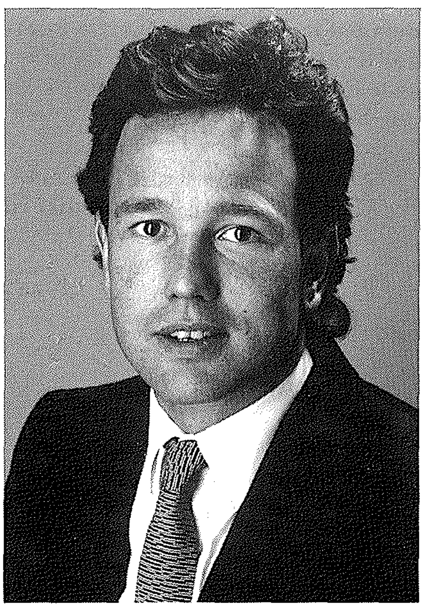
WARRANTS GET THEIR FOOTHOLD ON ASX

BIG ATTRACTION FOR INVESTORS AND ISSUERS



By ANTHONY B. HUNTER

The glamour investment in overseas markets, warrants are now showing their appeal in Australia. Their flexibility promises a big future.

THE overseas growth in the issuing of warrants has been phenomenal. Estimates vary but the 1991 Equity Derivatives supplement to *Futures and Options World* reports that 500 warrants are available over European stocks and indices. This figure obviously does not include the huge market for warrants over Japanese stocks and the recent growth in America.

Interest in Australia increased after November 1990, when the Australian Stock Exchange Limited (ASX) introduced new business rules to facilitate trading in warrants.

First off the mark was Macquarie Bank (MBL) with a series of 15 million call warrants over shares in Boral Limited which started trading on 10 January 1991. MBL followed up the Boral warrant on 18 July with an issue of 10 million call warrants over BHP shares.

Bankers Trust Australia Limited (BT) issued the first index warrant to be traded on the ASX. The four million call warrants over the All Ordinaries Index started trading on 27 June 1991.

Flexible structures

Warrants are similar to long-dated options. Specifications vary considerably between issues but they generally have a life of between eighteen months and five years. ASX warrant rules—Section 8 of ASX Business Rules—allow for considerable flexibility.

Warrants can be over shares, share price indices, currency, loan securities or commodities, provided the issuer can establish that the warrant would be defined as a security under the Corporations Law.

The issuer is free to structure the warrant so that settlement is either by delivery of the underlying security or by cash payment.

All three warrant series currently trading on the ASX are European exercise, meaning that they can be exercised only on the expiry date. However, European exercise is not mandatory for ASX-traded warrants.

They may also be American-style, which enables warrant-holders to exercise their rights at any time before the expiry date.

As the market develops, investors are likely to be offered a range of warrant series of varying maturity, form of exercise and settlement. Flexibility will allow competition between issuers in terms of pricing and the terms of the contract.

This contrasts markedly with the Australian Options Market (AOM), where contracts are standardised: each is an American-style deliverable option contract over 1,000

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shares at time of listing. On the AOM, the only competition is in price.

The decision to trade warrants on the ASX rather than on the Australian Options Market is consistent with overseas practice. Further, the AOM Clearing House guarantee behind AOM contracts does not extend to warrants, making it inappropriate to list them there.

How they work

The term "warrant" has different meanings in different markets around the world. In Australia, warrants are options issued by a third party.

In the case of the BHP warrants, Macquarie Bank issued the warrants and earned the premium income. It is also Macquarie Bank which must meet the obligations of settlement.

The issuer is the only party that can write a warrant. Investors in the secondary market are restricted to buying and selling long positions.

Because there is no clearing house guaranteeing contract performance, when a warrant is exercised the holder deals directly with the issuer in an off-market transaction. This may involve the payment of cash or the purchase or sale of a share or instrument depending on the nature of the warrant.

Clearly the creditworthiness of the issuer is a major consideration when selecting a warrant, especially when different issuers have warrants over the same underlying security.

The financial standing of the issuers is also of crucial importance because of the long-dated nature of warrants. They have a maximum life of five years—and much can happen in that time in both market conditions and the financial fortunes of participants.

For this reason the ASX has prescribed a restricted list of acceptable warrant-issuers. These include banks reporting to the Reserve Bank under the Banking Act, governments or institutions with a guarantor which is a bank or a government.

By only allowing "top-drawer" issuers, the exchange has ensured high integrity in the warrant market while enabling fairly liberal rules.

For example, there is no mandatory level of cover which must be maintained as a hedge for a warrant issue. The issuer may choose to be fully hedged with "back-to-back" cover or delta-hedged using a risk assessment formula, or the issue could be a naked write with no cover at all.

The choice is a commercial decision of the warrant-issuer. In practice, being financially prudent institutions, warrant-issuers maintain varying levels of protection.

Issuers must also be able to respond to the market's potential for diversity, tailoring products according to the needs of investors in much the same manner as over-the-counter options can be made to specification.

What's in it for investors?

Being options, warrants provide investors with a geared exposure to a share or market index for a limited outlay.

Overseas institutions find these leveraged investments attractive because they give the desired level of exposure to a security while minimising currency exposure.

Investors can structure a defensive strategy by taking a pre-determined level of exposure to a security through warrants and investing the balance of cash in fixed-interest securities.

Other investors may choose to switch between the underlying security and the warrant equivalent according to relative market prices. This strategy allows for profit-taking while maintaining exposure to the security to take advantage of continued upward movement.

Put warrants increase in value as the underlying security falls in price. Their attraction is profit for the bearish investor and insurance for the cautious investor.

Being long-dated, warrants will tend to be more expensive than their exchange-traded counterparts due to the time value component. However, they are useful instruments for investors preferring a longer time for decision-making or for investors who do not have time to monitor volatile short-dated options.

What's in it for issuers?

Like warrant-holders, the warrant-issuers hope to make money. They earn premium income when issuing warrants; they also calculate that the warrants will expire unexercised or, if they are exercised, that a sufficient hedge is in place to ensure a profit.

Another attraction is the enhanced market profile resulting from the issue of warrants.

Some market observers have claimed that warrants are largely a matter of repackaging, with institutions buying an instrument in one market and reselling at a higher price to another market.

This stems from the early days of warrants when Japanese companies issued low-yield bonds with a detachable option over the companies' shares attached as a sweetener; others issued convertible bonds. Enterprising institutions in Europe saw a wider market for the options. They bought up the Eurobonds and detached the options to be used as cover for the issue of warrants.

The institutions earned interest on the bonds and premium income from the warrants while being fully hedged in the event of exercise.

The so-called "covered warrants" were particularly appealing to institutions looking for geared exposure to the Japanese market with limited downside. In the late 1980s a bull market and high gearing meant that annual yields on warrants of 200-500 per cent were not uncommon.

Covered warrants were actively traded in the over-the-counter markets in London and Zurich before the establishment of formal secondary markets in Britain, the United States and a number of other countries.

In the formal markets the objective has been to avoid the excesses of the earlier unregulated markets.

The "repackaging" argument of the critics of warrants is undermined by the continuing need for differentiation between warrant issues.

Certainly, it is easy for an institution to buy up, say, a convertible note or Eurobond and issue warrants convertible into the same underlying security, thereby earning a yield on the note and premium income on the warrant, while remaining fully hedged in the event of exercise.

However, such opportunities may be expensive or not readily available.

Instead, back-to-back warrants have been superseded by a new generation of warrants tailored for niche markets.