Spread Betting

Expert knowledge means success

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Note: This publication has not been updated since it was last published. Some of the hyperlinks may have changed and may need updating. In addition, some of the information in this publication may be out of date.

Introduction

Spread betting was introduced over 25 years ago as a way to speculate on the financial markets. City professionals would place a spread bet on how much they thought the Stock Exchange would rise or fall. Today spread betting runs alongside fixed-odds betting on a variety of outcomes including sporting results, political elections, property prices and even the voting results of reality TV shows.

One of the attractions of spread betting on financial markets is its tax treatment. When you spread bet you are gambling on results as opposed to taking ownership of underlying assets. Your profits are therefore not subject to capital gains tax and you are not liable for stamp duty. You can bet on markets that may otherwise be inaccessible and make all your bets in sterling to avoid currency risks. Financial spread betting is looked at in more detail in a later section.

Spread betting is traded on margin, which means that you simply need to place a deposit of a small percentage of the position's total value (typically 10%). This leverage allows you to build a diverse and substantial portfolio from a significantly smaller amount of capital. However, if a bet does not go your way your losses may substantially exceed that deposit very rapidly and you may be required to make additional deposits at short notice to maintain your bets. Spread bets are therefore high-risk products and not suitable for all customers.

Spread betting firms are required by the Financial Services Authority (FSA) to assess whether spread betting "may be suitable" for each individual customer. Many firms also provide a pseudo spread betting service to allow you to "practice" your spread betting acumen without committing any hard cash. If you decide that spread betting is not for you, some spread betting firms now offer fixed-odds betting (traditionally used in sports gambling) as a way to trade in the financial markets. As with all investments, always ensure you fully understand the risks and seek independent financial advice if necessary.

What is Spread Betting?[1]

Spread betting is regulated by the Financial Services Authority. They provide the following definition of spread betting.

> Basically, it is similar to ordinary betting (fixed odds betting) but with an important difference. With ordinary betting, you're either absolutely right (your horse wins) and you win money depending on the odds quoted, or you're absolutely wrong (your horse doesn't win) and you lose the amount you have placed on the bet. With spread betting, the more right you are, the more you can win but the more wrong you are, the more you can lose – and your loss is not limited to the amount of your stake. Currently there's no tax to pay on any spread betting winnings (although this could change in the future).

Key Spread Betting Terms

- Buy (long) bet: A bet that the market will rise.
- Limit order: An order to buy/sell if the market reaches a more favourable level than the prevailing position.
- Margin: The amount of money required to open and maintain a position (typically 10%) of the position's total value.
- Sell (short) bet: A bet that the market will fall.
- Spread: The difference between the offer price (the price at which you can place a buy bet) and the bid price (the price at which you can place a sell bet).
- Stop order: An order to buy/sell if the market moves against your bet by a specified amount.

How does it work?

Let's use a football match as an example. The various spread betting firms quote different spreads for different scenarios. These could be anything from the time the first goal is scored to the goal margin between the two teams, to the total number of corners taken during the game, to the number of players shown a yellow card etc.

Taking the first scenario as our example – the time the first goal is scored. The firm is offering a spread of 31–34 minutes. So if you think the first goal in the game will come after the 34th minute, you place an **up bet** or **buy the spread** at a fixed price per minute, let's say £10 per minute. If you're right and the first goal comes in the 59th minute, you win £250, i.e. the difference between the top

end of the spread (34 minutes) and the actual minute the goal is scored (59 minutes) = 25 minutes.

59 (minutes) – 34 (minutes) = 25
25 x £10 = £250

But if the first goal is scored in the 10th minute, you lose £240. This is because the difference between the top end of the spread (34 minutes) and the actual minute the goal is scored (10 minutes) = 24 minutes.

34 (minutes) – 10 (minutes) = 24
24 x £10 = £240

By the same token, if you thought the first goal would be scored before the bottom level of the spread (e.g. before the 31st minute), you would place a down bet or sell the spread. So you'd win if the goal was scored in the 10th minute (£+210) or lose if the goal was scored in the 59th minute (£-280). The winnings can be good if you guess right, but the losses can be considerable if you guess wrong – far more than the amount you staked.

A firm may also quote a spread while the event is taking place. So, in the above football match, if no goal has been scored by the 20th minute, the firm may have changed its time of first goal spread from 31–34 minutes to 50–53 minutes. You may be able to close your bet in running (for example, if you had placed an up bet on the original spread at 34 minutes), which means that, unlike ordinary betting, you may not have to wait until the end of an event to take any winnings (or losses).

Reducing the risks

Different spread betting firms offer different services to reduce the risk of running up limitless losses. These may include putting a stop order on the bet which allows your bet to be closed if the spread moves through a specified level. Some firms offer a guarantee that you will lose no money beyond that specified amount. Otherwise a stop order won't stop you losing money, but it can put a limit on the amount you are prepared to lose. Spread betting firms all have their own terms and conditions detailing the exact mechanics of their particular bets and you should ensure you read and fully understand these before you place any bets.

Financial Spread Betting

Financial Spread betting speculates on the movement of an underlying share or index. The underlying instrument is never actually purchased or sold; it is simply "bet" on. This therefore opens up "investment opportunities" to ordinary investors in many financial markets that were previously difficult to access, including:

- Stock market indices such as the FTSE or NASDAQ;
- Individual shares from the FTSE 100 and FTSE 250, but also from leading US and European shares;
- Currencies, FX;
- Commodities such as gold and oil;
- Short term and long-term interest rates;
- Futures and options;
- Bonds.

Financial spread betting allows you to benefit when the price of an instrument falls or rises. In this section, we will primarily consider shares as being the underlying instrument.

A share will have a "bid price" and an "offer price"; the difference between the two being the spread. The bid price is the price at which the spread betting firm will buy the shares from you; the offer price is the price at which the firm is offering the shares for sale.

There are no fees to be paid when placing a spread bet: the costs incurred are included within the spread - the wider the spread the more expensive it is to trade.

The movement of a share is measured in points: generally for equities 1 point = 1 pence and for indices 1 point = £1.

If you believe the share price is going to rise you place a buy (or long) bet, if you believe the share price is going to fall you place a sell (or short) bet. You can place a bet of any value against every point movement in the underlying shares. Some spread betting firms do have a minimum initial account size, but this is often as low as £100.

To close a buy bet you place a sell bet on the same shares at the same £ per point at the current quoted price. To close a sell bet you place a buy bet on the same shares at the same £ per point at the current quoted price.

Your profit (or loss) is the points difference between your opening bet and your closing bet multiplied by the value of your bet per point (e.g. £1 per point).

Example: Spread betting on shares

Shareco is currently trading at 120 – 120.5.

Investor A believes that Shareco shares are going to rise in value and places a buy bet at 120.5 for £5 a point.

Investor B believes that Shareco shares are going to fall in value and places a sell bet at 120 for £5 a point.

If Shareco's share price rises to 125 – 125.5:
- Investor A will be able to close his position with a sell bet at 125 and make a profit of £22.50 ((125-120.5) x £5).
- Investor B could choose to close his position with a buy bet at 125 and take a loss of £25 ((125-120) x £5).

If Shareco's share price falls to 116 – 116.5:
- Investor A could choose to close his position with a sell bet at 116 and take a loss of £22.50 ((120.5 - 116) x £5).
- Investor B will be able to close his position with a buy bet at 116.5 and make a profit of £17.50 ((120-116.5) x £5).

Example: Spread betting on indices

The FTSE 250 is currently trading at 11000 and a spread is offered of 10996 - 11003.

Investor A believes the index is going to rise and places a buy bet at 11003 for £5 per point.

Investor B believes the index is going to fall and places a sell bet at 10996 for £5 per point.

If the FTSE 250 spread rises to 11033 - 11039:
- Investor A will be able to close his position with a sell bet and make a profit of £150 ((11033-11003)*£5).
- Investor B may choose to close his position with a buy bet and take a loss of £215 (11039-10996)*£5).

If the FTSE 250 spread falls to 10984 - 10990:
- Investor A may choose to close his position with a sell bet and take a loss of £95 (11003-10984)*£5).
- Investor B will be able to close his position with a buy bet and make a profit of £30 ((10996-10990)*£5).

Spread Betting v Share Purchase

The Advantages

- There is no stamp duty to pay as the underlying shares are never actually purchased. Traditional share purchases are liable for 0.5% stamp duty;
- There is no capital gains tax (CGT) to pay on any profits as opposed to up to 40% CGT on share value gains;
- There are no direct commissions or fees to be paid to the spread betting company;
- Profit can be made regardless of whether the market falls or rises;
- Risk can be limited using a "Stop Loss";
- Very small bets can be made;
- A small outlay can access a larger volume of shares;
- A single account can give you access to a broad range of financial markets;
- Bets on non-UK shares can be made in sterling so avoiding the currency risk of buying international shares.

The Disadvantages

- Large losses may be incurred if a "Stop Loss" is not used and a position moves against you;
- A capital gains tax rebate cannot be claimed for losses;
- As no underlying shares are being purchased, you have no voting rights and don't receive dividends.

Leveraging the margin

Financial spread bets are margined trading products so you only need to commit to a percentage of the full value of your spread bet available. The percentage may vary, but is typically 10% for FTSE 100 shares. This is one of the key attractions of financial spread betting over traditional share transactions. However, it is important to understand that although the initial outlay may be limited in a spread bet; the exposure may not be, as shown in the following example.

Example: Trading the margin

Shareout's shares are currently trading at £1.

If you wanted to purchase £1,000 of Shareout's shares:
- In a traditional share transaction you would be required to make the full payment of £1,000 to purchase £1,000 worth of shares (£1,000 shares at £1). You would also need to pay any commissions due plus Stamp Duty.
- In a spread bet you would only need £100 of margin (which you pay as an initial deposit) to place a spread bet of £10 per point on the equivalent of £1,000 worth of the shares.

The potential financial risk in both cases is still £1,000. If you bought £1,000 of traditional shares you would lose the full £1,000 if the share price fell to zero. If you placed a buy spread bet at £10 per point, you would also lose £1,000 if the share price fell to zero.

Margin call

If you place a buy spread bet and the share price falls the spread betting company will make a margin call if your open positions are running at a loss over and above the initial deposit. It is therefore advisable that you do not open positions that require all your available funds as an initial deposit.

If your funds are limited, you may wish to consider a stop or limit order that will limit your exposure by automatically opening or closing a position, once a specified limit is reached.

Limit orders

A limit order is set up to be executed at a better price than the prevailing price. For a buy bet it is therefore executed when the share price drops to a certain level and for a sell bet it is therefore executed when the share price rises to a certain level.

Example:
The FTSE 250 is currently trading at 11000 and a spread is offered of 10996 - 11003.

Investor A wishes to place a £10 a point buy bet with a limit of 10986. This order is held by the spread betting firm.

A week later the FTSE 250 spread is 10980 – 10986 and an opening trade of £10 a point is opened at the limit level of 10986.

Stop orders

A stop order is set up to be executed at a worse price than the prevailing market price. For a sell bet it is therefore executed when the share price drops to a certain level and for a buy bet it is therefore executed when the share price rises to a certain level.

Spread betting can realise both substantial profits and substantial losses. A stop loss allows a client to set a limit on any losses by automatically closing out a position at the desired price.

A stop order can also be used to open a position by allowing a buy bet to be placed for automatic invocation at a level higher than the prevailing market price when the share price is rising.

Example:
Shareco is currently trading at 120 – 125.

Both Investor A and Investor B believe that Shareco shares will rise in value and both place buy bets at 125 for £10 a point. Investor B also places a stop loss when he opens the trade at 100.

Two days later the price of Shareco shares drops sharply from 120 to 80. The closing price at the end of the day is 80-85.

Presuming that neither Investor A nor Investor B had taken any averting action during the day, at the end of the day:
- Investor A will have taken a loss of £450 (45 points x £10).
- Investor B's position will have automatically closed out at his stop loss level of 100 limiting his loss to £250 (25 points x £10).

FSA reviews Spread Betting Rules

One of the key areas of focus identified in the Financial Service Authority's August 2006 publication ('Financial Promotions: Progress update and future direction') was spread betting.

Spread betting is seen as a higher-risk area for consumers and the FSA therefore places great importance on the fair and adequate disclosure of risk (including the possibility of a customer incurring a loss greater than their original stake) and adequate assessment of whether spread betting may be suitable for the customer.

On 21 March 2007, the FSA published details of a review of spread betting financial promotions and examples of good practice.

In the review, the FSA looked at the overall quality of spread betting promotions, and whether they provided clear, simple and understandable information for consumers to use when deciding whether to spread bet.

The FSA also looked at how firms interpret the "may be suitable" assessment required by their Conduct of Business (COB) manual. Firms making direct offer promotions of derivatives (including spread betting websites that allow customers to set up accounts and trade) must have adequate evidence that spread betting may be suitable for the person to whom the promotion is communicated. All the websites the FSA looked at allowed some form of online assessment although some were judged inadequate.

The FSA found that, while many promotions were heading in the right direction, there remained room for improvement. To assist firms in ensuring that spread betting promotions are suitable and clear, fair and

not misleading, the FSA has provided examples of good practice.

The FSA considered that many of the examples of good practice for the suitability requirement are likely to be relevant to the new appropriateness test that the FSA has proposed for direct offer financial promotions of derivatives and warrants as part of the requirements coming into effect in November 2007 with the introduction of the new Conduct of Business manual (NEWCOB).

The "may be suitable" assessment

Firms can use a variety of techniques to meet the requirement to assess whether spread betting "may be suitable" for the customer. Firms must decide whether their chosen method enables them to gather adequate evidence to satisfy this requirement.

The FSA requires the assessment to cover at least the following areas:

- the customer's understanding of spread betting and how it works;
- the customer's understanding of the risks involved;
- the customer's appetite for risk; and
- the customer's ability to afford losses, possibly exceeding his/her initial stake.

Good practice – the customer journey

While there is no requirement for the "may be suitable" assessment to be interactive, the FSA do not consider it enough for firms to transfer the responsibility to their customers. The assessment should involve more than customers' simply saying that spread betting is suitable for them.

Firms need to have gathered "adequate evidence" from customers visiting the website that spread betting may be suitable for them. The assessment may take the form of appropriately-worded questions or statements that the customer must answer. If he or she provides appropriate responses to the questions, these responses would constitute adequate evidence that spread betting may be suitable for the customer.

The examples of good practice that follow typically reflect careful consideration of the customer journey through the website. A "good practice" journey will expose customers to all the necessary information about spread betting – the nature of spread betting, the commitment required and the risks involved – before they are able to open an account.

Examples of Good Practice

The following examples of good practice provided by the FSA relate to whether the promotion itself is clear, fair and not misleading, and whether spread betting may be suitable for the customer.

The examples of good practice do not cover the whole process either individually or taken together. There are elements that might contribute to an adequate process for assessing whether spread betting may be suitable; and for the fair and adequate disclosure of risk, the nature of spread betting and the commitment required.

Fair and adequate disclosure of risk, understanding of the nature of spread betting and the commitment required

- The overall layout of the website is in a clear format with easy links to follow;
- There is a prominent risk warning on the landing/home page;
- The risks are repeated further into the application process;
- The risk warning clearly links the customer's circumstances and the risks involved in spread betting (e.g. the customer must be able to afford to lose more than the initial stake);
- Information is provided on what spread betting is or there is a clear description of what spread betting involves;
- An explanation is provided of leverage in spread betting and that this can work the other way and increase the loss beyond the original stake.

Assessing whether spread betting may be suitable for the customer

- A risk warning appears in a new window (similar to a 'pop up') that needs to be agreed to before entering the site;
- The customer is given a short questionnaire and has to confirm his/her understanding of each of the points before proceeding further. The points cover:
  - The risk to capital and whether the customer can afford to lose more than the initial stake;
  - An outline of how different subjects of a spread bet show different types of behaviour (for example, spread betting on an index, compared to an individual equity, or to a commodity);
  - Following the earlier points, confirmation by customers that spread betting is suitable for them;
  - A reminder to seek independent

financial advice if the customer is unsure;
- The application process includes an effort to understand the customer's risk tolerance;

- customers are asked to confirm that they have read the risk disclosure document (found by clicking on a 'Risk' tab) before opening an account;
- just as for the disclosure of risk, the overall layout of the website is in a clear format with easy links to follow.

Spread Betting Firms

Some of the popular spread betting firms are listed below:

- Cantor Index http://www.cantorcapital.com/
- London Capital Group http://www.londoncapitalgroup.com/products/financial-spread-betting
- Capital Spreads http://www.capitalspreads.com/
- City Index http://www.cityindex.co.uk/
- CMC Markets http://www.cmcmarkets.co.uk/
- E*Trade https://global.etrade.com/gl/home
- Finspreads http://www.finspreads.com/
- Hargreaves Lansdown http://www.hl.co.uk/investment-services/spread-betting--and--cfds
- IG Index http://www.igindex.co.uk/
- Self Trade http://www.selftrade.co.uk/
- ETX Capital http://www.etxcapital.co.uk/
- Two Way Markets http://www.twowaymarkets.com/cfds/cfd/

WARNING:
Spread betting offers many benefits, but it is important to note that it carries a high level of risk to your capital, so you should only bet with money you can afford to lose. It is possible for you to lose more than your initial deposit and stake so you should ensure spread betting meets your investment objectives and seek independent advice if necessary.

Recommended Reading

The Financial Spread Betting Handbook: A Guide to Making Money Trading Spread Bets by Malcolm Pryor, published by Harriman House Publishing, ISBN-10: 1897597932, ISBN-13: 978-1897597934

The Beginner's Guide to Financial Spread Betting by Michelle Baltazar, published by Harriman House Publishing, ISBN-10: 1897597355, ISBN-13: 978-1897597354

Successful Spread Betting by Geoff Harvey, published by Take That, ISBN-10: 1873668589 ISBN-13: 978-1873668580

How to Win at Financial Spread Betting by Charles Vintcent, published by Financial Times Prentice Hall, ISBN-10: 0273654136 ISBN-13: 978-0273654131

Further Information

A useful (and comprehensive) website is http://www.financial-spread-betting.com/

This publication is for general interest - it is always essential to take advice on specific issues.

We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

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[1] The FSA guide can be viewed at: www.moneymadeclear.fsa.gov.uk/news/spread_betting.html