



DESCRIPTION OF FINANCIAL INSTRUMENTS AND INVESTMENT RISKS

General provisions

This brief description contains information about financial instruments and their inherent risks. It doesn't mean that this description includes all the risks and other important aspects of investing in financial instruments. The Client should entrust the Manager to create and / or to manage the Portfolio only if the Client understands the nature and a degree of risks of using financial instruments. The Client must carefully consider whether investment in financial instruments is suitable for him regarding his experience, objectives, financial situation and other relevant circumstances.

Definitions:

Financial instruments - as defined in the *Law on markets in financial instruments* of Republic of Lithuania and the deposits.

Manager - Investment management company "Dovre Forvaltning" UAB.

Portfolio - Client owned financial instruments (including cash) that are entrusted for management at the discretion of the Manager.

1. Risks related to investing in Financial instruments:

- (i) Country or politics risk (the overall political and economic risk arising from social, economic and legal factors in the country, which may reduce the value of investments in the country);
- (ii) Liquidity risk (the probability that a position (Financial instruments) cannot be liquidated (sold) in the desired time-frame and for the desired-price);
- (iii) Currency risk (the risk that the value of the investments will decrease due to unfavorable changes in foreign-exchange rates);
- (iv) Market risk (the possibility that a market of a particular asset class will decline and it will affect price and value of the assets);
- (v) Counterparty risk (the risk of having losses because of a counterparty failing to comply with its financial obligations);
- (vi) Systemic risk (the possibility that insolvency of an investor or one mediator of the Financial instruments of public trading would have a negative impact on other investors' and other Financial instruments mediators' interests);
- (vii) Legal risk (changes in risk related to legislative of financial instruments which may reduce the liquidity of financial instruments and / or price and / or the additional obligations of investors);
- (viii) The risk of communication networks and devices (the risk related to information technology equipment, communication networks, computer programs usage and data protection, which allows for the temporary possibility not to have an ability to perform the operation in time and in desired conditions);
- (ix) Risk of Financial instrument acquisition from foreign issuers (Financial instruments (issued by foreign issuers) that are purchased through Lithuanian mediators are normally accounted by the mediator of that foreign country under the name of the Lithuanian mediator, noting that the financial instruments are purchased on behalf of Lithuanian mediator's clients);
- (x) Issuer's risk (the risk of loss incurred because of a decrease in the value of financial instruments due to the fact that the issuer has not met its obligations);
- (xi) Information risk (the risk that the Client will incur losses due to the fact that, at the time of adopting a decision on investments into certain financial instruments, he will have no complete information on the issuer or the information will be misleading);
- (xii) Inflation risk (the risk that the purchasing power of money will decrease due to the increasing prices of various consumer goods and services, i.e. for a certain amount of money you can purchase less);



- (xiii) Price risk (the risk that due to adverse changes in the market price of securities the Client will suffer losses);
 (xiv) Interest rate fluctuation risk (the risk that due to the changes of the interest rate in the market the Client will incur losses or will not get profit).

2. Financial instruments that will potentially form a Portfolio and some of their specific risks:

▪ Shares

Shares are equity securities. Shares can be listed or unlisted. The listed shares are traded on a regulated market. Shares provide the right to participate in company's management, to get a share of the profit (dividends), to get a share of the liquidated company assets or other property and moral rights. The risk which investor undertakes when buying a share is the investor's paid price and the dynamics of that price. The price of shares depends on supply and demand, on the performance of the company-issuer, on national and regional economic conditions and other factors. The price of shares may fluctuate in the future and the dividend payment is not guaranteed. You can encounter capital risk, credit risk, market risk, currency risk, liquidity risk, legal market regulation risk and other risks when investing in shares. Shares that are listed on a regulated market and whose turnover is high are more liquid. Shares that are unlisted (equity securities that are not traded on a regulated market) in addition to other risks have a high liquidity risk.

▪ Bonds

Bonds are debt (not equity) securities. Bonds can be of varying maturity (from 1 to 30 years), also be denominated in a variety of currencies and have different yields. The issuer of bonds contracts to repay the principal and to pay interest as set of in the indenture of the issue. Bonds can be fixed interest (fixed interest payments – “coupons”), variable interest (regularly paid interest rates, which rates are based on other rates benchmarks), zero interest (bonds are issued at a lower nominal value and redeemed at a nominal value), convertible bonds (under certain conditions can be converted into company's capital), pre-refunded bonds (the issuer has the right to redeem bonds before maturity). The price volatility of debt securities is lower than that of equities. The redemption and interest payment of debt securities is guaranteed by the issuer so investors bear the risk of the issuer's bankruptcy. If the situation in the market is favorable debt securities may be sold before redemption and additional gains from a positive price change is obtained. But an investor may also incur losses for a price drop in the market. Typically bonds are traded off the stock market, therefore due to the potential negative changes or illiquidity; it can be difficult to find a buyer or seller. The longer is the maturity the greater is the risk that arises from price fluctuations. Bonds can be characterized as encountering price, market, liquidity, currency, interest rate and counterparty risks.

▪ Money market instruments

Money market instruments are financial instruments that are generally traded in the money market. Money market instruments are such instruments that can be converted into cash within a short period of time and without a significant loss of invested capital. Cash, deposits in banks, treasury bills (short-term - up to 1 year), government securities, short-term debt obligations and money market fund units are considered to be money market instruments.

Money market instruments are short-term investments so it is unlikely that the market price will suddenly change when investing for a short period. As the issuer of treasury bills is the state such securities are considered to be the lowest risk securities. The risk of short-term debt securities is slightly higher than treasury bills because the risk of issuer bankruptcy is included. Money market instruments mainly encounter currency, counterparty risk.

▪ Structural bonds

Structural bonds are debt securities where interest payments are linked to the return of other financial instruments. The risk of structural bonds directly depends on the financial instruments that they are linked to and it also depends on the issuer. The riskier the underlying financial instrument the higher the risk of the structured bond. The most risky structural bonds are linked to shares, raw materials, etc. However, structural bonds are less risky than shares or raw



materials because they are insured with the guarantee to pay the principal value on the date of maturity. In addition, structural bonds are less liquid. It is also necessary to assess the bankruptcy and credit risk of the financial instrument issuer. The risk of issuer, value, liquidity, and rating (the risk that a credit rating of the company issuing structural bonds will change) are the typical risks for the structural bonds.

- **Mutual funds**

The assets of a mutual fund are invested in shares, bonds, money market instruments and other financial instruments or their combinations. The investment strategy of the fund and the procedure for unit subscription or redemption is defined in its incorporation documents.

Investing into funds is less risky than investing in a company's shares or debt securities because the assets of funds are diversified by investing them in different companies, countries or financial instruments. The risk level of a mutual fund depends on the type of fund it is. Money market and bond funds have the lowest degree of risk and stock mutual funds usually have greater risk associated with them. The risk also depends on the geographical region of the fund's investment universe – a fund invested in the shares of a developing-country is riskier than a fund invested in shares of a developed country. Investment funds usually encounter price, market, liquidity, currency, interest rate and counterparty risks. It is also very important to pay attention to the experience and the competence of a fund manager, the risk of the fund strategy (i.e. which financial instruments compose the investment fund's portfolio; the more aggressive fund's investment strategy, the greater risk of losses).

- **Repurchase (REPO) trading**

REPO trading is the credit transaction, under which a person borrows money, sells or uses as collateral his securities for a person who lends money. The securities are repurchased on an agreed date. The interest paid for given credit is equal to the difference between the prices of selling and repurchasing. The seller of such securities borrows money for ensuring the temporary liquidity needs and the purchaser safely invests free assets as he receives the securities as a deposit.

It is a *repurchase agreement* for the person selling the securities and a *reverse repurchase agreement* for a buyer of securities. Investors who use repurchase and reverse repurchase agreements in their investment strategies encounter a higher than normal stock market risk. For example, a person who enters a repurchase agreement – borrows money and then invests it into shares – risks to lose the borrowed money. It should also be noted that REPO trading is relatively more expensive than a simple shares purchase or sale (due to higher interest and (or) the contract fees), so the risk of not covering the cost of a purchase or sale appears. It is also important to take into account the counterparty risk of default when entering a repurchase or reverse repurchase agreement. When a client puts securities up for collateral and borrows money from the bank he should be aware that the bank may unilaterally terminate the contract if the value of the pledged securities decreases.

- **Derivative financial instruments**

Derivative financial instruments are options, futures, swaps, forward rate agreements, derivatives of credit risk transfers (credit default swaps), financial contracts for differences and other derivative agreements that derive value from an underlying financial security which may include stocks, indexes, currencies, interest rates, yields, commodities and other financial instruments or economic indicators.

Such instruments can be used to hedge risks i.e., to protect yourself from adverse changes in asset prices. Derivatives are also used in taking advantage of price differentials between markets (called *arbitrage*). The decision to invest in derivative instruments is based on the expectation that the value of assets associated with the derivative instrument will vary during a certain period of time.



Types of derivative financial instruments:

Options

An option is an agreement that gives the buyer of the option the right (but not the obligation) to buy/sell the underlying financial instrument at a price agreed upon in the option agreement. The buyer of the option must pay the seller of the option a premium for the right to enter the agreement on a later date and the seller of the option must deliver/take delivery of the underlying security if the buyer decides to use his right to buy/sell. The biggest loss of the option buyer is limited to the amount of the total paid premium however the seller of the option may incur unlimited losses.

There are two types of options. An American option entitles the holder to take advantage of the option at any time during its life. The European option can be exercised only at the maturity of the option.

Warrants

A warrant is a special type of an option. When an investor buys a regular option the shares that are to be delivered to him or the shares that the investor plans to deliver are already in circulation and are freely traded on the secondary market. The difference when it comes to warrants is that the sellers are the companies on which shares the warrants are written and when a warrant is exercised new shares are issued for the price in the warrant agreement and delivered to the investor that exercised the warrant.

Forwards and Futures

Forwards and futures are the agreements to enter a contract at a predetermined price at a predetermined time in the future on specified financial instruments.

Futures and forwards may be deliverable then the settlement is done in the underlying or they can be settled in cash. Futures are marked-to-marked daily while forwards are usually settled on the last day of the contract.

Swaps

Swap is an agreement between the parties to exchange, for example, interest rates (for example, to change fixed rates into variable rates) or currencies (for example, to change the settlements in Litas to the settlement in Euro) for a specified period. Several interest and currency swaps may be combined in to a single swap.

Short-term borrowing of securities for the purpose of selling them (short selling)

Short-term borrowing of securities for the purpose of selling them (*short selling*) means selling a financial instrument (such as a share) which the seller does not own at a time of sale. This is done by borrowing a financial instrument from a holder. Such borrowed securities are returned on a particular day by buying the same financial instrument on the market and returning it to the lender. The return of *short selling* is positive if on a day of selling the market price of financial instrument is higher than the market price on the date of the expiry of loan's term, and vice versa.

Standardized derivatives and OTC derivatives

Derivatives can be standardized and non-standardized.



The main advantage of standardized derivatives is that conditions of the contract are always the same and traders of such financial instruments regularly publish the prices of derivatives.

In non-standardized derivative trading the conditions are agreed between two parties. Such transactions are commonly referred to as "OTC transactions" (OTC – over the counter). Banks and other financial intermediaries offer swaps and OTC derivatives (such as options or futures) that would meet their client's specific needs.

Features of derivatives

Indicator of financial leverages

The value of a derivative depends on both - the related assets price movements as well as the duration of the contract. The fluctuation of a related assets price causes the price changes of a derivative. It should be noted that the changes of the derivative's price is often greater than the price changes of related asset. **This is a leverage effect.** Investment in derivatives may give higher returns than investment in capital assets for which the instrument was issued. The invested capital may increase rapidly, several times if investment is successful. And vice versa, the *leverage effect* may be disadvantageous to investor - it may incur greater losses from investments in derivatives than it would have incurred by investing directly in to assets. All of invested capital may be lost if the price of related assets changes differently from what was expected. The chance to earn profits or have losses is highly variable and highly dependent on the structure and usage of derivatives. The duration of derivatives may be short or long – even several years long. It affects the *leverage effect* as well as the risk of the investment. For example, as the remaining life of the derivative decreases its sensitivity to the price of the underlying increases.

The risk of losing more capital than had been invested

The risk level of options is determined by whether the investor sells or buys an option. The buyer of a financial instrument can choose whether to buy or sell the related assets for a particular price. The seller of a financial instrument is obliged to buy or sell the related assets if the holder himself decides so. This means that the option holder (buyer) maximum will lose is the premium paid for the option. In other words, if for example, the underlying asset's price is lower the strike price of the option, at the end of the period of the contract the holder of the option will not use the option and will only lose what was originally paid for the transaction. So in any case the holder can not suffer greater losses than the premium paid for the contract.

However the situation of the issuer (seller) of options, futures and forwards is different. The issuer must buy or sell the underlying assets for an agreed price. This means that, for example, if the holder decides to exercise the option then the option issuer must sell the underlying asset for an agreed price irrespective of market prices. The issuer risks to lose much more than the premium which he received entering into the contract. Since there is no theoretical maximum limit of the market price of shares, the uncovered seller's option issue may incur practically unlimited losses.

The investor who short sells a share for a short-period assumes the same risk as uncovered option issuer. When an investor sells the borrowed shares he must return them on the agreed date, no matter what the stock market price is. So the possible loss amount in this case is also unlimited.

The main requirements applied for the issuing derivatives or for borrowing shares for a short selling

When a future, a forward or a short sale of shares is set up an investor who assumes commitment usually must submit an obligations compliance assurance tool. Since the value of assets on which the deposit has been made ranges, the requirements for deposits are also different. The leverage effect also applies for required level of deposit (margin). If the



party fails to submit the margin call, the requirement for additional deposits, the contractor has the right to immediately terminate the contract in order to limit potential losses. In accordance with the contract the contractor usually seizes the deposits such as pledged financial instruments and sells them in the market without consulting with the owner and uses the sale proceeds to cover the losses. So in order to avoid the forced closure of his position, the investor must carefully monitor the impact of price changes to the level of equity in the account.

3. Risk of investment strategy

Risk of investment strategy (Strategies intended outperform the markets may be partly or wholly unsuccessful) each portfolio is exposed to various risks depending upon the investment objective, investment strategy and asset allocation. The investment objectives of one or more of the portfolio management schemes could result into concentration on a specific asset/asset class/sector/issuer etc., which could lead to non-diversified portfolio which tends to be more volatile than diversified portfolio and lead to greater liquidity risk for the portfolio. Each portfolio will be exposed to various risks depending on the investment instruments used. The investment objective, investment strategy and the asset allocation may differ from client to client. However, generally, highly concentrated portfolios with lesser number of stocks will be more volatile than a portfolio with a larger number of stocks. There is no guarantee that active asset management or any strategy will be successful. Investing involves risk including the potential loss of principal. No investment strategy can guarantee a profit or protect against loss in periods of declining values. Past performance is no guarantee of future results.