Stock Markets Guides

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CFD Trading Beginners Guide

The stock market can be a volatile place. Every day, securities are traded on the financial markets across the globe. The buying and selling of securities on these markets cause price fluctuations that move the prices of these securities up and down.

Even the most junior investors grasp the basic concept of investing in the stock market. You buy shares and then sell them for more than you originally paid. This is how most investors in the stock market will make their money.

However, this is not the only way to make money in the stock market. In the hustle and bustle of the financial markets, a rare kind of trader can make money in the markets using a different type of financial instrument known as a CFD.

These financial instruments make it possible for these traders to make money in the markets irrespective of whether the value of a security rises or falls.

This post will explore the fundamentals of CFD trading, including the advantages and disadvantages of trading these instruments.

CFDs Meaning

The acronym “CFD” stands for contracts for differences.

Simply put, they are contracts between a buyer and a seller that stipulates the buyer must pay the seller the difference between the current value of an asset and its value at contract time. That sounds unnecessarily complicated.

Let's try to understand it by looking at the example below. This example will examine one hypothetical scenario where a trader uses a CFD to profit from the price of Apple shares falling.

A trader is looking to trade Apple’s stock using a CFD. The trader believes that Apple’s stock will drop at least 20% over the next few weeks because, among other things, the US Consumer Price Index (CPI) data was released and indicated a potential rise in inflation this month.

The trader wants to profit from this decrease in the price of Apple’s stock. They open a CFD trade on Apple’s stock at $100 per share. Thanks to the leverage permitted in CFD trading, to control a $100 position in this trade, the trader only needs to have $25 of capital as the brokerage permits leverage of 1:4.

The trader's hypothesis was correct, and Apple’s stock indeed falls 20% down to $80 per share over the weeks following the trade.

The trader then closes the position as they believe the stock has ceased falling. The trader’s profit is the difference between the purchase price (100$) and the selling price ($80). In this example, the trader has profited 20$ from the trade minus the brokerage's fees. The trader’s investment account will now have his original 25$ of capital used to open the trade and his $20 profit (minus fees).

Let's examine this example in the context of the definition given above. The scenario demonstrates a buyer (the brokerage) paying the seller (the trader) the difference in value between the current value of the asset ($80) and the value it had at the time the contract was made ($100).

What is a CFD? Simply put, a CFD is a financial instrument that allows traders to trade in the direction they believe the price of a security will go.

They can bet that the value will either rise or fall. If they are correct, their profit will be the difference between the original price and the securities when the trade is closed. CFD’s can be used on many securities, including ETFs, Stocks, Gold, Silver, and Forex.

CFD Trading for Beginners

Now that you know what CFDs are, you might be wondering, how do they work? Traders who use CFDs can basically do two things.

They can either buy (otherwise known as going long), which mimics a traditional share purchase whereby the trader gains when the price of the security increases. Or, they can sell (otherwise known as going short). When traders go short, they profit from decreases in the asset price, as in the example above.

Brokerages that offer CFDs profit from the spread they charge traders to open their positions (as well as other fees such as overnight fees).

The spread is the difference between the bid and the offer. Traders who use CFDs profit if they correctly speculate on the direction that the price of the security is going to go.

The hallmark of a CFD trade is that the trader does not own the underlying asset as they would when buying shares.

This means that if they open a CFD trade in Coca-Cola, they do not own shares of Coca-Cola. If they open a CFD position in Bitcoin, they do not own any Bitcoin. The trader does not actually own the asset on which the CFD is based; they are merely speculating on the price movements of that asset.

CFDs are similar to what is commonly referred to as “shorting” in the US markets.

It is easy for new investors to become confused between a CFD and commonly referred to as “shorting a stock”. “Shorting” differs from CFD trading in that when a trader shorts a stock, they are borrowing the stock from a third party and then selling the stock in the hopes of purchasing it back later for a cheaper price. CFD traders are simply seeking to profit from moves in a security’s price.

Unlike “shorting”, when trading CFDs, the trader does not actually own/borrow the underlying asset but is simply making a profit/loss based on their speculations of that securities price fluctuations. This is how a CFD trade works.

Before we begin to examine some of the basic advantages and disadvantages involved in trading CFDs, it should be stated that CFD trading involves fairly advanced trading strategies, and experienced traders should only employ them. Statistically speaking, most traders will lose money when trading CFDs. So, why do some traders decide to take on the risk?

Trading CFDs offers traders several advantages over traditional share purchases. To begin with, trading CFDs provides traders with higher levels of leverage (margin) to trade with.

Market name	Value per pip	Min spread	Average spread*	Margin required
Spot AUD/USD	US$10	0.6	1.33	0.5%
Spot USD/JPY	Y1000	0.7	1.26	0.5%
Spot EUR/USD	US$10	0.6	1.13	0.5%
Spot GBP/USD	US$10	0.9	2.38	0.5%

This allows them to control larger positions with less capital and maximize their potential profits (or losses). As we saw in our example earlier, the trader could control a $100 position in Apple with only $25 of capital.

However, regulations on the amount of leverage being provided, especially to retail traders, are quickly tightening.

In days gone by, traders were able to secure as much as 50:1 leverage. These days, many jurisdictions quickly restrict the amount of leverage available to retail traders, with many brokerages now offering as little as just 2:1 leverage.

We mentioned earlier how some traders in the US could “short” a stock and how the key difference between shorting a stock and using a CFD is that when you short a stock, you actually borrow the stock from a third party.

When you use a CFD, you do not actually own the underlying asset; you are simply betting on whether you believe the price will increase or decrease. This lack of ownership actually provides the trader using a CFD with several benefits. Since they are not borrowing the stock, they are not obligated to pay borrowing fees.

Similarly, in the United Kingdom, since traders do not own the underlying asset, they will also not be subject to taxes such as stamp duty.

Although the leverage and reduced fees/taxes are attractive, there are some significant disadvantages to trading CFDs.

Traders may not be subject to borrowing costs or taxes such as stamp duty, but they will have to pay a "spread" to the broker when they open their trade. Whilst this may not seem significant, it can quickly add up.

This spread is especially problematic when there are significant amounts of volatility in the price of a security as the volatility will increase the cost of the spread. As a result, it can be difficult for traders to profit from small price fluctuations in a security when trading CFDs.

The increased levels of leverage in trading CFDs can also become dangerous.

A highly leveraged trade exposes traders to far more risk if a trade does not go as planned. When using leverage, traders may also end up losing more money than they had originally invested into their position if the trade moves far enough in the wrong direction.

While stop-loss limits are available on most brokerages and can potentially prevent these catastrophic losses, they do not guarantee against losses. Even with a stop-loss, traders may still lose money, especially if there is a sharp price movement in the price of a security.

Finally, the CFD industry is not tightly regulated.

This is one of the major reasons why jurisdictions like the United States refuse to permit CFD trading. A CFD broker's credibility is predicated on their reputation, longevity, and financial position instead of government standing or liquidity. Liquidity can be especially problematic when there is not enough trading in the underlying asset, resulting in existing contracts becoming illiquid.

CFD vs Share Trading

Given the potential returns offered by CFD trades, it is natural for traders to wonder whether it is better to trade shares or CFDs and the differences between them?

There are several differences between CFDs and traditional share trading.

Firstly, with traditional share trading, you only have access to ETFs and individual shares. CFDs provide traders with access to a much wider range of instruments to trade with.

Secondly, there is a difference between the risk exposure that traders take on. With traditional share trading, a trader's risk is capped at the number of shares they purchased.

As we mentioned above, traders can lose much more than they originally invested when trading CFDs.

CFDs are much more versatile than buying traditional shares. They allow traders to benefit from any price fluctuations whilst buying shares only allows traders to profit if the price of the share increases. However, CFDs do not afford traders any voting rights in the company in the same way that owning shares do.

This means CFD traders are not able to express their opinions on any major company issues.

Once traders are familiar with the benefits and risks associated with trading a CFD, they begin to ask when either of these instruments should be used.

Coincidently, the use of CFDs has exploded since 2020. This is because CFDs are handy tools for taking advantage of extreme volatility in the markets, and over the last two years, the financial markets have known significant volatility.

In March 2020, the World Health Organisation declared Covid-19 a global pandemic. As a result of this, global financial markets went into free fall.

Major indices like the S&P 500 lost up to 30% of their value in the space of a month. These types of situations are an excellent time to capitalize on the benefits of CFD trading. Since traders have access to significant amounts of leverage when trading CFDs, they could take advantage of the falling market by opening a CFD position betting the market will continue to fall.

Doing this would have proved to be extremely profitable for traders who opened these positions in March 2020.

To summarise, traditional share purchases are more suited to the long-term investor planning to hold his shares for several years, whilst CFDs are more suited to the short-medium term trader looking to profit from price fluctuations quickly.

Trading CFDs can be especially profitable after black swan events such as Covid-19, 9/11, the dot-com bubble burst, and the 2008 financial crisis, which saw the collapse of major financial institutions.

CFD Trading Platforms

Unfortunately, not everyone will be able to trade CFDs.

Major jurisdictions, including the United States, do not allow for CFDs to be traded. Even in jurisdictions where CFD trading is permitted, such as Australia, retail traders may find that their leveraging capabilities have been significantly reduced when using CFDs.

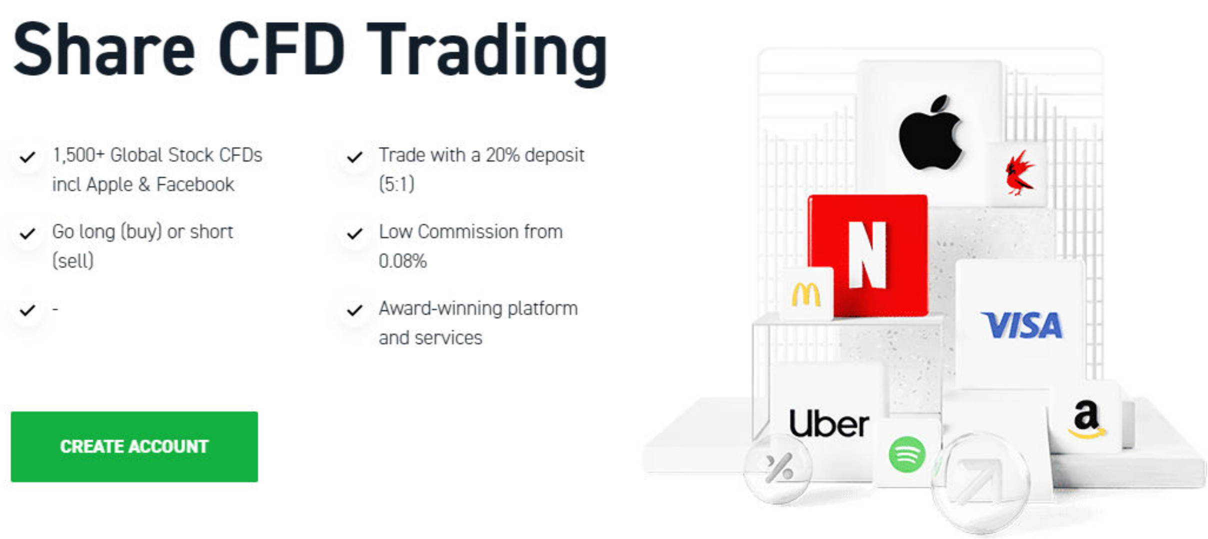
However, there are still several brokerages available where traders can take advantage of CFDs.

Since CFDs are poorly regulated, we will only list the four most reputable and reliable CFD trading platforms that traders can use.

- XTB

- Etoro
- Interactive Brokers
- IG Markets

Each trading platform will have its strengths and weaknesses and will be suited to different types of traders.



XTB will be most suitable for experienced traders looking to take advantage of a more advanced trading platform. Etoro traders will enjoy a very user-friendly interface that might be more suitable for junior traders. They also offer a practice account where junior traders can test their skills before putting real capital at risk.

Interactive Brokers is designed for both experienced and inexperienced traders and has access to almost any trading tool you can imagine.

Finally, IG is the largest of the four and offers some of the most competitive fees in the market. They are also allowed to operate in most countries, so you will likely be able to access their trading platform wherever you happen to be based.

How to Start CFD Trading

To start trading CFDs, there are three things every trader must do.

When starting to trade CFDs, every trader's first decision is which broker they should use.

Ideally, if a trader is inexperienced in CFD trading, they will sign up with a broker that they trust, and that will allow them to practice trading CFDs for free before graduating to the use of real capital.

After a broker has been selected, traders should begin to think about what kind of assets they want to trade. As we noted earlier, CFDs can be used on a wide range of different assets, including ETFs, stocks, commodities, and even cryptocurrencies.

It is recommended that traders focus on one asset class when they are beginning to trade with CFDs rather than spreading themselves thin trying to master everything at once.

Once they have selected a trading platform and an asset class to trade, traders should familiarise themselves with the different strategies they can use to trade CFDs. These strategies can include swing trading, trend trading, and scalping. Traders should be familiar with various strategies and have honed their skills on a practice account before trading with real capital.

After these three things are done, you are ready to begin trading CFDs.

Lastly

CFDs can be a fantastic way to take advantage of price fluctuations in the financial markets. They are extremely versatile instruments that allow traders to profit from any price movement in a wide range of assets.

Whilst they certainly have their place in the financial landscape, traders should utilize these instruments with caution. They carry significantly more risk than traditional share trading, and it is common for a novice investor to lose significant amounts of money when trading with these instruments.

Remember, the key to successful trading is risk management.

Do not over-leverage your positions, and keep a watchful eye on where you set your stop-losses. It is always better to take a small loss and live to fight another day than to wipe out your position by holding on to a highly leveraged CFD that you do not have the liquidity to sustain.

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