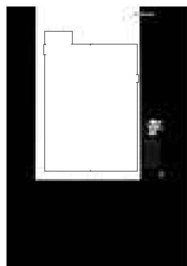
MEDIA MONITORS
INCISIVE INSIGHT



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Know the difference

Contracts For Difference (CFD) is a contract between two parties: the CFD trader, and a CFD provider. Under the contract, one party agrees to pay another for the difference between the purchase price and sale price of a CFD

CFD providers offer two way stock prices. For instance if *BHP* is trading on the *Stock Exchange* with buyers at $10.02 and sellers at $10.03, the CFD provider may instigate a two way price, meaning traders can buy CFDs at $10.01 and sell at $10.04.

Let's say you buy 1,000 CFDs at $10.04. Two days later, the price of *BHP* has risen and the provider is now buying CFDs at $10.21 and selling at $10.24. You now sell the 1,000 CFDs to the provider at $10.21 and your trade is complete. You made $170 on the trade.

So far, it appears that there is little difference to trading CFDs and trading stock through a 'normal broker'. So what are the advantages of trading the CFD?

The most recognisable advantage is that the amount of brokerage paid for the purchase of the CFD in the previous example is $0. The provider earned 'commission' due to the slightly wider spread than offered by the underlying market. In the example presented you would pay $10 difference for the buy and the sell. This compares to brokerage costs of up to $33 for the buy and sell through online brokers. (NB. Some CFD providers may choose to match the underlying price but charge a separate brokerage commission.)

Leverage

A second advantage is that you are not required to outlay money for the entire value of the trade. If you purchased the *BHP* shares through a stockbroker, you would have had to outlay $10,030 for the purchase of the stock. With the CFD in the previous example, you would only have to outlay an estimated 10% of that amount ie. $1,003. You are then able to free up the remaining $9,027 for other investment opportunities. The cost of doing this is that the provider has paid for the full purchase of stock by lending you the $10,030 and using your $1,003 as security. CFD providers often charge overnight bank rates which are generally very competitive as compared to 'margin lending' rates.

This now introduces the concept of 'leverage'. Remember in this hypothetical trade you made around $170. So with an outlay of only around $1,003, this represents a profit of (170/1003) 16.95%. Compare this to having bought the actual stock and made a profit of $170 (which would realistically be less because of higher brokerage costs) $10,000 = 1.7%. However, leverage can work both ways and you risk losing more than what you would have if you had bought the underlying stock.

Global diversification

Another advantage of trading CFDs is that most CFD providers allow you to trade thousands of stocks from around the world. Whether it's *BHP* here in Australia, *Cadbury Schweppes* in the UK, *Heineken* in the Netherlands, *L'Oreal* in France, *McDonalds* in the US, *Ericsson* in Sweden, *Nokia* in Finland, *Volkswagen* in Germany, *Nestlé* in Switzerland – all these CFDs are available for you to trade from your one account.

In the original *BHP* example, we showed how you could make money by buying the CFD. What if you wanted to sell the *BHP* first with the aim that you could buy back the stock at a lower price in the future. This is known as 'short selling'.

With 'normal' stockbrokers this isn't always possible and there are often additional costs for 'borrowing' the stock and/or compliance costs. With CFDs you are able to short sell as easily as you buy. Let's say, continuing with the *BHP* example, you choose to short sell *BHP* at the bid price of $10.00. Two days later, the stock falls and the CFD provider gives a bid and offer for the CFD at $9.80 and $9.83. You could then buy the CFD back at $9.83 and close the trade with a $170 profit (calculated the same as the previous example). But in this case, the provider has essentially lent you the stock, not cash. And on top of that the provider will pay you interest when you borrow the stock.

CFDs have proved a favourite with many traders, allowing them to gain leverage with the larger Australian stocks, exposure to foreign stocks, and providing portfolio protection through its ability to short sell, at a cost which is often less than traditional online brokers.

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