The Australian

Local traders flee from shares to currencies

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THE recent volatility in global sharemarkets has prompted thousands of investors to switch from trading the sharemarket to trading the foreign exchange market.

The trend has been emerging since the global financial crisis when contracts for difference started to gain traction. Initially traders were using CFDs to trade shares, but the latest trend is a new focus on currencies.

Chris Gore, currency analyst at GO Markets, sees a more global perspective as the driver.

"They want to look at the broader picture," Gore says. "The move is a by-product of the GFC."

There are two ways to trade forex: using CFDs or margin forex. According to Investment Trends, the number of active CFD traders (those who have placed at least one CFD trade in the previous 12 months) has jumped from 39,000 to 41,000 in the 12 months to May. Of that figure, just under half (46 per cent) traded CFDs over forex.

In terms of trades rather than traders, 27 per cent of CFD trades involved foreign exchange, a significant increase over last year, Investment Trends senior analyst Pawel Rokicki says.

But not all forex trading is through CFDs. Margin forex is more popular, with 43 per cent of traders using margin forex last year as against 26 per cent using CFDs only. There is not much difference between the two formats. Of the 18 per cent of traders surveyed who used both, 12 per cent could not tell the difference, not least because the differences had decreased through time.

Originally, under margin forex the provider would go into the market and take a position on your behalf. With CFD FX, you are taking out a contract with the CFD provider to pay the difference between the levels at which you opened and closed the contract

The CFD route tends to be the cheaper while the margin forex route is seen by some as more transparent, as you are dealing directly in the market.

Nowadays, margin FX might more closely replicate the processes of FX markets and therefore assumes the trader has bought at the spot price and the contract is designed to consistently roll over each day. (Spot transactions are designed to be closed out in the next two days.)

With some margin FX providers, after a period, sometimes after a month, this contract can expire and the trader needs to reopen their positions.

CFDs, by definition, don't have an expiry and are designed to allow easy speculation on prices.

Steven Dooley, head of research at ForexCT, says that from the traders' perspective the two systems deliver the same experience.

"The only real difference is in the back office," he says.

So what's the big attraction about trading in forex and why are traders abandoning the sharemarket? Dooley believes there are five key reasons Australian traders have switched their allegiance from shares to currencies.

First, he says, there is always a trend in the currency market. "In falling or volatile [share] markets, it can be difficult to find a clear upwards or downwards trend for trading," Dooley says. "In currency markets there is always a clear trend somewhere."

Second, in currency trading, liquidity is less of an issue because there's always a buyer. Indeed, the forex market experiences $4 trillion in trades every day.

"You can almost always get out quickly at the price you want to get out," Dooley says. "This is a huge advantage over shares because small-cap stocks such as the small mining stocks can be slow to get out of and can drag you down with the market."

Another advantage is that currencies are never delisted, as was the case, say, with Babcock & Brown shares in 2009. As a result, you never run the risk of your entire investment being wiped out. "This does not happen with currency. It may fluctuate, sometimes alarmingly, but countries will always need something to exchange for goods and services."

Cited as another positive is the so-called purity of the market, which is the result of it operating 24 hours a day and the fact the foreign exchange market is so large that it is extremely difficult for one player to manipulate.

Dooley also notes that because currencies are a reflection of a nation's economy and this information is freely available, it means there is little room for insider trading or market manipulation, as can happen with shares.

And currency pairs move on the will of each individual player, so nobody knows for sure the direction the currency will move, which presents the opportunity to make a profit. The busiest trading time is between 10pm and 2am AEST when British and US markets are open. Volumes during this window can jump fourfold.

Risk control is also an import factor. Although currency trading has the reputation of being risky, it also can provide some of the best risk-control techniques.

"The liquid 24-hour nature of forex means you can be certain stop losses will be triggered during market hours, unlike in sharemarkets where markets are closed for 18 hours a day," Dooley says.

While currency markets are open 24 hours during the working week so you can react to news and events in real time, you still need to be mindful of the 48 hours they are closed during the weekend.

Of course there is still plenty of risk involved with currency trading simply because it is premised on gearing, which can accentuate your gains just as easily as accentuate your losses.

"Leverage can be your friend or your foe," Gore says. "At the end of the day you are using a smaller amount of capital to give you a greater exposure to the market, so it's wise to have your contingencies in place."

This friend-or-foe terminology is also attributed to the volatility in the market.

For instance, in late July the Aussie dollar hit a high of US110.81c, but by August 9 dipped below parity. Most traders would have had a stop loss in place so they did not take the full brunt of the fall. But Dooley warns that if the currency is too volatile then it can wipe out most of the wins.

The reality is that for every winner in forex, there is a loser. One of the key concepts you need to get your head around is that you will not win every trade with forex. That's where the discipline comes in, as you need to know when to get out (and ideally have a stop loss in place).

"If your analysis is wrong, then you need to get out. You might only get 50 per cent of your trades right but you can still make money," says Chris Weston, of IG Markets.

The key is to make sure your gains are three to four times your losses on the top side. Say you had $10 and you put a stop loss in at $9, but on the top side you should be looking at $13 to $14.

Another plus for trading in forex is that it is much cheaper than trading in shares. If you trade shares it can cost you $20 to $30 to get in and out; if you trade in forex it can cost as little as $3 or $4.

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