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It's a gamble either way

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Advertisement

Contracts for difference are banned in the US but here they are sold to retail investors. Annette Sampson analyses the risks.

Clearly someone thinks the bull market is back. The promotion of leveraged products, which had slowed to a trickle as investment markets showed their nasty side, is back with a vengeance. Instalment warrants, gearing structures for self-managed super funds, even margin lending is making a comeback – though it will be some time before that reaches the glory days of old.

But possibly the most aggressively marketed form of leverage showing its face is contracts for difference, or CFDs.

Developed in Britain in 1974 as a way to leverage gold, CFDs are being pushed as the latest go-to investment for the get-rich-quick crowd. Basically, they are a highly leveraged way to get exposure to specific stocks, indices, or commodities without the hassle of having to buy the underlying investment. Depending on what you want to invest in, you can "borrow" as much as 95 per cent – in some cases even more – of the value of the underlying contract. A mere $100 upfront can buy you exposure to an investment worth 10 times that.

They're high-risk and that's fine – so long as you understand what you're getting into. But there are growing concerns that CFDs are being pushed to the wider investing community – including investors who either don't understand the risks, or for whom they are totally inappropriate.

A spokesperson for the Australian Securities and Investments Commission says the regulator reviews financial advertising for misleading and deceptive conduct and is currently examining CFD advertising.

In its recent submission to the Parliamentary Joint Committee on Corporations and Financial Services's inquiry into financial products and services, ASIC said officers would be attending "educational" seminars for CFDs and conducting surveillance of both product issuers and advisers. Its review will also include other complex products being marketed to retail investors, such as capital-guaranteed and capital-protected products and unlisted and unrated debentures.

Victorian MP Bob Stensholt has called for tighter regulation of investments such as CFDs, which he says have little or no relationship to real property and are "quite frankly betting or gambling".

"It's the white-shoe brigade – they've got a new angle," he says. "You're not trading in any security itself. You may as well go to the pokies and see if the reels come up.

"We should learn from the recent downturn and avoid using high-risk financial instruments like these. People should be dealing in real value in real securities."

A senior lecturer in banking and finance with the Australian School of Business, Dr Thomas Henker, says while sophisticated instruments such as CFDs and futures can be good for financial markets, he is "a bit concerned about the ability to promote them in Australia to all kinds of investors without making sure they understand what they're getting themselves into".

"A lot of retail investors, in particular, may not be in a position to judge whether these investments are appropriate or not," he says. "For many people, it's all about the lure of untold riches and profits but what they don't understand – or don't want to understand – is that if you have the potential to make huge returns there's also a strong possibility of losing similar amounts. Investors can take relatively large positions with little capital and a high degree of leverage. It doesn't take large movements in prices to result in very large losses or gains."

A CFD is basically an agreement with the issuer to exchange the difference between the price of something now and the price when you close out the contract. You can either take a position that the underlying stock (or market index) is going to rise or that it will fall.

You put up an initial deposit, or margin, and borrow the rest of the contract value. That margin will usually depend on what you're trading – the more volatile the underlying investment, the higher the margin.

You'll be charged interest on those borrowings if you go long (bet that the price will rise) but receive interest if you take a short position. If the market moves against you, you may be called to put up more collateral – similar to a traditional margin call.

But unless you employ risk-management strategies, such as stop losses (orders to sell your CFDs at preset levels to limit your potential losses), you can end up losing much more than your initial investment. Theoretically, your losses are unlimited, though in practice the CFD issuer will normally liquidate or close out your position if you don't maintain your margin.

Australia is somewhat unusual in having a substantial retail CFD investor focus. In Britain, where CFDs were developed, institutional investors are much more involved in the market, though this is largely because buying CFDs allows them to avoid stamp duty – which doesn't apply to shares in Australia.

The US regulators don't allow CFDs to be sold to retail investors at all.

ASIC has warned investors that while CFD advertising might make you think these are a mainstream financial product, they are borrowing to gamble.

"You take a punt with borrowed money on whether a share price or market index will go up or down ... [and] borrow up to 95 per cent or more of your bet," it says.

"Because of this borrowing, it's much riskier than a flutter on the horses or a night at the casino. Your losses are potentially unlimited."

Because of the leverage, ASIC says, a 1 percentage point price movement can result in a 10 per cent or 20 per cent loss. It says while CFDs may suit traders with the experience, knowledge and financial capacity to take on the risks involved, they can be a recipe for disaster for the unprepared.

This, however, hasn't lessened their appeal in the eyes of some investors.

In its latest CFD report, researcher Investment Trends says the number of active CFD traders has rebounded strongly as sharemarkets have recovered. In June, it estimated there were 32,000 active CFD traders – up 6000 on a year before. The market is worth about $400 million. Investment Trends principal, Mark Johnston, says most traders are frequent share traders who rely on technical analysis.

They're "overwhelmingly male", have fairly high incomes and are often well educated. The earliest adopters were sophisticated traders who had previously used other leveraged investments such as options and warrants, though the market has now broadened to include share traders. He says most started trading CFDs on shares but there has been an increasing trend to trade indices and currencies over the past two years.

Johnston says there are about 25,000 people who have traded CFDs but don't intend to do so in the next 12 months. However, 72 per cent say they will probably trade again. Only 28 per cent say they'll never touch them again.

When asked for negative experiences, many investors said they had tried trading, lost money and learnt the importance of using stop losses. Others had problems with trading platforms.

The Financial Ombudsman Service says it received an increased number of complaints about CFDs last year, though the total has still only risen from 24 complaints in 2007-08 to 37 in 2008-09. The most common problem was service standard (27 per cent), inappropriate margin calls or liquidation of CFDs (24 per cent) and misrepresentation (14 per cent).

The managing director of CFD issuer IG Markets, Tamas Szabo, disputes the need for greater regulation. He says CFDs are subject to the same requirements to produce product disclosure statements and belong to an independent dispute resolution scheme as do other financial products.

"CFDs are there for a certain type of investor," he says. "They're not suitable for everyone because they are leveraged. They're generally for people looking for short-term gains."

Szabo says IG doesn't seek uneducated investors and vets potential clients by asking questions about their earnings, savings, trading experience and knowledge of the risks involved.

"We'd knock back about 10 per cent of potential clients on the basis of lack of experience or knowledge," he says.

CFDs are not a generic product, with differences in product structures, pricing and how they are traded. While you can trade CFDs on the Australian Securities Exchange, most CFDs are traded over the counter – which means you're relying on your CFD provider for a trading platform. This results in an often confusing array of costs and claimed benefits.

Johnston says the type of market is a major point of competition and there is a fairly high level of confusion among clients about what's best. However a higher proportion of those surveyed favoured the "direct access" model, where CFD prices mirror the market price of the underlying assets. It was seen as being more transparent. With the other main model, the CFD issuer acts as a market maker – determining the price and, in effect, taking the other side of the trade. On the plus side, this allows these brokers to offer a wider range of contracts.

Risk-management tools such as stop losses and guaranteed stop losses (which get you out at your nominated level even if the market

"gaps" so that the price falls below your stop-loss level) can also vary. Some issuers are also more active in curbing clients' losses through limiting the leverage on more volatile investments and closing clients out if their losses are starting to mount.

A senior client adviser at Austock Securities, Michael Heffernan, says there's a place in the markets for CFDs but you need to understand what you're doing and be aware of the risks. "Certainly, none of my clients would go into it," he says.

But he warns there is no such thing as a magic bullet. "I've been a bit surprised to see [CFD providers] advertising on mainstream TV," he says. "They're really for day traders and high-risk takers, not ordinary retail investors.

"I know from experience that you can be lucky with trading but it can just as easily go in the opposite direction."

Figures are magnified either way

To demonstrate how CFDs work, IG Markets provided the simple example of a CFD over BHP shares. Let's say you thought BHP was cheap at $38 and decided to buy 250 shares worth $9500. Another way to get the same exposure would be to buy 250 CFDs over BHP. You'd have the same $9500 exposure but you'd need to outlay an initial margin of just $950.

Over the next five days, BHP's share price rises to $40 and you decide to take your profits. Your gross profit is $500.

You would make the same $500 gross profit if you'd bought CFDs but instead of a return of about 5.26 per cent, your return on your initial investment would be a staggering 10 times that — 52.6 per cent.

But what if BHP shares had instead fallen by $2 before you decided to cut your losses and get out? Again, you'd have lost a gross $500 before costs on both transactions. And again, in percentage terms you'd have lost roughly 10 times as much on the CFD — or more than half your investment.

With a more highly leveraged investment — say where you borrowed 95 per cent and put up an initial margin of just $475 — you'd have lost more than you invested on a mere $2 or 5.26 per cent price movement. Or more than doubled your money.

That's leverage.

What brokers can do with your money

ASIC has also moved to crack down on a gap in the Corporations Act, which allows CFD providers to use clients' funds for other purposes. Last month it issued a paper arguing for greater disclosure and controls over pooling arrangements where client money can be used to offset other clients' trades or to meet obligations incurred by the CFD provider.

If you think that sounds a bit like Opes Prime, where clients who thought they had traditional margin lending accounts found their stock had been used as security for the brokers' borrowings, you'd be right.

"It's similar in that if a CFD provider got into financial difficulties and your funds were sitting with the broker as margin funds, they'd be treated as the brokers' funds," says the managing director of IG Markets, Tamas Szabo. "But most brokers have controls that don't let that happen."

Nevertheless, Szabo says ASIC's move is a welcome one in ensuring greater client protection.

IG claims to be the only CFD broker that doesn't use client money for administrative purposes. Institutional dealer Chris Weston says it holds clients' funds in a separate trust account and can only pool funds with written consent from clients. "We're unusual in that respect," he says.

ASIC recommends retail investors trading in CFDs or other derivatives find out from their issuer how they look after client money, including:

Whether client money is held separate from the issuer's funds, as required by law.

Whether their money can be used to meet trading obligations of other clients.

Whether the issuer can use client money for their own purposes.

And where and how the issuer has disclosed its client money policies to the investor.

The Australian School of Business senior lecturer in banking and finance, Dr Thomas Henker, says most investors don't think about counter-party risk (the risk of losing money because of problems with the institution you're dealing with) when they invest but they should do their homework and invest only with reputable brokers. They should also make sure they fully understand any agreements they enter into. If you don't like or understand the agreement, he says, don't sign it.

"When they buy a new car, people spend a lot of time thinking about where to buy it," he says. "But that's almost an afterthought when people are opening a broking account. It's bad financial behaviour and there may be an urgent need for more education."

ARE CFDS FOR YOU?

WHAT YOU NEED	WHAT THAT’S LIKELY TO MEAN
Experience	You’ve extensively day-traded shares, options, future or

	other short-term derivatives, especially in volatile markets.
Knowledge	You know how CFDs work and know the trading rules and trading platform backwards. You've read the product disclosure statement and discussed the risks with your financial adviser.
Risk control	You've got fail-safe trading systems set up to stop unacceptable losses.
Financial capacity	You can afford any losses that your trading system can't avoid.

SOURCE: ASIC

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