

TradeReview

AUGUST 2009

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COPING WITH TRADING SETBACKS



Thousands of books have been published about the thrill, success and glamour people usually associate with trading. And there has been no lack of stories, either, about the luxurious and seemingly pampered lifestyle of high profile traders.

In contrast, you would find it difficult to get your hands on any book or article about how traders cope with trading setbacks. In fact, you may have noticed the dearth of materials about dealing with the challenges of trading, particularly with drawdown. The shortage of reading materials or reference to trading setbacks is definitely not helpful to traders, in particular to those who are new or those aspiring to become full time traders as they may not have a complete picture of the challenges of this endeavour.



"Even the best traders can't avoid drawdowns entirely."

In a recent article, **Alan Farley** (hardrightedge.com), author of *The Master Swing Trader*, says: "Even the best traders can't avoid drawdowns entirely. At its core, these losses are just a natural outcome of playing the financial markets."

Steve Ward, a trading coach and resident trading psychologist at Trade With Precision (tradewithprecision.com), points out a similar idea in his upcoming book, where he says: "All traders go through tough times at some points in their trading career. It is almost like it is a natural part of the path to success, a challenge or challenges that have to be endured and survived in order to take you to the next level."

"When you read *Market Wizards* you will find countless examples of traders who lost all of their money, sometimes several times, before making the changes required to allow them to move to the next level."

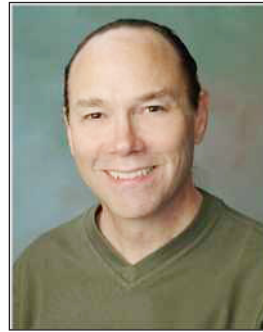
David Limburg, winner of the first CMC Markets trading competition in 2007, recalls how he not only suffered massive drawdown on his accounts during his early years of trading: "I lost my whole account, not once but twice. The first was during the September 11 attacks in the US. The other one was during a profit downgrade on a company which I have quite a substantial position."

Based on his recollection, David says: "Both these disasters were the result of my greed and stupidity. I was overly leveraged and not diversified enough. Despite these setbacks in my early days, I continued to trade and learnt a lot from them."

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Hamish Thompson, one of the traders featured in the book *Real Traders, Real Money, Real People* (Wiley & Sons Australia), has had his share of setbacks, also during his early trading days.

He says: "Probably the worst setback I have had was back when I was trading options and writing naked calls and puts. The risk reward was all wrong and the inevitable happened and the trades went against me big time."



ALAN FARLEY



STEVE WARD



DAVID LIMBURG



HAMISH THOMPSON



Arpad Marton, a fund manager at Banksia Price (banksiaprice.com) and trader who was also featured in the first *Real Traders* book, says his biggest setback resulted in not following his trading plan. "There were times I got excited about a trend, over-exposed myself and got a lesson," Arpad says, adding: "It is important to stick to the plan, as that is the only guide out of trouble – of course assuming you have a well developed trading plan."

Impact of setbacks/drawdown on your trading

For many traders, particularly those who have been used to previous bull markets (from 2003 to 2006), the market pullback from late 2007 to early 2009 may be the first major setback in their trading life. This may mean they don't have a mechanism to deal with the losses nor the strategy to bounce back.

After being an active trader for several decades, and given his interaction with other traders along the way, Alan said he's seen many variations of how traders are impacted by setbacks/drawdowns.

"It's really tough to turn on your trading screen after incurring a series of losses that might have been avoided in better days."

He says: "Drawdowns trigger all sorts of psychological and logistical issues. Realistically, it's really tough to turn on your trading screen after incurring a series of losses that might have been avoided in better days."

"Emotional extremes are difficult to manage during a major drawdown period, and they can prolong the pain unless the trader gets control fast and maintains a good attitude about losing money. I know this sounds hard, but despair and profit rarely travel together," he adds.

Coping with setbacks/drawdown

According to Alan, making strategic changes to your trading methodology helps to lower the emotional heat during this period. First priority is to reduce your position size and not to try to recoup your losses in one high-risk trade.

The pain of a drawdown period will turn you into a more profitable trader if you listen closely and adapt quickly to its embedded messages.

The key difference between good traders and bad ones is how they turn their drawdowns into acts of personal power. We're all shocked to discover we're just mortals when the tables turn and we start to take big losses. But the experience exposes us to the truth serum we need to survive and prosper in the long term.

Alan adds that: "Some traders may be tempted or may have the tendency to take on revenge-motivated trades immediately after a big drawdown. Most of the time this type of activity may set them up for more trouble and may take them out of the market permanently."



David admits to the emotional roller-coaster he went through following the wipeout of his account during his early trading days. But he's moved on since then.

"Today I am a better trader because of them. I guess you could call it tuition fees – all part of a steep learning curve. I taught myself how to trade and it would have been wiser to educate myself more before becoming so heavily involved in the markets," David says.

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For his part, Hamish turned what he called his worst setback into a learning opportunity. "After that experience, I decided to get better education and learn to build trading systems."

According to Steve, traders who take a more dynamic problem-focused approach to their trading challenges are more likely to return to higher levels of trading more quickly, and will most likely have greater levels of resilience and feel more in control of their trading outcomes.

He cites the book *Market Wizards*, which features many traders who lost their money, sometimes several times, and eventually succeeded and brought their trading to the next level after making the necessary changes to their trading.

"For me, dealing with a setback is just a matter of analysing why the setback occurred, what triggered it, how I felt about it, how I reacted to information and what the end result was. Once I knew the cause and the result I knew how to solve the problem and what (not) to do next time," says Arpad.

While he knows it is easier said than done, Steve says traders need to take a proactive approach to resolve the challenge when faced with a setback/drawdown.

"Traders must aim to identify the specific areas in which their performance is being affected. Whatever it may be, aim to identify the specific challenge and then be proactive in resolving it," he says.

"Tough times make tough people."

He also says: "Tough times make tough people. Getting through these times is often a function of desire and passion to achieve the end goal, self-belief and the mental and physical resilience to keep going and enduring this period."

In his upcoming book about trading with precision, Ward describes what he calls the "triangle of strength" as an effective strategy to focus on to get your trading back on track. This means focusing on the positives, your strengths and controllable factors affecting your trading.



TAKING THE GOOD WITH THE BAD



CHRIS DEVITT

An engineer by training, **Chris Devitt** didn't have the slightest idea on how the share market and share prices worked until he took redundancy and received some Telstra shares in the process.

"I didn't even know how to buy or how to sell, but I noticed that the share price was moving up and down. So I thought, hang on. Maybe I can make money out of this," Chris says, recalling his first trade to sell his Telstra shares.

Chris spent the next couple of years buying, holding and selling some select shares while running his own communications consultancy company.

"It wasn't really very active trading. I would be holding open positions for about six to eight weeks. It wasn't really my bread and butter then, just some additional income."

Chris switched from shares to contracts for difference (CFDs) when he learned about the benefits of trading CFDs. Today, he mainly trades CFDs on the top 200 companies, as he needs liquidity and price fluctuation.

"I watched and studied the market very intently during the first two years of my trading."

"I started with quite a small capital, and when I was making quite substantial profit I moved some more capital to my CFD trading account," says Chris. "I watched and studied the market very intently during the first two years of my trading. I didn't find it too difficult to trade."

Whether it's his engineering background or his attitude towards trading, Chris says he found trading quite easy and simple.

He admits to dabbling into charts and indicators during his early trading days: "I sat down and learned all that – charts, indicators. I even produced my own spreadsheet-to-graph market trends. Over the years I've come to the conclusion that I really don't need those things so much. All



I need is the buy and sell price and volume, and that's what I've been using for all my trades."

Now with more than six years of trading, Chris says one of the main things he's learned is that "markets are unpredictable". It may sound simple and obvious, but the reality is that many investors and traders are still trying to predict the market only to be dismally disappointed by their predictions. "I only look at price and volume," he says. "That tells me when people are buying. I place my trades depending on the momentum of the market. I look at price fluctuations as it gives me my potential entry and exit points."

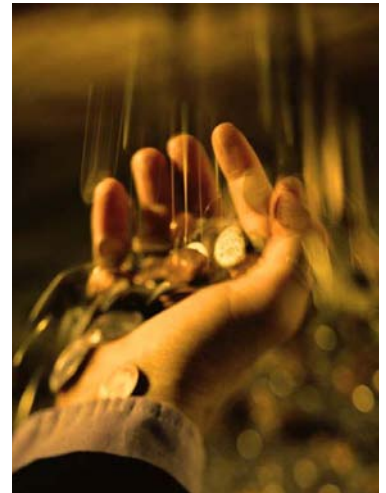
Like other traders who have been dealing with the market for several years, Chris has his own set of idiosyncrasies. "I tend not to trade on Mondays and Fridays." For Chris, it's a not a matter of Monday blues or looking forward to the weekend: "After years of looking at the market, I came to the conclusion that Mondays tend to be slow and sluggish because everyone's just getting back into the markets. The US market is not open yet (Monday Australia time) to give us any direction. Fridays tend to quiet down as people try to sell off their positions before the weekend, so most of the time I try to talk myself out of trading during Mondays and Fridays."

"I tend not to trade on Mondays and Fridays."

Chris also tends to trade only the long side of the market. But he does it with a slight variation from the conventional belief to buy into a rising market. Chris's technique is to buy (something) when the price is going down and to sell when it has reached a certain point between his entry and exit levels. "I don't try to pick tops and bottoms and I don't get greedy. I'm happy with some gains and once I know that the price has moved within my target range I may close a trade. I've had some trades where the price moved up after I close it, but that's just fine with me. I have already made some gains."

"Losses and gains are both part of trading and I think those who blame the market for their losses are not being objective about it."

For someone who has seen a lot of market turmoil over the years, Chris maintains a very positive and balanced view of the market. He has learned to take losses and winners as objectively as he can. "I deal with losses the same way as I deal with gains. They are both part of trading and I think those who blame the market for their losses are not being objective about it. I still believe that people should trade with money that they can afford to lose. They should be able to walk away from a big win or a big loss with equal objectivity."



Chris has also learned not to be emotionally attached to his trades. "I only look at price - where will I buy and where will I sell. Once you made a decision, you have to deal with it and its consequences."

"Once you made a decision, just deal with the consequences."

Knowing that leverage can be a double-edged sword for his trading, Chris makes sure that he uses it to his advantage. One way of maximising it to his benefit is by maintaining a substantial level of free equity in his account. This means he is not over-leveraging himself. Most of the time Chris would have twice as much free equity in his account for all his trade. This gives him the peace of mind that he won't be liquidated or closed out of his position in an untimely manner.

20 MOST COMMON TRADING MISTAKES

and how you can avoid them

We all make them. Whether we are new to the markets or have been trading for decades, we still commit some of them. We all have different ways of dealing with them. Some pay dearly, others just ignore them, and still others never learn and keep on repeating the same mistakes.

Kel Butcher's book, *20 Most Common Trading Mistakes and how you can avoid them*, presents a long list of mistakes traders make. However, despite his efforts to get views, insights and actual experience from various traders within the outside Australia, the book is by no means a comprehensive account of trading mistakes. Nonetheless, it is a commendable effort to point out some of the everyday mistakes that we could be taking for granted or just ignoring.

While the title says "20" most common mistakes, each mistake has sub-topics that make the list much wider than you think. It would be impossible to cover and to comment on each point

in detail in this article, so we have highlighted a few that affect many, if not most, traders at one time or another.

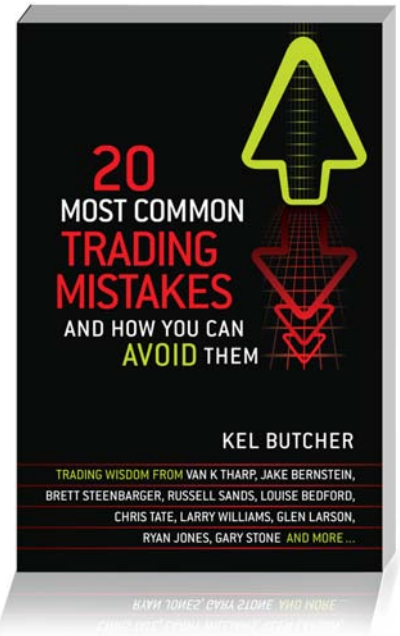
Anecdotes from some big names

Whether you are prone to making these mistakes or you think you've never committed any of them, the book provides some eye-opening and realistic examples from some big names in the trading world, including **Wayne McDonnell** (currency trader), **Larry Williams** (author and trader), **Davin Clarke** (Australian trader), **Russell Sands** (futures and FX trader), and **Jake Bernstein** (author and trader).

Keep it simple

In a chapter entitled "Complex Complexity", Davin Clarke, one of Australia's most prolific and successful traders, identifies two reasons why many traders tend to complicate trading and the tendency of many people to overcomplicate the trading process.

Davin believes that one reason people overcomplicate the trading



process is due to their prior experience with the market. According to him: "Many traders feel the need to be 'right' and have the highest win rate possible. They can not accept that trading is a numbers game and a proportion of losses are just part of the process."

Traders can't accept that trading is a numbers game and a proportion of losses are just part of the process.





In Davin's view, fear is another reason people make trading more complicated than it needs to be. He says: "It is scary putting your hard-earned money at risk on the market. It is natural to want to ensure that you have everything 100 per cent right so that you won't lose your capital."

Davin's antidote to this trading mistake (of overcomplicating your trading process) is to "keep it simple". He uses a simple trading strategy himself: "Keeping it simple doesn't mean that it is easy. By simple I mean using one or two trading strategies and you have clear entry and exit strategies. I have pre-set exit and stop loss strategies for each set up."

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Have an exit strategy

Many traders, particularly new ones, may still think that they make money (in a trade) when the price of share or CFD they buy goes up. While this is generally true, it is also true that many traders don't know when or how to take the "actual money" from the market – meaning they don't know how to exit a trade. This book takes the example of world-renowned trader Larry Williams to highlight the need for an exit strategy. In the chapter entitled "Where's the Exit?", Larry Williams discussed how he learned how to use stop loss levels the hard way.

Larry Williams says: "The reason I trade with an initial stop loss is to avoid the problem of thinking a market will come back once the trade has gone against me. Trading without an initial stop loss in place is the most certain way of losing money that I know of."

Williams cites a trade he took in live cattle contracts way back in 1973 when he lost more than \$1 million. He says: "I learned it is better to get stopped out at the original stop loss price, and to admit you are wrong early in the piece."

It's better to admit you are wrong early in the piece.

The other chapters are just as interesting and informative as the two discussed in detail here. It may be worth your while to have a read and find out which mistakes you're prone to committing, and find ways to avoid them.

Insight: ARE WE THERE YET?



DAVID TAYLOR

Following its March lows, the Australian share market rebounded after signs that so-called 'green shoots' were starting to appear in the economy. This was anything from a slower pace of contraction in the housing or jobs markets to business and consumer confidence starting to rebound. Commodity markets caught wind of this and started showing signs of life again. This led to a rally in equities, especially among the riskier mining or energy plays.

However, this bull phase in the market overshot reality somewhat. Leading into May and June, the market began a consolidation phase. We saw the price of oil and base metals in particular pull right back, and equity markets went with them. News that the World Bank and the International Monetary Fund (IMF) had revised downward the pace of worldwide economic growth was certainly a catalyst for the correction. On top of that there were fears of rising interest rates in the US as government bond auctions failed to attract investors and yields rose.

We have noticed recently that investor sentiment has improved.

Second quarter reporting

Leading into the second quarter reporting season in the US, share markets worldwide started to get very nervous. Essentially analysts had a very pessimistic view of how US corporates were holding up in the wake of one of the darkest chapters in US financial markets history. We have, however, been buoyed by the fact that second quarter earnings have surprised to the upside. In turn, commodity markets have been moving higher and equity markets remain attractive.



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At the time of writing, the market is focusing on leading economic indicators and corporate earnings results.

The argument has been that companies' results have only been surprising to the upside because of aggressive cost cutting, and that it will negatively feed back into the economy with rising unemployment. There is expectation that unemployment has further to rise, but that gross domestic product will move higher during fiscal 2010, and that will support company earnings.

What's coming next?

Leading indicators thus far have also been encouraging. Retail sales, industrial production, and business and consumer confidence across most developed economies are also showing signs of rebounding.

The eminent author and fund manager George Soros recently said he believes world economies, and indeed the market, are headed for a period of sluggish growth.

According to Soros, we have seen a period of extra-ordinary weakness.

This has been followed by a rally and some consolidation. We now await a period of sluggish or weak growth, which should be followed by an eventual recovery. Many commentators have been talking about a U or V shaped recovery.

In order to achieve at least this sort of scenario, we will need to see sustainable growth stemming from China and signs the US consumer is recovering from the worst financial crisis since the Great Depression. We will also need to see China maintain its investment in US Treasuries, and the US practise at least a degree of fiscal austerity in the medium term.

Now, there is a big argument to suggest that, given Australia's superior financial regulatory framework and well capitalised banks, we were always going to escape the worst of the global financial crisis. However, it has to be said that the pace and extent to which the federal government responded to the macro challenges facing our economy certainly helped to sustain us through a very difficult time.



The pace and extent to which the federal government responded to the macro challenges facing our economy certainly helped to sustain us through a very difficult time.

In addition to that, we experienced record low borrowing rates, effective corporate cost-cutting, and a stimulus-led consumer fight-back.

Certainly we met a challenging economic environment head on and came up reasonably well. It's certainly not over yet, but we are heading in the right direction.



Market responses

The market remains cautious. As is the case in the wake of any trauma, human beings need time to recovery and regain confidence. We need to see more signs that the macro environment has stabilised and firms will need to start hiring again.

On the micro level, consumers will need to budget more carefully moving forward and companies will need to continue to de-leverage and begin to expand once again.

Share markets have already started to anticipate this. We know plenty of cash is still sitting on the sidelines waiting to find a good home. When equities continue to outperform cash, asset class switching will become a no-brainer and investors will move into higher-yielding securities.

Plenty of cash is still sitting on the sidelines waiting to find a good home.

With share trading activity relatively light, and volumes down, investors hunger for an uninterrupted stream of encouraging leading economic indicators remains high. Given the trauma experienced by markets during the later half of 2008, this is very understandable.

What we have noticed recently though is that investor sentiment has improved. We even had Macquarie Group indicating at their latest annual general meeting that investor confidence should return to more normal levels in the second half of 2009 (that's now).

In addition, we have also seen some stocks rise after recent capital raisings. Virgin Blue and Australand are prime examples of this. Both of these stocks rose after resuming trade following an equity issue. So while the reasons for these issues are largely the same (reducing debt, funding flexibility and expansion plans), the market has now viewed these as an opportunity to buy into fair value stocks at a discount.





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NEW REPORT NAMES CMC MARKETS as Australia's most widely used CFD provider*

- highest market share among more experienced traders
- highest trading volume
- market leader for education

CMC Markets is Australia's most widely used CFD provider and has the highest trading volume among all providers, according to the latest Investment Trends June 2009 Contracts for Difference (CFD) report.

The Investment Trends report surveyed 7,598 investors about CFD trading behaviour and preferences.

The Investment Trends report surveyed 7,598 investors between April and June about their CFD trading behaviour and preferences.

Louis Cooper, Head of Distribution at CMC Markets, says CMC Markets trading volume domination is particularly pleasing: "Volume is an increasingly important measure for our business as we increase our focus on wholesale distribution to retail investors and the **Advantagepro** service we offer to high-volume experienced traders."

Well placed to meet traders' demands

The Investment Trends survey also shows CMC Markets to be the most widely used provider among more experienced traders. CMC Markets has offered targeted services to this segment for several years, providing additional support through its **Advantagepro** service which gives experienced traders free independent external research and discounted brokerage, as well as exclusive access to a dedicated sales trader who can work orders into the market.





LOUIS COOPER

Mr Cooper says that while experienced traders are a key target for CMC Markets, the business is well placed to meet the demands of traders at all levels.

Outstanding feedback on education

"This year's report has again shown lack of knowledge to be a major barrier to new CFD investors. Our aim is to provide investing education for life, and so our educational materials offer various levels of complexity and are provided across a wide range channels. We have made a significant investment in a dedicated education team and service to drive these initiatives," he says.

The Investment Trends research shows CMC Markets has received positive feedback for its educational materials and programs, with 65% of its primary clients rating CMC Markets as *very good/good* in this area.

For example, CMC Markets has developed an eight-module educational series called *Trading IQ* to help investors hone their trading skills – every new client receives this education pack, regardless of their level of experience. CMC Markets hosts over 20 webinars per month via its online education centre. For less experienced traders, it also currently offers what it calls a "No Loss Trade Day" to help develop trading techniques and an understanding of the trading platform.

CMC Markets takes nothing for granted

Mr Cooper says that CMC Markets does not take its leadership position for granted: "While it's great to see we're still number one in a number of areas, we recognise this is a highly competitive market and we have to remain innovative. We're investing considerably in our technology platform, and in the coming weeks

"Our aim is to provide investing education for life... We have made a significant investment in a dedicated education team and service."

expect to launch new functionality that meets the growing demands of investors to trade shares and CFDs in an integrated platform."

"This is a highly competitive market and we have to remain innovative"

Over one in four "next wave" traders stated the ability to trade shares and CFDs on the same platform would encourage them to begin trading CFDs or trade more frequently.

* 42% of currently active traders have a CMC account. CMC Markets has the highest market share among more experienced traders (those who have been trading CFDs for more than four years). CMC Markets has 30% trading volume (based on average trade size and frequency self-assessed by traders). CMC received the highest ratings on education from its clients when traders were asked to rate their main provider across a range of areas.

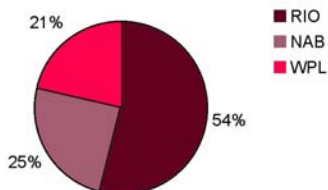
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SNAPSHOT

PROFIT VS TRADING VOLUME SHARE CFDS

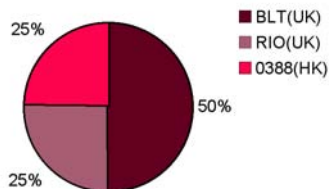
AUS Stocks

Top 3 most profitable for CMC clients - July 2009



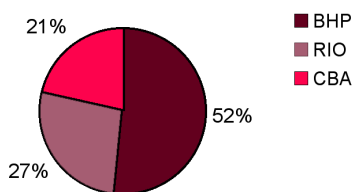
International Stocks

Top 3 most profitable for CMC clients - July 2009



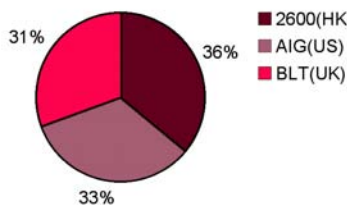
AUS Stocks

Top 3 by client trading volume - July 2009



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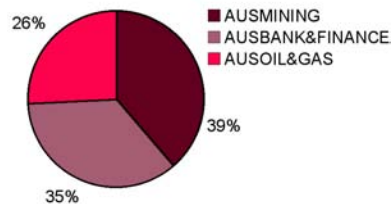
Top 3 by client trading volume - July 2009



PROFIT VS TRADING VOLUME SECTOR CFDS

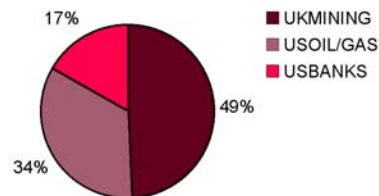
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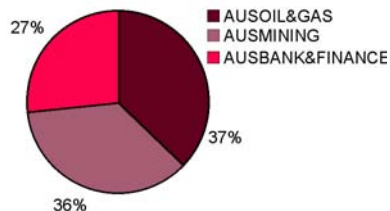
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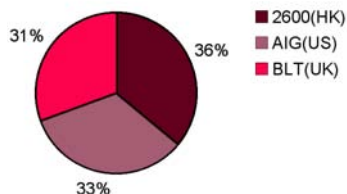
AUS Sectors

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