Knowing Your Trading Costs

Learn how to effectively accommodate for your transaction costs

CFDs are complex instruments and come with a high risk of losing money rapidly due to leverage. 73% and 70% of retail investor accounts lose money when trading CFDs with Tickmill UK Ltd and Tickmill Europe Ltd, respectively. You should consider whether you understand how CFDs work and whether you can afford to take the high risk of losing your money.

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We appreciate your feedback and look forward to hearing any thoughts or questions you have on the information included.

The Tickmill Research Team
Knowing Your Trading Costs

One of the most important aspects of trading, that inexperienced traders often overlook, is the underlying cost of managing and executing a trade. The amateur trader ignores business costs, choosing to only focus on the outcome of a trade. The professional trader pays keen attention to trading costs that underpin the routine running of his or her trading business. Like all commercial enterprises, there are fixed and floating costs.

Non-essential fees in trading may be additional money to cover bespoke technical analysis services, news wire, or squawk services, while shorter time-frame traders may choose to pay for enhanced connections. When you place a trade, you’re subject to some fixed costs. If you are trading through a retail FX broker, you will have to pay a commission for execution, or you will have to pay a spread. A spread being the pip difference between the bid quote and the ask quote. As with any marketplace, the fixed transaction costs vary from broker to broker; however, the market is very competitive. The good news for traders is that core transaction costs are not prohibitive to running a profitable trading business.

Depending on your trading strategy, a failure to consider transaction costs may have a significant impact on your long-term profitability. For traders choosing to execute a ‘scalping’ strategy on very short timeframes with small profit targets, a broker with wide spreads, may make a seemingly profitable approach deliver overall negative returns.

Many traders who have back tested or demo traded a short-term scalping strategy are disappointed with the results once they trade the strategy in live market conditions, by merely underestimating the impact of trading costs.

So, it’s essential to have an intimate understanding of all the associated fixed costs when trading. To better prepare you for managing your trading business, we’ll breakdown all the fixed expenses of executing, controlling, and exiting a trade. Remember, the essential aspect of managing your capital is understanding all the associated costs. For many traders, it’s not necessarily a failure to not make a profit in the markets; it’s a failure to not account for all the costs of doing business.
Knowing Your Trading Costs

1. What is the ‘Spread’?

The simplest way for a trader to understand the spread is to understand its context as a fee your broker charges you for executing your trade. When you open your trading terminal, for every currency pair, you will see prices flashing on your screen, one named the bid, and one called the offer or ask. The spread is the difference between the two prices or the midpoint; the broker takes the spread as payment for offering brokerage services e.g. taking your order and filling it in an available liquidity pool.

Let’s walk through the process:

1. If I want to sell or short GBPUSD at 1.2900, I’ll click on the sell button on my terminal where I’ll see two prices: 1.2898 and 1.2900.

   When I execute my sell order, the broker will fill my order at 1.2898, charging 2 pips for execution. This is the difference between the price my order was filled at and the ask/offer price.*

2. Let’s say we want to buy or go long on GBPUSD at 1.2900. When I click the buy button on my terminal; I’ll see two prices e.g. 1.2900 and 1.2902.

   When I execute my buy order, the broker will fill my order at 1.2902, charging 2 pips for execution. Again, this is the difference between the price my order was filled at and the bid/buy price.*

*Prices stated are for illustrative purposes only.
Knowing Your Trading Costs

The difference between the bid (buy) and the ask (sell) prices are indicative of the nature of the foreign exchange market. As an 'Over the Counter' or OTC marketplace, brokers advertise prices, like an auction system from their liquidity providers. This contrasts with exchange-traded products like stocks, where you execute trades at the last price the product was traded at. In the OTC Forex market, you are accepting prices quoted by your broker that are linked to the underlying price of an instrument. Still, the broker retains the right to adjust prices based on their available liquidity. For example in times of high volatility, the broker may widen their spreads.

2. The Bid-Ask

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<tr>
<th>Ask-Sell</th>
<th>Bid-Buy</th>
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<tbody>
<tr>
<td>1.2900</td>
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Check out Tickmill’s spreads here!
3. Spreads may Spread

Now that we understand how the broker provides the prices offered to their customers, it is essential to know that the broker spreads may vary depending upon market conditions. When markets are volatile or fast-moving, due to high impact economic data or unforeseen market news being released, the broker may widen spreads.

When markets are quiet and trading is slow, the broker may offer a relatively tight one or two pip spread. If volatility suddenly increases and liquidity is tight, the spread may increase to account for an increased risk faced by the broker. Especially when the broker is quoting prices that may be difficult to fill orders in their available liquidity pool.
4. Why Spreads Matter

So, now that we understand what the spread is and why they may broaden from time to time, we're going to examine the impact of spread variance on your profitability.

A single pip here or there may not sound like much but, it can have a major impact on a strategy’s profitability. If you trade with a broker and access tight spreads; you're more likely to experience positive outcomes. The secret to your success is not just in the spread but also in your broker’s execution. The spread is only half the battle. Your broker’s best execution practice will be important in determining whether you will benefit from the tight spreads they offer.

A broker may advertise tight spreads on your terminal, however, when you pull the trigger on your trade, you may find that your order is filled two or three pips away from your order level, negatively impacting your desired position. Less reputable brokers engage in numerous backroom tactics that disadvantage the less savvy trader; delayed execution, stop runs and even trade rejection, which dramatically erodes the ‘super tight spread’ they claim to offer. In some cases, brokers will cap trade sizes in relation to the spreads they offer; this is often hidden away in the very small print of the Terms & Conditions.

Spread policies can vary broadly amongst brokers. Some brokers offer fixed spreads; however, on closer inspection, those fixed spreads are often wider than floating spreads. Essentially you then end up paying a permanent premium for an insurance policy that is only required a very small percentage of the time. You are better served to find a broker who offers stable pricing, and who demonstrates execution practices that underpin the spreads they offer.
The final piece of the puzzle with respect to spreads is understanding that, as mentioned above, there are certain market conditions where all brokers adjust their spreads to mitigate their own risk in the market. Most commonly, these periods are due to increased market volatility, where major news releases encourage fast market action. You should also be wary of holding positions over the weekend, especially when markets are not under pressure or there is the chance of major ‘out of trading hours’ news releases. These situations can lead to gaps in market prices, and if the market gaps through your stop, your broker will be obligated to fill your order at the next available price. This scenario can have a terminal impact on your account.

When the Swiss National Bank pulled the ‘the peg’ on their currency, the market cratered within seconds, causing price gaps that left some traders seriously in the red. The event even led to some brokerage firms going into liquidation as they couldn’t cover client losses with their liquidity providers. So, it is essential to truly understand your risk when starting out, it may even be better to stand aside during high impact economic data releases, closing out all positions ahead of the weekend, to protect your account.
6. Commission Structures

Some brokers will apply commission charges to execute orders. Brokers who charge commission tend to offer tighter spreads than brokers who don't charge commissions. This is because the broker makes some of their money through their commissions so they can provide tighter spreads.

Brokers who charge commissions do so in one of two ways:

1. **Fixed**: fixed commission models mean the broker will bill you a fixed amount, regardless of the size/volume of your trade. E.G you will be charged the same for trading a micro, mini or standard lot.

2. **Floating**: a floating fee model means the broker will charge you commission based on the relative size of your trade. Brokers offering this model will reduce fees based on the frequency and size of trades.

An example of the floating fee model might be that the broker will charge £1.00 per £100,000 of currency traded. So, if we buy £1,000,000 of GBPUSD, we would pay a commission of £10 for trade execution. If a trader sold £10,000,000 of GBPUSD, the brokerage would charge £100 for executing the trade. Brokers will tend to offer a sliding scale of commission, subject to the net amount of currency traded.

When deciding on your preferred commission structure, it's important to take into account your own trading style or strategy. For example, scalpers opening many small trades will likely benefit from a floating commission structure, whereby the commissions will be lower due to the small size of the trades.
7. Administrative Costs

Brokers also charge administrative costs that aren’t as broadly advertised or understood as the headline Spread or Commission fees. Some brokerages bill customers for inactivity on their trading accounts if you don’t trade a monthly or quarterly minimum volume. You could also be billed for margin costs, and some brokers will even go as far as charge you for speaking directly to the broker on the telephone.
8. Leverage

Leverage is the facility a broker offers, by which a trader can increase the financial returns on their account versus their initial capital deposited. One of the principal reasons retail foreign exchange trading has become so prominent over the past decade is because of the access to leverage. Those without experience or understanding of how leverage works must use caution, as being over-leveraged can mean that you become liable for very high commissions due to excessive leverage. This is because most brokers charge commissions per lot and the higher the leverage you use, the more lots you’re able to open.

Check out Tickmill’s Margin & Leverage here!
9. The Roll (Swaps)

Another often overlooked cost of trading that can add up is the fee a broker will bill you for holding positions overnight. This cost is called the rollover or swaps and is specific to the foreign exchange markets. Each currency you trade has its own associated interest rate depending on the country of origin. So, when holding an overnight position in a currency pair, eg. GBPUSD, your account is subject to a daily rate of interest, charged as the difference between the two interest rates of the forex pair you are trading. These rates are fixed and are applied to your broker by their liquidity provider in the Interbank (wholesale) market. So, if you hold a long (buy) GBPUSD position overnight, then the rollover charge will be the equivalent of the difference between the rates in the UK and the US. This can have a positive or negative impact on your position.

As an example, if rates in the UK were at 2% and rates in the US were 1%, then the broker would credit your account by 1%. This is because you are a buyer of the higher interest rate currency and your trade would benefit from a positive carried interest rate. If you sold the GBPUSD and held the position overnight, then your broker would debit your account by 1% as your trade would have a negative carried interest.
10. Summary

We have learned in this ebook that there are many additional costs that traders need to consider, above and beyond their directional bias when placing trades. It is essential to a trader's long-term success that they are very thorough when deciding who they are going to place their hard-earned money with.

Traders must be aware of the underlying costs when placing, managing and exiting their trades. It is important to take your time to compare the spreads and commission structures of brokers. It is also essential that you look for a broker who provides consistently stable pricing and that the broker's execution technology is sufficient to match their spreads, which means that you are able to take advantage of tight spreads. It is also essential that when developing and backtesting your trading strategy, you take into account brokerage costs like spreads and slippage, as this is the only way to get a real-world view on the long-term viability of your strategy. Often once you have proved the theoretical concept of a profitable strategy through an extensive backtest, it is prudent to place a small amount of capital on deposit with your broker to forward test the strategy in 'live market' conditions as only by doing so will you really see whether the strategy has legs.
Live Account

Key Features

- **EXCEL WITH EXCEPTIONAL TRADING CONDITIONS**
  Take advantage of tight spreads and competitive commissions.

- **SUCCEED WITH THE ULTIMATE MT4**
  Advanced Technical Tools, 50+ Indicators and customisable charting in 39 languages.

- **ALL STRATEGIES ALLOWED**
  Trade the world’s financial markets by using virtually any trading strategy, including hedging and scalping.

Demo Account

Key Features

- **EXPERIENCE REAL MARKET CONDITIONS**
  Practice trading in real time, test tools and strategies and sharpen your trading skills in a completely risk-free environment.

- **FULLY-EQUIPPED TRADING PLATFORM**
  Explore the full suite of customisable tools and features that the MT4 platform provides to enhance your trading performance.

- **80+ TRADING INSTRUMENTS ACROSS 4 ASSET CLASSES**
  Access a wide range of markets including Forex, Stock Indices, Commodities and Bonds and discover some of the lowest spreads in the market.

Create Account

Demo Account
CFDs are complex instruments and come with a high risk of losing money rapidly due to leverage. 73% and 70% of retail investor accounts lose money when trading CFDs with Tickmill UK Ltd and Tickmill Europe Ltd respectively. You should consider whether you understand how CFDs work and whether you can afford to take the high risk of losing your money.