Rewarding risks

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Zoë Fielding

There's no doubt trading contracts for difference can be risky. For a start, there's the market risk that any investment involves. In CFDs this risk is magnified by leverage, which gives investors a much larger market exposure than if they'd used their own cash alone.

For every dollar you invest, the return from a trade that goes in your favour will be far greater using leverage than if you'd used only your own money. However, if the trade goes against you, you run the risk of losing substantially more than you put up initially.

Aside from market-related dangers, people who trade CFDs are exposed to specific risks that relate to CFD issuers.

CFDs are contracts with a provider. They're not, strictly speaking, investments. This means that if the provider fails or is defrauded, investors could lose their money.

In contrast, shares bought through a full-service or online stockbroker are held in the investor's name and usually won't be lost if the broker fails.

Unfortunately, provider-related losses can, and do, happen. Some 4000 investors had their accounts frozen when CFD issuer Sonray Capital Markets collapsed in June.

At a creditors' meeting in July clients were told to expect a return of about 27.5¢ in the dollar.

Sonray accounted for 2 per cent of the CFD market in Australia before its collapse, according to researcher Investment Trends.

There's not much you can do to guard against fraud or other so-called counter-party risks. Life would be pretty miserable if you went around expecting the worst from everyone. Each time you deal with any company, you're exposed to the risk you won't get what you're paying for. If you want to access a product or service you have to assume the business is acting in good faith.

You can take some steps to protect yourself and front of mind should be understanding your rights and responsibilities.

Various laws protect consumers and the Australian Securities and Investments Commission is now tasked with monitoring CFD providers and ensuring they play by the rules.

ASIC launched an investigation into the CFD market last year after becoming concerned about the risks in the product and about investors' understanding of them. It released its report in July.

The number of people trading CFDs had grown to 39,000 by May this year from 32,000 the year before. CFD issuers were managing about $350 million of client money in early 2009, according to ASIC's industry consultation.

The regulator found that many people didn't think of CFDs as "borrowing to invest".

However, when you buy a CFD, you pay a deposit to enter the trade. For example, you might decide to buy 1000 share CFDs at a cost of $20 a share. Rather than having to come up with the full $20,000 to invest in that position, you put down a fraction of that amount, maybe 5 per cent or $1000.

Although they're not loans as such, CFDs do behave much like a loan.

For starters, you can invest more than you actually have. If you're buying investments, the CFD issuer will charge interest on the difference between the total amount invested and the deposit you put up. If you're short selling some, but not all, providers will pay you interest on the difference.

As an investor, you're contracted to the provider to meet a margin call at just 24 hours' notice if the value of the underlying investment falls to a level the issuer considers unsuitable. That would mean putting in extra cash or selling other investments to return the CFD position to a suitable gearing level.

It's possible you could be liable for much more than you originally invested. ASIC's report gave the example of a long CFD position where the investor bought 10,000 share CFDs at $10 each, for a total position value of $100,000. With a 5 per cent margin requirement the investor would have put in just $5000 to initiate the trade.

If the price of the asset underlying the CFD was down 10 per cent (to $9 a share) at the end of the day, the total

position would be down $10,000 and the investor would have to put up additional capital to keep the position open overnight.

The additional margin required is equal to the change in the CFD price multiplied by the number of CFDs held, so the provider would make a margin call for $10,000 – double the amount the investor first committed.

If the investor fails to meet the margin call within the specified time, the provider usually closes the position and it can pursue the investor for the additional amount.

So those are some of the dangers. Have we scared you off? If so, CFDs probably aren't for you. It takes a lot of study and research to understand CFDs and how they can work for and against you. They're not suitable for those with a weak stomach for risk.

The good news is that, if you have the inclination, you can minimise each of the risks to which you're exposed when trading CFDs, and there are considerable profits to be made if you can master this product.

Some savvy traders even use CFDs to hedge risk out of their direct share portfolios during periods of market volatility.

When you start trading CFDs, the goal is to survive long enough to learn without wiping out your trading capital, says Justine Pollard, an experienced CFD trader, trading mentor and author of a book on trading plans.

Risk management is the key, Pollard says. "The entries are a small part of it. Anybody can buy something to enter a trade. It's actually knowing what to do next that makes it successful," she says.

Stop-losses

To lock in profits, minimise losses and avoid margin calls, Pollard sets exit points for every trade she places, based on the amount she's willing to risk.

She controls her exits using stop-loss orders, which are automatically triggered at a price set by the trader.

Although optional, Pollard says that stop-loss orders – also called contingent orders – should always be used when trading CFDs.

However, even with a stop-loss order in place, there's no certainty the issuer will execute the trade at the nominated price if the market moves very quickly or if the stock is trading thinly and no one wants to buy or sell from you.

A common problem is that a stock may close at one price and then open the next day's trading at a much higher or lower price. This is called gapping.

To be sure the stop-loss order will be executed at the requested price, you'll need a guaranteed stop-loss order. This type of order will close the position at the nominated level even if the stock never actually trades at that price.

You'll pay a premium for a guaranteed stop-loss order but CMC Markets' head of sales trading, Matt Lewis, says it is cheaper than buying a put option that might have the same effect on a share portfolio.

If you've short sold a stock and it appreciates by 15 per cent overnight but your guaranteed stop-loss was set to trigger at a 5 per cent rise, for example, you'll still stop out at the 5 per cent level even though the stock didn't trade at that price.

There's also no time limit on CFD contingent orders and guaranteed stop-loss orders. This is an advantage over options, which expire at a set date.

Pollard uses guaranteed stop-losses on some trades but not all.

"There are shares like BHP [Billiton] and Rio [Tinto] that naturally gap all the time so if I'm trading those then, yes, I use them," she says. "Also, if I'm in a position where the shares start to accelerate very fast, it could also go against you very fast."

It's important to note that issuers place restrictions on the way stop-loss orders can be used, requiring the trigger prices to be a minimum distance from the initial CFD price. Check the fine print for the conditions your provider applies.

Be conservative

Aside from using stop-loss orders, you can curtail the risk you take by being conservative with the leverage you use. CMC Markets' Lewis suggests as a maximum, gearing up to three times your capital.

If you have $10,000 that would equate to a $30,000 position in the market, or a 66 per cent gearing ratio (the provider's input to the total investment).

In contrast, a conservative gearing ratio on a margin loan is considered to be below 50 per cent (some financial advisers would say even lower). Most margin lenders won't allow loan-to-value ratios above 75 per cent for blue-chip shares and will apply 50 per cent or lower for many other securities.

Pollard says it's important to act responsibly with CFDs. She risks only 1 per cent of her trading capital on any one position and limits the number of open trades to five at a time.

These rules are part of a trading system that Pollard has developed over the years. She says her system helps her stay in control and mitigates risk.

Michael McCarthy, City Index's head of dealing, Asia Pacific, says a key element of a money management plan is a profit-to-loss ratio.

This is the proportion of trades that must go in your favour compared with those that go against you for you to break even.

"If you're looking to gain 100 points on an index trade and your stop-loss is 40 points away, you can pick a position successfully less than half the time because your profit-to-loss ratio is positive," he says.

"If you're going into trades and you're looking to make 40 points and your stop-loss is 100 points away, you could have a big problem because when you lose you're going to lose a lot more than you make.

"You have to be successful 75 or 80 per cent of the time just to break even in those scenarios."

Hedging

Some people who trade CFDs aim simply to break even, using them to hedge risk out of other parts of their portfolio. McCarthy says sophisticated investors have increasingly been using CFDs for hedging since 2008.

While some trade positions daily, hedging might involve holding positions open for up to three months. One approach is to short sell equity CFDs of stocks that are held directly, to take away the market exposure.

Say an investor owns BHP Billiton shares worth a total of about $40,000 but is worried the price will fall in the short term. To protect against this fall they could short sell an equal number of BHP CFDs so the share losses would be offset by CFD gains.

"Of course the reverse is also true – if those BHP shares continue to rise, although they'll make money on the shares that they're already holding that will be offset by losses on the CFD short position," McCarthy says.

CMC Markets' Lewis says it's important to have an opinion on how long the price may be weak and how low it might fall when entering this type of hedging position.

There's no point maintaining a neutral market position indefinitely, especially given the costs of short selling CFDs.

You can also use CFDs for an indirect or portfolio hedge. If you're holding a basket of shares that roughly matches the S&P/ASX 200 Index, you could short sell an index CFD to reduce the market exposure for a period.

If the market falls and your portfolio falls with it, the loss will be more or less offset by the gain in the short sold index CFD.

Lewis says some people use sector-specific indices to hedge parts of their portfolios. If financial sector stocks are expected to be weak for a time but other parts of the market are running well, you could short sell a financial index CFD to compensate for losses on that part of the equity portfolio.

Once you've entered a trade, you have to manage your capital. You must be comfortable selling out of the shares at a profit to close out the CFD position at a loss and vice versa.

There's also a chance the price of a stock you've short sold may rise and you'll have to meet a margin call, unless you've used a guaranteed stop-loss, in which case you'll lose money when the CFD trade closes automatically.

On the upside, your shares will have unexpectedly increased in value, which will offset that loss.

If you're using an index hedge, the index may fall more than your share portfolio. If that happens you might make more on the hedge than you lose on the shares. But if the index falls less than your shares, you'll be out of pocket despite the hedge.

“You’ve got to be aware of those risks when you put the trade on,” McCarthy says.

“But if you are, and understand that investment is about risk, that’s part of being in that world. You still have reduced risk in most scenarios.”

Cautious deals from a desktop

Zoë Fielding
James Harrold is a stay-at-home dad and private investor who manages the family’s investments while wife Violeta works as an IT consultant and their three daughters are at school.

James is finishing off a real estate project and most of his funds and energy are committed to that, but over the past four years he’s been actively trading contracts for difference and plans to continue to do so when he has more free time and capital.

“I want to supplement my income with trading,” he says. “Ideally I’d like to do this as part of an overall investment strategy.”

When James trades it usually involves a few short- to medium-term positions each week, with a couple of hours a day spent identifying these opportunities and placing trades.

He employs a system he learned from Justine Pollard, an experienced trader who mentors others through her business, Smart Trading, and who has written a book about developing a trading plan.

The system concentrates on managing risk, which is essential in trading. Its rules determine the level of risk on individual trades, the number of trades in the market and how much risk the overall portfolio can be exposed to at any time.

“Before I do a trade, the first question I ask myself is: How much am I happy to lose?” James says. “That rule is universal. I’m prepared to risk $X on this trade and if it fits the criteria of my system I’m prepared to take that trade, and if I lose that money then I get out of the trade and I don’t get back in until it comes up again.”

Stop-loss orders, and in some cases guaranteed stop-loss orders, allow James to automatically exit a position that’s moving against him.

He admits, though, that over the four years he’s been trading CFDs he hasn’t used them on every trade. “Whenever I haven’t, I’ve regretted it every single time,” he says.

The leverage in CFDs means losses are magnified, making them all the more painful. However, leverage is one of the attractions for James because it allows him to have his capital at work elsewhere.

Money management rules prevent him from receiving a margin call, he says.

“I have more than enough funds available to cover the risk level I’m at,” he says. “If I had five trades open at a certain risk level, I’d have three times that amount of money sitting in the account.

“I’d have a stop-loss in place. If it moved against me and got to my stop-loss, which is set at my risk level for that trade, the trade would simply close.”

James isn’t concerned about issuer risk – the possibility he’d lose his money if the CFD provider failed. He keeps only a modest amount of trading capital in his CFD account and as the balance grows he moves some out and stores it elsewhere.

James says that while he wouldn’t be happy if his issuer went under, the returns he has already made “would more than offset the losses”.

“It’s like having creditors. If one of them goes under you might lose some money but you’ve made a lot of money out of them over the years. So I don’t dwell on it.”

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