In finance, contracts for differences (CFDs) – arrangements made in a futures contract whereby differences in settlement are made through cash payments, rather than by the delivery of physical goods or securities – are categorized as leveraged products. This means that with a small initial investment, there is potential for returns equivalent to that of the underlying market or asset. Instinctively, this would be an obvious investment for any trader. Unfortunately, margin trades can not only magnify profits but losses as well. The apparent advantages of CFD trading often mask the associated risks. Types of risk that are often overlooked are counterparty risk, market risk, client money risk and liquidity risk.

Counterparty Risk

The counterparty is the company which provides the asset in a financial transaction. When buying or selling a CFD, the only asset being traded is the contract issued by the CFD provider. This exposes the trader to the provider's other counterparties, including other clients the CFD provider conducts business with. The associated risk is that the counterparty fails to fulfill its financial obligations. If the provider is unable to meet these obligations, then the value of the underlying asset is no longer relevant.

Market Risk

Contract for differences are derivative assets that a trader uses to speculate on the movement of underlying assets, like stock. If one believes the underlying asset will rise, the investor will choose a long position. Conversely, investors will chose a short position if they believe the value of the asset will fall. You hope that the value of the underlying asset will move in the direction most favorable to you. In reality, even the most educated investors can be proven wrong. Unexpected information, changes in market conditions and

government policy can result in quick changes. Due to the nature of CFDs, small changes may have a big impact on returns. An unfavorable effect on the value of the underlying asset may cause the provider to demand a second margin payment. If margin calls can't be met, the provider may close your position or you may have to sell at a loss.

Client Money Risk

In countries where CFDs are legal, there are client money protection laws to protect the investor from potentially harmful practices of CFD providers. By law, money transferred to the CFD provider must be segregated from the provider's money in order to prevent providers from hedging their own investments. However, the law may not prohibit the client's money from being pooled into one or more accounts. When a contract is agreed upon, the provider withdraws an initial margin and has the right to request further margins from the pooled account. If the other clients in the pooled account fail to meet margin calls, the CFD provider has the right to draft from the pooled account with potential to affect returns. (For more, see: Tips For Resolving Disputes With Your Financial Advisor.)

Liquidity Risks and Gapping

Market conditions effect many financial transactions and may increase the risk of losses. When there are not enough trades being made in the market for an underlying asset, your existing contract can become illiquid. At this point a CFD provider can require additional margin payments or close contracts at inferior prices. Due to the fast moving nature of financial markets, the price of a CFD can fall before your trade can be executed at a previously agreed-upon price, also known as gapping. This means the holder

of an existing contract would be required to take less than optimal profits or cover any losses incurred by the CFD provider.

The Bottom Line

When trading CFDs, stop-loss orders can help mitigate the apparent risks. A guaranteed stop loss order, offered by some CFD providers, is a pre-determined price that, when met, automatically closes the contract.

Even so, even with a small initial fee and potential for large returns, CFD trading can result in illiquid assets and severe losses. When thinking about partaking in one of these types of investments, it is important to assess the risks associated with leveraged products. The resulting losses can often be greater than initially expected.

Leverage

When a position is open in the Fund market, the market moves either towards or against the position of the trader. Each item in the price move corresponds to a fixed amount of capital that is added or subtracted from the balance of the trading account. If the market moves in the direction of the trader’s position, he makes money; if not, the trader is losing money.

Currency trading is made in the form of 'contracts' for a certain number of so-called standard lots. Each lot is equivalent to 100,000 units of currency. If the dollar is used as the quotation currency and the trader opens a position for one standard lot, he buys or sells 100,000 units of this currency.

Since the price move of a currency is measured in points - that is, each item has a share of 0.0001, - when trading with a standard lot, each item costs $10 (0.0001 x $100,000 = $10). If the transaction

brings 10 points of profit, the trader earns $100. If the price goes 10 points to the opposite side of the position, then the trader loses $100.

Not everyone has such a capital that allows you to trade currencies in the amount of $100,000, so you can use leverage, that is, borrow money from a broker to make a deal for $100,000 in the absence of $100,000 in your trading account.

When you use leverage when you open a position, you receive capital loan, but this money does not actually come to you to the account. However, you see how the current result of an open position changes, because now each item is more expensive, and price movement in one direction or another can potentially bring a higher profit or loss.

When performing trading operations on the "Margin Trading" terms, a relatively small change in the instrument rate can have a significant impact on the status of the Client's trading account due to the effect of leverage. When the market moves against the position of the Client, he may incur a loss in the amount of the initial deposit and any additional funds deposited by him to maintain open positions. The client is fully responsible for taking into account all risks, using financial resources and choosing an appropriate trading strategy.

When executing trading operations under margin trading conditions, even small market movements may have great impact on a Client's trading account due to the effect of leverage. The Client must consider that if the trend on the market is against them, the Client may sustain a total loss of their initial margin and any additional funds deposited to maintain open positions. The Client shall hold full responsibility for all risks, financial resources used and the chosen trading strategy.