What are certificates actually for?

Back in the 1980s, there were no straightforward options for private investors keen to hedge their securities portfolio or profit from sideways or falling markets. The prospects were equally poor for those who wanted to match the performance of Germany's DAX® index without having to buy equities in its constituent companies. There was no simple method of investing in gold, silver and oil, or of tracking the performance of international markets. All these areas were off limits except to professional investors and remained so until the 1990s, when the first certificate entered the market: a Dresdner Bank Tracker Certificate that tracked the DAX® on a one-to-one basis. This was followed by many other categories of certificates that revolutionised the opportunities available to private investors.

Why choose certificates?

Certificates allow investors to achieve a return whatever the market situation

Investment certificates and leverage products make it possible for investors to profit both when the price of the underlying asset rises and when it falls. Even sideways markets can generate a positive return. Whatever phase the market enters, investors can still achieve an attractive return.

Large selection of underlyings and asset classes

Structured products enable private investors to choose from a wide range of underlyings and invest in a particular sector or region by means of a single structured product. Previously, this was restricted to institutional investors.

A suitable product for every risk appetite

There are structured products to suit every risk appetite. On the more conservative side, for example, there are Uncapped Capital Protection Certificates or Capital Protection Products with Coupons. If we look at leverage products, the chances of returning a very substantial profit are matched by a considerably high level of risk, and as such they are only suitable for those investors who are prepared for that level of

What exactly is a certificate?

Certificates all have one thing in common. They are **derivative securities** for private investors and form part of a wider category known as **structured products**, so called because they are generally made up of several components. Unlike other derivatives, investment certificates are securitised and are thus often referred to as securitised derivatives. The term 'derivative' comes from the Latin verb 'derivare', which means 'to derive from'. Accordingly, derivatives are financial products whose price is derived from movements in the price of another product, known as the underlying. There are two major categories of certificates: **investment products**, which are geared to the medium and long term, and **leverage products**, which are associated with a higher level of risk and a relatively short-term investment horizon.

How are certificates structured?

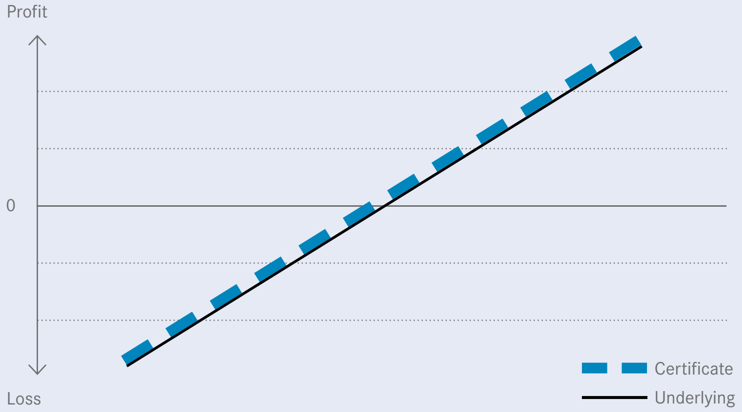
They are always based on an **underlying asset**. By way of example, this can be a specific company share, an index such as the German DAX®, a precious metal such as gold, or a commodity such as oil. The value of the certificate at a given time will depend on the price of the underlying. Unlike investment funds, there is no manager to intervene and therefore influence the price, so they are regarded as passive financial products. This also means there are no management fees for certificates. Certificates always contain one or more **option components** (as do Germany's popular building savings contracts). These components determine the individual features of each certificate, including its level of risk exposure and whether investors can achieve a return from upward, downward or sideways movements in the underlying.

exposure. As a general rule, the greater the opportunity for profit, the greater the risk. Accordingly, risk-averse investors can choose a solution that protects their capital, while those aiming for higher returns can opt for products with a leverage mechanism. There are, of course, many products tailored to investors with a medium risk appetite as well.

→ How do Tracker Certificates work, for example?

Tracker Certificates allow investors to replicate the performance of an underlying asset. If the underlying appreciates, the certificate will rise by an equal margin. If the price of the underlying falls, the certificate will decline by the same margin. This allows investment in a standard index such as the DAX®, or an index tracking the performance of China's leading solar power companies, for example.

Return profile for a Tracker Certificate



Inexpensive risk hedging

Theoretically, private investors could themselves trade on the futures markets and, for example, buy options to hedge their shareholdings. However, due to the very high costs involved and difficulty of trading derivatives on the capital market, it is not advisable for private investors to replicate the functionality of a certificate themselves. With certificates, issuers offer a single product with comparatively low transaction costs. Furthermore, there is no obligation to make additional payments with structured products, which limits the investor's potential loss.

Continuous tradability

The purchase of certificates is interesting for both self-directed and advised investors. Private investors can purchase certificates through an investment advisor at their bank. Alternatively, self-directed investors can purchase a certificate without investment advice using an online broker. In both cases, the purchase can take place either over-the-counter (OTC) or via a securities exchange. The buy and sell prices for certificates are updated and published on a second-by-second basis by the stock exchanges in Stuttgart and Frankfurt. Certificate issuers also provide a continuous stream of buy and sell prices covering all their products for OTC trading, allowing investors to trade at those prices. Consequently, investors can obtain a price for their certificates whenever they wish during exchange trading hours. Exchange trading provides investors a publicly regulated market supervised by an exchange supervisory authority. An advantage of OTC trading is that there are no brokerage fees, and generally no transaction charges.

High degree of transparency

Academic research on financial products distinguishes between six different forms of transparency, and investors need clear answers to the following questions. What is the product's underlying? What conditions are attached to the returns? Are the risks clearly specified, and are there appropriate risk indicators? What costs are involved? Can investors choose to sell the product at any time without difficulty? Can investors track the current value of the product at all times? As far as certificates are concerned, the answer in all cases is perfectly clear. Certificates are therefore more transparent than many other established financial products. For more information on transparency, please see: [Do structured products lack transparency?]

Low costs

To use the example of Tracker Certificates, the tough competition between investment certificate issuers means that there are usually no administrative charges for these very simple products - indeed, in some cases there is no longer any difference between the buy and sell prices. This fierce competition between issuers also has a beneficial impact for investors on the conditions attached to other product categories.

There is now formal evidence for this. In 2017, the Academic Advisory Board of the DDV prepared a cost study of unprecedented scope and detail. According to the study, the annual costs of investment in certificates average 0.71 percent. Even if the hedging costs of the issuers (i. e. the purchase costs of the product components) are included, the total costs only slightly exceed the one percent mark. These costs factors are playing an increasingly important role for most investors, especially with regard to other financial products.

Detailed information readily available

Before investing in a structured product, investors should first obtain all the information they need about the products in which they are interested. Detailed information is of course provided by the issuers. In addition, the DDV's website (www.derivateverband.de/ENG/Home) provides general information on investment and leverage products. Information on the creditworthiness of issuers is also important in this context. As is the case with all bearer bonds, investment certificates are exposed to credit risk. The DDV publishes information on its website on the Credit Default Swaps (CDSs) of the most important issuers to help investors assess their creditworthiness.

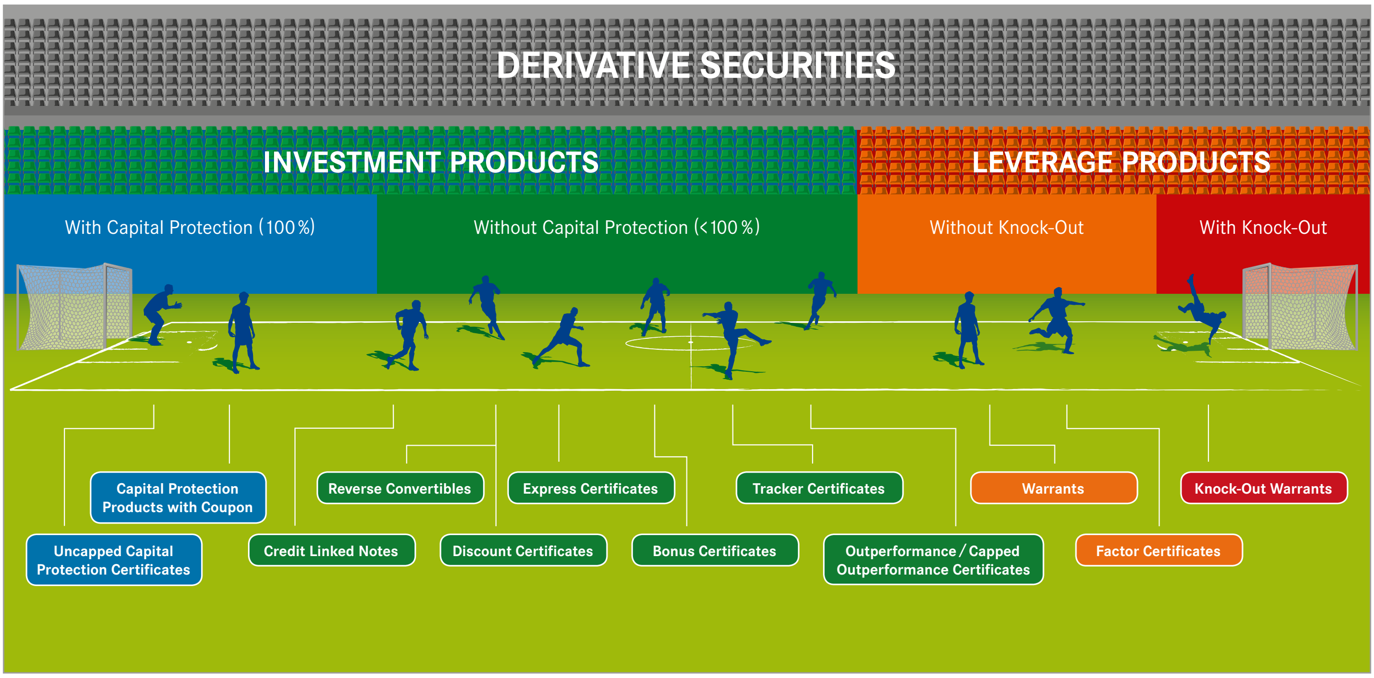
Since the start of 2018, all potential investors have had to be provided with a Key Information Document prior to purchasing a packaged investment product. In principle, this document applies to structured products and insurance-based investment products, and will also start to apply to investment funds from 2020. The Key Information Document presents the key features and functioning of a financial product on three pages, describes in detail the associated risks and benefits of the product in various scenarios, and also lists the product costs. The Summary Risk Indicator provides a clear presentation of the risks of the investment using seven risk classes. The Key Information Document is also intended to facilitate comparison between different financial products.

Effective investor protection

There is a comprehensive legal framework of German and European regulations for all structured products. These regulations contain the basic civil law provisions for securities as debt instruments as well as comprehensive and detailed requirements for the content of investor information such as in securities prospectuses and Key Information Documents. Furthermore, the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin) sets specific guidelines and, where necessary, requirements for market participants. Together with the voluntary undertaking that all members of the DDV have expressly committed themselves to in the Fairness Code, the purchasers of structured products are afforded effective protection.

The DDV's product classification system: the Derivatives League

The DDV's product classification system provides structure to the wide range of investment and leverage products. This Derivatives League compares the most important product categories to the eleven positions that make up a football team. The different types of products can mainly be differentiated in terms of the way they function and the degree of risk they involve.



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