INTRODUCTION TO CFDS

Overview

This e-book explains the basics of CFDs and how they can be used. It should be noted that this e-book deals with CFDs only. Information on other products offered by FP Markets such as Shares, FX and Warrants is available by calling 1300 376 233 or visiting www.fpmarkets.com.au.

To ensure your understanding of terms used in this booklet we have included a Glossary. To increase your knowledge of CFDs, you may find it valuable to visit the FP Markets website where you will find additional information on CFDs and other products offered by FP Markets www.fpmarkets.com.au.

CFD trading involves risk. You should only enter into CFD trades after you understand the nature and extent of your rights, obligations and risks.

Contents

What is a CFD?

A CFD is an agreement between two parties to exchange the price difference of a financial instrument. The profit and loss of a trade is determined by the difference in the entry and exit price of the underlying instrument from when the contract is opened and closed.

CFDs are a leveraged product, which allow the buyer or seller to gain full market exposure while only outlaying part of the full notional value of the instrument.

CFDs therefore offer the potential to make a higher return from a smaller initial outlay compared to investing directly in the underlying security.

Leverage usually involves more risks than a direct investment in the underlying instrument. It is important you understand that leverage has the potential to work against as well as for you as using leverage magnifies your trading profits and losses.

A full list of CFDs offered by FP Markets is available on our website at www.fpmarkets.com.au.

Advantages of Trading CFDs

CFDs have been used by professional investors for over twenty years and emerged first in the over-the-counter (OTC) or equity SWAP market. Equity swaps were used by institutions to cost effectively hedge their equity exposure.

CFDs have become one of the most popular derivative products in the Australian and European financial markets.

The popularity of CFDs has been driven by:

- Leverage: CFDs enable you to obtain full exposure to a share for a fraction of the price of buying the underlying instrument. CFDs require only a small initial margin as a trading deposit.
- The ability to go 'short': CFDs allow you to sell shares you don't own. This enables you to profit from falling share prices.
- Low transaction costs: CFD providers pass on volume discounts allowing you to benefit through lower transaction costs.
- Hedging: CFDs allow you to employ more advanced strategies such as hedging to protect your existing share portfolio.
- Simplicity: CFDs mirror the price of the underlying instrument, unlike other forms of derivatives (i.e. futures).
- Dividends and Corporate actions: CFDs allow you to benefit from dividends or bonus issues which may occur in the underlying instrument on which the CFD is based.

CFD Types

There's a long list of descriptions providers may give themselves, including Direct Market Access CFDs (DMA), Straight Through Processing (STP), DMA Pricing CFDs, Hybrid DMA and Market Maker CFDs.

To simplify, all CFD providers can be bundled into two easily recognisable groups that describe the framework used by each to create CFDs.

The two groups are Direct Market Access (DMA) CFDs, and Market Maker CFDs. All other descriptions used by CFD providers stem from these two groups.

The difference between these models relates to the ways in which the prices are derived and orders are placed between yourself and the CFD provider. DMA providers use cash market prices direct from the ASX, your CFD order is placed in the real underlying market, resulting in real time execution, true market prices, participation in the order book and opening and closing phases of the market.

Market Makers claim to base their prices on those offered in the physical market but as a middle man they have the ability to move prices in their favour as they see fit, causing slippage which can become a significant cost of trading. A Market Maker will often quote that they 'mirror the price', rather than actually matching the price, resulting in orders being filled at inferior prices. Market Makers do not hedge 100% of their CFD positions and can make money when you lose money.

When trading through a Market Maker your orders are at the discretion of a dealer. Your CFD order is not placed directly on the market, trading is slower, especially in fast moving markets.

- All CFD providers can be separated into two groups: Direct Market Access (DMA) and Market Maker.
- DMA providers use cash market prices direct from the ASX.
- Market Makers do not hedge 100% of their CFD positions and can make money when you lose money.

CFDs provide all the benefits of share trading combined with added advantage of being able to utilise your unrealised profit, and only outlay part of the full notional value of your position.

Direct Market Access vs Market Making

DIRECT MARKET ACCESS

- Identical price and liquidity to the Exchange – all orders flow onto the Exchange
- Orders automatically flow into the underlying market without intervention from dealers
- Real market liquidity
- No additional spreads – market price received always
- Can be a price maker or taker
- Can participate in opening and closing market auctions
- All trades 100% hedged
- Trades with clients – provider does not profit from client losses

MARKET MAKER

- Artificial prices controlled by dealer intervention – orders are not placed on the Exchange and withheld at the Market Maker's discretion
- Re-quotes and slower execution times as orders are withheld by a dealer
- False market liquidity
- Additional spreads – prices are changed at the discretion of the Market Maker
- Price taker – can only accept prices quoted by the Market Maker
- Cannot participate in opening and closing market auctions
- Trades may remain unhedged
- Trades against clients – profits from client losses

Direct Market Access CFDs

TRANSPARENCY

Transparency is a key ingredient of the DMA CFD market. All CFD orders are transacted in the underlying cash market ensuring complete pricing transparency.

All market information always reflects the cash market. This is the Direct Market Access (DMA) model of CFD trading and is no different to trading shares using leverage.

- All orders are entered into the ASX central market order book with those from other ASX market participants; this allows prices to be formed in a fully transparent and efficient manner.
- All trades are executed on a strict price/time priority. Price/time priority means the first person to enter the best price is traded against first. The result is everyone in the central market order book are treated fairly and consistently, no matter how big or small a trader you are.
- Anyone can put in a better bid or offer, as you are participating on the ASX. No one is forced to accept the price offered in the market.
- Being able to participate in the central market order book automatically provides you with the depth and liquidity of the ASX.

Your CFD order is placed in the real underlying market, resulting in real time execution, true market prices, participation in the order book and opening and closing phases of the market.

Features of a CFD

To gain a thorough understanding of the mechanics of CFDs it is important for you to become familiar with the key features of the product.

MARGIN

CFDs are traded on margin and there are two different forms of margin that may be payable when trading CFDs – Initial and Variation Margin.

INITIAL MARGIN

An Initial Margin is a deposit used as collateral to open a CFD position. The margin is held to ensure you can meet your obligations. A margin rate is expressed as a percentage and is calculated based on the liquidity and volatility of the underlying security. Margin rates typically range between 3% – 100%.

The margin requirement of a CFD position is calculated using the "mark to market" concept. This means that the current value of your position is assessed during each trading day. The margin required is adjusted to reflect the current market value of the position as the price of the underlying security fluctuates.

Additional margin amounts will be payable should you fail to maintain the required margin on your position.

CALCULATING YOUR INITIAL MARGIN

Quantity x Price = Full Notional Value
1000 x $10 = $10,000
Full Notional Value x Margin Percentage = Margin Required
$10,000 x 5% = $500
Your Initial Margin is $500.

VARIATION MARGIN

In addition to the Initial Margin required to open to hold a CFD position, you may also be required to pay an additional margin incurred by an adverse price movement in the market, this is

known as Variation Margin. The Variation Margin is based on the intraday marked to market revaluation of a CFD position.

For example, if you have a long position and the price falls then you are required to pay a Variation Margin. The Variation Margin is a percentage of the total position size and the amount required will cover the adverse movement in the value of your position.

On the other hand, if you have a short position and the price falls, you would receive a Variation Margin equal to the positive movement in the value of the position.

Failure to pay a Variation Margin call can lead to the position being compulsorily closed out. You as the position holder are obliged to pay for any shortfall in funds if Variation and Initial Margins are insufficient to cover the shortfall.

PAYMENT OF MARGINS

Margins are calculated on an intraday basis to ensure an adequate level of margin cover is maintained. This means that you may be obliged to pay more if the market moves against you. If the market moves in your favour, your margin requirement may be reduced.

Margin payments are usually required within 24 hours of being advised; in some circumstances margin call payments may be required on shorter notice. If you do not pay in time, your CFD provider can take action to close out your positions without further reference to you.

FINANCING

Financing is the daily cost incurred for holding an open position overnight. The financing rate is applied to the full value of your position and paid or received daily on long and short positions. If you hold a long 'buy' position you will be required to pay a financing charge, if you hold a short 'sell' position you will receive financing income.

Financing rates are calculated by your CFD provider by adding or subtracting a margin percentage from the RBAIOCR (Reserve Bank of Australia Interbank Overnight Cash Rate) and dividing the resulting amount by 365, representing the number of days in a year. The resulting percentage is then multiplied by the full notional value of the position to give you a daily financing rate.

CALCULATING THE FINANCING RATE

RBAIOCR + Margin (long position) / number of days in year = Daily rate (4.5% + 2%) / 365 = 0.0178%
Full Notional Value x Daily Rate = Daily Financing Payable
$10,000 x 0.0178% = $1.78
Your nightly financing rate is $1.78.

In the case of a short position you would receive the financing rate. In the calculation above you would simply subtract the margin from the RBAIOCR rate.

COMMISSION

CFD commission is calculated based on the full notional value of the position with a minimum charge. Commission rates will vary between CFD providers.

CALCULATING YOUR COMMISSION

Full Notional Value x Commission rate = Commission charged
$10,000 x 0.10% = $10
Your commission charge would be $10.

CORPORATE ACTIONS

Holders of CFDs are able to participate in corporate actions, including share splits, dividends and rights issues. Dividends are received when a long CFD position is held overnight over the ex-dividend date, conversely if a short CFD position is held over this period the holder of the CFD must pay the dividend. The dividend is credited the day the share goes ex-dividend unlike traditional shares as holders of physical shares may be required to wait for up to three months before receiving a dividend.

LEVERAGE

Leverage or gearing is like borrowing, it allows you to increase your potential return on a trade as you are able to increase your exposure whilst only contributing a fraction of the total value of the position.

Products such as shares are not leveraged and have a leverage ratio of 1:1. CFDs can have leverage ratio of up to 33:1 meaning that every $1 invested has the effect of multiplying the profit or loss by 33.

LEVERAGE EXAMPLE

You deposit $10,000 in your CFD account and hold five CFD positions that are each worth $10,000 (your total exposure is equal to $50,000), you have leveraged your initial capital by five times (or 5:1) leverage.

In the above example your maximum loss could be $40,000 in addition to your $10,000 initial deposit, however this would only occur should all of your five CFD positions fall to a zero value, this is highly unlikely but it illustrates the potential downside of using aggressive leverage.

To further illustrate the potential dangers of leveraging too aggressively we will look at another example which is something of a worst case scenario. If you decided to open the largest position possible using your available capital, assuming you are trading a share CFD with a 5% margin rate you could potentially open a $200,000 position. In this case it would take only a negative price movement of 5% in the underlying share price to completely eliminate all of your trading capital. A movement of 5% is well within the realms of possibility and could happen on a single trading day.

This example highlights that the higher your leverage ratio the more susceptible you are to adverse price movements. This example also highlights that employing a high leverage ratio means that all or the majority of your capital is tied up in maintaining your margin.

A small negative price movement will require the payment of additional margin, and you will need to deposit additional funds to cover the additional margin requirement. This is known as a 'margin call' and happens when you have no free equity in your trading account.

The leverage ratio you use should depend on your experience. If your initial trading capital of $10,000 grew to $20,000 then the same 3:1 leverage ratio would allow you to gain exposure to the value of $60,000 rather than the original limit of $30,000. Successful trading and capital growth will allow you to increase your market exposure while employing conservative leverage levels. Experienced traders who watch the market closely can use higher levels of leverage.

If you have additional trading reserves readily available, higher leverage ratios could be employed. You may have $30,000 allocated for trading in a separate account but hold only $10,000 in your trading account. You could consider leveraging the total $40,000 capital at 3:1 allowing you to gain market exposure of $120,000. If you employ this strategy it is important to monitor your CFD account closely to ensure you do not fall into margin call due to lack of free equity in your CFD account.

MARGIN CALL

Trading CFDs requires you to monitor three important values to assess the balance of your account, the deposit required to maintain your positions and the trading resources to take new positions. These values are referred to as Gross Liquidation Value (GLV), Initial Margin (IM) and Free Equity (FE). Your GLV and FE will decrease if your CFD position(s) move against you. A margin call occurs when your GLV falls below your Initial Margin or the amount you have in the account. Should this occur you must either close one or more of your open positions to reduce your initial margin requirement or deposit additional funds to fund your account.

Relatively inexperienced CFD traders should use a leverage ratio of 3:1. This level will allow you to gain additional market exposure whilst limiting the effects of any adverse market movements. The table on the opposite page illustrates how your maximum exposure amount changes as your equity fluctuates. The Gross Liquidation Value (GLV) is the total value of your account, irrespective of margin requirements. GLV is sometimes referred to as your Total Equity. This is the amount of capital in your account if you were to have no positions.

Gross Liquidation Value (GLV)	Leverage factor chosen	Maximum exposure
$3,000	3	$9,000
$4,000	3	$12,000
$5,000	3	$15,000
$5,500	3	$16,500
$6,000	3	$18,000
$8,000	3	$24,000

MARGIN CALL EXAMPLE

In this example we assumed you started with $5,000 capital in your account and you have three open CFD positions which have different margin requirements.

Currently the total margin requirement is $1,000 therefore the trader has $4,000 of Free Equity available to purchase CFDs. If we look at the total exposure in the market it is actually $15,000.

CFD	Share CFD price	Number of CFDs held	Margin required	Margin used	Exposure
ABC	$25.00	200	5%	$250	$5,000
XYZ	$10.00	500	5%	$250	$5,000
SST	$5.00	1000	10%	$500	$5,000
			Total	$1,000	$15,000

Trading capital	$5,000
Initial Margin	$1,000
Free Equity	$4,000

The table below illustrates the impact of a 30% adverse price movement to the share price of each CFD position on your account. The unrealised loss on the positions is $4,500 which has reduced the value of the account value of the account to $500 GLV.

CFD	Share CFD price	Number of CFDs held	Margin required	Margin used	Exposure
ABC	$17.50	200	5%	$175	$3,500
XYZ	$7.00	500	5%	$175	$3,500
SST	$3.50	1000	10%	$350	$3,500
			Total	$700	$10,500

GLV	$500
Initial Margin	$700
Free Equity	$(200)

As shown in the previous table the account has fallen in to a Margin call since the Initial Margin is $200 greater than the GLV or funds in the account. As soon as this occurs you would receive a request to top up your account immediately, or be at risk of part or full closure of your positions.

CFD Trading Examples

GOING LONG AND MAKING A PROFIT

‘Going long’ is simply buying a CFD position to profit from a share price increase.

The difference between the entry price and the exit price is the profit or loss that is made on the trade. The example below compares the Return on Investment (ROI) on identical CFD and share trades. This comparison illustrates the similarities between CFDs and shares while highlighting the fact that CFDs have the ability to greatly increase ROI.

Amy and Steve purchase 500 BHP Billiton shares, the shares are currently trading at $35 a traditional share position would require an outlay of $17,500. BHP CFDs have a margin rate of 5%, the margin required to open the position is $875. Steve opens a $17,500 share position and Amy opens a $17,500 CFD position. Both traders are charged 0.10% commission.

The table below illustrates the outcome for both Amy and Steve if the underlying price of BHP rose to $36.00 the following day.

	CFDs		Shares	
Day one		Amy		Steve
Opening Purchase Price		$35		$35
Buy Quantity		500		500
Commission Paid	0.10%	$17.50	0.10%	$17.50
GST		$0		$1.75
Total Exposure		$17,500		$17,500
CFD Margin - 5%	5%	$875		-
Initial Outlay		$892.50		$17,519.25

	CFDs		Shares	
Day two				
Closing BHP position				
Closing Price		$36		$36
Quantity sold to close position		500		500
Position Closed		$18,000		$18,000
Commission	0.10%	$18	0.10%	$18
GST		$0		$1.80
Financing charged at 6.5% p.a based on RBA rate of 4.5%*		$3.16		$0
$35.50 x 500 x (RBA rate + 2%)/ 365				
Total outlay		$913.66		$17,539.05
Gross Profit		$500		$500
Net Profit (Gross minus trading cost)		$461.34		$460.95
Return on Investment		50.49%		2.63%

*Financing is calculated at the closing market price of $35.50.

- Note: If the price of BHP had fallen by $0.50 Amy would have incurred a loss of $538.66.

GOING SHORT AND MAKING A PROFIT.

‘Going short’ is simply opening a short ‘sell’ CFD position to profit from a share price decline.

Amy believes Qantas Airlines (QAN) will release lower than expected profit figures and she expects the share price to drop in response. Amy places a sell order for 10,000 QAN shares at the current market price of $2.50. The margin rate on QAN is 5% so $2,500 is required as margin to open the position. The trade is placed and Amy holds a short QAN CFD position.

When opening a short position you have received a cash payment for the full value of your short position and receive interest on this amount at the RBA rate minus 2% pa. The overnight interest rate is calculated by dividing the per annum applicable interest rate payable by 365 (days per year).

The table below demonstrates the outcome of the trade assuming that the price of QAN falls by 10 cents to $2.40 the following day.

Please note we have not compared this trade to an identical equity trade due to the limitations with short selling physical shares.

Opening Short Qantas Position	
Price	$2.50
CFDs sold for $25,000 exposure	10,000
Total Exposure	$25,000
Commission (0.10%)	$25
Margin Requirement 5	$1,250
Initial Outlay	$1,275
Closing Short Qantas Position	
Price	$2.40
CFDs bought to close position	10,000
Position sized closed	$24,000
Commission	$24
Total outlay	$1,324
Financing Received at 2.5% pa based on RBA rate of 4.5% [($2.45 x 10,000) x (RBA - 2%)]/ 365	$1.68*
Gross Profit	$1,000
Net Profit (Gross minus trading cost + financial received)	$952.68
Return on outlay excluding cost of trade	71.95%

* Financing is calculated at the closing market price of $2.45.

- Note: If the share price of QAN had risen by $0.10, Amy would have incurred a loss of $1,047.32.

Scalping is a trading style that is particularly suited to CFDs due to the greater flexibility and lower transaction costs of CFDs. Scalping involves placing multiple trades throughout the trading session with a very short term focus. The aim of scalping is to frequently take profits from small price movements. Trades are often exited shortly after becoming profitable.

The time frame for scalping trades is intraday and ideally within a few minutes. This style removes the risk of holding positions overnight. With the holding time for scalping trades being so short this style reduces the likelihood of significant or large losses from adverse market movements.

Scalping is a trading style that allows easy entry and exit and allows profits to be made in all market conditions. Opportunities for short term trades occur in all market periods and during varying levels of activity.

The potential effectiveness of scalping lies in the fact that it is easier to catch small price movements of a stock such as $0.10 than to catch larger less frequent movements of greater than $0.50.

There are different approaches that traders take when scalping depending on the characteristics of the market and the stock itself. Large liquid stocks allow scalps to be made. Traders use the

leverage of a CFD to buy or sell large numbers of shares without having to outlay the full amount to profit from very small movements. An example of this would be to purchase 10,000 shares and to sell for a 3-5 cent profit. Assume you purchase 10,000 share CFDs at $5.00 and then sold at $5.03. The small movement of $0.03 provides a $300 profit (minus commission costs). Similar trades would be entered a number of times throughout the day with small profits continually being taken.

- Scalping involves placing multiple trades throughout the trading session with a very short term focus.
- This style reduces the likelihood of significant or large losses from adverse market movements.

Scalping trades can be made on both long and short trades. If employing this trading style it is important to maintain your discipline and adhere to your exit rules and ensure trades are held for a short term. The risk reward ratio for scalpers should be adjusted to be closer to 1:1 as position sizes and exposure is larger and slight price movements are compounded by frequent trades into larger profits.

CFDs allow traders to gain access to a strategy that involves matching two stocks against each other; one through a long and the other a short position. Often opportunities to pair two stocks together occur when a divergence in price of similar shares in the same sector arises.

When a pair's trade is opened a hedge is created so profits are made on the movement in price of the long position verses the short position. The offsetting nature of this removes the impact of overall market or sector movements. If the overall market was to move in a particular direction the trader should not be impacted since a gain or loss would be offset.

The strategy is simple to construct and is relatively low risk as it is market neutral.

As two stocks are played against each other, risk is limited. Profitability is based on stock selection and not overall market movements.

The strategy is most successful when two highly correlated shares are matched. Finding suitable stocks can involve either fundamental or technical factors to measure correlation and divergence. Historical data can be used to indicate a mean price or comparable ratios such as Price to Earnings. From this information a trader can attempt to profit from being long in the share that is below the mean or underpriced and short the share that is above the mean or overpriced. Profits can be made on both positions if the shares revert to the mean or converge.

Pair's trades are simple and also inexpensive. The offsetting positions reduce overnight financial costs as the short position generates revenue that can be used to cover the cost of the long. To reduce costs and mitigate risk the position size for each trade should be hedged and matched equally. Although this is a low risk strategy it is possible for stock specific factors to cause the divergence to widen resulting in losses on both positions. Traders should maintain stop-losses on both positions in case the stocks drift apart rather than come together.

An example of shares that may be suitable for pairs trading is selecting two highly correlated stocks such as National Australia Bank and Commonwealth Bank. Traditionally both stocks should move together as their businesses are similar.

How to Manage Your Risk Using CFDs

HEDGING

Hedging is the action of taking an equal but opposite position usually through a derivative, such as a CFD in order to mitigate or reduce the risk of an existing open position. A hedge will create neutral market exposure so any price changes will be offset by opposing positions.

A short hedge using a CFD is one of the simplest ways to lock in a price by short selling a share to offset the risk of any adverse price movements. A hedge allows a trader to offset any losses in a long position with profits from an opposite short position.

CFDs are a useful tool for hedging existing shareholdings because a short position can be made to hedge the exact position size required. Some hedging tools have standardised specifications and may not move in the same correlation of the underlying share. The risk that the hedge does not cover all the risk of the position is commonly referred to as basis risk. As CFDs are priced mirroring the market a neutral position hedge can be created with zero basis risk quickly and cost effectively.

Traders will short sell for two distinct reasons; to speculate and profit from selling high or overvalued shares with the intention of buying back to close the positions at a lower price in the future and to hedge risk.

Hedging via a CFD allows you to protect physical share positions without the complications of traditional short selling such as borrowing shares to sell.

Developing a Trading Plan

Developing a good trading plan will provide you with a solid framework to improve your trading. The first step to developing a trading plan is to define your specific goals and a time frame to achieve them. Successful trading is a by product of adhering to a sound plan that addresses your entry and exit strategies, risk and money management.

ENTRY

Fundamental or technical analysis can be used to analyse signals to determine when you should enter into a trade. There are a number of methods that can be used to determine your entry including 'buy low, sell high', 'buy high, sell higher' or 'buy high, sell low' for short selling.

A good trade entry price will generally account for around 10 - 20% of your overall trading success. Successful traders are able to pick entry points accurately, however overall they can often have more unsuccessful trades than successful but are still very profitable, through utilising good risk and money management strategies.

- A good trade entry price will generally account for around 10 -20% of your overall trading success.
- The exit price of the trade should be determined prior to entering a trade.

EXIT

The exit price of the trade should be determined prior to entering a trade. A stop-loss can be used to minimise any losses on a losing trade or to lock in profits on winning trades. A stop-loss should take into account the market you are trading, your trading goals, your trading time frame and your risk level. There are four main ways that stop-losses can be set. These methods can be used in isolation or together. It is important that you examine each exit price methodology to work out which method is best suited to your trading plan. Some methods are outlined below:

- Technical Indicators: Analyse technical indicators to determine stop-loss levels.

- Re-tracement methods: Analyse movements in the share price and place the stop-loss based on a set reduction in the share price (e.g. a 5% reduction signals your exit).
- Volatility based stops: These stops are triggered by considerable volatility. A stop order is triggered if volatility occurs past a pre-defined level.
- Pattern based stops: Analyse trend lines or lines of support. Trend line breaks represent an ideal time to open or close a trade.

Position Sizing

We have examined leverage as a concept and considered the leverage multiple which illustrates your current market exposure relative to your capital. While this measure is useful it fails to assist us in determining what position size we should open to meet our risk management criteria. The key to managing risk is to manage the position size of your trades. There are simple calculation methods that can be used to ensure positions are opened within your risk threshold.

The first model that we will consider is known as the 'fixed percentage risk model'. This method allows you to risk the same percentage of capital on each trade. Some traders may argue you should risk more on the positions you are very confident in and less on the ones that you aren't. This would generally be seen as unwise as we have already discussed there is no certainty to any market related outcome and secondly it would be worth asking yourself why you would risk capital on positions that you didn't feel confident about in the first place.

In order for this model to work we need to know three things which are our entry price, our exit price (stop-loss) and your available capital.

POSITION SIZING EXAMPLE

For this example we will be risking 2% of our capital in each trade. Our available capital is $10,000 therefore we will be risking $200 per trade. This percentage can be varied but realise that the larger the percentage the fewer losses you can sustain before it becomes difficult or indeed impossible to continue trading. For many traders it would be reasonable to suggest that 2% should be the maximum amount of your capital that is risked on any trade. Many professionals only risk 1% and take a more diversified short term portfolio as a further risk management strategy.

Entry price	$5
Exit price	$4.75
Available Capital	$10,000

Next we need to establish the 'share price risk', this is the difference between the entry price and the exit price.

Capital risk on each trade = $200
Entry price = $5
Exit price = $4.75
Share price risk $5 – $4.75 = $0.25

To calculate the position size we divide the capital we will risk per trade (i.e. $200 by the share price risk of $0.25). $200/$0.25 = 800 CFDs

In this example you should purchase 800 CFDs at $5.00 and place your stop-loss at $4.75. If the share price falls to $4.75 and your stop-loss is triggered you will lose $200 which is 2% of our available capital.

The benefit of this model is the amount you risk per trade is automatically adjusted as your trading capital fluctuates. If your capital increased to $15,000 the new calculated would reflect this change (i.e. 2% of $15,000 is $300 which is divided by $0.25
– 300/0.25 = 1,200 therefore 1,200 CFDs can be bought and you would still be risking 2% of your capital).

There is a variation of this method that can be employed called the 'fixed dollar risk model'. This model is effective at managing risk but unlike the fixed percentage model the amount that you choose to risk per trade will not fluctuate in line with changes to your capital. In this model you simply nominate an amount that you are willing to risk on each trade. Let us assume it is the same as the example above (i.e. $200). This amount is then divided by the share price risk. This method appeals to some people as it allows them to simply nominate a dollar figure that they are comfortable risking on each trade.

While both models are useful to manage risk they fail to factor in any costs associated with trading (i.e. commission). For instance, using the previous example our risk was going to be $200 and our share price risk was $0.25. Prior to calculating the position size we would deduct the commission charged on entry and exit for the trade. Assuming the commission is $10 on entry and $10 on exit totalling $20. This amount should be deducted from the capital at risk ($200 – $20 = $180) and the position size should then be calculated.

$180/$0.25 = 680 CFDs

> *A good trade entry price will generally account for around 10-20% of your overall trading success.*

Risk Management

Risk management will play a major role in any successful trading plan. If you use a trading method that allowed you to be successful the majority of the time you would assume that you would be profitable right? What would happen if your average losses were 60% bigger than your average wins?

Despite the fact that more of your trades are profitable, the fact that your losses are larger would result in your account going backwards especially when you factor in transaction costs. This illustrates that the key to trading success lies not in achieving a greater number of profitable trades but in intelligent position sizing, management of your trading capital and risk management. Careful consideration given to these factors can ensure you are not over exposed to the market and that any losses incurred are kept relatively small.

- Risk management plays a major role in successful trading.
- The key to success lies in intelligent position sizing, and correct risk management.
- Know your stop loss levels and predetermine your exit price.

As a side note, you should recognise as early as possible that losing trades are an inevitable part of trading. As a trader we always aspire to increase the number of profitable trades and minimise the number of losing trades but the truth unfortunately is that there are too many factors influencing share prices at any given point to predict the outcome of a trade with any real certainty. Rather than focusing on a futile aspiration of trying to maximise profitable trades it is advisable to instead focus on perfecting the things that you have a

very high degree of control over. This, in simple terms, means controlling your risk.

Risk management plays such a crucial role in trading success because it allows you to protect your capital. It is essential that you know your stop-loss levels prior to entering a trade. It is best to know your exit price in advance for a number of reasons. Firstly, it is a critical element in the position sizing methodology discussed previously. Secondly predetermining your exit level allows you to make a decision when you have no capital at risk. You may have found in the past that it can be very difficult to make a trading decision whilst you have a position open. This is because decisions can be influenced by your emotions. Instead of this, if you predetermine your exit level and ensure you exit at your predetermined price you should find the whole trading experience much less stressful.

> *In order for this model to work we need to know three things; our entry price, our exit price and our available capital.*

Money Management

Many traders overlook the importance of money management but it is a key component in determining your trading success. Money management refers to the process of analysing trades for risk and potential profits and managing trades to ensure trading longevity and maximise profitability. The important role money management plays is best illustrated through drawdown analysis.

DRAWDOWN

Drawdown refers to the amount of money that is lost trading, expressed as a percentage of your total trading capital. If every trade you took was profitable, your account would never experience a drawdown. Drawdown measures the money that is lost while trading but does not measure the overall performance. Drawdown is calculated when a trader experiences a losing trade and continues as the trading account hits new equity lows.

Assuming you start trading with $10,000 capital and your first trade incurs a $1,000 loss your drawdown is 10%. You place another trade with your remaining $9,000 capital and achieve a $1,000 gain then a further $2,000 loss, your capital is now $8,000 so your drawdown would be 20%.

($10,000 – $1,000 +$1,000 – $2,000) = $8,000 a 20% loss on the $10,000 capital.

Maximum drawdown is the amount of money that is lost prior to getting back to break even. If you began with $10,000 and lose $3,000 before getting back to break even, your maximum drawdown would be 30%. The process of recouping drawdowns is referred to as drawdown recovery which becomes increasingly difficult as drawdowns increase.

Drawdown recovery highlights the importance of intelligent money management and refers to the percentage gain necessary to recover from any drawdown. If you experience a 20% drawdown you need to make 25% (not 20%) profit to break even.

Loss taken	Gain necessary
10	11
20	25
30	43
40	67
50	100
60	150
70	233
80	400
90	900
100	No capital left

As the drawdown increases the percentage gain needed to recover the loss increases rapidly as illustrated in the following table.

Outlined below are some basic money management guidelines:

- Always use actual stop-losses, 'mental stops' do not work.
- Minimise the capital you risk on each trade, ideally you should aim to risk no more than 2% of your capital on any one trade.
- Limit your total portfolio risk – Your overall portfolio risk should be kept within 20% (i.e. if all your positions were stopped out you would retain 80% of your original trading capital).
- Never average down a losing position – If a position moves against you get out and cut your losses.
- Keep your reward-to-risk ratio at a minimum of 2:1, and preferably 3:1 or higher. This means that for every $1 used to trade you stand to profit $2.
- Understand the volatility of the markets you trade – You should adjust your position sizing accordingly. That is, you may take smaller positions in shares with greater volatility.
- Use trailing stop-losses to lock in profits.
- Move stop-losses as the market moves in your favour to lock in profits.
- Take at least a portion of profits – As the market moves in your favour close a portion of your position to take profits then move the stop-losses accordingly to lock in further profits.
- Ensure you have adequate capital and take small risks. This will allow you to trade profitably over the long term.
- Have a thorough understanding of the markets you are trading.
- Aim to keep maximum drawdowns between 20 and 25% – Once drawdowns exceed this amount it becomes increasingly difficult, if not impossible, to completely recover.
- Be willing to stop trading and re-evaluate the markets and your methodology when you encounter a string of losses. The truth is losing trades are inevitable.

Summary

The rapid growth of CFDs has in part resulted from their similarity to share trading but has been fuelled by the advantages that CFDs offer retail clients. Two key advantages are the ability to profit in falling markets through short selling and the ability to gain additional market exposure through leveraged trading.

We have introduced the concept of leverage and aimed to highlight the benefits it can present and also illustrate the potential dangers. It is essential that all traders employ a level of leverage which is appropriate to their experience and capital.

We have highlighted the fact that establishing a trading plan that covers entry and exit criteria, sound risk and money management is essential for your trading success. Spend time trialling the various systems available to ensure you are using the most appropriate systems for your trading style.

As this manual has illustrated, CFDs are a powerful product that enable you to make more effective use of your capital. They present a flexible and low cost alternative to traditional share trading.

> *CFDs are a powerful product that enable you to make more effective use of your capital.*

Where to From Here?

Start trading CFDs today with FP Markets' DMA Preparation Account

The DMA Preparation Account has been specifically developed to provide the support and education you need while you learn to trade CFDs.

FP Markets' DMA Preparation Account provides:

- Lower leverage levels – Margin rates from 25% to control your risk and position sizing before moving to our standard margins starting at 3%
- Lower minimum opening balance: $1,000
- Lower minimum commission – $5 min or 0.10% for the entire 8 weeks
- 8 weeks FREE access to our professional trading platform webIRESS
- 8 Lesson Educational Program to build your trading knowledge ••A

Dedicated Account Manager providing personalised service ••Free Trading Tools and Educational Seminars

Please refer to the FP Markets website for details of the DMA Preparation Account.

EXPERIENCE WEBIRESS

Request access to the FREE demo trading platform, contact a sales representative on 1300 376 233.

ATTEND A FREE EDUCATION SEMINAR

FP Markets have combined with a number of successful trading educators to develop a comprehensive training series to help you learn and recognise opportunities to trade volatile markets more successfully. Our educational lectures focus on Technical Analysis, Risk Management, Trading Psychology, Systems Trading and CFD trading. Visit

www.fpmarkets.com.au for seminar details and dates.

OPEN A CFD ACCOUNT

If you would like to open a CFD account with FP Markets;

1. Ensure that you have read and understood the FP Markets Financial Services Guide (FSG).
2. Ensure you have read and understood the FP Markets Product Disclosure Statement Part 1 and FP Markets Product Disclosure Statement Part 2.
3. Complete the relevant application for the account type that you wish to open.

Glossary

Contract for Difference (CFD)
An agreement between buyer and seller to exchange the difference in value of a particular instrument between when the contract is opened and when it is closed.

Finance
Financing is applicable on all CFD positions held overnight. The financial rate is applied to the full value of your position. If you hold a long 'buy' position you will be charged a financial interest, if you hold a short 'sell' position you may receive interest.

Free Equity
Free equity refers to your available funds in your account throughout the day. This also includes any intraday CFD transactions.

Initial Margin
Every trader in the ASX CFD market is required to put up an Initial Margin (deposit) for each contract they trade. This applies to both buyers and sellers. This Initial Margin is returned when the contract is closed out. The amount is normally set at a level designed to cover reasonably foreseeable losses on a position between the close of business on one day and the next. The amount of Initial Margin for each contract varies according to the price volatility, but is usually about 2% to 10% of the value of the contract.

Going Long
Going long refers to opening a buy CFD position to profit from a share price increase.

Going Short
Going short refers to opening a sell CFD position to profit from a share price decrease.

Gross Liquidation Value (GLV)
Your GLV is the total value of your account if you closed out all positions at the current market price minus any transaction charges or adjustments.

Mark-to-Market

A system whereby the value of an open position is revalued against the current market for the purpose of calculating variation margins.

Market Maker

Where the ASX CFD provider acts as principal, providing a two-way spread based which may not be the same as the market price. Market makers are price markers and make money when clients lose money.

Stop-loss order

An order placed at the same time as an order to open a position which becomes activated when the market price reaches a designated level. Stop-loss orders are used to close out losing positions to prevent further loss.

Variation Margin

Refers to the payment of profits or losses following revaluation of a CFD contract. For this purpose, open positions are revalued (or marked-to-market) daily.

Today’s date	Final Target Date	Date achieved

GOAL (Specific, Measurable, Attainable, Realistic, Tangible/Time)

Benefits for achieving this goal

Possible Obstacles	Possible Solutions

Specific Action Steps for Achieving this Goal	Target Date	Date Reviewed	Date Completed
1			
2			
3			
4			
5			
6			
7			
8			
9			
10			

Method of Tracking Progress:

Affirmations to Support This Goal:

Should you have any questions or enquiries, please don't hesitate to contact FP Markets.

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