Module 3
Risks of CFDs, and how to manage them

Topic 1: Magnified losses

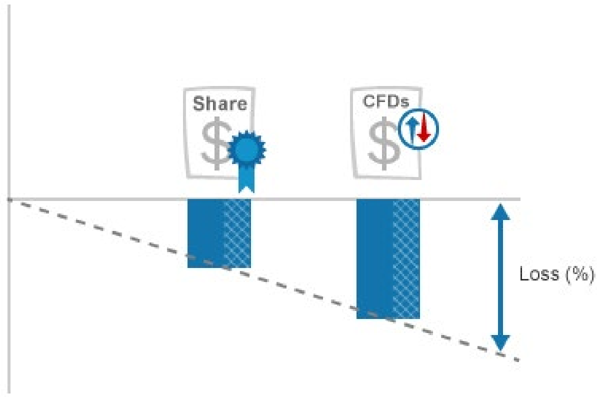
Introduction

CFDs are a high risk investment, and only suit certain types of investors.

The risks of trading CFDs include:

- the risk of magnified losses
- the risk of being required to put in additional funds
- the risk you are unable to trade out of your position at a price you are happy with
- the risk that exchange rates move against you - relevant to DJIA CFDs.

In this module we will look at each of these risks, and discuss ways you can manage them.



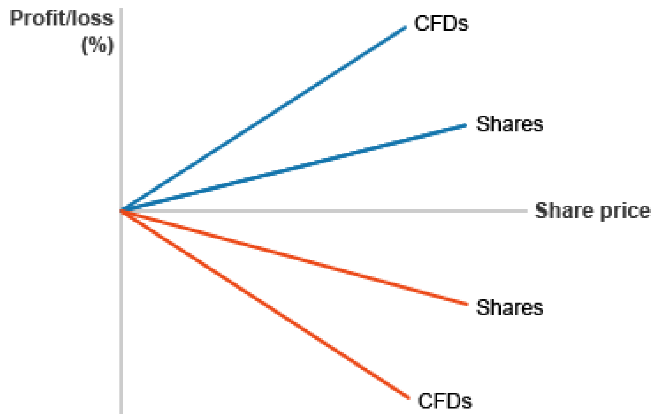
Magnified losses

CFDs are leveraged instruments.

When you enter a CFD position, you lodge an initial margin that is a fraction of the value of the underlying asset. However you are fully exposed to price movements in the underlying asset. In percentage terms, your gains and losses are magnified.

If the price moves in your favour, your returns from a CFD are usually much greater than the movement in the price of the underlying asset (in percentage terms).

If the price of the underlying moves in the wrong direction, your losses will be much greaer too.



Example 1: long position, price falls

XYZ shares are trading at $10.00. The initial margin for XYZ CFDs is 8%.

You have a view that the XYZ share price will rise.

You buy 10,000 XYZ CFDs. Your initial margin is $8,000.

The XYZ share price falls sharply to $8.00. You close out your position.

		Shares	CFDs
Open position	No. purchased	10,000	10,000
	Opening price	$10.00	$10.00
	Position value	$100,000	$100,000
	Initial outlay	$10,000	$8,000
Close position	Closing price	$8.00	$8.00
	Position value	$80,000	$80,000
	Profit/loss	-$20,000	-$20,000
	Percentage return on initial outlay	-20%	-250%

The table opposite compares the return from your CFD position with the movement in the XYZ share price.

While the share price has fallen 20%, the return on your initial outlay to open the CFD position is a loss of 250%.

Note: the returns in this example do not take into account your daily cashflows or brokerage.

Example 2: short position, price rises

The S&P/ASX 200 index is at 4000 points. The initial margin for S&P/ASX 200 CFDs is $255.

You think the index is likely to fall, and take a short position, selling 50 S&P/ASX 200 CFDs.

After three weeks, the index has risen to 4,400 points. You close out your position.

The table opposite compares the return from your CFD position with the movement in the index.

While the index has risen 10%, the return on your initial outlay to open the CFD position is a loss of 157%.

Note: the returns in this example do not take into account your daily cashflows or brokerage.

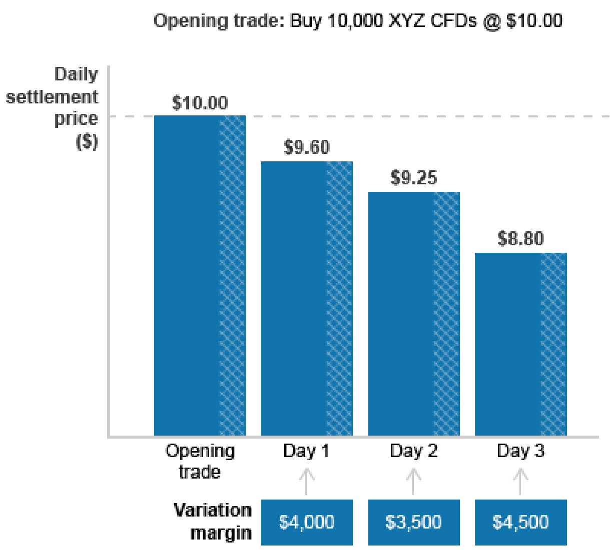
		Index	CFDs
Open position	No. sold	–	50
	Opening level/price	4,000 points	$4,000
	Position value	–	$200,000
	Initial outlay	–	$12,750
Close position	Closing level/price	4,400 points	$4,400
	Position value	–	$220,000
	Profit/loss	400 points	$20,000
	Percentage return	10%	-157%

Additional margin calls

On opening a CFD position, you pay an initial margin.

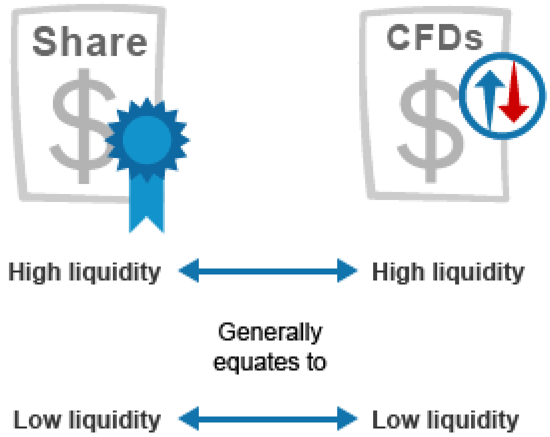
Each day your position is marked to market, and a variation margin will be called if the price of the underlying asset has moved unfavourably. You must have cash available to pay this margin, otherwise your broker will close your position out.

If there is a large move against you, the variation margins you will be called for may be much more than the initial margin you paid. In the case of short positions, you are exposed to the risk of potentially unlimited losses if there is a significant rise in the price of the underlying asset. (In the case of long positions, your potential loss is limited by the fact that the value of the underlying asset cannot fall below zero.)



Topic 2: Liquidity risk, currency risk

Liquidity risk



This is the risk you may not be able to trade out of your position for a price close to the underlying or that you may be unable to trade out of it at all.

There are several measures of liquidity for CFDs, including:

- the number of buyers and sellers
- daily volume
- spread between bid and offer prices, and
- open interest.

In the absence of other buyers and sellers, the quality of market making in providing liquidity is critical.

Designated price makers are given incentives to provide volume and tight spreads. However, there is no guarantee that there will always be suitable quotes in the market to trade against.

Liquidity risk also arises from liquidity risk in the underlying asset, due to the pricing relationship that exists between the two instruments.

Although equity CFDs are based on highly liquid companies, if for any reason the market in the underlying stock becomes illiquid, this will have an effect on the market for that CFD.

Currency risk

Not all ASX Listed CFDs are denominated in Australian dollars.

CFDs over the Dow Jones Industrial Average (DJIA) are denominated in US dollars. The CFD price is expressed in $US, and all margins and cashflows are paid in $US.

Movements in the $A/$US exchange rate will affect your profits and losses in $A terms.

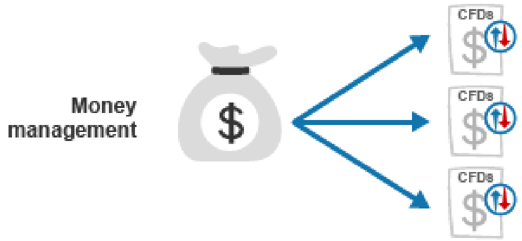
Currency risk will be discussed further in Module 5, when we cover Index CFDs.

Topic 3: Managing your risk

Given the high risk of CFDs, it is essential that you have a strategy to manage your risk.

One way to approach risk management is to think in terms of:

- position management - the way you manage the risk of each position you take, and
- money management - how you allocate your funds to your CFD positions.



Position management

CFDs are not 'set and forget' investments. You must actively manage your positions.

In contrast, many investors in shares take a long-term approach, and are prepared to hold their investment for a long time and ride out short-term volatility.

Because of their high leverage, CFDs are generally not suited to such an approach. Short-term volatility can result in very heavy losses.

Active management of your CFD positions calls for you to:

- monitor the value of your position frequently (at least daily), and
- be ready to take action to limit your losses.

At least once a day		
Monitor position	➔	Check prices
Make decision	➔	Buy? Sell? Hold?
Take action	➔	Implement decision

Be prepared to close out losing positions

Not every trade you make will be a profitable one. Even highly successful traders have losing trades.

However, successful traders are able to accept that a trade will not be profitable and are prepared to close out losing positions quickly.

At the time you enter the CFD position, it is wise to set a price at which you will exit the trade if the market moves against you.

Exiting your position means you will crystallise a loss. By accepting a smaller loss you avoid risking a larger one by leaving a position in place.

Setting exit points and having the discipline to stick to them is an essential part of position management.

Stop loss

Brokers can offer conditional order types to make it easier for you to set pre-determined entry or exit points. The most common of these order types is the stop loss.

A stop loss is an order type that allows you to set an exit point for an open position.

The stop loss refers to the price of the underlying shares. When the share price hits your specified price, your broker will seek to close out your CFD position on a best endeavours basis.

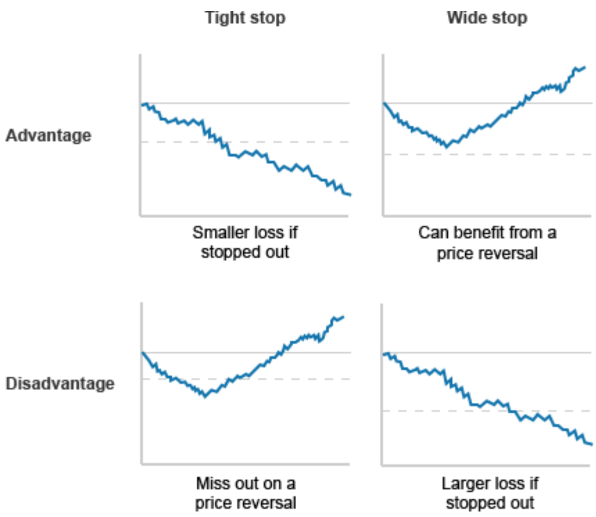
If you have a long CFD position, you will set your stop loss below the current share price.

If you have a short CFD position, you will set your stop loss above the current share price.

Where should I set my stop loss?

There are no hard and fast rules about where to set your stop loss.

Setting a stop close to your entry price (a tight stop) means you may keep your realised loss smaller.

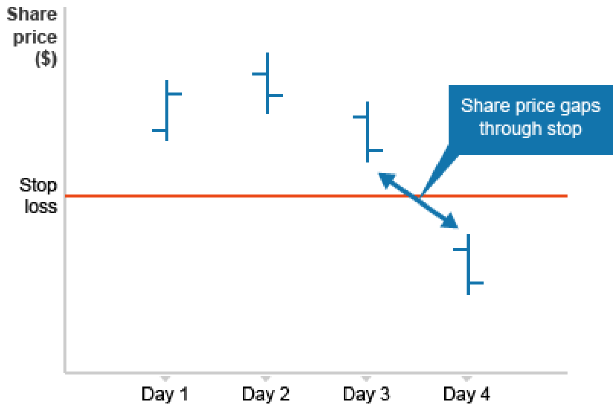


However, it means that with even a relatively small movement in the price of the underlying asset you will be stopped out of your position. You run the risk that the price movement subsequently reverses and you miss out on what could have been a profitable trade.

Setting a stop further from your entry point (a wide stop) means you are likely to stay in your position longer. A short term movement in the wrong direction may not be large enough to reach your exit price, leaving you in place to benefit if there is a longer term movement in the right direction.

However, your loss will be larger if your stop is reached.

A stop loss order is not guaranteed



Setting a stop loss order does not guarantee your loss will be limited to a certain amount.

The stock price may go through your stop without the opportunity to close out your position. This is called 'gap risk' - the stock may 'gap' through your stop loss.

For example, following a trading halt while a company announcement is made, trading may restart at a price significantly above or below the price before the announcement. Or a stock's opening price may be significantly above or below the previous day's closing price.

As a result, the loss you incur when you close your position may exceed the loss you would have made had you been able to close the position at your intended exit price.

Although not offered by ASX-listed CFDs, some providers of over-the-counter CFDs offer a 'Guaranteed Stop Loss' (GSL) feature that comes at extra cost.

A GSL removes gap risk, as your position will be closed out at the specified stop loss point, even if the price of the underlying asset has moved through the stop.

However, it is important to understand the limitations and costs of a GSL. For example, while a CFD has no expiry date, a GSL typically has a limited term.

The cost of a GSL can add significantly to the funding costs of a CFD position. The cost varies according to factors including:

- how far from the share price the stop is set
- the volatility of the underlying shares, and
- the term of the GSL.

Topic 4: Managing your risk (continued)

Protecting your CFD position with ETOs

The only way to ensure you will lose no more than a specified amount on an ASX Listed CFD position is to use exchange traded options (ETOs) in conjunction with your CFD position.

The use of ETOs means you can limit your risk to a known amount, but also benefit if the market moves in your favour.

ETOs are relatively complex products, suitable only for experienced investors. Using ETOs in combination with CFDs means you are operating in two different markets, employing two products with very different features. You should have a sound understanding of both markets and products before considering this strategy.

To find out more, please refer to the ASX booklet [ASX Equity CFDs: Protect your position].

Money management

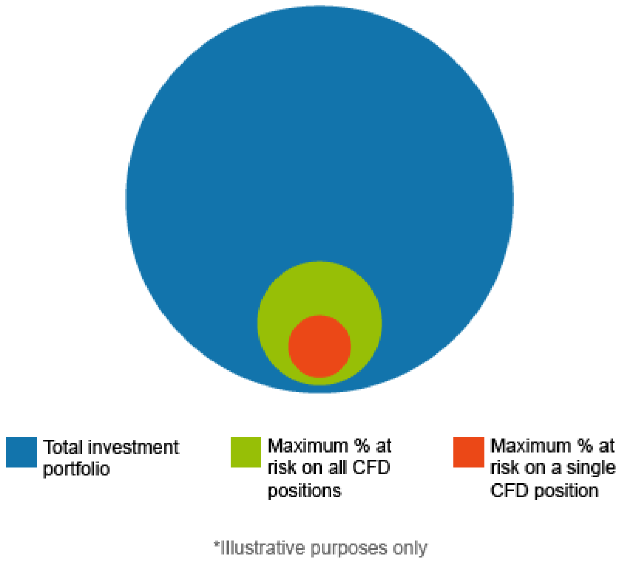
So far we have looked at how you manage individual CFD positions.

Also important is the way you allocate your funds to CFD positions. It is important to limit the amount you have at risk.

One approach is to consider your total investment portfolio, including existing investments and cash available for investment purposes, and set:

- a maximum percentage/amount you are prepared to risk on CFDs in total, and
- a maximum percentage/amount you are prepared to risk on any one trade.

For example, you might decide you are comfortable risking 5% of your investment portfolio on CFDs, and place a limit of 1% on any one trade.



There are no 'right' or 'wrong' limits - it depends on your investing profile and appetite for risk. However, given the high risk of CFDs, for most investors it is advisable to keep your exposure to CFDs low.

What is my 'amount at risk'?

Determining your 'amount at risk' is not a black and white exercise.

Technically, if you have a long position, your risk is that the share price falls to zero. If your position is worth $100,000, your amount at risk is $100,000.

If you have a short position of $100,000, your risk is unlimited. There is no limit to how high the price of the underlying asset could rise.

CFD position	Position value	Amount at risk
Long	$50,000	$50,000
Short	$50,000	Unlimited

A more common approach is to take into account your stop loss. Your amount at risk becomes the amount you are prepared to lose before you take action to close out a position (this is explained by the examples below).

For any given amount at risk, there is a trade-off between where you decide on your exit price and the size of your position:

- the wider your stop loss, the smaller the position you will be able to take
- the tighter your stop loss, the larger the position you will be able to take.

CFD position	Stop	Position size
Long	$ Share price / Stop	Larger
Long	$ Share price / Stop	Smaller
Short	$ Stop / Share price	Larger
Short	$ Stop / Share price	Smaller

Amount at risk - example

Assume the following:

- Amount you are prepared to risk on a CFD position: $5,000
- XYZ CFD price: $10.00
- CFD position: long

Scenario 1: Exit price at $8.00

You decide on an exit price at $8.00, $2.00 below the current XYZ price.

The maximum number of CFDs you can purchase is: $5,000/$2.00 = 2,500

The same assumptions apply:

CFD position	Share price	Stop loss (exit price)	Number of CFDs	Position value
Long	$20.00	$18.00	5,000	$100,000
Short	$10.00	$11.00	10,000	$100,000

Example: Calculating the number of CFDs to trade, assuming you are prepared to risk $10,000 on each position

- Amount at risk: $5,000
- XYZ CFD price: $10.00
- CFD position: long

Scenario 2: Stop loss at $9.00

You decide you will sell at $9.00, $1.00 below the current XYZ price.

The maximum number of CFDs you can purchase is: $5,000/$1.00 = 5,000

The tighter stop loss in this scenario allows you to buy more CFDs than in Scenario 1, where the stop was wider.

In both scenarios it may be wise to keep your position smaller than the maximum, to give you a margin for error in case you are unable to close out your position exactly at your stop loss point.

CFD position	Share price	Stop loss (exit price)	Number of CFDs	Position value
Long	$15.00	$13.00	5,000	$75,000
Short	$15.00	$17.50	4,000	$60,000

Example: Calculating the number of CFDs to trade, assuming you are prepared to risk $10,000 on each position

Topic 5: Preparing to trade CFDs

Trading CFDs calls for some preparation, both logistically and in your mental approach.

CFDs tend to be used as a 'trading' instrument, requiring frequent monitoring and active management of your positions.

If previously you have taken more of an 'investing' perspective, buying shares with the intention of holding for the medium or long term, you may need to adapt your approach.

	Trading	Investing
Time frame	Short term	Medium – long term
Position management	Positions adjusted frequently	Positions held for longer time
Monitoring	Frequent	Less frequent

On-demand internet access

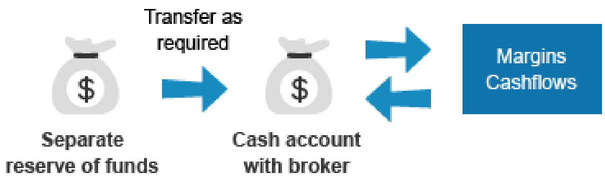
You need to be able to check prices whenever you want, and implement your trading decisions quickly.

In practice, this means having reliable access to the internet during trading hours.

If your job, or daily schedule, means you are often unable to access the market, this may inhibit your ability to trade effectively.

Covering margins and cashflows

You need to ensure you can meet your margin and cashflow obligations.



You will have an account with your broker from which the broker can withdraw money. It is also prudent to have a reserve of funds at call to transfer into that account if required.

If you have insufficient funds to meet your margin and cashflow obligations, your broker will close your position out, and you will be liable for any shortfall.

Mental preparation

It is important to understand what is required in order to be a trader, and to be confident that you can meet those requirements.

You need to have a thorough understanding of how CFDs work, a sound trading plan that incorporates the risk management principles outlined in this module, and the discipline to stick to your plan.

This kind of preparation will help you to make rational, unemotional decisions.

Trading preparation	
Knowledge	✔
Sound trading plan	✔
Discipline	✔

Paper trading

A period of practice can be invaluable. 'Paper trading' allows you to simulate the trading process without risking 'real' money.

You make decisions to enter and exit positions, place stop losses, and monitor your trades using real market prices, but keep records of those decisions on paper or electronically, rather than implementing them in the market.

Once you have rigorously tested your trading skills in practice, you can step into the real market and start trading.

Download the table opposite is an example of the records you should keep when you paper trade. Although it may appear complex, don't be put off! For help in calculating margins and daily cashflows, refer to Module 2. We will also work through a case study of a CFD trade step by step in Module 4.

Summary

- CFDs are a high-risk investment.
- You have leveraged exposure to price movements in the underlying asset.
- If the price moves against you, your losses will be much greater in percentage terms than the price movement in the underlying asset.
- Other risks of CFDs include the risk of margin calls, liquidity risk, and in the case of CFDs denominated in US dollars, currency risk.
- It is essential that you have a strategy to manage your risk, incorporating position management and money management.
- You need to monitor your positions frequently, and be prepared to exit losing positions.
- Stop losses are an important part of position management, although it does not guarantee your loss will be limited to a certain amount.
- You should also limit your amount at risk - on CFDs in total, and on each CFD position.
- It is important to be well prepared, both logistically and mentally, before you start trading CFDs.
- Paper trading gives you the chance to put your trading plan and decision-making ability to the test without risking real money.