TradeMentor

Chapter 1.1

The Stock and CFD Market

THE STOCK AND CFD MARKETS

The global financial markets have never been so vibrant and alive, and they have never been so accessible to you as an individual investor. You are in a unique position. Never before have individual investors, like you, had access to everything they needed to be successful on their own in the global financial markets. Now you do.

Both the stock and contract for difference (CFD) markets are exciting markets that give individual investors, like you, access to the world's stock markets with an exciting level of leverage and flexibility.

Let's take a look at the basics of how each of these markets work. We'll start with the stock market and then take a look at the CFD market.

THE STOCK MARKET

Investors trade stocks—shares of ownership in a company—through stock exchanges. Before the rise of the Internet, stock exchanges were physical trading floors where investors, or their brokers, could get together and negotiate prices for the stocks they were looking to buy and sell. While many of these physical exchanges, like the New York Stock Exchange (NYSE) and the London Stock Exchange (LSE) still exist, new Internet-based stock exchanges, like the NASDAQ, have developed. Regardless of whether the stock transactions take place on a live trading floor or in cyberspace, the important thing for you as an investor is that there is a place where you can buy and sell your stocks.

Why would you want to buy and sell stocks instead of simply buying and holding stocks? Investors buy and sell stocks based on their belief of what the price of the stock is going to do in the future. If they believe the price of the stock is going to go higher, they buy the stock. If they believe the price of the stock is going to go lower, they sell the stock.

Why Stock Prices Go Up and Down

Companies are in business to make a profit. You don't have to get any more complicated than that. Companies want to make a profit. When companies do make a profit, managers either reinvest the money back into the business for future growth or they distribute the money to the owners of the business. As you just learned, you are buying ownership in a company when you buy stock, which means managers would be distributing money to you. These cash distributions to stock holders are called dividends.

Companies that are growing and generating more and more profits tend to have stock prices that move higher and higher. Companies that are not growing and are not generating more and more profits tend to have stock prices that move lower and lower. As a stock investor, however, you cannot simply look at how well a company is performing today when you are choosing which stocks to buy and which stocks to sell. Investors are most interested in what they believe the company will do tomorrow, next month and next year. If they believe the company will continue to grow and generate profits, they will buy the stock. If, on the other hand, they believe the company will not continue to grow and generate profits as it has done in the past, they will sell the stock.

Now that you have a basic understanding of the stock market, let's take a look at the CFD market.

WHAT IS A CFD?

A CFD, or contract for difference, is a contract that rises or declines in value as the stock on which the contract is based rises or declines in value.

Why the Value of CFDs Goes Up and Down

A CFD gains or loses value as the *difference* between the price of the stock when you bought the CFD and the current price of the stock fluctuates. For example, if you buy a CFD that is based on a share of Microsoft (MSFT) stock, and the share of stock rises in value, the value of your CFD will also rise. Conversely, if you buy a CFD that is based on a share of MSFT stock, and the share of stock declines in value, the value of your CFD will also decline. The value of the CFD is directly tied to the price of the stock, which is why you must understand why stocks move before you invest in CFDs.

Leverage in the CFD Market

If the value of a CFD is directly tied to the value of the underlying stock, why not just trade the stock? Why would you want to trade CFDs instead?

The answer: leverage. When you trade CFDs, you can use leverage to enhance your investing returns.

When you buy a stock, you have to pay the full price of the stock. If the stock is trading at $25, you must pay $25 for the stock. If the stock is trading at $100, you must pay $100 for the stock. When you buy a CFD, on the other hand, you only have to pay a portion of the total price of the stock—sometimes as little as 5 percent.

Leverage enhances your profits, but it can also enhance your losses. Imagine you buy a CFD on a stock that trades for $50, but you only have to set aside $5 for the CFD because you are taking advantage of leverage and can pay as little as 10 percent on this particular stock. Now imagine that the value of the stock increases 10 percent, from $50 to $55. How does this affect your CFD trade? Remember, a CFD is a contract for *difference* so you make the *difference* between $50 and $55—which is $5. If you had bought the stock, you would have made a 10 percent profit ($5 ÷ $50 = 10%). However, since you bought the CFD instead and only had to set aside $5 to enter the trade, you made a 100 percent profit ($5 ÷ $5 = 100%).

While this is a tremendous return, you have to remember that leverage can also work against you. If you had entered this same CFD trade and the stock had declined $5, from $50 to $45, instead of rising, you would have lost a larger portion of your investment as well. If you had bought the stock, you would have suffered a 10 percent loss (-$5 ÷ $50 = -10%). Whereas, since you bought the CFD and only had to set aside $5 to enter the trade, you would have lost 100 percent of your investment (-$5 ÷ $5 = -100%).

Leverage is an incredible tool. Use it wisely.

Getting Started

Thousands of investors, just like you, are taking advantage of the profit potential of the stock and CFD markets. The basic concepts are simple to grasp—when companies perform well, their stock price goes up, and when companies perform poorly, their stock price goes down. Along with stocks, CFDs offer incredible flexibility to you as an individual investor. Once you understand what drives the stock market, all you have to do is open a trading account, do your research and click a few buttons in your online trading station. Then sit back and monitor your trades. It may take a little practice, but before long, you'll be making money like a seasoned professional. Start letting your money work for you.


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