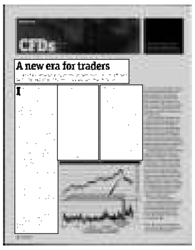

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BOTTOM LINE

CFDs

CFDs allow investors to punt on the price performance of a stock, index, currency or sector

A new era for traders

Times of extreme volatility on the sharemarkets call for different tactics to protect profits. Toni Case explains the strategies.

It was all so easy until October hit. A steadily trending market had provided ample opportunities for gains, when along came October 5 to spoil all the fun. Over the week that followed, the S&P/ASX 200 Index shed 4.3 per cent of its value.

If you were on the wrong side of a contract for difference (CFD) trade, it wouldn't have been pretty. But things would have been fine if foresight, or luck, had already put on the short side of a trade, or if you swung swiftly into sell mode as the floor came out from under the market. Most people, though, will have lost money during this time.

The chart shows the extent of the market's volatility in early October. In fact, October 5 saw the largest daily range (the difference between the day's highest and lowest price) since the beginning of the bull market in March 2003. There is little wonder that its dramatic move downwards took people by surprise. It's also interesting to note from the chart that market volatility has been steadily rising since August.

Volatility can be both friend and foe. Often it's the highly experienced trader that befriends a volatile market – employing dynamic trading techniques to profit from a violent swing in the market's direction. Conversely, amateur traders are more likely to make the mistake of trading in the same manner as they've always done – and watch aghast as their successful portfolio quickly unravels.

Before we leap into discussing the best strategies to employ in volatile markets, newcomers to CFDs are probably scratching their heads in confusion.

What is a CFD?

In brief terms, a CFD is a margin-trading instrument that allows you to gain exposure to the price performance of shares, indices, currencies and sectors. You're only required to put up about 10 per cent of the value of the underlying instrument, but all profits and losses are yours as if you owned the share or index outright. CFDs are high risk because small moves in the underlying instrument can result in big gains and losses.

If you faired poorly in the recent market sell-off, CMC Markets analyst David Land warns against adopting a "revenge" trading mentality in an attempt to regain lost ground.

Taking bigger and faster positions is a sure-fire way of losing even more money, he says.

Instead, you're probably well advised to stay out of the market than to trade while in an emotional state, Land says. "Or take a more reserved approach to your trading until the market direction becomes clear again."

By this, he refers to holding a more balanced mix of long and short positions rather than adamantly sticking to long-only trades.

As soon as volatility spikes, you should automatically cut your position size on any new trades

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to reduce risk, according to David Hunt, chief executive officer of Adest Trading. "Your position size should ebb and flow with the volatility of the market," he says. You can reduce your position size by either contributing more money to a trade or reducing the leverage taken.

Hunt notes that October was characterised by fierce dips and sudden rallies. But volatility is generally worst on the downside as stop losses are triggered and traders are forced out. October is also notorious for being a low month as the end of the reporting season coincides with a number of companies going ex-dividend.

To profit from the recent market sell-off, David Skilton, head of sales at IG Markets, notes that a number of its traders purchased CFDs based on the performance of the entire ASX as a short-term punt on the market bouncing back. Other traders searched the market to buy stocks such as BHP Billiton and Rio Tinto that were heavily sold off. However, instead of holding these stocks overnight, most offloaded positions by the end of the day to safeguard against a market gap.

To sum up, the secret to success in trading volatile markets involves cutting position sizes or reducing leverage, enhancing your monitoring efforts and, most importantly, maintaining a level head. **Si**

Toni Case is a financial planner who has worked in stockbroking and in funds management.