

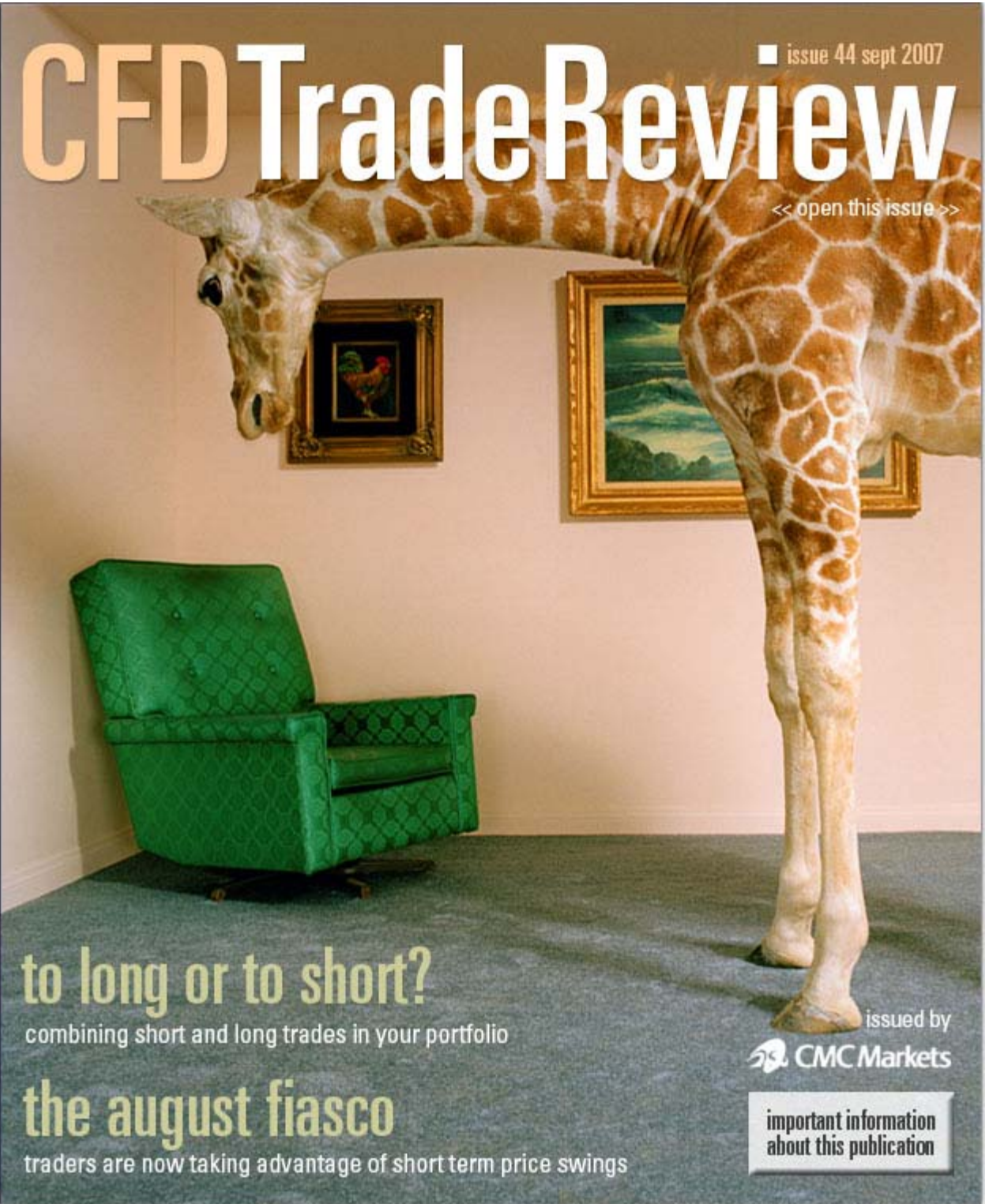
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CFD Trade Review

■ issue 44 sept 2007

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to long or to short?

combining short and long trades in your portfolio

the august fiasco

traders are now taking advantage of short term price swings

issued by

 CMC Markets

important information
about this publication

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THERE IS MERIT IN INVESTIGATING THE COMBINATION OF SHORT AND LONG TRADES IN YOUR PORTFOLIO

When the global markets started to get jittery in late July many of Ben's long trades were stopped out. One good thing was that those trades have made him money during the past months when the market was riding high. As the volatility continued Ben had to revisit his long (buy) trading system. On the other hand, David who has been getting some downtrend signals from his chart analysis for some time before the actual correction set in has been bracing himself for short selling opportunities. David has been profitable from the strong market moves in previous months but he's not shying away from the shorting possibilities either. Like many other traders who have experienced the ups and downs of trading over the years David is open to both the long and short side of the market.

It is a fact that markets (whether you're trading shares, CFDs, FX or other financial instruments) move in at least three directions: up, down and sideways. And for those who have been closely monitoring the global markets lately, particularly for the past few weeks, it would seem that the markets have been taking and trading in all these directions in one go – all in a day's work, as the saying goes.



For many traders and market observers it feels like the days of strong and seemingly endless bull run were suddenly a thing of the distant past. Some of those who have been conveniently riding the crest of the wave for the past few years have abruptly found themselves drifting. On the other hand there are those who found another wave to ride, though in a different direction and possibly something that requires more agility, flexibility and calculated risk taking.

Just as the markets move in different directions traders deal with the markets in different ways. Let's have a look at the different types of traders and their trading strategies amidst various market conditions.

Traditional long (buy) traders

Majority of traders belong to this group that takes advantage of strong uptrends in the markets. These are traders who have been happy to keep their trades open for weeks or months on end when the markets were skyrocketing, therefore capturing the big chunks of the uptrend.

When the volatility started to set in toward the end of July traders in this group have either scaled back on their trading or gone on the hunt for some bargain trades. Scaling back on trading can be done either thru reducing trade position sizes or reducing the number of trades being taken.

Assad Tannous (see this month's client profile) said he's using the volatile trading period to revisit his trading systems. "I've never had any big losses during the past six years and my systems have been very profitable for me. I'm happy to scale back a little on my trading and use this time to further enhance my trading systems. I'm also setting up a sort of trading warehouse that should be up and running before the end of this year where I will be sharing my trading system with other traders, so this is a great time to work out the details of that project," Assad said.

Ron Thurston, another CFD trader for more than five years now said he's still trading but has become very selective with his trades. For some, the recent strong runs on the oil price and gold have proved to be profitable trading opportunities.

"The erratic movement of the market for the past few months means it's quite difficult to pick which direction it will take the next day or even within the day. I've been very selective in my trading these days. I only trade something if I see some solid moves. For example, I've been trading oil during the past few weeks because the price has just been moving solidly and that's where the action is at the moment," Roy said.

Contrarian short (sell) traders

This group of traders are the ones taking advantage of falling prices and volatility in the markets. Though not many of them will readily admit it this group of traders may make more money during the most difficult times in the market – i.e. when prices are falling down and majority of the traditional traders are scampering away. This is because most of the time prices move at a faster rate on the way down than on the way up. This means that those who can steel themselves up and take the contrarian view when the market is moving toward the other direction can reap some hefty returns.

There's no question that majority of traders and investors get into the market with the view that prices will go up in the long term. This explains why there are very few people who trade short (or short sell) despite the reality that prices also come down once in a while.

When the market jitters set in the short sellers also brace themselves for a lot of action. Mark D. Cook, one of the world's top traders featured in Jack Schwager's Market Wizards book, is one of those traders who are not afraid to trade the markets on the downside. He was actively trading during the dot com bust and most recently during the volatile markets in the US.

For traders like Cook trading the markets on the short side (selling instead of buying) could be as easy as trading the long side as long as you trade with the trend. This means that if you're comfortable buying when the market is going up, you should also be comfortable selling when the market is going down. For majority of traders and investors this is easier said than done. Many market observers and analysts say there seems to be a 'prevailing psychological barrier among Australian traders when it comes to short selling. Many Australian investors and traders are in the market with the expectation that prices will go up, so it's quite difficult to change that mindset and make them profit when prices are falling."

Versatile long and short traders – This is another group of traders that trade almost anything and everything that moves. Whether prices are going up or down this group has a way of trading and taking advantage of trading opportunities. For these traders market volatility means trading opportunities. The more volatile the markets the more actively they trade.

Karen Schebella, an active CFD trader said, "I have one word for the markets over the last few weeks.....fantastic!! I have been very fortunate as I exited my trades 3 weeks before the market went down, and went sailing.

I'VE NEVER HAD ANY BIG LOSSES DURING THE PAST SIX YEARS AND MY SYSTEMS HAVE BEEN VERY PROFITABLE FOR ME

ASSAD TANNOUS

I came back one week into the drop and had a fantastic ride and made some good money. I love volatility."

Hamish Thompson, a mechanical systems trader has been busily enhancing some of his trading systems to accommodate the recent market volatility. He's continuously developing systems that address almost all market conditions to make sure that he captures all market moves.

Dave Limburg, winner of the 2007 CMC Markets CFD trading competition has been trading a combination of long and short trades since the onset of market volatility in late July. "Volatility has been good to me in terms of trading opportunities. I usually have a combination of long and short positions when the market is on an erratic phase like the one we've seen in the past few weeks," Dave said.

While going long or short has each own merit depending on the trend you're trying to capture, there is also merit in investigating further the combination of the two in trying to smooth out the equity curve of your trading portfolio. As we all know the markets will move either up or down or sideways, so why limit yourself to trading only one direction when you can trade in all three directions when the markets decide to move from one side to the other?

In the UK, where CFDs originated, traders have learned to maximise the use of CFDs to trade all market conditions. James Foulsham, senior dealer at CMC Markets who used to be in CMC Markets' London office said given the more mature nature of the UK markets, traders there are more attuned to trading in volatile markets, adjusting their trading strategies accordingly to take advantage of range trading opportunities.

traders and their strategy in volatile markets

LONG ONLY



Scaled down their trading through:

Smaller trade positions e.g. if they used to allot \$15,000 per trade before they may have scaled it down to \$10,000 per trade

Less number of trades which may be a function of the market not giving many long trade opportunities

Adjusting their stop loss levels or more diligent use of stops and other risk management tools

Refinement or adjustment of mechanical trading systems

On the lookout for bargain trade opportunities at the right time

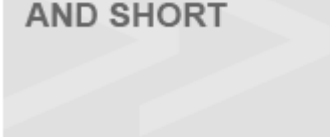
SHORT ONLY



Riding the markets on the way down and short selling to take advantage of falling prices

More diligent use of stop loss and risk management tools in case of short-term rallies and pullbacks

COMBINATION OF LONG AND SHORT



Trades almost everything that moves whether up or down

More diligent use of stop loss and risk management tools

Tend to be short to medium-term outlook in the market and may hold position over 1-3 months on average

More diligent use of position sizing and capital allocation per trade

trading techniques IN TURBULENT MARKETS

As these traders (quoted in the lead story) have shown the volatile market conditions have highlighted the need to implement money management and risk management strategies all the more. These real traders with realistic views of the market have not stopped trading in these volatile times, instead they've introduced some adjustments to their trading to take advantage of the ongoing market conditions. In reality, markets can either go up, down or sideways and traders must equip themselves to be able to trade all market conditions.

Here are several trading techniques available to CFD traders who want to take advantage of trading opportunities in volatile markets. If you want more information about these trading techniques, you can visit: www.cmcmarkets.com.au

1

SHORT SELLING

Short selling involves using a sell order as the opening trade with a view to buying the CFDs back at a later date at a lower price. This is quite the opposite to the more conventional method that most traders are used to which is using a buy order as your opening trade with the view to selling at a higher price which is also known as going long.

As you would imagine, short trading allows you to benefit from a falling share price. CFDs allow you to take this exposure more easily than any other financial product simply because there are fewer restrictions than you would normally be faced with.

2

STOP LOSS

A stop loss is an order that you place with your CFD provider which allows you to determine the position at which you would like to exit the position should the share price decline. As the name suggests it allows you to close out losing positions in order to preserve your trading capital.

Stop losses can form a key component of any trading strategy simply because they allow you to define your risk prior to actually entering any position in the first place. In fact for many trading strategies, the trader determines how many CFDs to purchase based on the difference in price between the entry point and the stop loss level.

3

HEDGING

A hedge takes place when you take out a position that behaves in a way that is contrary to one that you already hold. The view being that the profits made on one will counteract the losses made on the other. The advantage being that you can maintain your existing positions (eg in physical shares) whilst minimising your losses once the hedge (using CFDs) has been put in place.

One of the principal benefits of CFDs is that they allow you to go short very easily. For a number of investors this is advantageous in itself in that you can benefit from falling share prices simply by taking out a short position using CFDs. Importantly though there are a number of other benefits that can be taken advantage of by using CFDs as a part of your wider investment portfolio.

4

GEARING & LEVERAGE

Whenever you are using CFDs (or indeed any type of leveraged investment) you need to have a very firm grasp of how heavily you have levered your available trading capital.

So often the focus of traders falls almost exclusively on determining which CFDs to buy and sell but particularly in times of high volatility it is an imperative that you know exactly how much market exposure you have relative to your overall funds available.

5

PAIRS TRADING

Pairs trading is a trading strategy that falls under the category of what is known as 'direction neutral trading'. In this strategy your objective is to take a short position and a long position in two different CFDs with the view that the up and down movements of the different CFDs will largely cancel each other out.

This type of strategy means that each of the positions effectively act as a hedge for the other and for this reason it is imperative that you chose the positions that you undertake very wisely.

To know more about these trading techniques, visit: www.cmcmarkets.com.au

THERE IS ALWAYS SOMETHING NEW TO LEARN
THAT COULD IMPROVE YOUR TRADING RESULTS



learning by trading

Assad is not someone to shirk hard work. He's used to working long hours – 4AM starts on 13-hour days all week – when he was still running his own café/deli shop several years ago.

What he didn't realise then was he was in for a different kind of hard work when he finally decided to sell his business to go full time trading.

"I owned the café for more than a year and it was doing well, but I couldn't forget the long hours. I didn't like the early starts and there came a point where it (long hours) affected my health and my lifestyle," Assad recalled how he made the shift to trading.

"I was lucky enough to start trading in 1997 just before the beginning of the tech boom. Before I made the jump into fulltime trading I was buying tech stocks at random and due to the momentum in the market I was able to make enough money to convince myself to quit work and start trading fulltime," he added.

Nothing could have prepared him for what's in store for him as a fledgling full time trader.

"As soon as I started trading full time the world stock markets plunged due to the Asian crisis and I lost 30% of my capital overnight," Assad recalled, saying that the pain was almost unbearable.

Despite this upsetting entry into the world of trading, Assad disregarded his broker's advice to stop trading for a while until the market settles. What he did was sign up with an online broker the next day and got right back into the market. Once the market recovered Assad found himself buoyed by the rising tide of the dot.com boom.

"When I look back to the tech boom what I realised is that I didn't have a clue what I was doing then. I thought I was trading perfectly but that was due to the bullish nature of the market. I think 1999 was and still is my best year in trading and personally I believe it will be hard to beat due to the fact that I will probably never see such a bullish market again," Assad said.

With more than eight years of full time trading behind him now Assad is confident that his trading has definitely improved and matured over the years.

"Most of what I learnt was through trial and error. I realised that if I didn't repeat the mistakes I made then the lesson learnt would be worth the amount of capital I lost due to that error," Assad reasoned.

Based on his own experience, Assad said, "The most valuable education is experience. No matter what you read in textbooks or hear in seminars until you apply it in the markets it doesn't have the same value in an educational sense. I personally believe you can never have too much education. It's a continuous learning curve. There is always something new to learn that could improve your trading results. I can never over emphasise it but you always learn from your mistakes."

"I have developed my own mechanical trading system that put a big emphasis on risk and money management. I find the older I get the less risk I take," he added.

Nowadays Assad don't have to start work at 4AM each day. Using his mechanical trading system and all the initial research work during the previous years he usually trade from 10AM – 4PM except for those days when he may find some trading opportunities in the US or UK market and he would spend another couple of hours or so getting into trades.

He had also started sharing his trading systems with a group of traders which is developing into a trading community. The plan is to have a trading 'warehouse' up and running before the end of this year.

With his mechanical trading Assad admits that trading could sometime be a bit boring and repetitive. But there are at least two things that keep him going and interested in trading.

"More than anything else, first it would have to be satisfying my ego and a close second would have to be making money. Nothing satisfies me more than knowing I can consistently out smart the market. I view the market as a game and the money I make is a way of keeping score. Due to my trading being mechanical sometimes it can get boring and repetitive but being able to strictly stick to a system and ignoring the noise is a great test of mind and will power that I thoroughly enjoy."

Assad placed sixth during the 2007 CMC Markets Trading Competition with a 180.8 per cent return on investment on his initial trading capital. He trades almost everything that moves in the market. These days he trades mostly Australian, US and UK share CFDs, some Index CFDs and FX as well.

the AUGUST FIASCO



**many traders
are now taking
advantage of short
term price swings**

When the ASX 200 Index closed near the 6400 level on 20th July 2007 it did not show any sign of the impending market fall that would reverberate from the world's biggest economy – the United States of America. When news of the US sub-prime crisis started to trickle out into the global markets the local index shed more than 300 points in a matter of a few days.

The US sub-prime market revealed a toxic recipe of corporate debt being sold at far too low interest rates. The market was looking at a large number of loans that once would have been held within the banking system but is now being spread far and wide. Wall Street had packaged sub-prime debt and sold it at very low margin (considering the risk entailed), in essence not allowing for the defaults that would emerge.

The fundamental reason behind this chaotic condition was that the extent of the sub-prime problem suddenly became glaringly obvious. As a result a number of domestic and international funds started to report sharp losses and began shutting down.

Global markets were in tenterhooks as the full impact and repercussions of the sub-prime crisis continued to unfold and seemed to be much worse than had previously been thought.

In response to the sub-prime fiasco US President Bush outlined a series of policy changes to help borrowers avoid default and stay in their homes. Global central banks started pumping ample liquidity into the banking system and the US Federal Reserve lowered the discount rate. These swift moves had seemed to quell the markets pain and now touts of a bull market are starting to emerge.

During the last market retracement, signs that the worst may be over started to prevail. While the Dow Jones Industrial Average made a new low, the Russell 2000 and the banking sector remained above their previous lows, thereby displaying short term strength. It is also interesting that two sectors that have been the most directly affected by the housing problem – the Dow Jones home construction index and the Dow Jones Equity REIT index also preformed relatively well.

The metals market has continued to remain firm which is indicative of a continuing strong global economy vis-a-vis a slowing US economy.

Domestically, a stretched labour market spells inflationary tendencies. However, the current credit turmoil may restrain the Australian Reserve Bank's hands until after the federal election when the outlook gets clearer.

Trading during volatile times

No one doubts that the sub-prime issue is a cause for concern and reaction unlike many market jitters over recent months such as the Shanghai shakeout in February – March 2007. Each time we see a market top or bottom it pays to bear in mind that markets are driven in the short term by perception and in the long term by underlying fundamentals. Almost always this discrepancy between perception and fundamentals will cause the market to overshoot, and this has been seen lately. This overshooting has turned many investors from long term traders into short term or intra-day traders.

When trading during volatile times, traders with good money management strategies in place seem to contain losses whilst enabling them to ride the good times. Another factor that proves invaluable is the trader's psychology.

We have found that personality influences trader perceptions and ultimately is the key to success or failure. Balancing your mind is just as important as market analysis in the short term. As many veteran traders and trading coaches have said before you need to master yourself, your psyche and your money management to become a successful short-term trader.

Many traders are now taking advantage of short term price swings. The idea is to buy when your assessment of the market tells you that prices are rising and sell when the uptrend runs out of steam. Alternatively traders have also short sell when their analysis points to a downtrend and buy to close their positions when the downtrend starts bottoming out. The concept sounds simple. However, in volatile conditions money that comes easily can slip through your fingers just as quickly.

Professional traders can trade against trends only because they are ready to run at the first sign of trouble. Before you anticipate any price reversal make sure that you have your exit strategy and your money management fine tuned.

When trading during volatile times, traders with good money management strategies in place seem to contain losses whilst enabling them to ride the good times

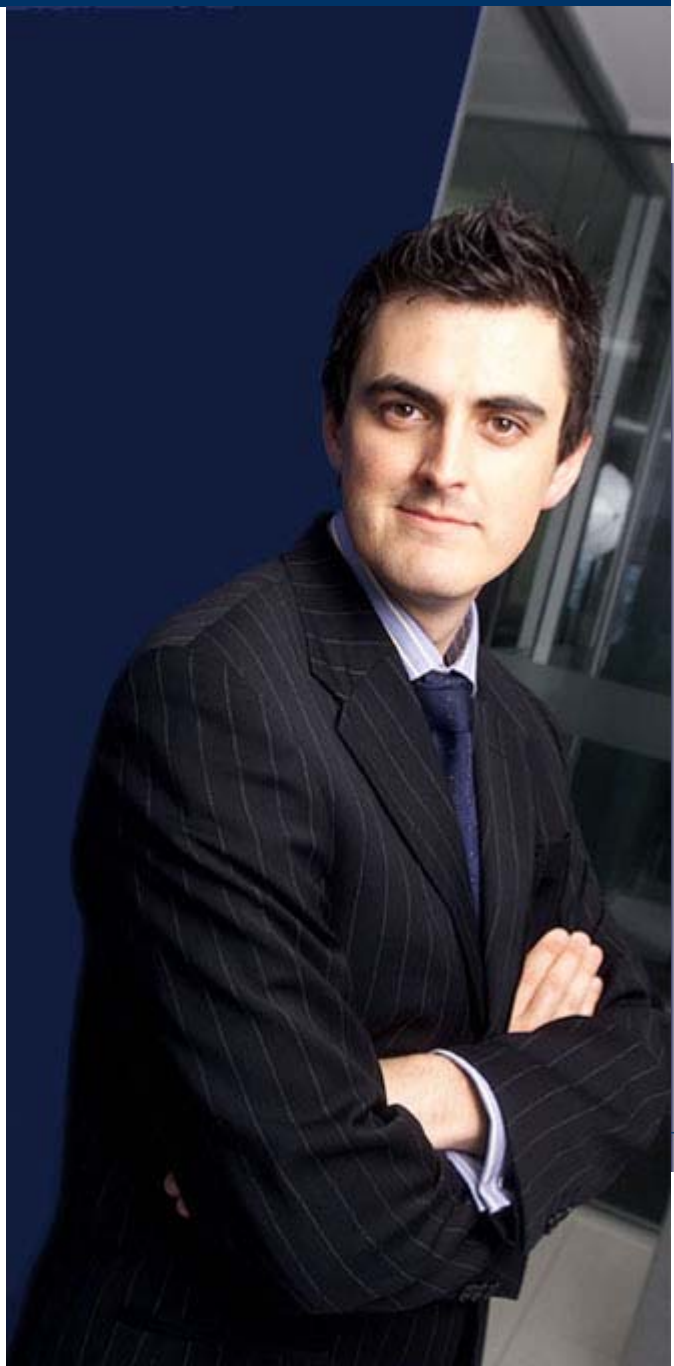
Readers are invited to ask Dave questions about trading strategies. Write to Dave at d.land@cmcmarkets.com

Is day trading just getting a bad rap?

Everyone has a method of trading that appeals to them more than any other and for me it has long been trend following because I personally find it to be one of the most intuitive types of trading. I have also found breakouts to be an effective means of seeking and exploiting rapid moves in the market. Particularly in trend trading there is an exposure to the market that is likely to last for some time (frequently several weeks or into the months) until such time as a short term trend line begins to lose some of its puff.

Periods of peak market volatility, similar to that we have seen in recent months, have created a troubling situation for so many traders incorporating leverage in that their market exposure has turned out to be well over what would have been a sensible amount. On the other hand, there are vast numbers of investors who have used quite a modest level of leverage who have been feeling the pinch.

This brings me to the crux of the story and it is the idea that is considered almost universally risky but may actually have just gotten a bad rap – day trading. First of all let's consider how we define day trading. My personal view is that it is simply a position that is opened and closed within the confines of a single trading session. The detail held within this statement though is where both the problems and the benefits of this method are most obvious.



When you think about it, with this method you have a number of drawbacks. Foremost amongst these is the fact that your profit per trade will almost certainly be lower than it would have been had you held the position over a number of trading sessions. Of course if there is a gap upwards in the morning then you have no way of taking advantage of that other than if you were in the position the previous day. The opposite of this though is a real advantage in that you aren't exposed to gaps downward when the market opens the other way.

You are probably aware that if you are making smaller gains in the market then you will need to invest a larger amount in order to make the whole thing worth your while. It is on this point that I believe the whole concept comes unstuck for most traders, but it is not the method that is at fault instead it is the actions of the individual that are.

In my observation of people the problem begins to unfold when they begin to trade outside their chosen mandate which states that they won't hold positions overnight. However, in the event of a position moving against them or indeed if it moves greatly in their favour then they may choose to hold the position overnight.

Whilst in principle, these options (particularly the latter one) may sound acceptable it deviates distinctly from

the method that they have chosen. The real downside of this will quickly become apparent.

For this to be an acceptably profitable methodology you tend to need to take on larger positions. The reason why this doesn't breach any sensible risk parameter is the fact that you will be consistently monitoring the position keeping in mind that this is the furthest thing from a set and forget strategy that you can achieve. You will also be likely to set your stop losses very close to your entry point because with a larger position your margin for error becomes much narrower than you may previously have been used to.

To imagine the danger of this strategy you need to consider something along the following lines. Imagine that you buy into a position in the morning with the view that you will close it out before the end of the day. Now imagine the indecision that you feel toward the end of the day as the position moves strongly in your favour. Every trading instinct that you have will probably be telling you to hang on until the next day as it will quite possibly continue higher when the market opens again.

There are two problems with this (with the second simply being an extension of the first) and they can be conquered by aggressively following your strategy.

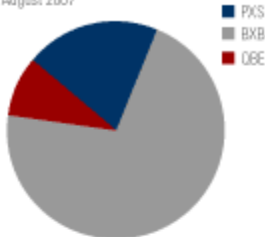
Remember that your strategy is to close out before the end of the day. You may well be correct when you speculate the stock will carry on the next day but imagine that the Dow Jones Industrial Average falls 300 points overnight. In all probability you will see a gap lower when trade opens the next day and there is no way to unwind your position. Keeping in mind that your position, by the nature of the strategy is larger than it would otherwise have been so you are now well outside of your risk parameters for either a day trade or a longer term trade and it has all been because of a failure to follow your rules.

I would suggest that this is the main reason behind the stigma associated with this type of trading. It is not that it's a weak model. It is more that it requires a very refined level of trading discipline in order to be successful. There are other shortcomings of this method such as the increased transaction costs which are certainly not to be underestimated. In addition your profit potential (based on share price movement) is severely limited relative to longer term models such as trend following. The real strength I believe should be the ability that you have to remove your overnight risk but as I have already stressed the onus of doing this is placed squarely on the shoulders of the trader.

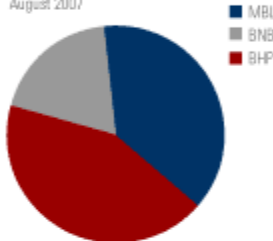
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Profit Vs Trading volume: Share CFDs

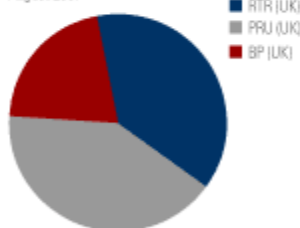
AUS Stocks
Top 3 most profitable for CMC Markets clients
August 2007



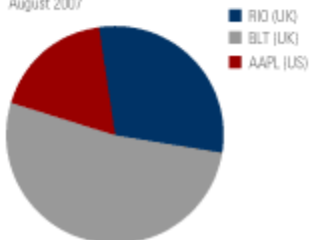
AUS Stocks
Top 3 by client trading volume
August 2007



International Stocks
Top 3 most profitable for CMC Markets clients
August 2007

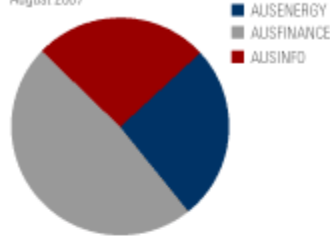


International Stocks
Top 3 by client trading volume
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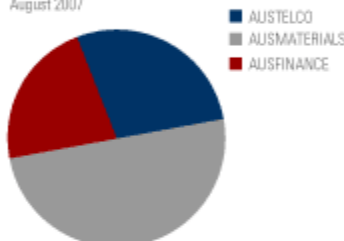


Profit Vs Trading volume: Sector CFDs

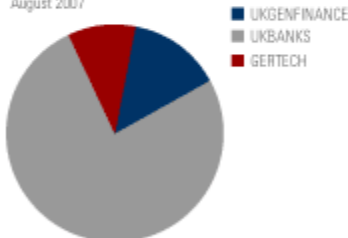
AUS Sectors
Top 3 most profitable for CMC Markets clients
August 2007



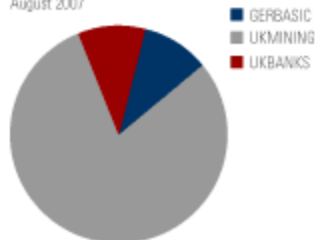
AUS Sectors
Top 3 by client trading volume
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International Sectors
Top 3 most profitable for CMC Markets clients
August 2007



International Sectors
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August 2007



Market slightly up despite rollercoaster ride

The Australian market managed to finish the month of August up 1.7% despite a rollercoaster ride which saw the index down 7.6% at one stage. Sub prime mortgage concerns dragged US indices lower which in turn filtered through to other markets.

Brambles Limited (BXB) was the most profitable CFD for investors last month, with the company reporting a 36% increase in profit. BXB ended the month at \$13.80, which was up 24%. Pharmaxis Ltd (PXS) was another company to report good results and closed the month 21% higher at \$4.07. Insurer QBE posted a record half yearly profit which was up 56%, pushing its price by 16% to \$34.85.

Among the sectors, AUSMATERIALS was again the most popular in August whilst AUSTELCO and AUSFINANCE also saw high turnover.

AUSFINANCE was among the stronger performing sectors, posting a monthly increase of 2.9%. This made it the most profitable sector for CFD traders who took long positions. Intra-month volatility allowed short term traders to capitalise on large ranges in AUSENERGY and AUSINFO, despite both sectors ending the month relatively unchanged. Investors who bought at the lows on August 17th and held to month's end saw good returns in each of these sectors as the market rebounded in late August.

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