

ATTITUDE TO RISK

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



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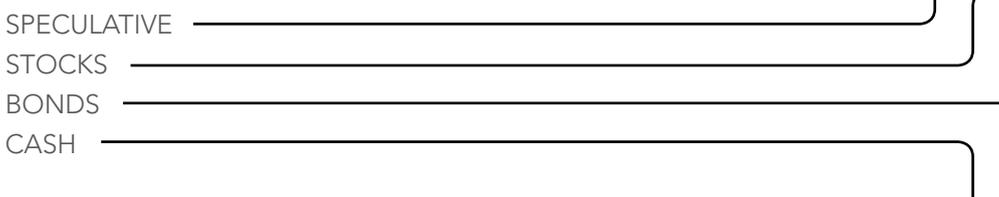
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ATTITUDE TO RISK

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

At first, this increased exposure might make geared forms of trading seem unacceptably risky. However, geared products are in common use and ultimately it comes down to your personal attitude to risk. While there are people who consider geared products to be too risky – and some who consider anything other than cash and bonds to be too risky – such an extremely risk-averse attitude is rare. 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 money in asset classes with greater risk and greater returns, such as equities.

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



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.

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Geared forms of trading, 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 deposits but you also have the potential to make large returns for a relatively low injection of cash.

Many homeowners may have already experienced a gearing of sorts when taking out a mortgage: putting down a proportionately small payment gives you access to a property that is often worth many times more than the money you have laid out.

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

Consider trading Wall Street Cash with us for example (our Wall Street price allows you to gain an exposure to 30 of the leading shares in the US. A mini contract on Wall Street gives you an exposure of \$2 for every point movement. This might not sound like that large a deal, but with the market trading at a level of 13390 it means that you are commanding equity with a value of \$26,780 (the level of the market multiplied by the \$2 per point deal size). If the market was to halve in value – unlikely but far from impossible – you would lose 6695 points or \$13,390.

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Buying 100 shares of Google at a share price of \$765.50 is equivalent to investing \$76,550 in the stock. If the share price was to go all the way to zero, you would lose the whole \$76,550. If you were to place an equivalent trade as a CFD your initial margin would only be 5% of this underlying value: \$3827.50.* Quite clearly investing \$76,550 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 \$76,550. 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.

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. As a consequence, beginners often like to start with small trade sizes, which is why our introduction programme offers the flexibility to place trades that are smaller than our usual minimums (ie smaller than one contract) when taking an exposure to 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.

*The margin rates quoted are for a Trader Account

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 be applied when using our CFD trading service 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.

RISK MANAGEMENT

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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 using our CFD trading service to simultaneously gain exposure to 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 underlying 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 just one market.

Of course, there are some unusual instances in which a market can move unexpectedly, regardless of how well you've studied it. For example, when the Swiss National Bank unpegged the Swiss franc from the euro in January 2015, the resulting market gap took the vast majority of traders by complete surprise. While instances like this are rare, they do highlight the importance of having a sound risk management strategy.

For the best chance of staying on top of price movements, 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 you can easily use our CFD trading service to speculate on thousands of markets, there are both advantages and disadvantages to trading across a large and varied range. 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 suits you, you might want to narrow your focus.

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.

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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 are likely to be some sharp price movements around the prevailing trend— you do not want to have your Stop-loss knocked out by such price-swings, which are insignificant in terms of the overall market direction.

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 Wall Street at 13300 with a limit at 13400 and a Stop-loss at 13250 has a risk/reward ratio of 1:2 – 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 conventional wisdom that the risk/reward ratio should be greater than 1:1 and ideally at around 1:2. 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.

SUMMARY

By now you should:

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

Spread bets and CFDs are leveraged products. Spread betting and CFD trading may not be suitable for everyone and can result in losses that exceed your deposits, so please ensure that you fully understand the risks involved.

Please note that although the material contained within our introduction programme 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. Our examples are for illustrative purposes only and do not reflect events in the markets. The information is for guidance only and we accept no liability for its accuracy or otherwise.

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