

Financial Instruments and Associated Risks

Overview

This document provides an overview of the principal types of financial instruments and the risks associated with investments in such instruments. The overview is not exhaustive and factors that are not listed here may impact the value of the relevant financial instrument.

Financial instruments involve various risks and therefore it is essential to study the nature of the instrument and the risks it entails before deciding on making an investment. It is important that the investor does not trade in financial instruments unless he/she is fully aware of the risks involved in such transactions and that he/she takes into account his/her financial strength and experience in trading in such investments.

The following shall be kept in mind when assessing whether a financial instrument is suitable for an investor:

- a) The investor must possess sufficient knowledge and experience to evaluate the financial instrument in question.
- b) The investor must be aware of the risks associated with investing in the financial instrument in question and the impact that the investment may have on the investor's assets and financial capacity.
- c) The investor must acquaint him-/herself with and understand the terms which apply to the financial instrument in question and the markets where the instrument is traded.
- d) The investor must be able to assess (either on its own or with the assistance of an advisor) the impact of external factors such as economic fluctuations, changes in interest rates and other similar factors which may impact an investment in the financial instrument in question.

General risk factors

Financial instruments involve various risks, but several risk factors apply to any type of financial instrument and are discussed below:

- a) **Market risk:** The risk that changes in market prices have adverse effect on financial instruments.
- b) **Interest rate risk:** The risk that changes in interest rates have adverse effect on the value of a financial instrument.
- c) **Currency risk:** Exchange rates fluctuate and financial instruments that are registered in foreign currency can entail currency risk. Changes in currency rates can cause profit or loss although the currency value in which the underlying instrument is registered does not change.
- d) **Liquidity risk:** The risk that an investor cannot easily sell or buy a specific financial instrument at a certain point in time, or is only able to do so on terms that are considerably poorer than the norm in an active market at any time. This can be caused by various factors, such as inactive market with a particular instrument, contract size and other factors that may affect the supply and demand and market participants' behaviour.
- e) **Economic risk:** Economic fluctuations often affect the prices of financial instruments. The fluctuations are variable, they can vary in time and magnitude and can affect different industries in various ways. When deciding on an investment an investor must be aware of the general impact of economic fluctuations, including between countries and different economies, on the value of financial instruments.
- f) **Country risk:** The risk includes, among other things, political risk, currency risk, economic risk and risk relating to capital transfers. This refers to the economic factors that could have a significant impact on the business environment in the country in which the financial instrument is registered.
- g) **Legal risk:** The risk that the government makes changes to existing laws or regulations that can have adverse effect on financial instruments, for example changes in tax laws or laws regarding capital transfers across borders.
- h) **Inflation risk:** When investors assess the yield of a specific financial instrument, it is necessary to do so with regard to inflation and inflation outlook to estimate the expected real return on investment and current asset value.
- i) **Counterparty risk:** The risk that a counterparty will not meet his contractual obligations in full.
- j) **Settlement risk:** The risk related to a counterparty not meeting the contractual obligations on the settlement date. Settlement loss may occur due to default or due to the different timings of the settlement between relevant parties.
- k) **Sustainability risk:** Sustainability risk, means an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment.

Risks associated with individual financial instruments

1. Shares

Shares are issued to a shareholder as evidence of the holder's ownership interest in the limited company in question. Shares may be issued as written instruments or electronically in a central securities depository. A shareholder enjoys the rights provided by law and the company's Articles of Association.

Investing in shares may involve the following risks:

- a) **Company risk:** By purchasing shares, the investor contributes funds to the company concerned and in turn becomes an owner of the company along with other shareholders. Therefore, the shareholder, as owner, is involved in the development of the company and the changes which occur to its assets and liabilities. It can be difficult to estimate the return that the shareholder may expect to receive on the investment. In the event of bankruptcy, the shareholder may lose the funds that it originally contributed since priority is not given to shareholders' claims during bankruptcy proceedings.
- b) **Price risk:** The price of shares may fall and/or rise without it being possible to predict the timing or duration of such fluctuations. Price risk must be distinguished from company risk; however, jointly or separately, these factors influence the price of shares with resultant risks for investors.
- c) **Dividend risk:** The amount of dividends, if any, which investors receive from their shareholdings, is determined by the profits of the company in question and its dividend policy. Dividend payments may cease should the company suffer losses.

2. Bonds

Bonds are written declarations in which the issuer unilaterally and unconditionally accepts its obligation to pay a certain amount of money at a given time in accordance with the stated terms. Bonds are generally issued by companies and government bodies. The bond terms, such as interest and maturity, are always determined in advance. Interest can either be fixed or variable. Bonds can also be index-linked, in which case the principal of the debt will be adjusted in accordance with a specific price index, e.g. the consumer price index. The principal of the debt is either paid in one sum on the final maturity date or on predetermined due dates. The purchaser of a bond (the creditor) has a claim against the issuer (the debtor) for the payment of money in accordance with the terms of the bond.

Investing in bonds may involve the following risks:

- a) **Issuer risk:** A bond issuer may become unable to pay its obligations. Such insolvency may be temporary or permanent. Economic and political developments in the sector and the countries in which the issuer operates may impact its payment capacity. In the same manner, the issuer's credit rating may change as a result of positive and/or negative developments in the issuer's operations and influence the market price. Normally there is a connection between the interest on the issuer's bonds and its credit rating, the lower the credit rating the higher the interest rate.
- b) **Interest rate risk:** The market risk factor which has the greatest impact on bond prices are changes in interest rates in the relevant market. An increase in general interest rates leads to a reduction in the market value of the bonds and vice versa. This risk becomes greater as the maturity of the bond in question is longer.
- c) **Call risk:** Bonds may be callable by the issuer prior to maturity. Such redemption may affect the expected yield of the bond in question, for instance if market interest rates are lowered.
- d) **Risk associated with different types of bonds:** Risks other than those listed above may be involved in investments in different types of bonds. Investors are therefore advised to familiarise themselves with the terms of each individual bond issue as they are presented in the prospectus for the bond class and not to make a decision to invest until an assessment of all the risk factors associated with the bonds in question has been carried out.

3. Funds

The sole purpose of UCITS and alternative investment funds is to accept funds from investors for collective investments in financial instruments and other assets on the basis of diversification, in accordance with the fund's existing investment strategy. The difference between these funds lies principally in their investment authorizations. UCITS and alternative investment funds for retail clients are always subject to redemption and unit holders can therefore request to redeem their holdings whenever it suits them. Management companies can also set up other alternative investment funds, which they are unauthorized to market towards retail clients. There are no legal restrictions on investments in funds of this kind and investments in them are therefore considerably riskier than in other funds. Such alternative investment funds are not subject to redemption and generally have a predetermined life span. There are many funds with different investment strategies and the legal rules that govern their activities can also vary.

Investing in funds can entail the following risks and investors are advised to familiarise themselves with the investment strategy of the relevant fund before making an investment decision:

- a) **Sale and redemption:** There is no certainty of there being an active secondary market for UCITS or shares in the relevant fund and it might therefore be difficult for investors to sell their shares. Moreover, in some funds there are restrictions on and/or fees connected to the redemption of shares. UCITS and alternative investment funds are, however, always subject to redemption. However, situations can arise in markets in which trading in the underlying assets of funds is restricted, due to temporary uncertainty regarding the issuers of financial instruments owned by the fund. In such cases, it is permissible to temporarily suspend redemptions in the fund if it is considered necessary to protect the overall interests of the unit holders in the fund.
- b) **Legal risk:** The operations of specific funds may fall under Icelandic or foreign laws, which may mean that certain forms of investor protection or operational restrictions which may apply in one jurisdiction do not apply in other jurisdictions.
- c) **Leveraging:** Some funds are authorised to finance certain parts of their activities with loans and to invest in derivatives agreements. This kind of leveraging can increase the risk of the fund's operations and entail costs that can result in a decline in the value of the investor's shares in the fund.
- d) **Right to participate:** Investors in the fund generally have little or no right to participate in and/or have any influence on the activities of the relative fund.
- e) **Investment strategy:** The investment strategies of funds can vary a great deal. Some funds make specialised investments and, for example, only invest in certain kinds of financial instruments and/or in certain market areas. The risk that the fund bears is therefore primarily connected to the relative financial instruments and/or market areas. Funds may also invest in areas where there is a lot of competition and where there are therefore fewer investment opportunities. Risk policies and diversification differs between funds, but generally speaking the risk is higher in funds that have less risk diversification.
- f) **Evaluation:** If a fund invests in assets which are not liquid it may be difficult to estimate the value of its units/shares.
- g) **Underlying assets:** There can be a variety of underlying assets in a fund, such as shares, bonds, investments in other funds and derivatives. Funds may be subject to market risk and risk inherent in their investment strategies, such as investments outside the regulated markets, short selling financial instruments and leveraged purchases and/or sales which can result in losses for the relevant fund. In evaluating the risk inherent in investing in certain funds one should bear in mind the risk factors that can have an impact on the value of the underlying assets in the fund.
- h) **Management:** The activities and performance of individual funds depends on the competence of its management and staff. The fund manager generally makes investment decisions in accordance with the fund's investment strategy. Bad decisions by the management can result in losses for the fund and investors. If an agreement between a fund manager and key staff members is terminated, there is no guarantee that competent staff can be recruited without the fund suffering losses.

4. Derivatives

A derivative is an agreement in which the settlement clauses are based on the variation of a particular factor during a particular period, such as interest rates, exchange rates, securities prices, securities indices or commodity prices. Derivative agreements give investors rights, which may be optional, to buy or sell certain underlying assets or request a cash settlement. The value of these agreements is based on the development of these underlying factors from the contract date to the settlement date.

Investments in derivatives are often leveraged so that a slight change in the value of the underlying assets can have a proportionately high impact on the value of the derivative agreement with accompanying positive or negative consequences for the relevant investor. Derivative agreements are temporary and can therefore be worthless when they expire, if prices do not develop as the investor had anticipated.

Investments in derivatives should only take place when investors are prepared to withstand considerable losses. Investments in derivatives agreements are subject to certain terms, such as collateral requirements and margin calls, which investors are advised to acquaint themselves with before making an investment.

Examples of varying derivatives contracts are:

4.1 Forward contracts

Forward contracts stipulate the obligations of the contracting parties to buy or sell certain assets at a certain price and a predetermined time. Contracts of this kind can also be settled in cash. Forward contracts are very risky investments, particularly in view of the fact that investors often only have to contribute a part of the amount that is invested and therefore take a loan for the difference. This leverage means that a slight change in the prices of the underlying assets can have a proportionately high impact on the value of the agreement and consequently increase or decrease the market value of the agreement.

4.2 Options

An option is a contract which gives one contracting party, the buyer, the right but not the obligation to buy or sell specified assets at a predetermined price at a specified time or within specified time limits. As a payment for that right, the other contracting party, the seller, receives a certain fee which is determined by the market value of the option at the beginning

of the contract. There are many different types of option agreements and each has its own characteristics. What matters the most, though, is whether the investor is the buyer or seller of such an agreement.

Purchase of options:

The purchase of an option agreement entails less risk than the sale of one because, if the price development of the underlying assets is unfavourable for investors, they can decide not to exercise their option. The maximum loss of the investor is therefore the option fee that was paid at the beginning of the agreement.

Sale of options:

The sale of an option agreement entails considerably more risk than the purchase of one. By selling an option agreement, the investor assumes the obligation to buy or sell the underlying asset if the buyer of the option exercises his/her right. The investor who sells the option agreement may need to put up collateral at the beginning of the agreement and additional collateral if the value of the agreement develops unfavourably for the seller and, at the moment of settlement, the seller may suffer a loss which far exceeds the option fee which the seller was paid at the beginning of the option agreement. In the case of a put option in which the investor owns the assets, which he/she has undertaken to sell, the risk is less. If the investor does not own the assets he/she has undertaken to sell the risk can be unlimited.

4.3 Financial contracts for differences

In some forward agreements and option agreements, the settlements are only permitted to be made in cash. Investments in agreements of this kind entail the same risk as investments in regular forward agreements and/or option agreements, see chapter 4.1 and 4.2.

4.4 Swap agreements

A swap agreement is an agreement between parties to swap different payment flows over a certain period. There are different types of swap agreements, but the most common types are interest rate agreements and currency swap agreements. The main risk factors in interest rate and currency swaps are interest rate risk and currency risk.

Interest rate swap agreements:

This is an agreement in which the parties swap interest payments on specified principals for a certain period in the same currency. In most cases one of the parties pays fixed interest on the specific principal and in exchange receives variable interest.

Currency swap agreements:

This is an agreement in which parties swap interest payments on a principal in two different currencies and the swapping of principals occurs at the beginning and end of the agreement period. Thus currency swaps can be used to convert loans or assets from one currency to loans or assets in another currency.

4.5 Derivatives outside the regulated market

Trading in derivatives frequently occurs outside the regulated market and financial undertakings are obliged to inform investors when this occurs. Investing in derivatives outside the regulated market may entail the risk of investors not being able to settle open derivatives agreements because there is no market for the relevant financial instrument, in addition to which the value of these agreements may be unclear.

5. Unlisted securities

Unlisted securities are, for example, bonds and shares that are not listed on regulated markets. Investments in unlisted securities bear higher risk than in listed securities.

Investing in unlisted securities may involve the following risks:

- a) **Liquidity risk:** Unlisted shares are not listed on regulated markets and can therefore often be illiquid and their price formation may be imperfect and lack transparency.
- b) **Shortage of information:** There are fewer information disclosure requirements placed on unlisted companies than there are on listed ones, in addition to which there is generally less news and analytical data on unlisted companies than on listed ones. The operations of these companies are therefore less transparent and risk increases since less information regarding their operations is publicised.
- c) **Small cap risk:** The operations of unlisted public limited companies are often considerably smaller than those of listed public limited companies. Operations are therefore considerably more vulnerable to changes in general economic developments and/or political circumstances which entail economic consequences.

Warning

All trading in financial instruments entails risk. Investors should evaluate their intended investments in light of their knowledge and experience, financial positions and investment objectives. It is risky to trade in financial instruments without having a full understanding of the nature and scope of the risk the trading entails.