UNDERSTANDING INDEX CFDS

Contents

Introduction to FP Markets

FP Markets (FP) is an Australian owned company which commenced trading in 2005 and is part of the First Prudential Markets Investment Group which provides CFDs to retail and wholesale clients both in Australia and Europe.

FP Markets was founded by a team of experienced individuals who have been involved in the Australian CFD industry since its inception.

It soon became apparent that providing CFDs via a Direct Market Access (DMA) model would be the future of CFD trading as this model provides fair and transparent prices to retail clients and aligns the interests of the firm with that of its clients as the firm does not profit from client losses. All Forex CFD trades are hedged so that again our interest are aligned and FP Markets is dedicated to providing clients with the best possible pricing.

With a large offering of equity, FX, Indices and commodity CFDs from international exchanges, we have established ourselves as an award winning global leader for DMA CFDs.

FP Markets has one of the most competitive Forex CFD offerings in Australia, and also covers the widest range of Equity CFDs and Shares from the one platform, shaping the local DMA CFD industry. As well as offering a broad product range in Australia, FP Markets in London provides one of the most competitive CFD offerings throughout Europe.

All our products are offered on the basis of direct market access, enabling you to deal in the actual markets on the same, or almost the same terms as a professional trader. Our single platform, developed in Australia, enables you to trade our full range of products without the need to switch platforms for overseas markets, commodities, currencies, indices and overseas shares.

OUR SUCCESS

- Education – FP Markets strongly believes that the key to successful trading is in a trader's education.
- Platform – FP Markets offers its clients the ability to trade from a range of Iress based trading platforms that give all clients' access to CFDs with the best execution across Equities, Indexes and Forex.
- Account Types – FP Markets offer access to a range of account types so you can tailor your account to your specific needs.
- CFDs – FP Markets specialises in Direct Market Access (DMA) CFDs across many markets and products.
- Safety – FP Markets has sophisticated and robust risk management systems which have ensured stability through a variety of market conditions.
- Regulation – FP Markets (Australia) is regulated by Australian Securities and Investment Commission (ASIC) and FP (United Kingdom) is regulated by the Financial Services Authority (FSA).
- Support – FP Markets offers 24 hour trading support.

What are Sharemarket Indices?

A sharemarket index is a way of measuring the performance of the sharemarket overall and comparing it with moves in other assets, including overseas sharemarkets.

For traders, contracts for difference (CFDs) based on sharemarket indices offer a feature few other trading instruments can provide – the ability to buy or sell the sharemarket as a whole and reap gains from its performance without trading individual stocks.

As well as making gains from rising share prices, it's also possible to profit from expected sharemarket declines by selling share index CFDs, buying them back later at a lower price if the downturn does occur. Selling index CFDs is a strategy used by investors as well as traders. Investors with a large portfolio of shares can protect themselves against the risk of an overall sharemarket decline by selling CFDs representing the value of their portfolio, or a portion of it, so that in a declining market the profits on sold CFDs offset, or partially offset, the losses on the portfolio.

FP Market's CFD offering in share indices is based on its ability to trade directly in the global futures markets where index derivatives, including futures over various share indices, are traded. Each transaction made by a client is matched by a trade executed at the current price in the futures markets. Ensuring that you receive the market price. FP Markets does not benefit from the losses of any clients.

Index CFDs are not restricted to the local sharemarket. CFDs are also available based on share index futures markets in the US, the UK and Germany (where indices over European stocks are also traded) thus covering the most important of the world's advanced economies.

INDEX FUTURES CFD TABLE

UNDERLYING CONTRACT NAME	EXCHANGE	CODE	COUNTRY OF EXPOSURE	DESCRIPTION OF UNDERLYING INDEX
S&P/ASX 200 - SPI 200*	SFE (Sydney Futures Exchange)	AP	Australia	The ASX 200 is market-capitalization weighted, meaning a company's contribution to the index is relative to its total market value i.e. share price x number of tradeable shares.
E-MINI DOW* ($5)	CBT (Chicargo Board of Trade)	YM	USA	The Dow Jones Industrial Average™, also referred to as The Dow®, is a price-weighted measure of 30 U.S. blue-chip companies. The Dow® covers all industries with the exception of transportation and utilities, which are covered by the Dow Jones Transportation Average™ and Dow Jones Utility Average™.
E-MINI S&P 500* ($5)	CME (Chicargo Merchantile Exchange)	ES	USA	The S&P 500 is a free-float capitalization-weighted index published since 1957 of the prices of 500 large-cap common stocks actively traded in the United States.
E-MINI NASDAQ* ($5)	CME (Chicargo Merchantile Exchange)	NQ	USA	The NASDAQ-100 is a stock market index of 100 of the largest non-financial companies listed on the NASDAQ.
DAX Futures* (FDAX)	ERX (Eurex)	FDAX	EU	The DAX (Deutscher Aktien IndeX, formerly Deutscher Aktien-Index (German stock index)) is a blue chip stock market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.
DJ Stoxx Euro 50*	ERX (Eurex)	FESX	EU	Euro Stoxx 50 is a stock index of Eurozone stocks designed by Stoxx Ltd, an index provider owned by Deutsche Börse and SIX Group. According to Stoxx, its goal is "to provide a blue-chip representation of Supersector leaders in the Eurozone".
FTSE 100*	LIF (London International Financial Futures and Options Exchange)	Z	UK	The FTSE 100 Index, also called FTSE 100, FTSE, or, informally, the 'footsie', is a share index of the 100 most highly capitalised UK companies listed on the London Stock Exchange.

* Data provided by IRESS Data Pty Ltd

Traders who use index derivatives like CFDs, rather than trading shares, are shifting their focus from analysing and trading large numbers of stocks and instead concentrating on the factors that affect the domestic economy as a whole, and thus have a positive or negative affect on the whole stockmarket. Although sharemarkets do react to similar macro-economic forces as a nation's currency, the correlation between them is not perfect. The sharemarket represents only a portion of the total economy – listed companies producing goods and services – while the corresponding currency is more representative of the economy as a whole, including levels of government and household debt, the value of property assets and of fixed-interest investments.

Sharemarkets respond more to changes in consumer demand, employment and the stage of the economic cycle as the economy moves from strong growth to more sluggish growth. These may affect currency values, too, but currencies are more immediately responsive than shares to fiscal (governments initiatives that affect the economy) and monetary (monetary authority intervention in money supply) policy changes, in particular any changes that affect interest rates. They also respond more to global economic conditions such as are indicated by trade surpluses and deficits, the strength or weakness of competing economies and shifts in global economic growth and demand for goods and services.

Anyone who has traded shares in Australia will know about the indices that measure the performance of the overall sharemarket. The two most well-known are the S&P ASX All Ordinaries Index, which takes in the prices of a very broad range of stocks, and the S&P ASX 200 index, which measures the combined performance of the top 200 stocks as measured by market capitalisation. Market capitalisation means the total worth of the company as valued by the market and is calculated by multiplying the share price by the number of shares issued.

INDEX CONSTRUCTION

Indices over a nation's sharemarket are constructed by taking the prices either of a broad range of stocks or a representative sample of the biggest stocks in the underlying equity market. These prices are added together and divided by the number of stocks in a price-weighted index like the Dow Jones Industrial Average, which gives most weight to high-priced stocks. Or an index can be weighted according to the proportion of the market each stock represents, based on their market capitalisation, like the S&P ASX 200 Index. The index is designed to track the value of an investment in a portfolio of all the stocks included in the index.

Note that the indices traded on futures markets around the world are price indices only – they do not take into account the value of any dividends paid on shares, but track only the portfolio gains or losses based on the underlying share prices.

From time to time the make-up of the index is reviewed and any stocks that no longer meet the criteria for inclusion are dropped and new ones added to replace them. This may happen, for example, when a company's share price or market capitalisation has fallen below the threshold for inclusion.

The Nasdaq index of technological stocks in the US, tracks the performance not of stocks in general but of those involved mainly in computers, the internet, mobile communications, biotechnology and related fields. It includes only non-financial stocks. For this reason moves in the Nasdaq index do not closely match movements in the US indices based on large stocks or a broad range of stocks, although there is some correlation.

FUTURES MARKETS

Futures markets first arose in agricultural commodities in Japan and the US as a way for producers and consumers to set prices for crops that were still growing in the fields. The contracts would be settled by delivery at harvest, but before then could be traded by growers, consumers and speculators. Markets for future delivery, or future settlement, were extended in the twentieth century to financial instruments such as share indices and bonds.

A futures market normally trades most of its contracts for delivery in the near future – over the next three to six months – although in some markets futures contracts can be made for periods of a year or more. They are designed to provide a way of reducing financial risk by allowing share traders to sell quickly and easily when they anticipate falling share prices, and to buy back in the same way when the drop in share prices has ended. Those who expect to invest in shares can use futures to hedge against a price increase until they have the funds available.

Futures contracts are traded on a margin system that requires traders to pay an initial margin or deposit typically amounting to around 10 per cent or less of the contract value. Any trading losses must be paid immediately in the form of further margins. If the contract is held until expiry, it is settled either by delivery (for commodities) or in cash (for share indices). Traders of commodity futures who do not wish to give or take delivery must buy or sell back before the delivery date.

For index futures, at expiry your bought contract is sold at the index level applying at that time, or your sold contract is bought back at this level. If you wish to keep a bought position in the index after the current contract expires, you need to buy another futures contract in the following expiry month. Maintaining a position in this way is referred to as rolling the contract over, that is, replacing an expiring futures contract with a new one in the following month.

Index Futures

Prices of share index CFDs are based on the relevant share index futures markets, and corresponding orders are executed in the futures markets where those indices are traded.

For the Australian sharemarket, ASX 200 index (SPI 200) futures contracts are traded on the Sydney Futures Exchange, a division of the Australian Securities Exchange. Globally, share index futures are among the most liquid and actively traded derivative markets.

You probably know that futures markets work slightly differently from other financial markets, in that they trade contracts that expire at a known future date. Because the futures market is pricing the value of the index in the future, the price for a specific future month will not be the same as the index in real time based on changing share prices. As with other futures markets the future price is generally higher than the actual index, the difference representing the cost of holding a portfolio of shares until the delivery date. To simplify, the futures price has a fair value based on today's actual index level (known as the cash or spot index), plus the cost of funds until delivery, less any income from dividends over that period.

To illustrate, the following table compares the closing December futures price with the spot price for the SPI 200 futures contract on the ASX (SFE division) on 20 September, 2011:

SPOT AND FUTURE PRICE SPI

S&P/ASX 200 (SPOT)	SPI Futures December '11 Expiry
4040.2	4045

In this case, the December futures price is just 5 points higher than the actual index, when fair value would suggest that at a funding rate of 8 per cent and average dividend yields of around 3 per cent, the December contract should be about 60 points or more higher. In the unusually volatile and uncertain market conditions existing at the time, the futures market was effectively pricing in an expected decline in the index by December.

A futures contract has an expiry date during the month when settlement is due. This is the settlement month, known as the delivery month in the commodity markets where delivery takes place. Index futures are settled in cash on the expiry date, and can be subject to unusual fluctuations at that time. Before settlement of the futures contract is due, any open speculative position must be closed and re-opened in a more distant futures settlement month.

Although many index futures contracts have settlement months in other nearby months of the calendar (for example, October and November), the most actively traded months are the financial quarter months (March, June, September and December). Futures trading activity in these settlement months typically increases in volume as the expiry date moves closer over time.

Index CFDs

If you want to replicate the performance of the market as a whole, you need to buy all the listed stocks, weighted according to their size.

That's often impractical and can be prohibitively expensive, but fund managers discovered that by buying only those stocks that tend to have a noticeable effect on the index level – typically just the largest companies – they could get very close to the performance of the market without buying all the stocks.

This led in turn to indices that tracked the top companies – often the 50 or 100 or 200 largest stocks. It can still be expensive and time consuming to buy all the index stocks, but with the advent of index derivatives such as futures and CFDs it's possible to take a viewpoint on the direction of the overall market, and to profit whether it's moving up or moving down, just as if you had bought or sold all those stocks.

As you know, a contract for difference (CFD) is an agreement to receive a profit on any bought contract whose price rises, and to pay up any loss when the price of a contract falls. Similarly, a contract to sell is an agreement to receive profits if the price falls, and pay up losses if the price moves up against you.

CFDs allow those who have expectations about the future direction of prices – in this case share indices – to profit from those expectations, if correct. They also provide an avenue for hedging of risks associated with share portfolios. Holders of shares are at risk from overall sharemarket declines, and can hedge by selling index CFDs.

A feature of all CFDs, including index CFDs, that makes them attractive to traders is the ability to trade at high leverage. Leverage involves borrowing most of the value of the CFDs you trade, and paying the rest – as little as 3 per cent for share index CFDs – as an initial margin. Any losses that exceed the initial margin must then be paid up daily in the form of maintenance margins.

As an example, a CFD over the S&P ASX 200 index (based on the SPI 200 futures contract) has a value of $25 times the index level. So if the futures price is at 4200, an index CFD at this price has a value of AUD105, 000 ($25 x 4200). The initial margin required for a contract of this size is 3 per cent, or $3,150. Margins on CFDs are typically less than those required for the underlying futures contracts. The advantage of leverage is that it multiplies profits compared to the initial outlay – you borrow most of the value of the contract (97 per cent if you put up a 3 per cent initial cash margin), but you make profits based on the change in the full value. The other side of the coin is that if you make losses on CFDs, they too will be multiplied by the leverage of borrowing. This makes it imperative to manage the associated risks using careful position sizing and stop-loss orders (see page 15).

A CFD over the SPI 200 index is effectively a futures contract, which means that it will have a slightly different price from the actual or spot index – the index as published throughout the day by the Australian Securities Exchange (ASX). Movements in the futures price will be closely related to those in the underlying index, but may not match them exactly. Futures markets are actively traded by professionals who are able to take advantage of futures prices that drift from fair value, based on the spot index level. This means that they tend to revert quickly to their fair value, including any premium or discount for market risk.

If you hold an index CFD position for a long period – for example, several weeks – the futures contract on which the CFD is based may approach its expiry date, in which case your position will need to be rolled over to the next available futures month.

Index CFDs are available only in the financial quarter months of March, June, September and December (the active futures trading months), so in September your September futures position would need to be closed (any long positions sold and any shorts bought back) and re-established in the December settlement month. This would involve paying the usual commission per contract to buy and sell.

Advantages of Index CFDs

LIQUIDITY

Index CFDs access the liquidity of index futures markets, which are among the most active futures markets in the world. Australian index futures are traded on the ASX futures market, the Sydney Futures Exchange, whose index futures contracts trade a notional average value of around $4.5 billion daily. Futures over US and international indices are traded on the Chicago Mercantile Exchange, part of the CME group which is the world's biggest futures market, with a volume estimated at USD45 billion a day.

LONG TRADING HOURS

Most index futures markets are open for much longer hours than the corresponding sharemarkets, allowing traders access at almost any time via electronic trading systems. Most index futures markets close only briefly each day for clearing. Liquidity at times outside of normal sharemarket trading hours may be much lower than it is when the sharemarket is open.

DIRECT MARKET ACCESS

Your CFD contracts are backed by actual trades in the index futures markets; they are not a rolling cash product. This allows you the confidence of knowing your exact spread or cost of trading and of knowing your price is the actual futures market price at the time you traded.

LEVERAGE

One of the big advantages of CFDs is the leverage they offer to traders, enabling them to earn greater percentage profits compared to their initial outlay than is possible by trading without leverage. Leverage arises from the ability to trade on a small initial cash outlay – the margin.

Index CFDs can be traded with an initial margin payment just 3 per cent of value, which means that for an outlay of around USD1800 you can trade index CFDs the US sharemarket based on mini S&P 500 index futures worth USD59,425 at an index level of 1188.5.

This doesn't mean that you can safely trade a mini S&P 500 contract with just enough trading capital in your account to cover the margin. Attempting trades of this size when your trading capital is limited to $2000 or even $5000 is almost certain to lead to the loss of all of the capital in a short space of time. People who have this experience tend to stop trading. They reason that there is no point in trading larger amounts after such a failure. They're probably right unless they learn about and adhere to the risk management rules that ensure they do not over-trade and have stop-loss orders in place to protect their positions (see page 15).

SHORT SELLING

In the sharemarket, there are restrictions on short selling (selling shares you do not own to profit from a fall). Short selling may also involve costs such as a stock borrowing cost on exchanges (such as the ASX) where naked sort selling is not permitted and those who do so must have access to actual stock.

But there are no such restrictions in the share index futures markets, and none in index CFDs. If you believe the overall sharemarket is likely to fall, you can sell index CFDs and profit if your expectation is correct. This involves the risk that the index will rise after you have sold, which would lead to losses. Such losses need to be curbed by appropriate use of stop-loss orders and adherence to risk management rules.

LOW COST

Commissions on index CFDs are fixed at a low rate per contract, usually around $15, so it's not expensive to trade them, especially compared to the cost of buying the shares, or even CFDs over all the shares in an index, which would involve anything from 50 to more than 250 stocks.

DIVERSIFICATION

Although equity markets do tend to move in tandem, the correlation is far from close. US sharemarkets tend to move in the same direction as the Australian market, but often move further in percentage terms over a particular period. Trading indices based on sharemarkets in other parts of the world – including Europe and Japan -- offers alternative opportunities, especially at times when the local sharemarket may be going through a period of consolidation. Consolidation is when a market trades over a fairly narrow range for an extended period, making it difficult to earn trading profits because there is no clear direction.

Margins, Risk Management, Position Sizing and Stop-losses

Like trading in any market, the goal of trading in index and commodity CFDs is to make profits by taking risk and managing the risk carefully.

To do otherwise exposes the trader to the larger risk of erosion of trading capital through unnecessary, or unnecessarily large, losses. Once trading capital is eroded beyond a certain point – generally taken to be about 50 per cent – it is very difficult to trade in such a way that the amount of capital is restored to its starting value. A 50 per cent loss of trading capital requires you to earn a 100 per cent return on your remaining funds in order to recover, and very few traders can achieve such returns consistently. They may double their money or better on some trades, but there will inevitably be losing trades in any trader's book.

A few simple risk management rules, carefully followed, will allow you the best chance to optimise your returns, avoid overtrading, keep losses on losing trades to a minimum, reduce the need to pay up losses in the form of margins, and allow the maximum profit to be gleaned from winning positions. The primary aim – even ahead of making profits – is preservation of risk capital, since no trading at all can be done, and no profits made, without that.

First, set your stop-loss order before entering any trade. Your stop-loss order (also called a stop order or just a stop) – is the order you give your broker, or execute yourself, in order to prevent runaway losses. It gets you out of any losing trade quickly and is your first line of defence against unnecessary capital loss. It's an order to quit the trade as soon as the loss reaches a certain known point – a point at which the market has signalled that it is indeed moving against you and giving you the sign to exit. Looking at historical price and volume information can assist in identifying these signals and levels. Calculate the placement of the stop using what you know about how far the index typically moves before it makes a reversal, and how far it tends to move each day. Study the concepts of support and resistance and take these into account when placing stops.

Second, calculate your position size based on the stop-loss order. A useful rule of thumb is to make sure your maximum loss on the trade must not exceed one per cent of your total available trading capital. Suppose your capital is $200,000 and the stop-loss order is placed 40 index points away from the entry price on an ASX 200 index trade. If your stop-loss is triggered (by the market reaching the stop-loss price) then the loss will be AUD25 x 40 or $1000 for a single index contract. Since your maximum acceptable risk on any trade is $2,000 (one per cent of $200,000), the number of contracts you can safely trade is $2000 divided by the $1000 expected maximum loss, or two contracts. ($2000/$1000 = 2).

In the gold market, where you can trade a mini gold contract of 10 ounces, you might place your stop-loss order USD50 away from the entry price, depending on your assessment of the technical factors showing up in your chart analysis. Since each USD1 movement in the gold price represents a profit or loss of USD10, your loss of the stop order is triggered will be USD500. Given the same amount of risk capital as in the previous example ($200,000), you can afford a loss of no more than $2000 on your position, so the maximum number of 10-ounce gold contracts you can trade is four contracts ($2000 divided by the maximum expected loss of $500). Remember that the number of contracts you can trade will change if you move your stop-loss (exit) point. The more room you give the market to move before your stop-loss is triggered, the smaller the position size the rules will allow.

Third, stay in the market as long as possible. You should have a target price that you expect the market to reach, and this should be at least as far in profit as the stop-loss price is in loss. In other words, you should stand to gain at least as much as you stand to lose, and more if possible. This is often stated as a risk-reward ratio, really the ratio of reward to risk, which should be at least 2:1 in the share index market and preferably 3:1. Your target price should represent a realistic expectation of making three times as much, if possible, as the amount you would lose if the stop-loss were triggered. The target price is estimated using your analysis of the technical position of the currency – its price charted

in terms of the base currency against the reference currency and analysed for trends, reversal patterns, candlestick signals, volatility and the price crossing over the moving averages you are using in your analysis. (See Technical Analysis, p. 20).

But the target price should not necessarily be the exit price, unless the market is telling you it's time to quit a favourable position before it turns around. One way to ensure you maximise profit is to use a trailing stop order. This is a stop order that gets you out of the market on a reversal of a given size, calculated using the daily average price move of the index or commodity and your knowledge of how big a move typically constitutes a reversal of direction. You then quit the market automatically, but only if the price is signalling a probable change of direction against you.

Remember that when holding a CFD position, any losses that amount to more than the initial margin must be paid up daily. But if you follow the rules above, the amount at risk (one per cent of your portfolio, or $2000) should not be more than the amount paid in margins. At an index level of 4000, for example, 3 per cent of contract value on two contracts would amount to around $6000. A triggered stop-loss would close the contracts before any margin call was made.

Similarly, in gold CFDs, the value of a 10-ounce contract at USD1800 is USD18,000, and the margin requirement is 3 per cent of value, or USD540. At a stop-loss of USD40 away from the entry price, your loss would be limited to USD400 on a single contract. You can trade more contracts, but you have to put up margin on each. You can trade wider stops, but much wider stop losses would require a reduction in position size.

For long-term traders, running wide stops – that is, allowing the market much more room to move before you exit automatically – may be necessary when markets are volatile. Remember that widening your stop-loss – that is, moving it further away from your entry price – requires a recalculation of your position size. A wider stop will require a reduction in position size because your total risk will increase to more than one per cent of your trading capital – the maximum that sound risk management permits on any trade.

Factors Affecting Share Index Levels

What makes the sharemarket go up or down? In very simple terms, a sharemarket is a measure of a nation's industrial, commercial and financial productivity.

This covers a wide range of activities, from mining and manufacturing to retail and banking services. As well as being influenced by the factors that affect the various sectors of the markets – such as resources, financials and consumer discretionary – the overall market is driven by the macro factors that affect the overall economy in which companies operate.

These factors may include:

The stage in the economical cycle. There are times when an economy is growing strongly, economic growth (as measured by gross domestic product or GDP) is growing at a healthy rate of around 3 per cent a year, inflation is on the high side but being successfully curbed, there is full employment and interest rates are comparatively high as demand for credit increases. At such times companies tend to prosper, vehicle and retail sales tend to increase, company earnings are sound and the stockmarket, despite fluctuations caused by intermittent good and bad economic news, is in a steady upward trend. Such periods, which may last years, are often followed by a period of much slower growth. Consumers who borrowed freely during the growth stage begin paying back debt and saving. Demand for credit falls, as do interest rates, as the central bank attempts to rekindle demand by lowering the price of credit. Unemployment increases, retail sales drop, company earnings dwindle and the sharemarket is likely to be in a slow but steady decline until recovery begins and the cycle starts again.

Economic indicators. Sharemarkets are constantly in a state of attempting to guess what the economy will do next – continue in the current stage of the cycle or begin a new one. They look at indicators such as:

- Gross Domestic Product (GDP), which measures the nation's overall productivity.
- Employment rates, which indicate growing prosperity if unemployment is rising and increasing financial hardship if it is falling.
- Interest rates. Rising interest rates indicate demand for credit is increasing, a healthy sign. Falling or very low rates indicate a period of sluggish growth or downturn.
- New housing and vehicle sales. People buy houses and cars at times of economic upturn, growth and optimism. Falling sales indicate uncertainty about the economic future or lack of the capacity of consumers to buy.
- Retail sales. When the economy is growing, retail sales tend to improve, which in turn benefits manufacturers , retailers and credit providers, whose better earnings tend to drive the overall sharemarket higher. Falling retail sales threaten this prosperity and tend to lead to a falling market.
- The consumer price index (CPI), which measures inflation. Inflation is normally expected to be of the order of 2 per cent a year. If it is much more, it is a sign that the economy is growing very strongly and may become overheated. If inflation is very low, it indicates sluggish growth in the economy.
- Commodity prices. Since all economies consume raw materials, and these are important inputs into company profitability levels, commodity price increases tend to indicate growing demand, but may also be inflationary. For a commodity producing country like Australia, rising commodity prices improve the profitability of resources companies, which make up a major proportion of the local sharemarket index. Among the most important commodities in this context are oil, precious and base metals and agricultural commodities, especially grains.

Technical Analysis

Technical analysis is the study of changes in price and volume as a way of working out which way a share index or commodity is likely to move next.

Markets are unpredictable, but people are not. They tend to over-react, first in one direction and then in another, and charts can help in identifying possible turning points for CFD trades.

Remember that the chart of a share price, index, currency or a commodity like gold, can't make accurate predictions about future price direction, and is not expected to. CFD traders who use charts do so to get an edge – to lift the number of potential winning trades by identifying possible turning points in share and other market prices.

Such turning points can be elusive, because although traders do tend to respond to similar situations in similar ways, each unfolding of price is different from every other. Technical analysis assumes that the similarities will be enough to indicate, at least as often as not, when a market is likely to turn.

Turning points are also entry and exit points for successful trades, so we want to get as close to them as possible, recognising that it's almost impossible to pick tops and bottoms exactly. We also want to catch the longer-term moves in the time frame we choose – perhaps a few days or a week – without being caught by short-term moves in the opposite direction.

Before entering a trade, we want to know exactly where we should be getting out at a loss if the trade happens to go against us.

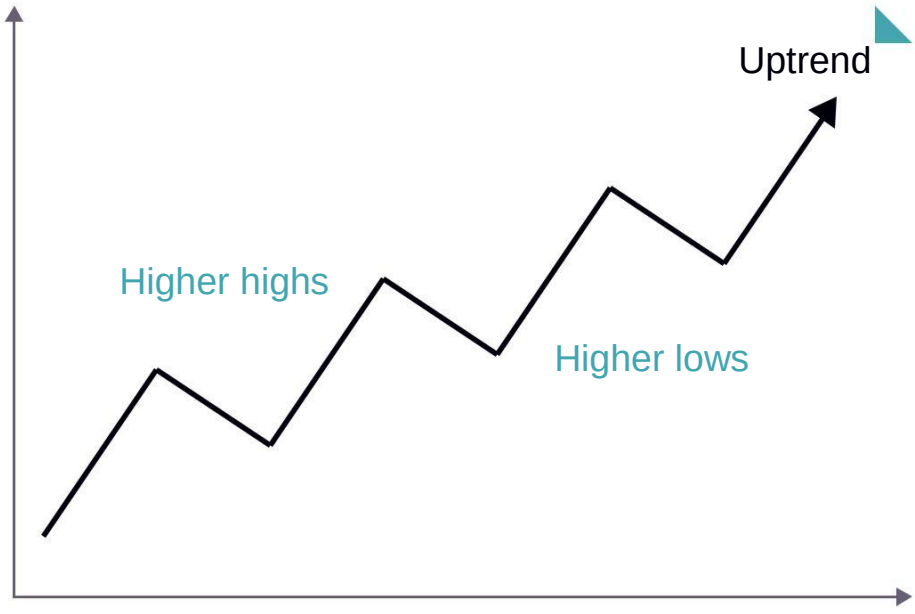
If I buy index or commodity CFDs, I need an order to get me out of the trade if the price starts to fall. The question is, how far must it fall before I decide to quit?

Here is where technical analysis can help, since the answer – as well as the answer to "when should I buy or sell to begin with?" is given by research into how that particular stock, or commodity, has behaved in the past. Technical analysis using past price data shows which patterns and indicators tend to work best for the stock or currency in question.

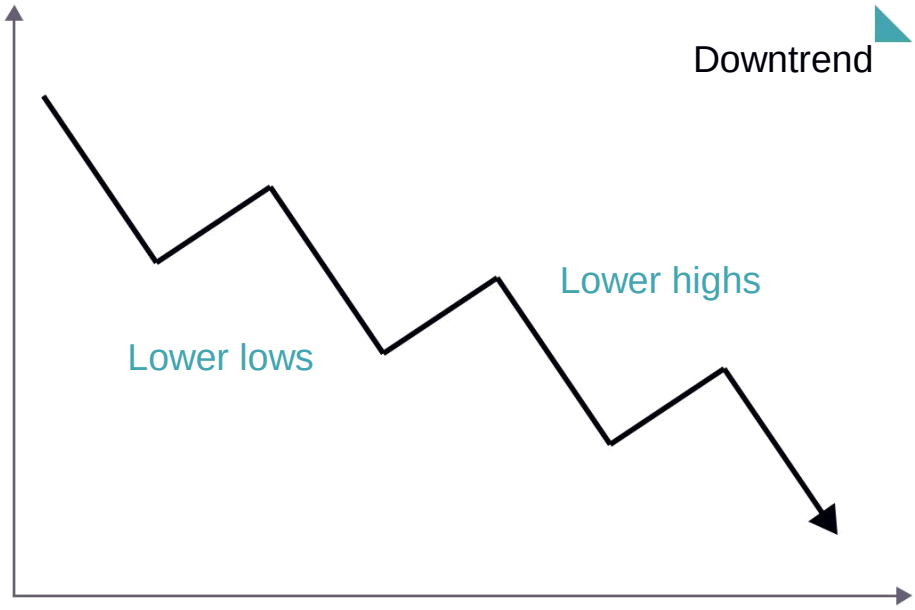
Although charts are essential for a complete picture of the market, a shift in basic fundamentals – factors that affect supply and demand – can make nonsense of a chart's signals, which is why it's often advisable to take this into consideration when such news about such fundamentals is expected, and always a good idea to follow the relevant economic and business news and trends.

UPTREND AND DOWNTREND LINES

The trend line – up or down – is one of the basic chart patterns and one of the most reliable. Markets don't usually move up or down evenly. After moving up, they often dip to a low, then move much higher before dropping back to another low, higher than the last. If you can join a series of three of these ever higher low points in a straight line, you have a trend. If the price stays above the trend line, the upward movement is likely to continue, but if it falls convincingly below it, a new downward trend is likely in the near future.



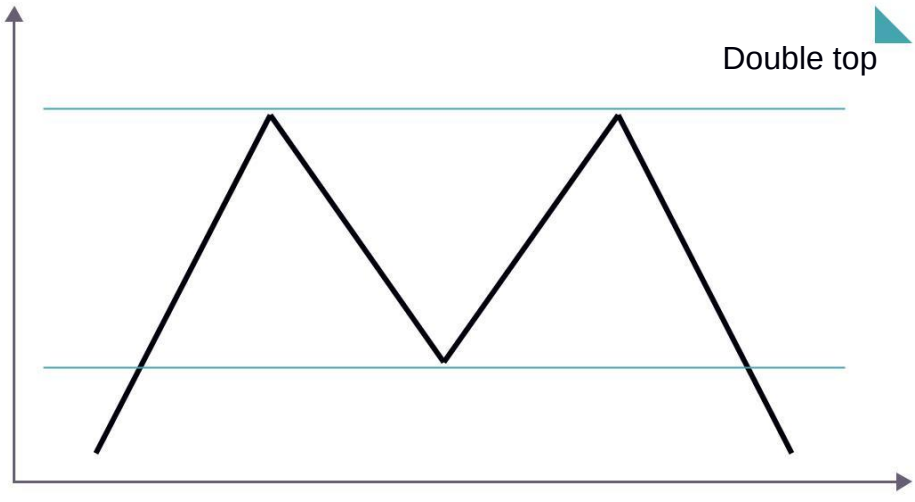
The reverse of this is the downtrend line, in which a series of ever lower peaks are connected, with at least three in a straight line defining a downtrend. The downtrend line forms a downward slope to the right, sitting on the succession of lower peaks, and if the price breaks up firmly through the downtrend, this is a buy signal.

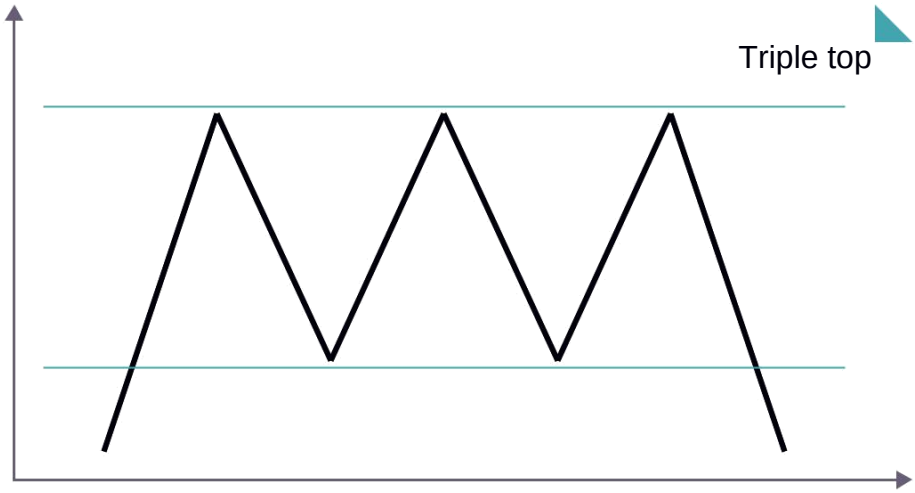


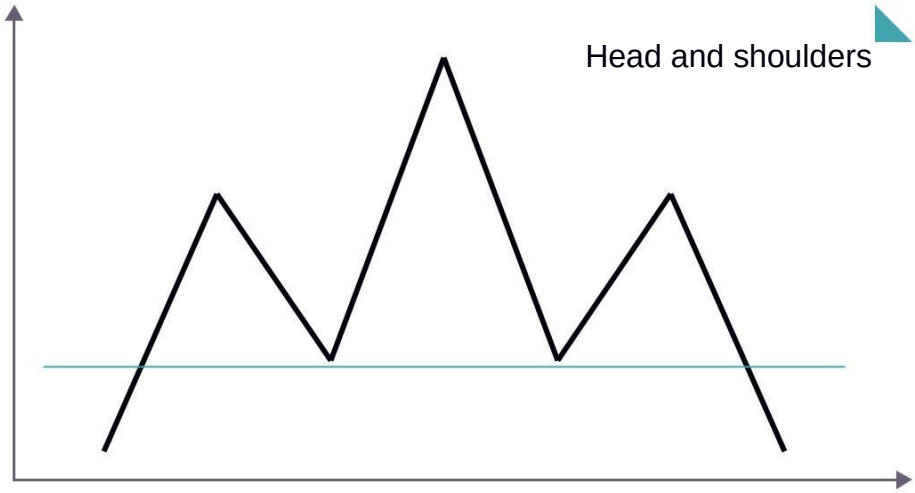
REVERSAL PATTERNS

There is a variety of standard patterns that indicate the market is about to change direction, and traders need to be familiar with them all – double and triple tops and v-reversals, for example, among others.

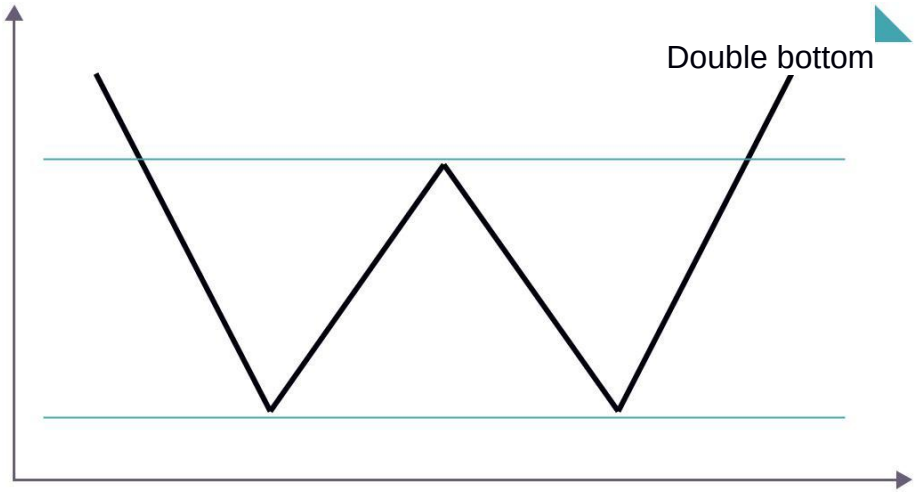
The head-and-shoulders top is considered one of the most reliable, although it appears only rarely. A top pattern is one that indicates a likely imminent price fall. A head-and-shoulders top occurs when a market forms a peak (left shoulder) followed by a higher peak (head) and a third peak more or less level with the first (right shoulder). The neckline joins the two low points on either side of the head, and the target price is the same distance below the neckline as the top of the highest peak is above it.

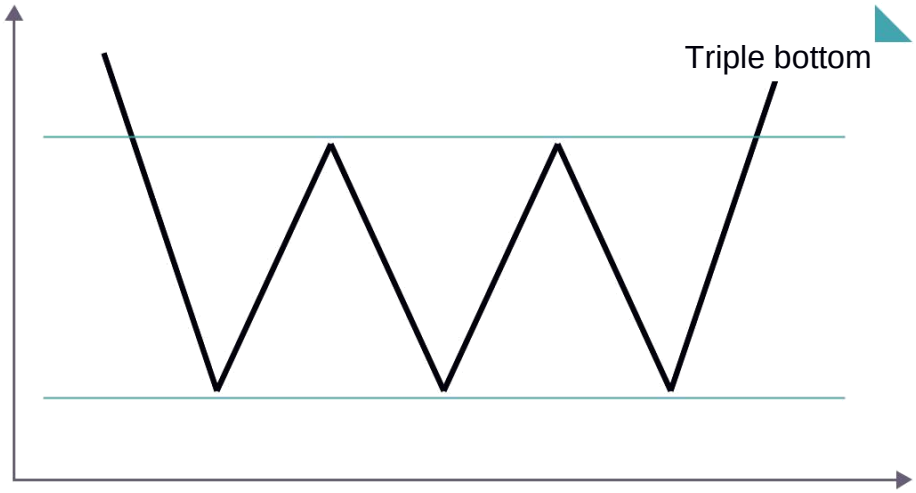


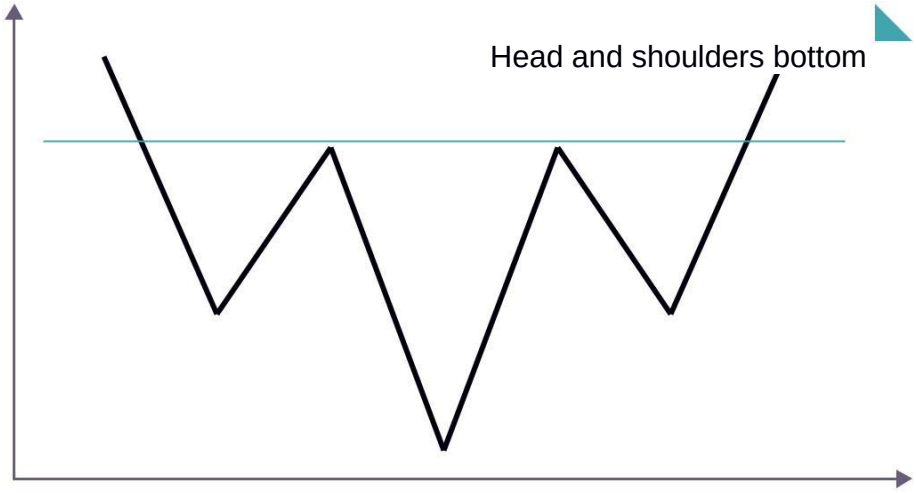




All the top patterns have corresponding bottom reversal patterns, which indicate the market has fallen as far as it's going to, and will now begin to rise. A head-and-shoulders bottom looks like the top variety turned upside down, with the target price the same distance above the neckline as the head is below it.

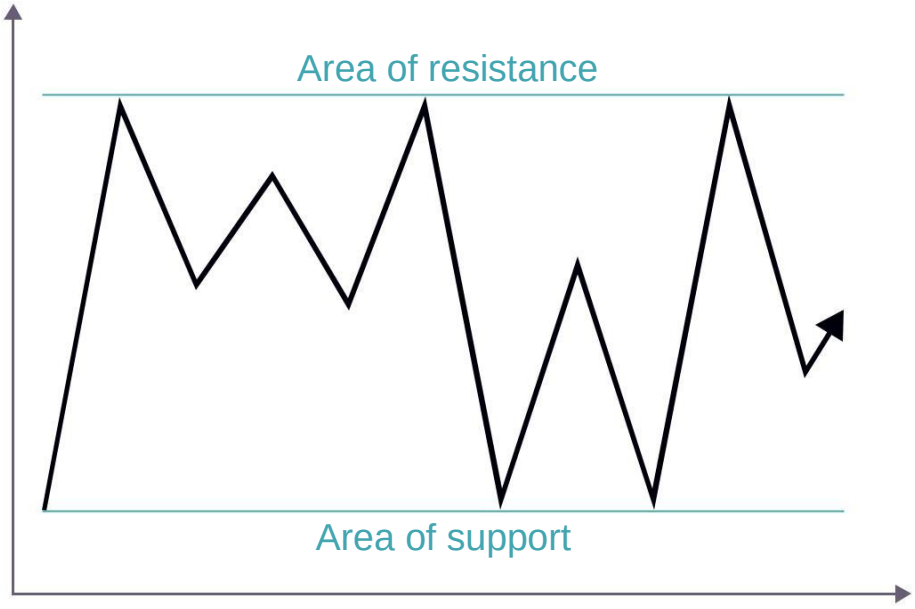



Triple bottom


Head and shoulders bottom

SUPPORT AND RESISTANCE

Along with a simple trend line, support and resistance are perhaps the most useful indicators for traders seeking entry and exit points and setting stop-loss levels. A support level is where the price has, in the past, been moving down but has run into fresh buying and bounces back up. At a price where this has happened more than once, a support level is considered to be in force, and the price is likely to bounce off the support level if it reaches it again. If a price moves up from a support level and you buy CFDs, place the stop-loss order price just below the support price, since a break through it is likely to result in loss if you hold the position.



On the other hand, if the price repeatedly moves up to a particular level to find that fresh selling halts the upturn and sends the price south, this is known as a resistance level. Place the stop above this level if the market moves down from a previous resistance point and you sell CFDs.

If a downward moving market can convincingly penetrate a support level, or when a rising market easily moves through a resistance level, this is a sign that the current trend is strong and likely to continue. It represents a possible entry point, to be confirmed by other signals.

MOVING AVERAGES

Take the closing price of a share on each of the past ten days, add them and divide by ten. Plot the figure on the bar chart along with today's prices. Repeat the procedure the next day, dropping the oldest price and inserting the latest, and you're now plotting a ten-day moving average.

Ten days, 30 days and 200 days are among the typical periods used, but moving averages can be calculated for any period. A share index or commodity that has been trading below its moving average and whose price rises above the moving average is giving a possible buy signal. The longer the period of the moving average, the more reliable the signal tends to be; the shorter the period, the earlier the signal. Finding the optimum trade-off between these two for the share index or commodity CFD you're trading involves doing some research into its past behaviour.

A popular type of moving average is one that is weighted to give recent prices more effect on the average than prices on earlier days. Technical analysts also calculate moving averages for more than one period and look for places where the longer term average crosses the shorter term or vice versa, or where they diverge. This analysis is known as moving average convergence and divergence, or MACD.

INDICATORS AND OSCILLATORS

Chartists use a variety of analysis tools, some of them quite complex. They include relative strength indicators (RSIs), which attempt to show whether a market is overbought or oversold, momentum indicators, and oscillators based on statistical analysis. The relative strength indicator looks at the size of recent upward movements compared to downward ones and signals an overbought market – one in an uptrend but due for a fall – with an RSI of 70% or more. A market is probably oversold – one that has been dropping but is likely to rise – has an RSI of 30% or less. Indicators and oscillators like these should not be used in isolation – they may give poor signals unless these are confirmed by other technical factors.

Example Trades

LONG TRADE – E-MINI DOW INDEX CFDS

CFDs for the E-mini Dow Index are based on the corresponding futures contract on the Chicago Board of Trade, part of the CME group of futures markets formed in 2007 and which now also includes the NYMEX (the New York Mercantile Exchange) and Comex (the New York Commodities Exchange).

The Dow Index itself is the well-known Dow Jones Industrial Average, which is based on prices of the 30 highest-priced stocks on the American stock exchanges (including the New York Stock Exchange and the NASDAQ exchange for predominantly technological stocks). The companies include such household names as General Electric, McDonald's, Procter & Gamble, IBM and Kraft Foods.

E-mini Dow Index CFDs give traders the opportunity to trade a much smaller contract size than the standard Dow Jones index futures contract, which is for USD10 times the index. The mini contract is half that size, at USD5 times the index.

Your technical and fundamental analysis suggests that, after a period of decline, the US sharemarket is about to stage a recovery. You have trading capital of AUD100,000. The futures market price for the closest active month, based on the Dow Jones Industrial Average, is at a level of 11,255 and you decide to buy at this level, placing your stop-loss order at 11,198 -- just below the support level you have identified.

Since the stop-loss order is 57 index points below the entry, your expected maximum loss is 57 x USD5 or $285 on each contract you trade. With capital of AUD100,000 the maximum permitted loss under risk management rules is $1,000, which means you can trade 3 contracts at this stop-loss level.

If the Dow Jones Industrial Average futures price falls to your stop-loss level of 11,198, the stop-loss will be triggered and your loss on the trade will be USD855 plus costs.

On the other hand, if the index rises to 11,515, and from your study of the charts you think the market is now due for a downward correction, you exit the contract at a profit as your trailing stop is triggered (see "Stay in the market as long as possible", p. 15).

E-MINI DOW

	OPEN TRADE	CLOSE TRADE
DATE	8-Mar	12-Mar
B/S	BUY	SELL
CODE	YMH1	YMH1
PRICE	11255	11515
QTY	3	3
VALUE	$168,825	$172,725
MARGIN(3%)	$5,064.75	$5,181.75
BROKERAGE	$45.00	$45.00
INTEREST	0	0
FUNDING RE-QUIRED	-$5,109.75	$0.00
TOTAL TRADE CONSIDERATION	-$168,870	$172,680
PROFIT/LOSS		$3,810

Profit before costs is USD3,900. Your costs will be a flat rate brokerage of USD15 to open each of the three contracts (USD45) and USD15 to close them (USD45 and an interest charge based on current interest rates less average dividends over the four days which is built into the opening and closing prices. Total costs on the trade, excluding the small interest charge, are therefore USD90, giving a net profit of USD3,810.

CURRENCY CONVERSION

FP Markets will set up a ledger in the corresponding currency to account for all transactions. As cash costs are triggered – such as brokerage, interest payment, and the closing price for the position – these will be brought back to Australian dollars the following morning Australian eastern standard time between 10am and 12pm.

Your profit of USD3,810 is converted into Australian dollars at the current exchange rate using our house foreign exchange dealing facility, giving you a more competitive rate than your bank. At an exchange rate of USD1.0205 per Australian dollar, for example, your profit would be AUD3,733.

SHORT TRADE – SPI 200 CFDS

The SPI 200 futures contract traded on the SFE division of the Australian Securities Exchange (ASX) is based on the S&P ASX index of the 200 largest Australian listed stocks by market capitalisation.

Fairly high levels of trading capital are needed to trade this contract with its value of around $100,000 (at an index value of 4000). For this example, we will assume available trading capital of $200,000, which means your maximum acceptable loss on any trade is $2,000.

Your analysis of price charts and fundamental factors suggests that the Australian sharemarket is showing signs of an approaching drop in value. You decide to sell index CFDs at around the current futures level of 4360.0, expecting it to reach 4012.0 over the next few weeks. Average daily trading ranges and other technical factors suggest that your stop-loss order should be placed at 4435.0, or 75.0 points above the entry price.

This stop, if triggered, would result in a loss of $25 x 75.0 per contract, or $1875, indicating you can trade no more than one contract under standard risk management rules. You sell one contract at 4360.0. If the market unexpectedly rises, your position is stopped out (your automatic exit triggered) and you buy back at a loss of $1,875, as expected.

Here is the result if the market almost reaches your target price of 4012.0 but then makes a reversal, signalling an exit at 4025.

SPI 200

	OPEN TRADE	CLOSE TRADE
DATE	25-Apr	17-May
B/S	SELL	BUY
CODE	APM1	APM1
PRICE	4360	4025
QTY	1	1
VALUE	$109,000	$100,625
MARGIN(3%)	$3,270	$3,018.75
BROKERAGE	$15.00	$15.00
INTEREST	0	0
FUNDING REQUIRED	-$3,285	$0.00
TOTAL TRADE CONSIDERATION	$108,985	-$100,610
PROFIT/LOSS		$8,375

Costs are based on commission only. Commission of AUD15 is charged per contract, equating to a total round trip cost of AUD30. Interest & dividends are incorporated into the futures price and thus are not payable.

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

Level 5, Exchange House 10 Bridge Street
Sydney NSW 2000

T:- 1300 376 233

F:- +61 2 8252 6899

fpmarkets.com

AFSL 286354 ABN. 16 112 600 281