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Wealth

Profit at the margins from CFDs

- by: Gillian Bullock
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Dealers in the share trading room at CMC Markets in Sydney. Picture: Kristi Miller

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IT has been almost 10 years since contracts for difference were first introduced in Australia and they have been growing in popularity since.

Financial service market research group Investment Trends estimates there are 41,000 traders in CFDs in Australia and that figure is rising. While there are more than 35 CFD providers in Australia, the lion's share of the market is held by the original players, IG Markets and CMC Markets. In 2005 there were only 9000 traders, so the number has increased more than fourfold.

It is reasonable to infer that this growth will continue.

There were, for instance, 2000 more traders this year than last year.

But while shares were the flavour of the month when CFDs first hit these shores in 2002, they now bring up the rear in popularity.

According to Tamas Szabo, chief executive of Australia's largest CFD provider, IG Markets, with more than 34 per cent of the market, shares made up 80 per cent of business in 2002. Now their percentage is below 20 per cent.

"The focus [in CFDs] is now on forex and indices and then followed by commodities and shares," Szabo says.

CFDs are a leveraged derivative financial product. Drilling down into the definition, a derivative is a financial product whose value is derived from the value of another asset. So, for example, rather than invest directly in BHP Billiton shares, you may put your money on the possibility that BHP shares will move in a certain direction.

And you make that bet -- which to all intents and purposes it is -- with a CFD provider. Since CFDs are all about margins and leverage, you need to recognise that while any gains will be magnified, so will any losses.

Most people would tend to trade in indices over shares, particularly in the present environment when markets are in free fall, although it can be equally argued that it is difficult to pick movements in the indices at present. "It's extremely difficult to pick individual stocks in this environment," Szabo says.

Trading in indices has seen a spike up in recent times as people look to counter the slump in the actual sharemarket as you can short with a CFD.

Index CFDs are viewed as less risky than individual stocks, as you are spreading your risk across the whole market rather than on a single company.

But just because we are in a falling market, it does not mean that you should go short (your opening order is a sell order) exclusively. McCarthy observes that when the ASX 200 index fell by 41.29 per cent in 2008, the market rose on nearly 45 per cent of the trading days.

With a traditional share investment you would be in for the long haul, weathering the market fluctuations, but the object for the short-term trader in CFDs is to capture smaller moves in the market.

And the facts bear this out, with the average trade in CFDs lasting only three days, according to Szabo.

But while CFD trading may possibly lead to risk reduction, few people use it for this purpose. Mostly they simply want to trade, and trading is not without its dangers, as you are generally buying the shares on margin and leveraging yourself in the market.

CFD providers offer some minimisation strategies. For instance, you might seek a guaranteed stop loss. This is particularly useful when dealing with shares and indices as you can face a gapping risk where shares may fall sharply overnight while the market is closed and when they open they plunge beyond your stop loss. But Szabo says covering the gapping risk is not that popular as it comes at a price of about 30 basis points.

CFDs are attractive because of the low associated costs, so to pay 30 basis points for a guaranteed stop loss may seem somewhat extravagant.

Meanwhile CMC Markets offers zero leverage with its new Tracker platform. By having zero leverage you bring your overnight financing fees down to zero.

And as a means of differentiating its offering, ForexCT says its CFDs have no margin calls but have a bigger spread of one to two points more than elsewhere to compensate.

If you're not open to margin calls you have reduced exposure, particularly when your CFD is in shares where you can be victim to the gapping risk.

Steven Dooley of ForexCT provided an example. "If you have \$1000 in your account and took a leveraged long position [that is, bought] of \$10,000 in US-listed Apple shares, then after the market closes, let's say Apple announces it is withdrawing its iPhones from the market. When trading opens the next day, let's assume Apple stock has fallen 20 per cent on the open, which means you are \$2000 underwater.

"If you only had \$1000 in your account, if you were liable to margin calls, your broker would say you need to top up a further \$1000 or the position will be closed. And even if it is, you will still owe \$1000."

If you had no margin calls, then the position would be closed and your account would have a zero balance, so you would drop only the \$1000, not \$2000. But of course that comfort zone comes at a price, and you will pay more for the transaction.

And that's the point; one of the attractions of CFDs is the cheapness of trading in the market. Szabo says headline rates are \$8 to \$10 so "it beats any stockbroker".

CFDs thrive on volatility. Szabo says the rate of account openings in August this year went through the roof. "August was a stand-out record month," he says. "People see volatility as an opportunity to profit in the short term."

But given the associated risks, it's not surprising experts will advise you to always start small.

There is also a dark side to CFDs. They have featured in some insider trading cases in Australia in the past two years.