Module 5

Attitude to risk

TradeSense

Module 5

Attitude to risk

In this module we take a look at risk management and its importance.

TradeSense Australia, June 2011, Edition 10

Attitude to risk

In the previous module we looked at the concept of gearing and how a CFD trade can offer an exposure many times greater than the deposit required in order to place the trade.

This then begs the question: are geared products unacceptably risky? It comes down to your own viewpoint, of course, and your own attitude to risk.

Without a doubt there are people who will consider geared products to be too risky. In fact, there will be people who consider anything other than cash and bonds to be too risky. Such an extremely risk-averse attitude is rare, and most people are comfortable distributing the majority of their funds across a safe broad-base and then complementing this with a smaller proportion of their wealth in asset classes with greater risk attached but also greater returns, such as equities.

You may be familiar with the concept of the investment pyramid, which lays out visually how a balanced investment portfolio should be structured:

Attitude to risk
(continued)

The higher you go up the pyramid, the more risky the type of investment is and the higher the potential return. At the bottom of the pyramid are the safest asset classes with the lowest returns; the base is broad and is designed to support the more speculative investments.

Geared products, including CFDs, would exist in the speculative section at the top of the pyramid: as we have seen in previous modules, with CFDs it is possible to lose more than your initial deposit but you also have the potential to make large returns for a relatively low injection of cash.

Hopefully, as someone who has opened a CFD trading account, you will have already made the decision to give geared investments a try.

In fact many of us, as homeowners, may have already experienced a gearing of sorts when taking out a mortgage: putting down a relatively small payment gives you access to a property that is often worth many times more than the money that you have outlaid.

With geared products it is essential that you always bear in mind the underlying value of any trade that you place.

Take our Australia 200 market for example (this is a market that is influenced by the 200 leading shares on the Australian Stock Exchange and that can be nominated to expire against the closing level of the ASX 200). A mini-contract on the Australia 200 gives you an exposure of $5 for every point movement. This might not sound like that large a deal, but with the market trading at a level of 3600 it means that you are commanding equity with a value of $18,000 (the level of the market multiplied by the $5 per point deal size). If the market was to halve in value – unlikely but far from impossible – you would lose 1800 points or $9,000.

Buying 60 shares of Google at a share price of US$400.60 is equivalent to investing US$24,036 in the stock. If the share price was to go all the way to zero, you would lose the whole US$24,036. If you were to do the trade as a CFD, your initial deposit would only be 5% of this underlying value: US$1201.80*. Quite clearly investing US$24,036 in Google by physically buying the shares offers you no less exposure than doing the equivalent trade as a CFD. In both cases, your worst-case scenario is losing the amount of equity that you are commanding which is US$24,036. The important thing is to not lose sight of how big your actual exposure is, and to always keep in mind that the deposit you are required to put down as margin is but a fraction of your total exposure.

**The margin rates quoted are for a Trader Account*

Obviously no one wants to lose money, but everyone has a different attitude to risk.

Most people who are new to trading tend to start being very risk averse – which is a sensible way to start off. It makes sense to take a softly-softly approach when you are finding your way. As a consequence, beginners often like to start off by placing smaller trades, and it is for this reason that we offer members of TradeSense the flexibility of smaller minimum commissions on shares and smaller than our usual minimums (i.e. smaller than one contract) on other markets.

We looked in earlier modules at trading with and without Stops. Clearly a position without a Stop-loss attached to it has a greater risk than an equivalent position with a Stop attached. As a result, if you are risk-averse it is likely you will want to trade with a Stop.

At the other end of the scale there are people that have a relaxed attitude to risk, are comfortable taking on a large exposure and are happy to run positions 'naked' without any kind of Stop-loss.

Trader Account

A basic deposit account, the Trader Account allows you the flexibility of trading with or without Stop-losses as you see fit.

The initial margin required for any trades that are placed on this account, whether you are trading with or without a stop, needs to be cleared on the account in advance (we looked at how initial margin is calculated in the last module).

If you are trading without a Stop-loss, there is no specified point at which a trade will be closed out should it move against you. As the initial margin required for a trade is just a small portion of the underlying value that you are commanding, you need to fund your account adequately if your positions run into a loss.

It is vital to monitor the status of your account and open positions, therefore: if your account balance does not sufficiently cover both the initial margin required for your trades and any running losses, we may cut back or close your open positions. We will endeavour to notify you by email that further funds are required before we get to this point, but in certain market conditions this may not be possible.

Risk management

Risk can be defined as exposure to uncertainty. Generally speaking, the more risky a product, the greater the potential return. For example, putting a lump sum of cash into a savings account for a known percentage return is a low-risk investment – you know what you will receive as a return over a fixed period of time and there is therefore virtually no exposure to uncertainty. The only risk is the risk of default – the unlikely scenario of the bank going under.

If you can receive 4 to 5% with a savings account, it follows that any investments that you are looking at that are more risky should offer potential returns that are greater than 4 to 5%. If the investments are slightly more risky, they should offer potential returns slightly in excess of this amount. If they are many times more risky, you should be looking for potential returns of several times this amount.

Diversification

One simple way to minimise risk is to have a balanced, diverse portfolio. If you are investing in shares, owning a number of shares across a range of sectors should protect you to some degree: the more diverse your portfolio the more likely it is that, should a certain sector perform poorly, other sectors may compensate.

Diversification can work for CFDs if, say, you are placing a large number of small trades on a large number of shares: diversifying the deals across a number of companies from a variety of sectors will work to spread your risk. Selling one index and buying another with which there has historically been a strong correlation will also no doubt serve to reduce your risk.

These are somewhat defensive measures though. In the same way as hedging, they help to reduce the chances of a loss, but can hamper your ability to maximise a profit.

It should also be pointed out that uncertainty may come in the form of ignorance. When trading a particular market, the more you know about that market, the less uncertainty there will be. Placing a wide range of trades across a lot of very different markets will inevitably spread your knowledge and research precariously thin. For example, if you are dealing simultaneously on the FTSE 100, the euro versus dollar exchange rate, the price of coffee and the price of oil, it is unlikely that you will be able to satisfactorily keep tabs on the assorted economic indicators and specific pieces of news which will be affecting the price of each market. This increases the chance of being caught out by an unexpected price movement that you may otherwise have been aware of had you been concentrating on the one market.

For this reason, it can pay off to specialise in certain markets, and focus your efforts in those areas with which you are comfortable, and most knowledgeable. So, although with CFDs you may be able to trade thousands of markets, there are no medals awarded for dealing them all – it may be worth trying out different markets if it isn't immediately obvious where your strengths lie, but once you have found a market that works for you, stick with it.

Selected risk

Sometimes it can be worth taking on a more risky trade if there is sufficient upside. The important thing is to be as aware as you can of the risks and to put in place measures to protect yourself – such as a Stop-loss – or be ready to act swiftly should you need to cut your losses. Consequently, it is essential to monitor the state of your CFD portfolio at all times; fewer open positions at any one time will clearly be easier to monitor closely.

A way to analyse the risk of a potential trade beforehand is to look at the historical volatility of that market; this should affect the way in which you deal. If you are trading on an instrument that has historically been very volatile, it may be a good idea to reduce your deal size. A low-volatility share or index might indicate that you should increase your deal size.

Risk Management

In the case of the high-volatility instrument, a smaller deal size will allow you to place a wider Stop-loss than normal. You may well have correctly discerned the general movement of the market, but with a volatile market there is likely to be some kind of see-sawing effect on the way – you do not want to have your Stop-loss knocked out by such price-swings, which are insignificant in terms of the overall trend.

Risk/reward ratio

This is a straightforward notion, whereby the expected gain to be made from a trade is likely to be in excess of the potential loss. The ratio is calculated as the expected gain divided by the worst-case scenario (so you really need a Stop-loss attached in order to quantify this).

For example, buying the Australia 200 market at 3550 with a limit at 3650 and a Stop-loss at 3500 has a risk/reward ratio of 2:1 – if you think it is likely to move that whole 100-point range. You are trying to gain 100 points of profit, whilst risking 50 points.

The notion of risk/reward ratio is fairly theoretical as the real probabilities of the two outcomes are unlikely to be known and there may be unforeseen potential risks. Nevertheless, it is a useful concept to bear in mind. In the above example, it wouldn't make much sense to run a 50-point risk in order to make a 20-point gain.

It is an oft-cited piece of conventional wisdom that the risk/reward ratio should be greater than 1:1 and ideally at around 2:1. In practice, the risk/reward ratio should be tailored to suit the specifics of the trade. If you think that you are likely to make money nine times out of ten on a certain trade, it may be worth going with a low risk/reward ratio. If you are taking a long-shot, it would demand an unusually high risk/reward ratio. Trial and error will no doubt be required to help you determine what ratio best suits any given trading strategy that you are utilising.


1234.56
789.12
567.24
9904.8
1267.46
4543.18
101.14
307.49
994.90
387.48
2456.00
9904.80
437.76
3679.10

Summary

By now you should:

- Be acquainted with how a balanced investment portfolio is structured
- Have a feel for the risk of CFD trading in comparison to other investments
- Understand diversification of risk and risk/reward ratio

Remember that CFDs are a geared product and can result in losses that exceed your initial deposit. Trading CFDs may not be suitable for everyone, so please ensure that you fully understand the risks involved.

Please note that although the material contained within TradeSense is updated regularly to ensure accuracy, the information given is subject to change, often without notice, and therefore may not reflect our most current offering. It is for guidance only and no liability is accepted by IG Markets for its accuracy or otherwise.

A Product Disclosure Statement for our CFD product is available from IG Markets Ltd and should be considered before deciding to enter into any transactions with IG Markets Ltd.

This programme is provided for information purposes only and should not be regarded as financial product advice. The information does not take into account your specific objectives, financial situation or needs. Therefore, you should consider the information in light of your specific objectives, financial situation or needs before making any trading or investment decision. IG Markets recommends you take independent financial advice before any decision about whether to trade with IG Markets in the products we offer.

TradeSense is a trading name of IG Markets Ltd. Minimum commission, interest, exchange fees, variation margin and other fees and charges may apply. ABN 84 099 019 851. AFSL No. 220440.

IG Markets Ltd
Level 7
417 St Kilda Road
Melbourne VIC 3004

1800 601 799
(NZ: 0800 442 150)
www.tradesense.com.au