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Introduction to the Financial Markets

INTRODUCTION TO THE FINANCIAL MARKETS

What is Financial Markets Trading?

Financial trading may seem daunting if you're at the beginning of your trading journey. This can be especially true with the technical language that's often used. In essence, financial trading involves prediction, namely whether the price of something will go up or down. It's important to understand the risks of trading; you may make good money but you could just as easily lose it.

Before we can get into the fundamentals of financial trading, you'll need to grasp the basics. We'll start by looking at what you can trade.

What is being traded?

Financial trading is the buying and selling of financial instruments. It works the same as any other market; a two way street of buying and selling goods. There are a variety of different financial instruments traded on the markets, some of the main categories include:

- **Forex**
- **Commodities**
- **Shares**
- **Indices**

Forex: There are different terms you might come across such as foreign exchange, currency trading, and FX. All of these terms mean the same thing. Forex trading happens via online brokers, banks, market makers, and traders around the world. Since all transactions occur via a computer network, there is no centralised marketplace.

Commodities: This is the trading of physical assets such as raw materials or agricultural products. The most popular products to trade amongst retail investors is gold and crude oil.

Shares: This involves the buying and selling of parts of a company. For example, if I believe Apple is excelling in its economic performance, I might want to buy a share of the company to trade on the market.

Indices: Indices is the value of a group of companies which are represented by a single number. Examples of indices include the FTSE 100 and Nikkei 225.

Trading could take place because you want to buy a whole or part of an asset, for yourself or a company. You've probably taken part in trading and not realised it. For instance, if you were going on holiday to Portugal from the UK, you'll need to convert GBP to EUR. To do this, you will have participated in the Forex market.

Most of the time trading takes place because you or an individual wants to make a profit on the movement of an asset in price. You might not be able to purchase the whole asset so you speculate on the price of either future contracts, or contracts for difference (shares, commodities, and indices). You can trade assets quickly because buyers and sellers meet electronically through online brokers.

The financial market is regulated by strict legislation, this helps control fraud and illegal activity. In the UK, the financial regulator is the Financial Conduct Authority (FCA).

Who trades?

There are various kinds of people who trade the financial markets, and for a variety of reasons. Here are some examples of the types of people you'll see trading:

- **Brokers** - They're specialists with experience in trading and trade on behalf of their clients
- **Banks** - Can act on behalf of other companies
- **Retail investors** - Can participate in the markets through investments in funds, buying shares and also trading through spread bets and CFDs
- **Institutional investors** - Look at making profits for themselves and their clients through a portfolio. Examples include asset managers and mutual fund providers

Why do people trade?

Most people trade in order to generate money, it's as simple as that. However, there is definitely a risk of losing money when you trade. Still, the money you put into the market has a greater potential to grow compared to money that is dormant. If you have effective strategies in place, and you trade intelligently, you're more likely to become a successful trader.

There are two forms of trading in the financial markets. The first is long-term investing, which involves buying and holding assets for a long period of time. The second is active trading (also known as speculation) which is geared towards short-term movements in the market.

WHERE DOES TRADING TAKE PLACE?

There are two ways in which you can trade: on an exchange or over-the-counter (OTC). Placing a trade on a company depends on whether or not the company is public or private. If you wanted to trade shares in a private company, you would need to contact the company directly as they'll not be listed on the Stock Exchange. Private companies are under no obligation to sell their shares if they don't want to.

On the other hand, public companies have more shareholders as they're publicly listed. They have stricter regulations, which include the appointment of a board of directors, as well as the mandated disclosure of financial information to the public at least twice a year.

What draws people into becoming a shareholder of a company are the 'dividends'. The company pays shareholders a dividend when it is generating profit. This compensates for when the share price of the company isn't moving much. Also, if a company does well financially, its valuation tends to increase and this causes the share price to rise. This is also beneficial for you if you've invested.

The stock exchange

The Stock Exchange trades most major shares.
You might already have a vague idea of what stock exchange trading is, as it's a popular concept often depicted in movies and appears frequently in financial news. You may be thinking of a large hall, full of people shouting and gesturing at each other whilst on the phone to clients, all of them trying to buy and sell at the same time. It just seems like pure havoc.

This depiction could have held weight in the past when most stock exchanges took place in a physical building. However, as electronic trading has now become the norm, many stock exchanges closed their trading floors and have instead switched to online platforms.

The process of a stock exchange trade

1. The trader informs the broker as to how many shares he/she wishes to purchase.
2. The broker sends the order through to the department clerk.
3. Once the order is passed to a trader, he/she will search for another trader who is selling the desired shares that he/she is interested in. The two will agree on a price. This information is then relayed back to the client by the broker.
4. After the processing stage, the customer receives a confirmation within the space of a few days.

Yes, it might sound complicated and time-consuming. But in today's market, the whole process only takes a few minutes.

The New York Stock Exchange:
The New York Stock Exchange (NYSE) is located on Wall Street, New York. The NYSE was founded on 17 May 1792, by 24 stockbrokers who signed the Buttonwood Agreement, which created a centralised agreement to exchange securities in the American market. The total market capitalisation recorded in March 2018 amounted to $23.12 trillion, which is equivalent to 40% of the total world stock market value.

NASDAQ:
The National Association of Securities Dealers Automated Quotations (NASDAQ) is also located in New York and was founded in 1971 as the world's first electronic stock market. In March 2018, its total world capitalisation reached $10.93 trillion, which makes it the second-largest stock exchange on earth. The top listed companies featured in NASDAQ include Google, Apple and Tesla, amongst others.

The Tokyo Stock Exchange:
The Tokyo Stock Exchange, founded in 1878, is Japan's largest stock exchange. Its combined market capitalisation recorded in 2018 was over $4 trillion. It's home to companies such as Toyota and Honda.

The Shanghai Stock Exchange:
The Shanghai Stock Exchange (SSE) is currently the world's fourth-largest stock exchange. The market operates through two classes of stock for every listed company. There are A-shares and B-shares. A-shares are quoted in Yuan and are open to foreign investment through a special qualified program. B-shares are open to foreign investment and are quoted in US dollars.

The Hong Kong Stock Exchange:
The Hong Kong Stock Exchange (SEHK) was formed in 1891 by the Association of Stock Brokers. It's one of three major stock exchanges in China. It should be noted that this stock exchange has no physical location, instead all trades occur via an electronic network.

The London Stock Exchange:
The London Stock Exchange (LSE) was founded in 1801. Currently, it's the largest stock exchange in Europe. In March 2018, the market capitalisation amounted to $4.38 trillion.

Over-the-counter trades
The electronic market matches buyers and sellers together through computer networks. This method is also used by banks and institutional traders. Individuals don't have access to the electronic markets, therefore it makes sense that a broker would act as the middle man.

A broker accesses the market for you, places an order and finds a buyer or seller through computer processes. The foreign exchange market is probably the most famous over-the-counter market, as there is no single venue where FX is traded.

Types of Brokers

The main types of broker include:

Full-service broker - This broker works on a high commission basis. They curate and execute trading strategies specifically suited to clients' investment goals.

Advisory based broker - This broker provides basic advice and recommends specific trades to their clients. Although, they do take a step back when it comes to making final decisions on trades.

Execution-only broker - This broker has minimal influence over traders' decisions. They simply carry out trading instructions provided by their clients. What's more, there is no advice given by an execution-only service.

SPREAD BETTING

Spread betting is a bet on the future direction of a market, while a CFD is an agreement to exchange the price of an asset from the opening and closing of a contract. It's a derivative strategy where participants don't own the underlying asset they speculate on (such as a stock or commodity).

You can spread bet on anything from horse racing, and sporting events to political decisions. It's quite common for market participants to spread bet on the value of financial assets.

Some examples of the financial instruments you can spread bet on include:

- **Shares**
- **Currencies**
- **Commodities**
- **Stock indices**
- **Interest rates**
- **Government bonds**

Financial spread betting is essentially predicting whether the instrument's market price will go up or down. If you think that the price will rise, you buy (also known as going long). If you think that the price of the asset will drop, you sell (also known as going short).

If your prediction turns out to be correct, your profits can grow in relation to the market price. If the market price is not in your favour, your losses will increase as the price movement rises. You won't physically own the underlying asset, but you will gain or lose on price changes as if you did.

Benefits of spread betting

No taxes

When you make money on CFDs or physical trading in the UK, you need to pay capital gains tax on any profits above £11,700. However, when trading the market via a spread betting account, you won't usually need to pay taxes (as long as your profits don't constitute your main source of income). Professionals spread betters and gamblers who live off of their trading or gambling income need to pay tax like anyone else. To figure out what situation applies to you here, speak with a qualified tax professional.

No commission or fees

Some brokers may not charge commission or brokerage fees to open and close trades. There could also be an option to leave your account without paying any fees. ATFX offers spread betting with zero commission.

How does spread betting work?

You can attempt to profit from both rising and falling prices by going long or short on any of the markets.

When you're spread betting, you'll always be presented with two prices; the buy price and sell price.

For example, if I wanted to bet on the price of gold, I would see "1356/1358" on the spread betting platform. If you think the price will rise, then you would buy-in at the higher price, which is referred to as the offer price (1358). This also works the other way around. If you expect the price to drop then, you'd sell at a lower price (1356).

Spread betting gets its name from the gap between two prices, which is called a spread.

Spreads work in points and are essentially a fee that the spread betting provider will charge to place the bet for you. The tighter the spread, the better it is for you. A narrower spread means that the market will have to move less in your favour for the bet to become profitable.

For example, the difference between 1356 and 1358 means that the market price would have to rise by two for you to start to make money. However, if the spread was just one, then the market would need to gain by one point before you'd start to make any money.

Spread betting is staking money on each point of movement of an assets price. If a share moved one penny in the underlying market, that would be equivalent to one point. You can put as much as you want on each point of movement (this is subject to the provider's minimum/maximum bet size).

To work out the profit and loss of a spread bet, you multiply the difference between the opening and closing prices by the amount you have staked per point.

Let's take the example we used before for gold prices.

The sell and buy price is 1356/1358. You want to place a buy bet on the offer price which is 1358, staking ten pounds per point.

You then find out that demand is exceeding supply, which means that the price of gold is rising. Now the market quotes you a price of 1456/1458.

You then decide to close your position and sell at 1456. The difference between your purchase and sell-price would be 1456-1358, equaling to 98. This number multiplied by your ten pounds stake per point amounts to a £980 profit for you.

It should be noted that online spread betting carries risks, and had you shorted crude oil at the sell price of 1356, you would have seen a loss of £1020.

CFD TRADING

A contract for difference (CFD) is a popular form of derivative trading. It's an agreement between a 'buyer' and a 'seller' to exchange the difference between the current price of an underlying asset (shares, currencies, commodities, indices, etc.) and its price when the contract is closed. It's a relatively simple security calculated by the asset's movement between trade entry and exit, computing only the price change without consideration of the asset's underlying value.

You don't own the physical asset you're trading. This enables you to speculate on the rising or falling prices of fast-moving financial markets, such as forex, indices, commodities, shares and treasuries. The key calculation to work out your profit is: the difference between the price at which you enter and the price when you exit, multiplied by your number of CFD units.

What's more, CFDs are leveraged products. They offer exposure to the markets while requiring you to only put down a small margin ('deposit') of the total value of the trade. They allow you to take advantage of prices moving up or prices moving down on underlying assets.

When the contract is closed you'll receive or pay the difference between the closing value and the opening value of the CFD and/or the underlying asset(s). If the difference is positive, the CFD provider pays you. If the difference is negative, you must pay the CFD provider. Leverage magnifies profits, but it is important to remember that losses will also be amplified.

CFDs are also known as derivatives. On a CFD market offering, there's a two-way price that's quoted.

How to trade CFDs

Let's say you wanted to trade a CFD on gold and there's a provider offering a spread of 1563/1569. If you sell - the bid price will be 1563. If you buy - the offer price is 1569. If you believe that gold prices will rise, then you buy at the offer price. In the same vein, if you fear gold prices will drop, then you sell at bid price.

CFDs are traded in standardised contracts, another term for this is 'lots'. Most CFD brokers will allow their clients to trade parts of a contract (such as one tenth). This is particularly beneficial to investors who don't have the margin or capital to buy a full contract.

For example, if the FTSE 100 is trading at 7000/7001 and you buy one lot, the prices could rise to 7050/7051 a few days later. Since you bought at the 7001 price, you can close your position via the sell price of 7050, and make a profit of forty nine points. Every point is worth ten pounds in one contract. As a result, your final profit is £490. You also need to know that whilst that looks good, the exact opposite can happen as well. In this example, if you sell at 6952 having bought at 7001, you would have lost £490.

The rise of CFD brokers can be attributed to their unique offering to traders i.e. the ability to trade less than one full contract. It allows investors with less money to access the markets on similar terms to wealthy investors.

CFD calculation examples:

The number of contracts you've traded, multiplied by the value of the contract per point of movement. This is multiplied again by the difference between opening and closing prices.

You can decide exactly how many contracts you'll trade with but remember that the value of a single contract will differ from market to market.

If you want to hold a position overnight, your broker will likely charge you financing/funding charges. The cost of borrowing or lending assets is mirrored through funding charges. It means that for each day your position remains open, the more charges you incur.

Online CFD trading differs from spread betting in the following ways:

- **Deal size:** CFD trading means you're buying and selling contracts that represent a certain amount in the underlying market. With spread betting, you're speculating on the amount of money per point of whether the market will go up or down

- **Capital gains tax:** CFDs are classified as financial instruments and subject to capital gains tax. With spread-betting, profits are free from capital gains tax. This may appear to be a disadvantage when trading with CFDs but for tax purposes, any losses can be offset against future profits. You should always seek independent tax advice nonetheless

- **Transparency:** Some traders prefer CFDs as their prices are somewhat similar to the prices seen on the underlying exchanges. This means a trader can easily verify whether they're getting a good deal

ISA ACCOUNT

In the UK, an ISA account is another way for people to save or invest without incurring any tax*. ISA's come in two forms; cash or shares.

Cash ISAs operate in the same way as traditional savings accounts; the money you deposit into the account receives a rate of interest. Stocks and shares ISA lets you invest in qualifying assets. It's important to remember that with any sort of investment, profits are not guaranteed.

On 6 April 2016, flexible ISAs were introduced by the government, allowing customers to withdraw part of their money and then redeposit it at a later date. This does not reduce your total allowance.

The benefits of having a stocks and shares ISA includes:

- A tax-free* bubble is formed for your money. You won't have to pay any capital gains tax on the profits you've made when you sell the shares

- It's fairly easy to open. If you have a share dealing account then it only takes a few minutes. Your broker might not charge admin or transferring fees

- You can use the ISA for more than investing in stocks and shares. You can trade and buy government bonds, ISA-eligible Exchange Traded Funds (ETFs), and Unit Trusts

An ISA is particularly useful if you're interested in investing without leverage. For example, if you wanted to hold shares in Tesco for one year and have £10,000 to invest, using an ISA would be cheaper than investing in Tesco via a CFD or spread betting broker. You won't be charged any financing fees with an ISA account. However, you won't be able to trade with leverage as you can with a CFD and spread betting broker. You'll also lose access to advanced charting packages and be unable to quickly enter and exit the market.

*This article does not take into account your personal circumstances and you should seek independent tax advice.

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