

making money from **CFD** trading

how I turned
\$13k into \$30k
in three months

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Wrightbooks

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Getting started

In this preliminary chapter, I will explain some basic concepts and then outline my trading approach. If you are already an experienced trader, comfortable with sharemarket jargon, you can probably skip over the basic concepts and go straight to the details about my trading method.

Market jargon

Feedback from showing early drafts of this book to peers indicated that I used a lot of market jargon. Working on dealing desks and as a broker means the jargon has become second nature to me. For the average private trader, it's not always obvious what the jargon means, so I have added this section here at the beginning of the book to lay a foundation of terms commonly used throughout.

Long or short/bull or bear

If you've ever traded shares, you are probably familiar with the terms 'bull' and 'bear', but you won't necessarily be familiar with the idea of 'going long' or 'going short'. Most share investors aim to buy and hold and then sell at a profit when the market goes up. With CFDs, you can make money from prices going up, but you can also make money when prices go down. If you think the market is going up, you're a bull, and you are likely to take a long position. If you think the market is going down, you're a bear, and you're likely to take a short position.

Going long means entering a position by buying something and then selling it when the price has risen. Going short means entering a

position by selling something you don't actually own, and buying it back when the price has fallen.

Just say the price of Bluescope Steel (BSL) is quoted as \$8.35–\$8.36. If I expect the price to rise, I will go long by buying at the offer price of \$8.36. This gives me a 'long position'. I will make money if I exit the position by selling at a price above \$8.36. If I expect the price to fall, I will go short by selling at the bid price of \$8.35. This will give me a 'short position'. I will make money if I exit the position by buying at a price below my entry at \$8.35.

Some people have a bent for the upside or the downside—you're either a natural bull or natural bear. I'm a natural bear, so I find it hard not to go short no matter how bullish the market is.

A benefit of going short CFDs is that you will be paid interest on the position. If you have a long position, you have all the benefits that someone holding physical shares enjoys, such as dividends, although you do not receive voting rights.

If you have trouble with the concept of going short, don't feel bad—it does seem strange at first. I spent half an hour with one of my flatmates trying to explain the idea of selling something you don't own, and he's a doctor!

Margin and leverage

CFDs are a unique way of trading share price action, requiring only a fraction of the capital you would need to trade physical shares. The amount of cash you must deposit as margin varies from one CFD provider to another, but the going rate is usually somewhere between 3 per cent and 20 per cent of the value of the underlying shares. For instance, to trade a position worth \$20 000 with five per cent margin requirement, you will need a deposit of \$1000. This equates to 20 times leverage.

Order book, market depth or price depth/bids and offers

When people refer to the 'order book', they are referring to all current buy and sell orders for a particular stock. These can be viewed on a 'market depth' or 'price depth' information screen. Your market depth screen will usually set out all buy orders for a stock, ranked in order from highest bid to lowest. It will also show you all sell orders, ranked from lowest offer to highest.

The 'bid price' is the best or highest price market participants are prepared to pay for a stock. The 'offer price' is the best or lowest price at which market participants are prepared to sell a stock. The screen shot in 'Getting started' figure 1, below, shows price depth for Bluescope Steel. The bid price is \$8.35. The offer price is \$8.36.

'Getting started' figure 1

Bids and offers on Marketmaker price depth screen

Price Depth BSL (Au)					
9,274	8.350 /		8.360		208
9,515	8.340		8.370		3,000
9,160	8.330		8.380		2,900
12,025	8.320		8.390		16,882
5,500	8.310		8.400		25,000
27,040	8.300		8.410		2,000
20,189	8.290		8.420		6,500
300	8.280		8.430		15,983
1,360	8.270		8.440		2,000
5,659	8.260		8.450		4,100
Mid	8.3550	Change	-0.0300	High	8.380
Open	8.3450	% Chg.	-0.36%	Low	8.340
Close	8.3850				

Volume and liquidity

Looking back at the price depth screen on the previous page again, you will see that a column of smaller numbers runs beside the central columns that list the bids and offers. These smaller numbers represent the ‘volume’—that is, the number of shares—which traders wish to buy or sell at each particular price. The number on the left-hand side of the bid price represents the volume traders wish to buy at that bid price. The number on the right-hand side of the offer price represents the volume traders wish to sell at that offer price. Our sample screenshot shows us that market participants want to buy 9274 share CFDs at the bid price of \$8.35, and to sell 208 share CFDs at \$8.36.

I consider market depth when deciding if a stock is looking strong or weak. Large numbers of orders at prices only incrementally below the best bid price indicate that the market is ‘well bid’; that is, likely to be strong; similarly, large numbers of sell orders at prices incrementally above the best offer price also indicate that the market is likely to be strong. However, this is not always the case: the order book can change quickly, and orders can be removed suddenly and at any time during the trading session.

Liquidity is shown in the number of orders and the volume of shares at each price level. High liquidity means there are many orders and large volume. Low liquidity means there is lower volume and/or orders placed in the market.

Order types

Before you start trading, you need to know your order types so that you can use them to maximum advantage. The following is only a brief introduction; for more detail, please see my first book, *Contracts for Difference: Master the Trading Revolution* (Wrightbooks, 2003).

Market order—Entering on a market order means accepting the current bid price to go short or buying at the current offer price to go long. Market orders are used by traders who are eager to take a position immediately and are not interested in waiting for the price to go lower before buying or for it to rise before selling. For example, if BSL is quoted at \$8.35–\$8.36, to buy ‘at market’ would be to pay the current offer price of \$8.36. To sell at market is to enter at the current bid price of \$8.35. Nine times out of ten I will enter on a market order.

Limit order—A limit order is placed below the current market level for a buy order and above it for a sell order. A limit can be used to enter or exit a trade. If traders want to pay less than the current offer to buy, or sell at a price higher than the current bid price, they’ll place a limit order. For example, if BSL is quoted at \$8.35–\$8.36, traders may want to wait, hoping that they will be able to buy at a price lower than \$8.36. Therefore they might place an order to buy ‘on limit’ at \$8.30.

Stop-loss order—In my trading diary, I will often note that I have been ‘stopped out’ of a position. This means my CFD provider closes my position because a stock’s price has hit the level at which I have placed a stop-loss order. A stop-loss order is placed below the market for a long position and above the market for a short position, with the aim of limiting losses should the position go against you. Stop-loss orders do not only apply to losing positions; they can also be used to exit a winning position and realise profits.

Trailing stop-loss orders—To ‘trail’ a stop-loss order is to move the order closer to the current price in order to maximise profits or minimise losses from an open position. Setting a trailing stop is common practice when a position moves into profit and the market continues to move in the direction of the profitable trade. As a position becomes more profitable, I continue to trail my stop-loss level. Well, that’s the theory. Your CFD provider will not trail a stop-loss order automatically. You must do this for yourself.

‘One cancels other’ order—If you have a clear target for a profitable exit, you might want to work a limit order in conjunction with a stop-loss order. This can be done with an order called ‘one cancels other’ (OCO). As soon as one ‘leg’ of the order is executed, the other side is immediately cancelled. An OCO is commonly used to simultaneously work orders to exit an existing position if it goes into loss, or to exit if it is in sufficient profit.

‘If done’ order—The ‘if done’ order is another contingent order that is handy if you are not able to watch price. If you are entering on a limit order, the ‘if done’ order can be attached to a stop-loss order, making sure that as soon as your entry is executed, you have a protective stop in place.

Support and resistance

Support levels and resistance levels are probably the most basic concepts of technical analysis, and they are the two most important tools of my trading strategy. A stock’s support level is based on old chart lows. It is the point below the current price action at which downward price movement has halted in the past. A stock’s resistance level is based on old chart highs, and is the point above the current price action at which upward price movement has previously halted. Support and resistance ‘lines’ can be plotted on a chart.

Looking at figure 2, opposite, it is obvious that a support level, once breached to the downside, can become resistance, and vice versa.

Even if you use a trading system based on more advanced indicators, you should still be aware of support and resistance levels on a stock’s chart. I am always looking for old chart reversal levels, and stay extra vigilant when prices get near these levels. If a support or resistance level can pause or stop a trend it is important; if a market shrugs it off, it says that trend has underlying strength.

'Getting started' figure 2

Support and resistance



Double bottoms and double tops

A double top pattern is a twice-tested high that is confirmed when the intervening low is breached on a closing basis. A double bottom is a twice-tested low that is confirmed when the intervening high between the two lows is breached on a closing basis.

A double bottom, especially in a bull market, is one of the most consistently reliable patterns. This pattern not only gives a safe buy signal, but usually provides an early buy signal, too, because the pattern is often the starting point for gains far greater than your initial pattern-based targets.

Spike tops and bottoms

Spike tops and bottoms are another favourite pattern of mine. They usually represent extremes of emotions and as such are terminal points of overbought or oversold conditions. They form within the day and require a fast reaction to exploit the turnaround.

Range

A stock's trading range is an important tool. Lots of my entry and exit signals are based on chart patterns that form when the price moves between resistance and support on several occasions, creating a rectangular pattern.

When a stock makes new lows and then starts trading within a relatively narrow price range without making new lows, this is called a basing range. Some stocks will often reverse into a sustainable new uptrend after the confirmation of such a pattern, while others will consistently make spike lows or rapid unchecked lows before resuming the uptrend.

'Consolidation' and 'congestion' are interchangeable terms which describe a trading range that does not result in a reversal in the trend. They are in effect a pause before the trend resumes and are equally important buy or sell signals.

Continuation pattern

A continuation pattern is seen when price movements resume in the direction of a trend which was established before a trading range started to form.

Intra-day break-outs

I also look at intra-day break-outs compared to closing levels. Rangebound or consolidation patterns often contain intra-day

breaches of the range, but then close within the range. This is often a good buy signal in the case of a downside break and a good sell signal in the case of an upside break. I discuss this in the trading tip I present at the end of week 3.

My trading platform

Many of the best features of CFD trading are related to the kind of internet-based trading platforms that are around today. The best brokers now provide their clients with software offering a range of services, including charting facilities, news and online order placement. Having spent years executing futures orders by telephone, I believe this kind of facility makes my trading more disciplined, results in far fewer errors and saves me much of the stress and time involved in talking to a broker.

I use the CMC markets platform, *Marketmaker*. (See ‘Getting started’ figure 1 on page 3 for an illustration of a *Marketmaker* screen.) It gives me flexibility in placing orders, along with instant access to the market and real-time profit and loss statements.

I have a series of prices for share and index CFDs loaded on my *Marketmaker* platform.

Marketmaker has a position-keeping log and pending order log, both of which are called ‘blotters’. I always keep both blotters open. This reminds me to place stop-loss orders for open positions at my predetermined price levels. It also alerts me when these orders are potentially ready to be executed—when a price trades near my predetermined level, this is highlighted on my pending order blotter. The position-keeping blotter is useful because it shows ‘tick-by-tick’ or incremental changes in a continuously updated running profit and loss.

The platform also allows me to build a favourites list of individual share CFDs. I remove a stock from this list if I have a bad run of trades on it and decide I should stop trading it. This takes away the temptation.

My CFD platform also offers a world of other trading opportunities aside from local share CFDs—an entry into sophisticated markets that are usually only open to traders who maintain separate accounts to trade foreign exchange or futures. I can access and trade real-time markets such as oil, gold, silver, wheat, overseas share CFDs and index CFDs, US and euro treasury bonds, every major currency, many minor ones and cross rates. Whichever market I choose, *Marketmaker* gives me access to charting facilities, market depth information (where available), and also gives me the ability to ‘back-test’ trading systems.

The back-testing facility on *Marketmaker* allows any technical indicator to be tested using historical data. This opens up a range of possibilities for new traders looking to devise a tradable system. I would recommend using the back-testing facility on a number of different stocks. You might find some systems work best using weekly charts rather than daily charts, or give better signals about some stocks than others. The best approach can only be determined by a process of trial and error. You will also find there is a difference between the results you get when you back-test a system and the outcomes you achieve using it in real life.

A free, fourteen-day trial version of *Marketmaker*® v5.0 is available at <www.cmcmarkets.com.au/cfd/soft_trial.jsp>. This demo software gives you full access to:

- real-time pricing, including global share and index CFDs and all major world currencies and cross rates
- risk-free ‘trading’ with a virtual US\$10 000 demo account

- real-time breaking news for Dow Jones and expert analysis from Reuters Research
- multiple online order types including market, stops, limits and OCOs.

If you are interested in seeing how this platform works, I'd recommend experimenting with this demo software for a couple of weeks.

My trading method

Once you begin trading you will quickly discover there is no holy grail. The smartest way to make money is the way that suits you best, but you won't discover what this is until you start trading. The right approach will depend on your circumstances—whether you have a full-time job, how much time you can spend watching the screen, your financial means, and your actual analysis style. There is no single ideal approach, and developing your own trading style is a process of evolution.

I had my first trade back in the 1990s trading a US 30-year T-Bond futures contract on a joint account with my boyfriend at the time and another friend. The position was fabulously profitable at first, but then it turned down. We hung in there, but eventually took away only a meagre profit. That was the starting point of my trading education.

Like many trading neophytes, I studied the most complicated and esoteric strategies first. Gann, Elliott wave and astrology were some of the methods I subscribed to in my early days. They all worked, but each of them required an enormous amount of study and that made trading unenjoyable. Scouring an astronomical almanac for 'moon void of course' or 'Venus opposition Mars' was too laborious when all along I had the best trading tool staring me right in the face:

pure price action on the chart. It took me years to realise just how important price was.

Acknowledging the importance of price led me to develop a trading approach that relies on some embarrassingly simple technical patterns.

I consider myself a ‘break-out trader’, that is, I buy stock once its price moves above a certain predetermined level and sell it when it drops below a certain level. I nearly always enter on a market order, which means that I pay the current offer price or sell at the current bid price, but I use a stop-loss order to exit. I very rarely use limit orders to open or close a position.

I have no mechanical trading approach and use no technical indicators and I don’t care about volume traded, only volume on market depth. I watch price action, study the charts and am not afraid to buy high and sell low; stop and reverse; or get stopped out and re-enter in same direction if the price action says I should.

I also like to add to positions. This is sometimes called ‘pyramiding’ or ‘scaling-in’, and it means investing more in a position as it moves into profit. For example, imagine that you buy Aristocrat Leisure (ALL) at \$10 for 1000 share CFDs. Each 1¢ move up or down in the price of ALL equals \$10 that you have gained or lost. If the price of ALL goes up to \$10.20, you might therefore decide to buy another parcel of 1000 shares. Now that you have doubled your exposure, every 1¢ price move means \$20 is added to or subtracted from your account. As a position moves further in my favour, I continue to add, so that each incremental move in the underlying delivers increasing profits.

My trading approach could be characterised as having three basic steps:

1. Buy or sell on a break-out to enter.
2. Exit on a pullback for a buy or rebound for a sell.

3. Add to positions as they move in my favour and trail stop aggressively as profits grow.

I describe the various chart-based techniques I use in planning my entry and exit strategies throughout this book. You will also find a specific trading tip at the end of each chapter.

My stock selection criteria

I started trading a limited selection of share CFDs using an approach based on nothing more than trial and error. I first looked for stocks that obeyed the rules of technical analysis, forming familiar patterns and moving to target once the patterns were confirmed. I chose stocks which followed these rules to a degree that would allow me to implement strategies based on the pattern outlined above. My 'usual suspects' include Aristocrat Leisure (ALL), Bluescope Steel (BSL), Coles Myer (CML), Newcrest Mining (NCM), Excel Coal (EXL), Oxiana (OXR) and Jubilee Mines (JBM). There is one other stock that I began trading for the first time halfway through the book. It ended up being my most profitably traded CFD, but I won't tell you what it is just yet.

These days I know more about stock selection than when I started. The first thing I consider now is the market depth. As I explained above, market depth is the volume of interest from buyers and sellers—the number of offers or bids being made—at various price levels. You will find that market depth information becomes increasingly important as you become more serious about your trading. I rarely place an order, especially on the stocks that are traded at relatively low volumes, without checking the number of bids or offers being made first. This tells me whether there is enough volume available to cover my order.

Different stocks suit different traders. The names I gave above should not be read as a list of the best or the only share CFDs to trade. Some of those I have mentioned go off the boil at times, or become too unpredictable to trade. I am constantly trying new shares. You will find that some share CFDs might have a clear ‘set-up’ or entry pattern only infrequently—occasionally they may be very profitable, but the rest of the time they should be left alone. A good rule when considering trading a new share CFD is to check its liquidity. Thin or illiquid stocks, no matter how attractive their price action, can be frustrating and costly to trade. That was one of the best lessons I learnt when choosing which share CFDs to trade.

Apart from high chart predictability and good liquidity, the other criterion I base stock selection on is volatility. I am impatient, so trading a stock that takes two weeks to move 10¢ is agonising. It is not only boring, but also not cost-efficient. Every time I buy and hold a CFD position overnight I attract a financing charge. As long as the stock does nothing, it is costing me money.

Back-testing is another useful tool in stock selection. In the final month of my three-month trading period, I back-tested a system on my CFD platform and started trading it on a demo account. (I will discuss this in detail in my diary entries for week 11.) As it was only a demo account, I did not trade real money, so even though I was successful, my ‘profits’ on this account are not included in my final total profit figure. It was a departure from my normal trading style, which is much less rigid. However, the success of my back-testing experiment proves there is no single way to make money. It also is great inspiration for those traders hoping to make the break from full-time work to full-time trading. The trading system was based on a low-maintenance, end-of-day approach—a perfect interim strategy for traders with limited time wanting to gain a feel for the market before giving up their day job.

My daily routine

I trade from home. I work from my laptop, using an extra screen. On one screen I have charts and live prices and on the other I have my own Excel spreadsheet with the day's open and closed positions. I have broadband and cable television connected to the office. I watch bad daytime programming more often than I look at the business channel. The business channel is most helpful before the market opens, when it has a run-down of the US markets and a pre-market summary of the local market. As the morning progresses, the focus on other Asian bourses does not interest me, so I tend to switch over.

The first thing I look at when I turn on the trading platform in the morning is the price action of the Dow Jones Industrial Average, known on *Marketmaker* as the 'US 30'; spot gold; and crude oil. I often review positions if I see a big drop in my profit figures during the day. It is common to see a large profit as the market opens and then a fall in this figure as the day progresses.

I watch the charts—the 5-minute and the 30-minute charts as well as the daily charts. Like most traders, I work backwards from longer term to shorter term, analysing the weekly charts first, then the daily charts. As the day progresses, I focus chiefly on the intra-day charts. However, in the last half-hour before the close I check the daily chart again, trying to see how the day is likely to end. Although I am a short-term trader, taking a position for a maximum period of a few days or weeks, I always monitor closing price action. Closing prices are a good indication of how a stock might open the next day. When a downward day closes with a big rally on its highs, it is often a sign that there will be more buying the next day. However, this is not always the case: the close gives a better indication of the future performance of some stocks than others.

When trading gets really boring I lie on the couch in my trading room and watch TV or I go outside to check out the sea, take a

closer look at my garden or play with small dog. I generally don't do much—just watch the prices.

I never call my CFD broker if I can help it, but have the number programmed into my mobile phone for easy access in case I am away from my desk. When I'm out of the office I use either my MarketSource mobile data service or the CMC Markets mobile *Marketmaker*, which supplies prices to my mobile phone and allows me to trade from my phone.

★ ★ ★

Now that we've covered the basics, we're ready to get started.