White Paper on Spread Betting

by

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Abstract

The objective of this paper is to enable retail customers and brokers to learn more about spread betting and contracts for difference. It aims to remove the stigma attached to the term 'betting' by demonstrating that these retail derivatives are very similar to traditional products traded in the markets. We also show that in reality trading and gambling lie along the same risk continuum.

Derivatives, securities whose values are derived from other assets, have been used for hundreds of years by companies and the wealthy to invest and manage their risks. Their use is so commonplace that they exist for everything from wheat and sugar to the price of gold or the level of rainfall. Spread betting and Contracts for Difference (CFD) are close relations of the most basic derivatives. These retail derivatives make international markets accessible to normal investors and can reduce their tax liabilities. The retail derivatives industry faces a number of challenges. To grow it must expand its constituency to include female, ethnic minority, international and older customers while considering product development and how best to represent the industry and all its customers.

The paper begins by explaining the long history of derivatives and how they have eventually evolved into spread bets and CFDs and how those products compare with futures contracts. They are specifically not compared to options contracts. Whilst plain vanilla options have existed for some time, they are relatively complicated and less similar to spreads or CFDs. The future of the industry is then addressed through the future of the customer base it serves, future consumer markets and the challenges that the retail derivative firms face. If the industry continues to sustain and improve on its growth rate, the number of people in the UK with a spread betting account could more than double from its current level of 400,000 to one million by 2011[1]. To achieve this, the industry has to extend its appeal to a more mass market audience by going beyond their existing client base of white affluent males under 45 years old to embrace women, ethnic minorities, older people and international markets.

[1] Finspreads estimate, based on annual growth rate of around 20% (Mintel Remote Betting Report, August 2005)

It's trading, Jim, but not as we know it

Preamble

In the late 19th century the American satirist Ambrose Bierce wrote that, "the gambling known as business looks with austere disfavour upon the business known as gambling". What was true in the 19th century is just as true today. It provides the spread betting industry with perhaps one of its most significant challenges – how to convince the consumer that essentially there is no difference between traditional trading and spread betting. The word gambling is defined by one dictionary as:

n 1: money that is risked for possible monetary gain
v 1: take a risk in the hope of a favourable outcome.

With the possible exception of those who invest in companies for the sake of the company itself, and leave their money with that company, the definition adequately covers most trading activity.

Understanding that it is not the product that carries inherently more or less risk but the person and mindset using that product would help not only the individual consumer but also the industry, the legislators and the regulators. Such an understanding would, for example, have produced an entirely different ruling by the House of Lords in the Hammersmith & Fulham `swaps' case of the late 80s. In 1991 the HoL ruled that local authority interest rate swaps were illegal. Their lordships ruled in this way not because the swaps were used as hedging instruments but because they were used illegally in this particular instance. The reality was that it was the performance of the councillors that was at fault and not the financial products or the concept of hedging. Covering risk on behalf of the rates-payers seems an eminently sensible activity. The real issue that led to such a poor ruling by their lordships was that the process smacked of gambling in the traditional usage of word and was, therefore, considered as being ***overly*** risky. In fact, the informed professional gambler is the same animal as the fund manager, someone who is paid to be more knowledgeable about investment/betting than the individual placing money with that expert.

Almost any transaction can be adjusted to suit the particular risk characteristics of the individual consumer. And, in fact, products can start with one intention and are utilised for another. Indeed, financial derivatives originally appeared in the early 1970s as a counter to the volatility introduced into the markets by the breakdown of the Bretton Woods system of fixed exchange rates. Another example is the development of credit derivatives that were originally intended to reduce the risk and exposure of organisational finances by building in stability and predictability and consequently insuring against volatility.

However, gamblers immediately recognised that you did not actually need to own a commodity in order to be able to trade its derivatives, you could very simply bet on how the market would move. Thus a product designed to increase stability could be used in a manner that would actually act as a volatility force multiplier. One of the JP Morgan team that originally developed the credit derivative remarked, when asked how she got into the business, "I had read *Liar's Poker* and thought that trading derivatives sounded sexy and fun". That's gambler-speak.

Background

Historically, financial institutions had an advantage over individual traders. The institutional traders had instant access to international markets, commodities and currencies from their desks in the City. They could balance a multitude of risks and grasp opportunities not easily available to individual investors or even to their brokers. Perceived economic threats from abroad, such as the rise of the Japanese economy, posed less of a problem for institutions because they could easily diversify into foreign stock markets. Similarly, the gathering competition from emerging economies today has provided a similar opportunity, rather than a threat. Because of this lack of individual access the impact of geopolitics on oil, gold and other commodities threatened the lone investor, while for the banks it provided opportunities which were available at the end of a phone or, more recently, a mouse click.

The cutting edge of globalisation and technology gave banks easier access to very traditional financial products. Ironically, despite all the new technology, the instruments used by the banks were the same familiar products. Assets such as commodities or entire national stock markets were traded through old-fashioned futures contracts. A futures contract being an agreement where parties agree a price for something now and then exchange the goods at an agreed fixed future date.

A futures contract is the simplest form of a derivative product, a security where the price is derived from the price of something else. The earliest examples of futures contracts date back 3,800 years to Babylonian farmers' sales of grain. The farmer and his client could manage their risks because they knew in advance what their cash-flows would be. Both parties could calmly plan ahead, safe in the knowledge that the price they agreed many months before would be adhered to. Unforeseen events such as price slumps from bumper harvests or profiteering during droughts could be avoided.

Rather than the individual deals of the ancient world, modern futures contracts are usually traded on exchanges. However, this particular aspect of modernity probably started back in Japan in the 1600s. A market developed there to redistribute (spread) the risk related to the production and distribution of rice. By the mid-1700s the Dojima and Sakata rice exchanges were so important that songs were composed about the rice market.[2] Leading figures from the exchanges were even granted the honorary title of Samurai to become financial consultants to the government.

[2] Nison (1991)

During the initial 3,500 year period of futures contracts every contract tended to be different. Each contract would be based on the amount of grain that a specific farmer was selling to their customer. By 1865 the fifteen year old Chicago Board of Trade (CBOT) was serving the needs of most Midwestern grain farmers and purchasers. They decided to standardise their contracts' quality, quantity, delivery times and location – price was, therefore, determined by market forces ***within*** the exchange. For example, the CBOT contract size for wheat is 5,000 bushels and the delivery months are March, May, July, September and December. Each contract is for the same physical amount of grain and you would trade as many contracts as required. Rather than a bespoke 50,000 bushel wheat contract to be delivered in September, the executed trade would be for ten September wheat contracts.

Prior to this standardisation, it was difficult to compare deals. By making pricing more transparent traders are able to see clearly what the market price is for the wheat that will be delivered in September. By the late 1960s the exchanges began offering futures contracts on non-agricultural commodities. For the first time there was a market for trading gold and silver futures – the right to receive or deliver the metals at a later date. Over the last century exchange trading in futures contracts has extended to many of the commodities we take for granted in our daily lives. Corn, soyabeans, cattle, pork, cocoa, sugar, coffee, copper and platinum, to name but a few. Trading in futures also dominates how we view the energy markets. The oil and natural gas prices we read about in the news are determined by trading in the energy futures markets of London and New York. Nearly every primary raw material that we consume is traded as a futures contract. If evidence were needed of the significance of this to the average citizen it can be found in the recent 20%-plus rises in domestic gas prices which were directly linked to the futures purchasing model.

The risk management tools initially used by farmers were so simple they were applied to other markets. It was realised that the commodity itself is actually irrelevant, it is unimportant as to whether the underlying asset is wheat, cattle or gold. It was only a matter of time before the simplicity of futures would lead to a whole new breed of financial products for banks and investment funds – traded financial derivatives. In 1971 the Bretton Woods system of pegging international currencies to each other, based on gold, collapsed. Currencies were left to "float" in the market and became a risk or investment like any other. The Chicago Mercantile Exchange (CME) launched the International Monetary Market (IMM) where parties could agree on an exchange rate months in advance of the transaction.

Exchange traded futures contracts on financial instruments had not existed prior to this – the genie was out of the bottle. Only the imagination restricted what could be traded in this way.

Over the next decade several important futures contracts were launched by the Chicago exchanges. CBOT launched a futures contract on 30 year US Treasury Bonds in 1977. In 1982 the CME offered a futures contract on the Standard and Poors 500 index of the American stock market. Whilst agricultural futures contracts tend to be settled with the delivery of the wheat or cocoa, for example, most financial futures are settled in cash. This way the buyer of a profitable Standard and Poors 500 index contract does not wait for receipt of the 500 stocks at the agreed price when the contract expires. Instead the seller would hand over the buyer's profit in cash, had the buyer sold all the stocks instantly at the higher market price. The parties square up the difference in value since the deal was struck, rather than handing over the securities on the settlement date. Hence the umbrella terminology for swaps and futures as 'Contracts for Difference'. Without cash settlement the buyer would have to await the transfer of the 500 stocks to his account at the agreed price so as to sell them for a profit in the market.

The American markets were not alone in embracing financial futures. Competition between the international futures exchanges has led to futures contracts on wide range of financial products since the 1970s. The Swiss and German owned Eurex has grown to be world's largest futures exchange and LIFFE in London, now owned by Euronext, is home to British futures trading. Between them they compete to cover short and long term government bonds from the United States, Japan, the Eurozone and Britain. Single stock futures exist for most of popular shares in Britain and the continent and there are even futures contracts on macroeconomic production, inflation and GDP.

The Present - farmer would be amazed

The simple idea behind futures contracts is so useful that they are now used in a spectacular number of areas. For example, the growth in global trade has increased the volatility in the shipping markets. Units of freight space on the ships are traded, allowing manufacturers and shipping firms to manage risks from fluctuations in the market. Futures contracts are also traded on the right to buy or sell the ships themselves at a future date. The industrialisation that fuels this trade also drives pollution fears and international regulation of emissions from companies. Now companies can trade their emissions quotas. The increasingly volatile weather of recent years has become an increased risk to companies. As a consequence those companies are increasingly turning to futures contracts on rainfall, snowfall, frost and the temperature. Weather risks are important to any companies for whom rapid seasonal turnaround is crucial to margins such as re-insurers, soft drinks companies, energy companies and even fashion retailers. The CME saw a 170% surge in the number of opened weather derivatives last year.[3] Even rubbish has value and there are now growing futures exchanges dedicated to trading recyclables such as paper and plastics.

The nineteenth century grain farmers would be amazed at how accepted derivatives have become. The number of markets and asset classes they now cover are impressive and their commercial usage is commonplace. Everyday corporations use them to manage the risks affecting their businesses, such as foreign exchange or interest rate risks. 92% of the 500 largest corporations use derivatives to manage their risks according to the International Swaps and Derivatives Association.[4] Of these 500, the 35 British companies all make use of derivatives. The usage of derivatives is increasing by 22% per annum and by July 2005 the value of the assets underlying these derivatives amounted to $201.4 trillion,[5] around four times the value of global GDP.

Innovation is, of course, never-ending and did not stop when applying futures contracts to new markets and assets. The banks have developed more complicated “exotic” derivatives from plain vanilla derivatives such as futures contracts. These non-standard contracts serve the specific needs of a bank or large company to shift risk and plan for the future. The banks employ quantitative analysts to design and price these products – the “rocket scientists” of the finance world. The value of an exotic derivative could be based on any number of conditions and often using more than one underlying asset, perhaps a mix or basket of stocks or commodities.

[3] http://www.cme.com
[4] ISDA 2003 Derivatives Usage Survey, http://www.isda.org/statistics/surveynewsrelease030903v2.html
[5] ISDA 2005 Mid-Year Market Survey, http://www.isda.org/statistics/recent.html

An example of an exotic contract might be a security that pays interest, similar to a bond; however, this interest payment is instead determined by returns on an index of traded commodities; this interest payment will continue until the expiry of the contract unless one of five specified stocks rises 10% above its price at the start of the contact. It is perhaps clear (or unclear) from this example why these are described as *exotic* contracts.

Banks have had easy access to all these markets for so long *and* moved on so far from the farmer's humble starting point. However, as financial products have become more and more complex and more and more derivative in a recursive, Russian-doll type relationship, it is only a matter of time before there are derivatives of credit derivatives, a sort of `derivatives cubed'. As a consequence such products become ever more distanced from individual investors who have ended up without easy access to even the simplest derivatives. Even plain vanilla futures contracts are not as easily available to the individual investor as other financial products due to the additional requirements when opening a futures account. Wealthier investors might have enough capital to open their own futures trading accounts but even they would still face several restrictions. Restricted to their domestic market only, they would still be isolated from trading or managing the risks from international stock markets. Commodities not traded at home or trading foreign currencies to hedge risks or speculate would still be a problem. To get around this they could open accounts with foreign brokers or pay exorbitant fees. Notwithstanding this, however they manage to trade foreign markets, their overseas investments would still be vulnerable to a plunge in value of the foreign currency of their investment. And these are the problems that just the wealthier investors faced – everyone else simply never got a look in. They could only miss out on opportunities and watch quietly, at the mercy of international shifts in wealth. Individual investors had been left behind. What was needed was a single trading account that allowed exposure to many different types of assets, in many countries and with the ability to manage currency risks from any foreign investments.

Today, of the £1.2 trillion traded annually on the London Stock Exchange[6], it is estimated that 40% is equity derivative related. It is estimated that 10% of the total figure relates to spread betting, making the annual UK spread bet consideration about 120 billion per annum, a figure a far cry from the take up of the Babylonian farmers[7].

[6] LSE official statistics, www.londonstockexchange.com
[7] LSE official statistics, www.londonstockexchange.com

Contracts for difference and spread betting

It was this inequity in access to the complete range of trading opportunities that a new breed of firm saw as an opportunity. They have offered new ways for investors to trade the markets and manage their risks. Financial spread betting and contracts for difference (CFDs) give normal investors the opportunity to trade a wide range of assets from a single account. They can trade British or foreign shares, indices, commodities, bonds, currencies or even hedge funds.

Spread betting permits investors to bet on price movements in the markets, and not just metaphorically. Legally, spread betting is defined as gambling. The investor only bets on moves in market price without any of the benefits, or encumbrances, of ownership or the opportunity to take actual delivery of the real asset. It allows individual investors to take control of their own investments without the need to rely on a middle-man to make the trade and/or offer `expert' advice. Unlike a fixed-odds bookmaker or casino, not all companies offering spread bets or CFDs benefit from your losses. If you use a traditional bookmaker to gamble on a sporting event it is certain that they hope and require that you lose. Spreads and CFDs do not represent the same risk for the company and can be managed. The firms hedge their risks by taking positions in the underlying market and make their money from the transaction costs for each trade – the spreads or CFD commissions. They could take the same position as you in Microsoft shares, instead of your Microsoft spread trade, and if you make money it is paid for by their equivalent trade. This way they look forward to customer success. It is also in their interests to encourage responsible trading which they do, at least in part, by offering training courses and risk management orders.

Spread betting works by being quoted two prices for a trade that are around the current market price, known as `the spread'. The higher price is what you "buy" at and the lower price is what you can "sell". It is important to note here, that you can sell without owning the asset i.e. you can "short" the market. An investor would stake a certain amount of money for each unit the price changes from the price traded. For UK shares these units would be pennies. The objective is the same as for traditional investment, making money by predicting how share prices will behave. The spread is analogous to the commission you pay to trade. If you buy and sell before prices change you would lose the value of the spread. The final profit or loss is a multiple of the stake multiplied by the amount that the price has moved in the specified direction. If you had staked £1 per point on a spread around the quote on the FTSE 100 at 5900:5902, this would mean you 'bought' it at 5902. If the spread then moved to 5922:5924 you could 'sell' it to close out the position at 5922 – a profit of £20 on this trade.

The definition of a CFD appears similar to spread betting. The investor does not own the real asset and benefits from a change in its value. The difference is that CFDs are intended to replicate all the financial benefits of share ownership bar voting rights. Dividends and rights issues are replicated by crediting the account as if each CFD were an actual share. For example, if one owned a CFD on Marks and Spencer you would receive any profit or loss from the movements in the actual share price. However you would also receive any dividend payments from Marks and Spencer that you would have received had you owned the actual stock instead.

One of the main attractions of spread betting and contracts for difference are the various tax benefits compared to conventional investments. CFDs and spread bets do not grant ownership of the underlying asset or related voting rights and so are not subject to stamp duty. At 0.5 per cent, Stamp Duty Reserve Tax on share transactions in the UK is the highest in Europe. Even for wealthy investors with access to their own futures accounts there are further benefits from trading spreads or CFDs. Because spread betting falls within gaming laws, it is also exempt from capital gains tax and so spread betting is completely tax free. CFDs incur capital gains tax but unlike spread bets and futures contracts, investors in CFDs are not just hoping for a change in the traded share price. CFDs are intended to replicate all the dividend benefits of share ownership. CFDs have no settlement date, because the intention is replication of share cash-flows, unlike futures contracts and spread bets which must be “rolled over” to the next contract on expiry.

Whilst financial spread betting has the tax benefits of gambling, the dominant industry players are not part of the traditional gambling industry. They are owned by financial firms whose businesses specialise in currencies, commodities and financial derivative products. When a futures contract is traded the exchange matches the two parties to the trade; the farmer and the food producer or the gold buyer and seller. In the case of CFD trading and spread betting the counterparty will always be the company issuing the spread bet or CFD. There is no exchange needed to match parties hence they have entered into an OTC (over the counter) contract. This allows orders in particular to take on forms that would not be possible on an exchange, such as guaranteed stop-loss orders. Precisely the same as when investors trade shares or futures, it is sensible for them to place stop-loss orders when opening new positions in case prices move against them. Some markets can have their stop-losses guaranteed, even if the underlying price moves through your stop-loss level. This eliminates the risk of slippage or market gaps.

Another important consideration is that spread bets on foreign securities are based on the numerical value of the traded price rather than the currency value. Put otherwise, there is no currency risk when trading international markets with spread bets. For example, buying a share at $10 and selling at $15 is a 50% return. If you owned the share itself you would instead own it in dollars. Any return from that trade would be more or less than 50% depending on what happens to the value of the dollar during the same period. Your equivalent spread bet profit would be 50%, giving the investor no currency risk.

Fig 1

	Shares	Futures on Shares / Commodities	Spread – Betting	CFDs
Costs and Taxes				
Stamp Duty	Yes	No	No	No
Capital Gains Tax	Yes	Yes	No	Yes
Broker's Commission	Yes	Yes	No	Yes
Benefits				
Receipt of Dividend	Yes	No	Yes	Yes
Voting Rights	Yes	No	No	No
Trading				
Ability to Margin Trade	No	Yes	Yes	Yes
Ability to go Short	No	Yes	Yes	Yes
Fixed ownership/contract period	No	Yes	Yes	No

Both spread betting and CFDs are very similar to futures contracts, as summarised in figure 1 above. The trades are settled in cash like the majority of financial futures, with your profits or losses accounted for on the balance of your account. Like a futures contract trading before expiry, a spread-bet or CFD position does not require you to buy or sell the real underlying asset. This has several benefits. If you believe that a company's mismanagement will translate into a falling share price or that the price of oil will fall due to the discovery of new oil fields you can benefit from the fall in price. To make money on the way down you can take "short" positions, and more easily and cheaply than in spot markets such as normal shares. Alternatively, a short spread bet or CFD position could be used to hedge against losses in a real share already owned, locking in a profit without incurring a tax liability. The other appeal of CFDs and spread betting is that they are margin products, giving the investors the option of leveraging up their trades. This is the same as making trades on credit, giving the option of retaining ready cash for other things. Because leverage increases risk not all investors make use of this ability.

The futures exchanges know that only 20% of traders make money. The same is true for spread betting and CFD traders.[8] There are several reasons for this. If you are trading for profit you need to earn at least the spread or commission you have paid to make the trade. If you are using spread bets or CFDs to hedge an existing position the intention is to lock in any gains just in case the holding goes against you, or equalise a loss made in the underlying. As an example, an investor may need to lock in the current profit from a Vodafone trade but cannot cash in the profit because the shares serve as collateral for other personal obligations. Instead of selling his Vodafone shares he could 'short' a Vodafone CFD to benefit from any fall in price to compensate for any reduction in the share value.

[8] Academics have also found that of the 20% of daytraders who make money, even fewer do so consistently – *Do Individual Day Traders Make Money? Evidence from Taiwan*, Barber, Lee, Liu, Odean, NBER, May 2004

Where to now?

The UK spend on betting has increased sevenfold since Gordon Brown's cut on betting tax in 2001, with £59billion being spent last year alone[9]. According to research giant Forrester, 76% of the UK's 29 million adult internet users admit to regularly placing a bet either online or offline[10]. This change in the UK's wider betting habits cannot fail to have an impact on the spread betting industry as people look for new experiences beyond the traditional. In the UK the spread betting industry has been at the forefront of offering online trading and analysis tools, frequently stealing a march on traditional share trading services. The current market for spread betting is almost completely internet based and is in a similar market to other online trading accounts. The investors currently exploiting online trading services are predominantly white, male, affluent internet users who are under 45 years old.[11] Of course, this is not unexpected. The early adopters of all new technology applications are generally this same group, whether they are trading online, the first to buy books or home electronics online.

The needs of this group will change as it gets older. Pensioners currently only number 5% of the customer base, a figure that will grow. They are already being encouraged to worry about their insufficient pension pots and they will begin to structure more of their portfolios with a view to the long-term and managing risks to their capital. Finspreads, for example, has seen an average 15% year on year growth in the 55+ market since 2002. Successfully meeting the challenge of retaining existing customers will further change the age profile of the customer base. And this is without mentioning that the population at large is aging.

Current adverts for CFDs and spreads tend to revolve around macho objects of desire: glitz, cars, aeroplanes and the like. This will necessarily change for any longer term products that are offered to an older age market. Any products with longer expiries, perhaps measured in years, would compete at least indirectly with traditional brokers who do not aspire to the wheeling-dealing image.

The spread betting and CFD companies will therefore have to cater for these older customers in the future. However, this market segment known as "empty nesters, silver surfers' are only one element of the potential market so far under-represented in the financial gambling arena. If, as expected, there will be an annual growth rate of between 20%[12] and 26%[13] in the number of spread bets and CFDs used by retail investors, that growth is unlikely to occur simply in existing segments of the market.

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[9] Jonathan Brown, *The Independent, 25th May 2006*
[10] Forrester, 24th May 2006 www.forrester.com
[11] Mintel Remote Betting Report, August 2005 and Mintel Interactive Investing Report, August 2005
[12] Mintel Remote Betting Report, August 2005
[13] http://www.celent.com/PressReleases/20051206/FinancialBetting.htm

If these products are to be more widely used, logic dictates that the profiles of the investors must change. The challenge for the industry is to decide which other groups are going to be interested in spread betting or CFDs in future years. Also, will the industry be able to serve these groups without cannibalising their existing client base?

Traditionally ***women*** have been conspicuous by their absence in spread betting and CFDs. In recent years, however, this has been changing. Sandy Jadeja, Chief Market Analyst of Finspreads, has seen an increase in their numbers trading and attending his educational seminars, at first steadily, and then growing more rapidly; and this trend seems unlikely to reverse. Interestingly, Mr. Jadeja also notes that women have a different, more calculated, trading mentality. They tend to prepare their research more effectively and be more cautious. Sheila Gleason, Marketing Operations Director at Barclays Wealth Management, has noticed that Barclays' own research shows that "women do about 40% more research than men on every trade". Research from Digital Look shows the same result – women clearly outperform men when investing.

They also trade or game online less compulsively than men and are less likely to become addicted. Finspreads has seen a 10% year on year growth in female clients over the past 2 years, a figure fairly representative of the industry at large. Compared to when the company formed in 1999 they now have over 300 times the number of female customers. However, despite the growth in female spread-betters they are only in the region of about 10% of all account holders. This correlates with the percentage of women in the overall gambling population which is usually stated to be between 8%-12%. There is concern in the industry, therefore, that the rapid recent growth in female participation may have plateau-ed at the general level.

Contrary evidence is provided by online poker where there has been a dramatic increase in the numbers of women to somewhere in the region of 45% of punters. It is not entirely clear what has driven this increase – anonymity, challenge, complexity and hygiene have all been suggested as reasons. The spread betting industry will need to understand what drove this enormous rise in female participation and attempt to replicate it for spread betting. As mentioned before, while adverts for CFDs and spreads focus on the macho online gaming billboards have even included fluffy bunnies to appeal to the female consumer. Whatever it takes the spread betting industry must address it.

Ethnic minorities are also likely to be important sectors where growth might be expected in the retail derivatives industry. Although immigration is not new, growth in the United Kingdom population has been increasingly driven by immigration since the mid-1990s. Will the first wave of immigration from the new EU states settle and prosper here like past hard-working immigrants? Past immigration from the Indian subcontinent has developed into an affluent middle class. According to the Institute of Asian Professionals 10% of business startups are the brainchilds of Asian entrepreneurs, even though they make up only 5% of the UK population. Just as the Hispanic constituency in the United States is growing in importance for marketing a wide range of products, so too could British ethnic groups. Australia provides an interesting experiment in targeting ethnic groups. Australians with a far-eastern heritage are viewed as a specific market segment and Britain is certainly following suit.

Adrian Buthee of Two Way Trade, a CFD brokerage, points out that the British Asians already constitute a very noticeable group of traders, and certainly the largest ethnic minority group. It may be politically incorrect to characterise racial stereotypes but it would also be commercially incompetent to ignore 'a priori' evidence that suggests preferences for financial products based on ethnic background. It is important, therefore, to segment individual markets not only by age and gender but also by ethnic sub-groups if the evidence for so doing is strong.

The industry will also continue to seek out new international markets. Ireland and Australia are already important markets, but these are not incredibly different environments from the British market. In the far-east and the Indian subcontinent, however, there is a greater tendency to think of commodities such as gold as an investment. The Chinese are even planning to open a theme park entirely dedicated to the yellow metal.[14] The £14 million (€20 million) park will allow visitors to watch gold being mined and processed. The more adventurous will even be able to mine gold for a day. For the more serious Chinese 'gold-bug', a special edition of the China Economic Daily was published in two gold versions. The more expensive issue cost each reader just over £4,500 (€6,600) to catch up on the news and used 500 grams of gold.

Per-capita income of China's urban residents grew by 9.5 percent in the first half of last year. According to a report of the Gold Field Mineral Service, a metals consultancy, this income growth will lead to annual gold sales in China of 600 tons in five years.

[14] http://www.abc.net.au/news/newsitems/200603/s1595500.htm

If proven to be correct, China would replace India as the largest gold consumer in the world. The Chinese certainly have an appetite for the commodity markets as evidenced by the impressive over-attendance and crowding when companies such as IFX Markets run seminars and education events in Shanghai. There is also an undeniably deep gaming culture amongst the Chinese that extends from financial markets to the more obscure. One bizarre sub-group of people are actually paid to intensively play in simulated online worlds. It may be odd but the imperative is real cash. The in-game currencies have a market value and can be traded on auction sites such as Ebay, at values that the Economist has noted gives some virtual worlds greater GDPs than many small countries. Virtual trading in virtual worlds is, perhaps, the ultimate derivative. As mentioned above we are already close to derivatives cubed, trading in the virtual world may be derivatives to the power of infinity. This gaming and trading propensity is clear to Western companies but relatively untapped.

China's currency, the Renmimbi, has not yet been floated and their favourable export position probably means they may not do so any time soon. However, India may soon float the Rupee and remove currency controls. This freedom will also bring more business into the retail derivatives industry, even to London based firms. In post-colonial times London has retained a certain allure for the Indians in particular. This obvious interest in London is similar to the manner in which many former colonies look to former colonial powers – the financial industry is fortunate both to have a prime financial centre in London and strong historical links to one of the largest emerging markets in the world. Floating the Rupee would also lead to spreads and CFDs on the Rupee that British Asians and Indians nationals would likely trade. It would be relevant as an emerging market trade and would certainly serve as a measure of the volatility in geopolitical relations in the region. Even if there is a delay in floating the Rupee, the leverage that retail derivatives offer allow Indian nationals to get round that limitation.

While spread betters are primarily retail clients, users of CFDs also include financial institutions that need to replicate all the financial benefits of owning an asset. Hedging with CFD issuers already accounts for around 40% of trading of British equities, although the vast majority of this trade is institutional. Nevertheless, spread betting and CFDs have stayed close to the humble roots of the agricultural futures contract. So far they have avoided the complexities of the exotic derivatives offered by banks to large companies. Perhaps over time it is inevitable that more products will be offered to the individual investor and their brokers as financial awareness and education increases amongst consumers. These will probably share some of the more basic features that banks have included in exotics.

To a certain extent it is already happening with products such as `binary bets'. Normal spread betting is similar to trading the markets – you are rewarded or penalised as the market moves similar to as if you own the asset. Binary bets are based on whether or not something will happen – whether the FTSE closes above 5800 at the end of June, for example. In the final days of June the quote for this binary bet will be near to 100 if the FTSE is a long way above 5800, because there is almost a 100% chance it will close above 5800. On the other hand, if you believed that despite this, the market was going to fall substantially and close below 5800, you would go short and wait to cover the bet at the end of June at 0. This is similar to the barrier options that banks sell to corporations. Digital options are another wholesale banking product similar to binary bets, except that the investor profits even if the FTSE breaks 5800 only once before the expiry of the contract. Binary bets are priced using similar models to those employed in wholesale banking.

A range of contracts on property indices could potentially tap into the property fever. Contracts for trading regional property indices like a normal spread bet or swap contracts are all possible. David Mercer of Finspreads notes that Deutsche Bank and Eurohypo completed the first UK property swap on commercial property in January 2005. The deal was between a UK insurance company and a UK property fund where the insurance company wanted to decrease it's exposure by £40 million. The 3 year CFD struck between the parties allowed the two entities to swap their UK property exposure. Basically the seller exchanged the total return on their property portfolio, which encompassed income and capital growth for a LIBOR related return paid by the buyer based on a notional principle of £40 million.

Mercer said "It is only a matter of time before these swaps are conducted on a basket of retail properties and the retail investor can hedge or trade the value of what is generally their biggest asset - their home. The market is potentially huge with 15 million home owners in the UK and an estimated value of £2.8 trillion (£2,800 billion). Our challenge is to simplify the product which allow retail investors to transfer their property risk without the need to buy or sell their home. Speculators or even people who do not own property would buy the CFD and gain exposure to UK property without the need for capital outlay or the risks involved with buying a home. Likewise, homeowners can hedge, on a short term basis, against a decrease in the value of their core asset by selling the CFD".

At the moment there is not enough liquidity in the market and the recognised industry benchmark, the Investment Property Databank UK Property Index, is focussed purely on investment property at this stage. Finspreads are currently in discussion with the providers of property derivatives in the commercial market and aim to be the first to bring the retail product to the street.

Regional disparities in the annual growth of the property market is another consideration for those wishing to extend the property derivative market and distribution.

There will certainly be a market for complex products that serve the needs of more advanced investors. However, the industry must generally err on the side of simplicity. It is simplicity wherein the mass market lies. Extending access and education for the original and more basic products is important to the mass market while ever more exotic products are needed to retain the interest of the specialist financial gambler. There will also be those people who want to trade basic contracts but with more instant feedback of profit or loss. The closest expiries available tend to be daily although hourly[15] and five minute[16] binary expiries are offered by some firms. There is of course nothing stopping a trader from closing a daily position after holding it for only one second. Nevertheless, very short term expiries would certainly target a different and decidedly more speculative market of spread-better. As with extending expiries for the older age market, offering shorter expiries would also allow the industry to target another market with the minimum of changes to their products range.

Yet another market can be found with the likes of Victor Chandler, a traditional bookmaker, which has bricks and mortar outlets in places such as Mayfair. This serves the desire of some of their wealthier customers to take a flutter when it takes their fancy just by popping in. There is no reason why this type of outlet and product could not serve the financial spread betting industry. This market would also be quite different to the online, white male stereotype of existing customers and avoid cannibalising that market.

Another avenue might be the online betting exchange. David Buik of Cantor Index believes that it is only a matter of time before the exchanges turn their full gaze on the financial markets. These website services allow you to offer your own spreads or accept other peoples'. They are quite similar to direct access platforms in other financial markets that allow you to bypass a broker and deal with the market more directly, such as Island or HotSpotFX. Nevertheless, financial betting exchanges have not had the same success as traditional spread betting or CFDs. Most people tend to prefer to deal with the firm itself as there is more confidence that the firm will always provide the liquidity to close out the position when it is needed. This notion, that anonymous `layers' cannot offer liquidity may, however, be purely perceptual and evolve over time.

[15] Betfair
[16] Ladbrokes – in fact awarded innovation of the year at the eGaming awards

Additionally, there will be more innovative ways of using the products that already exist. One approach that could appeal to entrepreneurs would be for a non-financial institution to hire a betting team to provide their insurance policies. Look at the position Tottenham Hotspur found itself in.

They were in a position to finish fourth in the Premier League but if they did so they would miss out on participation in the Champions' League (and at least £10m additional revenue) if at the same time Arsenal were to win the 2006 Champions League. The easiest way for them to have insured against such an eventuality would have been to hedge against the losses by betting on Arsenal either to finish fourth and/or to win the Champions League. Betting against certain activities simply acts as an insurance policy but would of course need to be policed by the football league to ensure one party was not incentivised to adversely perform.

New products ***will*** be developed and these will be quickly replicated by all firms. Profitability will, therefore, come from managing brand loyalty and from the management of 'interbanking' issues such as liquidity, credit lines and risk management. These choices are very important indeed for the retail derivatives industry. The industry's greatest problem comes from no longer being adolescent. There is relatively little scope remaining to differentiate products. The industry recognises that it needs to move beyond the young, white, male professional into female, grey, ethnic and international markets. According to Ed Warner of Finspreads, it appears that the appeal remains fairly exclusive – customers still tend to be semi-professional or at least aspiring to act as such. Beyond the professional or aspiring semi-professional trader lies the mass market – these are people who do not know what a spread-bet is or could not tell the difference between a CFD and a DVD. They are, nevertheless, quite happy to open online share accounts or hand over money to others to manage for them in collective funds.

As David Jones of CMC Markets points out, "education and educative marketing is the key in bridging the gap in perceptions". Active customers' perceptions of the industry are very different from the perceptions of potential customers. This is quite simply because most potential customers are more solidly "retail" and unfamiliar with the financial industry, let alone spreads and CFDs. Yet spread betting and CFD firms have been the vanguards of online trading services and competitive pricing in Britain. It is spread betting that has given the amateur traders access into what has hitherto been a professional game. This has been fundamental change in consumer choice in a country where traditional share dealing commissions can be three or four times the cost of similar trades in the United States, even before considering stamp duty.

Despite opening up choice, the retail derivatives industry has not explicitly claimed to represent the interests of the mass market. If choice is in the interest of the consumer then perhaps stating this explicitly is important to the industry as regulators move into the area of retail derivatives.

The EU Markets in Financial Instruments Directive (MiFID) extends regulation of the European financial services to contracts for difference, commodity derivatives and credit derivatives for the first time.

Whilst the FSA has regulated financial spread betting in the UK for some time, it is only MiFID that has required Irish financial regulators to assume responsibility from their gaming authorities.[17] In this instance increased regulation to protect the public was in fact welcomed by most of the Irish spread betting industry. They were already accustomed to their UK operations being regulated by the British FSA. This does not mean that all changes in regulation will be welcome, just as other elements of MiFID have been heavily criticised.

Tomas Carruthers, Managing Director of the online financial portal Interactive Investor, points out that; "if the retail derivatives industry does not come together to represent itself it may have strategic choices made for it by future regulators". The Association of Private Client Investment Managers and Stockbrokers, the British Bankers Association and the Association of British Insurers represent other sectors in the financial industry when necessary. Even the most benign industries such as grocers have industry associations that serve as authoritative voices on collective issues. They are also accepted as more legitimate champions of their customers' interests than the statements or lobbying of a single institution. Yet the retail derivatives industry remains comparatively unprotected if there are to be any future regulatory threats.

Notwithstanding, the recent FSA consultation paper which seeks to apply principles–based regulation to listing rules failed to address CFDs in any meaningful way. While acknowledging the need for a comprehensive and transparent disclosure regime, the FSA seemed to say that it was just too difficult. There is another regulatory problem that has failed to receive any genuine discussion; as telecoms technology accelerates towards ultimate convergence who will regulate gambling over the airwaves which is precisely what spread betting is. Will it be the gaming commission, the FSA or perhaps it should be Ofcom?

[17] http://www.bettingbusiness-online.com/98/100/232/articles/5435.php

Given that over 90% of spread betting occurs over the internet and the difficulties of regulating other types of online gambling (sports, poker etc.) has been well documented, it may be that the bigger companies would actually welcome regulation as it provides comfort for the consumer and respectability for the companies. Taking the on-line gambling community as an example, anything (even taxation) that adds respectability to an industry adds value.

Sportingbet.com, one of the online gambling industry leaders, even went to the extent of spending large sums lobbying the US political establishment to tax online betting; surely a unique position for a bookmaker to take.

However, the logic was obvious – taxation adds legitimacy, legitimacy provides comfort. Further, it is not impossible that unforeseen events may lead EU or British regulators to restrict access to products to only high net worth or sophisticated investors. Hedge fund access remains relatively restricted. If that were the case successful retail derivatives firms will be left only competing on operational efficiency and their institutional relationships - brand loyalty is not relevant to professional traders. Professional traders are already likely to hold a number of spread betting and other accounts. This brand-less model of competing only on operational efficiency depends on economies of scale that would certainly lead to consolidation in the industry.

It is likely that at some point in the not too distant future the retail derivatives industry will feel the need to come together in a formal association to create a consensus: a consensus that these products should be available to retail investors, rather than reducing choice. Unlike the United States, Britain does not have a history of competitive commissions or access to leveraged margin accounts. Hopes of a retail derivatives industry have been dashed before. When LIFFE first opened in the 1980s the British retail brokerages rushed to buy seats on the fledging exchange. Retail access to these derivatives never took off in the same way that spread betting and retail CFDs have done. That success and the choice given should be coveted and provides a confident platform of well deserved legitimacy. Serving the mass market does not preclude serving the smaller niche market of professional traders, but it is our opinion that it is easier to lose the opportunity of accessing the mass market.

When the industry first launched binary bets they were wrong to think that the mass market would find them simple. For a traditional gambler binary bets are closer to normal fixed odds bets and thus more familiar. Yet even as education has increased, the average investor in CFDs or financial spread betting does not appear to have found binary bets as easy to understand as a plain CFD or spread bet.

It is likely that increased competition to fulfil investor needs will lead to more innovations. It is, however, just as likely that those more complex products will only be taken up by more experienced traders. "Normal" spread betters and CFD users plainly think in terms of traditional capital gains from price increases.

The retail derivatives mass market is not hugely different from other financial markets such as stock broking. To access this mass market, or at the very least attempt to compete, companies will feel the need to focus on brand and the value added services that they offer their clients. As mentioned earlier, education is a constant theme. The industry has been at the forefront of proactively educating the public through educative marketing and seminars. This will certainly continue. Adrian Buthee, of Two Way Trade CFD brokerage, sees that education process extending not only to seminars and analytical tools, but to full service trader support.

He sees "a growing minority of traders who want to trade independently, but with the opportunity of talking through trades and risks with a broker on the phone". With almost all spread and CFD traders using online systems this is a bold statement, but if it comes to fruition it would represent an important market segment. The traditional stock-broking industry does in fact already offer CFDs to its clients, and often even from within their managed account services.

Angus McCrone, a seasoned commentator and a senior economist for the Centre for Economics and Business Research, points out that "general investment sentiment will drive a lot of the business" regardless of other the developments. It is a sign of the industry's success and growing maturity that it faces the same problem as traditional brokerages. The problem for the industry is to explain to consumers who tend to hang on to their money when the markets are falling that by using retail derivatives they can actually hedge against falling markets, or even benefit from them.

That is the difficulty for the industry as a whole in a nutshell. There is a huge educational task for the industry to convince the public, the regulators and the legislators that all forms of trading are essentially the same type of activity. The only real difference being the *level* of risk which can be located on a continuum from post-office savings at one end to betting on the proverbial two flies at the other end. It must also be recognised that it is not the product which lies on this continuum but the use to which that product is put and the risk mindset of the user.

Additionally, for the industry to grow, this newly educated public must be segmented and targeted more efficiently because simply being first to market is no longer sufficient. The risk mindset of the consumer is the key factor in trading predispositions so products must have the flexibility to be able to be used in a variety of ways by a variety of investors.

Finally, it is essential that the industry is coordinated and presented as a homogenous and self-regulated group in which investors can place their complete trust. Of course, such a change in perception is far from easy and has much more to do with emotion than rationality. There remains a stigma attached to the terms betting and gambling.

As the 19th century satirist quoted at the opening of the article illustrated, such double standards are nothing new but must be addressed. Unless it is addressed, an industry that adds genuine choice and would enable a larger section of the public to engage in financial trading, will be impeded.

Glossary

Binary betting
Binary betting allows you to take a view on whether an event is going to happen or not, for example whether the FTSE is going to close up on the day or not. There are only two outcomes with a binary bet – as an event either occurs or not. Binary markets are quoted on an index between 0 and 100 – if the event in question occurs then the market settles at 100 or if the event does not occur, the market settles at 0.

Bond
The investor loans money to an entity (company or government) by purchasing bonds. The bond is for a defined period of time at a specified interest rate. If the market price of the bond falls this implies a rise in the interest rate yielded to the purchasing investor, and vice-versa.

Capital Gains Tax (investment income taxable by)
Incurred by the profit from selling an asset that has increased in value. Capital losses on assets liable for capital gains tax can generally be offset against total capital gains for the tax year.

Cash Price
See Spot Price

CBOT
See Chicago Board of Trade

CFD
See Contract for Difference

CGT
See Capital Gains Tax

Chicago Board of Trade
Originally a commodities exchange established in 1848. Today it trades both agricultural and financial contracts. As well as the original agricultural contracts such as such as wheat, corn and soyabeans, they now offer options and futures contracts on a wide range of products including gold, silver, U.S. Treasury bonds and energy materials.

Chicago Mercantile Exchange
The second largest futures exchange and the largest in the United States. Originally setup as the Chicago Egg and Butter Board in 1898. The exchange now focuses on futures on interest rates, currencies, equities and indices. It does still trade a relatively small amount of agricultural products.

Contract for Difference
A derivative contract that replicates most of the financial benefits of owning the underlying asset.

CME
See Chicago Mercantile Exchange

Derivative
A security whose value is derived from another asset. This underlying asset does not need to be owned by either buyer or seller and can be a spot instrument or another derivative.

Eurex
The largest derivatives market in the world, dealing primarily with European derivatives. It is owned by the German and Swiss stock exchanges. The products that trade here include bonds, European stocks and STOXX indexes.

Futures contract
A legal agreement to make or take delivery of a specified instrument, a commodity such as coffee or a financial instrument such as shares for example. Delivery/settlement takes place at a fixed future date at a price determined at the time of dealing.

Gap
A jump in price creating a range of prices in which no trading has taken place. They are generally caused by sudden unexpected news and are more common with less liquid securities.

Income tax
Incurred by the income generated by an asset. This income could be a dividend from a cash share just as it could be income from one's own labour.

IMM
International Monetary Market

International Monetary Market (IMM)
The currency futures exchange of the Chicago Mercantile Exchange set up in 1972.

Long
To go or be long or enter a long position is to purchase a security in the hope it will rise in value.

Notional Value
The value of a derivative's underlying assets at the spot price. This is the number of units of an asset underlying the contract, multiplied by the spot price of the asset.

Roll Over
To replace an old expiring position with equivalent contracts of a later expiry

Short
To go or be short or enter a short position is to sell a security in the hope it will fall in value. This is simpler in derivative markets. Spot markets require the investor to borrow securities so as to sell them and buy them back at a lower price. A cash short sale also requires financing to compensate the securities lender. Derivatives do not face these constraints.

Spot Price
The price an immediately deliverable asset – as opposed to the price of a derivative contract based on the spot price of an asset

Spread
The difference between the price that an investor can sell or buy a security at any given time.

Spread betting
Betting on the move of a spread quoted by a spread betting company. The spread is around the price of an asset such as a share or commodity.

Stamp Duty
Taxation on a cash share purchase. Derivatives based on the shares do not incur Stamp Duty.

Standard and Poors 500
An index of the 500 largest American companies weighted by market- capitalisation. This is generally seen as representing the US stock market.

Stop-loss
An order to completely or partially exit an open position when the price reaches a certain price. They are designed to limit an investor's loss on a specific trade.

Swap
A contract in which two parties agree to exchange periodic payments. E.g. One payment is at a fixed rate and the other is variable.

About Finspreads
Finspreads, launched in April 1999, is a market leader in the financial spread betting industry with over 30,000 accounts worldwide. Based in the City of London the company offers clients the opportunity to buy or sell the world's individual shares, stock markets, currencies, metals and commodities, through its derivative products.

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