CFD Day Trading

Guide

DAYTRADING.COM

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Contracts for difference (CFDs) are popular with day traders looking to trade at low cost and with leverage to maximize profits. CFDs are high-risk, high-return derivatives whereby the trader does not own the underlying asset they are speculating on.

This **guide to CFD day trading** will explain how they work, discuss the pros and cons of using them, and provide a rundown on how traders can get started.

Quick Introduction

- A **contract for difference** is an agreement between two parties to pay the difference between the opening and closing price of an asset.
- They are flexible instruments that allow traders to profit (or lose) from changes in asset values without having to own the **underlying security**.
- CFDs can be used to gain exposure to a variety of asset classes including stocks, commodities, forex and cryptocurrencies.
- Traders have the option of opening both **long** and **short** positions, thus allowing them to make profits even when markets fall.
- CFD brokers tend to offer leverage, providing traders with the opportunity to make larger profits (or conversely bigger losses if things go wrong).

What Are Contracts For Difference?

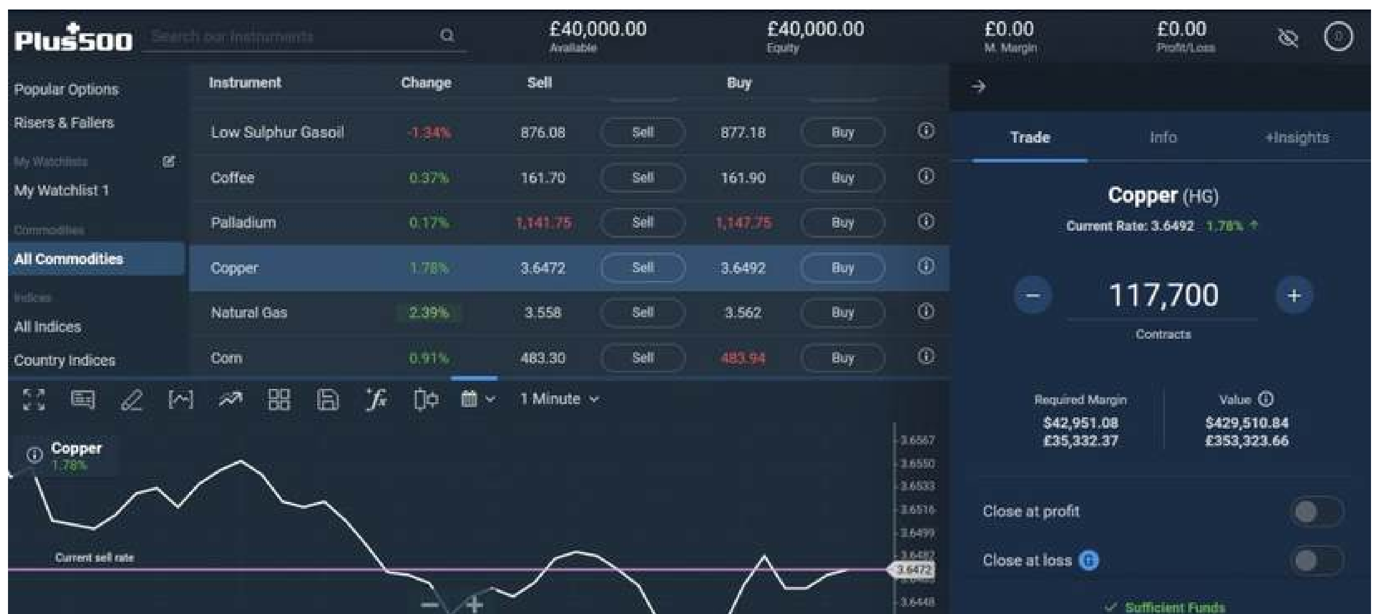
CFDs provide traders with the opportunity to speculate on price movements across a diverse range of asset classes.

Critically, holders of these contracts do not own the underlying asset themselves (such financial instruments are known as derivatives). They simply aim to make money on any **price changes**. They also risk losing money, if prices move against them.

These instruments are an agreement between two parties – the trader and the broker – to pay the difference between the opening and closing price of an asset. These can include **stocks**, **currencies, commodities** and **cryptocurrencies**.

CFDs were introduced in the early **1990s** as a way for hedge funds, institutional investors and professional traders to gain exposure to equities on the London Stock Exchange. Over time the market opened up to retail investors and has steadily evolved, resulting in the rapid industry growth of the last decade.

CFD trading is popular across the globe, although it is banned in some territories, including the **US** and **Hong Kong**. This is because using leverage unwisely can **lead to large losses**.



How Do CFDs Work?

CFDs are typically traded **over the counter** (which puts them in the category of OTC securities).

In other words, there is no centralized exchange where they are traded like stocks, commodities and futures contracts, for example. Instead, they tend to be offered directly to traders by brokers and financial institutions.

Individuals can choose to go **long** (speculating on the price going up) or **short** (speculating on a falling price) when trading CFDs.

They can also decide whether or not to use **leverage** to multiply their potential returns (or losses when a position goes the wrong way!).

Long Versus Short

CFDs allow traders to speculate on rising and falling asset prices. This is because they do not transfer ownership of the underlying asset when the trade is executed.

If an investor thinks the market will rise, they will go **long** and purchase a contract from their broker. Conversely, they will go **short** if they believe prices are going to fall. In this instance, they will borrow the CFD from the contract provider and sell it to the market.

So how do traders make money? In the case of a long trade, an investor will buy the CFD at the market price and look to sell it back after (hopefully) the value of the underlying asset has risen. They will then pocket the difference, which is paid by the brokerage.

However, if the asset falls in value, the trader will be required to pay the difference to the CFD provider, resulting in a loss.

The process of **going short** works in the opposite way. Bearish traders will borrow the contract from the broker and sell it in the hope of buying it back at a lower price later on. But if the price unexpectedly rises, the trader will have to repurchase the CFD at this higher price and pay the difference to the contract provider.

The Leverage Factor

Many people are drawn to CFD trading because they have a chance to use **leverage** to pump up their potential returns – though the risk of losing money also increases.

The use of funds borrowed from an online broker allows individuals or entities to control a larger position than if they used just their own funds. This increases both reward **and risk**.

It is common for CFDs to offer higher leverage than most other financial markets. There are several factors that determine how much leverage one can access, including the brokerage used, the asset being traded, and the rules laid down by the relevant regulator.

> *To use leverage, traders need to put down a portion of the total value of the investment, known as margin. The balance is borrowed from the broker.*

In the event that the trade moves against them, an investor may be required to deposit additional funds to cover potential losses. This is known as a **margin call**.

Asset	Leverage
Forex Majors	1:30
Forex Minors	1:20
GOLD, GOLDEURO, GOLDoz, GOLDgr	1:20
SILVER, SILVEREURO	1:10
PLATINUM	1:10
PALLADIUM	1:10
Spot Base Metals (Aluminium, Copper, Lead & Zinc)	1:10
Spot Index Major	1:20
Spot Index Minors	1:10
Futures of Indices	1:20
Future Indices Minor	1:10
Energy Spot	1:10
Futures of Energies	1:10
Futures on Commodities	1:10
All Shares	1:5

Here you can see the maximum leverage that FxPro offers CFD traders for different asset classes. A leverage ratio of **1:5** (or margin rate of 20%) means that a trader can control a position size of $5,000 with just $1,000 of their own capital.

Whilst the use of leverage can supercharge a trader's earnings, massive losses can be racked up if markets move in an unexpected direction. The number of people who end up making a negative return is significant.

Managing Leverage Risk

This is why taking a sensible approach to leverage is essential when CFD trading. It is a good idea for beginners to use **low leverage** or even no leverage at all.

Leverage of **1:2** or **1:3** can help new traders take part in the market without exposing themselves to monster levels of risk.

When your CFD trading strategy is paying off, it can be hard to resist racking up higher levels of leverage in the pursuit of bigger profits. But keeping a level head (and especially at the beginning) in this situation is critical. One highly leveraged loss can wipe out all the success you've had leading up to that point.

It is also important for traders to use tools like **stop loss orders** to help them establish strong risk management protocols. These particular functions automatically close a position when the market plunges to a price level that the trader has pre-selected, which in turn helps to minimize losses.

Take profit orders are another weapon that successful CFD traders frequently use. They work in a similar way to stop losses in that they close a position when prices reach a certain level, in this case when the market has risen to a point previously identified by the investor.

Not only do take profit orders allow profits to be locked in before the opportunity passes. They help minimize the emotional aspect of the CFD day trading process, thus preventing traders from chasing bigger profits based on unsound reasoning.

Trading Fees

When it comes to trading costs, the primary thing to consider is the bid and ask spread. Individuals will trade at the buy (or ask) price if they wish to take a long position, and will trade at the sell (or bid) price if they want to go short.

> *Brokerages make money by offering CFDs at a slightly wider spread than the actual market spread.*
>
> *Higher spreads can substantially eat into a trader's profits, so it's important to keep a close eye on this.*

Some firms also charge a flat fee, known as a **commission**. Serious day traders looking to keep costs down may opt for a raw spread account with ultra-tight spreads and a low, fixed commission.

Finally, CFD traders should be aware that there may be a fee if you hold positions open overnight. This is known as a **swap fee**.

A CFD Trade In Action

Let's say that a trader expects the share price of **Tony's Tyre Store** to increase. They choose a broker and decide to buy some CFDs in the company. The tyre retailer's shares are at that time trading at **$50**.

The investor deposits $1,000 with a broker that offers maximum leverage of **1:5.** This allows them to control a position of up to **$5,000** (5 x $1,000).

Using that $1,000 as the initial deposit, they decide to buy **100** CFDs in Tony's Tyre Store, thereby creating a position that maxes out that total allowance of **$5,000** (100 CFDs x $50).

Now let's assume that the retailer's share price has gone up to **$55** over the next week. The trader has made a $5 profit per CFD, meaning their total profit on the trade stands at **$500** (100 CFDs x $5). At this point, they decide to close out their position and book those profits.

So what return has the person made on their initial margin? This can be calculated by dividing the profit ($500) by the initial margin ($1,000) and then multiplying the resulting figure by 100.

The trader above has made a cool **50%** return on their initial margin, which is far higher than they could have expected had they simply bought shares in Tony's Tyre Company.

Had the individual spent their initial $1,000 to buy 20 shares (at $50 a piece) in the retailer, they'd have made a far-lower profit of **$100** and an inferior return of **10%** on their investment.

Pros & Cons of CFD Trading

- ✔ **High flexibility:** Traders can choose to speculate on a variety of asset classes and across many different markets. This effectively allows one to trade at any hour of the day, although some brokerages limit the times when business can be transacted.

- ✔ **The leverage factor:** These derivatives allow traders to do business with more money than they typically would in traditional investment markets. So individuals can control larger positions than if they had used just their own cash, providing an opportunity to make better returns.

- ✔ **Low costs:** CFD day trading is often more cost-effective than buying and selling other assets or financial instruments. This is because brokers charge small (or even zero) fees when traders enter and exit positions.

- ✔ **Strong liquidity:** CFD trading volumes are high, which allows investors to open and close positions simply and quickly. It also helps keep bid and ask spreads tighter, which is an important feature in keeping costs down.

- ✔ **No ownership of the underlying asset:** This allows short-term traders to go long or short, thus giving them the opportunity to make money even if markets fall. It also means that charges like stamp duty are not applicable.

- ✘ **Risk of large losses:** While trading on margin can turbocharge profits, using lent funds from a broker is also highly risky. This is especially dangerous in the CFD market due to the elevated levels of leverage that are available.

- ✘ **Counterparty risk:** CFDs are transacted over the counter and not through an exchange, meaning that traders leave themselves at the mercy of the creditworthiness and integrity of the counterparty. Transparency is also weaker with OTC instruments like CFDs, and information on prices and trading volumes can be harder to source.

- ✘ **Regulatory problems:** The CFD industry is subject to far less stringent rules that other markets, which in turn means lower investor protection. While regulators are getting stricter with how CFDs are highly traded, tightening regulations could cause problems like higher costs for traders, reduced product choice and lower leverage.

How To Trade CFDs

It's pretty straightforward to get started with trading CFDs. This is one reason for their soaring popularity in recent years. But as is the case with speculating using any financial instrument or on any asset class, mastering it is an art form and takes a lot of **time** and **discipline**.

Here are some of the key considerations for beginners starting their CFD trading journey.

1.Research

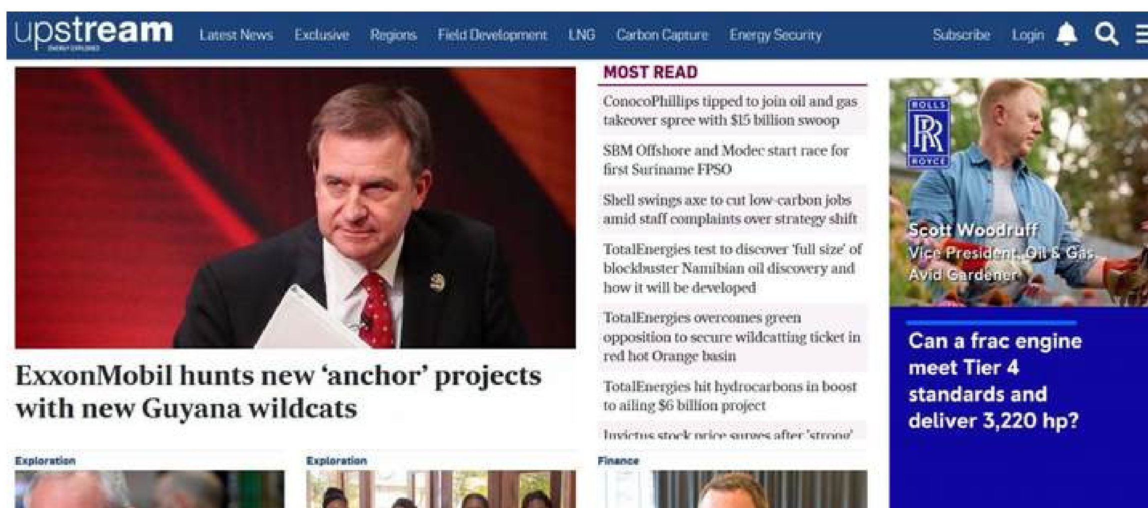
This is a no-brainer, really. As well as researching the particulars of how CFDs themselves work, a broader knowledge of **financial markets** and what moves them is essential.

Fortunately, a wealth of CFD trading resources exists online for beginners to get up to speed including educational websites and financial news sources.

At this stage a trader will also get an idea of what underlying assets they may like to speculate on using CFDs. Of course, this will require them to expand their knowledge still further.

For instance, traders who wish to bet on oil need to understand how supply and demand-side factors interact to influence prices.

Key things to acknowledge include OPEC+ production levels and geopolitical conditions in the Middle East, economic data like GDP and factory output reports, and changes in the value of the US dollar.



A trader will also need to consider which trading strategies to use when buying or selling CFDs.

Key things to think about at this point include how frequently they wish to trade and what time of day; their attitude to risk; and whether they prefer to use **fundamental** or **technical** analysis.

2. Open An Account

Selecting which brokerage to use is the next step for new investors. The firm they eventually decide to use will depend on a wide variety of features including:

- How easy-to-use and stable the trading platform is, and whether or not sophisticated tools (like advanced charts, news feeds and automated trading) are available.
- The range of underlying assets that can be speculated on using CFDs.
- The availability (and potential levels) of leverage.
- Margin requirements, and whether these suit the trader's risk tolerance and trading strategy.
- Educational resources and other useful CFD day trading materials for beginners.
- Whether or not a demo account is available that can help new CFD traders get up to speed.
- Regulatory status and reputation with customers and market experts.
- Spreads and fees.

3. Buy or Sell

If you buy you go *long*. If you sell you go *short*.

Bring up the trading ticket on your platform and you will be able to see the current price. The first price will be the bid (sell price). The second price will be the offer (buy price).

The price of your CFD is based on the price of the underlying instrument. If you have a reason to believe the market will increase, you should buy. If you believe it will decline, you should sell.

4. Trade Size

You now need to select the **size** of CFDs you want to trade. With a CFD, you control the size of your investment. So although the price of the underlying asset will vary, you decide how much to invest.

Brokerages will, however, have **minimum margin requirements** – or more simply, a minimum amount that is required in order for the trade to be opened.

This will vary asset by asset. It will always be made clear however, as will the total value (or your exposure) of the trade.

Volatile assets such as cryptocurrency normally have higher margin requirements. So a position with exposure to $2,000 worth of Bitcoin, might need a margin of $1,000 for example.

A well-traded stock however, may only need a 5% margin. So a $2,000 position on Meta, may only require $100 of account funds.

5. Add Stops & Limits

This will help you secure profits and limit any losses. As explained above, most CFD trading strategies for beginners and experienced traders will employ the use of **stop losses** and/or **limit orders**.

They tie in with your risk management strategy. Once you have defined your risk tolerance you can place a stop loss to automatically close a trade once the market hits a pre-determined level.

This will help you minimize losses and keep your accounts in the black – leaving you to fight another day on subsequent trades.

A limit order will instruct your platform to close a trade at a price that is **better** than the current market level.

If you opt for a trading bot they will use pre-programmed instructions like these to enter and exit trades in line with your CFD trading plan. These are good for closing trades near resistance levels, without having to constantly monitor all positions.

6. Monitor & Close

Once you have placed your trade and stop or loss limits, the trade will shift along with the market price. You can view the market price in real time and you can add or close new trades.

This can be done on most **online platforms** or through **mobile apps**.

If your stop loss or limit order hasn't been activated you can close it yourself. Simply select 'close position' from the positions window. You will be able to see your profit or loss almost instantly in your account balance.

Taxes

Although you can trade CFDs all over the world, where you're based and the market you're trading in can throw an expensive spanner in the works. CFD trading in Brazil will be different to that in the UK, Australia, India, South Africa, and Singapore.

This is mainly because of CFD taxes.

Different countries view CFDs differently. Some consider them a form of gambling activity and therefore free from tax. Some countries consider them taxable just like any other form of income.

The tax implications in the UK, for example, will see CFD trading fall under the capital gains tax requirements.

Although you get a **£10,100** annual exemption, any profits that exceed that will be taxed. This means you should keep a detailed record of transactions so you can make accurate calculations at the end of the tax year.

So, before you start CFD day trading, find out whether you will pay personal income tax, business tax, capital gains tax, or if you're lucky, no tax. Once you know what type of tax obligation you will face you can incorporate that into your money management strategy.

Bottom Line

The use of leverage means CFDs can be an attractive way for short-term investors, such as day traders, to make large returns. There is a good selection of CFD brokers to choose from and a variety of asset classes for them to speculate on.

However, trading these financial instruments shouldn't be taken lightly and may not be suited for beginners with a low-risk tolerance. Losses can get out of control quickly, and so a disciplined approach is essential.

FAQ

What Is A CFD?

A contract for difference, also known as a CFD, is a financial instrument that allows traders to speculate on rising and falling prices without owning the underlying asset.

CFDs are popular with short-term retail traders and can often be traded with leverage, allowing investors to take a much larger position than their balance would otherwise allow, increasing returns and losses.

Is CFD Trading Legal?

CFD trading is legal in many jurisdictions, including the UK, Australia and Europe. With that said, CFDs are banned in some countries, such as the US.

You can check the latest rules and regulations on the respective regulator's website.

Are CFDs Suitable For Day Trading?

CFDs are popular with day traders. They can be more cost-effective than traditional investing vehicles like share dealing. The availability of leverage also means traders can amplify their buying power and potential returns.

With that said, CFD day trading is also risky. An effective risk and wallet management strategy is essential.

Recommended Reading

- Best CFD Brokers and Trading Platforms in 2024
- CFD Commodity Trading
- CFD Crypto Day Trading
- CFD Demo Accounts
- CFD Fees
- CFD Forex Trading
- CFD Indices Trading
- CFD Stock Trading
- CFD Taxes
- CFD Trading Apps
- CFD Trading Books
- CFD Trading For Beginners
- CFD Trading Signals
- CFD Trading Software
- CFD Trading Strategies
- CFD Trading vs Share Trading
- Trading CFDs For A Living

For Specific Countries

- CFD Trading In The UAE
- CFD Trading In Malaysia
- CFD Trading In Indonesia
- CFD Trading In The UK
- CFD Trading In Canada
- CFD Trading In South Africa
- CFD Trading In India 2024
- CFD Trading In The USA
- CFD Trading In Singapore
- CFD Trading In Australia

Article Sources

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- Basics Of CFD Trading In Forex - Martin Maga, 2020
- Leverage Trading: A professional approach to trading FX, stocks on margin, CFDs, spread bets and futures for all traders - Robert Carver, 2019
- Contracts For Difference (CFD) - ESMA

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Risk Warning: Trading CFDs on leverage involves significant risk of loss to your capital.

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