Chapter 3.1

Hedging with CFDs

HEDGING WITH CFDS

Successful share and CFD traders realize that protecting the money they have is just as important, if not more so, than earning more money from trading. They know that it takes money to make money as a share and CFD trader, and they will do whatever it takes to protect their investment capital.

Hedging is a trading technique that allows you to protect the trades you are in against sudden and unexpected losses. Hedging also provides you with increased flexibility to remain in investments when you may otherwise have been forced to exit for a substantial loss. Perhaps the greatest benefit of hedging is you do not have to hedge every trade, yet you have the ability to apply a hedge to almost any trade at any time.

CFDs can be used as part of a hedging strategy to help protect existing share and CFD positions and your total portfolio. Since a CFD is a margined product, you can use its leverage to protect the total value of a share position without having to pay a lot up front for it.

In this section we will discuss the following three strategies for hedging your trading positions and your trading account as a whole:

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HEDGE—SINGLE SHARE

One popular hedging strategy that combines share and CFD trading is hedging a single share position with a CFD during turbulent market times.

Imagine you are currently holding 10,000 ABC Bank shares. It is November 2007 and you expect the bank to have some short-term problems due to the credit squeeze stemming from difficulties in the U.S. housing market. However, you believe it is only a short-term weakness and the ABC Bank is a sound long-term investment.

Initially you bought those 10,000 ABC Bank shares at £5.82 back in November 2005 for a total of £58,200. Currently, ABC is trading between £7.20 and £7.40 but, with the credit crisis looming, you expect to suffer a significant short-term loss on the share, perhaps pushing the price as low as where it was when you invested. However, you expect to see the share price find support, turn around and resume its previous upward trend.

Because you don't know for sure that the market will go up or down, you decide to hedge your position rather than selling out. To hedge you position you decide to sell an equal number of CFDs at the current market price to offset your share investment and create the hedge.

In this case, you sell 10,000 ABC CFDs at £7.40 to cover the 10,000 shares of ABC Bank share you own. Thanks to the leverage you enjoy with CFDs, you are only required to put up 10 percent of the value of ABC Bank shares – at a cost of £7,400 (10,000 shares × £7.40 per share × 10% = £7,400).

At this point one of the following three things can happen:

- The share price can go up
- The share price can go down
- The share price can remain where it is

Share price goes up—if the share price goes up you will make a gain on your share trade which will be offset by the loss on your CFD trade. For example if the share price rises from £7.40 to £8.40 you will make £10,000 on your share trade, but you will also lose £10,000 on your CFD trade. At this point, if you believe the share price is going to continue rising, you can unwind the hedge by buying back the CFDs you sold.

Share price goes down—if the share price goes down you will make a gain on your CFD trade which will be offset by the loss on your share trade. For example if the share price drops from £7.40 to £6.40 you will make £10,000 on your CFD trade but you will also lose £10,000 on your share trade. At this point, if you feel the share price is ready to turn around and resume its previous trend, you can unwind the hedge by buying back the CFDs you sold.

Share price remains flat—if the share price remains flat you will not make a gain or loss on either your share or your CFD trade. For example if the share price remains flat at £7.40 you will make £0 on your share trade but you will also lose £0 on your CFD trade. At this point, if you feel the share price is ready to resume its previous trend, you can unwind the hedge by buying back the CFDs you sold.

Regardless of what the share price does, the outcome from the hedge is therefore that you will retain any profit from the point at which you establish the hedge.

PAIR TRADING

Another popular hedging strategy combines buying a CFD on the share of one company and simultaneously selling a CFD on the share of another company in the same industry. This hedging strategy is called pair trading because you are trading a pair of CFDs. Pair trading is based on the fact that the shares of companies in the same industry tend to move in the same direction. When an industry is performing particularly well most of the shares of the companies within that industry tend to do well. Conversely when an industry is performing poorly most of the shares of the companies within that industry tend to do poorly.

As a pair trader you are looking to buy a CFD on the share of the strongest company within the industry and sell a CFD on the share of the weakest company within the industry. Once you have entered your pair trade you anticipate that one of two things will happen:

- the shares of both companies will move higher but the share underlying the CFD you bought will make a larger move up than the share underlying the CFD you sold
- the shares of both companies will move lower, but the share underlying the CFD you sold will make a larger move down than the share underlying the CFD you bought.

In both scenarios you count on losing money on one of your CFDs, but you count on making enough money on the other CFD to offset your losses and provide you with a net gain. It is like making a prediction that, if you are going to race a new Porsche against a 1961 Volkswagen Beetle, the new Porsche is going to win. Of course the new Porsche may get a flat tyre or break down before it can cross the finish line, which would allow the Volkswagen Beetle to win, but the chances of that happening are slim.

Of course it is also possible that both trades can move in your favor - allowing you to profit from the CFD you bought as its underlying security moves higher and allowing you to profit from the CFD you sold as its underlying security moves lower.

Conversely it is possible that both trades can move against you -causing you to experience losses from the CFD you bought as its underlying security moves lower, and likewise causing you to experience losses from the CFD you sold as its underlying security moves higher.

Imagine you are interested in constructing a pair trade on shares in the oil industry, and you believe British Petroleum (BP:xlon) and Royal Dutch Shell (RDSb:xlon) would make excellent trading candidates for a pair trade. You look at the two shares, and British Petroleum is trading at £5.72 and Royal Dutch Shell is trading at £20.36.

When you enter a pair trade it is crucial you weight each side of your trade equally. Otherwise the trade will be out of balance and may not perform the way you expect it to. To balance you pair trade, you must ensure you control the same amount of value in whatever assets on which the CFDs are based. For example, in this case, you are looking to control approximately £100,000 worth - or 17,482 shares at £5.72 per share (17,482 × £5.72 = £99,997.04) - of British Petroleum shares and approximately £100,000 worth - or 4,911 shares at £20.36 (4,911 × £20.36 = £99,987.96) - of Royal Dutch Shell shares.

Now that you know how many of the underlying shares you want to control, and the current trading price of those shares, you can enter your trade. Because you are trading CFDs, which employ leverage, you can control £100,000 of the underlying share without using £100,000 of your own money. In this example, you only have to cover 5 percent of the value of British Petroleum's share price, or £4,999 (£99,997.04× 5% = £5,000) and 10 percent of Royal Dutch Shell's share price, or £9,999 (£99,987.96× 10% = £10,000). In total you must therefore provide approximately £15,000 in margin to enter this trade with CFDs, not the full £200,000 if you were to use the shares themselves.

You must also remember that you either pay or receive interest each day when you trade CFDs on margin. In this case you will pay interest of £22.80 per day on the British Petroleum CFDs you have bought, yet you will meanwhile receive interest of £22.80 per day on the Royal Dutch Shell CFDs you have sold. These payments and credits will offset each other in this pair trade.

Now imagine that the price of British Petroleum rises slightly to £5.735 and the price of Royal Dutch Shell falls to £19.52 as your trade progresses over 14 days, and you exit your trade. Your profit on the British Petroleum position is £0.015 per CFD, or £262.23 (17,482 × £0.015 = £262.23). Your profit on the Royal Dutch Shell position is £0.84 per CFD, or £4,125.24 (4,911 × £0.84 = £4,125.24). Your total profit on this pair trade is therefore £4,387.47 (£262.23 + £4,125.24= £4,387.47).

HEDGE—INDEX DIVERSIFICATION

Hedging does not require you to be in two offset positions simultaneously like you are when you hedge a single share position by offsetting it with a CFD. You can also hedge your overall account risk by diversifying your investments across a broad spectrum. Whether you believe shares are more likely to move higher or lower, you can improve your chances of success by buying or selling a broad range of CFDs.

The easiest way to hedge by diversifying is to buy an index-tracking CFD. An index-tracking CFD is a contract that derives its value from a large share index, like the S&P 500 or the FTSE 100, and not from a single share.

Imagine you believe that shares in general are going to move higher, but you aren't exactly sure which ones you should buy. Since you don't want to risk missing out on the predicted upward movement in shares just because you might choose the wrong ones, you decide to buy a few index-tracking CFDs - the FTSE 100, NASDAQ, S&P 500, Dow Jones and DAX index tracking CFDs. Now, if shares in general increase in value, you will make money on your trades. Even if a few shares in each index decrease in value, the average performance of the entire index will most likely counterbalance these negative movers.

This concept also works when you believe shares in general are going to move lower. You can sell index-tracking CFDs and benefit from the price drop in the overall market.


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