The Beginner's guide to CFD trading

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What is CFD trading and how does it work?

A Contract for Difference (CFD) is a method of trading shares, stock indices, currencies or commodities enabling the investor to take positions in rising and falling markets, without buying or selling physical assets or incurring stamp duty charges. CFDs are the most appropriate means for engaging in short-term trading.

CFDs are a useful investor tool and comprise a significant portion of daily LSE trading. The ability to trade CFDs is available for most Official list shares but also major indices including the FTSE 100, FTSE 250, FTSE All Share, Dow Jones 30, S&P 500, DAX 30, CAC 40 and Euro Stoxx 50.

A CFD is an agreement between two parties to exchange the difference between the closing price of the contract and the opening price of the contract. Typically an investor "goes long" ie buys exposure to a rising asset or "goes short" by buying exposure to an asset falling in value.

When an investor uses a CFD then leverage comes into play.
Leverage works as follows. If I bought a house for let's say £1,000 and property prices fall 20% my surveyor will value the house at £800. If I then sold the property at £800 I would have lost £200 or 20% of my investment. Without leverage my loss would mirror the market's movement.

If however I bought the house using a 50% deposit then my equity in the house is worth £300. I would still have lost £200 but it would be a higher proportion of my initial equity investment of £500. I would have lost 40% of my initial investment. My use of leverage has magnified the market's loss.

Leverage can work greatly to an investor's advantage. If I had bought the house many years ago, let's say for £1,000, I put down a 25% deposit ie £250 and borrowed £750 on interest only repayment terms. In this case, I originally had quite a low deposit but I had control over an appreciating asset worth four times my starting equity. My property is now worth £5,000 hence my equity in the property has gone from £250 to £4,250 a 17 fold increase on my initial investment. This demonstrates the power of leverage in an environment where prices rise over the long term.

CFDs work exactly the same way! The small initial outlay, the margin equates to the deposit in the property example, can control shares worth substantially more.

Using our system you would typically deposit 10% for share CFDs and between 5% and 10% for index CFDs. This is known as "margin" and is put up by the investor and represents the capital that is immediately at risk. Margin effectively works to leverage up or down the overall trade, if a client pays 50% margin then that would mean for every £100 of underlying value there is £50 of equity.

You will be required to pay a financing charge if you "go long" (usually a premium of 2.5% to LIBOR) for the outstanding amount, ie if you deposit 10% then you have to borrow 90%. You will receive financing if you sell a short position (usually LIBOR -2.5%) at a daily rate pro-rated at annual rates (daily financing = closing day value of the open position x rate% / 365).

If a position is closed during the day ie an investor "goes long" then "goes short" then financing payments are not relevant.

Financing costs are linked to interest rates!
There is no fixed expiry date for CFD trading, a trade is closed when the client feels it is right to collect profits or cut their losses. Share dealing must be done on agreed settlement dates (T dates).

Using our CSSI Trader system a client will have direct access to the market either by calling our brokers or via online access. The pricing mechanism is very transparent and makes it easy for clients to work out their trading positions and exposures.

Using the CSSI Trader system any client trades would need to be closed internally, ie positions could not be transferred or netted off with another broker.

Engaging in CFD trading amounts to accepting risk exposure, please note our Risk Warning to ensure that you understand the workings of leverage before opening a CSSI Trader account.

There are ways to manage risk exposure using "stop loss". These work to cap your gain or loss per trade and can be entered at the time of making the trade or afterwards.

Equity CFD

The CSSI Trader system offers CFD trading on UK, US, and European equities.

A "Long" position in the underlying equities is profitable if the share price rises post the trade. It requires the payment of a daily financing charge. A "long" position also receives dividend payment at the close of business on the day before the ex-dividend date.

A "short" position in CFDs will profit if shares prices fall, it receives daily financing income but will lose money if share prices rise. A "short" position gets dividends debited at the close of business the day before the ex-dividend date. Running a "short" position means you are effectively selling shares that you do not own.

Buying and selling stocks is a bit out of date!!

Reasons for using CFDs
Both short and long positions add significant flexibility for clients because if they were trading equities they would have to deliver the shares subject to contract. This would be a far more capital intensive exercise.

"Shorting" is an important tool in "bear" markets or during periods of volatile trading, or just after a big gain in shares or simply to hedge an existing portfolio.

"Shorting" has come in for a lot of criticism lately, the FSA and SEC prohibited short sales of leading financial stocks.

Behind the scenes when an investor buys an Equity CFD the dealer is engaging in the opposite trade ie if the investor goes long Vodafone at 120p the dealer is short Vodafone at the same price.

In the events of a rights issue, bonus issue, stock splits or stock consolidations CFD positions are adjusted to replicate the corporate action on the underlying shares. These will be applied on the close of business on the preceding business day to the ex-corporate action date.

Trading strategies using CFDs:-

Hedging against market movements or against an existing portfolio.

Markets are volatile. Our CFDs enable clients to hedge against an existing portfolio, without having to sell the portfolio which may trigger tax charges or other complications. Using the CSSI Trader platform we can advise clients on how best to structure an effective hedge for their portfolios.

"Pairs" trading; this is a sophisticated technique allowing trading in similar companies. If for example you believe one company is expensive relative to another, the CFDs can be used to long the cheaper stock and short the more expensive stock.

Equity CFDs are perfect for "bottom up" investors or "stockpickers" who want to back companies whose prospects are not reflected in the shares.

Please see our worked example of CFD Trading vs Share Dealing (on an Advisory account)

Opening the trade:-

CSS Investments CFD – "LONG"	**Share Dealing – "BUY"**
BP CFD quote	BP share quote
Bid 488p – Offer 488.75p	Bid 488p – Offer 488.75p
Buy price 488.75p	Buy price 488.75p
No of CFDs: 1,000	No of shares: 1,000
Underlying value of shares: £4887.50	Underlying value of shares: £4887.50
Stamp Duty: N/A	Stamp Duty: £24.44
Commission: £24.44	Commission: £48.88
Compliance Charge: £10.00	Compliance Charge: £10.00
Initial Margin: £488.75	Consideration: £4,970.82
Total Debit from CFD a/c: £523.19	Total Cost: £4,970.82

The major difference with CFDs is the initial cost amounts to the total debt (ie the initial margin plus commission).

Closing the trade a week later...

BP CFD quote	BP share quote
Bid 525p - Offer 525.5p	Bid 525p – Offer 525.5p
Sell price 525p	Sell price 525p
Underlying value of sale proceeds: £5,250.	Sale proceeds: £5,250.
Commission: £26.25	Commission £52.50
Compliance Charge: £10.00	Compliance Charge: £10.00
Financing cost: £2.81 (calculated on a daily basis)	Financing £0.00
Profit on the Trade: £289.00	Profit on Trade: £216.68
Return on Investment: 59.13%	Return on Investment: 4.359%

In calculating the profit on the trades on the CFD side, we take the underlying value of the sale proceeds and subtract commissions & compliance charges on both opening and closing the CFD; we subtract the financing costs and the underlying value of the shares.

Clearly owing to the geared effects of the CFD trade against a stock trade the return on investment using the CFD route is magnified.

Please note: If the price of BP had fallen during the same period and it was decided to cut the position there would have been a corresponding loss created. Examples of losing trades can be found in the FAQ's section on our website.

"Shorting equities using CFDs"

In this example we have assumed that the investor has £1,000 in their deposit account. This is sufficient margin for trading up to around £5,000 worth of shares.

If you take the view that in the short-term a share is overpriced then you would "short" ie sell a short. When opening the trade, the "short" transaction would look like this:-

Open Trade

Price of ITV Group	45p
Number of shares	10,000
Value of shares	£4,500
Stamp Duty	(No stamp duty on CFDs)
Commission	£22.50
Compliance charge	£10.00
Margin (10%)	£450.00

Closing Trade; 1 month later

Price of ITV Group	40p
Number of shares	10,000
Value of Shares	£4,000
Stamp Duty	(No stamp duty on CFDs)
Commission	£20.00
Compliance charge	£10.00
Financing Income	£11.10 (calculated on a daily basis)
Overall Profit on trade	£448.60

Trading Index CFDs

The same principles apply with index CFDs, again we use the index value, we deduct commissions, compliance charges and financing charges for long positions, we add financing income for short positions and use margin. Again we assume the client has £1,000 in their deposit account.

FTSE 100 CFD	Bid 5,095 / Offer 5,099
Opening Trade – SELL ie "Short"	
Sell Price	5,095
Number of CFDs	1
Underlying value of trade	£5,095
Commission	£7.64 (15 bps)
Compliance charge	£10.00
Initial Margin (deposit) 5%	£254.75

Closing Trade – BUY (1 month later) ie "long"	Bid 5,010 / 5014 (NB -81 pts)
Buy Price	5,014
Number of CFDs	1
Underlying value of trade	£5,014
Commission	£7.52 (15 bps)
Compliance charge	£10.00
Financing Income	£12.56 (calculated on a daily basis)
Overall Profit on Trade	£58.40
% Gain on initial margin investment	**22.92%**

Please note: If the FTSE 100 had risen during the same period and it was decided to cut the position, there would have been a corresponding loss created. Examples of losing trades can be found in the FAQ's section on our website.

Financing income is received for CFD short positions and deducted from CFD long positions. The financing cost is based on LIBOR, ie the market interest rate +/- 2.5% depending on whether the position is short or long.

CSSI Trader quotes competitive two way prices for CFDs on leading stock indices. The CFD index product helps investors take a view on the market generally without having to go into the specifics of individual stock investment.

The product also adjusts for dividends. Obviously this will depend on dividend payout levels, however long CFDs receive dividend adjustment credits, short CFDs will have dividend adjustments debited.

Types of orders and other tools applying to CFD trades

An order is an instruction to the broker to buy or sell. There are a number of different types of orders.

A "limit" order ie buy 1000 Marks & Spencer CFDs limit 250p this means the client cannot pay more than 250p per CFD.

Limit orders are an important tool for all CFD traders as it helps risk management especially in circumstances where markets are moving rapidly.

A "market" order ie buy 1000 Marks & Spencer CFDs this is executed "at the market" ie at the market offer price. The principle is the same as the "at best" order in share trading.

Stop losses are the usual tool for controlling risk and hence the magnitude of profit or loss.

A simple "stop loss" can be put onto a CFD trade at the time of the trade and afterwards. Hence taking the Marks & Spencer example let's say at the time of the trade we put on a stop loss at 240p, hence should the shares fall to 240p the shares would be sold and the position would close out automatically hence the expression "the trade was stop lossed out".

A "trailing stop loss" is useful for protecting against a fall in the share price whilst maintaining exposure to further gains. A trailing stop loss would set a stop loss at a fixed percentage under the share price. If the share price rises, the stop loss rises in direct proportion. If the share price falls, the stop loss fixes and the shares are sold when the share price hits the stop loss. The trailing stop helps investors protect against loss without having to monitor the share price.

Margin & Payment requirements

Any CFD position is valued constantly relative to the market. This may require further margin payments during the day if the shares are volatile or if the CFD position requires further margin.

At the close of business every day the CFD position is evaluated for margin requirements. The CSSI Trader account does this automatically.

If the CFD position is loss-making and the loss exceeds the original margin then the account holder has to pay further funds into the account to replenish the margin. This is called the "maintenance margin" the amount of margin that must be maintained at all times on the account.

In the context of US markets, the NYSE and the Nasdaq the dealer must ensure that a 50% "initial margin" is available in cash or securities before a trade is placed. After the trade is placed the dealer must ensure that the "maintenance margin" is adhered to. This means a margin of 25% ie equity of 25% in the account.

For example if a deposit of £2,500 is being used as initial margin to support a £10,000 CFD position and the CFD position falls in value to £8,000 then the deposit would have to be topped up by £1,500 to maintain the required margin of 25%.

SUMMARY

Our beginner's guide is intended to give you a flavour but "you can only learn by trying!"

Feel free to sign up on our website at www.css-investments.com

We hope this guide has been informative and clarified some of the more technical points to CFDs. Please send us any questions you might have.

General Risk Warning

The market information relating to the past performance of an investment is not necessarily a guide to its performance in the future. The value of investments or income from them may go down as well as up. As stocks and shares are valued from second to second, their bid and offer value fluctuates sometimes widely. The value of investments may rise or fall due to the volatility of world markets, interest rates and capital values or, for investments held in overseas markets, changes in the rate of exchange in the currency in which the investments are denominated. You may not necessarily get back the amount you invested.

You should carefully consider in the light of your financial resources whether investing in stocks and shares is suitable for you.

CFD & Spread Bet Risk Warning

You should not deal in CFDs or Spread Bets unless you understand their nature and the extent of your exposure to risk. You should also be satisfied that the product is suitable for you in the light of your circumstances and financial position. Although CFDs/Spread Bets can be utilised for the management of investment risk, it may not be suitable for some investors. In deciding whether to trade in CFDs/Spread Bets, you should be aware of the following points.

CFDs/Spread Bets can only be settled in cash. Investing in a CFD/Spread Bets carries the same risks as investing in a future or an option or other derivative product. Transactions in CFDs/spread Bets may also have a contingent liability and you should be aware of the implications of this as set out below.

Contingent liability investment transactions, which are margined, require you to make a series of payments against the purchase price, instead of paying the whole purchase price immediately. If you trade in contracts for differences, you may sustain a total loss of the margin you deposit with your firm to establish or maintain a position. If the market moves against you, you may be called upon to pay substantial additional margin at short notice to maintain the position. If you fail to do so within the time required, your position may be liquidated at a loss and you will be responsible for the resulting deficit. Even if a transaction is not margined, it may still carry an obligation to make further payments in certain circumstances over and above any amount paid when you entered the contract.

Before you begin to trade, you should obtain details of all commissions and other charges for which you will be liable. If any charges are not expressed in money terms (but, for example, as a percentage of contract value), you should obtain a clear and written explanation, including appropriate examples, to establish what such charges are likely to mean in specific money terms. In the case of futures, when commission is charged as a percentage, it will normally be as a percentage of the total contract value, and not simply as a percentage of your initial payment.

Collins Sarri Statham Investments Ltd. 6th Floor 5 Lloyds Avenue London EC3N 3AE
Telephone: +44 (0)20 7264 2360 Facsimile: +44 (0)20 7264 2361 www.css-investments.com Email: info@css-investments.com

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