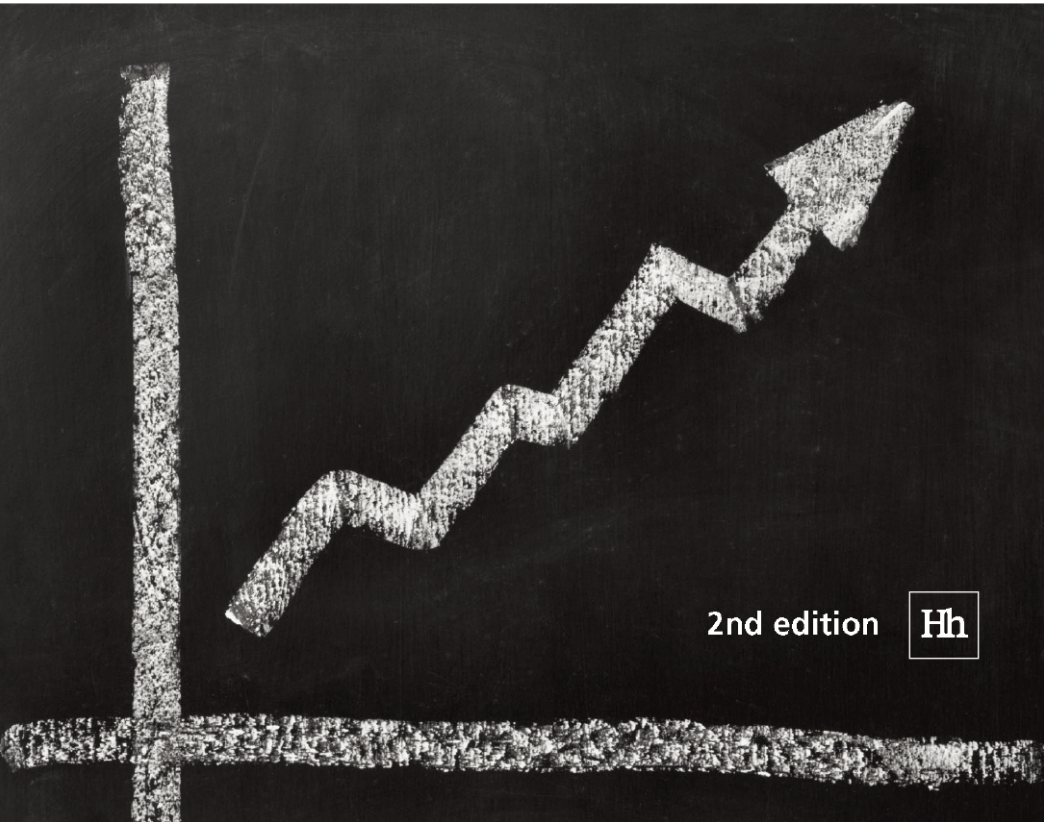
The Beginner's Guide to

Financial Spread Betting

Step-by-step instructions and winning strategies

Michelle Baltazar



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Contents

Biography

Michelle Baltazar is an award-winning finance journalist. She wrote a weekly column on derivatives for London-based investment magazine *Shares*. Prior to *Shares*, she worked for Australian business magazine, *Business Review Weekly*.

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Finally, to my family and friends: *thank you*.

Introduction

In the summer of 2003, two close friends from south-east London, Clive Smith*, an owner of a travel agency, and Joan Irving*, a school teacher, made a decision that would soon change their lives.

They placed a bet of £1,000 on a handful of shares through a form of trading called spread betting. The pair traded a host of shares including online company MyTravel, airline giant British Airways and pharmaceuticals group SkyePharma.

Eight weeks later, that £1,000 turned to winnings of more than £1 million.

You would be hard pressed to find any other form of trading that allows such a scale of return possible for the average punter. Spread betting was once the domain of institutional investors, City traders and high rollers. Not anymore. Clive Smith and Joan Irving are just two of more than 100,000 people across the country that have turned to it as a natural extension to their investment strategies.

In between turning £1,000 to £1 million, there were periods where the bet could have gone either way. To make the chain of decisions they had made, involved more than luck and sheer guts. They did their research, attended shareholder meetings and kept abreast with market news.

The aim of this book is to give you a basic understanding of how spread betting works, so that, just like Smith and Irving, you can find out how to turn a pauper's budget into a king's ransom.

It is worth noting that before they made their million, Smith and Irving made some costly mistakes. This brings us to an issue that should be at the forefront of a novice spread better's mind: managing risk. The secondary aim of this book is to explain the risks involved, and how to reduce them.

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* Details have been changed.

The road to successful spread betting starts with education. By the time you finish reading this book, you should know how to place a spread bet, the rules of the game and how to trade successfully. The appendices and glossary at the back serve as your quick and handy cheat notes when you start trading. As the saying goes: ‘Don’t just learn the tricks of the trade. Learn the trade.’

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Why spread bet?

"Progress always involves risk; you can't steal second base and keep your foot on first."

– Frederick Wilcox, author

What is spread betting?

Let's start with a question.

If you have £1,000 of spare savings, and you want to invest in the stock market, what is the best way to do it?

If you have the time and the inclination to research companies, you could buy shares directly in a handful of companies and manage your investments yourself.

If you don't have confidence in your own stock-picking abilities, you could buy units in a unit trust or other collective fund. A fund manager would then make decisions about which companies your money is invested in and take a fee for his service.

If you don't fancy paying the costs for professional advice, you could put your £1,000 into an index or tracker fund. This would diversify your investment across a wide range of companies and ensure that you get the same return as the market average, no better, no worse.

All these options are valid. None are inherently better than the others. Their suitability depends on your personal circumstances.

However, there is another option which will, potentially, allow you to make much higher returns from your £1,000. It is called spread betting.

Spread betting is a form of trading in which you bet on the price movement of a share, index, currency, commodity or bond. It is a way of playing the stock markets without actually owning any shares.

The concept was created in the 1970s by a then 35-year old investment banker called Stuart Wheeler. But it is only since the late 1990s that spread betting has gained widespread appeal. **In a nutshell, it allows access to markets that were previously restricted to institutions, banks and wealthy investors.**

How? The three main catalysts are the internet, the increased volatility in world markets and the simplicity of spread betting.

- The **internet** jump-started enormous changes to the workings of the stock market. First, it allows easy access to market information that traditionally was only available to institutions and wealthy investors. Second, it allows investors to try their hands at investing 'anonymously'. Third, online trading systems have lowered charges to a level that is practical for both the average investor and the spread betting company.
- The recent subprime crisis in the US, which carried across into the European markets, sent the stock markets tumbling. Spread betting was an ideal medium to take advantage of these markets, as unlike conventional share trading it **allows investors to bet on markets going down.** The falling markets provided plenty of these so-called 'short-selling' opportunities. We will cover this more fully in chapter 8.
- **Simplicity**. Spread betting is a type of derivative (a financial instrument that is 'derived' from an underlying market such as equities). Of all the derivatives available, it is seen as the easiest to understand.

From one product (the gold price) in the 1970s, there are now more than 4,000 financial and non-financial instruments to choose from. Financial instruments include equities, commodities and indices, while non-financial ones include sports and fancy bets.

In short, the industry is continually changing shape to reach a wider market.

Pros

The main advantages of spread betting, all of which are explained more fully later in this book, are:

- It is **easier to understand** than other financial instruments. The process is less complex than that for options, futures and Contracts for Difference (CFDs).
- You can start with a **small amount of capital**. You can open an account for less than £100. Trades can be placed from an account balance as low as £28.
- You only **pay a fraction of the full cost of the trade,** usually 10%, up front. This is called **margin trading.**
- It enables you to profit from rising (bull) or falling (bear) markets.
- It is **commission-free**. All the costs associated with the bet are built into the bid-offer spread.
- Gains are not taxable. Unlike share trading where gains made are potentially taxed at your current income tax rate, spread bets are not subject to capital gains tax.
- There are also income tax savings. For example, if you own a share paying a dividend, **income from that dividend is taxable at your current income tax rate**. Spread bets do not pay dividends. Instead, the dividend payment is built into the price so the holder of a position in a dividend-paying share will reap the rewards in the form of a cheaper buy price.
- No **stamp duty**. Spread bets are free from stamp duty, currently charged at 0.5% on all share purchases. This is because a spread bet is a contract between the client and the spread betting company and no physical exchange of shares actually takes place.
- The savings do add up. For a purchase of £5,000 of any share, the stamp duty charge paid to the government is £25. A trader who deals twice a week, 52 weeks a year will end up paying £2,600 in stamp duties alone.

- If you were to trade £25,000 in normal share transactions each trading day via a stockbroker, you would pay the government more than £31,500 in stamp duty over a year.

Other advantages:

- **One account** for a range of financial products. One spread betting account allows investors to trade indices, single shares, currencies, commodities, bonds and options on a number of global markets.
- **Instant execution**. Spread betting companies are not brokers, so all trades placed are contracts between the client and the spread betting company. This means that each execution is not necessarily traded over an exchange so there is no delay in routing the order. This allows instant execution in markets where this would not normally be possible.
- **No currency risk**. Dealing in foreign shares can be cumbersome and impractical if you are an average investor. You have to deal with a third party and pay transaction charges. **Spread betting allows traders to bet in pounds per point on international shares.**
- **Dealing in pounds per point,** dollars per point or euros per point makes tracking your investments much easier. For example, if share X is up 15 points on the day, it is far easier to estimate your profit by calculating that you have made, say, a £125 per point increase than calculating your number of shares, say 12,500 multiplied by 15 points, less broker charges stamp duty, tax and so on.
- **Extended trading hours.** Some spread betting companies are open 24 hours a day. This is in contrast to normal market trading hours, which run from 7.00am to 9.00pm.
- **Less paperwork** is involved compared to conventional share dealing.
- Setting up a spread betting account is simple and easy. All that is required, in most cases, is a signed application form and utility bill.
- It is a **practical form of short-term investing** to complement any long-term investments.

- Trades executed online are **anonymous, fast and cheap**.
- **Online trading platforms** for spread betting are said to be more advanced compared to those for traditional share dealing.
- Some spread betting companies offer a **virtual trading platform** for you to practice on. This offers an opportunity for potential spread betters to understand the markets, the dealing process and test trading strategies before committing real money. The ability to practice with virtual money reduces the risk of entering into incorrect positions and helps novice traders to understand the risks involved in dealing with geared products.
- Spread betting companies provide access to investment research, news, tutorials, market updates and commentary that are normally only available to institutions.
- The **type of bets** you can do range from financial (shares, indices, commodities, currencies), sports-based (football, horse racing, rugby) to fanciful (how many sips of water the Chancellor is going to drink during his Budget speech).
- **Unlimited profits with limited losses**. You can control when you want to take profits and run your bet until the point at which you decide to close it. The losses can be unlimited too but, as we shall discover later, they can be capped through stop-losses.

Cons

The disadvantages are:

- **You incur your loss when you close the trade** (all spread bets have an expiry date). With conventional share dealing, you crystallise your loss only when you sell the shares (no expiry date).
- If spread betting on equities, **you do not get dividends** because you are betting on a price movement rather than buying the shares. You get the benefit of the dividend through the price.
- The spread is different to the cash market spread so you have to factor in a certain increase or decrease in the price before you are in profit.
- Losses on bets **cannot be offset against capital gains** you make either on other spread bets or from your conventional share investments.
- You can lose more than your initial deposit or capital. The margin trading involved means that while potential profits are magnified, potential losses are also magnified, except for trades with stop losses. With ordinary share trading, you cannot lose more than the amount you invested in the shares. With spread betting, there is no such limit.
- Spread betting is not ideal for long-term investing as costs are incurred each time a spread bet is 'rolled' over or extended to a new expiry date. All spread bets have a definite expiry date. If you wish to run your trade beyond the expiry date you must roll your position over from one quarter to the next.

Key points

- Spread betting allows access to markets that were previously restricted to institutions, banks and wealthy investors.
- There are pros and cons to spread betting. Profits are not taxable. However, in spread betting you can lose more than your initial capital.
- The industry is continually changing shape to appeal to a wider market.