

CFDs: OVERVIEW AND TRADING ONLINE

In this module we look at the basics: what CFDs are and how they work. We look at some worked examples, as well as how to place a trade online and other basic features of our dealing platform. We also discuss why this form of trading has become so popular in the last few years and the advantages that our service offers over other forms of trading.



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WHAT IS A CFD?

CFD stands for Contract for Difference. A CFD is a type of derivative, meaning the price of a CFD is derived from the value of some other asset such as a share or currency pair, but it can effectively relate to any financial instrument.

Rather than trade or exchange the asset itself, a CFD is a deal whereby two parties agree to exchange money according to the change in value of the underlying asset between the point at which the deal is opened and when it is closed. One party will be a buyer (of the value of the asset), and one will be a seller. The buyer will make money (from the seller) if the asset value increases and will lose money (to the seller) if it decreases. Conversely, the seller will lose money as the price of the asset rises and make money as it falls.

Put simply, CFDs are a means to gain exposure to the change in value of a financial instrument without actually being in possession of that instrument.

When you trade with us we act as a CFD provider, meaning that when you choose to place a deal, we will take the other side of the transaction. You choose whether you are buying or selling, and this defines us as being either the seller or the buyer in the contract.

How this works will become clearer if we look at an example of using a CFD to trade a share.

EXAMPLE 1

BUYING G.E. PLC

When trading shares using CFDs, the procedure and terminology are similar to normal share dealing (and in many cases exactly the same).

General Electric (GE) is trading on the New York Stock Exchange at 2992/2993¢. Having watched G.E.'s share price over the last month, you feel that the stock is undervalued and you think that now might be the time to take a position.

You decide to buy 800 shares as a CFD with us. Rather than physically taking ownership of the shares, you are instead opening a contract with us that gives you the same financial exposure as if you had gone out and actually purchased the same number of shares.

The price that we quote for shares is always the same as the price that is trading on the stock exchange. You therefore open your deal at 2993¢, the offer price of the shares.

Just as with a regular share transaction, we charge a commission.

Our standard commission for US shares is 2 cents per share.

This means that your opening commission is:

2¢ x 800 shares = \$16.00

MARGIN

A fundamental difference between trading a CFD and physically buying and selling shares in the conventional manner is that when trading a CFD you only need to initially deposit a small portion of the value of your exposure. This is known as margin (discussed in depth in Module 4 – Leverage and Margin) and means that you do not have to tie up as much of your funds with a trade as would normally be the case.

The amount of margin required varies according to the liquidity and volatility of the underlying instrument. For US shares the margin requirements begin from as low as 5% of the underlying value, but can be larger, depending on which share you are dealing.

Should the share price move adversely, however, you need to be able to send further ongoing margin.

In this case, GE is margined at 5%.*

You are dealing in 800 shares at a price of 2993. This means that the underlying values of the shares in which you are dealing is $800 \times 2993 = \$23,944$.

The margin of 5% is therefore just **\$1197.20**.

*We operate a tiered system of margining whereby very large positions in a given stock may result in a higher margin rate beyond a certain threshold. More details are given in Module 4, which discusses leverage and margin.

FUNDING

One of the key concepts of CFDs is funding. In this example, you are buying \$23,944 worth of equity (as a CFD) but you do not need to pay for the full value of the shares. Instead, you initially only have to hand over 5% and you are effectively borrowing the value of the shares.

As a result, you are charged a financing cost on the value of the underlying asset.

The cost of borrowing is based on a lending rate for the relevant territory or country. In the case of GE, as with all US shares, the rate is based on a US lending rate (specifically, we use 1 month ICE USD LIBOR rate).

For a long position (that is, a deal where you have bought and want the underlying to rise in value) you might pay 2.5% above that rate. Let's say that the underlying lending rate is 0.4%. You will therefore pay 2.9%. This is an annual rate, but the financing is calculated on a daily basis using the following equation:

Daily interest adjustment = No. of shares x current share price x $i/365$
Where i = the applicable annual interest rate

For each day that you hold the position, therefore, you accrue a financing cost. This is calculated and debited from your account on a daily basis.

In the equation above, the daily funding is calculated by dividing the annual interest on the whole underlying value by 360, which is the divisor used for US shares; for shares in the UK, Singapore and South Africa we use 365, however.

With our example, let's say that GE closes at 2999 on the first day. The first daily interest adjustment is calculated as follows:

Adjustment = 800 shares x 2999¢ x 0.029/360
= \$1.93

FUNDING

CONTINUED

DIVIDENDS

Net dividends are credited to long positions held at the close of business on the day before the ex-dividend date.

At the time of GE's ex-dividend date, your position is still open. The net dividend is 10¢ per share and this is credited to your account balance as shown:

$$800 \times \$0.10/\text{share} = \$80$$

SHAREHOLDER RIGHTS

As you do not own any actual shares, you are not entitled to any shareholder rights, such as voting on corporate actions.

Over the next few weeks, GE makes steady gains and 22 days after you opened the deal the share price is trading at 3106/3107¢. You decide to take your profit.

You sell 800 shares at 3106, the market bid price, and close your deal entirely.

Your closing commission is 2 cents per share:

$$2\text{¢} \times 800 \text{ shares} = \$16.00$$

Your profit on the trade, before taking into account commission and adjustments for interest and dividends, is calculated as follows:

Closing level: 3106¢	
Opening level: 2993¢	
<hr/>	
Profit per share: \$1.13	
Profit on trade: \$1.13 x 800 shares = \$904	

Of course if the price of GE had dropped, you would be looking at a loss. If for example, the price had dropped to 2905/2906, you would close at 2905:

Closing Level: 2905¢	
Opening Level: 2993¢	
<hr/>	
Loss per share: 88¢	
Loss on trade: 88¢ x 800 shares = \$704	

FUNDING

CONTINUED

We also have to take into account the commission that you have paid and the adjustments made for interest and any dividends.

You hold the position for 22 days. Using an annual financing rate of 2.5% + 0.4% = 2.9% this might amount to a total financing cost over the period of \$42.46. Over the 22 days during which you hold the position, the shares go ex-dividend, paying a net dividend of 10¢ per share. An adjustment was made to your account of **\$80**.

The overall profit is calculated as follows:

Profit on trade:	\$904
Opening commission:	-\$16
Closing commission:	-\$16
Interest adjustment:	-\$42.46
Dividend adjustment:	\$80
Overall profit:	\$909.54

In the instance where the price of GE actually fell to 2905/2906, resulting in a loss of 88¢ per share, the overall loss would come to \$698.46.

Loss on trade:	\$704
Opening commission:	-\$16
Closing commission:	-\$16
Interest adjustment:	-\$42.46
Dividend adjustment:	\$80
Overall Loss:	\$698.46

GOING SHORT

The trade detailed above is an example of going long of a share price (ie buying a share and wanting the price to rise). With CFDs you can also go short.

That is, you can sell shares first with the hopes of buying them back later at a lower price. With such a transaction, the CFD provider acts as the buyer and you as the seller. The advantage of being able to go short is that it is possible to make money even when share prices are not rising (which, of course, they can't do all the time).

As going short is the opposite of going long, the net dividend adjustments described in the example above work in reverse.

That is, when you take a short position, net dividends are debited from your account if a position is held at the close of business on the day before the ex-dividend date.

Interest differs slightly in that it can be either credited or debited to your account depending on the lending rate of the relevant territory at the time.

EXAMPLE 2

SELLING BANK OF AMERICA CORP

After monitoring a recent bounce in the share price of Bank of America Corp, you remain unconvinced that it will be able to sustain such levels given continuing problems in the general economy.

Bank of America Corp is trading in the market at 1764/1768¢ and, judging some kind of correction to be likely in the coming weeks, you sell 30,000 shares as a CFD. You deal at 1764¢, the market bid.

Your opening commission is US shares are commissioned at 2 cents per share. So "Your opening commission is 2¢ per share. In other words, the opening commission is $30,000 \times 2¢ = \$600$ ".

This amount is automatically debited from your trading account as soon as you place the trade.

MARGIN

In this case, Bank of America Corp is margined at 5%.

The underlying value of the stock that you are commanding is 30,000 shares x 1764¢ per share = \$529,200.

5% of this is **\$26,460** and this is the amount that you deposit as initial margin.

FUNDING SHORT POSITIONS

Funding for short positions works slightly differently to long positions in that interest can be either credited or debited from your account depending on the interbank lending rate at the time.

For example, if LIBOR is greater than your financing fee, you will receive interest for being short as the fee is subtracted from, rather than added to, the interbank rate. If the financing fee is greater than the lending rate, this will appear as a debit to your balance.

In the same way that rates on loans are generally higher than savings rates, the amount you may receive for being short is not as much as the amount that you pay for being long.

Let's say that the rate happens to be 0.4%. For a short position funding would be calculated by considering an IG charge of 2.5% and taking away this 0.4% rate, giving 2.1%. This is an annual rate, but the financing is calculated and debited daily to your account.

With our example, let's say that Bank of America closes at 1350¢ on the first day. The first daily interest adjustment is calculated as follows:

$$\begin{aligned}\text{Adjustment} &= 30,000 \times 1350\text{¢} \times 0.021/360 \\ &= \$23.62\text{¢}\end{aligned}$$

DIVIDENDS

By selling shares you are foregoing any dividends after the time of your sale. For that reason, net dividends are debited from short positions held at the close of business on the day before the ex-dividend date.

It's important to note that not all stocks can be shorted. Although we offer this facility on the vast majority of shares for which we have CFD dealing, there are some stocks for which the necessary mechanisms (such as institutional lending of the stock) are not available in the underlying market to allow us to hedge short-positions satisfactorily. Such stocks are 'unshortable' (also referred to as 'unborrowable'). Moreover, there may be stocks with 'tight borrowing' whereby you are able to take a short position, but will receive less than the normal daily funding (or none, as the case may be). Such conditions are subject to change: a stock may be unborrowable one week, but not the next. Our dealers will always be able to inform you of the latest condition for a specific stock. There are also some stocks that cannot be shorted owing to regulatory restrictions.

FUNDING SHORT POSITIONS

CONTINUED

Your prediction regarding the share price proves to be correct over the next few weeks, as Bank of America gradually drops in price. Nineteen days after you opened the trade, the price is 1300/1304¢ and you decide to take your profit. You buy back 30,000 shares at the market offer of 1304¢ in order to close your position.

Your closing commission is again 2¢ per share:

$$30,000 \text{ shares} \times 2\text{¢} = \$600$$

Your profit on the trade, before taking into account commission and adjustments for interest and dividends, is calculated as follows:

Opening level:	\$13.64
Closing level:	\$13.04
Profit per share:	60¢
Profit on trade:	60¢ x 30,000 shares = \$18,000

To arrive at the actual profit on the trade, we also have to consider the commission that you have paid and the adjustments made for interest and dividends.

You hold the position for 19 days. Using an annual rate of 2.5% - 0.4% = 2.1% this might amount to a total debit over the period of \$448.78.

Over the 19 days during which you hold the position, the shares do not go ex-dividend. There is therefore no adjustment to be made on account of dividends.

The overall profit is calculated as follows:

Profit on trade:	\$18,000
Opening commission:	-\$600
Closing commission:	-\$600
Interest adjustment:	-\$448.78
Dividend adjustment:	-\$0
Overall profit:	\$16,351.22

FUNDING SHORT POSITIONS

CONTINUED

Of course Bank of America may have risen in value resulting in a loss for you. Let's look at what would have happened had the price risen to 1430/1434:

Loss on trade:	-\$21,000
Opening commission:	-\$600
Closing commission:	-\$600
Interest adjustment:	-\$448.78
Overall loss:	-\$22,648.78

OUR ONLINE DEALING PLATFORM

Our CFD trading service is available over the telephone via our dealers, from our range of mobile apps, or on our dealing platform.

Dealing online can provide significant benefits, including near-instant execution of trades, thousands of streaming prices, integrated news and analysis and a selection of advanced dealing tools.

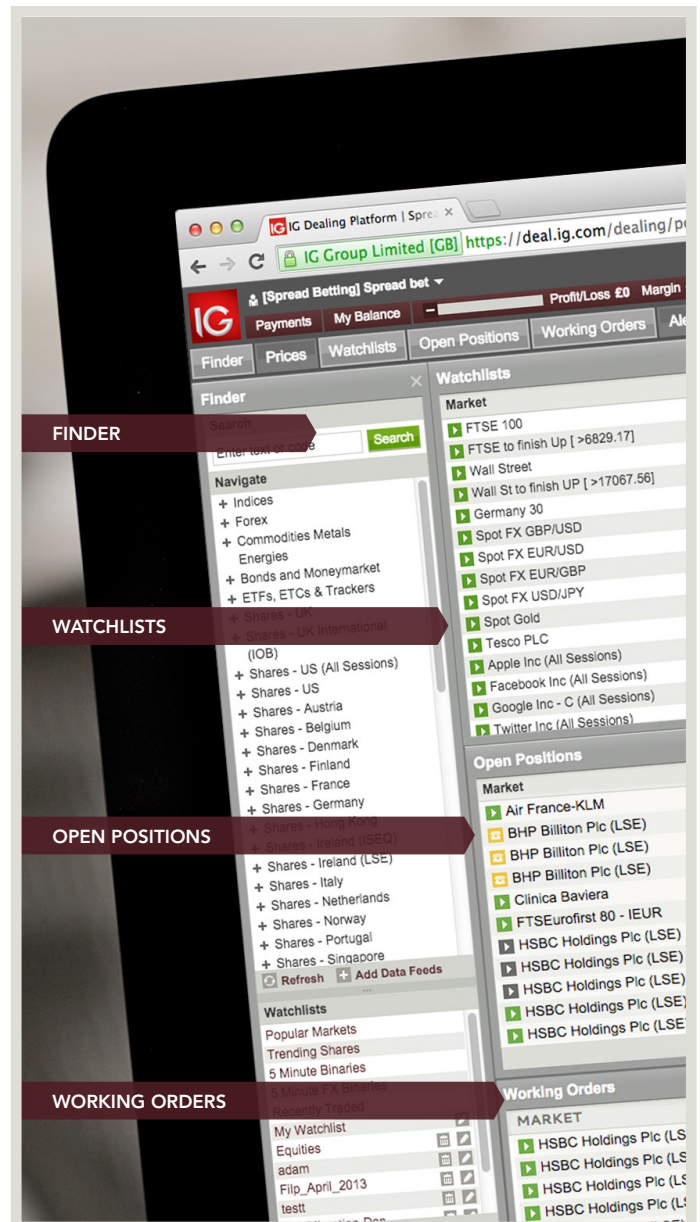
When you log in to our dealing platform, the screen is split into four specific areas, as shown.

All windows can be toggled on or off by using the buttons that appear at the top of the screen. 'Finder', 'Watchlists', 'Open Positions' and 'Working Orders' are selected as a default, but there are other options that can be selected to offer you further functionality.

For example, selecting the 'Tools' button launches a window which contains links to a variety of trading tools including charts and news.

The 'Watchlists' panel at the top shows a list of our more popular markets. The 'Finder' panel on the left is used to navigate to any of our thousands of markets, which can then be displayed as streaming live prices in a 'Prices' panel. From any live price that you are looking at you can open a deal ticket (with which you can place a trade). You can also choose to add your favourite markets to your own personal watchlists (you can set up a maximum of five watchlists).

Let's look at an example of placing a trade online.



EXAMPLE 3

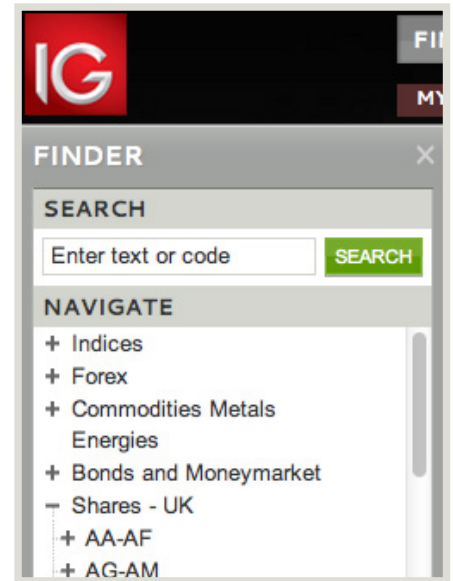
SELLING VODAFONE

1 It is early October and you think a fall in the UK share price of Vodafone is likely. Selling the shares as a CFD will allow you to profit if such a fall occurs. You decide to go online and check what prices we are making on Vodafone.

To do so, you first need to access the live price for Vodafone. There are two ways to do so from within the 'Finder' section: you can choose to use the navigation tree or use the 'Search' function.

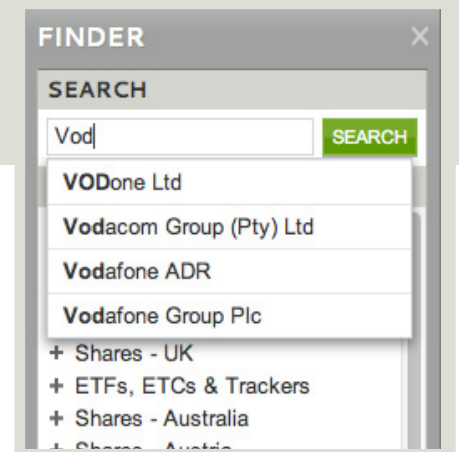
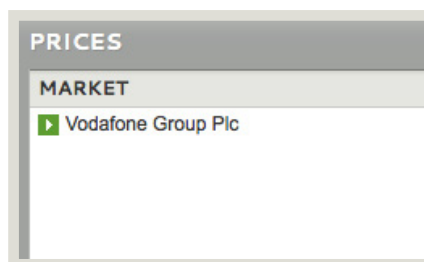
Using the 'Search' function is as simple as typing in part or all of the instrument's name. As you type in letters, a dropdown automatically displays markets that match; the more letters you type in, the narrower the results that are displayed.

Selecting the market of your choice and then clicking 'Search' imports the results of your search into the 'Prices' section.



2 You can also search through our markets using the navigation tree. As Vodafone is listed in the UK, you expand the 'Shares – UK' directory. You then expand the directory that corresponds to the letter with which the share begins.

3 You then expand the directory that corresponds to the letter with which the share begins. In this case, it is 'V' that you want.



EXAMPLE 3

SELLING VODAFONE

CONTINUED

To place a trade, you first need to specify the deal size (in this case, the number of shares). To do this you enter a quantity in the box entitled 'Shares'. Below this box there is a 'Currency' box that indicates in which currency you will be realising profit or loss. In this case, as we are dealing in a UK share that is priced in pounds sterling, the currency is indicated as 'GBP' (pounds).

You choose to sell 10,000 shares: you enter 10,000 in the 'Shares' box. The bottom half of the deal ticket is an optional section offering the ability to attach further dealing instructions; this is covered in detail in Module 3 – Using Orders to Trade. Making up your mind that you are happy to deal at the price that is showing, you click on 'Sell'.

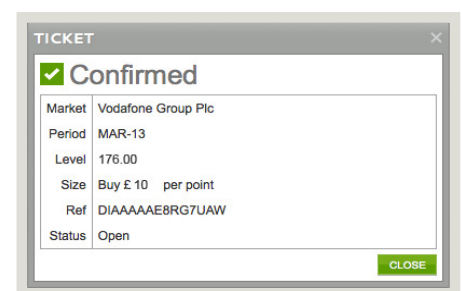
7 You receive an acceptance message that confirms the trade you have placed (please note that it is possible for deals to be rejected. The vast majority of trades – over 90% – are accepted, however). The acceptance message includes the details of your trade, along with a reference number.

8 As soon as your trade has been accepted, your position appears in the 'Open Positions' window.

You hold onto your position for the better part of two months. The whole time that your position is open, it is possible to check the profit/loss of the position by looking at the valuation in the 'Open Positions' screen. The share price never really drops in the way that you had anticipated, and eventually starts to make some gains. 42 days after you opened the trade, you decide to cut your losses.

Checking the price online, you see that Vodafone is now trading at **162.9/163.0**.

You decide to close your position.



EXAMPLE 3

SELLING VODAFONE

CONTINUED

9 To close your position, click on the relevant deal in the 'Open Positions' panel.

To help you, your running profit/loss for the position in question is displayed in the 'Close Position' screen (which updates with the changing price).

Click on **'Buy'**.

You receive another confirmation back telling you that you have bought 10,000 shares to close at 163.0.

Your loss, before taking into account commissions and adjustments for interest and dividends, is calculated as follows:

Closing level:	163.0p
Opening level:	161.0p
<hr/>	
Loss per share:	2p
Loss on trade:	2p x 10,000 shares = £200

To arrive at the overall loss on the trade, we also have to consider the commission that you have paid and the adjustments made for interest, borrow and dividends.

EXAMPLE 3

SELLING VODAFONE

CONTINUED

Our standard commission on UK shares 0.1%.

Opening commission = $0.1\% \times 10,000 \text{ shares} \times 161\text{p} = \text{£}16.10$

Closing commission = $0.1\% \times 10,000 \text{ shares} \times 163\text{p} = \text{£}16.30$

For being short of a UK share you might be charged an annual rate of 0.5% for borrow, resulting in an overall debit over the 42 day period of £10.

19 days of funding at a rate of (2.5% - 0.4%) 2.1% equates to a total funding charge of £17.60.

Over the 42 days during which you held the position, the shares went ex-dividend, paying a net dividend of £0.01 per share. A dividend adjustment was therefore made to your account: this was a debit of 10,000 shares x £0.01/ share = £100.

Loss on trade:	-£200
Opening commission:	-£16.10
Closing commission:	-£16.30
Interest adjustment:	-£17.60
Borrow charge:	-£10
Dividend adjustment:	-£100
Overall loss:	-£360

ONE-CLICK DEALING

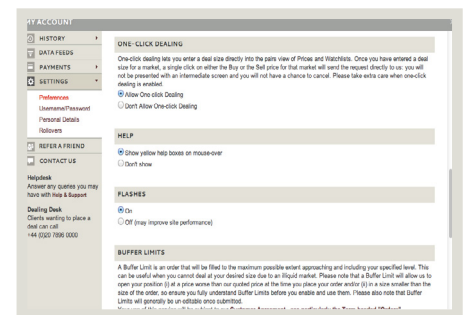
We also offer an alternative way of viewing prices. In the previous example, the prices were viewed as a list. There is another mode in which you can view prices as 'pairs', as shown.

Contract	Sell Price	Buy Price	Low	High
Vodafone Group Plc DFB	176.62	177.03	176.12	178.33
Vodafone Group Plc DEC-12	176.72	177.48	176.22	178.79
Vodafone Group Plc MAR-13	176.81	178.28	176.31	179.59
Vodafone Group Plc JUN-13	176.79	179.03	176.39	180.40

Clicking anywhere on a 'Sell' or 'Buy' price launches a deal ticket. As well as giving you the choice of how price information is displayed visually, the pairs mode offers another benefit. It is possible to set your account to 'One-click Dealing', which allows you to deal on markets directly from prices in the pairs view, without needing to open a deal ticket.

To enable 'One-click Dealing' you need to go to the 'My Account' section, which can be accessed by clicking on 'My Account' in the top right-hand of the screen.

Once you have launched the 'My Account' window, click on 'Settings', then 'Preferences'. Select 'Allow One-click Dealing' and scroll down to the bottom of the page and click 'Set Preferences'.



Spread bets and CFDs are leveraged products. Spread betting and CFD trading may not be suitable for everyone and can result in losses that exceed your deposits, so please ensure that you fully understand the risks involved.

ONE-CLICK DEALING

CONTINUED

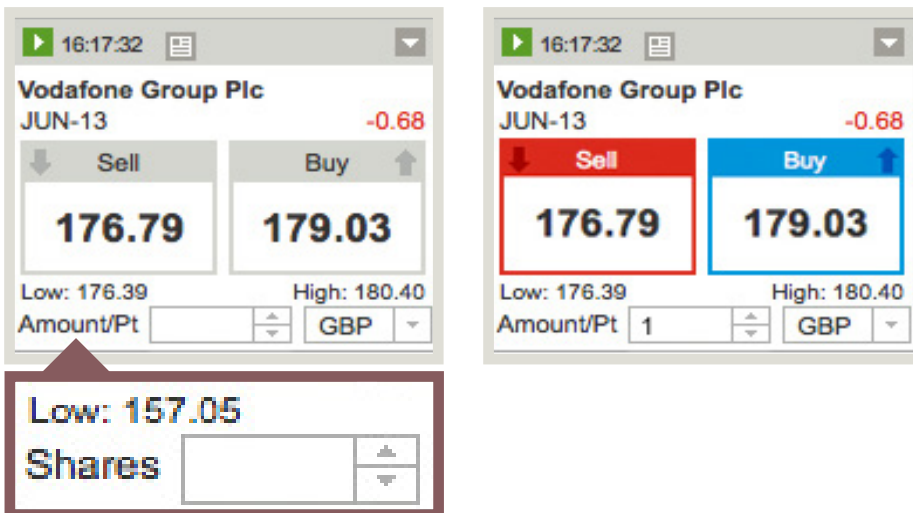
To view the deal tickets in pairs mode, go to the 'View as' drop-down list in the top-right hand corner of the platform and select 'Pairs'.

Now when you look at prices in the pairs mode there is a field where you can specify the size of the deal ('Shares' in the images shown).

If you enter a deal size in this field, the 'Sell' and 'Buy' buttons become dealing-operational as shown.

Now if you click either 'Sell' or 'Buy' you will directly initiate a deal.

'One-click Dealing' makes it even quicker and easier to place a trade than normal, especially if you pre-fill in the number of contracts or shares in which you intend to deal, but you should take care if this setting is enabled. With the intermediate step of the deal ticket removed, you should be cautious not to accidentally place a trade.



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ADVANTAGES OF USING OUR CFD TRADING SERVICE

CFDs have grown in popularity over recent years for a variety of reasons.

The simple long-term buy-and-hold strategy offered by investment in conventional shares no longer has the same appeal amongst the retail market that it once did. At the same time, small investors have started to become less risk-averse in their approach.

Further to this, CFDs offer a number of excellent benefits that are not normally available through normal share trading:

LOW COMMISSIONS AND SMALL MINIMUM TICKETS

Our standard commission rate for US share CFDs is a competitive 2¢ per share, with a minimum charge of just \$15. Furthermore, as a new client on our introduction programme you'll benefit from even smaller minimum charges for the first two weeks, which allows you to try out our service and practice trading CFDs with minimal risk.

LOW MARGIN RATES

Maximise your trading power by taking advantage of the small margin requirements for CFDs. You can deal on shares by putting down as little as 5% of the underlying value.

For example, taking a position equivalent to \$10,000 worth of equity in a stock that is margined at 5% would require a deposit of only \$500, offering you the convenience of only having to send further funds in the eventuality of the position moving against you.

ADVANTAGES OF USING OUR CFD TRADING SERVICE

CONTINUED

ABILITY TO GO SHORT

Buying shares is usually done as a result of the view that the share price will go higher and that there will be the opportunity to sell the holding for a greater amount at some point in the future.

As we all know, however, share prices don't always go up, and the ability to profit from falling as well as rising markets can therefore be very useful. Because no shares are physically changing hands when you trade CFDs, selling to open a new position is just as easy as buying, giving you trading opportunities that are not readily available with conventional share dealing.

SPEED OF TRADING

Whether you are dealing over the telephone or via the internet, transactions are executed very quickly, with internet deals typically transacted in just fractions of a second.

GUARANTEED STOPS

We offer the ability to restrict the potential loss on a trade to a fixed amount, specified by you at the opening of the transaction.

Stop-losses are dealing instructions that can be used to close out a position in the event of the market moving a certain amount against you (there is detailed information on Stops in Module 3 – Using Orders to Trade). Normal Stops will not always provide complete protection against particularly fast-moving prices (for example, after a profit warning). We offer special Guaranteed Stops that will always be executed at exactly the price you have set and thereby provide total protection against any unforeseen adverse movements. We charge a small limited risk premium if your guaranteed stop is triggered.

ADVANTAGES OF USING OUR CFD TRADING SERVICE

CONTINUED

FLEXIBILITY AND CONVENIENCE

CFDs are not just limited to shares: we also offer a wide range of different financial instruments (this topic is discussed in depth in Module 2: Financial Markets). Stock indices, commodity prices and FX rates are just some of these many different markets, and they can all be accessed quickly and efficiently from your single CFD trading account.

24-HOUR TRADING

Although shares trading is constrained to stock exchange hours, many of our financial products, such as leading stock indices and FX, can be traded 24 hours a day. This means you can open and close positions even when the underlying financial markets are shut.

Spread bets and CFDs are leveraged products. Spread betting and CFD trading may not be suitable for everyone and can result in losses that exceed your deposits, so please ensure that you fully understand the risks involved.

SUMMARY

By now you should:

- Understand what CFDs are and how they work
- Understand how the commission on a share trade is calculated
- Have an understanding of the effect of interest and dividend adjustments on a CFD position
- Be familiar with the advantages that CFDs offer
- Know how to search for prices online
- Be able to open and close a trade online

Spread bets and CFDs are leveraged products. Spread betting and CFD trading may not be suitable for everyone and can result in losses that exceed your deposits, so please ensure that you fully understand the risks involved.

Please note that although the material contained within our introduction programme is updated regularly to ensure accuracy, the information given is subject to change, often without notice, and therefore may not reflect our most current offering. Our examples are for illustrative purposes only and do not reflect events in the markets. The information is for guidance only and we accept no liability for its accuracy or otherwise.

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