

CFD FACE VALUE AND CASH VALUE

By Daryl Guppy

Leverage is at the core of CFD and derivative trading. It's also sometimes referred to as gearing. However the concept is sometimes a little confusing for new traders. In these notes it's not our intention to go into the theory of leverage. We want to focus on the practical application and understanding of leverage in a CFD environment.

Leveraged trading allows the trader to use a down payment process. Rather than paying the full amount for the shares he pays only a deposit on the value of the shares. The result is a difference between the cash he pays and the nominal value of the shares.

The two key concepts are:

- Face value
- Cash value

Our proposed trade is with BKN and the current price in the market is \$4.13. We are prepared to spend \$10,000 to buy BKN. If we bought the shares directly then we would buy 2,420 shares at \$4.31 for a total CASH cost of \$9,994.60.

The CASH VALUE of the trade is \$9,994.60. In this purchase the FACE VALUE of the trade is also \$9,994.60.

Name	Buy price	qty	Face value
BKN	\$ 4.13	2,420	\$ 9,994.60

In a leveraged CFD trade the CASH value remains the same at \$9,994.60 but the FACE value of the position changes.

Here's the first part of the trade calculation. The trade uses 10% leverage so the quantity of shares we purchase is now multiplied by a factor of 10 so we purchase 24,200 shares. We are paying a deposit of one tenth of the cost of the shares. The total CASH required is \$9,994.60. On the spreadsheet this is shown as the CFD CASH COST. This is the amount you must pay to enter this trade. This is the CASH VALUE of the trade.

Name	Buy price	qty	CFD cash cost
BKN	\$ 4.13	24,200	\$ 9,994.60

The second part of the calculation frightens new CFD traders. Due to the leverage the calculation shows the trader <buys> 24,200 shares at \$4.13 for a FACE VALUE of \$99,946.00!! This simply means that his CASH deposit of \$9,994.60 gives him access to shares with a FACE value of \$99,946.00. The spreadsheet shows this as the FACE VALUE

Name	Buy price	qty	Face value
BKN	\$ 4.13	24,200	\$ 99,946.00

The risk in the trade is calculated on the CASH value of the trade. This is the amount of CASH you will lose if the trade is closed at the stop loss level.

Name	Buy price	qty	Face value	CFD cash cost	Cash Risk
BKN	\$ 4.13	24,200	\$ 99,946.00	\$ 9,994.60	1,210

The FACE VALUE calculation is for reference purposes only. The most significant figure is the CFD CASH COST because this is the amount of cash you must pay to purchase the shares. This is the base figures against which the cash proceeds from the sale of the shares are assessed. The next most significant figure is the CASH RISK as this is the amount you will lose if the trade is closed at your stop loss point.

The CASH RISK is calculated from the CASH COST of the trade and the nominated stop loss exit price. If the trade is closed at your stop loss price then the CASH RISK is the amount of funds that you will lose. The CASH RISK should be kept at a maximum of 2% of the total portfolio capital you are trading with. On a \$20,000 portfolio this cash risk should not exceed \$2,000.

The most important feature to remember is that it is the CASH COST and the CASH RISK that reflect the actual cash transfers in your account.