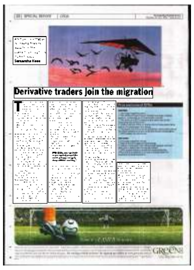

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A simpler alternative is drawing traders away from the warrants and options market, says **Samantha Keen.**

Derivative traders join the migration

The popularity of contracts for difference, or CFDs, lies in the fact that they are a relatively simple to understand form of derivative. However, just like any other derivative product, the risk of losing a lot of money – much more than the original investment – remains high.

Warrants or options are more complicated but will give you similar leverage over shares or an index contract. You pay a small premium relative to the value of the underlying investments and if the price moves as you expect, the reward can be a handsome profit. If you lose out, then the original investment is gone.

Another similarity between warrants and options, and CFDs is that the trader never actually owns the underlying asset, but rather speculates on the movement in its price. Traders derive a profit or a loss depending on the difference between the opening and the closing price of the asset. Unlike warrants and options, the CFD trader holding a long position receives dividends and other benefits of share ownership.

Justine Pollard, sole principal of Newcastle-based investment business Smart Trading, www.smarttrading.com.au, says she trades full time after having traded on a range of different instruments over the last five years, including options, warrants, shares and CFDs.

"Basically I had a good experience trading shares and the next thing I wanted to try was derivatives. Everybody talks about options and makes it sound like it's easy money. But when you do it, it's a whole other story," Pollard says.

"I left my full-time job in 2000 and traded full-time. I spent most of that year trading options and warrants without a great lot of success."

Pollard explains that the price of an option is determined through complicated calculations relating to the movements of share prices and the volatility of the share to which they are linked.

The good thing about CFDs compared to options is that the pricing is simply linked to the price of the shares or index to which they relate and there are no expiry dates, Pollard says.

> **'With CFDs, you can trade in any market around the world and you can go to sleep without worrying.'**

The relationship between the price change of the underlying asset and the CFD is very simple. If shares in BHP Billiton, for example, rise by 5¢, then a CFD based on those shares will also rise by 5¢.

Eva Diaz, communication manager at CMC Markets and author of the book *Real Traders, Real Lives and Real Money*, published by Wrightbooks, says the prices of CFDs are a straight one-to-one to the asset.

"It's cheaper and easier to trade in this market," Diaz says.

Just like any other derivative product, the biggest pitfall of trading CFDs is in the leverage. The margin requirement of a CFD is just 3-10 per cent of the share or product to which it is linked.

If you have a $10,000 stake and you are gearing $100,000 of equity, then you only need a 10 per cent price move to wipe out your entire capital base.

Pollard points out that leverage is a double-edged sword – you can increase your profits by a lot but you can increase your losses by just as much.

Unlike warrants and options that limit losses to the premium that traders initially outlay, losses on CFDs can be higher than the initial deposit.

A losing position on a CFD is subject to a margin call where the trader must top up collateral to maintain the original loan-to-value ratio.

Pollard says that to limit downside risk, investors can do one of two things. They can reduce the degree of leverage at which they trade or use guaranteed stop loss orders.

A stop loss order allows the trader to choose a price at which the trade will automatically exit. A guaranteed stop loss order costs about $30 and gives the guarantee that the trade will definitely exit at a given share price, even if the shares have fallen below that chosen benchmark.

"Everything is taken care of for me," Pollard says. "Stop losses means that CFD trading is not so demanding on yourself. With CFDs, you can trade in any market around the world and you can go to sleep without worrying as you can set up stop loss orders. It opens up to a whole new realm."

Dan Semmler, head of CFDs at Macquarie Bank, says the biggest benefit of CFDs is that they allow retail traders access to functions that were previously only available to professional investors.

These functions are the high gearing, the ability to short sell, the ability to have lots of transactions

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calculated through one account and trading on a diverse range of markets such as foreign exchange and offshore products.

Pros and cons of CFDs

THE PROS

- Leverage magnifies gains.
- The ability to trade shares, foreign exchange, indices, sectors, commodity and interest rate markets.
- The price of a CFD changes at the same rate as the underlying instrument price.
- Unlike options, CFDs on shares do not have expiry dates and do not experience time decay.
- The buyer of a CFD receives dividends, stock splits and all the other benefits of share ownership except voting rights.
- CFD traders can short-sell.

THE CONS

- Leverage magnifies losses.
- Daily interest charges on borrowings.
- Hidden costs when the CFD provider quotes a bid and offer that is wider than the actual market.
- CFD market makers provide the market liquidity.
- The CFD is a relatively new and untested market in Australia for retail investors.

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