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Word of Caution and Advice: Fully understand the risks involved before placing your money!

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In the last couple of weeks we have experienced another unfortunate event in the ongoing (and expanding) list of Cyprus' financial troubles, namely the substantial loss of wealth of a number of our fellow citizens from their investment in the Contigent Convertible (CoCo) bonds of our two main banks.

From what we know thus far, it looks like that a number of these investors (not all of them though) had invested blindly into these securities without properly understanding the risks involved, thinking that it's another deposit scheme that provides a higher interest rate to what they have been earning thus far.

I fully agree with those that are demanding a thorough investigation into this matter to understand what exactly went wrong so that such unfortunate repeats do not occur in the future.

If an investor wants to take extra risk hoping for extra return, that's perfectly fine. But he/she should be properly warned about such risks. On the other hand, investors should also realize that they should be more careful as to where they invest their money. Don't invest without fully understanding the instrument involved and the risks involved!

The purpose of this article is to shed some light to ordinary people as to the type of risks that can be found in debt instruments, so that they are more prepared in the future. A prime source of risk is credit risk, i.e. the risk that the issuer will fail to satisfy the terms of the obligation. That could involve the issuer missing a promised interest payment, or even failing to pay the original amount borrowed (principal). It could also involve a restructuring of the existing debt, if the issuer is unable to meet its obligations (as in the case recently with the Greek government).

That is why the rating agencies are important, as their assessment provides us with an indication whether the issuer has the ability to repay us back according to the provisions of the debt contract. It used to be the case that government debt was considered to be free of credit risk, and that corporate debt (debt issued by corporations) entailed such risk (at various levels).

Well, not anymore, as we painfully found out through the restructuring of the Greek government debt (although there were lots of prior warnings, such as the case with the Russian and Argentinian default in 1998 and 2002, respectively).

However, credit is certainly not the only source of risk, and we should fully understand all the other types of risks involved in such instruments. One of them is interest rate risk, decomposed into price (maturity) and reinvestment risk. Because of the way debt instruments are priced, when interest rates go up, their prices fall (and vice versa). The price sensitivity to interest rate fluctuations varies from one instrument to another, and is an important measure that investors should seriously take into account (known as duration). Thus, if you invest for example in a long-term government bond you are exposed to interest rate fluctuations (maturity risk). On the other hand, if you have a long-term investment horizon but you decide to invest in short-term debt securities and roll over your position each time they expire, you might end up with a lower reinvestment rate if interest rates drop in the future (reinvestment risk).

Another important source of risk, especially in the corporate debt market, is liquidity risk. Liquidity refers to the ability to sell large volumes of the debt instrument quickly, without substantial loss of value, and without having to pay high transaction costs. Corporate and emerging debt markets are considered less liquid than government debt markets from developed economies, such as the US. Cyprus government and corporate bonds are also illiquid which translates into substantial risk if you need to liquidate them. You might not be able to find a buyer, or if you do find a buyer he/she might be only willing to trade at a large discount to the fair price.

As with any type of investment, debt instruments are also exposed to inflation risk (or purchasing power risk). For example, receiving 1,000 euros ten years from now will most certainly not have the same purchasing power as 1,000 euros today, because prices in the meantime will fluctuate (and most likely will go up). Long-term instruments are obviously more exposed to this risk than short-term instruments.

Note that in some developed markets (US or UK), there are debt securities that directly protect you against inflation by having their interest payment and principal adjusted each period accordingly. In more special cases, investors can be exposed to call or exchange-rate risk. In some cases, corporations or governments issue what are known as callable bonds, i.e. bonds that the issuer has the right to call back (or redeem) prior to maturity at a specified (callable) price. This will happen when interest rates go down and the issuer has the ability to refinance their debt at a lower interest rate. Thus, holders of such securities are obviously exposed to call risk.

Exchange-rate risk occurs in case of investment in foreign assets, i.e. securities denominated in a foreign currency. Obviously, due to exchange-rate fluctuations, such investment entails risks that investors should take into account. Finally, risks in debt instruments (or any other investment vehicle) can be decomposed into firm-specific and market risk. Firm-specific refers

to the risk originating directly from the issuer. For example, investing in oil companies would entail substantial firm-specific risk, as the profitability of the company depends to a large extent to the company's ability to extract the planned quantities of oil reserves, as well as to the price of oil in the future (which can be very volatile).

However, such risk can be eliminated by holding a well-diversified portfolio. What cannot be diversified away though, is market risk, i.e. the fluctuations of your portfolio with the general market movements. In any case, we should always aim to hold well-diversified portfolios so that we completely eliminate firm-specific risk.

To my mind, the lack of sufficient diversification is probably one of the most important mistakes committed by institutions in Cyprus (banks, provident funds, pension funds, etc.). They have placed much of their wealth in local (or regional) securities, ignoring the benefits that could have been achieved by diversification. If they had been more diligent in their risk assessment and construction of their portfolios, the losses incurred by their investment in Cyprus or Greek government and corporate bonds could have been offset by gains in other assets (from the international market).

As noted in the beginning, the purpose of this article is to shed some light as to the type of risks that can be found in debt instruments. Let's hope that all of us (individuals and institutions) are more careful in future investments by seriously taking into account all of the above sources of risk, so that these mistakes are not repeated.

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