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Wealth

The highs and lows of complex investing strategy

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THE biggest danger of trading in contracts for difference is that you can lose more money than you started with.

But fans of the leveraged strategy point to the positives of being able to take advantage of short-term price movements, the opportunity to hedge your existing share portfolio, easy access to international markets, low commissions and the ability to profit from falling markets. So, when they are good they are very, very good, but when they are bad they are rotten.

The Australian Securities and Investment Commission, which regulates the industry, has expressed concern over disclosure and investor awareness about the risks associated with CFDs.

"CFDs are extremely risky financial products," ASIC chairman Greg Medcraft says. "Most investors don't understand that complexity and they don't get independent financial advice. That means we need CFD issuers to do a much better job of spelling out to investors the risks as well as the rewards of this complex product."

IG Markets chief executive Tamas Szabo says CFD suits those who already actively trade on markets and are comfortable with the format.

Some providers offer free seminars on CFDs, occasionally advertised as the fast road to riches, that lure in the uninitiated.

So concerned are the authorities about trading in CFDs that the ASIC recently issued seven disclosure benchmarks that providers must address in disclosure documents on an if-not, why-not basis to ensure retail investors understand the risks involved. In addition, ASIC has been in discussions with the Australian Financial Markets Association about industry-developed standards for the CFD market. This is distinct from the benchmarks.

ASIC's benchmarks, developed in consultation with the main players in the CFD market, include making sure investors understand the features and risk and explaining the counterparty risks of hedging and the financial resources of the provider. For instance, the first benchmark stresses the importance of the client understanding the concepts of leverage, margins and volatility. The second warns that if a client opens an account with a credit card, this may be a warning that they can't afford the upfront cash and are unlikely to be able to pay the margin calls.

When you are dealing in over-the-counter CFDs, you will be exposed to counterparty risk. As such you need to rely on the issuer taking appropriate measures to reduce the risk of it not being able to meet its liabilities. So the provider should have appropriate hedging strategies in place. The issuer should also explain its policy on maintaining adequate financial resources as it is operating in a dynamic and volatile environment with a high rate of cash turnover.

You can take out a CFD using one of three models: market maker, direct market access or exchange-traded CFDs.

ASIC has also recently issued an investor guide, *Thinking of Trading Contracts for Difference*, in which it runs through the three trading models.

If you opt for the market maker model, then the provider comes up with their own price for the underlying asset on which the CFD is traded. If you trade CFDs with a market maker then you are a price taker. With a market maker, the provider does not always hedge their client position with other counterparties or in the underlying market. As a result your provider may directly benefit if you lose on your trade.

If your provider operates using the direct market access model, then they will place an order in the market for the underlying asset when you take out a CFD. You can watch the transaction taking place. Trading this way makes you a price maker. While pricing is more transparent with this method, the range of CFDs offered is smaller as there needs to be sufficient trading volume for a particular CFD to be available. DMAs apply only to Australian shares; all other asset classes use market maker models.

IG Markets says 80 per cent of providers would be market makers and just 20 per cent direct to market.

The third method is exchange-traded CFDs, which are listed on the Australian Securities Exchange through an authorised broker. You can trade in CFDs on most big stocks including BHP Billiton, Amcor, Woolworths and Wesfarmers. Exchange-traded CFDs carry a much lower level of counterparty risk as they use the ASX clearing house; the contract for the buyer and the seller is with the clearing house. Financial services market research group Investment Trends estimates that less than 5 per cent of CFDs are exchange traded.

The first two methods of trading are referred to as over-the-counter CFDs, where the contract is an arrangement between you and the provider where you are both counterparties to the trade.

Before you start trading it is highly recommended you do some trial trading. Most CFD providers allow you to operate a demo account. According to a study by financial services market research group Investment Trends, 57 per cent of new traders operate a demo account before they begin trading with their own money.

To start trading in CFDs, you need to pay money into a margin account. The amount is in effect the deposit you need to open a position. If you have \$1000 in your margin account and the CFD provider has a margin requirement of 1 per cent, then you can trade up to 100 times your initial investment; that is, open a position of \$100,000. While this may sound an amazing opportunity it's worth remembering that the lower the margin you pay, the more the profit or loss will be magnified even with a small price fluctuation. You need to have sufficient funds in your trading account to meet your margin requirement should the position go against your prediction.

Margins are generally higher for shares, particularly if they are less liquid, than for forex and commodities.

Margin calls can be what brings down CFD traders. If you have insufficient funds in your trading account to cover a loss then you will be asked for a margin call. Not all providers alert you to your need to pay as they assume you are watching the markets, although the main players do. Either way, it is largely expected that you will pay on the same day.

If you take a long position and hold the position overnight then you will need to pay an interest charge as you are basically borrowing funds to invest. This charge is generally a small percentage above the interbank overnight cash rate but it can be substantial.

If you take a short position, then you usually receive interest credit at a rate just below the interbank overnight cash rate, although in some cases you can end up owing money. The amount of leverage allowed will depend on the product. Szabo says a good leverage level for shares would be 3 per cent to 5 per cent while it would be as low as 1 per cent for foreign exchange. "You are never going to see a currency halve overnight," he observes.

One argument put forward in favour of CFDs is that they offer you the ability to gain exposure to offshore markets at a reasonable price. Rather than searching around finding a broker that can invest directly offshore, you can trade in the likes of Apple or McDonald's much more simply than if you were to seek to buy the actual shares. Another advantage cited is the ability to benefit from a falling market. This is achieved by going short (that is, selling) a stock or index.

Michael McCarthy, chief investment strategist at CMC Markets, says while some people are traders in CFDs, others are investors who use them in conjunction with another investment as a way to minimise risk. For instance, they will go short in the market to benefit from market falls to hedge against their existing shareholders. Other means of hedging could include options and warrants, but they don't offer stop-loss orders to minimise your loss. In addition, CFDs generally have no time limits.

McCarthy says trading in CFDs is counter-intuitive. "How you trade depends on your circumstance but the trading principle is the same," he says. "You run profits and cut losses."

That's why it's important not to let emotion come into the equation. Whenever you take a position, you should always rationalise your strategy.