GETTING THE EDGE

EQUITY CFD TRADING

CREATING OPPORTUNITY

CFDs AND FOREX TRADING

EQUITY CFD TRADING OVERVIEW

Maintaining your strategy when trading equities as CFDs can be very challenging. Trading equities can invoke strong reactions both emotionally and psychologically; having a strict strategy that involves risk mitigation and correct research will be highly advantageous and will reduce the risk of emotional trading. The difference between trading equities and trading currencies, for example, is bottom-up views are just as influential as top-down views. The advantage of a bottom-up view is that it gives you a clear picture of the underlying company, the sector it operates in and its future potential.

FUNDAMENTALS – THE KEY TO VALUATION

Fundamentals are a key part of any strategy. Investing in a company with strained or floored fundamentals adds unnecessary risk for the savvy investor.

The fundamentals of a company include its strategy direction, management structure and balance sheet. Is the company highly leveraged? Is it trading on skinny or fat margins? Or is it currently experiencing cash-flow issues? A good way to view a company's position, and thus the stock price, is to understand what state the business is in.

For example, mining and energy companies tend to have four phases:

1. Exploration phase
2. Construction phase
3. Production phase
4. Mature phase

The first two tend to be quite expensive and can make the stock highly volatile because the company is not producing anything; thus revenue can be zero, and positive stock moves are highly conditional on events such as discovery.

FUNDAMENTALS ARE A KEY PART OF ANY STRATEGY

PRICE-TO-EARNINGS RATIO

Fundamental analysis also lends itself to pricing and valuation methods. The most common valuation metric is price-to-earnings (P/E). This is the ratio between the current share price divided by the current earnings per share. The higher the P/E the greater the expected earnings are in the future (this could also suggest the stock is expensive due to overcrowding and has artificially raised the P/E).

Another way of looking at a high P/E is that the share price has pushed past fair value, and that current earnings are not supportive of the higher share price. It is also important for investors to understand the limitations of P/Es; they don't capture the full picture of the underlying assets of the company, or the fact that earnings could be under pressure from capital expansion (construction phase) or experiencing a seasonal downturn (mature phase). Because of this, P/E should not be viewed on its own.

P/E =

$$\frac{\text{RATIO BETWEEN THE CURRENT SHARE PRICE}}{\text{DIVIDED BY THE CURRENT EARNINGS PER SHARE}}$$

PRICE-TO-BOOK RATIO

Another metric to look at is price-to-book (P/B) or price-equity ratio. This is the current share price divided by the total assets, minus intangible assets and liabilities of the last quarter. P/B looks at the total value of assets the company owns versus the share price. A low P/B could illustrate the company is cheap, and the market is undervaluing the current situation. However, it could also mean there are structural issues with the assets the company owns and could see write-downs justifying the figure.

RETURN-ON-EQUITY RATIO

Return-on-equity (ROE) is the net income (in percentage terms) returned to shareholders. It illustrates how much profit a company makes with the capital shareholders investing in the company. It is calculated by taking the net income for the full fiscal year divided by the equity the shareholder has – the higher the percentage, the better the returns. Again, this captures just one part of the business and tends not to be forward looking. Because equity markets are (in theory) forward looking, this may not give the full picture as to the outlook of the company. Profit can be lost quickly if assets and earnings are under pressure.

All four of these methods aid in the understanding of the current situation of a company. Valuations without an understanding of the company itself can be disastrous, which is why you need to have stop losses and profit margins firmly researched before investing.

EMOTIONS VERSUS STRATEGY

Emotions such as greed and fear can overwhelm an irrational investor. These two emotions are ever present in equity trading, which is why CFD trading can be a benefit; strict rules can be built into the product as part of your strategy. However, due to gearing, the amount you could lose relative to your initial investment is greater than for conventional share trading.

A strategy-strict investor will know their target price and profit margin and once it is achieved will actually take the profit. This is harder than most people realise; believing your trade could go higher is a major issue for irrational investors. More traders lose out on the upside than the downside and the reasoning for this is because they don't have profit points locked in to their strategy. Stop losses limit the downside, but most forget to consider their exit point on the upside. It never hurts to lock in profit, which is where limit orders are very useful.

It is the same on the way down; traders can be plagued by thoughts like 'it will return' and 'something will change to move the share higher'. This is exactly why you need a stop loss; it limits your emotional influence, and like we documented in 'Getting the edge – Trading strategy', the stop loss – if it is triggered – is designed to mitigate risk.

Trading with your strategy, not your emotions, is vital. You will never pick the top, nor will you pick the bottom; be happy with the profit and loss ranges you researched and lock them in. This will help you get the edge over other equity traders.

ROE IS THE NET % RETURNED TO SHAREHOLDERS

EMOTIONS SUCH AS GREED AND FEAR CAN OVERWHELM AN IRRATIONAL TRADER

TRADING WITH YOUR STRATEGY, NOT YOUR EMOTION IS VITAL

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