



**Indices, currencies and commodities are rejuvenating contracts for difference, writes James Dunn**

DERIDED by some as a symptom of the sharemarket bubble, contracts for difference have evolved beyond the share market, their overall popularity largely defying the economic gloom.

As expected, the sharemarket slump, and the increased volatility in share prices has had an effect on the market for CFDs. According to the 2008 Contracts for Difference Report conducted by research house Investment Trends, the number of active CFD traders fell from 31,000 in April 2007 to 26,000 in August 2008, and average trade size fell from \$55,000 to \$41,000.

“Last month, interest in stocks from our clients hit a record low,” says Tamasz Szabo, chief operating officer of CFD provider IG Markets and chairman of the CFD Market Committee of the Australian Financial Markets

Association.

But Szabo says business is booming because the CFD market is “de-equitising anyway”. He says interest in indices, currencies and commodities is more than making up for a drop in equity activity.

“Eighteen months ago, CFDs on shares accounted for 80 per cent of our business. That’s now about 15 per cent.

“Our biggest market now is currency CFDs, which are about 35 per cent of our business. Index CFDs represent about 25 per cent of the business and commodities CFDs [have] almost overtaken equities. Because interest in these markets is so strong, the customer uptake of the product remains very healthy.”

CFDs first appeared in Australia in March 2002, three years after their introduction in Britain, but they are banned in the US. The Australian Securities and Investments Commission calls them “very high risk”.

A CFD is a financial derivative that represents a theoretical order to buy or sell a tradeable asset, say a certain number of shares or amount of gold.

The investor closes the transaction by taking the opposite action. The investor’s final profit or loss is determined by the difference between the opening and closing price, with

the difference paid at the close of the contract.

The attraction to many investors is the highly leveraged nature of CFDs: traders can leverage an investment in equity with a deposit of as little as 3 per cent. In index, commodity and currency CFDs, the deposit can be as low as 1 per cent. It is this leverage that causes much of the criticism levelled at CFDs, to the effect that they are little more than a short-term punting chip, which in inexperienced hands can cause big problems. “You can put, say, 5 per cent down on a share purchase and get the same profit as an investment 20 times the size. But by the same token, leverage can amplify your losses,” says Kevin Saunders, general manager of trader education and trading company TCT Australia.

Alex Douglas, head of business development and market strategist at CFD provider City Index, says CFDs have been wrongly perceived as solely a tool for leverage.

“When CFDs first arrived in Australia, we were in the middle of a bull market and the perception grew up around them that they were simply a great means of getting lots of leverage

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and really benefiting from the market's rise," Douglas says.

"Now we've had a change in conditions and people need to change their mindset and look at some of the other benefits of CFDs, which revolve around their ability to help manage risk."

During the past 18 months, index CFDs have "well and truly shaded" individual stock CFDs, Szabo says. "The volatility of individual shares, and especially the fact that they can gap much lower overnight, has been a major problem for traders in that time.

"Even the top stocks can generally move much more than the index on a day-to-day basis. Plus, investors have realised that if they're trading individual stocks,

they're exposed to a lot more company-specific variables such as management decisions.

"But when you're trading the index, you've got 200 companies you're investing in.

"To a large extent you're more affected by what's happening in the US and China. It's more of a bigger-picture type of investment."

Much the same kind of thinking is driving the burgeoning growth in the use of currencies and commodities CFDs, he says.

"We're about to start promoting Australian dollar-denominated CFDs, which allow Australian clients to remove the currency risk from trading in overseas indices and commodities."

But Murray McGill, senior adviser at Patersons Securities, is

concerned at the apparent growth in CFD usage.

"I don't think there are enough retail clients operating at a sophisticated enough level to use CFDs to justify the growth we're seeing," he says. "As a firm, we're very, very cautious about the use of CFDs by retail clients, because they're an instrument that uses a high degree of leverage, and unless an investor understands leverage very well, and understands stop-loss orders very well, they shouldn't be using them."

McGill describes CFDs as the "automatic weapons" of the stockmarket world: "They can be safe in experienced hands, but if you don't know what you're doing, you're highly likely to get hurt."