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Seven Things to Consider Before Trading CFDs

The world is not a certain place, and it is not certain that equity markets will rise consistently based on historical market cycles. For this reason, many of Rivkin's clients seek greater flexibility than that offered by a stockbroking account.

Contracts for Difference (CFDs) give our clients a means to find flexibility, but we recognise that the nature of CFD trading brings with it many risks.

In conjunction with increased awareness and news about CFDs, I have produced this piece to highlight some practical points that I, as someone who deals for CFD clients on a daily basis, feel are relevant to those interested in trading CFDs.

Scott Schuberg - Managing Director
Rivkin Securities Pty Ltd

Rivkin Securities' CFD dealing product is a core part of the Rivkin business. We do receive transaction and financing-based revenue that is derived from client trading activity, just as we receive commissions from brokerage on equities, options and warrants trading. That said, we offer this product because we truly believe in giving our clients the flexibility to trade based on positive or negative views on major global financial markets.

Please be aware that in this piece—unless specified—I neither make specific reference to, nor do I speak on behalf of, any particular CFD provider or their practices. I am speaking in general terms about the CFD product and some of the characteristics that I have witnessed through very close association with the CFD industry for many years now.

1. Know the CFD product issuer

Rivkin Securities clients have an important relationship with our product issuing CFD partner when trading with us. As well as having a relationship with, and trust in, the Rivkin brand, Rivkin CFD clients should **form a relationship and trust with the CFD product issuer.** Rivkin has access to audited financial statements as well as information gathered during its years of close relations with its partners and this information is available to every client or prospective client who requests it.

When choosing a CFD product issuer to do business with, approach it as though you were analysing a public company, looking for such things as:

- Consistent and reliable revenues
- Consistency in the way the company runs its business
- Manageable debt
- Approved compliance practices, examined and signed off by a credible auditor

Finally, don't be afraid to pick up the phone and ask questions of your CFD product issuer. Due to the business they are in, you might be surprised at the resources and measures employed by them to comply with financial and regulatory requirements.

Finally, ask the product issuer for details of relevant industry and regulatory bodies such as the Financial Ombudsman Service or the Australian Securities and Investment Commission, so that you can gain information from a third party that is not driven by business agendas associated with making money from your trading activity.

2. Know where and on what terms you are depositing your cash

The way the CFD product issuer handles client money is governed by ASIC regulatory guide 212, 'Client money relating to dealing in OTC derivatives.' You can view this regulatory document by visiting www.asic.gov.au and searching for RG 212.

As per the advice contained within this regulatory document, I would encourage clients to ask the CFD product issuer for the details of its use of client money.

Assuming the product issuer doesn't commit fraud, the most significant risk that arises from depositing your cash with a CFD product issuer is the risk that some of your funds might be used to cover the obligations of another client. If this happens and neither the client nor the issuer has the money to cover the obligation, the company will become insolvent and you will become a creditor at risk of losing part of the cash you have deposited.

There are only two CFD product issuers in Australia that I know of that DO NOT USE one client's funds to cover the obligations of another. Rivkin Securities CFD clients are with one of those issuers, and more information about this can be viewed by visiting http://www.cmcmarkets.com.au/cfd-trading/risks-cfds/safety-and-security.

3. Once you understand leverage, be responsible with it

Leverage is quite simple: If a CFD product has a margin of 5%, you can open a $100,000 position with just $5,000. It is also simple, however, to use leverage recklessly and potential exists to lose more than your initial investment because of this.

Ask yourself a few questions: If you are holding $100,000 worth of a medium-sized mining company, based on an account with $5,000-$10,000 in it, are you prepared if something goes wrong? What if a mining disaster occurs and the company's operations are shut? **Can you handle a loss of 25%, 50% or even 100% of that $100,000 investment?** Similarly, if you have taken a 'short' view of a mining company—speculating that the price will go down—and that company locks up and is subject to a takeover at a 40% premium to the last sale price, are you prepared to take a 40% loss of the face value of the trade?

Leverage should be seen as a convenience associated with CFD products, but should not be underestimated as a risk. Recently I have seen central bank intervention that has pushed major foreign exchange pairs by 10s of percentage points in moments; so even in the most liquid markets that are immune to corporate risks such as takeovers and bankruptcy, price risks remain that can render predetermined stop losses useless.

4. The CFD product issuer may or may not 'hedge' your trade

Unless stated otherwise in their product literature, **the CFD issuer may either 'hedge' your trade, by mimicking the order in the underlying market** (i.e., you buy 5,000 copper CFDs, so the issuer buys 5,000 copper futures), **or the issuer may choose not to hedge.** If the issuer does not hedge, they may either be 'netting off' your buy or sell order with other clients who are trading the same instrument in the opposite direction, or they may be managing and potentially profiting or losing from the risk that is created by remaining 'unhedged.'

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In some instances, these actions of the CFD issuer may result in them making a profitable trade from one of your losing trades. For instance, if you buy a gold CFD at $1,700 and the CFD issuer does not hedge, gold might drop to $1,650, and then you close the position. This will have resulted in a $50 loss that will be taken from your account and given to the CFD issuer.

If there was no cost of trading or hedge in place, the issuer may have made money at the same time as you lost money. This is a heavily debated issue. Some traders will feel that if they get a great price and a great fill, then why should they care what happens on the other side of the contract. Others might feel as though it is unethical if the CFD issuer makes money out of a trade where the client has lost, or vice versa. I do not wish to get involved in this debate; my greatest concern for clients is the protection of their money, their growth as an investor/trader and the quality of the product we make available to them.

5. You are trading the CFD issuer's market, not anybody else's

You will be trading markets that are created by the CFD issuer on their own terms, which will be present in the Product Disclosure Statement available when you are opening an account.

There might be 10,000 BHP available to sell on the ASX at $42.50 when you are looking at the market depth of your trading screen. Due to trading activity from other clients, which is taking place unbeknownst to you on the CFD issuer's system, the provider may only be able to make 5,000 available to you. On the other hand, they may be able to make 30,000 available to you if there are many clients selling.

Another example is if you are trading a product called 'Australian 200,' as a hypothetical example. This may seem to move in line with and represent the level of S&P 200 futures or the S&P 200 index, but ultimately the product issuer's price might be a few points above or below other references that you are monitoring.

Ultimately, the CFD product issuer's mandate should be to give you great pricing and great fills on great products, but, as the market maker, **they have the right to make prices and volume available that are driven by their own operational issues rather than what is available on the 'real' market equivalents.**

6. Understand the basis of the product you are trading

CFDs are electronic agreements. If you buy a BHP CFD at $40.00, you do not own a share of the company 'BHP Billiton Limited.' What you own is an agreement between you, the account holder, and the CFD product issuer, stipulating what each party's obligations are. If you sell BHP at a later date at $42.00, the CFD product issuer is obligated to pay you $2 per unit bought. If you sell BHP at a later date at $38.00, you are obligated to pay the CFD product issuer $2 per unit bought. **In essence, you are always just trading the price, not the underlying instrument.**

7. If you are a beginner trader, be prepared to experience emotions invoked through realising profits and losses more quickly due to leverage

Through employment, most people I know earn a set amount of money per hour, be that $20, $30 or $50 etc. Based on these figures, when you bet $100 on a horse at a track or on a blackjack table, you can lose something that took you between two and five hours to earn in less than a minute. Unless you're extremely wealthy or have a very high risk appetite, you may quickly experience some powerful emotions:

- Anger at yourself for being so reckless
- Anger at the system that accommodated this behaviour
- Regret that you cannot reverse the situation
- Self-pity that you used poor judgement

If a healthy awareness and expectation of these emotions are not present, you might be driven to do one of the following:

- Create a larger, new bet to win your money back quickly
- Make a series of more frequent bets to win your money back quickly
- Vent your fury at the system that allowed you to make these bets

Because CFDs represent 24-hour markets, thousands of new and exciting instruments, as well as leverage, the same negative emotions that might drive you to gamble may well be stimulated through CFD trading.

How do you combat this problem? **Have a strategy.** If you have devised your own system or you are using somebody else's system through their qualifications and experience, then you should instantly have rules, risk parameters and guidelines by which to trade. You should have an estimated risk for every trade you place and stick to that risk, and be aware of the worst possible scenario for every trade you place. You'll finish up with a system that can be adhered to and blamed if things go wrong, which will help you avoid self-pity and reckless responses to losses, should they occur. Trading should be run like a business, with your own personal strengths, weaknesses, threats and opportunities analysed before devising how you can buy in or form a strategy to produce a positive trading experience.

Conclusion

CFD accounts give clients access to thousands of global trading instruments through their personal computers and electronic devices, using a single login. Trading these instruments presents a liberating opportunity to learn, trade and hopefully profit from the ebbs and flows of global financial markets. The thought of being able to create trade ideas based on global economic, political and structural events is truly inspiring to someone with a strong interest in financial markets.

Before you start trading, however, you need to eliminate the fear that comes from not knowing the product that you are dealing with.

This includes more than just the risks of trading with a leveraged product; it includes being familiar with the way CFD products and the CFD industry are structured and managed.

If there is more that you would like to know about the CFD industry and you think Rivkin can help, please contact our office and ask for me or one of my colleagues on the Rivkin Securities dealing desk.

Yours sincerely,

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Rivkin Securities Pty Ltd