Bundled CFD's...Another Risk Event Awaits

- **CFD's offer leverage and superior returns.**
- **They also carry heightened risk.**
- **It is 10-years since the start of the financial crisis.**
- **Be wary of too much asset bundling!**

What is a "contract for difference" or "CFD"?

In the realm of finance and investments, instead of being offered an actual underlying instrument such as an equity or fixed income instrument one can be placed into a contract for difference or "CFD".

These should be seen as nothing less than a leveraged product i.e. with a small initial investment, there is potential for returns equivalent to that of the underlying market returns.

Note we underline the word potential as with any investment nothing is assured, however, when leverage is invoked one can be sure that the risk factor is magnified.

For the professional trader, even a well skilled private player this would appear to be an obvious investment instrument. However, one should restate the age-old mantra of *caveat emptor* or buyer beware.

The reality is that where we deploy leverage, creating margin trades, the fact is that the position can magnify profits but also losses as well. The superficial advantages of CFD trading all too often masks the associated risks as shown in Figure 1.

Figure 1: The Several Levels of Interdependent Risk Associated With CFD's
Source: Spotlight Ideas

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Counterparty Risk (CPR)

The counterparty is that institution acting as the provider of the asset in a financial transaction. In trading a CFD, as buyer or seller, the actual asset traded is the contract issued by the CFD provider.

Therefore, this creates an exposure of the investor to the provider's other counterparties, including other clients the CFD provider conducts business with. So, the risk is far murkier than the simple buying equity from a market maker.

The associated risk associated with these counterparties is founded on the probability that a counterparty fails to satisfy their financial obligations. The consequence being that if the provider proves unable to meet these obligations then the value of the underlying asset becomes irrelevant.

Market Risk (MR)

CFD's are clearly a member of the derivative family and if one believes the underlying asset will rise, the investor will choose a long position. Of course, it naturally follows that an investor will opt for a short position if they believe the value of the asset will decline in value.

Markets only exist because different agents hold differing opinions as to the direction of the next price movement. That implies someone must be wrong and even the most experienced traders or active investors are never correct 100% of the time.

Even a sophisticated pricing model can be blindsided by unexpected information, changes in market conditions, government policy or exogenous shocks. These can result in aggressive price changes. So the leveraged DNA of CFD's find that small changes in other variables may have a significant impact on returns.

An unfavourable effect on the value of the underlying asset may lead to a new margin call which if not met in a timely manner may result in the position being closed by force and so incurring a loss. Therefore, investors really need to be aware of what is their unique level of risk tolerance.

Client Capital Risk (CCR)

Not every jurisdiction allows CFD's i.e. they are classified as illegal in some quarters. However, where they are permitted one should study what client money legislation is in place to afford the investor protection from potentially harmful practices.

Legally, money transferred to the CFD provider must be segregated from the provider's money to prevent providers from hedging their own investments.

However, the law may not be so rigorous as to prohibit the client's money from being pooled into one or more accounts. When a contract is agreed, the provider will withdraw an initial margin and has the right to request further margins from the pooled account if price moves are adverse.

If several other clients in the pooled account fail to meet their margin calls, the CFD provider has the right to draft from the pooled account with potential to affect potential returns. In short, the investor may not be comfortable with the company they are keeping in the pooled account.

Liquidity Risks (LR)

Markets can be like the tide; they turn quickly and underlying conditions can affect many financial transactions and consequently magnify the risk of losses.

When there are not enough trades being made in the market, i.e. there is a lack of volume, for an underlying asset, the existing contract can become illiquid. At this point a CFD provider can require additional margin payments or close contracts at inferior prices, (see the section on market risk above).

Markets can move quickly from extremely low levels of volatility to sudden surges so causes the prices of assets to gap higher or lower in an instant. This fast flow means the market moves from being orderly to becoming *"plastic"* and the price of a CFD can fall before one's trade can be executed at a previously agreed upon price. This means the holder of an existing contract would be required to take sub-optimal profits or cover any losses incurred by the CFD provider.

Bottom Line (BL)

The bottom line is the investors profit and loss account (P&L). Leverage implies that for a small initial fee the potential for high returns/losses is large and we have illustrated how CFD trading can result in illiquid assets and severe losses.

In trading CFDs, stop loss orders are highly recommended although they can be irrelevant in plastic markets. They are designed to mitigate the apparent risks. To overcome fast markets, one may find a CFD provider will offer a protected or guaranteed stop loss order, however, one has to consider what fee is involved for such a service.

When thinking about partaking in one of these types of investments, it is important to assess the risks associated with leveraged products. **The resulting losses can often be greater than initially expected.**

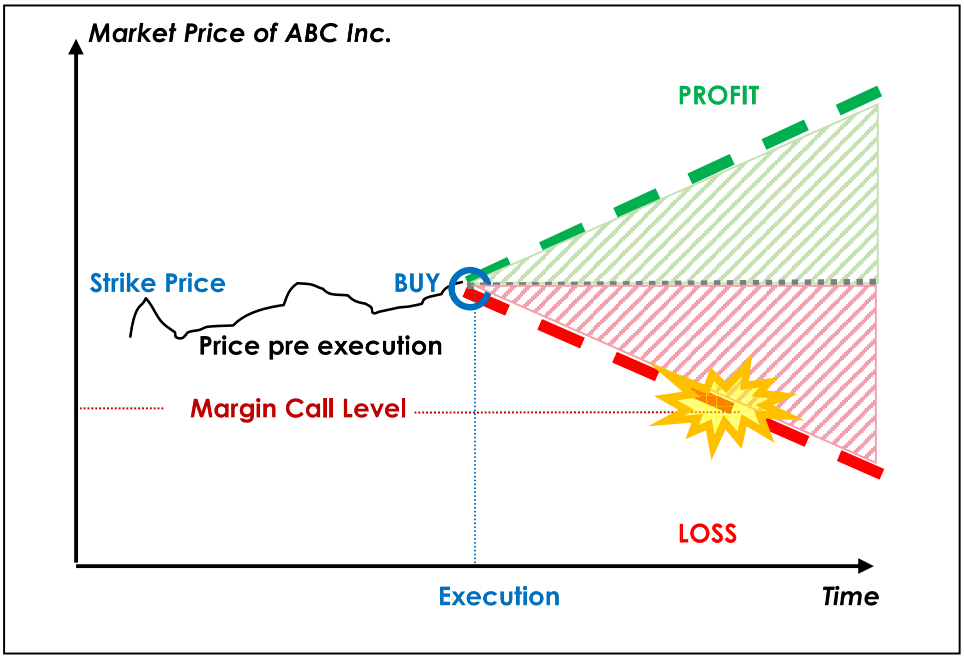

Figure 2: The Mechanism of CFD's; Losses Or Profits Can Be Generated
Source: Spotlight Ideas

The price at which a CFD is trading will always match the current market price of its underlying asset. If one wanted to acquire an equity CFD of ABC Inc. then the CFD will increase in value as ABC Inc.'s equity price increases. The illustration in Figure 2 is the bullish scenario. In contrast if ABC Inc.'s equity price decreases then the CFD loses value accordingly and at a certain, pre-agreed level of decline a margin call will be issued.

With leverage, one can agree to exchange the difference in price of a larger amount of an asset without committing to the full cost of the position at the outset. If one wanted to open a position equivalent to 500 ABC Inc. shares in a standard long equity trade that would mean paying the full cost of the shares. In contrast with a CFD, one could put up just 10% of the cost.

Of course, one will still exchange the difference in price of 500 ABC Inc. shares from when the position is opened to when it is closed out, so the profit and loss will still be calculated on the full size of the position. Therefore, profits can be multiplied many times; but so can the losses even to the extent of exceeding ones original deposit. Hence the seller may demand a margin call or close one's trade at a heavily loss.

Complex trading...larger risk

Not all trades or investment strategies are based around a bull or bear view of an individual asset.

As an example, foreign exchange is based around a "pair", e.g. Euro's and Dollars, EURUSD or Dollar's and Yen, USDJPY. If one part of the pair rises the other must fall in value, i.e. this is a binary decision. The same could be arranged for equities, e.g. a long position in BHP Billiton Plc and a short in Rio Tinto Plc.

Pairs trading strategy works by taking the arbitrage opportunity of temporary anomalies between prices of related assets which will tend to return to a long-run equilibrium level. When such an event occurs, one asset will be overvalued relative to the other asset.

One can then invest in a two-asset portfolio (a pair) where the overvalued asset is sold (short position) and the undervalued asset is bought (long position). The trade is closed out by taking the opposite positions of these assets after the asset prices have settled back into their long-run relationship.

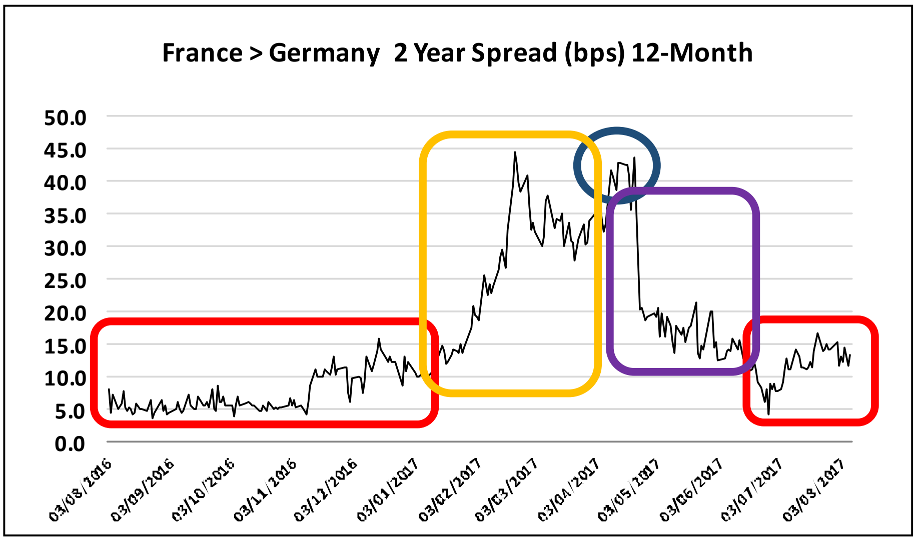

Figure 3: The Pair's Mechanism of French and German 2-Year Debt

Long-Run Relationship Spread

Election Risk, Could Le Pen Win? Sell France Buy Germany

Macron Wins...Therefore Buy France and Sell Germany

Be Prepared To Return To Neutral

Source: Spotlight Ideas

Figure 3 illustrates this point through the spread of French 2-Year debt over the German 2-Year in the past 12-Months. Market fears around the 2017 Presidential election created great pair trading opportunities by working the 2-Year spread of France over Germany.

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Pairs trading allows profit capture from short-term discrepancies in the two asset prices. Since the profit does not depend on the movement of the market, pairs trading can be said as a market-neutral investment strategy. However, the pattern can be broken as a relationship breaks out from an old channel by breaking over 2σ from the running mean of the trade. Unless there is a return to the former long-term equilibrium, a new trend may have evolved and being on the wrong side of the pairs trade can become extremely costly indeed.

For the investor that looks at pairs trading there are four approaches to be considered.

1. ***Distance approach***
2. ***Combine forecasts approach***
3. ***Stochastic approach***
4. ***Cointegration approach.***

If one uses CFD's positions to replicate the trade we at Spotlight prefer the cointegration approach.

This incorporates mean reversion into a pairs trading framework and if the value of the portfolio is known to fluctuate around its equilibrium value then deviations from this value can be traded against by using a cointegration coefficients weighted (CCW) rule.

The CCW rule works by trading the number of unit in two assets based on their cointegration coefficients to achieve a guaranteed minimum profit per trade. The minimum profit per trade corresponds to the pre-set risk tolerance boundaries upper-bound (U) and lower-bound (L) chosen to open trades. The optimal pre-set boundary value is determined by maximising the minimum total profit (MTP) over a specified trading horizon with respect to one's risk profile.

MTP is a function of the minimum profit per trade and the number of trades during the trading horizon. The number of trades is also influenced by the distance of the pre-set boundaries from the long-run cointegration equilibrium. The higher the pre-set boundaries for opening trades, the higher the minimum profit per trade but the trade numbers will be lower. Of course, the opposite applies for lowering the boundary values.

Worrying trends

A recent innovation in the field of CFD's is the use of "*Copyfunds*". These group together the top performing traders within an online brokers platform and allow the client to invest in them as a group.

It removes some of the risk associated with social trading and the idea is that copyfunds will diversify one's portfolio and spread the risk across many traders instead of just one or two.

Firstly, one needs to have enough capital to invest in many positions at once and for Spotlight the real concern is that for all the early levels of success the real leverage is generated by not just using singular CFD's.

Pairs are used and in addition they use the concept of bundling groups of CFD's together. This is said to mitigate some of the risk that investors are exposed to with a single CFD. Oh...we at Spotlight recall the same claim being made for collaterised mortgage obligations (CMO).

How long before one jurisdiction that allows CFD's will not just approve Collateralised CFD's (CCFD) but start rebundling those as well into even more magnificently leveraged tools:

CFD → CFD Pairs → CCFD → CCFD² → CCFD³

If these instruments are based around pooled accounts one could face a squeeze at both ends of the asset structure.

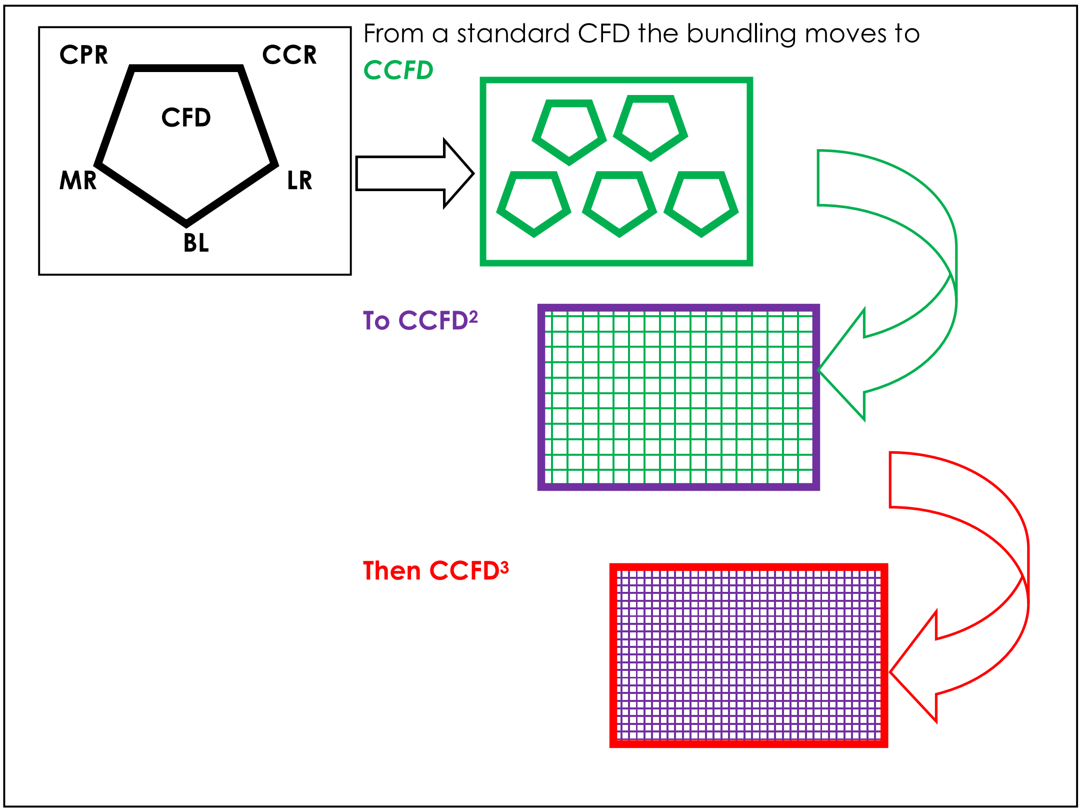

Figure 4: The Pathway of Bundling CFD's Opens Heightened Contagion Risk.
Source: Spotlight Ideas

Of course, all the while the wheel is spinning the markets allow CFD's, pairs and even the bundled or collaterised hybrids to generate substantial gains. However, no-one really saw the crash that began 10-years ago today causing such havoc.

Some may say Spotlight is being a Cassandra and yet one small incident involving Iran or North Korea or something as local as auto or car loan exposures could be a spark to send indices tumbling. Maybe the normalisation of central bank balance sheets will see the skinny yields on bonds give way to a yield and spread expansion. It really is a venture into uncharted territory.

All we are saying, is that on this day, the 10th anniversary of the start of the global financial crisis a modicum of caution amid the hubris may well prove advisable.

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