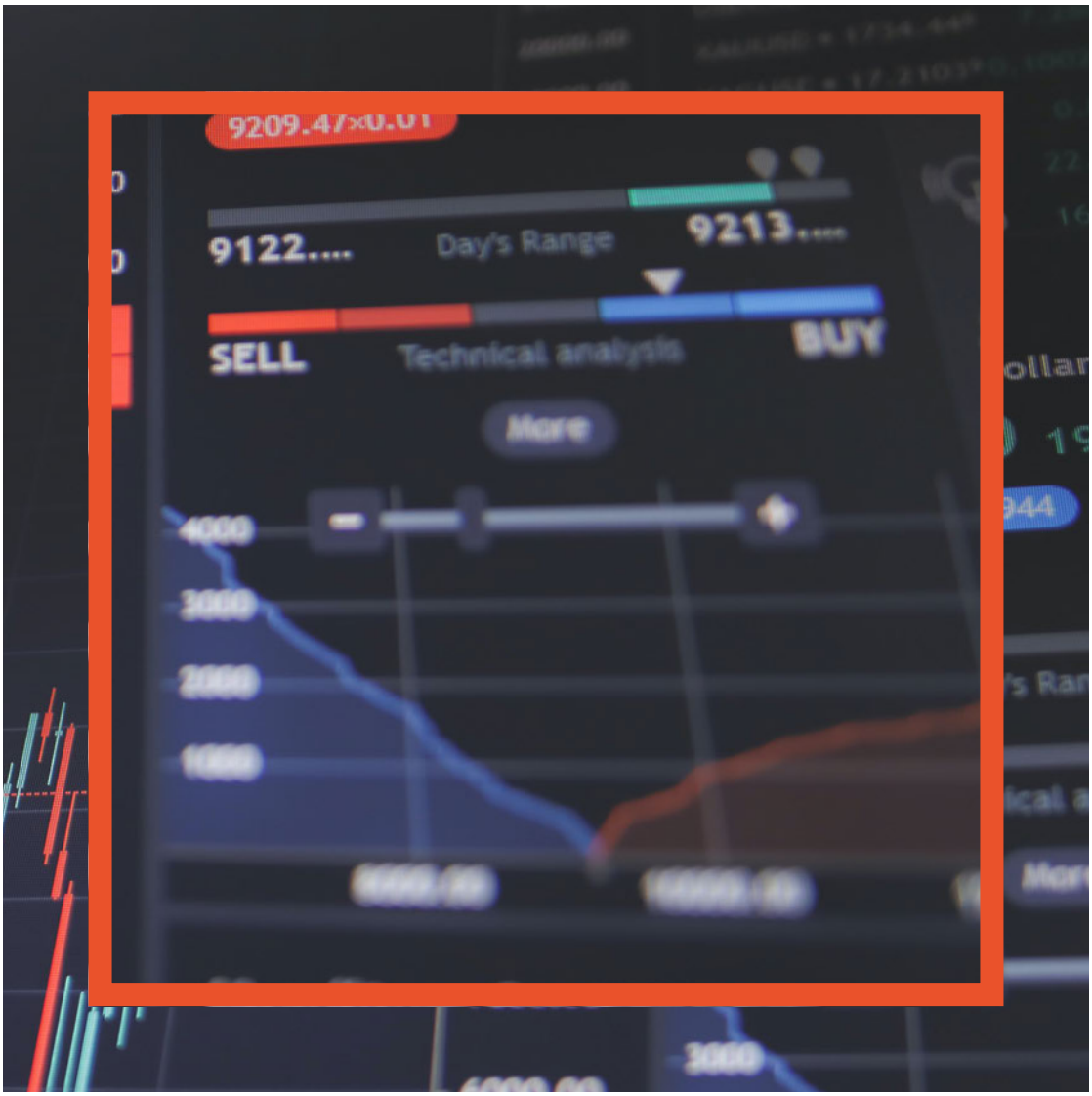
# THE ADVANTAGES OF TRADING WITH CFDS




Swissquote

**«If you cannot do great things, do small things in a great way.»**

Napoleon Hill

# Table of contents

# What are CFDs and how do they work?

CFD means **«Contract for Difference»**. It is a derivative that uses leverage and offer the investor an opportunity to profit on the difference between the opening and closing price of a position. CFDs are available for different financial products: shares, stock indices, bonds, currencies, commodities and interest rates. One of the most immediate advantages is that investors can take either long or short positions. As such, these products can be used for both speculation and hedging.

Investing with CFDs also gives you leverage. To open and maintain a position, you must provide a margin, as is the case in the futures market. The margins required in CFD trading are usually lower, which is why CFD trading is very popular among retail clients. But that's not the only reason!

## Long & Short

Opening a **long** position, or going long, reflects a bullish view on the share. For example, I buy Amazon at USD 3'600 with the belief that I will close the position in the future, selling the stock at a higher price. However, I will incur a loss if the share price falls.

Conversely, opening a **short** position, or going short, reflects a bearish position: I sell Amazon at USD 3'600 with the belief that I will close the position in the future, buying the stock at a lower price. However, I will incur a loss if the share price increases.


You think the **stock price will rise**
You buy the stock
You take a **Long** position


You think the **stock price will fall**
You sell the stock
You take a **Short** position

# CFD Jargon

| Expression | Description |
|---|---|
| CFD | CFD means «Contract for Difference»: the broker credits or debits your trading account in the amount of the difference between the entry price and closing price of the position. Most experts define this derivative instrument as a swap contract. |
| Leverage & Margin | **Leverage** is an instrument that allows you to multiply your market exposure without committing additional capital. In investing, the amount required to open and maintain a leveraged position is called **margin**.<br><br>Example: 20% margin means that USD 2'000 is required to keep a position open totalling USD 10'000.<br><br>**20% margin** equals a **leverage** ratio of 100:20 = 5<br><br>In this case, with a trading account that has a balance of USD 10'000 and leverage ratio of 5:1, you can open positions totalling up to 10'000 x 5 = USD 50'000. If leverage is used properly, you can potentially achieve greater diversification. |
| Overnight cost | The costs of maintaining the position, as you pay or receive an interest rate on credit for the use of leverage, which is actually a liquidity loan. Also known as «borrowing cost» or «cost of carry». |
| Long | An open trading position to buy, with intent to gain from rising prices. |
| Short | An open trading position to sell, with intent to gain from falling prices. |

# CFDs vs Shares

To put this into practice immediately, let's look at an example with two traders, Warren and John.

Warren trades in stocks and buys 10 AMZN shares at USD 3'600.

His investment therefore totals USD 36'000.

John has the same market view and thinks that Amazon shares will rise in the days to come, but instead invests in Amazon CFDs.

So he buys 10 CFDs on AMZN for USD 3'600.

His investment value (= notional value) therefore totals USD 36'000.

His broker requires a 20% margin on the position, so the margin is calculated as 36'000 x 20% = USD 7'200.

So what changes in the profit and loss management of the position? Practically nothing.
Novice investors often mistakenly believe that the use of leverage will make calculations overly complicated.

**Remember:** the risk of your position should be determined based on the total value, i.e., the notional value. Warren and John therefore run the same financial risk, as they both invested USD 36'000.

So why does John decide to use an instrument like CFDs instead of investing directly in shares? Simply because John is not interested in Amazon's dividends or voting rights at the shareholders' meeting (don't forget that CFDs are a derivative product; investors don't buy shares directly and therefore relinquish certain rights). In our example, John simply wants to open a position on Amazon that allows him to benefit from movements in the share price. He can also take advantage of margin trading to create more liquidity in the portfolio to open new positions.

| SCENARIO | Warren | John |
|---|---|---|
| | Buy 10 stocks<br>Investment value: USD 36'000 | Buy 10 CFDs<br>Investment value: USD 36'000<br>Margin USD 7'200 |
| **Price rises 10%** | **Profit USD 3'600***<br>Profit 10% | **Profit USD 3'600***<br>Profit 10%<br>(calculated on notional value)<br>Profit 50%<br>(calculated on margin) |
| **Price drops 10%** | **Loss USD 3'600***<br>Loss 10% | **Loss USD 3'600***<br>Loss 10%<br>(calculated on notional value)<br>Loss 50%<br>(calculated on margin) |

*Those figures do not take into account the commissions charged by your broker.

Based on this table, it is immediately clear that:

- **The profit and loss scenarios are the same,** depending on the price movement.
- The difference lies in the margin used. John will use only a fraction of his portfolio, keeping liquidity available to open other positions and diversify his portfolio (note: the margin required may vary depending on the share chosen by the financial intermediary and the type of account).

# CFDs vs Shares: comparison table

| Contracts for Difference | Shares |
|---|---|
| CFDs allow investors to take positions based on upwards or downwards movements in share prices. | Invest upwards in the stock. |
| CFDs provide investors the benefits of stock trading (i.e. capital gain) excluding stamp duty payments; altought they don't receive dividends they receive cash adjustment (where taxes are already deducted). | By investing in stocks, investors are entitled to dividends (if distributed) and the right to vote at the shareholders' meetings. Stamp duty taxes are required. |
| Leverage allows investors to allocate a lower capital for margin requirements and amplifies both profits and losses. By trading on CFDs, retails investors benefit from negative balance protection. | Leverage is not used, losses can not exceed your initial deposit. |
| CFDs platforms allows both speculative and hedging positions, hence is possible to hedge long positions by opening short trades on the same asset. | Hedging is not an option. |
| CFDs are over-the-counter products. | Shares are listed on regulated stock exchanges. |

# Hedging vs Speculation

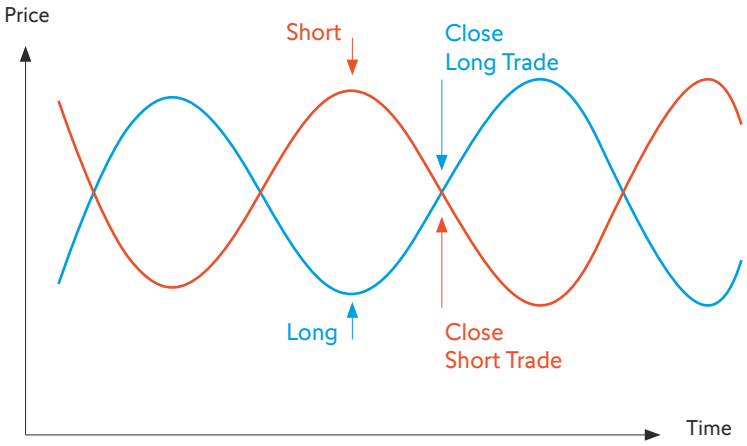
All derivative instruments, such as futures, options and CFDs, were created with the purpose of hedging risks. A wheat producer may decide to hedge the financial risks arising from the price difference between the time of harvest and the time of sale by using a derivative instrument. In the same way, an equity investor may hedge the risk of a bullish position in equities with a bearish position on CFDs.

**Example:** Céline has had a bullish position in Nestlé shares in her portfolio for three months, but she thinks the price will slip downward in the coming weeks. For various reasons, she does not want to close her position, and instead prefers to hedge the downward risk. So she decides to open a short position on the Nestlé CFDs to hedge the risk of the bullish equity position. After a few weeks, her prediction comes true, and Cèline decides to close her bearish position on the CFDs, realising the profit that offset the loss on the bullish share position.

In most cases, CFDs are still used to speculate on movements of the underlying asset. The time horizon for investing in a CFD position is usually short to medium term, but some traders prefer to maintain longer term positions. Remember that leverage, if used properly with prudent risk management, can provide a more diversified portfolio, because it increases buying power.

# Other potential uses of CFDs: Pair Trading

Pair trading, also known as spread trading or statistical arbitrage, is a technique dating back to the 1980s pioneered by Gerry Bamberger and Nunzio Tartaglia from the quantitative department at Morgan Stanley.




**General Idea of pairs trading**

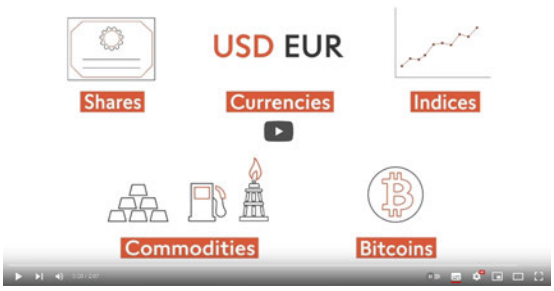
The strategy monitors the performance of two securities with a historically high correlation. When the two securities deviate, the trade involves shorting the outperforming security and longing the underperforming stock, assuming that the spread between the two will eventually converge. Divergence between the securities may be due to temporary supply and demand changes, large buy/sell orders for a security, reaction to important news about one of the companies, and so on.

# Index CFDs

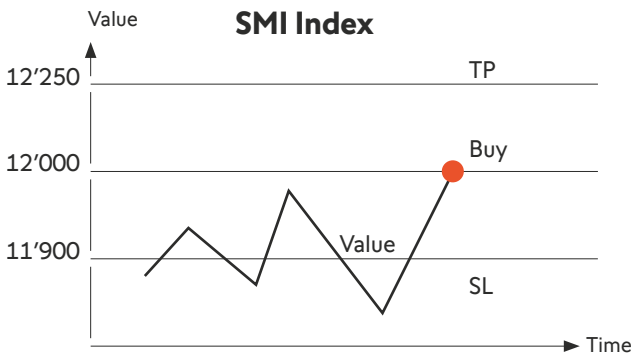
So far we have mostly discussed share CFDs. But as we mentioned in the first paragraph of this e-book, a contract for difference can have a variety of underlying assets: stock indices, bonds, currencies, commodities and interest rates. Swissquote's platforms cover all these asset classes.

In particular, stock indices are representative of baskets of stocks. For example, the S&P 500 and the Dow Jones 30 can be taken as a representation of the United States stock market, and the Nasdaq 100 of the US tech sector. On this side of the ocean, the SMI 20 tracks the performance of the top 20 Swiss companies; the Euro Stoxx 50 is the main European basket, and the DAX 40 is the German index.

While these indices can be traded both through futures contracts and CFDs with the future as the underlying asset (i.e. a forward contract), the simplest solution is to use the spot CFD, i.e. a CFD that replicates the trend of the portfolio. This type of contact is listed by several brokers. It is a simple product and usually the point value of the contract is only USD 1 (or EUR 1 or CHF 1, depending on the index). There are no quarterly expirations specific to futures, and the leverage ratio is high (up to 50, with all the benefits and risks that entails). **-> VIDEO**




Let's take an example using the Swiss index. Jimmy buys the CH20 index, which reflects the Swiss economy, at 12'000 points, and sets his stop loss order at 11'750 and his take profit order at 12'250. After a few hours of trading, the index reaches the take profit level, and the trade is closed with a profit. As he bought one contract, his profit on the trade was CHF 250. However, if the trading had reached the stop loss level, he would have lost CHF 250.



# Margin call

Margin call is a 2011 film starring Kevin Spacey that was shot on Wall Street. Financial traders also know that a **margin call** is a feature on all trading platforms and exchanges to safeguard trading accounts and avoid a negative balance.

Put simply, it is a warning sent by the platform to traders running low on funds in their trading account, in order to keep their positions open. The risk is that one or more positions could be closed out automatically, unless the trader does it manually or adds more liquidity.
Once the margin call is met, if their portfolio positions sustain further losses, traders could reach what is called the **stop out level**. This is the point beyond which the protection level is exceeded and losses are too high. The broker is then forced to exit or is «stopped out» of the losing positions.

**It is important to know how margin, margin calls and stop outs work before trading derivatives.**

# Common mistakes

Usually, **before you start playing a sport, you know the game rules**. In football, the ball is considered out of bounds when it physically crosses the boundary line on the pitch. In basketball, the ball is considered out of bounds if it touches the ground or a player beyond the boundary line on the court. It works the same way in leveraged investing. You need to know the basics before you start investing, which is one of the reasons why demo platforms are available. In this ebook, we explained how to manage risk, how to hedge a position, and how to try to benefit from price movements with long and short positions in the portfolio, while maintaining adequate diversification. We reviewed the concepts of margin call and stop-out, which should be avoided through good risk management. What about the next step? Start practising and remember all the notions expressed in this e-book. You should consider setting your stop loss on every trade (you know we talk about this in another e-book dedicated to risk management?) You can easily find it on the Education section of our website!

# Next steps – Start trading with Swissquote

1

Go to **swissquote.co.uk/forex**

2

Open a MT5 or Advanced Trader demo account

3

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CFDs are complex instruments and come with a high risk of losing money rapidly due to leverage. **77.15%** of retail investor accounts lose money when trading CFDs with this provider. You should consider whether you understand how CFDs work and whether you can afford to take the high risk of losing your money.

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