

STRATEGY OVERVIEW

Strategy Name	Directional CFDs
Time Decay	Does not affect CFDs
Underlying Outlook	Bullish or Bearish
Margin	Margin is held for the risk involved in trading CFD's. A secondary function of margin is also to protect your capital as it works in a similar way to a built in stop loss.

What is a CFD?

A CFD (or Contract for Difference) is simply an agreement to exchange the difference in value of a particular financial instrument between the time at which the contract is opened, and the time at which it is closed. CFDs allow you to buy or sell at the quoted price enabling investors to profit from rising or falling markets. CFDs are a convenient and inexpensive method of short selling shares.

The financial instruments that can be traded using CFDs are numerous. From a single trading platform investors can gain access to markets such as commodities, foreign exchange, overseas stock market indices and the shares listed on those exchanges, as well as options on Australian and overseas assets.

CFD Types explained

There are various CFD models available to investors and it is important to note the key differences between them to help you choose the model that best suits your trading and investing needs. The major CFD models are Direct Market Access and Market Maker.

Direct Market Access

Direct Market Access (DMA) CFDs provide the actual prices and liquidity present within the exchange. Trading using this model eliminates the need for a 'middle man' (or market maker) as orders are passed directly through to the physical market in real time using real prices, resulting in the investor benefiting from complete order transparency.

Market Maker

As the name suggests, this model involves the use of a Market Maker (MM). The market and prices available through a Market maker are based on the actual exchange, but are not physically linked to the exchange; essentially the market is synthetic. This method of trading can be advantageous to an investor in a number of ways. Firstly, the Market Maker may be able to provide a higher degree of liquidity on particular stocks, and they can potentially compensate for a lack of market depth at a particular price. Investors may also gain exposure to a wide range of exotic markets, indices and currencies using this model as well as the added protection associated with guaranteed stop losses.

Strategy

Similar to Futures, CFDs cover a broad range of products. Share CFDs allow a position to be leveraged in a similar way to a margin loan with outright stock purchase. CFDs are easily traded intraday and can return significant profits with limited outlay.

Our Directional CFDs strategy attempts to identify short to medium term trends (both going up and going down) in the top 100 shares of the Australian market. It uses a technical approach that combines chart analysis with a few chosen indicators that we believe signal the beginning of a trend, to confirm entry.

Ideally we are targeting small moves in the underlying share. Strict money management techniques are also implemented to protect your trading capital and lock in profits. This is achieved with a combination of technical and trend stops which are usually below an important technical support/resistance and trail the underlying share as it moves in a favourable direction. As these stops are not guaranteed, gaps in the security may cause greater losses however as we are constantly monitoring the trades there chances of this occurring are relatively small.

The strategy involves constantly monitoring the market for opportunities that fit our entry parameters, mainly focusing on the top 100 shares as these instruments trade with sufficient liquidity to implement the directional-based strategy. Once an entry signal appears we monitor the chart for a confirmation signal and then enter the position at the next available price.

Example

Underlying:	BHP
Margin per contract	5%
Value per point move	In line with underlying
Expiry	No set expiry however traded intraday.

Greg is looking at BHP and notices that it is showing signs of an uptrend forming. He decides to go long and enters the CFD when BHP is trading at \$43.02. He buys 1000 shares through a CFD.

If Greg purchased the underlying shares he would be up for \$43,020 plus costs however as he has purchased the shares through a CFD he only needs to put up 5% of the face value. This means that he only needs \$2,151 in his account to control 1000 shares of the underlying.

Greg's analysis is correct and during the day BHP rises to \$44.00. He closes his position by selling the CFD's and makes a profit of \$980. The calculation is below:

$$\begin{aligned} \$44 - \$43.02 &= \$0.98 \text{ profit} \\ \$0.98 \times 1000 \text{ shares} &= \$980 \end{aligned}$$

Hedging

Hedging is an investment made in one instrument in order to offset the risk of price fluctuations in another instrument. A benefit associated with trading CFDs is the ability to short sell stocks or other instruments thereby allowing an investor to hedge existing long positions they may have.

The Directional CFDs strategy involves looking for uncommon situations that the average investor does not have access to (such as proportional takeovers) and using CFD's to reduce or hedge the downside risk of the trade whilst still allowing upside.

Example involving Hedging

XYZ was under a proportional takeover from a Japanese company WXY. WXY offered to purchase 20% of XYZ for \$14 (about a \$3.50 premium over the price of XYZ at the time). It was recommended that investors purchase XYZ shares and also sell CFD's against their position to hedge their holding. This effectively meant that the maximum loss was the transaction cost associated with opening the position whilst still allowing the investor to benefit from the substantial takeover premium on offer.

When the deal was finalised and a record date for determining entitlements announced, investors were advised to unwind 20% of their hedge and tender their shares at \$14.

The result was a very low risk trade that produced very good returns.