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AVOID COMMON CFD MISTAKES

Overview

Some mistakes are simply that, mistakes. They can be made by anybody. Even the most seasoned professionals have been known to accidentally buy instead of sell or trade the wrong quantity or even the wrong security from time to time. These mistakes can generally be avoided by exercising the appropriate level of care.

Most other mistakes are the result of either a lack of preparation, knowledge or discipline on the part of the trader. Having the ability to avoid making these mistakes will greatly improve your chances of developing into a successful trader.

While it is wise to learn from your mistakes, it is even better (and considerably less expensive) to learn from the mistakes of others. By outlining some of the most common mistakes made by CFD traders, we hope that you will be able to avoid making the same mistakes.

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Misuse of Leverage

One of the major advantages of CFD trading is the ability to trade securities on margin. Instead of outlaying the full face-value of a transaction, CFDs allow a trader to take the same position in the market with an outlay of just 10%, 5%, or even less. Despite a smaller commitment of capital, the trader still acquires exposure to the impact of price swings for and against the full face-value of the trade. This gives CFD traders a greater exposure than can be achieved by trading traditional, non-leveraged securities.

> *One of the major advangtages of CFD trading is the ability to trade securities on margin.*

A CFD trader trading securities on a margin of 10% can effectively leverage their trading funds by a factor of 10. If trading products on a margin of 5%, leverage of 20 times is available. This would mean that a trader with a $10,000 trading account could be controlling positions with a face-value of $200,000, or even more if lower margin rates are available. This is shown in the table below.

Account Value	Margin	Leverage Factor	Maximum Exposure
$10,000	5%	20:1	$200,000
$10,000	10%	10:1	$100,000
$10,000	20%	5:1	$50,000
$10,000	50%	2:1	$20,000

- One of the major advantages of CFD trading is the ability to trade securities on margin.
- Despite the smaller commitment of capital, the trader still acquires full exposure to the impact of price swings.
- The potential for profit is greater, but so is the risk.

Many CFD traders look only at the extra buying power that leverage makes available to them. They make the mistake of ignoring the fact that leverage is a double-edged sword.

Despite only outlaying a fraction of the face-value of a trade, the CFD traders account balance wills for or against the full sized position. This is fantastic if prices move in the anticipated direction.

If trading a security on a margin of 5%, a price rise of 1% in the underlying market could deliver gains prices moved against the CFD position by 1%, it could result in a loss of 20% of the amount initially outlaid as margin.

If CFD traders overlook this feature of trading on margin, they risk making the mistake of taking on too much risk.

Not Understanding the Impact on your P&L

Closely related to the misuse of leverage is the mistake of not understanding how a particular trade will impact your profit and loss. Because of the substantial leverage that is associated with CFD trading, seemingly small outlays can result in large moves in the overall profit or loss of your CFD trading account. This can take some traders by surprise.

Consider a CFD priced at $2.40 that trades on margin of 5%. If a trader wishes to buy 10,000 of these CFDs, the outlay will be just $1,200 margin. With this relatively small investment, the trader will be controlling a position worth $24,000.

On a position of this size, a price move of one cent will have an impact of $100 on the overall account balance.

The simple way to calculate this is to multiply the number of securities by the smallest movement in price. This is calculated using the following formula:

CFD position size x Minimum Price Movement = Dollars per point

CFDs position size	Price movement	Dollars per point
10	$0.01	$0.10
100	$0.01	$1
$10,000	$0.01	$10
$10,000	$0.01	$100

- Small outlays can result in large moves in your overall profit and loss.
- The overall impact depends on the size of your total account.
- A loss of $1,200 on a $1,500 account would see 80% of the account wiped out. However on a $40,000 account this represents a much smaller loss.

If you opened a long position in the above mentioned CFD at $2.40 and the price increased by $0.12, you would have made an unrealised profit of $1,200. However, if the price of the CFD fell by the same amount, you would have an unrealised loss of $1,200. Although these moves represent a 100% gain or loss in respect to the initial margin outlaid, the overall impact will depend on the size of your total account.

For a trader with just $1,500 in their account, a trade that results in gains or losses of $100 per $0.01 of price movement will clearly have a massive impact on the overall P&L.

However, if the same trade were taken by a trader with $40,000 in their account, the relative impact would be much smaller.

A loss of $1,200 on a $1,500 account would see 80% of the account wiped out. However, a loss of $1,200 on a $40,000 account would reduce the overall balance by just 3%, which is clearly more acceptable.

Traders should be aware of both the impact of a one-point ($0.01) move in the security they are trading and how this relates to their overall account.

Traders should be aware of the impact of a one-point move in the security they are trading.

Incorrect Position Sizing

To avoid taking on too much risk through the misuse of leverage, it is important to develop a strategy for calculating the appropriate size of your trading positions. Many CFD traders make the mistake of simply trading right up to the maximum size available with their leveraged funds. This is often done without any regard for the amount of risk exposure that such a position generates.

There are a great many methods available for calculating appropriate position sizes. However, the more successful ones tend to start with the trader determining what they personally regard to be an acceptable level of capital risk for any single trade if it were to go against them. Traders then calculate a position size that meets these criteria.

For example, consider a trader who decides to restrict losses on any given trade to $200. If this trader wanted to buy a CFD at $1.40 with a stop-loss at $1.15, the amount at risk would be $0.25. The appropriate trade size would be determined by the following formula:

Maximum Risk Amount / Risk Per CFD = Position
Size $200 / $0.25 = 800

The method outlined above is typical of a method known as Fixed Fractional position sizing in which a certain percentage of the overall account balance is risked on each trade. Because many traders elect to risk 2% of their account on any one trade, this method is also often referred to as the ‘2% Rule’.

A slight twist on the Fixed Fractional method is the Volatility based method of position sizing.

This technique also uses risk as a certain percentage of the overall account balance on each trade, but the level of risk per security (share/CFD) is based on a measure of volatility, such as the Average True Range (ATR). Using this methodology, a trader will take larger positions when volatility is low and smaller positions when volatility is high.

- It is important to develop a strategy for calculating the appropriate size of your positions.
- The more successful methods involve the trader determining what they consider to be an acceptable level of capital risk for any single trade.

*For example, a trader with a $10,000 account might decide to risk 2% of the account on any given trade, or $200. If the buy price is $1.40 and the ATR is $0.20, the stop might be set at 2*ATR, or $0.40. The quantity to trade would therefore be $200 divided by $0.40, or 500 shares/CFDs.*

Other methods of position sizing include allocating a fixed dollar amount of equity to each trade, buying or selling a fixed number of shares/CFDs of each trade or varying the size of each trade according to overall profitability.

> *Many traders make the mistake of not closing poorly performing positions quickly enough. One tool that makesthis easier is the stop-loss order.*

The diligent use of a suitable position sizing strategy will also help you to avoid the common mistake of placing all of your eggs in the one basket. Nearly everybody knows that it is unwise to place all of your funds into any single investment and yet people continue to make this most basic mistake, thus exposing their account to significant risk.

Poor Trade Management

While traders frequently commit an inordinate amount of time to selecting, planning and executing new positions, they often make the mistake of exiting these trades with much less thought. This is unfortunate as it is the exit, after all, that will determine whether a trade has been profitable or not.

This is where the traders' enemies of hope, fear and greed make an appearance. It is human nature to grasp quickly at profits (due to greed) while the fear of incurring a loss will see the same trader leaving poorly performing positions open in the hope that prices will move in the desired direction and reduce losses or even see them turn into profitable trades.

There is an old saying among traders that you should, 'Let your profits run and cut your losses short'. In other words, if you have a profitable position, you should allow that trade to achieve its full potential, rather than closing it out at the first sign of
(a small) profit. On the other hand, if you hold a position that is moving against you, you should move quickly to exit that position, before the loss becomes too great.

If you are managing your trades correctly, your average winning trade should be considerably larger than your average losing trade. Once you have the discipline to trade in this way, you should be able to achieve overall profitability even if only half of your trades are winners.

Many traders make the mistake of not closing poorly performing positions quickly enough. One tool that makes this easier is the stop-loss order.

Once you have identified a price level that corresponds with the level of risk that you are willing to take on a particular trade, a stop-loss order can be placed at this level to automatically close out the trade. This removes the human element from the exit, reducing the risk that the emotion of hope will interfere with rational trading decisions.

It is important to understand that a stop-loss order simply provides a trigger point for the execution of an order. If a sell stop has been placed on a long position, the stop-loss will be activated if price trades at or below the nominated stop level. From time to time, this can result in trades being executed at a price that is less favourable than the nominated stop-loss price. This is known as slippage.

- The exit position determines whether a trade has been profitable or not.
- Rather than closing a trade at the first sign of profit allow the trade to achieve its full potential.

Many traders make the mistake of not closing poorly performing positions quickly enough. One tool that makes this easier is the stop-loss order.

Not Understanding the Instrument Being Traded

Being over-the-counter products, there are a great many differences in the specifications of contracts available as CFDs. If you are trading these products, it is your responsibility to know what these specifications are.

For example, what exactly does 1-CFD of this security represent? Is there a physical underlying security? Is there an expiry? What if you still hold an open position at expiry? Is there a financing fee? Can it be sold short? What are the trading hours? Which currency is it priced in?

Speaking of currency, have you considered the impact that movements in the GBP could have on your holdings? Do you have a currency overlay strategy in place to dilute the impact of adverse currency movements? If the GBP gains against the currency of the country that you have invested in, any gains you might achieve in that foreign position will be eroded. Even worse than that, if you have incurred a loss on your foreign position, a weakening GBP will amplify this loss.

By far, the majority of traders invest in equities listed in their own country. This is known as 'home country bias'. The simple reason for the existence of this phenomenon is that traders are more comfortable trading securities that they are familiar with. How well do you really know the market conditions in the USA or Asia? How well do you know the local conditions and regulations of those foreign markets? Is it really convenient or practical for you to sit up for half the night to trade a security that trades on an exchange on the other side of the world?

Sometimes, it might be better to stick to CFDs based on markets that you are familiar with rather than venturing off into markets you don't fully understand.

- Know your product, there are a lot of differences between specifications of contracts available for CFDs.
- It can be a good idea to stick to CFDs based on familiar markets.

Using the Wrong Order Type

Trading with real money should be viewed as a serious business. As such, you should take the time to ensure that you thoroughly understand the most basic tools of the business. Many CFD traders have missed opportunities or closed out of trades at the wrong time simply by placing the wrong type of order. At the very least, you should understand the following order types.

MARKET ORDER

Used to execute a trade at the current market price.

STOP ORDER

To exit a trade, place a stop order at a level that is worse than prices currently available in the market. On a long position, the stop-loss order to sell would be placed below current market prices. Conversely, on a short position, the stop-loss order to buy would be placed at a level above current market prices.

LIMIT ORDER

To exit a trade, limit orders are placed at a level that is better than the current market price. When seeking to lock-in profits on an open long position, a limit order to sell would be placed at a level above current market prices. If seeking to lock-in profits on a short position, a limit order to buy would be placed at a level below current market prices.

- Don't miss an opportunity; make sure you are familiar with all the order types.

Using an Inappropriate Strategy

A common mistake among traders involves using an inappropriate strategy, or worse still, having no strategy at all.

Using some type of strategy on a consistent basis, even a simple moving average cross-over system, provides a framework of discipline for the trader. This is generally going to deliver better results than a haphazard approach or the use of a constantly changing series of strategies.

Some care must be taken when selecting a strategy. It would be a mistake to attempt trading a strategy based on five minute charts if you are unable to access your trading platform for much of the trading day. Similarly, it would be a mistake to use a strategy based on monthly charts if your trading horizon is measured in days or weeks.

People tend to hold a belief that a more complex system must be a better system. This is especially true among certain groups of traders. They develop systems that employ huge numbers of inputs and require extremely complex calculations and algorithms. They often produce charts that are so heavily covered in indicators that it becomes difficult to see the price action. While some of these complex systems certainly can be profitable, the more inputs and calculations they require, the more potential there is for something to go wrong.

In many ways, a simple strategy is often better (and easier to follow with confidence) than a more complex system.

One of the tools employed by many strategies is the short trade. This is where a trader sells a security that they don't currently hold in anticipation of buying it back again at a lower price in the future. While it can be argued there is little difference between taking a long position or a short position, the short position may not be appropriate for a highly conservative trader.

In theory, a short position holds much greater risk than a long position. This is because of the difference in the maximum potential adverse excursion for each type of trade. With a long position in equities, the worst possible move would be for the

- Select an appropriate strategy. This will provide you with a framework for discipline.

equity to fall to zero and become worthless. For a short position, where losses will mount as prices rise, the maximum adverse excursion is theoretically unlimited. While holding a short position on a security with a skyrocketing price is unlikely, it is a possibility. Accordingly, it might be considered a mistake for a highly conservative trader to trade on the short side, especially without a stop-loss order in place.

> *While some complex systems can be profitable, the more calculations they require, the more potential there is for something to go wrong.*

Not Learning How to Use Your Trading Platform

It is hard to imagine that a builder would get far without learning how to use his tools, or that a surgeon would have happy patients without learning how to use her tools. Yet many traders throw up their arms claiming to be 'computer illiterate' and 'no good with technology' and somehow still imagine that they will be successful.

Sure, there is a steep learning curve involved when trading on a new platform. But coming to terms with this and putting in the effort to get beyond any lingering fears of technology is essential if you are to become a successful online trader.

It is no good waiting until you have open positions and the markets start moving before you figure out how to place or adjust a stop-loss or take-profit order. You need to 'know' how to move around the platform and open, close or adjust orders without having to look up the user guide.

- It is essential to know your trading platform if you want to be a successful trader.

FP Markets provides access to a range of educational tools that outline the features and functionality of webIRESS. We conduct in-house platform demonstrations, webinars and over the phone platform walkthroughs to ensure you feel comfortable with webIRESS before you start trading. For more information visit fpmarkets.com.au.

You should also prepare for more extreme situations. Consider what might happen if your internet connection were to fail or if your computer became infected with a virus and was not operating at its peak.

> *You need to know how to move around the platform and open, close or adjust orders without having to look up the user guide.*

As a safety measure, it is wise to keep your CFD provider and account manager's phone number written down (in hardcopy) near your computer.

It is also good practice to keep a list of your open positions so that you know what your exposure is.

Not Taking Responsibility for Trades

While most traders keep a keen eye on their open positions, there are those that make the mistake of not doing so. By frequently checking on your open positions you will know what your overall exposure to the market is and whether you are in profit or loss.

In addition to errors, some traders simply forget that they have placed certain orders, or through unfamiliarity with the platform, find that they have accidentally placed orders without intending to do so. It is best to detect these mistakes as quickly as possible by monitoring your open positions.

Mistakes made when entering trades are more common that you might think. Traders frequently hit buy instead of sell (and vice versa) or enter the wrong quantity or even the wrong ticker symbol. These are simple mistakes that are often put down to having a 'fat finger'. However, if you take your trading seriously, you should ensure that you exercise the appropriate level of care.

> *If you are in the market to make a profit, it is important that you approach your trading in a serious, business-like manner.*

Trading for the Wrong Reasons

Most people undertake trading with the goal of making a profit. However, there are some people that participate in the market for entertainment, either consciously or unconsciously.

If you are in the market in order to make a profit, it is important that you approach your trading in a serious, business-like manner. People that trade for entertainment, or to impress their friends, will be lucky to break even, let alone make a profit.

Be careful not to make the mistake of viewing yourself as a serious trader if, in fact, you are just seeking entertainment.

- Make sure you are in the market for the right reasons.
- Approach trading like you would a serious business.

Over-Trading

Another important mistake to avoid is the temptation to over-trade. This is a greater risk for traders that are not following a predetermined strategy.

Sometimes, choosing to sit on the sidelines until a clear trend emerges is in itself a valid strategy.

Traders should also avoid the mistake of consistently trading fully leveraged positions just because they have margin available. Each trade should be considered on its own merits and within predetermined risk parameters.

To avoid the possibility of being exposed to such a dire (if unlikely) outcome, it is important that you do not trade with money that you cannot afford to lose.

> *Sometimes choosing to sit on the sidelines until a clear trend emerges is in itself a valid strategy.*

Psychological and Emotional Mistakes

Making money in the markets requires a trader to place trades that are ultimately 'correct' and deliver a profit. Because of this, many traders develop the mind-set that they must be correct on every trade. This can be a dangerous mistake to make.

If you cannot accept the fact that you may have been wrong on a particular trade, you will find it hard to close out of a losing position. Instead, your mind will find ways to convince itself that you may yet be proven correct and the trade may swing around and become profitable. There is a risk that subconsciously, you will only see evidence that supports want you want the market to do, while becoming blind to evidence that suggests you are wrong.

If you can accept that you won't get every trade right and that you don't actually need to get every trade right, you will be in a much better position to manage your trade effectively.

Being wrong is something that we are conditioned from a young age to feel bad about. Instead, we are taught through positive reinforcement that we should feel good (and even self congratulatory) about being right. This can present serious problems when trading.

- It's ok to be wrong, accept that you won't get every trade correct.

> *By frequently checking on your open positions you will know what your overall exposure to the market is and whether you are in profit or loss.*

If your losing trades cause excessive emotional distress, you will find it difficult to analyse the market rationally. There is a danger that you will start over-trading in an effort to make back losses or to 'get even' with the market. This is likely to place you in an even worse financial and emotional position.

On the flip-side, winning trades can generate feelings of elation and invincibility. If you make the mistake of allowing this emotion to take hold, you may find yourself taking excessive risk or making silly mistakes through carelessness.

Where possible, you should aim to keep your trading related emotions under control. Using a tested and proven strategy can help you minimise mistakes associated with emotion.

Another mistake that is common among traders is the desire to focus only on positive outcomes. People tend to start thinking about how they might spend their potential profits, while ignoring the downside risks. Wiser traders will focus on the downside risk potential of each trade and will make sure that this is within their predefined parameters.

- Emotional distress can cause a trader to chase a loss, this will make it difficult to analyse the market rationally.
- Evaluate all the potential risks before placing a trade.

Not Understanding the Suitability of CFDs

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

The ability to trade CFDs has greatly improved the trading opportunities for a great many traders. They are an ideal trading vehicle for traders with a relatively short-term time horizon and a desire to increase their market exposure on a given level of available capital.

They may not be so suitable for traders with a longer term time horizon due to financing charges which can build up over time. Similarly, traders that are unable or unwilling to monitor their open positions and manage their trades might find that CFDs are not suitable for them.

No matter what your reason for trading, you need to pay special attention to the amount of money that you allocate to your trading account. What would your financial situation be if you were to lose the whole lot?

Finally, anybody considering adding CFDs to the trading toolbox should make sure that they understand the risks associated with this product. As with any financial product, the risks will be significantly higher if you don't take the time to understand the product. For further information on the associated risks of trading CFDs, please refer to the Product Disclosure Statement available from our website at www.fpmarkets.com.au.

Summary

In summary, the key to avoiding mistakes is to be aware of the environment and situations that cause them. By putting in the effort to understand the mechanics and terminology of CFD trading and knowing how to use your trading platform you will be able to avoid many of the most common mistakes. Most of the others can be avoided by taking care when placing and amending orders and keeping your emotions in-check.

For traders that do understand how CFDs work and learn to minimise the associated risks, there can be substantial benefits. Through the utilisation of leverage and the convenience
of online trading, short-term traders now have greater opportunities than at any time in the past.

> *Short-term traders now have greater opportunities than at any time in the past.*

Want More Information on CFDs

FP Markets offers access to a wide range of complimentary trading tools and resources. Visit www.fpmarkets.com.au for more information.

Our DMA CFDs delivers REAL Transparency, Reliability and Trading Value. Access the largest range of Australian Share CFDs from just 3% margin and outstanding trading value.

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