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## A lesson to learn about betting ahead

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Well, well. Surprise, surprise. Who could have guessed there would be problems with contracts for difference (CFDs), the highly geared derivative products that bet on the future prices of shares, markets or commodities. The failure of CFD broker, MF Global, has once again highlighted the potential pitfalls of investing on steroids. Australian traders who are clients of MF Global, a US broker that failed last week and is in administration, are hopeful of a full refund of their outstanding account balances. But that could be wishful thinking. Between \$400 million and \$500 million belonging to about 13,000 clients of MF Global's Australian arm is believed to be at risk.

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If you have heard of CFDs it may be because they have been heavily advertised as a safe way to play the markets. Or perhaps you caught the repeated warnings by the Australian Securities and Investments Commission (ASIC) about the possible pitfalls, stating CFDs are "much riskier than a flutter on the horses or a night at the casino".

According to researcher Investment Trends, there are about 40,000 active CFD investors in Australia, up from about 9000 in 2005. Growth is expected to continue. Some of these investors will be ordinary investors, such as those trading CFDs in their self-managed super funds, who are using some retirement savings to trade.

It appears that the main, or core, users of CFDs are share traders.

Ordinary investors should avoid CFDs because it is about betting on the direction of future prices and it's a bit like a novice driver behind the wheel of a racing car. The potential to leverage-up the investor's capital increases the risks. Investors who are highly geared could easily lose more than their initial capital and end up owing money. And with CFDs, that could occur in days. Small investors are not likely to be able to effectively manage the stop-loss settings that brokers provide.

For investors, the usual rules about investing should apply before venturing into particularly risky investments. If investors do not understand a financial product, they should not invest in it.

It could be argued that CFD trading is beyond most ordinary investors' abilities. It is best for most people to favour simplicity and transparency over complexity and leave the too-clever-by-half investments to those people who can afford to lose their money.

Should anything go wrong, complexity always works in the favour of the providers.

Layer upon layer of complexity also makes it harder to work out how much is being paid in fees. If traders want to take punts with their money, fair enough. They are likely to be better educated and have more investment experience than the broader population. If their investments blow up, they are probably in a better position than most people to find a real job.

Following its "health check" of CFDs in 2009, ASIC chose not to restrict CFDs being sold to the financially illiterate. Instead, it put the onus on CFD providers to "qualify" investors before taking them on as clients.

From March next year, CFD brokers must assess investors' experience.

Investors will be screened by CFD brokers about their understanding of concepts such as leverage, margin lending and volatility.

The most surprising part of this latest example of light-touch regulation is that the regulator has decided to leave it to the brokers themselves to determine the best method of conducting the assessment. Even in the US, the bastion of let-it-rip capitalism, these products cannot be sold to retail investors.

Given that most CFD issuers distribute directly to investors through mass-media advertising, rather than through financial advisers, retail investor are particularly vulnerable.

Earlier this year, the Financial Ombudsman Service called for investors to be banned from using CFDs unless they first obtain a certificate from a financial planner or an accountant that says they are competent to trade CFDs. That's a much better idea than the regulator's light-touch approach.

Another problem, apart from their inherent riskiness, is "counter-party" risk, where the CFD provider co-mingles investors' money - some clients' funds could be used to cover others' losses. In time we will know whether MF Global did segregate client funds or whether the broker used client funds to meet other clients' obligations or the broker's own obligations.

Sometimes financial products are so complex that all the disclosure in the world will not adequately protect investors. I defy any ordinary investor to judge something like counter-party risk, especially when it extends to some other party, apart from the broker, that they may not honour their side of the contract.

Yet, almost as if testing how far the ridiculous notion of "anything goes, just disclose" can be pushed, the regulator is requiring brokers to disclose their capital, liquidity and hedging positions.

The regulator has also tightened disclosure of risks and fees of CFDs with more warnings about the risks in advertising.

But surely the regulator is joking if it expects ordinary people to come away from reading the disclosure documents with any real idea of where the risks lie.

*This story was found at: <http://www.smh.com.au/money/investing/a-lesson-to-learn-about-betting-ahead-20111111-1nav2.html>*