Financial Instruments

*Simplified brochure issued in connection with «MiFID» regulations (Directive relating to financial instruments markets)*

*January 2010*
## Financial Instruments Brochure

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This is an information brochure issued by ING for its retail (private) customers and drawn up in connection with the “MiFID” legislation (directive relating to financial instruments markets).

This summary brochure is by definition simplified: it is based on the “Financial Instruments” brochure issued by the Febelfin association, from which several excerpts have been taken, with the kind permission of Febelfin.

In this brochure ING has preferred concision, with a view to providing basic information about the various types of financial instruments concerned by the MiFID directive.

The financial instruments concerned by the MiFID and outlined here are bonds, equities, collective investment undertakings, alternative investments and the main derivative instruments (namely options, warrants and futures).

We take a brief look at their main features, the various types, their pros and cons (see Part I) and the risks that characterise them as investment instruments (see Part II).

Products such as “deposit accounts”, “term accounts” or investment products in the form of insurance (Branches 21 and 23) are not included, as they are not targeted by the MiFID directive.

For more information, ING invites its customers to read the exhaustive Febelfin brochure available on the www.ing.be website under the “legal information” tab, as well as on the Febelfin website: www.febelfin.be, from where it can be downloaded. ING customers may also obtain a printed copy (in French, Dutch, English or German) on request from their ING branch, specifying that they would like the brochure issued by Febelfin.

For any questions relating to the instruments described in this brochure, ING customers can contact their ING liaison officer.
Part I. Financial Instruments concerned by the MiFID

We refer to the table in part II for the “Risk” aspects linked to this type of financial instrument.

1. Bonds

1.1 Description

A bond is an acknowledgement of debt by the issuer; it represents a fraction of a loan issued by an issuer for which the bondholder receives interest (coupons). The issuer can be:
- a Belgian or foreign public body
- a Belgian or foreign private enterprise
- an international organisation
- a credit institution (in this case we refer to savings certificates rather than bonds).

Their principle is straightforward: an interest rate which gives right to the payment of a periodic coupon, a loan term, a purchase price and a redemption price at maturity. Some bonds do however have specific features which we will examine in Point 1.3 (main bond types).

1.2 General features

Primary / secondary market
Bonds are issued on the primary market and it is possible to subscribe to them during a subscription period. After this period, bonds may be traded (bought/sold) on the secondary market where prices vary daily (when interest rates rise, prices fall and vice versa).

Issue price and redemption value
A bond may be issued at par (issue price= 100% of nominal value), above par (e.g. nominal value 100, price displayed 102) or below par (e.g. nominal value 100, price displayed 98). The redemption value at maturity is often 100% of the nominal value but a redemption premium may be planned.

Term
The term is determined when the bond is issued but early redemption (“call”) can be planned. Early redemption or a call means that the issuer reserves the right, on certain dates or at certain periods determined at issue, to end the loan and repay the bondholder at a previously determined price. The term also influences the bond’s yield. Generally, the longer the loan term, the higher the interest rate.

Issuer quality
Most issuers receive a rating, which is a standardised code allocated by independent rating agencies (Moody’s, Standard & Poors, Fitch, etc.). This rating assesses the debtor’s solvency. The higher the rating (e.g. AAA), the lower the debtor risk. Nonetheless during the lifetime of the bond, this rating may be reviewed.

1.3 Main bond types

Bonds can be distinguished according to two different points of view: according to their type or according to their issuer.

1.3.1 Bonds by type

• Ordinary bonds:
Ordinary bonds have a fixed term coupled with a fixed rate throughout this term. Holders of ordinary bonds are not eligible for any special rights; if the issuer goes into liquidation, they are reimbursed after all preferential creditors.

• Priority bonds
Holders of priority bonds are reimbursed as a priority if the issuer goes into liquidation. The repayment of capital and interest is guaranteed by some of the debtor’s assets.

• Subordinated bonds
If the issuer goes into liquidation, holders of subordinated bonds are only reimbursed after all other bondholders (preferential and ordinary creditors).
- **Zero-coupon bonds**
  Zero-coupon bonds are characterised by the absence of a coupon (interest is not paid annually, but capitalised until maturity); and a below-par issue, i.e. investors pay less than the nominal value at the time of issue (the issue price is far below the redemption price as it is equal to the current nominal value on the issue date and at the fixed rate).

- **Indexed bonds**
  These are bonds whose yield is linked to the trend in one or more indices (e.g. inflation, gold price, stock exchange index or share price, specific exchange rate); various indexation clauses may be stipulated: for instance, only the redemption price is indexed and no coupon is paid.

- **Floating Rate Notes (FRNs)**
  With this type of note, the coupon amount is not fixed but revised periodically.

- **Convertible bonds**
  Like ordinary bonds, convertible bonds have a fixed rate and term. What differentiates them is the right (not the obligation) of the bondholder to request, for one or more given periods, and at conditions set in advance, their conversion into equities.

- **Bond cum warrants**
  A bond cum warrant is linked to a share; a warrant confers the right to buy the underlying share at a price set in advance. Separated from its warrant, the bond becomes an ordinary bond. Separated from the bond, the warrant has the same features as all warrants (see Point 5.3.2).

- **Reverse Convertible Bonds (RCBs)**
  An RCB is a standard short-dated debt security that offers a relatively high coupon. This coupon should be regarded as remunerating the option reserved by the issuer (usually a bank) of redeeming RCBs upon maturity, whether in cash at the nominal value of the securities in question, in shares, or at the equivalent of their value in cash. Such securities are redeemed either in cash or in equities, but always at the bond issuer's discretion. Given the inherent risks, the Belgian Banking, Finance and Insurance Commission (CBFA) has asked credit institutions to no longer use the term “bond” for this type of instrument.

- **Perpetual bonds**
  These are bonds for which no maturity date is set. They are however accompanied by a call (early redemption).

- **Structured bonds**
  Also called “Structured Notes”, these are bonds which run for a set period with, in most cases, protection of subscribed capital and they offer a potentially higher coupon. The underlyings of a structured bond may be collective investment undertakings, indices, a basket of equities, fixed-income indices, commodities (indices), etc. This product is aimed at well-informed investors owing to its degree of complexity.

1.3.2 Bonds by issuer

- **Savings certificates**
  This is an acknowledgement of a debt from a borrower (the financial institution) towards a lender (the investor). In return for the capital paid to the financial institution, the investor receives interest on the amount entrusted for the agreed term (often from 1 to 5 years, sometimes 10 years or more). Upon maturity, the capital is repaid. Different types of bank savings certificates, such as ordinary bank savings certificates, step-up bank savings certificates, capitalisation bank savings certificates (annual interest is not distributed but added progressively to the initial amount), bank savings certificates with optional capitalisation (= growth bonds) or with periodic payment of interest (quarterly, monthly, half-yearly).

- **Linear bonds (OLOs)**
  Linear bonds are denominated in euros, are dematerialised and are issued mainly by the Belgian treasury for short-, medium- and long-term periods (up to
30 years). Their interest rate, term and redemption price are fixed. They are issued in stages and the issue price is fixed by auction. These instruments are essentially designed for professionals. Individuals may be able to invest in them on the secondary market via their financial institution.

- **Government savings certificates**
  Government savings certificates are fixed-yield securities with an annual coupon, issued by the State in euros for non-professional investors. These certificates are issued 4 times a year (March, June, September and December) and quoted on the Brussels Stock Exchange.

- **Corporate bonds**
  A bond issued by a company is a debt security that represents participation in a long-term loan issued by a private sector company. As a rule the interest rate is normally higher than for bank savings certificates or government savings certificates to offset a higher credit risk.

- **Eurobonds**
  Eurobonds are bonds issued internationally (in several countries at the same time) by private companies, public institutions, sovereign states, and international organisations, outside the country of the currency in which they are issued. They are usually denominated in different currencies. The currency of the issue (exchange risk), the quality of the company issuing the loan (the issuer), the yield and the possibility of redemption before the due date are factors which investors should consider carefully when choosing Eurobonds.

1.4 Pros & cons of bonds

1.4.1 Pros

- In principle, and with regard to most bonds, this type of investment does not offer any uncertainty (amount, date of interim income and capital repayment determined at the time of issue).

- Bonds provide a higher return than short-term investments, with a lower risk than equity investments. Generally the lower the issuer’s rating (which implies a higher risk) the more attractive the return.

- Bonds allow investors who are looking for returns to generate an attractive yield.

- Investment in bonds, essentially in OECD government bonds, is possible for very low amounts and is thus accessible to all.

- In addition to a regular income, bonds can generate capital gains when the market rates fall below the rate of the bond held.

- Unlike “private” investments, bonds can generally be traded at any time on a secondary market.

1.4.2 Cons

- Capital is only guaranteed at maturity.

- During the lifetime of the loan, the value of the bond will fluctuate depending on various factors, of which interest rate trends and the financial soundness of the issuing company.

- The real value of the principal at final maturity is generally lower than the principal at the time of issue owing to inflation. This phenomenon, called “monetary erosion”, is even greater when inflation is high and the bond is long-dated. It will be offset if the nominal interest rate is greater than the average inflation rate during the lifetime life of the bond.

- A loan can only be acquired at the initial conditions during the subscription period. Outside this period, the loan will be obtained at a variable price and the purchase price will be higher as it will include stock market fees.
2. Shares

We refer to the table in part II for the “Risk” aspects linked to this type of financial instrument.

2.1 Description

A share is a certificate of ownership of part of a company’s capital. Shareholders therefore own the company in proportion to the number of shares they possess. Individuals who subscribe to them generally opt for instruments without a maturity (they may only exit by selling the share, no redemption is scheduled contractually), no fixed yield and no nominal or fixed value. The price of a share is a compromise between income (dividends and capital gains) and risks. Such risks can be ascribed to many factors which are both inherent in the company (such as its financial, technical and commercial position, investment policy, its prospects and those of its economic sector, etc.) and external as the stock market is impacted by political events as well as the economic and monetary situation (at both an international and a national level). Furthermore emotional or irrational factors can intensify market price fluctuations upward or downward. All these complex factors influence the share price and can make it relatively volatile in the short term. Thus, shares should be regarded as a long-term investment. In most cases, shares are grouped together in an “index” which pools shares with common characteristics, whether from a geographical perspective (national indices such as the BEL-20, CAC 40, DAX, FTSE, Dow Jones, Nikkei), or from a sectoral or stock market capitalisation perspective (small cap indices, etc.).

2.2. General features

Return
The “return” on a share consists of both the dividend and price fluctuation (capital gain).

Risk
The investor bears the entire company’s risk (he/she will not receive any income if the company does not perform well, and in the event of bankruptcy, the shareholder is placed after creditors in the distribution of the proceeds from the sale of assets (in other words, most of the time, he/she may not recover anything in the event of bankruptcy). On the other hand, as they are joint owners, shareholders have the following rights:

Rights attached to shares
- dividend right: if the company has made a profit and the general meeting resolves to allocate such profit, either wholly or in part (and not to reinvest it or to appropriate it to reserves), shareholders are entitled to a portion of this profit, known as the dividend. Dividends can vary from one year to the next, depending not only on the profit made but also on the profit appropriation policy. If the financial year closed with a loss, it may mean that no dividend will be distributed. Therefore dividends are never guaranteed.
Dividends are generally paid out in cash. Sometimes shareholders also have the option of receiving their dividends in the form of new shares (stock dividend) according to a predetermined allocation.
- voting right at annual general meetings and extraordinary general meetings for approval of the annual financial statements, the appointment and resignation of directors, and approval of the dividend amount distributed to shareholders; shareholders therefore have a right of control over management.
- right to information: before a general meeting, shareholders may peruse the company’s balance sheet, the content of its securities portfolio, the auditors’ reports, and other regular or occasional information communicated by the company; shareholders may request explanations of the company's position.
- right of apportionment: in the event of liquidation, shareholders are entitled to a share of the registered capital.
- right of subscription (priority for new shares) in the event of a capital increase decided with the shareholders’ agreement. Shareholders not wishing
to participate in a capital increase can sell their subscription right on the stock exchange if the shares are listed. Some companies sometimes allot free or “bonus” shares.

- **right of transfer**: in the case of listed companies, shareholders can sell their shares on a stock market.

### 2.3 Main share types

**Shares representing a company’s capital**

Shares can have the following features:

- **Shares with or without voting rights**: voting shares allow shareholders, as joint owners, to participate in general meetings, voting, and management of the company. Non-voting shares give entitlement to a dividend which cannot be less than that granted to voting shares.

- **Preference shares** may give entitlement to a share in the annual profits before all other shares. If the company goes into liquidation, they are redeemed before all other shares.

- **Shares with VVPR strip**: available since 1 January 1994 through public issues, these typically Belgian shares can, under certain conditions, generate dividends that are subject to reduced withholding tax.

**Shares not representing a company’s capital**

To be differentiated from shares: founders’ shares do not represent the share capital or a material contribution and cannot have a nominal value. They are issued in return for a non-financial contribution to the company, in other words a contribution which cannot be evaluated. They give entitlement to a portion of the profit during the life of the company and/or if the company goes into liquidation. Holders can only exercise their voting rights in certain cases.

- **Listed shares**
  
  Certain conditions laid down by the regulatory authorities must be fulfilled before a share can be admitted for listing (including minimum size, publication of regular and detailed information, corporate governance rules, etc.).

- **Sectoral shares**
  
  From the point of view of market investment, a distinction can be made between four sectors:

- cyclical shares (construction, commodities, chemicals)
- growth shares (telecoms, pharmaceuticals, IT)
- financial shares (banks and insurance companies)
- defensive shares centred on consumables and retail services (production and distribution).

### 2.4 Pros and cons of shares

#### 2.4.1 Pros

- In financial terms, it has been demonstrated that, over a long period, the return on shares is greater than that on bonds. This is explained by the risk premium demanded by investors. Unlike bonds, the return on shares mainly consists of the capital gain acquired over time rather than just the income (dividend) distributed.

- **Liquidity**: shareholders can sell listed shares through a stock market on a daily basis. The “liquidity” of a share indicates the ease with which it can be bought or sold.

#### 2.4.2 Cons

Shares represent a risky investment (see table in Part II):

- unlike the fixed interest earned by bonds, dividends are variable income which depends on the company’s performance,

- the share value in the market fluctuates in line with the company’s prospects and the general market trend.

### 3. Collective Investment Undertakings (CIU)

We refer to the table in part II for the “Risk” aspects linked to this type of financial instrument.

#### 3.1 Description

Collective investment undertaking (CIU) is a general term designating an entity, with or without legal personality, which receives funds from the public and
invests them collectively in a group of transferable securities, in accordance with the risk-spreading principle. CIUs are a form of collective portfolio management. The most popular CIUs are “SICAVs” (open-ended investment companies). However, the term CIU covers a range of products that have a specific legal character.

- SICAVs (sociétés d’investissement à capital variable) (open-end investment companies);
- Fonds de placement (investment funds) (including Belgian pension savings funds);
- SICAFs (sociétés d’investissement à capital fixe) (closed-end investment companies), including SICAFIs (sicaf immobilières) (closed-end real estate investment companies);
- PRICAFs (closed-end investment funds for venture capital); and
- SICs (sociétés d’investissement en créances) (debt securitisation funds).

We will only talk here about SICAVs and investment funds.

3.2 General features

- Both SICAVs and investment funds provide the opportunity to increase or decrease their capital daily. The major difference between the two forms is that a SICAV has a legal personality, whereas an investment fund does not: a fund is the indivisible property of its shareholders. Specifically, this has tax implications which will not be outlined here.
- CIUs are subject to specific legislation and prudential supervision by the Banking, Finance and Insurance Commission regulatory body.
- Asset management is entrusted to specialists who invest the amounts collected in various transferable securities (equities, bonds, money market instruments, real estate certificates, currency, forward investments, etc.), while respecting the fund’s investment policy outlined in the prospectus. Investors do not have the right to examine the investment policy adopted by the CIU. To find out whether a CIU meets investors’ needs, they should refer to the fund’s issue prospectus.
- CIUs reinvest the funds entrusted to them by the public according to the risk-spreading principle.
- The net asset value corresponds to the market value per share of the portfolio’s net assets. This net asset value is calculated periodically, more often than not daily, and is published in the financial press.
- CIUs are managed in the exclusive interests of participants. By investing in a CIU, you can spread the investment risk and gain easier access to foreign markets and stock exchanges.
- CIUs are obliged to respect the provisions relating to investor information (compiling of an issue prospectus, annual report, half-yearly report relating to performance, publication of net asset value, etc.).

3.3 Main CIU types

As well as being distinguished by their legal form, CIUs can also be distinguished according to their distribution policy and investment strategy. Here we will briefly see how they differ.

3.3.1 Distinction by distribution policy

A distinction is made between income shares on the one hand, and capitalisation shares on the other. Some companies let investors choose between the two types.

- **Income Shares:** These entitle investors to receive a regular dividend (most often annually). All or part of the income earned is then paid to their holder.

- **Capitalisation shares:** The income received is not distributed to shareholders but automatically added to the invested capital and reinvested. No income or dividends are distributed. Investors only see a return on their investment when their units are sold: this is why the income is in the form of a capital gain.
3.3.2 Distinction by investment strategy

Today there is a vast number of CIUs, primarily SICAVs. CIUs can be grouped together depending on the type of securities held in the portfolio (liquid assets, bonds, equities, precious metals, real estate certificates, or a combination of any two or more).

- **Money market funds** invest mainly in liquid assets and short-term securities (less than one year), such as fixed-term deposits, Treasury bonds, short-dated bonds, commercial paper, and certificates of deposit.
- **Medium-term funds**: invest in fixed-yield securities (bonds) with a maturity of between one and three years.
- **Bond market funds**: invest mainly in fixed-yield securities with a maturity of more than three years.
- **Equity funds**: invest primarily in company shares and secondarily in derivatives (see point 5.3) such as warrants, options, etc.
- **Funds with capital protection**: with a maturity date on which a minimum redemption amount is scheduled for investors. This amount represents total (100%) or partial protection of the initial investment (minus costs and taxes). The underlying securities in these funds can be very varied in type. Most of the time, these underlying securities are equities or bonds. However, a fund with capital protection is more targeted towards fixed-yield securities. The manager must in fact ensure that the initial outlay will be recouped. Here, CIUs operate at two levels, firstly, repayment of the initial outlay upon maturity, and secondly, linking of the fund’s performance to the trend of a related underlying. A distinction is made between two categories of funds with capital protection: “ratchet funds” and “other funds”.
  - “Ratchet funds” minimise the risk of the index falling upon final maturity. The ratchet system allows gains to be definitively blocked, either at a specific level or at a specific time, regardless of the fund’s subsequent performance.
  - “Other funds” do not ratchet gains at interim periods, but on maturity, the increase in the underlying index is taken into account (less than 100%, 100%, or more than 100%).
- **Hybrid funds**: invest in both equities and bonds. A distinction is made between several types of hybrid funds, according to their risk profile:
  - “defensive” (low) hybrid funds devote most of their assets to risk-free investments (e.g. 75% is invested in bonds, mostly denominated in stable currencies),
  - “neutral” hybrid funds distribute their assets more or less evenly between risky investments (equities) and non-risky investments (bonds);
  - “dynamic” and “aggressive” hybrid funds devote most of their assets to risky investments (e.g. 75% is invested in equities).
- **Pension savings funds**: Certain investment vehicles have been favoured by the authorities to promote individual pension savings (Royal Decree of 22 December 1986 establishing a pension savings system). The new investment conditions governing pension savings funds are indicated in the law of 17 May 2004, amending the 1992 Belgian Income Tax Code with respect to pension savings. Anyone aged between 18 and 64 who is liable to pay personal income tax may invest a maximum amount (EUR 870 in 2009) in a pension savings plan and deduct this amount from his/her income on his/her tax return. On reaching the age of 60, investors can leave the plan subject to a one-off, final tax payment. Anyone wishing to leave the fund earlier (before retirement) must pay more tax. Pension savings funds enjoy a preferential status and have proved popular among Belgians. They are hybrid funds as they invest in both equities and bonds. The investment policy of this type of fund is also subject to certain legal restrictions.
- **Real estate funds**: invest mainly in real estate. This category includes funds that invest solely in other real estate funds or in land certificates (SICAFIs).
- **Pricafs**: are fixed-capital investment companies that invest in unlisted companies and growth enterprises.
- **Fund of funds**: are CIUs that invest in other CIUs. Fund of funds managers select other fund managers for a given region, sector, theme, etc.
- **Hedge Funds**: (see point 4.2.2) are deregulated funds using so-called “alternative” or unconventional portfolio strategies with the aim of hedging market or speculative fluctuations or aimed at generating positive returns regardless of market trends (absolute return strategy (also called absolute return funds)). Some of these funds also seek to implement “gearing” as part of these strategies, which considerably increases the risks. However, low-risk hedge funds also exist.

- **Index funds**: the investment policy followed by these funds is to track as accurately as possible a reference index trend (e.g. a national stock index (Bel 20 in Belgium) or a sectoral index). This fund’s trend thus follows the average performance of the index in question.

- **Trackers**: A tracker is an index fund quoted on the stock exchange. Investors are thus able to access a diversified equities portfolio in a single transaction. By investing in a tracker, investors invest directly in the performance of the index. A tracker combines the benefits of shares (simplicity, continuous quotation, etc.) with those of traditional funds (access to a broad range of securities, diversification).

### 3.4 Pros and cons of CIUs in general

#### 3.4.1 Pros

- **Diversification**: CIUs allow investors to build up a diversified portfolio and spread risks.

- **Managed by professional fund managers**: greater returns and more efficient; professionals can respond faster to market events. CIUs are a suitable solution for investors who do not have the time, inclination or requisite know-how to conduct their own portfolio management, including buying and selling shares at the right time, choice and arbitrage of bonds, etc.

- **Economies of scale**: in view of the amount of the funds involved, it is possible to benefit from reduced charges (e.g. on stock market transactions) and to obtain better returns.

- **Investments tailored to investors’ requirements**: the broad range of CIUs available and the specific character of each one effectively meet the diverse and particular requirements of investors.

- **Possibility of investing small amounts**: investors can participate in several markets, or several currencies, even with a modest outlay; diversified portfolio with a modest amount.

- **Access to specific markets which are difficult to access or are not at all accessible to private individuals (e.g. Asian markets) or to sophisticated financial products such as futures and options.**

- **Liquidity and transparency**: the net asset value (in the case of SICAVs), or the market price (in the case of SICAFs), is calculated at least twice a month and often even daily. In addition to the compulsory information provided to investors (prospectus and annual and half-yearly reports which must be submitted beforehand to the regulatory authority), many websites of financial institutions publish comprehensive information in the form of technical fund sheets and brochures. This freely accessible information enables investors to easily track their investments and the overall economic and financial situation.

- **Depending on the type of fund and the underlying in which the CIU will be invested, account should be taken of some of the pros which are specific to the financial instrument in question** (see “pros” list for each of the financial instruments outlined in this brochure (for instance, the advantage of a ratchet fund which allows an intermediate increase to be definitively locked in and obtained on maturity whatever happens, etc.)).
3.4.2 Cons

• Charges: units and shares in a CIU generally give rise to the collection of management charges (the main component of the fee), initial and exit charges (which can vary considerably depending on the CIU’s specific features and on the financial institutions which market them), and stock exchange taxes (TOB).

• Depending on the type of fund and the underlying in which the CIU will be invested, account should be taken of some of the cons which are specific to the financial instrument in question (see “cons” list for each of the financial instruments outlined in this brochure (for instance, the higher risk run by an equity fund than by a bond fund, etc.).

4. Alternative Investments

We refer to the table in part II for the “Risk” aspects linked to this type of financial instrument.

4.1 Description

Alternative investments are those which cannot be made via standard asset categories (bonds, equities or money markets). They have unique characteristics in terms of the risk/return ratio. In many cases, they are highly sophisticated.

4.2 Main types of alternative investments

There are four broad groups of alternative investments:
- real estate investments,
- hedge funds,
- private equity, and
- gold, gold mines, precious metals and commodities.

4.2.1 Real-estate investments

• Real-estate certificates
  A real estate (or property investment) certificate is a security which entitles the holder to part of the rent and sale price of the building (or group of buildings) to which it refers. The issuer is officially the owner of the building; the holder of the certificate is only the financier.

• Real-estate SICAFs (SICAFI)
  A SICAFI is a real estate fixed-capital investment company. This concerns securitised real estate, thus investors acquire real estate not directly, but indirectly – through the purchase of a security representing the SICAFI real estate. SICAFIs are obliged to invest in a several properties (no more than 20% of its assets can be invested in a single property). These are mainly offices, commercial or semi-industrial premises and sometimes housing. The SICAFI can also hold real estate certificates and securities from real estate companies.
4.2.2 Hedge funds

A hedge fund is an investment product which seeks to maximise performance using alternative investment strategies and to generate positive returns regardless of the trends observed on the financial markets (absolute return strategy). The investment practices used by hedge funds are leverage, short selling, derivatives and arbitrage. Hedge funds are complex products reserved for well-informed investors (see point 3.3.2).

4.2.3 Private equity

This term refers to funds supplied to companies which are not quoted on the stock exchange. Several reasons may lead to this type of investment (development of new products and technologies, structural strengthening of the balance sheet, increase in working capital requirements, etc.).

An investment in private equity can also be achieved via funds and thus means the risk linked to an individual company can be limited.

4.2.4 Gold, gold mines, precious metals and commodities

Precious metals have been regarded as means of investment from time immemorial. Gold is the most popular precious metal for investment purposes. It has for a long while been regarded as a safe-haven investment in the event of exceptional circumstances (such as war and political instability). Compared with other forms of investment, it has the advantage of being easily tradable throughout the world at a known price when expressed in accordance with international standards. The benchmark price of gold is stated in US dollars (USD) per ounce. This relates to gold in account, i.e. not physically deliverable. Gold is mainly traded in the form of futures and options (see point 5.3). Similarly, there is also a large physical market expressed in local currency (euro, etc.) and, where applicable, in units of local weight (kilogram, ounce, tael). Nowadays it is the physical market that follows the trend set by the futures and options market. Fluctuations can be significant, and euro-based investors should not underestimate the currency risk.

Other precious metals, whose markets are highly speculative and not recommended for small investors, they mainly include silver, platinum, palladium, iridium, rhodium, etc. These metals are mainly traded in US dollars on the US markets. Under normal market conditions, they are not generally available in physical form.

Raw materials (commodities): It is mainly via commodity futures and futures that investments are made in commodities (where one unit is exchangeable against another unit of the same commodity) such as wheat, precious metals, oil, gas, cotton, coffee, etc.

Traders carry out such transactions to hedge against any adverse price trends, and investors/speculators do so to take advantage of price fluctuations on markets where such commodities are traded.

4.3 Pros and cons of alternative investments

4.3.1 Pros

Alternative investments are investment instruments which, in principle, offer the benefit of a low correlation with traditional investments. They thus allow a marked improvement in portfolio diversification and improved long-term returns while reducing the risk.

4.3.2 Cons

- Product transparency is generally less than that for traditional investments.
- Liquidity of alternative investments is generally lower than for traditional investments.
- These products are designed for well-informed investors who are well aware of the rules of the game and closely track market trends.
5. Derivative financial instruments

We refer to the table in part II for the “Risk” aspects linked to this type of financial instrument.

5.1 Description

What is a derivative financial instrument?
Financial derivatives have been developed to hedge the risks associated with exchange and interest rates and, primarily, volatility. They are called derivatives in the sense that they are “derived” from the underlying financial instruments they are intended to hedge. They can be used for hedging or speculative purposes. A financial derivative gives its holder the right, or the obligation, to buy or sell an underlying asset (e.g. a share, currency or stock market index) at a fixed price prior to and during a specific period. A derivative should not be confused with an investment in the underlying asset. On expiry of its exercise period, it becomes valueless.

5.2 General features

Gearing
Financial derivatives allow considerable returns to be made in relation to the outlay. This is known as gearing. For example, paying the premium is all that is required to invest in options. The potential returns can be substantial. However, the associated risk is also significant: the entire outlay can be lost. Gearing operates, therefore, in both directions. Investors should never forget that the hope of high returns is coupled with a high risk. Investors selling an option will receive a premium but, in return, may expose themselves to unlimited risk (selling a call option without having the underlying at their disposal).

For investors daring to take risks
Financial derivatives are very high-risk investments: the return on investment varies considerably and recouping the amount invested is far from certain. Derivatives should, therefore, represent only a limited part of a total portfolio. The specialist financial markets offer standardised contracts and coordinate the market-making, which means that anyone can buy or sell contracts by systematically locating a counterpart. Euronext.liffe is a single derivatives trading platform that offers equity, index and interest rate derivatives.

5.3 Main types of derivative financial instruments

The main types of derivative financial instruments are: options, warrants and futures.

5.3.1 Options

An option is a financial contract that simply gives the holder of the option the right, but not the obligation, to buy (call option) or sell (put option) an underlying asset at a predetermined price (exercise price) on a specific date (European-style option) or during an agreed period (US-style option). Many options are not linked to one specific share but to a basket of shares whose performance is measured by a stock market index. The option confers a right on its buyer/holder, but an obligation on its seller/writer: if the holder of the option wishes to carry out a transaction, the seller is obliged to do so. In exchange for such an obligation, the seller receives a premium. The premium received by the seller remunerates him/her for the obligation, and therefore for the risk that he/she agrees to take on. The premium is the option price and reflects what the market is prepared to pay for the exercise right it represents. Options can be traded in a secondary market.

EXAMPLE OF A CALL OPTION
Let us consider the case of a call option which, for the next three months, allows the purchase of share “x” at a price of 50 euros, and let us assume that the current share price is 45 euros and that the option costs 1.50 euros. The buyer, who has paid 1.50 euros for this option, hopes that share “x” will have risen sufficiently in three months, so that it is more...
worthwhile exercising the option (i.e. paying 50 euros to obtain one share) than buying the share on the stock exchange. In this case, the total cost will be 51.50 euros (strike price of 50 euros plus the option price of 1.50 euros). If the share is worth 55 euros three months later, the investor will make a gain of 3.50 euros (55 euros – 51.50 euros) by exercising his option and reselling the share directly on the stock exchange. Prices above cost (51.50 euros) will make an increasingly higher gain for the option. The value of a call option increases, therefore, with the probability that the market price will exceed the strike price; this is all the more likely as the option has a long life and the share is considerably volatile. However, if share “x” is worth less than 50 euros, the investor will not exercise the option; he will incur a loss (representing a gain for the seller of the option), but it will be limited to not more than his initial investment, namely the price of the option, i.e. 1.50 euros. Considering the purpose for which it is bought, a call option is therefore a bull contract.

EXAMPLE OF A PUT OPTION
A put option allows share “x” to be sold at 50 euros in three months’ time, and let us assume that the price of the option is 1 euro. If on expiry the share loses ground and falls to 45 euros, the holder of the option will exercise his right and make a gain of 4 euros (50 euros – 45 euros (price of the share) minus 1 euro (price of the option)), by selling an option at 50 euros which he can buy for 45 euros on the stock exchange. If, however, the share price exceeds 50 euros at expiry, the holder of the option will let his option lapse without exercising it, and the transaction will show a loss limited to the amount of the premium paid, i.e. 1 euro. In practice, an option is rarely exercised as it results in the purchase or sale of shares at the strike price, on which standard stock exchange fees are charged. This is because market positions can be settled by closing trades, which is considerably less expensive. The holder of the option therefore waives his right by a closing sale, and the seller can terminate his obligation to deliver by a closing purchase.

5.3.2 Warrants
Warrants are very similar to options (call/put). A warrant is a financial instrument which gives its owner the right and not the obligation, to buy (call warrant) or sell (put warrant) an asset for a defined period at a predetermined price. The investor can exercise his right if this is profit. In fact, the warrant can be compared to an option with a longer lifespan. The asset may be a share, a basket of securities, a bond, a currency, a commodity or an index and is also referred to as a warrant underlying.

5.3.3 Futures & forwards
A “future” is a forward contract under which two parties undertake to buy or sell a specific quantity of an underlying security (currency, bonds, stock market indices etc.) at a fixed price and on a specific future date. In contrast to options, futures contracts imply an obligation on both parties: the buyer of the future undertakes, when the contract expires, to receive the underlying, in return for payment to the seller of a sum called the “amount due”. For its part, the seller of the future enters into a commitment to deliver the underlying when the contract expires, in exchange for the amount due. “Forwards” are similar structures which are not listed on the stock exchange. They can be tailored to suit customers’ specific requirements.
5.4 Pros & cons of derivative financial instruments

5.4.1 Pros

• Derivative financial instruments give investors the opportunity to cover in full or in part, all or some of the asset categories in their portfolio when the assets which make it up are liable to experience a substantial adverse trend.

• They offer the opportunity to speculate on a significant gain in the short term thanks to gearing.

• Derivative financial instruments energise portfolio management.

5.4.2 Cons

• Derivative financial instruments quoted on the market are generally standardised to allow an efficient market. Thus the underlying asset does not always correspond exactly to the asset which the investor wishes to cover. Customised coverage can be arranged, but will be to the detriment of the product's liquidity.

• Aimed at well-informed investors who are completely familiar with the rules of the game and closely track market trends.

Part II. The various risk types of financial instruments

1. Different risk types - Definition

1.1 Insolvency risk

The insolvency risk is the probability, for the issuer of the transferable security, that the debtor will no longer be able to meet its commitments. The quality of the issuer of a transferable security is very important as the issuer is responsible for repayment of the initial capital. It is imperative to assess this risk effectively. The poorer the issuer's financial and economic position, the greater the risk of not being repaid (or of only being partly repaid). The interest rate offered by this type of issuer will obviously be higher than that offered by a debtor of better quality for a similar product. One way or responding to this issue is a rating: risk assessment, also known as rating, established by an independent body such as Standard & Poor's, Moody's or Fitch.

1.2 Liquidity risk

Sometimes an investor wishes to recoup his money (capital + any interest) before the investment matures, either out of necessity or to reinvest in a product with a greater return. The liquidity risk is the probability, for the investor, of encountering difficulties when recouping the whole initial capital invested before the fixed maturity (if there is one). The liquidity of an investment is affected by a number of factors, namely:

• the volume of transactions on the market in which the product is traded: prices fluctuate more in a limited market where a large order can result in a significant price variation. The bigger the market, the lower the liquidity risk,

• the costs associated with leaving an investment,

• the time required to recoup funds (payment risk).
1.3 Exchange risk

When investing in a currency other than euro, there is inevitably an exchange or currency risk. The exchange risk is the probability that an adverse trend in the currency being invested in will reduce the return of the investment. If the trend in the currency is adverse, the return will be eroded following the shortfall in profit due to the conversion to euro. If the trend is positive, the investment will enjoy a “normal” return, as well as a capital gain due to the favourable exchange rate. A distinction can be made between five major regions from the viewpoint of the “currency” risk: the euro zone, European countries outside Euroland (UK, Switzerland, Sweden, etc.), the dollar zone, Japan, and the emerging countries (Asia excluding Japan, Latin America and Central Europe).

1.4 Interest rate risk

The interest rate risk is the risk associated with a change in interest rates in the market, resulting in a drop in the financial instrument price. In the case of fixed-rate investments, such as bonds, the interest rate risk is expressed by the probability that a change in rates will not result in a change in the market price of the bond and, therefore, in a capital gain or loss. If selling in the secondary market prior to maturity when the market rate is more than the nominal rate of the bond, the investor will incur a capital loss. On the other hand, if the market rate is less than the nominal rate, the investor will realise a capital gain, all other elements remaining equal.

Example: a ten-year bond issued in 2001, whose rate is fixed at 5%, will see its value decrease if the market rate rises to 6% in 2002. However, its value will increase if the rate falls to 4%.

In the case of variable-rate investments, such as shares, an interest rate rise generally has a negative impact on share prices.

1.5 Volatility risk

The volatility risk is the probability that the price of a variable-yield investment will fluctuate more or less severely, resulting in a capital gain or loss. Investors will book a capital loss if the price drops and a capital gain if it rises.

1.6 Risk of no income

The risk of no income is the probability that an investor cannot withdraw income from his investment. This will result in an absolute loss owing to inflation and a relative loss compared with a remunerative investment (opportunity cost).

1.7 Capital (or redemption) risk

This is the probability that the investor will not recoup his entire initial outlay upon maturity or on exiting from his investment. When investing in shares for instance, the capital risk is significant as the capital invested fluctuates in line with the company's financial and economic position, as well as according to the trends witnessed on the stock markets.

1.8 Other risks

Risks specific to a type of investment. See summary table point 2.
2. Summary Table

This table shows the risks specific to each type of financial instrument.

<table>
<thead>
<tr>
<th>Insolvency risk</th>
<th>Liquidity risk</th>
<th>Exchange risk</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Bonds</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.1. Bank savings certificates</td>
<td>Negligible, since credit institutions are closely supervised by the Banking, finance and insurance commission (CBFA). Credit institutions are obliged to adhere to the “System for the protection of deposits and financial instruments” which indemnifies investors if any credit institution goes into liquidation. Bank savings certificates are also concerned if they are nominative, dematerialised or held in accounts with the issuing institution.</td>
<td>Relatively liquid investment instruments. Bank savings certificates are not officially tradable on the stock exchange. Investor wanting to access the money held in a bank savings certificate earlier than planned can either look for a buyer, or ask the bank to redeem their savings certificate with the redemption price agreed with the bank. In practice, most of the banks buy back their own bank savings certificates.</td>
</tr>
<tr>
<td>1.2. Government certificates / linear bonds (OLOs)</td>
<td>No risk. In OECD countries, the State is regarded as the best debtor (sovereign state).</td>
<td>- Government certificates: no risk. Government certificates are a readily negotiable instrument and are easy to resell on the stock market before maturity subject to proper conditions. - Linear bonds: liquidity risk nil owing to the high volume of long-term public debt, the major activity in the secondary market, and the role played by market makers.</td>
</tr>
<tr>
<td>1.3. Bonds-others</td>
<td>Depends on the quality of the issuing company. This quality is assessed by ratings agencies which give ratings to companies. The higher the rating, the lower the risk. Ratings agencies are however not infallible and from time to time, there are accidents (especially as regards eurobonds/convertibles, etc.)</td>
<td>Depends on the existence and operation of a secondary market for the security. The greater the transaction volumes, the lower the liquidity risk.</td>
</tr>
<tr>
<td><strong>2. Shares</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Shares constitute risk capital. The company issuing them is, therefore, not obliged to redeem them. In the event of liquidation, shares can lose almost their entire value.</td>
<td>Liquidity is assured by the existence of an organised market, i.e. the stock exchange. It essentially depends on the volume of trading for the security: the higher the company’s market capitalisation, the broader – and so more liquid – the market for its shares.</td>
</tr>
<tr>
<td>Interest rate risk</td>
<td>Volatility risk</td>
<td>Risk of no income</td>
</tr>
<tr>
<td>-------------------</td>
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<td>------------------</td>
</tr>
<tr>
<td>The interest rate is fixed for a pre-defined term. As long as this is respected, the rate risk is nil.</td>
<td>Investors will sustain a capital loss in the event of selling in the secondary market when the market rate is more than the nominal value. In the opposite scenario (market rate less than the nominal rate), the investor will make a capital gain.</td>
<td>Nil.</td>
</tr>
</tbody>
</table>
| See “Bank savings certificates”. | See “Bank savings certificates”. | - Classic bonds which acquire interest: low risk  
- Structured bonds linked to equities or stock market indices: potentially high risk since income is dependent on trends of the underlying  
- Convertible bonds: interest is paid until conversion. | Structured notes: According to the conditions stipulated for structured notes, the capital risk can vary from 0% (full capital protection) to 100% (no capital protection). Repayment conditions may thus depend on relatively risky underlyings (equities, stock market indices, etc.). | Bonds can be coupled with a call option, which allows the issuer to redeem the loan before the due date at a specified price and on a specified date (option used when the market interest rate has become significantly less than the bond rate). |
| An interest rate rise in the markets usually has a negative impact on the trend in share prices. This effect is indirect. For example, if rates rise, this means that it would be more expensive to the company which is financed via borrowing, which will weigh down on its costs. In addition, if bonds become more attractive, the equity market will tend to suffer as a result since this will reduce investors’ attraction to risk capital. | Dividends represent variable income. The company may decide, for various reasons, not to distribute dividends some years. | The investor bears the whole company’s risk. There is always a risk of reselling shares at a loss (i.e. at less than the purchase price) or a risk to lose the whole value of it. This risk is high, especially in the short term. | The market risk (uncertainty about interest rate trends, inflation, and the economic and political situation, not to mention unforeseen events) can never be dismissed in the equities markets. In the case of foreign stock exchanges, there is a specific risk as trends may be more adverse overall than on Euronext. |
3. Collective investment undertakings (CIUs)

<table>
<thead>
<tr>
<th>Insolvency risk</th>
<th>Liquidity risk</th>
<th>Exchange risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>The risk of a CIU failing is practically out of the question. The diverse nature of securities in the portfolio considerably reduces the debtor risk. CIUs which are authorised in Belgium are closely supervised and must meet very strict standards. The debtor risk is obviously more significant for CIUs which specialise in loans to high-risk debtors.</td>
<td>- Low for the most part. These securities can always be sold at market conditions. - Variable for SICAFs: despite their stock exchange listing, liquidity varies considerably from one fund to the other and over time. When the market is in the doldrums, disagios are sometimes high, making it difficult to sell.</td>
<td>This depends on the currency in which the portfolios are their respective underlyings are denominated.</td>
</tr>
</tbody>
</table>

4. Alternative investments

4.1. Real estate

- Depends on the quality of the issuing company. The higher the internal diversification of the investment, the lower this risk is (a SICAFI will depend less on this risk than a real estate certificate, as a result). - Some certificates are not quoted on Euronext Brussels, but can be traded at Weekly Public Sales. With regard to quoted certificates, liquidity depends on the volume of transactions. The number of real estate certificates issued is generally fairly limited. - The same applies for the liquidity of a SICAFI. Some small and medium-sized SICAFIs have fewer transactions. As it happens, when the market is thin, an order to buy or sell can affect the price if there are too few counterparties. - The exchange risk is dependent on the currency in which the Hedge Fund is listed and the currencies in which the fund's assets are expressed. 

4.2. Hedge Funds

The absence of transparency in terms of investment policy is a major risk factor. Hedge fund investments generally offer low liquidity. The time period between the sale of units and crediting of the investor's account may vary from a few weeks to several months. The exchange risk is dependent on the currency in which the Hedge Fund is listed and the currencies in which the fund's assets are expressed.

4.3. Gold, gold mines shares, commodities

- Physical gold: fairly low risk except for certain specialised gold coins. In the case of gold mines shares, this depends on the volume of transactions. - Commodities: see derivative instruments since it is mainly via commodity futures and futures that commodities investments are made. - As the gold price is fixed in dollars in the international markets, fluctuations in this currency can offset or accentuate a drop in the gold price. - The same thing can be said for commodities prices, which are also generally fixed in US dollars in the international markets.

5. Derivative financial instruments

The risk lies in the fact that the counterparty may not fulfil its commitments. Investors should ensure that the issuer is solvent. If the writer is a controlled institution, the risk is fairly low, but exists all the same. Derivative products can be traded in organised secondary markets (see Euronext) or over the counter directly with a credit institution. However, liquidity is relative: obtaining a good price when reselling is not guaranteed. Nil for derivative products denominated in euros. The exchange risk can be high for derivative products denominated in other currencies, especially those that are volatile.
<table>
<thead>
<tr>
<th>Interest rate risk</th>
<th>Volatility risk</th>
<th>Risk of no income</th>
<th>Capital risk</th>
<th>Other risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>This depends on the underlyings in which CIUs invest. In terms of a bond CIU for instance, this risk is the same as that of an ordinary bond with a residual maturity equal to the average maturity of the bond portfolio of the bond fund. The interest rate risk exists throughout the entire investment period.</td>
<td>This depends on the underlyings in which the CIUs invest. Generally speaking, the diversification characterised by CIUs offers lower volatility than that of underlyings taken individually.</td>
<td>Everything depends on the distribution policy to which the investor has subscribed. A capitalisation CIU does not distribute income, unlike a distribution CIU.</td>
<td>Depends on price trends of the CIU, in line with financial market trends.</td>
<td>Depends on the nature of the underlying.</td>
</tr>
</tbody>
</table>

| Yes. Sensitivity to interest rate fluctuations (in principle, a rise in market rates results in a drop in value, as with company shares). As real estate certificates/SICAFI are long-term investments, their return partly depends on long rates. | Yes. Depends to a large extent on the trend in the property sector and on characteristics specific to the premises (location, age, quality of materials, quality of tenants, etc.). | The income distributed is variable: it depends, among other things, on the occupancy rate of the premises and the rent indexation. | Real estate certificate: A capital gain or loss may be realised when the premises are sold; the value of the certificate at final maturity is therefore unknown. SICAFI: No, apart from the risk of price volatility as, in principle, a SICAFI has an unlimited term and there is no planned repayment of capital on any date. | Depends on the nature of the underlying. |

| Depends on the nature of the strategy, but has only low correlation with traditional equity and bond markets. | Rate volatility may be significant and could bring about a reduction in value. Volatility however depends on the strategy followed. | Most hedge funds are capitalisation funds. | The wide range of products used, among them derivative products, and the use of loans to produce gearing, may bring about substantial losses when selling, if the manager makes the wrong decisions. | Hedge funds are generally created in countries where supervision by the authorities is limited, or non-existent, which increases risks substantially, including of fraud, non-respect of the investment strategy, endangering of the financial structure, and so on. |

| - A rise in interest rates may also affect share price fluctuations for gold mines shares. Generally speaking, an increase in interest rates will have a negative effect on the price of gold (since the opportunity cost of physically holding it increases) and as a result, this will negatively affect gold mine shares. | - The gold price and the price of gold mines shares are highly volatile. So there is a significant risk of reselling at a loss, at a market price below that of the purchase, especially in the short term. | - Holding physical gold does not generate any income. Gold mines shares give entitlement to a dividend, with variable income not being able to be distributed some years. | - Commodities: see derivative products. | Investors sometimes have trouble obtaining sufficient and accurate information. This makes investment in this area more risky. |

| - An increase in interest rates in the international markets also indirectly influences the price of commodities, by impacting the level of consumption, and as a result, demand for these commodities. | - The volatility of the price of commodities is very significant and varies depending on numerous parameters, among which international demand for the commodity in question, but also on geopolitical factors which are often less predictable but which nonetheless have a strong influence on prices. | | | |

| A rate rise affects share prices and indirectly affects the price of derivative products. In addition, derivative products whose underlyings are of a bond nature are even more sensitive to such an eventuality. | Since derivative products are speculative instruments, their prices are very volatile. They reflect trends and anticipations for the underlying assets. | Derivative products do not generate income, only a potential capital gain depending on the price of the underlying security. | There is no redemption. The return on investment varies considerably and recouping the invested amount is far from certain. On expiry, the derivative product becomes worthless. | If the underlying asset displays an adverse trend, the derivative product can become worthless (for the buyer of the option, loss limited to the premium paid). Potential unlimited risk in the event of sale (or redemption). |