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Topic 1: Why use instalments?

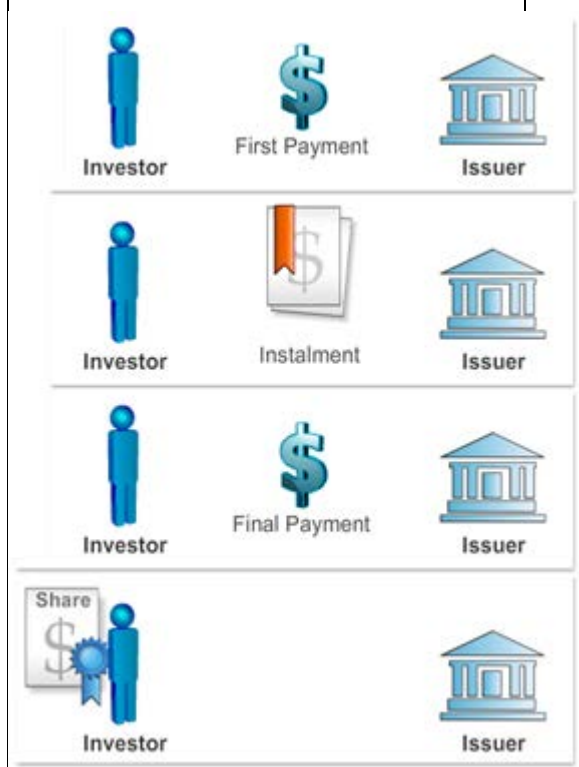
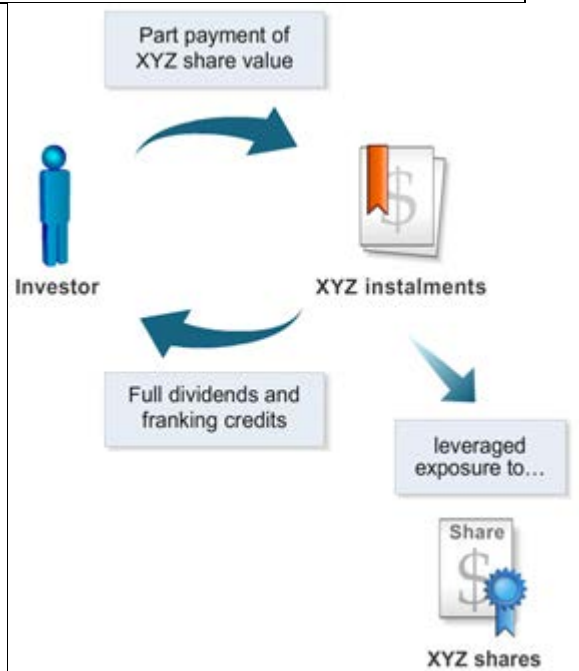
Instalments are the most popular type of warrant traded on the ASX.

Some of the features of instalments include:

- Leveraged exposure to the share market
- Obtain greater dividends and franking credits than for the same capital outlay in the underlying
- You can use instalments in a self managed super fund (SMSF)
- Instalments are tradeable on the ASX.
- Aside from these features that are common to all instalments, [warrant issuers](#) have issued several different types of instalments each with its own particular features.

Instalments have several features that investors may find attractive:

- You can buy shares on a part payment basis - paying a portion upfront and, if you choose to, making the second payment at a later date
- You have the choice to walk away and not make the second payment, forfeiting only the first payment
- You are entitled to the full dividends and franking credits paid on the underlying shares
- They offer leveraged exposure, but with a lower risk profile than many other leveraged products
- You can choose a high or a moderate level of gearing
- No margin calls.



Leveraged exposure

Leverage (also called gearing) means a given movement in the price of the underlying asset causes a larger movement, in percentage terms, in the price of the instalment.

Leverage comes about because the instalment costs less than the underlying share. Because the price of the instalment moves roughly in line with changes in the share price, a small movement in the share price results in a proportionally larger change in the instalment price.

If the share price rises, your percentage returns from the instalment are greater than if you held the share. However, if the share price falls, your losses will also be magnified.

The greater the level of gearing, the more dramatic is this effect.

Enhanced dividend yield

The instalment holder is entitled to the full dividend and franking credits paid on the underlying shares.

Because the first instalment payment costs less than the share, the percentage yield is higher on the instalment.

Dividend yield is calculated as the dividend divided by the share price.

Looked at another way, \$10,000 will buy you more instalments than shares. As you receive the full dividend and franking credits on the instalments you will receive more in dividends and franking credits from an investment in instalments than the same investment in shares.

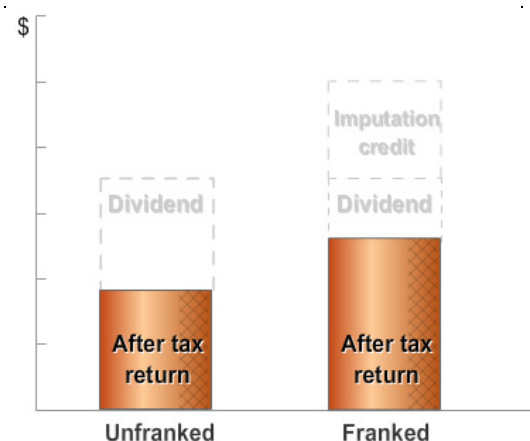
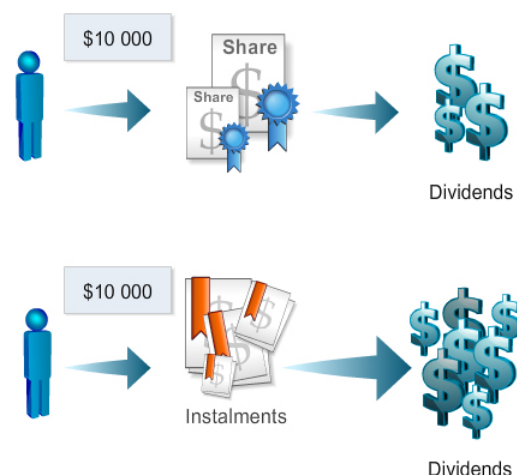
For example, a \$10.00 share paying \$0.50 in dividends has a 5% yield (this equates to $\$0.50/\10.00).

Tax benefits

Increased franking credits

You can use instalments to increase your franking credits.

For superannuation funds, this can be particularly attractive. Any excess credits may be used to reduce tax on other earnings, or contributions made to the fund.



Following the investor paying their marginal rate of tax, the franked dividend provides a larger net return.

Interest deductibility

Because you don't have to pay the full amount of the share price upfront, the instalment issuer is effectively lending you the final payment amount. The interest on this loan is built into the instalment price.

In some circumstances, this interest cost may be tax deductible.

Instalments and superannuation

Under the rules covering super funds, borrowing money to invest is prohibited. Opportunities to gain leveraged exposure are therefore limited.

Instalments are one of the few eligible forms of gearing within a SMSF. They do not breach the rules against borrowing, and because the final payment is not compulsory, the issuer has no recourse to the fund's other assets.

The increased dividends and franking credits are also attractive to super funds.



Topic 2: Why use instalments continued

Comparison with margin lending

Depending on your investment strategy, instalments may offer some benefits over margin lending, which is another popular way to gear into the sharemarket:

- Instalments are traded on ASX, just like shares. You can buy and sell instalments on the market, making it easy to increase or reduce your exposure at any time.
- There are no margin calls - instead investors have predetermined events (e.g. roll-over or expiry) when they might expect to incur a charge to remain in their investment.
- You can walk away from the final payment of an instalment.
- Margin lending is not allowed in a SMSF.
- There are no credit checks.

You should always consult your financial advisor if you are comparing instalments to margin lending.

Risks of Instalments

There are certain risks involved in investing and trading instalments. This section deals with some of the general risks associated with most instalments (and warrants in general), but it does not deal with all aspects of risk associated with instalments. There is a more complete discussion of risks in Course 2 topic 5 "Instalment risks".

Risks include:

Performance of the underlying asset

Generally, the success of an instalment depends on how the underlying asset performs.

If you are trading a bullish view using instalments, to be profitable you would need the underlying share to increase in value. If the share price fell you may be exposed to a loss on your instalment. However, no matter how far the share price falls you can not lose any more than the initial investment.

	Instalment	Margin loan
Tradeable package on the ASX	✓	✗
Available over most blue chip shares	✓	✓
Credit checks not required	✓	✗
No margin call if the share price falls significantly	✓	✗
Loan does not need to be repaid	✓	✗
Eligible for SMSF	✓	✗

Limited life

Instalments have an expiry date and therefore a limited life. On expiry instalments cease trading and can no longer be exercised. It is possible an instalment will expire without your expectations being realised. Also the value associated with the life of the instalment (such as funding cost or time value) will decay.

Credit risk of the issuer

Neither ASX nor its subsidiaries guarantees the performance of the issuer.

Each instalment is a contract between the warrant issuer and the holder. The holder is therefore exposed to the risk that the issuer will not perform its obligations under the contract.

Since the ASX warrants market began, no warrant issuer has defaulted on its obligations to settle upon exercise of an instalment. Credit risk is further reduced as the issuer has the underlying security held in trust.

No claim can be made to the [National Guarantee Fund](#) (NGF) in relation to the primary issue of an instalment or the settlement obligations of the issuer arising from the exercise or expiry of an instalment.

Leveraged returns, leveraged losses

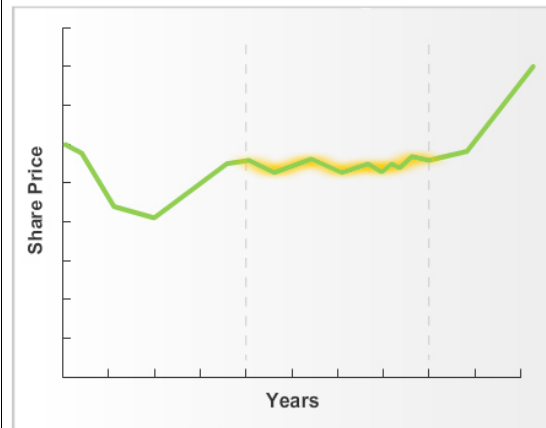
Leverage means that you can make large percentage profits from warrant trades when your view on the underlying asset proves correct.

However, it also means that if your view turns out to be incorrect, your losses in percentage terms may be large.

A feature of instalments is that your loss is limited to the initial investment amount.

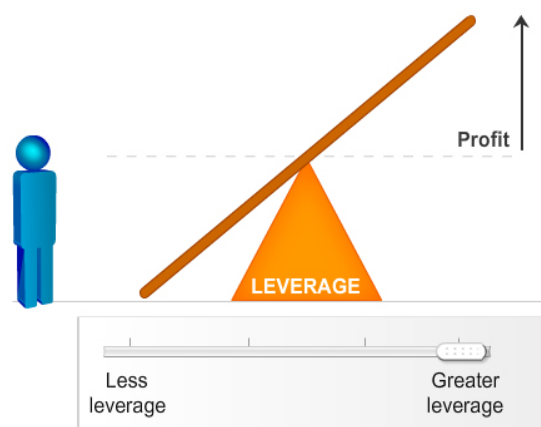
General market risks

The market price of a warrant is affected by the same factors that affect all stock market investments. These include movements in domestic and international markets, the present and expected economic environment, investor sentiment, interest rates, exchange rates and volatility.



Instalments have a limited life. Investors may hold an instalment during a sideways or downtrending market and miss potential future uptrends.

Increasing your leverage increases your potential for profit and loss.



Liquidity risk

This is the risk that you may not be able to sell your instalments for a reasonable price in the market. This could be because there are insufficient orders to buy your instalments, or the price at which others are prepared to buy them is very low. A lack of liquidity in an instalment series may be due to a lack of liquidity in the underlying instrument.

[More information on warrant issuers making markets](#)

Extraordinary events

Issuers often reserve the right to nominate, with the consent of ASX, an extraordinary event which may result in the early expiry of an instalment series.

Examples of extraordinary events include:

- suspension in trading of the underlying security
- the de-listing of the underlying company
- a takeover of the underlying company

As a consequence of an extraordinary event the instalment's expiry date may be brought forward, or the instalment may lapse with any intrinsic payment provided to the holder.



Topic 3: What is an instalment?

Looked at simply, an instalment is a way to buy shares in two stages.

Australian investors first came to this concept via instalment receipts, such as those over Telstra and the Commonwealth bank.

Instalment receipts worked in the following way: you made an initial payment for the instalment receipt, and some time later a second payment to receive the fully paid share.

You received the full dividends and franking credits, and also benefited from any increase in the share price.

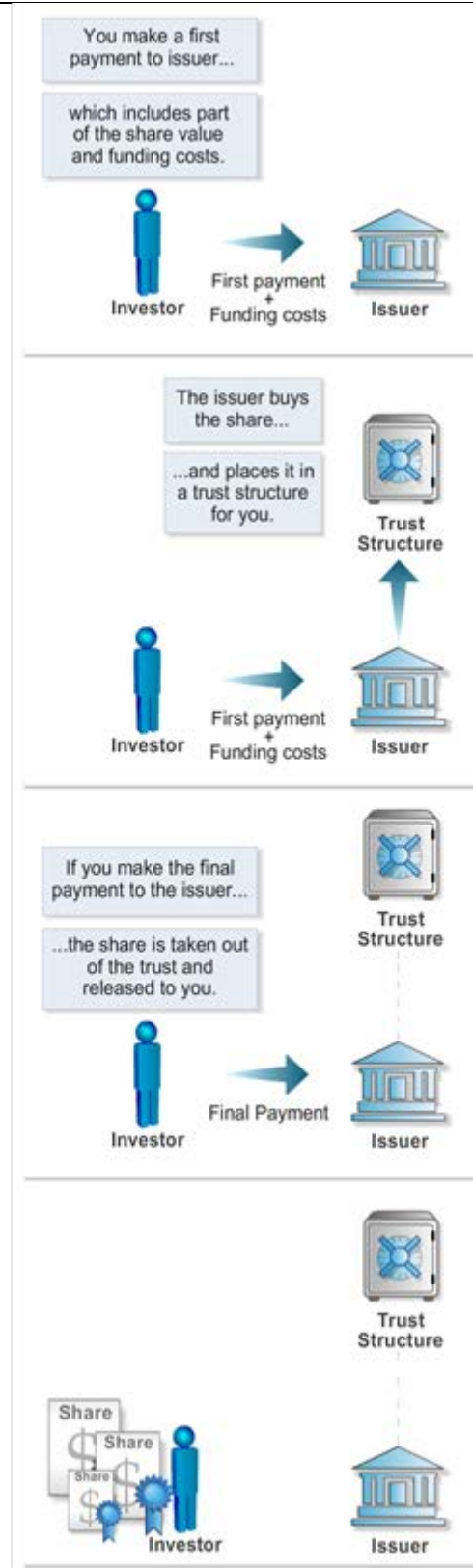
The key difference between instalments and instalment receipts is that you are not compelled to make the final payment of an instalment. If you don't make the final payment, you do not get the shares, and you lose the initial payment. In this circumstance, if the instalment is in-the-money, you may receive an Assessed Value Payment from the issuer.

At the outset when you invest in an instalment, you pay for part of the share, while the issuer pays for the rest. The instalment issuer buys the share and places it in trust, with you as the beneficial holder.

If, later on, you decide you want the underlying share, you make the final payment to the issuer, repaying them for their contribution to the purchase of the share.

The time between buying the instalment and making the final payment may be months or years. The issuer is effectively making a loan of the final payment amount to you for this period. The funding costs of this loan are built into your initial payment to buy the instalment. Funding costs include interest, protection to walk away, and the issuer's costs of structuring the instalment. This can be recalculated at a predetermined future date.

From the time you buy the instalment, you receive dividends and franking credits paid on the underlying shares.



Borrowing to invest

Borrowing to invest is a well-established strategy.

Gearing gives you more exposure than you could achieve just by using your own capital. If the asset performs well, leverage increases your profits. The opposite is true if the asset performs poorly, leverage magnifies your losses.

The instalment issuer funds part of the initial purchase of the share. You do not have to repay the issuer until the time you make the final payment, so you are effectively borrowing this money from the issuer.

You don't have to make the final payment, and the issuer has no recourse to your assets if you don't. This type of loan is called a non-recourse loan. Your maximum possible loss is the initial payment for the instalment.

What is in the instalment price?

To get the fully paid share, you make two payments:

the first payment (the instalment price), and
the final payment (or loan amount).

The first payment has two parts:

- the capital amount, which is a portion of the share price, and
- the funding cost, which is the cost of borrowing the final payment from the issuer.

The funding cost is made up of interest, fees and loan "insurance" which provides you with the privilege to walk away.

You can work out the funding cost by the following formula:

Funding cost = (first payment + final payment) - current share price

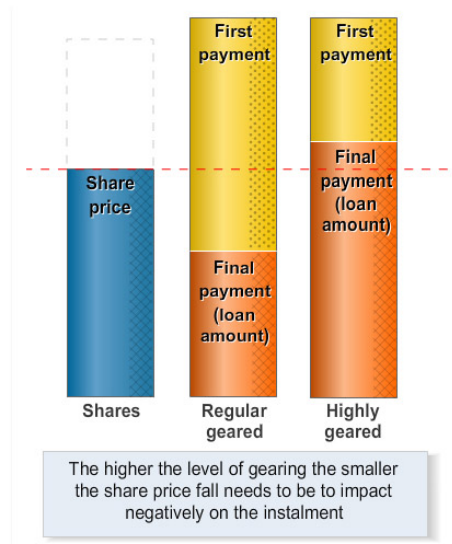
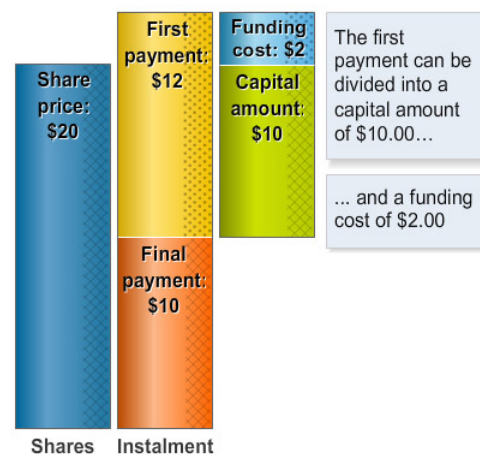
Gearing level

The size of the final payment determines the gearing of the instalment. The larger the final payment, the higher the gearing, or loan-to-value ratio (LVR).

The gearing level is calculated as:

Gearing level = final payment/share price

Instalments with a LVR of 40-65% are generally referred to as regular geared, and



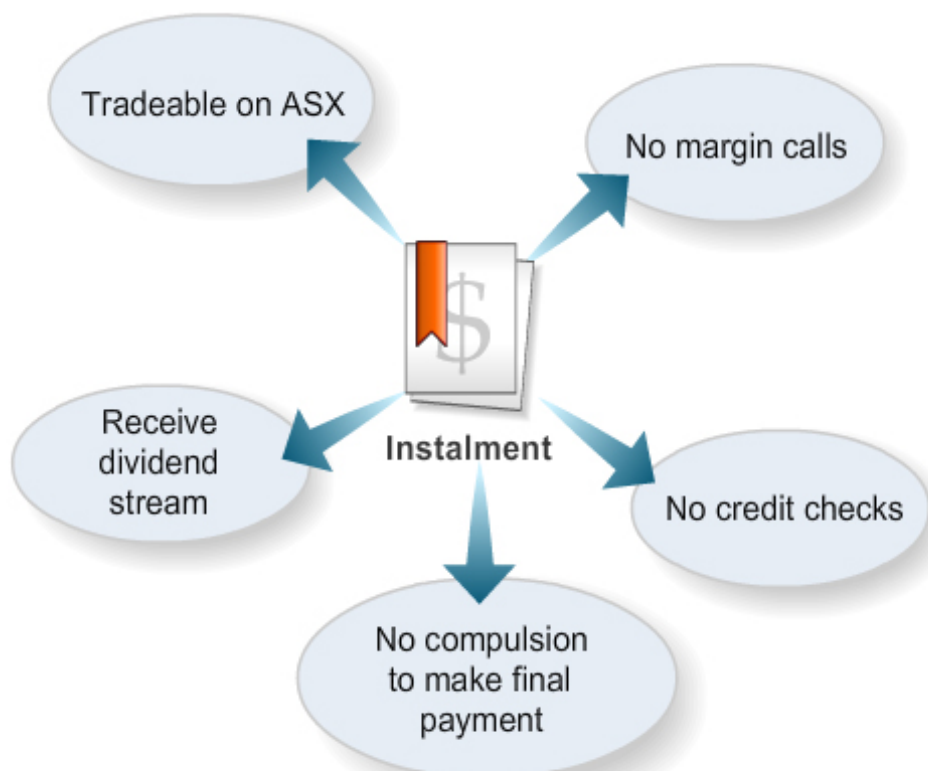
those with a LVR of 65-100% as highly geared.

The higher the gearing, the smaller the first payment for the instalment and the larger the final payment.

Instalments offer a convenient bundle of features

As well as geared exposure, instalments combine several features that are not readily accessible in any other single product:

- ASX quoted instalments are tradeable on ASX just like shares
- The loan made to you is non-recourse
- You cannot be called for margins - (rolling into new instalments and reset decisions are made at pre-defined times)
- There are no credit checks, or establishment or break fees
- You receive the dividends and franking credits paid on the underlying securities.



Topic 4: Features and mechanics of instalments

Features of instalments

When an instalment is issued it is accompanied by an explanatory document called a product disclosure statement (PDS). This disclosure document sets out the important features of an instalment, including:

- underlying asset
- expiry date
- exercise style
- settlement method, and
- final payment amount.

The instalment price (the first payment) is not specified in the disclosure document, but is determined by the price of the underlying asset, and market forces at the time.

Underlying asset

Instalments are issued over a range of underlying assets, including:

- ASX-listed securities
- Baskets of ASX listed securities, and
- Listed managed investments including Exchange Traded Funds (ETFs) and LICs.

Expiry date

The expiry date is the final date of the instalment's life. At the end of this day, the instalment lapses, and the holder's right to exercise ceases.

When issued, the term to expiry can be anywhere between three months and fifteen years.

Exercise style

An instalment is either American style exercise or European style exercise.

An American style instalment may be exercised at any time during the life of the instalment, while a European style instalment may be exercised only at expiry.

Specified by
issuer in PDS

Expiry date

Exercise style

Underlying asset

Settlement
method

Final payment

Determined by
market forces

Instalment price
(first payment)

Exercise style	Able to exercise	
	Before expiry	At expiry
American	✓	✓
European	✗	✓

Settlement method

Instalments are usually settled by physical delivery. When you exercise an instalment and make the final full payment, legal ownership of the underlying security is transferred to you.

Final payment

The final payment may also be referred to as the loan amount.

It is the amount the issuer contributes to the purchase of the share placed into trust - and is the amount you must pay the issuer to take ownership of the underlying securities.

In the case of ordinary instalments, the final payment is usually fixed for the life of the instalment.

However, it may be adjusted if there is a corporate event that affects the value of the underlying asset. Examples of such events include share splits, bonus issues, and returns of capital to shareholders. Details on these circumstances and outcomes are detailed in the instalment's PDS.

Here's an example of an instalment:

Warrant code: XYZIZC

Underlying asset: 1 ordinary share in XYZ Ltd.

Expiry date: 23 March 2009

Final payment: \$15.00

Exercise style: American

The holder of this instalment has the right to pay \$15.00 on or before 23 March 2009 and in return receive one ordinary share in XYZ Ltd. During the life of the instalment, the holder is entitled to the full dividends and franking credits paid on XYZ shares.

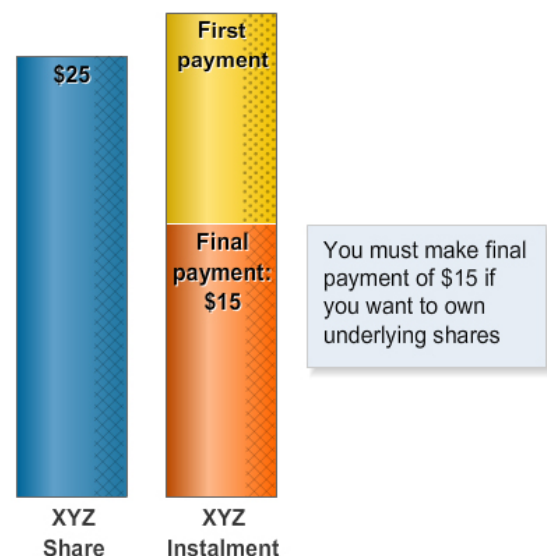
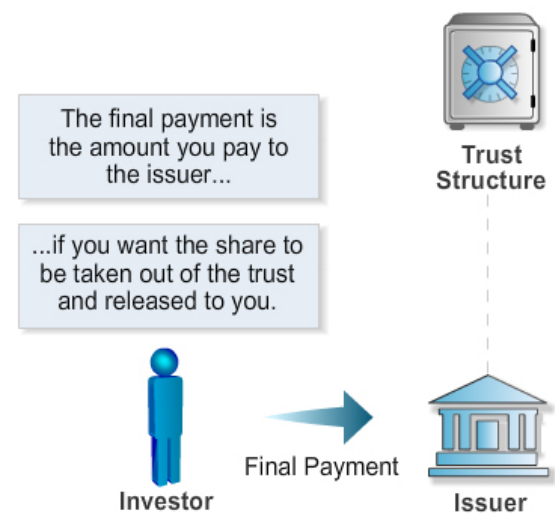
First payment (instalment price)

The only element of the instalment not pre-determined by the issuer is the first payment, or price.

The instalment price can be broken into:

- capital amount, and
- funding cost.

The capital amount (intrinsic value) is the difference between the final payment and the current share price. As the share price

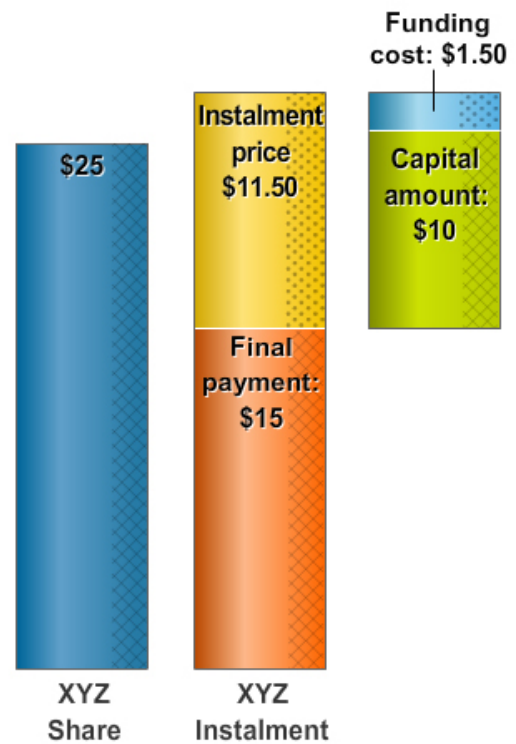


changes, the capital amount, and therefore the instalment price, changes.

If XYZ shares are trading at \$25.00, our XYZ instalment, with a final payment of \$15.00, has intrinsic value of \$10.00.

Prior to expiry, an instalment should trade at more than intrinsic value. This reflects the funding cost of the instalment.

If our XYZ instalment is trading at \$11.50, the funding cost is \$1.50, the price of the instalment less the capital amount (= \$11.50 - \$10.00).



Topic 5: Prepaid interest deductibility

Funding cost

The funding cost depends primarily on:

- interest rate set by the issuer
- term until expiry
- level of gearing (the higher the gearing, the greater the interest charged) and
- protection cost

As the funding cost is built into the instalment price, there are no on-going interest or fee payments during the life of an ordinary instalment.

Interest component of funding cost

As the expiry date approaches, the interest component of the instalment's value gradually declines. This is because new buyers of instalments are effectively borrowing the loan amount for a shorter term, and therefore the interest amount attached to the loan is smaller. This is referred to as interest decay. At expiry there is no interest or fee component left. The instalment is worth intrinsic value only.

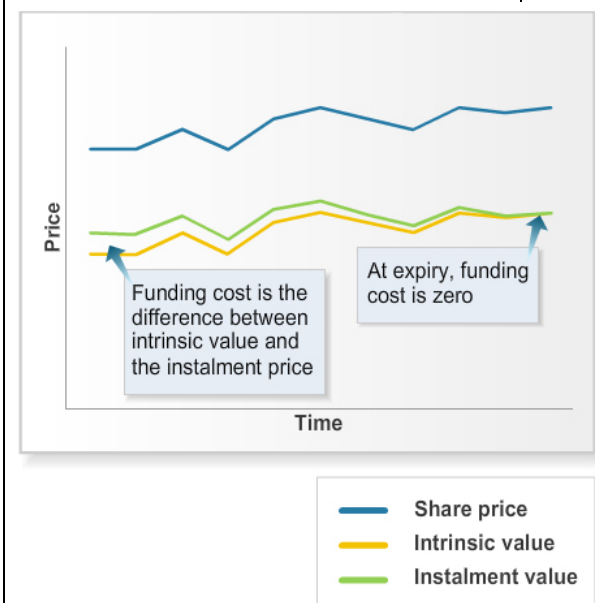
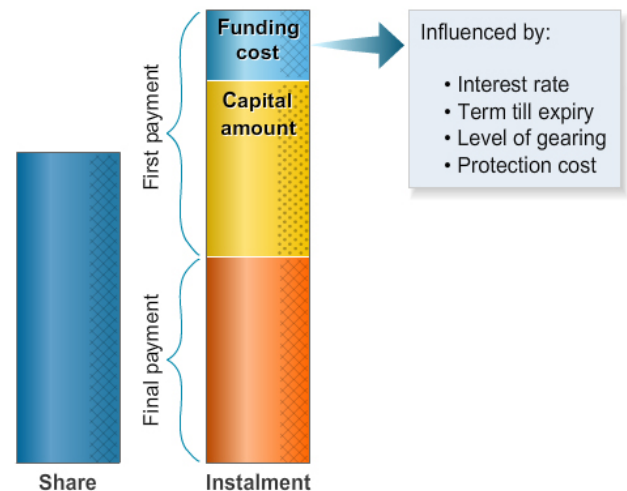
This process, known as interest decay is gradual for regular geared instalments, but more severe for highly geared instalments, reflecting the higher funding cost.

Depending on your circumstances, the interest component may be tax-deductible. The disclosure document will explain the treatment of pre-paid interest as a tax deduction. It is advisable to consult your tax adviser for advice on your own taxation circumstances.

Protection cost

The protection cost reflects the value ascribed to the instalment holder's right not to repay the loan amount and to walk away. It is sometimes referred to as the "intrinsic put option" (not to be confused with the holder's put option).

The protection cost of the instalment's value will increase if the price of the underlying asset decreases, as it becomes more likely that the holder will walk away from the loan. The reverse is true for increasing share



prices. The value of the protection cost will also be affected by the passage of time. This is discussed further in course 3 "Instalment pricing".

Prepaid interest deductibility

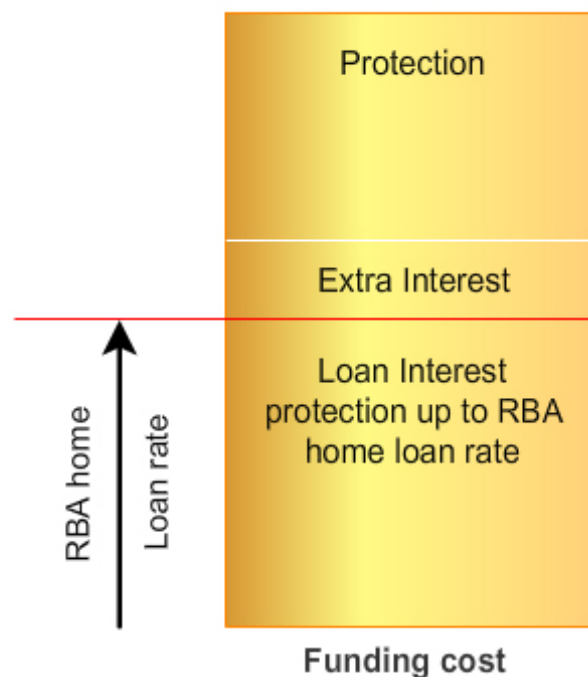
The funding cost of an instalment comprises interest and fees.

You may be able to claim a tax deduction for these costs. It may be possible to claim for as much as 12 months' prepayment of interest. In some cases it may only be possible to claim for accrued interest, rather than the entire prepaid interest amount.

The disclosure document contains information detailing taxation benefits of the instalment. Consult your tax advisor for advice on your own circumstances.

This is a complex area of taxation legislation, and the rules applying to the deductibility of funding costs may change over time.

For more information, please refer to the paper ['Taxation Treatment of Warrants'](#) by Deloitte.



Post Budget 2008 Any amount over RBA rate add to cost base