

Contracts for difference

Introduction

Contracts for Difference (CFDs) were originally developed in the late 1980's in London and used by institutional investors to gain exposure to stocks on the London Stock Exchange (LSE) in a cost-effective way. They were launched to private investors in the late 1990s, since when usage of these contracts by both private and institutional investors has grown dramatically as they can offer flexible, cost-efficient access to the investment markets.

CFDs are financial derivatives that allow investors to take advantage of the changes in prices on a range of underlying financial instruments, such as equities, without physically owning them.

CFD providers have responded quickly to demand for their product by expanding their offerings from just LSE shares to include indices from around the globe, many global stocks, commodities, fixed interest securities and currencies.

What is a CFD?

A CFD is a contract between two parties, typically referred to as the buyer and seller, where the profit or loss is determined by the difference between the buy and the sell price of the underlying investment. As the name suggests, the contract states that the seller will pay to the buyer the difference between the current value of an asset and its value when the contract is closed. If the difference is negative, then the buyer has to reimburse the seller instead.

CFDs typically have no fixed contract size so a fund manager can trade both large and small volumes. There are no standard contract terms for CFDs and each CFD provider can specify their own terms.

The CFD is started by making an opening trade on a particular investment with the CFD provider or broker. This creates a 'position' in that investment. CFDs are open ended contracts with the buyer able to choose to end the contract when they feel the time is right. If the underlying investment's price moves in the opposite direction from that expected the contract can remain open until it moves in the direction originally anticipated, however this may lead to greater losses and increased charges.

CFDs offer many of the benefits of trading assets without having to physically own them. They mirror the underlying investment's performance as well as any corporate actions, such as dividends or stock splits, which take place. CFDs are not true equity stakes in the underlying company though, and do not confer any voting rights.

Unlike share dealing, CFDs don't incur stamp duty but they are subject to capital gains tax. If a loss is made this can be used to offset other gains.

There is also counterparty risk, which is the risk associated with the financial stability or solvency of the CFD provider. If the counterparty fails to meet their financial obligations, the CFD may have little or no value regardless of the underlying instrument and how it performs and any investment may be lost.

What is the Margin and Margin Trading?

Investors in CFDs only need a proportion of the total value of a position to trade. The initial payment, or margin, represents a percentage of the value of the contract. A CFD is known as a 'margin' product and the investor who takes out a CFD is said to be trading 'on' or 'at the margin.'

When an investor agrees to such a contract, they buy a certain number of units. Because they are trading at the margin, the money provided up front is effectively a deposit. This is a percentage of the investment's initial value. The level of margin depends on the type of underlying investment and is set by the CFD provider or market maker.

For example, a CFD based on the share price of oil company A is priced at £10 per unit with a margin of 20%. An investor buys 1,000 units. If buying the shares directly they would have to pay £10,000 however the CFD requires a margin of 20% or £2,000.

Many investors use margin trading to generate much larger profits by gearing up. In the example above, the investor effectively invests in 1000 shares for an initial outlay of only 20% of their value. They have bought 5 times as many shares as would normally be possible for their £2,000.

Conversely, many fund managers use CFDs as part of their risk management strategy. The manager will use 20% of their money to buy shares which would normally cost them 100% of their investment. They place the other 80% into safer assets, such as money market funds, to generate further, albeit modest, returns. If the CFD trade moves in the wrong direction they will offset some of their losses with the interest they have made on the safer assets.

What types of margin are there?

There are always two types of margin with a CFD trade; initial margin as in the example above and variation margin.

Initial margin is usually between 0.5% and 30% depending on the underlying investment and depends on the perceived risk associated with that investment in the market at that time. For example, during the liquidity crisis initial margins on equity based CFDs were increased to counter the increase in volatility in the world's stock markets. Margins will tend to be lower for trades in assets which are larger, more liquid and less volatile.

Variation margin is applied to an investor's position in response to the price movement of the underlying investments. If the investor's CFD generates a loss this would be deducted from the investor's account. This is all done in real-time as the market moves lower, known as 'marked to market'. Conversely, if the share price moves higher the investor's account would be credited with the running profits.

Variation margin can therefore have either a negative or positive effect on an investor's cash balance. If prices move against an open CFD position, additional variation margin may be required. The CFD provider may call upon the party to deposit additional sums and in volatile markets this may be at short notice. This is known as a 'margin call'. This creates a liquidity risk as if funds are not provided in time the CFD provider may liquidate the position at a loss for which the investor is liable.

How do investors use CFDs to benefit from rising prices?

Using the example above, a CFD based on the share price of oil company A. An investor believes the company is strong and offers good potential for share price growth. The investor buys 1,000 units priced at £10 with a 20% margin;

Initial outlay is $(£10 \times 20\%) \times 1000 = £2,000$.

The share price rises and the CFD unit price rises to £14. The investor decides to close the contract. The profit or loss is the final price minus the initial price multiplied by the number of units;

Profit is $(£14 - £10) \times 1000 = £4,000$. The margin is refundable, and profit is in addition.

What happens if the share price falls?

The investor has also bought a CFD based on the share price of oil company B. The investor believed the price of shares in this company would also rise but they fall.

The investor buys 1,000 units priced at £15 with a 20% margin;

Initial outlay is $(£15 \times 20\%) \times 1000 = £3,000$.

The share price falls and the price of the CFD unit falls to £9.

Their position will be $(£9 - £15) \times 1000 = -£6,000$, a loss.

When there is a loss the initial margin will go towards the loss and the investor would have to pay out £3000, on top of the £3,000 initial margin.

How do you use a CFD for short strategies?

An investor who has identified a share in a company which they think will fall in value can enter into a CFD to sell a stock, or 'go short'. See Investment Bulletin 16 - Long/short investing strategies.

If the investor above had expected the price of shares in oil company B to fall they would have entered into a CFD to 'sell' 1,000 units. The current unit price is £12, and the margin is 20%. With this type of CFD, the investor commits to buying back the units at the time the contract ends, so if they have fallen in value they will make a profit.

The share price falls and units in the CFD fall to £6.

The investor has to buy back units at $(£6 - £12) \times 1,000 \text{ units} = -£6,000$

(i.e. a negative amount, so the investor is effectively owed £6,000 profit.)

The broker pays the investor back £8,000 (£6,000 profit plus the £2,000 margin).

Can you limit potential losses with CFDs?

Investors in CFDs can opt to implement a safety mechanism known as a 'stop loss order' if the price of the underlying investment moves in the wrong direction. Stop loss orders can be set to trigger an exit from the contract at a pre-determined level.

To protect against a fall in the share price of oil company A, even though the investor believes the value will rise, they can implement a stop loss order. The investor chooses £8.50 on a unit price of £10.

Loss limited to $(£8.50 - £10) \times 1000 \text{ units} = £1,500$ (Liquidity in the market and speed of price fall can determine the final exit value).

What is Pairs Trading?

Pairs trading is a strategy of purchasing a combination of long and short CFDs and can be used to reduce market risk and focus on the relative performance of two investments rather than their actual performance. This is known as a market neutral strategy.

Pairs trading is achieved by buying a CFD in a share of one company and at the same time, selling exactly the same amount of a CFD in the share of another company, usually in the same sector.

The pairs trade aims to remove market or sector risk and exploit the relationship between the prices of two investments. It doesn't matter whether the market rises or falls since the outcome of the trade simply relies on the relative movement of the two shares.

For example, oil company A is due to announce its latest results and fundamental analysis suggests that its short-term potential is positive due to recent oil finds and increased production. At the same time, oil company B is falling victim to concerns over its oil reserves and political unrest in the countries it operates in. It is therefore decided to go long oil company A and sell short oil company B at exactly the same time and in exactly the same value for each CFD.

What charges are associated with CFDs?

The CFD provider may make a number of charges as part of the trading or open position. Commission is normally charged on the face value of the contract on both opening and closing a position. If an investor trades with a market maker or broker, they may also suffer a bid/offer spread (the difference between a buying and selling price). However, some brokers may factor explicit fees into the spread.

CFDs are subject to a daily financing charge, usually applied at a previously agreed rate linked to an interest rate benchmark such as the London Interbank Offered Rate (LIBOR). The buyer of a CFD will pay this 'interest rate' whilst a seller may receive the interest. Charges are typically taken on a daily basis for this facility, so the longer a contract is open, the higher the charges.

Summary

The emergence of CFDs has enabled private investors to access new instruments and strategies that were previously only available to professional investors. CFDs allow transparency and ease of execution with the dealing process being almost identical to that of trading equities. However, unlike other financial derivatives their price directly mirrors the price and liquidity of the underlying investment.

Whilst they offer the potential to create significant gains in a relatively short period, caution should be exercised as the potential losses from dealing CFDs can be unlimited and should therefore be left to experienced and professional investors.