A guide to CFDs

Contracts for Difference

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Before you continue, a word of caution

CFD trading involves initially depositing only a small percentage of the total trade value, and so losses could quickly exceed your initial deposit requiring you to make further payments. This makes it higher risk, and is why it should only be considered by more experienced and sophisticated investors.

This guide does not constitute personal investment advice. CFD trading is not suitable for everyone; please understand the risks involved and if you are in any doubt of its suitability for your circumstances you should seek personal advice.

Any examples contained within this guide are for indication purposes only. Please ensure you fully understand the terms of any contract before opening a position.

Introduction

Colin Dewar
Head of HL Markets

If you are reading this guide the chances are that you've already bought and sold shares through a traditional stockbroker. But have you ever wanted to maximise your trading capital by initially only paying a fraction of the full value of your deals? What about also having the potential to profit from a falling market price as opposed to only being able to speculate on the market going up? What if you could do this on a wider range of markets with lower trading costs?

A growing number of experienced private investors are already doing this by using Contracts for Difference (CFDs) for shorter term trading as part of a balanced portfolio.

If you understand the risks involved, and would like to find out about the main features of CFDs then you need to read on.

Here's why

- You can maximise your buying power by initially paying only a small percentage of your deal.
- You could profit in rising or falling markets – provided you trade the right way of course.
- You can trade CFDs on UK, US and European shares.
- You can also trade CFDs on indices, currencies, commodities, and much more.
- Currently CFD trades are exempt from UK Stamp Duty.*

**Please remember that tax laws can change and are subject to individual circumstances.*

ONE WAY TO UNDERSTAND MARGIN IS TO COMPARE IT TO BUYING A HOUSE

Imagine two investors buy identical houses for £500,000 each. Investor A pays cash, and Investor B puts down a 10% deposit and borrows the rest. For the sake of simplicity we will assume the loan is interest free. After a few years the value of the houses rise to £750,000 and both investors decide to sell.

Investor A is very happy, his £500,000 house is now worth £750,000 and he has made a 50% profit on his original investment.

However, Investor B is even happier. He has only paid £50,000, and borrowed £450,000. He pays off his loan of £450,000 from the sale proceeds, and is left with £300,000 in cash. He therefore has a £250,000 profit on his original investment, or a profit of 500%.

Had the price of the property fallen to £250,000, both investors would be looking at a loss. If they sold their properties, Investor A would make a loss of £250,000 (50%), and Investor B would lose his £50,000 deposit and need to pay a further £200,000 - a total loss of £250,000 (500%) - negative equity. This clearly demonstrates the high-risk nature of dealing on margin.

What is a CFD and how do they work?

Contracts for Difference are used as a way of dealing on the price movements of financial instruments such as shares and indices without actually owning the underlying asset.

They are called “Contracts for Difference” because when you open a new CFD position you are entering into a contract with the CFD provider to exchange the difference between the opening value and the closing value of an underlying financial instrument (e.g. share, index, etc.).

This may sound complicated, but in reality CFDs are traded in a similar way to ordinary shares. Generally, for CFDs on shares, one CFD is equivalent in value to one share. Many CFD providers will quote the same prices for a CFD as in the underlying market.

For example

- *Tesco’s share price is 195 - 195.25p*
- *Tesco’s CFD price is 195 - 195.25p*

Similar to share dealing you also buy or sell a required number of CFDs. Therefore, in this example you could buy 1000 Tesco CFDs at 195.25p and sell at 195p.

As you do not actually own the underlying asset, there are a number of key features which set them apart from ordinary share trading.

Long or short, you decide

When you buy shares in a traditional manner, you usually take the view that the share price will go up and you will sell at a higher price. This is known as "long" or "going long". The flip side to this is "shorting" or "going short" where, if you think the share price will fall, you sell first with a view to buying back at a lower price and therefore make a profit.

CFDs allow you to trade "long" or "short" which opens up a new dealing opportunity, as you have the potential to profit in rising and falling markets, providing you trade the right way.

If you think that	you would go	your opening deal will be	your closing deal will be
The price will rise	Long	Buy	Sell
The price will fall	Short	Sell	Buy

Trading on margin

When you buy shares, you normally have to pay for them in full – your broker gives you the total price, and you must pay by the settlement day. If you bought £10,000 worth of Tesco shares you would be expected to pay the full £10,000.

CFDs work differently. For example, you would only be expected to pay 5% (£500) of the value for a Tesco CFD trade worth £10,000. This is known as the deposit or initial margin. This means you have exposure to the movements of £10,000 worth of Tesco for initially just £500, which is known as "gearing" or "leverage" and has a significant impact on your return and potential losses.

IMPORTANT: the above examples are for illustration purposes only, all margin is variable. Ensure you fully understand the terms of any contract before opening any position.

Trading examples

The best way to see exactly how a CFD works is to look at some simple examples. Remember you can trade both long and short with a CFD, so it is important to look at both types to fully understand how they work.

You will see that a small percentage movement in the share price constitutes a far greater return (or loss) on your initial deposit. This is the gearing effect of margin. This can substantially increase your profits, but also increase your losses.

Long trade example

Let's assume Tesco's share price is currently at 195 – 195.25 and you decide that Tesco is due for a rise. You buy 1000 Tesco CFDs opening a long trade. The example below shows what would happen if you were right and the price goes up and also what would happen if the price goes down.

	Scenario A Price goes up 10p to 205 - 205.25p	Scenario B Price goes down 10p to 185 - 185.25p
Number of CFDs	1000	1000
Total value when you buy	£1,952.50	£1,952.50
Initial margin required	5%	5%
Initial payment required	£97.63	£97.63
Value when you sell	£2,050	£1,850
Profit /loss	£97.50	-£102.50
Return	99.87%	-104.99%

IMPORTANT: the above examples are for illustration purposes only, to show the impact of price movements and margin. These exclude the impact of financing, dividends and commission costs which will be looked at later in the guide. Ensure you fully understand the terms of any contract before opening any position.

Trading examples

A short trade is the opposite of a long trade and is used with a view that the underlying price is going to fall.

Short trade example

Let's look at the same two scenarios as before but this time with the initial view that the price will go down. Therefore your opening transaction is a sell and you open a short trade.

Remember the Tesco CFD price is currently 195p to sell and 195.25p to buy.

You'll see that the effect is the opposite to a long trade, when the price goes up you make a loss, but when the price goes down you make a profit. The gearing effect of trading on margin is also the same on a short trade and means that both profits and losses are magnified.

	Scenario A Price goes up 10p to 205 - 205.25p	Scenario B Price goes down 10p to 185 - 185.25p
Number of CFDs	1000	1000
Total value when you sell	£1,950	£1950
Initial margin required	5%	5%
Initial payment required	£97.50	£97.50
Value when you buy	£2052.50	£1852.50
Profit /loss	-£102.50	£97.50
Return	-105.13%	100%

IMPORTANT: the above examples are for illustration purposes only, to show the impact of price movements and margin. These exclude the impact of financing, dividends and commission costs which will be looked at later in the guide. Ensure you fully understand the terms of any contract before opening any position.

Trading on indices

We've already mentioned that there is a very wide range of investments in which you can trade. We will now look at trading on indices.

Let's assume the UK Stock 100 Index CFD price is currently 5998 - 6000 and you believe it is going to go up, so you place a long trade to buy 5 UK Stock 100 Index CFDs.

The following example details what would happen if you were correct and the market rises and also if you were incorrect and the UK Stock 100 Index falls (this example is based on a contract size of £10 per point).

	UK 100 Index rises 50 points to 6048 - 6050	UK 100 Index falls 50 points to 5948 - 5950
Number of CFDs	5	5
Total value when you buy	£300,000	£300,000
Initial margin required	0.5%	0.5%
Initial payment required	£1,500	£1,500
Value when you sell	£302,400	£297,400
Profit /loss	£2400	-£2,600
Return	160%	-173.33%

IMPORTANT: the above examples are for illustration purposes only, to show the impact of price movements and margin. These exclude the impact of financing, dividends and commission costs which will be looked at later in the guide. Ensure you fully understand the terms of any contract before opening any position.

Ongoing margin and margin calls

Like dealing in ordinary shares, profits or losses from trading CFDs are only realised when you close the position. However, with a CFD you must always ensure that you have enough money on your CFD account to cover not only the initial margin of the trade, but also any unrealised losses.

If your net loss on all your positions exceeds the amount of money your broker requires you to have on your account as margin, then your broker will contact you to top up your cash balance. This is called a margin call.

How do you know how much margin is needed?

Different brokers will apply different rules and you should make sure you fully understand what your broker requires from you. This is just one example of how it could work.

Let's assume you have paid £3000 into your account. Using that money, you have opened up several positions with a total initial margin requirement of £2000. Look at the difference in these examples, depending on whether your positions make or lose money (see table below).

As soon as your account has a negative total position, your broker could contact you and ask you to top up the cash held, so that your total position remains in credit. Your broker could automatically close out your position should it fall negative.

Most providers would recommend that you keep some extra cash on your account to cover any small price movements against you.

	At open	Up £1500	Down £500	Down £1500
Account balance	+£3000	+£3000	+£3000	+£3000
Aggregate profits/losses	+£0	+£1500	-£500	-£1500
Total initial margin	-£2000	-£2000	-£2000	-£2000
Total position	+£1000	+£2500	+£500	-£500

IMPORTANT: the above examples are for illustration purposes only. Any margin requirements are subject to change. Ensure you fully understand the terms of any contract before opening any position.

Charges

Commission - As with an ordinary share trade, commission will normally be charged on both the opening and closing deals. This will vary from broker to broker and will typically be based on a percentage of the overall transaction, often in line with institutional dealing rates of 0.1% to 0.2%.

There is no dealing commission on index, sector, currency or commodity CFDs.

No UK Stamp Duty – As you don't trade the physical shares you don't have to pay the 0.5% UK Stamp Duty under current UK tax laws*. Just think, on a £10,000 ordinary share trade you would have to pay UK Stamp Duty of £50. Please note, UK tax laws may change.

Overnight financing – CFDs are traded on margin and as such when you buy a CFD there will be a financing charge. This is because you are effectively borrowing money to finance the purchase. The opposite occurs when you sell short a CFD, where interest is receivable.

For a UK share, the cost of borrowing money is based on the London Interbank Offered Rate (LIBOR), plus or minus a set percentage, depending on whether you are buying or selling. The charge is normally based on the full value of your position, and not the amount you pay on margin. As these rates are annual rates, they are relatively small on a daily basis. Even though CFDs are generally short term investments, if you hold CFDs overnight the cost can mount up over time. The cost of financing will apply every calendar day, but will typically be credited or debited to your account at the end of each trading day.

For Currency CFDs the financing is calculated by using the interest rate differential between the two currencies.

LIBOR is the London Interbank Offered Rate, and is usually close to the Bank of England Base Rate. The actual rate varies and can be found every day in the Financial Times newspaper.

Dividends – With many CFD providers net dividends are credited to long positions and debited from short positions held at the close of business on the day before the ex-dividend date. Payment is typically credited or debited to your account on the ex-dividend date.

Voting – As you don't actually own the shares, you have no entitlement to voting or other shareholder rights. Although you are accountable for the shares, the broker is hedging the position in the market and is therefore the physical owner. As such you have no right to vote on corporate actions, although some brokers may take your wishes into account in their vote.

**Tax laws may change and are subject to individual circumstances.*

Huge range of investment choice

How often have you heard market commentators say “The Dow performed strongly”? Or “It has been a bad day for retailers, but tech stocks picked up”? Or “Gold rose again”? In addition to the flexibility to trade UK, US and European Shares you can use CFDs to open up a whole new way of investing, by choosing the index, currency, sector or precious metal you think will do particularly well – or particularly badly.

UK, US & European Equity CFDs	Most CFD providers will provide the ability to trade CFDs on UK, US & European Shares all from the same account, making it as easy to trade Nokia as it is to trade Microsoft or Vodafone. Non-UK shares will often be traded in their domestic currency and once a position is closed you can decide if you want to convert the money back to sterling or hold it in the domestic currency for future deals.
Index CFDs	These are extremely useful if you don’t have a view on an individual share, but feel that an index as a whole will move in a certain direction. As with all CFDs, you can go long (if you think the Index will rise) or short (if you think it will fall). You can trade Index CFDs in many of the world’s major global markets, including the UK Stock 100 Index, Dow Jones, NASDAQ 100, S&P 500, Nikkei and Dax 30. The underlying Index does not have a buy and sell price which means the CFD provider will normally quote a price based around the current index level. CFD providers will often offer them at as little as 0.5% margin, although this varies from provider to provider.
Currency CFDs	Foreign Exchange is the world’s biggest market, over 10 times bigger than the combined value of the world’s stock markets. Currency CFDs allow you to access the price movements of the world’s major currencies. The spread between the buy and sell price on currencies is extremely tight and are generally traded with very low margins, typically as low as 0.5%, although this varies between provider.
Sector CFDs	Sector CFDs allow you to take a position on the directional movement of individual market sectors, such as Banks, Pharmaceuticals, Retailers and many more. These work in the same way as Index CFDs, where the provider will give you a price based on the underlying sector level and you can then go long or short depending on your view.
Commodity CFDs	Commodity CFDs allow you to gain exposure to the commodity markets, giving you increased flexibility in your trading strategies.

Tools of the trade

Stop loss orders

A Stop Loss is an order which closes out your position at a certain price if the market starts moving against you. You can place a Stop Loss when you open a trade or on an existing open position, and with most providers you will be able to adjust or cancel the Stop Loss as the market moves.

Stop Losses are perhaps the most frequently used order by stockmarket professionals and are the most underused by private investors dealing on margin. But why? Professionals use Stop Losses to reduce their risk and cut their losses – they set themselves parameters of what they are willing to lose and stick to it. Private investors on the other hand, still aren't fully harnessing the benefits of Stop Losses and all too many hold onto positions that are running away from them. It's impossible to constantly monitor your portfolio and unless you use a Stop Loss you could get a nasty shock the next time you check your account. Some providers will also allow you to have a 'trailing' Stop Loss, so that you can protect your profit as the price moves.

Guaranteed Stop Loss orders – Occasionally, prices move quickly and jump or 'gap' past certain price levels, perhaps due to a profit warning or a record set of figures. This can be fantastic news if your position is the right way, but a potential disaster if it's not.

An ordinary Stop Loss order will only be triggered at that level if the market trades at the price you set. If the market price then gaps past your level, your position will be closed at the next available price. A Guaranteed Stop Loss (GSL) order gives you complete protection at your Stop Loss level and acts as a type of insurance policy. You pay a small premium to the provider, who in turn guarantees executing your trade at the Stop Loss price you set.

Some brokers will offer special types of account where a Guaranteed Stop Loss is required for every trade placed – this means you can place trades safe in the knowledge that your risk is managed from the outset.

Limit Orders – As well as using orders to minimise risk and protect the downside of your investment, most providers will also give you the facility to set a Limit Order to buy or sell if the price moves to a more favourable level than the current price. Limit Orders can be used to open or close a CFD trade.

For example you may have a long position in Vodafone Group Plc at 200p. You might

Stop loss		
If you go	**You will**	**set your Stop Loss**
Long	open your position with a buy	below current sell price
Short	open your position with a sell	above current buy price

decide that should the price reach 220p you would like to take your profit and therefore set a "Limit Sell" order at 220p. Alternatively, you might have a keen interest in Vodafone Group Plc but think it is over-priced and decide to set a Limit Buy order to open a position should the price go down to 180p. When placing a Limit Order, you will normally have two options of how long you can leave your order open for; 'Good For Day' (GFD), which means your order will be valid until the end of the trading day, or 'Good Till Cancelled' (GTC), meaning your order will be valid until you instruct the provider to cancel it.

Linked Orders – A linked order allows you to place two orders against the same deal, e.g. both a Stop Loss and a Limit Order. If one order is executed the other one will automatically be cancelled.

TIPS on becoming a better trader

Ultimately, whether you make or lose money is down to you and the strategies you adopt. When trading CFDs, the risk and reward are always there in equal measure and the successful trader is one who knows how to minimise one and maximise the other. Here are a few tips that might help:

- Only trade with money you can afford to lose.
- Don't get carried away by trading up to your margin limit – it is usually better to trade small amounts over time, than risk losing one huge amount very quickly.
- Never open a position without setting a Stop Loss order to protect yourself.
- Never invest on a whim, but identify your target price and invest at the right time. Most investors will enjoy more success from a handful of companies or markets that they watch closely.
- Get to know the trading platform first by using a trading tutorial. Learn how to take profits using Limits and cut losses using Stop Losses.
- Greed is always a big factor when investing. Set yourself profit targets and stick to them.
- Think about how much you are willing to lose. Set your Stop Loss and keep to it, don't keep moving your Stop Loss further away in the hope that the price will recover. Cut your losses and look for other opportunities.
- Only open a CFD trading account and start trading once you fully understand the concept and all the risks involved.
- You can also use CFDs to "hedge" existing physical share holdings against short term price falls. You do this by selling a CFD and protecting your profits whilst maintaining a full shareholding and voting rights attached to it.

Frequently Asked Questions

Q. How do I find out about different margin requirements and when I can trade?

A. Nearly all CFD providers will provide you with 'Market Information Sheets' which give you the trading hours, margin requirements, minimum deal size, etc.

Q. How much money do I need to open an account?

A. This will vary from provider to provider; you can often open an account without having to deposit.

Q. How risky is CFD trading?

A. CFD trading is high-risk as you are trading on margin. You can limit your risk by using Stop Losses and Guaranteed Stop Losses. Remember don't use all your money on just one trade – start small and build up.

Q. Can I use a CFD for longer term trading?

A. There are generally no expiry dates on CFDs. Theoretically you can hold them as long as you want, provided you maintain the minimum margin requirement and cover the financing costs. However, they are designed to help investors benefit from relatively short term market movements, not as long term holdings. Financing costs can also make it expensive to hold a long CFD position open for a long time.

Q. How important are Stop Losses?

A. Stop Losses are an essential tool for successful traders. They are generally underused by private investors who do not take advantage of one of the most important trading facilities available.

Q. Because it's risky do I need to constantly watch the markets?

A. Not if you place a Stop Loss. Although the margin element of CFD trading means that gains or losses can be achieved more quickly than via conventional trading, you will have all the investment tools you need to be able to set your Limits and Stops, so that you can manage your losses and take your profits without having to sit in front of your computer 24 hours a day.

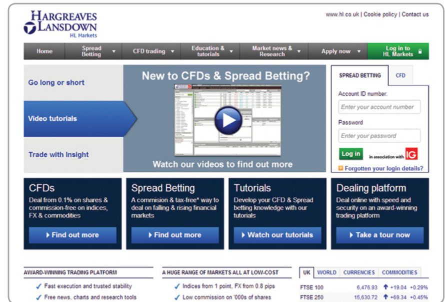
How to get started

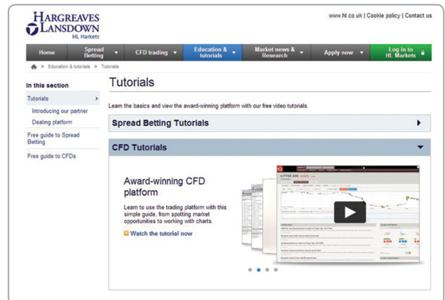
Simply visit www.HLMarkets.co.uk to watch video tutorials, learn more, or apply now. In our opinion there is no better CFD service. The costs are low, the information is second-to-none and the online, mobile and telephone service is exceptional. Hargreaves Lansdown provides Contracts for Difference in association with IG who are an award-winning execution-only provider. They offer:

- Permanently tight spreads across markets
- A huge range of markets, including: global stock indices, 70+ forex pairs and commodities
- Over 6,000 Share CFDs, binaries, options and much more

You can analyse and trade the world's financial markets with speed and security on an award-winning platform, which provides:

- Price improvement technology and fast execution
- Deal through market-leading charts; using quick charts or advanced charting
- Free financial news; live market news feeds
- Fully customisable layout; personalise the layout to suit your dealing
- Insight; live data, analysis and aggregated views of what other clients are trading
- Trusted stability: 99.96% core platform uptime (average per month, IG globally, 12 months to October 2015).





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