Trading can be like taking on Tiger every day. Photo AP

Pitching your strategy against the best

A rising market is a good time to try CFDs. Just be aware you'll be in with the big-hitters, writes **David Coe.**

Markets are on the move upward again as appetite for risk returns. But many investors are torn. Should they hang back? Do portfolios need protecting from further falls? Or is it time to jump in and try sophisticated trading strategies?

In times like these, the lure of profits from both rising and falling markets is deliciously attractive and some might be tempted to try using contracts for difference (CFDs) for the first time.

But as old-timers will tell you, there are more ways to lose money than to make it in the markets – especially for timid investors tempted to use the small margins on CFDs to ease their way back into the market. When it comes to CFDs, small errors can have expensive consequences. Novices trading CFDs need to be well informed and well armed. They need knowledge, a good trading plan and the discipline to execute it. That's why CFD providers recognise the importance of educating clients.

I-Deal director John Robertson says: "When you trade, you must be professional. It is as if you are competing against Tiger Woods on the PGA tour every day with every position you take."

That's because CFDs are like mini futures contracts. When you take a position in stocks, interest rates, commodities, currencies or indices via CFDs, you're effectively playing against the pros – banks, superannuation funds, scalpers, market makers, commercial hedgers, seasoned investors, even international hedge funds – who move prices on the wider market. Make a mistake and you learn an expensive lesson.

As a trader, you need to know the differences between the three ways to access CFDs and which suit you. And with thousands of securities available, you also need to know which you want to trade and which brokers provide them.

PULLING OUT ALL THE STOPS

Stop-loss orders can be the most troublesome aspect for novice traders. The idea is to set a price at which you automatically exit the trade and protect your capital when on the wrong side of a move. This is critical when trading leveraged products because leverage magnifies your losses as well as your profits.

Stops are prices at which your broker will exit all or part of your position, depending on your instructions. The exit can be to limit losses when price moves against you, or to take profits.

If you set a stop-loss that is too close to the current price, you can lose money before the market resumes its move in your favour. If you set a stop too far away, you can lose even more money if the market keeps moving against you.

Stops on ASX-listed contracts for difference (CFDs) are triggered only if the CFD – not the underlying stock – trades at that level. So if the underlying stock goes past your stop and you decide to exit manually, you could trigger your own stop order and effectively double your position.

Stops that apply to specific contracts – April crude oil, for example – can drop out of the market when the contract rolls over to the May contract.

If you're not monitoring your positions adequately, your safety net can unknowingly disappear.

There are also different types of stops that allow for sophisticated trading strategies but not all brokers provide all types of stops. These include: **"If done" stops** let you trigger a sequence of buy and sell orders. **"One cancels other" stops** allow you to set a price target and a stop loss, and then when one is hit, you don't have to worry about cancelling the other. **"Close of market" stops** allow you to ignore intraday price fluctuations. Some platforms mimic this by allowing you to set a timeframe outside of which your stop won't be triggered. **"Good till cancelled" stops** remain in force as it says. If you forget about one, you could end up in a position without knowing. **Guaranteed stops** take away the risk that the market will gap over your stop and in the process take more of your money than you expect. Many competent traders say this is just insurance in another name with extra cost. **Limit stops** let you either set a profit target and exit automatically, or enter a trade at a level that preserves enough upside to make a profit.

Other things you need to know include where to place a stop-loss order, how to take profits, how to measure the risk in any given trade and the principles of money management.

Choosing a broker is also critical. There are many CFD providers and competition among them is fierce. Yet each broker suits a market niche. Your job is to identify your needs and pick a broker who meets most of them.

Leverage works like this: you pay a deposit, or margin as brokers call it, and effectively own the asset. The smaller the margin, the greater the leverage and the quicker you'll lose money if you're wrong. Brokers that provide the greatest range of instruments often offer their own purpose-built online trading platforms with buy and sell prices that reflect, but may not be identical with, those on official markets. This has advantages and disadvantages. And different brokers offer different ways to exit your trades automatically, whether to prevent losses or take profits. These stop-loss orders vary in sophistication.

There are three ways to access CFDs. Direct market access (DMA) CFD providers offer their clients 100 per cent transparency in pricing and a number of buyers and sellers because they offer the same prices as those quoted on the Australian Securities Exchange. When a CFD position is opened, the provider takes the same position on the ASX.

When the position is closed, the provider closes its position and credits any gains or losses to the client's account.

> **Don't allow yourself to be fully leveraged. Make sure you have a buffer.**

Providers who act as market makers offer the greatest range of products because they have their own bid and ask quotes. But the potential is for pricing to be different to the underlying market, and market makers are open to the claim that they profit from clients losing money.

ASX-listed CFDs offer a genuine marketplace, where buyers and sellers come together to trade. Multiple market makers are engaged by the ASX to provide constant bids and offers but they are acting on their own account. The risk of the person on the other side of your contract going broke is limited to the exchange. With other CFDs, you would be an unsecured creditor if the provider were to fail.

Once you're clear on the sort of CFD you want to trade, then consider a broker.

CommSec is Australia's biggest retail stockbroker. It has 1700 CFDs, and it provides what it says is the most comprehensive suite of products for retail financial markets. It offers mostly non-advice, direct-market access and ASX-listed CFDs. Its head of investment lending, Brian Phelps, says novices should know how to trade both long and short in markets. "And don't allow yourself to be fully leveraged. Always make sure you have a buffer," he says.

CMC Markets advertises itself as Australia's largest provider and offers more than 3500 CFDs here and abroad. It makes its own markets on a proprietary platform and, less well known, also offers direct market access. With its comprehensive peer-to-peer online networking, it sees itself as the Facebook of trading. Senior dealer Matt Lewis says: "If there's a market clients want us to make, we give a price. We're now looking at carbon emissions trading."

And I-Deal is a boutique broker offering direct market access to 6000 CFDs as well as futures and foreign exchange in a tailored service for professional traders. It has both web-based trading and a proprietary platform.

Once you've short-listed brokers and the types of CFDs you'd like to use, consider the merits of various trading platforms. These are computer programs that deliver prices and other market information to your desktop and allow you to place buy and sell orders online.

WebIRESS is regarded as the industry leader and is similar to the program used in broking houses. It provides live price feeds, high-speed execution, and lots of functionality as well as the convenience of direct market access trading at any computer with internet access.

Proprietary platforms strive to set themselves apart with advanced charting tools and exclusive materials for clients, such as analysis, commentary and education. Some providers claim their platforms cope better with huge spikes in volume during volatile trading periods.

Phone trading took a great leap forward with the advent of iPhones and other 3G phones. As well as taking voice orders by phone, CFD providers are starting to offer applications that can be downloaded so that you can trade online with your phone.

There are contracts on a staggering choice of securities but no broker provides them all. ASX-listed CFDs cover the top 50 shares as well as indices, foreign exchange and gold. Direct-market access CFDs usually cover more shares on the ASX and some international markets. Market makers often have lower margin requirements and offer a wider range of international CFDs.

But when all is said and done, the most important thing to understand is your trading plan: know what you want to trade and have an entry and exit plan.