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CFDs on ASIC's radar

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Contracts for difference (CFDs) have been under investigation by the Australian Securities and Investments Commission, but they are still a useful investment tool if you know what you're doing. ASIC said in a report released this month that issuers of CFDs needed to do much more to ensure investors understand the risks in trading these types of financial products.

A CFD is an agreement between two parties to exchange the difference between the entry and exit price of a contract. They are generally highly geared products, which means the amount you put down is only a fraction of the market value of the contract. You can take CFD contracts out on a number of assets such as shares, commodities, currencies or indices.

ASIC's study, *Contracts for Difference and Retail Investors*, found retail investors are confused about how CFDs work, do not understand the significant risks in trading CFDs, do not seek financial advice before investing, and often, do not receive sufficient information to make informed decisions about trading CFDs. The report is topical given that CFD promoter, Sonray Capital Markets entered into voluntary administration in June.

CFDs are a highly leveraged derivative product marketed to and traded by retail investors. CFDs are essentially a leveraged bet on future changes in the market price of a share or commodity, or the value of an index or a currency exchange rate. The majority of CFDs are issued and traded over the counter (OTC).

The head of sales trading at CFD trading house IG Markets, Harley Salt, says CFDs work best when the market is volatile. "If the market is moving sideways then investors don't make money," he says. "The recent volatility in the market has meant CFD activity has picked up."

To help with their decisions, CFD traders are offered a range of tools, including guaranteed stop-losses, which automatically exit a position once a certain loss has been reached. Trailing stop-losses, where stop-loss positions are reset as the price moves, are also available. For example, say you buy a share at \$1 and set a stop-loss at 90 cents – you are limiting your loss to 10 cents. If the share goes to \$1.10, your stop-loss is reset at \$1 – still 10 cents.

"Investors wanting to open accounts with us have to meet minimum criteria," Salt says. "This includes minimum savings and earnings but also minimum levels of experience. We won't open accounts for just anyone."

One of the criticisms of CFD trading is that you can lose more than you put up. Salt says this is especially true if you go short [selling something you don't own in the belief the price will fall] on a stock.

"Say you go short on a \$1 stock of which you've short-sold 1000 units," he says. "If another company makes an offer for the company and its share price shoots up to \$1.50, then you have a running loss of \$500. This is why the guaranteed stop-loss option is a good idea."

There are a number of costs associated with CFD trading. At IG Markets investors pay 0.1 per cent of the trade on the way in and out, and a guaranteed stop-loss option costs 0.3 per cent.

Salt says there is also an interest component. "If you were going long on a \$10,000 position, it works out at about \$1.85 a day, based on an interest rate of about 6.7 per cent," he says. "What you pay in interest depends on what your position is at the end of the day. If it's worth less you pay less, if it's worth more, you pay more."

He adds when you go long you can also receive all the dividends that are paid. The costs for going short are reversed – investors receive interest and they have to pay the dividend.

According to the June 2009 Australian CFD report from research house Investment Trends the number of CFD traders in May 2009 (when the research was conducted) was 32,000, up from 26,000 in August 2008.

A senior analyst with the firm, Pawel Rokicki says when asked what role CFDs play in their financial strategy, 45 per cent of traders in 2009 cited shorting; 39 per cent cited speculative trading, and 37 per cent saw CFDs as an alternative to margin lending.

Access to a wider range of markets and instruments was increasingly seen as an advantage CFDs had over other financial products: 43 per cent cited the ability to trade indices as a benefit, a third cited access to overseas markets and 30 per cent cited access to foreign exchange markets as a benefit.

CFDs have been called a form of gambling by parties such as ASIC, which on the consumer affairs section of its website states 'put simply, CFDs are like borrowing to gamble'.

CMC Markets chief market strategist Ashraf Laidi says going into almost any financial investment without any knowledge could be termed a form of gambling.

"Does speculation equate to gambling? No," he says. "If you take action based on sound market knowledge then that is not gambling because you have understood that the markets are moving in an explained manner. With CFDs, it is all about educating clients about how markets move and why."

For investors wanting to know whether CFDs may suit them, ASIC has a complex investment products checklist on its website that highlights some things to consider.

This story was found at: <http://www.smh.com.au/money/on-the-money/cfds-on-asics-radar-20100722-10114.html>