

# Contracts for Difference (CFDs)

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# Welcome to Alexander David

Alexander David Securities helps private clients to realise significant value in a dynamic trading environment, focusing on the very real potential of neglected opportunities.

We are a trusted advisor and critical friend and look to establish long term relationships with every client. We have an old fashioned commitment to customer service but operate in an efficient, performance-driven culture to deliver results.

Our ethos is to be “in the market”, developing the essential insights necessary to provide astute business and investment guidance. We are well connected and bring our contacts, knowledge and experience to bear in every interaction.

Ultimately we deliver the market insight and investment advice you can trust.

## INSIGHT

- Alexander David Securities is well connected throughout the City
- we are in-touch and in-tune with a fast changing, dynamic market
- we are adept at spotting neglected opportunities.

## ADVICE

- we listen carefully to our customers and treat them as individuals not numbers
- we tailor our advice to meet specific objectives and circumstances
- we provide, accurate, timely and valid information and guidance.

## TRUST

- we set out to create long term relationships
- we deliver against a promise
- your success is essential to our success.

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# What are Contracts for Difference (CFDs)

A CFD is an agreement between two parties to settle, at the close of the contract, the difference between the opening and closing prices, multiplied by the number of underlying shares specified in the contract.

CFDs are traded in a similar way to ordinary shares. The prices quoted by many CFD providers are the same as the underlying market price and you can trade in any quantity just as you would with an ordinary share. You will be charged a commission on the trade and the total value of the transaction is simply the number of CFDs bought or sold multiplied by the market price. There are some distinct differences from trading ordinary shares that have made them increasingly popular as an alternative instrument to speculate on the movements of shares or indices.

## Advantages of Contracts For Difference

- CFDs are traded on margin (as low as 5% of purchase price) so you can maximise your trading capital
- NO Stamp duty is payable (saving 0.5% compared to a traditional share purchase)
- You can profit from falling or rising markets by trading long or short
- A single account can give you access to a far greater range of financial markets
- You can trade indices
- You can limit and manage your risk using “Stop Loss” and “Limit Order” facilities.

## Risks of Contracts For Difference

- The geared nature of margin trading markets means that both profits and losses can be magnified and unless you place a stop loss you could incur very large losses if your position moves against you
- CFDs are less suited to the long term investor. If you hold a CFD open over a long period of time the associated costs increase and it may be more beneficial to have bought the underlying asset
- You have no voting rights as an investor
- If you hold a stock that goes ex-dividend you will receive 80% of the dividend
- If you are short of a stock then you will have to pay away the full amount of the dividend.

# Key Features of Contracts For Difference

## Traded on margin

Rather than pay the full value of a transaction you only need to pay a percentage when opening the position. This is referred to as “Initial Margin”. The key point is that the margin allows leverage, so that you can access a larger amount of shares than you would be able to if buying or selling the shares themselves.

The margin on all open positions must be maintained at the required level over and above any marked to market profits or losses in order to keep the position open. If a position moves against you and reduces your cash balance so that you are below the required margin level on a particular trade, you will be subject to a “Margin Call” and will have to pay additional money into your account to keep the position open or you may be forced to close your position.

## Trade in rising or falling markets

CFDs allow you to trade LONG or SHORT. A Long Trade is where you BUY an asset with the expectation that it will rise, just as you would when buying a normal share. A Short Trade is where you SELL an asset that you do not own in the expectation that the price will fall and you can buy the asset back at a cheaper price. Shorting in the ordinary share market is almost impossible. With CFDs however, you can go short as easily as you can go long.

## No Stamp Duty

There is no stamp duty on CFDs as you do not actually buy the underlying share.

## Commission

Commission is charged on CFDs just like on an ordinary share trade. The commission is calculated on the total position value not the margin paid.

## Overnight Financing

Because CFDs are traded on margin if you hold a position open overnight it will be subject to a finance charge. Long CFD positions are charged interest if they are held overnight. Short CFD positions will be paid interest.

The rate of interest charged is set at 2.5% above or below the current LIBOR (London Inter Bank Offered Rate).

The interest on each position is calculated daily by applying the applicable interest rate to the daily closing value of the position. The daily closing value is the number of shares multiplied by the closing price. Each day's interest calculation will be different unless there is no change in the share price.

## Trade Shares and Indices

CFDs allow you to take a view on shares and indices as well as some sector-specific indices (such as Telecoms).

## Risk Management Facilities

Because of the higher risk nature of trading on margin, we offer comprehensive “Stop Loss” and “Limit Order” facilities so that investors can manage their risk in fast moving markets.

# How do Contracts For Difference work

The best way to demonstrate how a CFD works is to look at some key examples:

## Share CFD Example: Long Trade

A long trade is a position that is opened with a buy in the expectation that the share price will rise.

### *ITV is currently trading 77 – 77.25*

Investor A believes that ITV is going to rise and places a trade to BUY 20,000 shares as a CFD at 77.25p. The total value of the contract would be £15,450 but they would only need to make an initial 10% deposit (initial margin) of £1,545.

The commission on the trade is £77.25 (£15,450 x 0.5%) and, because they are buying a CFD, there is no stamp duty to pay.

A week later, Investor A's prediction was correct and ITV has risen to 81.75 – 82.0 and they decide to close their position by selling 20,000 ITV CFDs at 82.25p. The commission on the trade is £81.75 (£16,350 x 0.5%).

The profit on the trade is calculated as follows:

Opening Level	77.25p
Closing Level	81.75p
Difference	4.50p
Profit on trade, (4.5p x 20,000)	£ 900.00

### **Overall Profit**

To calculate the overall profit you must take into account the commission and financing charges on the deal.

Profit On Trade	£ 900.00
Commission	-£ 159.00
Financing Charge	-£ 23.50
Overall Profit On the Trade	£ 717.50

**A 46.44% profit on the initial margin.**

## Share CFD Example: Short Trade

A short trade is a position that is opened with a sell transaction in the expectation that the share price will fall.

### *Barclays is currently trading at 555 – 556*

Investor B believes that Barclays is overvalued and is going to fall. The investor places a trade to SELL 2,000 shares as a CFD at 555p. The total value of the contract would be £11,100. Even though they are selling short, they would only need to make an initial 10% deposit (initial margin) £1,110. The commission on the trade would be £55.50 (£11,100 x 0.5%).

A week later Investor B's prediction was correct and Barclays falls to 529 – 530 and they decide to close their position by buying 2,000 Barclays CFDs at 530p, the commission would be £53.00.

The profit on the trade is calculated as follows:

Opening Level	555.00p
Closing Level	530.00p
Difference	25.00p
Profit on trade, (25p x 2,000)	£ 500.00

### **Overall Profit**

To calculate the overall profit you must take into account the commission and financing charges on the deal. Remember with a “Short” sell the financing charge is credited to the holder.

Profit On Trade	£ 500.00
Commission	-£108.50
Financing Charge	£ 3.80
Overall Profit On the Trade	£ 395.30

**A 35.61% profit on the initial margin.**

# How do Contracts For Difference work (continued)

## Example: Index CFD Trade

Although indices are not quoted like ordinary shares with a BID and ASK price, CFD providers will quote a BID and ASK price for index CFDs and allow you to trade indices as a CFD.

*The FTSE 100 is currently trading at 5790 and the quote is 5787 – 5793 on the FTSE CFD.*

The price to buy 1 CFD is £5,793, due to the size of an Index Trade and the reduced volatility when compared to an individual share, the margin requirements are usually lower. We have used a margin level of 5% in this example.

Investor A believes that the FTSE is going to rise and buys 10 Index CFDs at £5,793. A total value of £57,930. The margin required is just 5%; £2,896.50.

A week later the FTSE has risen and the daily FTSE spread is now 5990 – 5996.

The profit on the trade is calculated as follows:

Opening Level	£ 5,793.00
Closing Level	£ 5,990.00
Difference	£ 197.00
Profit on trade, (£197 x 10)	£ 1,970.00

### Overall Profit

To calculate the overall profit you must take into account the commission and financing charges on the deal,

Profit On Trade	£ 1,970.00
Commission	-£589.15
Financing Charge	-£ 88.80
Overall Profit On the Trade	£ 1,292.05

*A 44.6% profit on the initial margin*

## Stop and Limit Orders

Because of the geared nature of trading on margin it is essential to have access to facilities that let you open or close positions if certain levels are reached.

### Limit Order

A Limit Order is one that is executed at a better price than the prevailing market price, i.e. for a Long CFD Trade when the stock drops to a certain level or for a Short CFD Trade when the stock rises to a certain level.

## Example: Limit Order

*Vodafone is currently trading at 180 – 180.5*

Investor A wishes to buy 10,000 Vodafone as a CFD with a limit of 175, therefore they do not wish the order to be opened unless Vodafone reaches 175.

This order is held by the CFD Provider until the limit level is reached.

The next day Vodafone is 174.5 – 175 and an opening trade of 10,000 Vodafone is opened at the limit level of 175.

## Stop Order

A Stop Order is one that is executed at a worse price than the prevailing market price. One of the most common uses of this is a Stop Loss Order. It is possible to make substantial profits when trading CFDs as well as substantial losses which is why we recommend you place a Stop Loss when you open a trade:

### Stop Loss

A Stop Loss is a price level set by the client on a particular trade, that if reached, automatically closes out the particular position at the desired price.

## Example: Stop Loss

*Lloyds TSB is trading at 467 – 468*

Investor A and Investor B both believe that Lloyds will rise and both buy 2,000 Lloyds TSB at 468 as a CFD. However, Investor B also places a stop loss when he opens the trade at 457.

The following day Lloyds drops steeply during the day trading down from 467 to 430.

Investor A has not been watching the price of Lloyds all day and therefore when he checks the price at the end of the day it is now 430 – 431 and he is running a £750 loss. Investor B has not been watching the market either however his position has been automatically closed out at his Stop Loss level of 457, limiting his loss to just £200.

# Trading Strategies

## Short Term Trading

The ability to gear up your trading capital by trading on a margin, combined with no stamp duty make CFDs an ideal instrument for short-term trading.

## Hedging

You can also use a CFD to protect your long-term holdings against variable market conditions. It may be cheaper to open a short CFD position in the shares rather than sell the physical shares in order to buy them back later.

## Pairs Trading

If you believe that one company is undervalued compared to another company (e.g. Barclays against Lloyds) you can use CFDs to go long on the cheaper stock whilst going short on the more expensive stock.

## Tax Efficient Trading

If you have a holding of physical shares you can sell CFDs against this without crystallising a potentially taxable capital gain. This enables you to control the time at which you realise capital gains or losses and may reduce your tax liability.