The Basics of Financial Trading

by Kaleigh Giacomoni

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What are CFDs?

CFD stands for Contract for Difference, and is a common form of derivative trading. CFDs allow investors to speculate on the rising or falling prices of many instruments including Forex pairs, Stocks, Cryptocurrencies, Commodities, Indices, and Bonds. With CFDs you don't buy or sell the underlying asset or instrument, instead you buy or sell a number of units of the particular instrument, determined by whether you think the prices will rise or fall. For every point the price of your traded instrument moves in your favor, you will gain multiples of the number of CFD units that you have bought or sold. For every point the price moves against you, you will make an equivalent loss.

There are two types of transactions that an investor can make based on their speculation of the future movement of a particular asset. If you believe the instrument in question will move upward in price than you would buy the CFD. If on the other hand, you believe the instrument will move downward in price, then selling the CFD would be the most obvious action.

A CFD is a leveraged product, meaning you can magnify your profits, however, your losses will also be multiplied, as they are based on the full value of the position. The amount of earnings or loss is determined based on the value of the underlying asset when opening and closing a specific position. In other words, the net difference between the purchase price of a CFD and the sale price of the same CFD is calculated, resulting in an overall profit or loss for each transaction.

In conclusion, a Contract For Difference is directly linked to a specific financial asset, and the potential profits orlosses coincide with the change in value of the instrument in question. The main difference between trading a physical asset and a CFD is the fact that the ownership of said product is not changing hands when the transaction takes place.

What is Forex?

Forex refers to the largest and most liquid financial market in the world, the Foreign Exchange market. The Foreign Exchange Market can be attractive to investors due to the constant movement of currency prices. With Forex you are able to speculate on the strength of one nation's currency against another nation's currency. Foreign Exchange is traded in pairs, the first currency listed is the Base Currency, and the second being the Quote Currency.

For example, with the EUR/USD you are speculating on the strength of the Euro versus the United States Dollar. If EUR/USD is listed at 1.12, that means that it costs $1.12 USD to purchase one Euro. When trading Forex, an investor will open a position on a currency pair based on which currency they believe will appreciate in value. If the investor believes the EUR will rise against the USD, they will purchase the EUR/USD. If the Foreign Exchange moves in their favor they will make a profit, however, if it moves against them, they will make a loss.

A currency is always traded in relation to a secondary currency. If traders were to sell one currency, they are in turn purchasing another. When trading Forex electronically there is no physical exchange of money. Instead, traders often open a position on a specific currency pair in the hopes that there will be some movement in the strength or weakness of the pair.

Unlike others, this market is not centralized, instead, it is an electronic network of brokers and banks. Due to differing time zones, the Forex market is open 24 hours a day, 5 days a week. Some currency pairs are even open to trade on holidays, assuming at least one of the countries or global markets is in operation. Additionally, the investor has the option to trade popular currency pairs such as EUR/USD and USD/CAD, or exotic pairs including JPY/NOK and AUD/MXN.

"Trading effectively is about assessing probabilities, not certainties."

What are Stocks?

A Stock or Share is a type of financial asset, that represents a portion of ownership in a corporation. More specifically, a Share entitles Stockholders to a portion of a company's profits or losses. Stocks are almost always the foundation of an investors portfolio, as they have historically outperformed many other investments.

A corporation will sell Shares of their company in order to raise funds that will be used to operate or expand their business. An investor will then buy Stock, entitling them to a proportionate amount of the assets of said corporation. The portion of the corporation's profits or losses that each shareholder is entitled to is based on the amount of Stocks that are owned. For example, if a company has made 100 Shares available, and an investor purchases 5 Shares, they own 5% of the company.

For clarification, it is important to note that a Shareholder does not in fact own a corporation, they own Shares that are issued by the particular corporation. This means that a corporation is able to own assets such as property that is held separately from the Shareholders. However, owning Stock in a company gives an investor the right to receive dividends (share of the corporation's profits), the ability to vote in Shareholder meetings, and the right to the liquidation balance.

Shares are most commonly traded on Stock Exchanges. There are more than 60 Stock Markets worldwide, with some of the biggest being in New York, Tokyo, Hong Kong, and London. Due to the differing time zones, it is possible to trade on various Stock Markets 23 hours a day, 5 days a week. It is also possible to trade after hours on some Exchanges, however, the hours vary based on location.

What is Cryptocurrency?

A Cryptocurrency is defined as any digital or virtual currency that is decentralized and uses cryptography as a form of security. These digital currencies can be used to make virtual transactions, as well as traded with other Crypto Investors. Cryptocurrencies are continuously fluctuating, making the market extremely volatile which can be attractive to investors and traders.

Similar to other financial markets, the price of Cryptocurrency is heavily based on supply and demand. The exchange rate between a particular cryptocurrency and another currency can fluctuate widely, however as of February 2019 there was a market value for all combined digital currencies of over $120 billion USD. The value of each individual unit of a virtual currency varies greatly. If we use Bitcoin as an example, you can see the price fluctuation in December 2017; when it hit over $19,000 USD followed by a 20% fall to around $15,000 USD hours later.

Some of the most popular digital currencies are Bitcoin, Ripple, Ethereum, and Litecoin. The way that these, and other cryptocurrencies operate is based on blockchain technology. The central idea behind blockchain is that it is a virtual ledger of economic transactions that is incorruptible, allowing digital information to be distributed but not copied. The blockchain network has been created in a way that it has no central authority, the information within the ledger is transparent and accessible by anyone.

Unlike other financial exchanges, the Crypto market is open 24 hours a day, seven days a week. However, the trade volume of the market can still vary, depending on the opening hours of the largest exchanges such as New York, Sydney, and London. The non-stop nature and volatility of the Cryptocurrency market has made it a popular exchange with investors.

What are Commodities?

A commodity is any raw material or agricultural product that can be used in commerce. There is a standard quality that is expected with a specific commodity, however, there is a possibility that it may differ slightly. Commodities are bought and sold worldwide in relation to the global trends of supply and demand. Some traditional commodities are precious metals, coffee, beef, and oil. However, with the advances in technology, there are also new types of commodities including Foreign Exchange, emissions credits, and bandwidth.

The most common way the commodities are purchased or sold is through futures contracts on financial exchanges. There are two types of transactions that can be made on a Commodity Exchange. The first type is a buyer or producer that uses futures contracts for hedging, the second type is a speculator.

A speculator is an investor who trades commodities with the goal of profiting from the high degree of daily range in value of the markets. These investors do not want to take physical ownership of the asset at the end of the futures contracts. Instead, they wish to take advantage of the liquidity of the market and the volatile price movements. As the demand for a commodity increases, so does its price. The opposite occurs when the demand for a commodity decreases.

There are approximately 50 major Commodity Markets around the world that operate close to 24 hours a day, 5 days a week. Despite the long hours that allow Commodities to be traded, certain times of day show varying degrees of participation, liquidity, and pricing volatility.

"Trading doesn't just
reveal your character,
it also builds it if you stay
in the game long enough."

What is an Index?

An index is a theoretical investment portfolio representing a specific segment of a financial market. In other words, a Market Index is a predefined collection of financial assets within the Stock Market, used to provide a broad depiction of the current trends within the economic sector. Investors adopt Indices to gauge overall market movements and performance, in order to manage their portfolio.

An index is calculated based on the combined value of all underlying assets within the index. There are different methods used to calculate an index, which is determined and maintained by the provider of the index. Each individual asset has an impact on the strength or weakness of the Market Index. Assets are weighted differently, meaning that the impact each financial instrument has on the index can vary. Indices can have values based on fundamental-weighting, revenue-weighting, market-cap weighting, and float-weighting.

Unlike other financial markets, it is not possible to purchase a portion of an Index, as it is only hypothetical. There are multiple ways that Investors can speculate on a Stock Index including Index Funds, ETFs, and CFDs. Although you cannot invest directly in an index, it is still a popular option among traders as it allows traders to diversify their portfolios.

There are almost 50 major Stock Indices that can be divided into three categories: global, regional, and national. Global Indices like FTSE All-World Index, S&P Global 1200 Index, and Dow Jones Global Titans 50, track markets globally. A regional Index covers specific geographical areas such as Europe, Asia, or Latin America. Some examples of common regional Indices are the Euro Stoxx 50 Index and FTSE ASEAN 40 Index. National Indices are used to represent the strength or weakness of a market in a specific country. Some of the most popular national Indices are the Dow Jones Industrial Average, S&P 500, DAX 30 Index, and Nasdaq.

What is Leverage?

Leverage is the use of borrowed capital to magnify investments on financial assets. To clarify, an investor is able to trade with more capital than they have invested, in order to amplify their buying power. Using leverage allows a trader a larger return on investment, meaning if the market moves in their favor the profits will be multiplied. The same of course is true if the market moves against the investor, the losses will also be multiplied.

For example, if you were to invest $1000 and speculate on the Oil market with the leverage of 1:20, you would then be able to trade with the weight of $20,000. This multiplies the buying power of an individual investor, allowing them to trade larger volumes than would be possible with their initial investment of $1000. The benefit of using leverage is that if the price of the financial asset, in this case, Oil, rises then your profit is multiplied by 20. Of course, the risk of loss is also equally multiplied when trading with leverage.

Leverage is calculated as a ratio, it is the size of the investor's funds to the size of the broker's credit. Although the brokerage firm will set a maximum amount of leverage, the investor often has the opportunity to select their own level of leverage. Investors should carefully consider the leverage ratio that suits them best in relation to each individual financial instruments, in order to manage risk accordingly.

Leverage can be used when trading most financial instruments including Forex, Stocks, Cryptocurrency, Commodities, and Indices. The amount of leverage available varies based on the brokerage firm, as well as the financial instrument that is being speculated on. Leverage is a complex trading tool and can be profitable when trading, while the reverse is also true.

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