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Five Reasons to Trade Stock CFDs

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An alternative way for traders and investors of all experience levels

Introduction

A Contract for Difference (CFD) is an alternative way to trade a wide range of financial markets, such as stocks, indices, and commodities without the buying and selling of any underlying assets. CFDs are financial contracts that pay the difference in price between the opening and closing trades. CFD pricing is derived from the underlying market. For example, the Apple CFD will have the same price as Apple listed on the Nasdaq exchange. When you trade a CFD, you're getting the same exposure as you would if you had bought the asset it tracks, but instead of investing in the market, you're buying a contract for a fraction of the stock's value.

There are several reasons why traders choose to go for stock CFDs over traditional stock trading. Including leveraging*, shorting, and hedging your existing position. CFDs come with some extra features and flexibility that you'd struggle to find when investing. However, like any leveraged derivative investment, there is always an element of risk when trading CFDs and it is important to understand the key features of CFDs before deciding whether or not to risk money.

Let's take a look at some of the advantages of trading CFDs.

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1. Resemblance to traditional trading

CFDs are designed to mirror traditional trading, so if you're already familiar with traditional trading and investing, CFD trading might be easier to understand than other derivatives. You will be buying and selling contracts designed to mirror the assets they represent.

A single CFD tends to represent the standard unit of trading of its underlying market. To set your position size, you decide how many contracts to buy or sell. If you want to trade the equivalent of 50 Apple shares, for instance, you can buy 50 Apple stock CFDs.

Let's look at the mechanics of a transaction:

- You trade Tesla by buying 100 CFDs at $950, then close your position at $1,000. You exchange the difference in Tesla's price with your provider, earning $50 for each CFD, or $5,000.
- If Tesla shares had fallen to $900, then the result would be a loss of $50 for each CFD.
- With investing, you'd be selling your shares for $50 less than you paid for them. With CFD trading, you'd still exchange the difference in Tesla's price – but because the market has moved against you, you pay your provider $50 per share.

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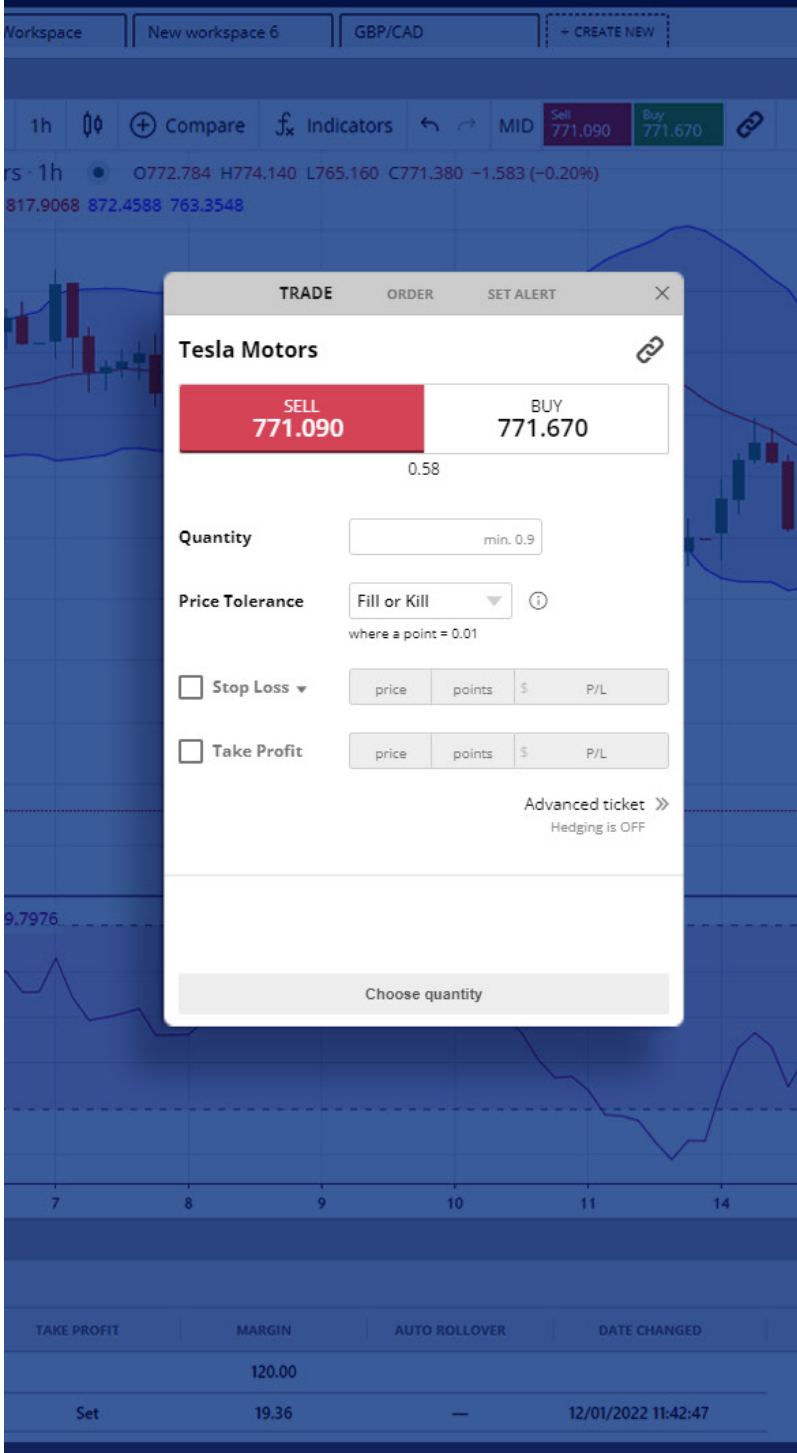
2. Profit from falling markets:

The main difference between CFDs and traditional trading is that with CFDs, you never own the underlying asset. This brings several opportunities , the ability to short a stock being the main one. Doing this enables you to profit when markets fall in price, which adds a whole extra dimension to your trading.

If you've researched a stock but believe that it's in for some tough times, you may want to consider shorting it. Instead of searching for a new opportunity, you could short the company with a CFD, earning a profit if its share price falls. However, if the stock rises instead, you'll earn a loss.

Unlike investing, you don't have to borrow anything to short a CFD. It's the same process as going long, just the other way around. You can sell any market that you can buy, including stocks, indices, and commodities.

To open a short CFD position, you sell your chosen number of contracts instead of buying them. Then, when you want to close your trade, you buy the same number of CFDs, or simply close the position.



3. Do more with less

Another benefit to never owning the asset you're trading is leverage. Leverage enables you to open positions without paying for their total value – instead, you pay a deposit known as your margin. This works because you're only speculating on the price movements of markets, not buying them outright.

Leverage exposes you to greater potential profits but also greater potential losses.

The funds needed is the amount of capital required in your account to open a new CFD trade and varies across the different stocks. Let's take Netflix for example, the margin required is currently 30%.

Meaning that if you were to purchase ten CFDs of Netflix at a share price of $600, you would need to have a minimum of $1,800 in your trading account. Compared to a traditional investment account where ten shares would require a deposit to open the trade of $6,000.

	Netflix CFD	Netflix Stock
Quantity	10 CFDs	10 Shares
Value of Trade	$6,000	$6,000
Margin Required	30%	100%
Funds Needed	$1,800	$6,000

However, it's important to remember that a losing trade will be based on the full $6,000. For example, if the Netflix share price were to fall to $550, the resulting loss on both the CFD trade and the stock trade would be the same, $500.

As we have seen, using CFDs allows you to avoid tying up all your capital on just a few positions. Furthermore, in the example of a profitable trade, the return on investment (ROI) may be far greater than traditional stock trading. For example, if the share price for Netflix were to go up to $650, the ROI on the CFD trade would be 27.7%, while the ROI on the stock trade would be 8.3%.

	Netflix CFD	Netflix Stock
Original Funds Needed	$1,800	$6,000
Trade Value Upon Closing at $650	$6,500	$6,500
Trade Profit	$6,500-$6,000 = $500	$6,500-$6,000 = $500
Trade ROI	$500/$1,800 = 27.7%	$500/$6,000 = 8.3%

27% However, just like the ROI is more for the above example, there is a potential of having a negative 27.7% ROI if the position goes against you.

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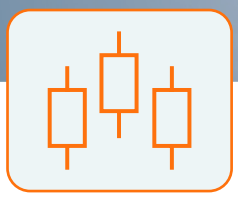
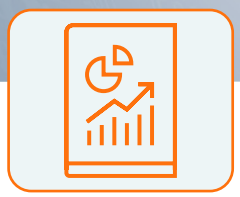
4. Trade multiple products in one account

CFD brokers tend to offer access to a wide range of asset classes, so you aren't limited in what you can trade. At FOREX.com, for example, you can buy and sell the below CFDs:

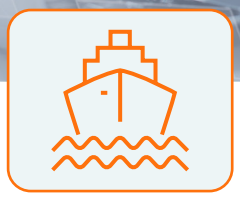


Stocks



Indices

Metals



Commodities

ETFs

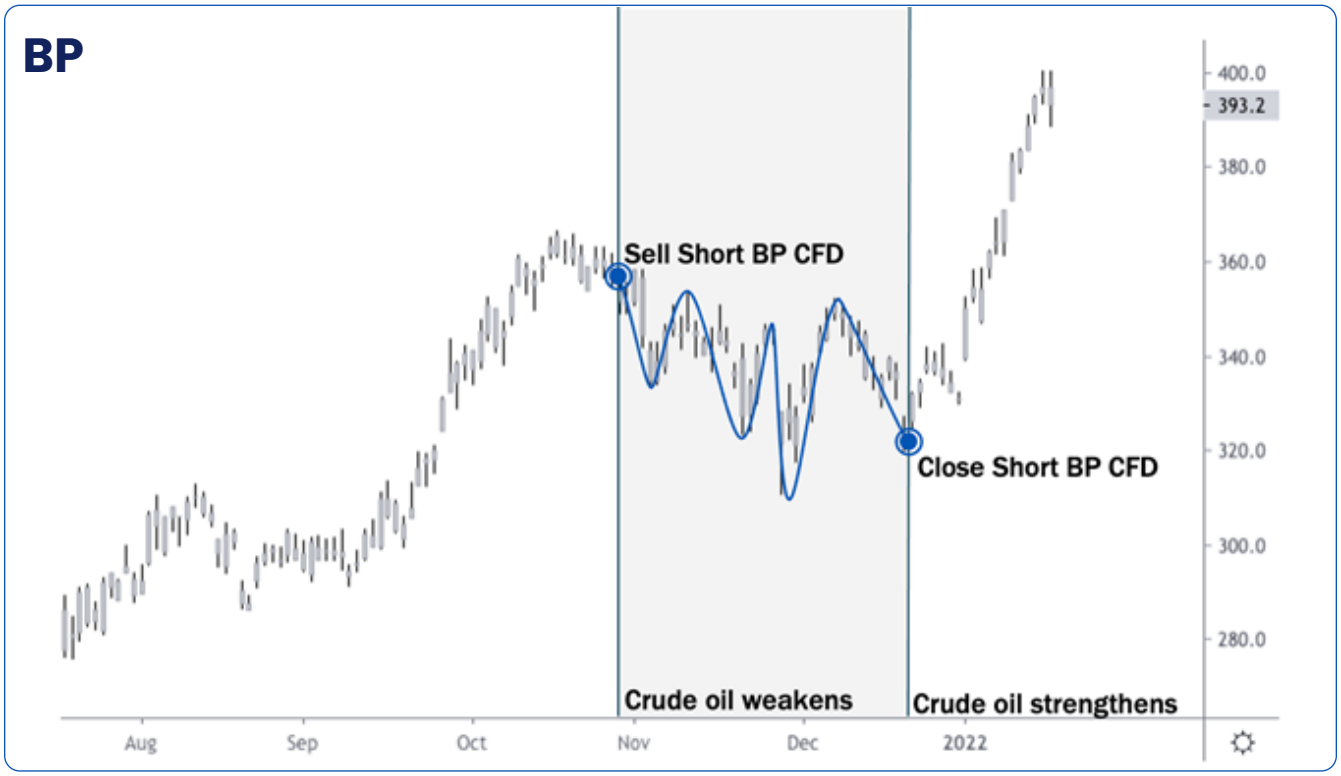
5. Hedging risk with CFDs

Remember that you can use CFDs to take short positions? As well as opportunities from falling markets, this can be a useful way of offsetting the risk from negative moves in your investment portfolio. For example, say you hold 1,000 American Airlines shares but are worried about a spike in oil prices hurting the company's bottom line in the short term. You could sell your stock – but that would close your position entirely.

Using CFDs, you can open a short CFD position equivalent to 1,000 American Airlines shares. Then, any negative moves in your portfolio will earn you a profit from your CFD position, cancelling out the loss. If airline stocks start to climb again, you can close your CFD position. And remember that all of this hedging can be done with a fraction of the capital, due to the margin rates offered in CFD markets.

Let's consider an example using CFDs to hedge risk in an investment portfolio:

- You have a long-term investment in the UK oil and gas stock BP which is at risk of selling off due to recent crude oil weakness.
- To hedge your short-term risk, you decide to sell short the BP CFD to capitalize on any weakness that might result.
- Remember, to have the same exposure, you would sell the equal number of CFDs as shares in your investment portfolio.
- After 6 weeks, you note that crude oil strength is forecast to return so you close your CFD hedge.
- The resultant profit from the short CFD trade should equate roughly, excluding overnight CFD finance charges, to the reduction in your investment portfolio.



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Summary

CFDs are financial contracts that allow traders and investors the opportunity to profit from price movement without owning the underlying assets.

The main features to trade CFDs are:

1. CFDs mirror traditional trading making CFD trading easier to understand compared to other complex derivatives.
2. The ability to short a stock which offers the opportunity to profit from falling markets.
3. Not owning the underlying assets means you're trading with leverage which allows you to open positions without paying for the total value freeing up your capital for more opportunities. Leverage exposes you to greater potential profits but also greater potential losses.
4. Brokers tend to offer access to a wide range of asset classes so you can trade multiple markets in one place.
5. The ability to Hedge CFDs allows you to offset risk from negative moves in your investment portfolio.
6. Although we are providing some of the benefits of trading CFDS, you should be aware that CFD trading is fast-moving, requires risk management plans and carries significant risk of loss.