

Module 1

CFDs:
overview and dealing online



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In this module we look at the basics of 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 CFDs offer over other forms of trading.

What is a CFD?

CFD stands for Contract for Difference. A CFD is a type of derivative: the price of a CFD is derived from the value of some other asset. Often with CFDs it is based on the price of a share, but it can relate to effectively 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, therefore, 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 dealing CFDs with IG Markets, 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.

The ins and outs of how this work will become clearer if we look at an example of using a CFD to trade a share.

Example 1: buying Brambles

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

It is early March and Brambles is trading on the Australian Stock Exchange at \$4.49/4.50. Being bullish about the prospects of the support services in general, you feel that the stock is undervalued and that a recent sell-off in Brambles has been overdone.

You decide to buy 2000 shares as a CFD with IG Markets. This means that 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 \$4.50, the offer price of the shares.

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

Our standard commission for Australian shares is 0.1%.

This means that your opening commission is:

$$0.1/100 \times 2000 \text{ shares} \times \$4.50 = \$9$$

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 deposit a small portion of the value of the stock that you are commanding initially. This is known as margin (and is discussed in depth in Module 4).

The amount of margin required varies according to the liquidity and volatility of the underlying instrument. For Australian shares the margin requirements start at 5% of the underlying value, depending on which share you are dealing.*

Only having to put down a fraction of the value of the stock that you are commanding obviously makes trading easier and more convenient. It means that you do not have to tie up as much of your funds with a trade as would normally be the case.

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

In this case, Brambles is margined at 5%.

You are dealing in 2000 shares at a price of \$4.50. This means that the underlying values of the shares in which you are dealing is $2000 \times \$4.50 = \9000 .

The margin of 5% is therefore just \$450.

**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.*

1	16	3.88	3.88	3.88 - 0.00
6	74	4.88	4.75	3.88 + 0.13
9.	99	6.75	6.56	4.75
1	123	8.25	8.13	6.75 + 0.25
	5	7.88	7.81	8.13
	26	8.31	8.25	7.81
	8	1.75	1.75	8.25
	1	1.25	1.25	1.75

Funding

One of the key concepts of CFDs is funding. In this example, you are buying \$9000 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 full 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 Brambles, as with all Australian shares, the rate is based on the Reserve Bank of Australia's Cash Rate (a rate charged on overnight loans between financial intermediaries).

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 the Cash Rate. Let's say that the Cash Rate is 3.0%. You will therefore pay 5.5%. 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 $i/360$

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 annual divisor for most territories; the UK uses 365, however.

With our example, let's say that Brambles closes at \$4.49 on the first day. The first daily interest adjustment is calculated as follows:

$$\begin{aligned}\text{Adjustment} &= 2000 \times 4.49 \times 0.055/360 \\ &= \$1.37\end{aligned}$$

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 Brambles' ex-dividend date, your position is still open. The net dividend is \$0.175 per share and this is credited to your account balance as shown:

$$2000 \text{ shares} \times \$0.175/\text{share} = \$350$$

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 couple of weeks, Brambles makes steady gains and by late March, 22 days after you opened the deal, the share price is trading at \$5.65/5.66 and you decide to take your profit.

You sell 2000 shares at \$5.65, the market bid price, and close your deal entirely.

Your closing commission is 0.1%:
 $0.1/100 \times 2000 \text{ shares} \times \$5.65 = \$11$

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

Closing level:	\$5.65
Opening level:	\$4.50
Profit per share:	\$1.15
Profit on trade:	\$1.15 x 2000 shares = \$2300

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 5.5% this might amount to a total financing cost over the period of \$34.

Over the 22 days during which you hold the position, the shares go ex-dividend, paying a net dividend of \$0.175 per share. An adjustment was made to your account of \$350.

The overall profit is calculated as thus:

Profit on trade:	\$2300
Opening commission:	-\$9
Closing commission:	-\$11
Interest adjustment:	-\$34
Dividend adjustment:	\$350
Overall profit:	\$2596

Going Short

The trade detailed above is an example of going long of a share price (i.e. buying a share and wanting the price to rise). With CFDs it is just as easy to go short of a share.

That is, you can sell shares first with the hopes of buying them back later at a lower price. In effect you owe the stock by doing this. 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 Macquarie Group

It is mid-May and after monitoring a recent downturn in the share price of Macquarie Group, you decide that the trend is set to continue.

Macquarie Group is trading in the market at \$34.30/34.31 and, judging some kind of correction to be likely in the coming weeks, you sell 1000 shares as a CFD.

You deal at \$34.30, the market bid.

Your opening commission is 0.1% of the underlying value. In other words, the opening commission is $0.1/100 \times \$34.30 \times 1000 = \34 . This amount is automatically debited from your trading account as soon as you place the trade.

Margin

For a deal of this size, Macquarie Group is margined at 10%.

The underlying value of the stock that you are commanding is $1000 \text{ shares} \times \$34.30 \text{ per share} = \$34,300$.

10% of this is \$3430 which is the amount that you deposit as initial margin.



Funding

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 the RBA's Cash Rate is greater than your financing fee, you will receive interest for being short as the fee is subtracted from, rather than added to, the Cash 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 Cash Rate is 3.0%. For a short position you might receive 2.5% below the Cash Rate. You will therefore receive 0.5%. This is an annual rate, but the financing is calculated on a daily basis.

With our example, let's say that Macquarie Group closes at \$34.10 on the first day. The first daily interest adjustment is calculated as follows:

$$\begin{aligned}\text{Adjustment} &= 1000 \times \$34.10 \times 0.005/360 \\ &= \$0.47\end{aligned}$$

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 IG Markets 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.

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.

Your prognosis regarding the share price proves to be correct over the next few weeks, as Macquarie Group gradually drops in price throughout May. At the end of May the price is \$30.35/30.36 and you decide to take your profit.

You buy back 1000 shares at the market offer of \$30.36 in order to close your trade 13 days after you opened it.

Your closing commission is 0.1%:
 $0.1/100 \times 1000 \text{ shares} \times \$30.36 = \$30$

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

Opening level:	\$34.30
Closing level:	\$30.36
Profit per share:	\$3.94
Profit on trade:	$\\$3.94 \times 1000 \text{ shares} = \\3940

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 13 days. Using an annual rate of 0.5% this might amount to a total credit over the period of \$6.

Over the 25 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 thus:

Profit on trade:	\$3940
Opening commission:	-\$34
Closing commission:	-\$30
Interest adjustment:	\$6
Dividend adjustment:	-\$0
Overall profit:	\$3882

PureDeal: our online dealing platform

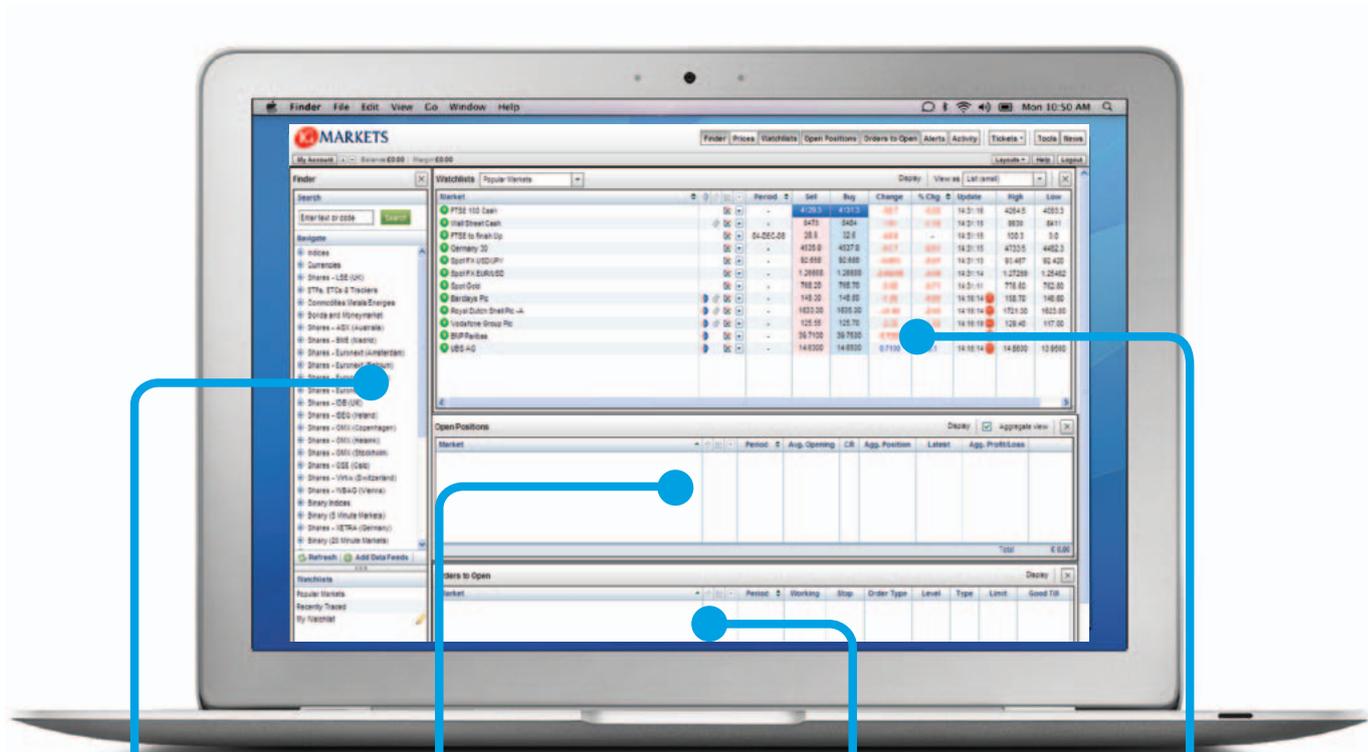
Our CFD trading service is available over the telephone, via our dealers, or via our PureDeal platform. Trading over the telephone allows you to ask our experienced team of dealers any questions that may arise when placing a trade, and a good deal of our clients enjoy the friendly and efficient telephone service that we offer.

These days, greater numbers choose to deal online, however, enjoying such benefits as near-instant execution of trades, thousands of streaming prices and a host of advanced trading tools.

When you first log into PureDeal, 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' pane at the top shows a list of our more popular markets. The 'Finder' pane on the left is used to navigate to any of our markets, which can then be displayed as live prices in a 'Prices' pane. 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).



Finder

Open Positions

Working Orders

Watchlists

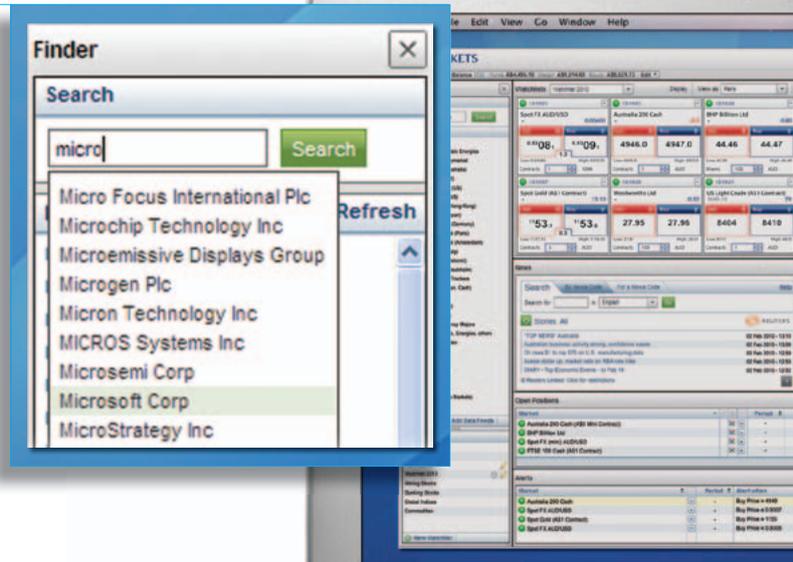
Example 3: selling Microsoft using PureDeal

1 After being impressed by a number of recently launched applications that compete with Microsoft products, you anticipate a weakening in the share price of Microsoft in the near future. Selling the share 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 Microsoft.

To do so, you first need to access the live price for Microsoft. 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.



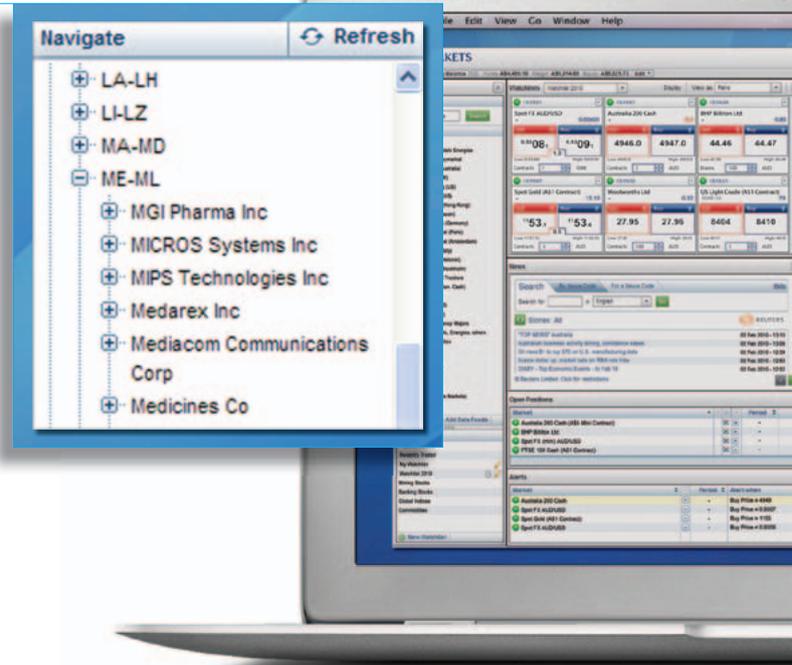


2 You can also search through our markets using the navigation tree. As Microsoft is a US company, you expand the 'Shares – US' directory.

US stock prices may not be available as a default; the 'Selecting live share prices' section in Module 2 (on page 14) has information on how to activate more stock prices.

Example 3: selling Microsoft using PureDeal (continued)

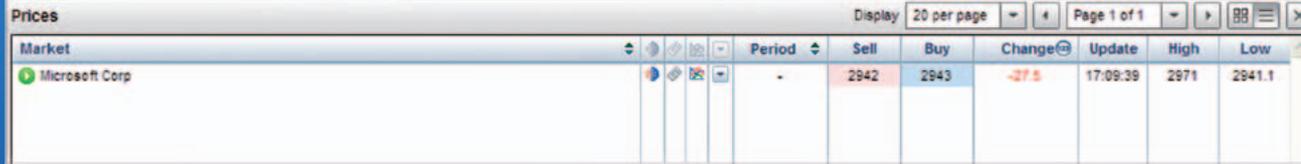
3 You then expand the directory that corresponds to the letter with which the share begins. In this case, it is ME-ML that you want.





4 Scrolling down to Microsoft and clicking on the directory name, displays all available markets on Microsoft in the 'Prices' section.

Example 3: selling Microsoft using PureDeal (continued)



Market	Period	Sell	Buy	Change	Update	High	Low
Microsoft Corp	-	2942	2943	-27.5	17:09:39	2971	2941.1

5 The current bid and offer prices are displayed (below the 'Sell' and 'Buy' headings, respectively), along with other useful pieces of information, such as the net change on the day and the day's highest and lowest prices for the share. The 'Period' is marked as '-'. This absence of a dated period means you can hold a position as long as you want (CFDs on some products have expiry dates which mean that if you hold your position to that date it will automatically close or 'expire'). You click the green button next to 'Microsoft Corp' which launches the 'Deal Ticket' (clicking on the market name does the same thing).



6 This 'Deal Ticket' is populated with the current price and allows you to enter the details of the trade that you would like to place.

The bid (29.42) and offer (29.43) of the current price appear in the 'Sell' and 'Buy' boxes, respectively.

The price constantly updates in both the 'Prices' section and the 'Deal Ticket', so that you can sit with the price in the 'Deal Ticket', waiting for the right price, if you so wish.

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 an American share that is priced in dollars, the currency is indicated as 'USD' (US dollars).

You choose to sell 2000 shares: you enter 2000 in the 'Shares' box.

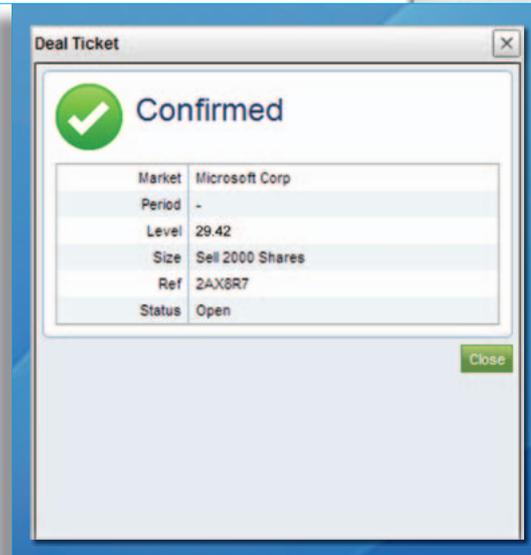
The bottom half of the 'Deal Ticket' is an optional section offering the ability to attach further dealing instructions; this is covered in detail in Module 3.

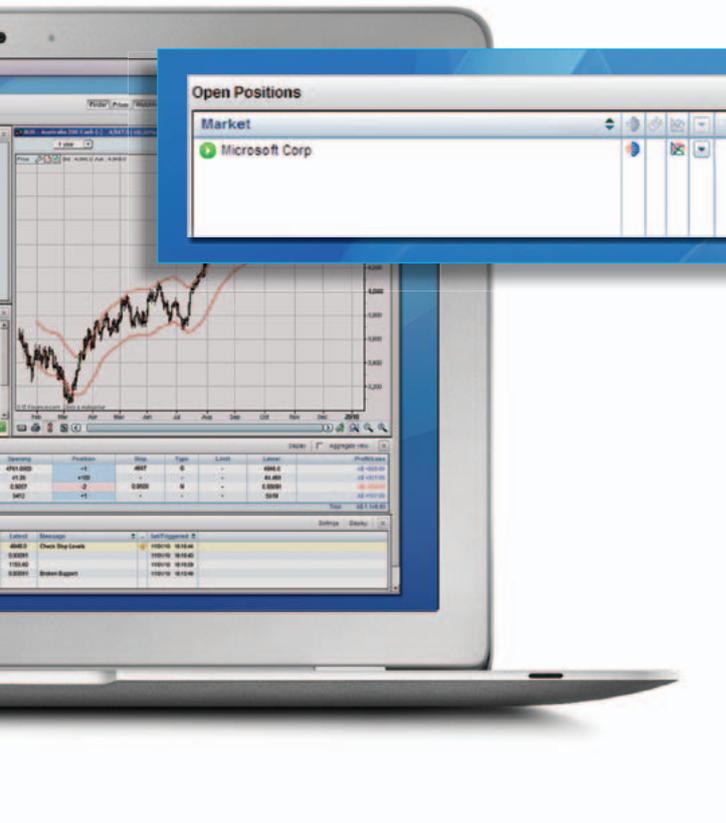
Making up your mind that you are happy to deal at the price that is showing, you click on 'Sell'.

Example 3: selling Microsoft using PureDeal (continued)

7 You receive an acceptance message that confirms the deal you have placed (please note that it is possible for deals to be rejected. The vast majority of deals – over 90% – are accepted, however).

The acceptance message includes the details of your trade, along with a reference number; you should always check that all the information about your deal is correct and make a note of the reference number.





8 As soon as your deal 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 Microsoft is now trading at 29.91/29.92. You decide to close your position.

Closing your position

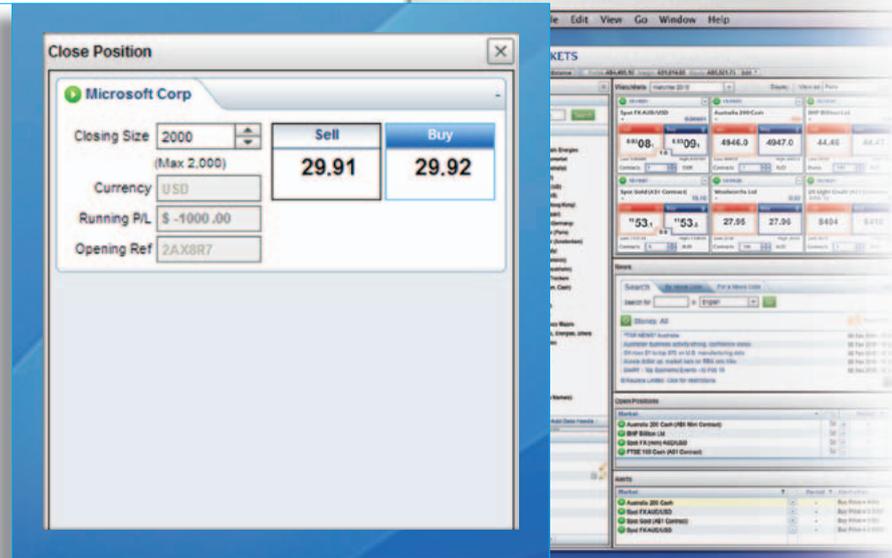
9 To close your position, you need to deal in the opposite direction to your open position. If you deal in the same size as your open position, you will close the whole trade.

If you deal in a size that is less than your open position it is possible to close part of a deal. You want to close your entire position, however. The quickest way to do so is to open a 'Close Position' screen. This is a special type of Deal Ticket that ensures you are dealing in the direction that is required to close an open position and also pre-populates the correct transaction size in order to achieve a complete close. The 'Close Position' screen is opened by clicking on the green button (or the market name) of a position in the 'Open Positions' screen.

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).

You click on 'Buy'!

You receive another confirmation back telling you that you have bought 2000 shares to close at 29.92.



Example 3: selling Microsoft using PureDeal (continued)

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

Closing level:	US\$29.92
Opening level:	US\$29.42
Loss per share:	US\$0.50
Loss on trade:	US\$0.50 x 2000 shares = \$1000

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 and dividends.

Commission on US shares is charged per share traded, rather than as a percentage on the consideration, with our standard rate being 2 cents per share.

Opening commission = $US\$0.02 \times 2000 \text{ shares} = US\40

Closing commission = $US\$0.02 \times 2000 \text{ shares} = US\40

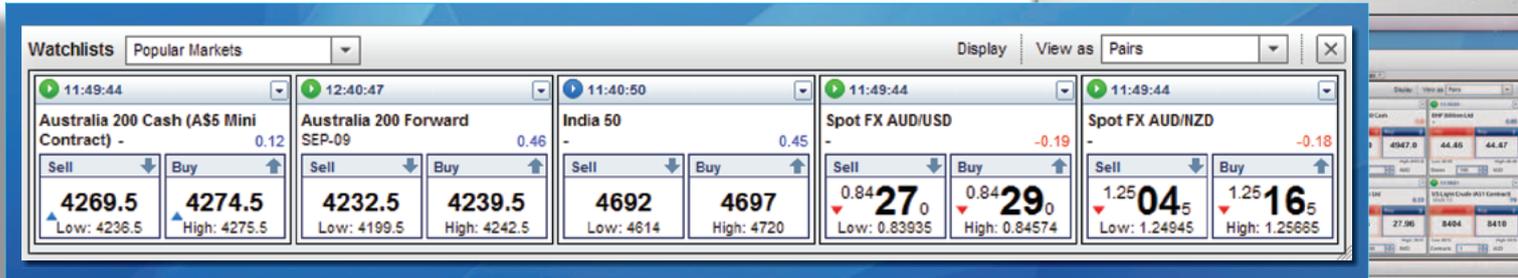
For being short of a US share you might receive an annual rate of 0.5%, yielding an overall interest credit over the 42-day period of US\$34 for interest.

Over the 42 days during which you held the position, the shares went ex-dividend, paying a net dividend of US\$0.10 per share. A dividend adjustment was therefore made to your account: this was a debit of 2000 shares x US\$0.10/share = \$200.

Your overall loss is therefore:

Loss on trade:	US\$1000
Opening commission:	US\$40
Closing commission:	US\$40
Interest adjustment:	-US\$34
Dividend adjustment:	US\$200
Overall loss:	US\$1246

'One-click Dealing'



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

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 also 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 left-hand of the screen.

Once you have launched the 'My Account' window, you need to click on 'Preferences' within the 'Settings' section and then switch 'One-click Dealing' to 'Enable', before finally clicking on 'Set Preferences'.

'One-click Dealing' (continued)

The screenshot shows a trading interface with five market pairs displayed in 'Pairs' mode. Each pair includes a time, name, bid/ask prices, and a 'Contracts' field.

Time	Instrument	Change	Low	High	Contracts
11:56:53	Australia 200 Cash (A\$5 Mini Contract) -	0.11	4269.5	4273.5	AUD
12:40:47	Australia 200 Forward SEP-09	0.46	4232.5	4239.5	AUD
11:40:50	India 50	0.45	4692	4697	USD
11:57:09	Spot FX AUD/USD	-0.09	0.84352	0.84372	100K
11:57:09	Spot FX AUD/NZD	-0.2	1.25024	1.25144	100K

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

Advantages of using CFDs

CFDs have quickly grown in popularity over recent years for a variety of reasons. Some of this is due to changes in trading attitudes: as private investors have become more sophisticated, they have sought more sophisticated methods of trading.

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, and 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 Australian share CFDs is a competitive 0.1%, with a minimum charge of just \$8. Furthermore, as a member of TradeSense you will benefit from even smaller minimum charges for the first six weeks of the programme, which allows you to try out our service with small positions.

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.

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 be very useful, therefore. 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.

Cost efficient

Our commissions are small: with a standard commission rate for Australian shares of just 0.1% you can keep your transaction costs down. What's more, commissions on CFDs are not subject to GST.

Speed of dealing

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.

Flexibility and convenience

CFDs are not just limited to shares: we also offer an incredibly wide choice of different financial instruments (the range of markets available to you is discussed in depth in Module 2: Financial markets). Stock Index levels, commodity prices and FX rates are just some of these many different markets, and they can all be dealt through your single trading account, all with the same convenience of small margin rates.

24 hour trading

Although share 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.

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

Remember that CFDs are a geared product and can result in losses that exceed your initial deposit. Trading CFDs may not be suitable for everyone, so please ensure that you fully understand the risks involved.

Please note that although the material contained within TradeSense 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. It is for guidance only and no liability is accepted by IG Markets for its accuracy or otherwise.

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