covered Warrant or may be offered a price less than you paid for it.

Covered Warrants are Securitised Derivatives* suitable for professional clients and sophisticated retail clients in the UK, who have a good understanding of the underlying market and characteristics of the security. In particular, it is important that an investor appreciates at the outset that they could lose all their capital when investing in this securitised derivative, even if it is held until the end of its term.

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*A securitised derivative (SD) is a security listed on the London Stock Exchange and issued by a bank via an Issuing Programme which is approved by the UK Listing Authority. Final Terms are published for each SD which provide investors with its characteristics and its pay-off at maturity. The product features given in the Final Terms are prescribed by the approved Issuing Programme.

THIS COMMUNICATION IS FOR SOPHISTICATED RETAIL CLIENTS IN THE UK.

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