



Treading a fine line between making huge gains or losses

CFDs are the new trading fad, but they are not for everyone, **David Potts** writes.

IT SOUNDS wicked to be getting paid for something you don't own and then some for selling it.

Then again if things pan out the wrong way, this not owning something that you can also sell could cost a fortune. In fact there's no limit to how much you could lose, except that is, until you run out of money. Now that's what I call evil.

So you could say there are distinct pluses and minuses to contracts for difference – CFDs to you – which are like shadow shares.

They're usually compared with other so-called derivatives such as options, warrants and futures contracts. Like the others, CFDs are linked to a particular stock which you don't have to own outright.

If anything, CFDs are a more extreme version because you never own the shares. But unlike its rivals, you get any dividends paid though without the franking credit.

You might also have to pay out the dividend when short selling CFDs, but I'm coming to that.

The other big difference is that you can trade any number of CFDs because there's no one-size contract that fits all, and they never expire which thankfully removes other complications such as the price depreciating over time.

Which means CFDs behave exactly like the shares they shadow that you never get to own.

So why bother?

LEVERAGE ME UP

Glad you asked because CFDs have three things going for them that are hard to ignore.

One is leverage. So is the other. Then there's leverage.

They're also the easiest and cheapest way of making money in a falling market.

Oh, did I mention leverage?

The beauty of CFDs is that you only have to cough up a fraction of the price of the trade. The deposit, or so-called margin, for a BHP CFD, for example, might be as little as 3 per cent.

This offers two possibilities. Because the CFD costs 97 per cent less than the share, you don't need nearly as much capital. Instead of parting with \$1000 for 33 BHP shares, you only need \$30 for the same amount of CFDs. That's 90 cents for a BHP CFD, which is identical to the share.

Or you can buy 33 times as many shares, sorry CFDs, for your \$1000.

So for just \$300 you'd have a portfolio of BHP CFDs worth \$10,000.

That's leverage all right.

And remember, even though you don't own the BHP shares – not even a claim over them, come to that – the CFDs will behave exactly the same way dollar for dollar or cent for cent.

If BHP rises 7 cents, the CFD rises 7 cents as well. But the profit on 33 BHPs is \$2.31

which wouldn't even cover the GST in selling them, let alone the brokerage. The profit on the 33 CFDs is also \$2.31, but get this: since you've only used \$30 of your own money, and made \$2.31, the return is 7.7 per cent in one day.

All right, it isn't really because you're up for brokerage which on a CFD trade is very low, but not that low. Although brokerage starts from IG Markets' \$1, usually it's \$10 up to \$10,000 of value – of the shadowed shares, that is – then 0.1 per cent.

By the way, there's no GST on the brokerage. Don't ask me why.

If you'd put in \$300, the return in a day would have been a whopping 71 per cent though it probably still wouldn't pay off the mortgage.

Also, leveraging has a huge downside.

A little goes a long way when prices are rising, but becomes a lot when they're falling. Take a \$100,000 trade for which you need a margin of 5 per cent or \$5000. The price needs to drop just

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5 per cent, which is hardly unknown, and you've wiped out your capital. If it drops 10 per cent, you suddenly owe \$5000.

ON THE MARGIN

By putting so little up front, it's not hard to see that a price rise will be magnified many times over.

Which reminds me of something else that's weird but good about CFDs. Unlike other derivatives, it doesn't matter how big your order is because it won't affect the price or the market.

That's because buying a CFD is a bet, er, I mean deal, between you and the provider who never has to supply the shares because you never get to own them.

Where was I?

Oh yes, in a way CFDs are closer to margin loans than to other derivatives. The differences are the margin you need is much lower at 3 to 10 per cent than a margin loan's 15 to 30 per cent, while CFDs never give you possession of the shares.

There's also a difference for DIY super funds. Margin loans are illegal in a DIY fund but CFDs, so long as the deposit is cash rather than other stocks used as collateral, are treated the same as instalment warrants and so have the green light.



But doesn't a margin loan come with interest? You bet, and so do CFDs held for more than 24 hours. Known as the financing cost, since the other 90 to 97 per cent of the value of the share has been borrowed from the CFD provider, the rate is 2 or 3 per cent above the Reserve Bank's cash rate of 6.25 per cent.

That's about the going rate for margin loans too, but remember the brokerage on share trades is about three times that of CFDs.

True, a margin loan can make equity or margin calls if the share price drops. You can also get margin calls on CFDs. In fact, they're worse. If the value of the shares, sorry CFDs, falls below what you paid, you have to top up your deposit, or sell and incur a loss.

To be fair, a CFD margin call takes the value of your whole portfolio into account, so one dud trade might be cancelled out by a better one on a different stock. "As a broker, I saw many sound trades closed at a loss on a margin call," writes Catherine Davey in *Contracts For Difference: Master The Trading Revolution*. "Frequently these trades then proceeded to go back into profit" – sadly without the trader.

Davey says margin calls "can make you think you have a flawed trading system when, in reality, you have either underfunded your account or taken a position that is too large".

THE LONG AND THE SHORT

It's a salutary warning. CFDs give you a hell of a lot of leverage, aggravated by the fact that many providers even take credit cards, but don't go to

town on it. Because of the daily interest charge, CFDs aren't normally a long-term investment although you do get any dividends, funnily enough, well before shareholders.

That's because your account is credited the day they go ex dividend, which can be weeks before the designated payment date.

It's a whole new ball game when it comes to short selling. This is selling CFDs you don't own on shares you don't own. Well, that shouldn't be hard to handle.

And the CFD provider will pay you interest each day that you're short selling. Mind you, the daily interest is the Reserve Bank cash rate less – yes, less – 2 or 3 per cent. By getting paid, you'd think this would have day traders lining up for short selling. But even though short selling is where CFDs can really come into their own, few traders make a big thing of it.

Still, if you think BHP's price will drop in the next few days because it's gone too high, it's possible to make money by short selling.

Instead of buying BHP CFDs, technically called "going long", you go short by selling them. Remember, you don't have to own CFDs to short sell them. Nor even borrow them, as you would if you short sold shares.

Once you've short sold and the share price has dropped, you then buy the same number of CFDs, and the difference is your profit. It's the reverse of going long, including getting interest instead of paying it. Since you're getting paid for it, holding a long-term short position makes more sense than a long one.





> CASE STUDY: DAVE LIMBURG

Risky business - but he loves it

THANKS to a gammy knee – the result of a soccer injury – Dave Limburg, 27, gave up his landscaping business for what's proving to be the more lucrative trade of contracts-for-difference dealing.

"I love it," he says. "It's like playing chess. I earn a lot more than from landscaping. It's much better."

After dabbling in shares, then CFDs, he became a day trader 18 months ago after scouring how-to-do-it books and online demonstrations.

But like other CFD traders, it was a hard slog at the start. "I wouldn't say I was an instant success," Dave says. "The best way of learning is losing money."

He must have a point since in the past year he says his return is over 600 per cent, and he is one of the frontrunners for the \$100,000 trading prize being offered by CMC Markets.

You get used to triple digit returns when you talk to CFD traders. That's because the degree of gearing is so high (the deposit is as low as 3 per cent of the value of the trade) that even a modest gain gets accelerated.

For example, a 10 per cent profit on a \$100,000 trade zooms to 333 per cent because you've only put up \$3000.

By the same token, the dollar amount might not look quite so amazing, not that \$10,000 is to be sneezed at. Dave's average trade is about \$50,000 which he holds for a week.

He only trades CFDs on highly liquid stocks. Setting a stop-loss price is critical, especially

You'd want to be pretty pessimistic about the stock, though. A small interest payment isn't going to wipe out a capital loss. Also, any dividends are debited from your account.

So when short selling, you need to find out whether the share is paying a dividend during the period you're trading it. Also, some providers charge you for the franking credit as well as the dividend when you go short.

However, short selling should come with a health warning. Unlike buying shares or even CFDs, where the downside stops at zero with the company going bust or being delisted, with short selling the downside is, er, an upside with no bounds. The price could rise to anything, as your losses skyrocket.

STOP THE LOSS, I WANT TO GET OFF

Because of the power of leverage that they unleash, stop losses are essential in CFD trading



SELF TAUGHT: Dave Limburg. Picture: ANTHONY JOHNSON

in short-selling where there's no limit to the potential downside (see "The Long and the Short" in the main story below).

One trap in CFD trading is that the price could drop through the stop-loss before the next trade, locking you in.

You could find yourself with a bigger loss than you bargained for.

Like most CFD providers, CMC Markets offers a guaranteed stop-loss, which costs extra but Dave doesn't use it.

Although he says he was "hammered" in the recent market correction because he didn't use it, he still says the risk is worth it. "I take the risk and I've more than made up for it."

if you don't want to risk going broke. They cut in at pre-set prices when the market is going against you.

For example, if you're long BHP and bought the CFDs at \$30, a stop loss might be at \$29.50. If the price drops to this, you cut your losses and sell.

You can do the same in reverse for short selling

But there's a trap; a stop loss isn't always a stop loss. Depending on how fast the market moves and the policy of the CFD provider, it's possible to be "stopped out" at a lower price than you wanted. If BHP plunges to \$26 as soon as the market opens, that'll be your stop loss, not the \$29.50 you intended.

For a bit extra, usually about \$30, you can guarantee the stop loss.

Also bear in mind that CFDs haven't been tested in a market crash. The CFD is an agreement with your provider who you want to be sure will be around in the tough times. If your provider goes under, nobody else is going to buy your CFDs.