GET LEVERAGE!

LEARN HOW TO USE LEVERAGE TO MAXIMISE YOUR PROFITS.

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What is "Leverage?"

In its purest sense, Leverage allows us to do "more with less."

In the financial world, the concept of leverage is used by investors to significantly increase the returns on an investment. Leverage is commonly seen as a "double-edged" sword in trading. It has its fans and its adversaries.

Those in its camp love the fact that large amounts of money can be made with "little money down" while those in the opposing camp lament the fact that leverage always causes accounts to "blow-up." This quickly gives an impression that high leverage is "risky."

While many traders have heard of the word leverage, few have a clue about what leverage really is, how leverage works, and how it can impact their account. In short, leverage is quite a misunderstood term, especially in the area of Forex Trading. Having said that, let's delve into the topic a bit more before we draw any conclusions.

Now, leverage involves "borrowing a certain amount of money." In the world of Forex, that money is usually borrowed from a broker. For instance, when a trader opens up an account with a broker, the amount of leverage provided is either 50:1, 100:1 or 200:1, depending on the broker. Some brokers today even offer leverage of up to 400:1 or 500:1.

Let's quickly run through some basics to understand the use of leverage a bit more.

When you trade 1 standard lot in Forex, you are trading 100,000 units of the base currency. For example, let's say that the current price of USD/JPY is 100. This means that 1 USD is equivalent to 100 Japanese Yen at that point of time.

You assess the market and realise that the US dollar is undervalued against the Japanese Yen, which means that you initiate a BUY order in the hope that the price moves up.

Now, to buy 1 standard lot of USD/JPY at the current price of 100, you are actually buying 100,000 units of US Dollars. Most of us do not have that kind of money to initiate the trade! Hence, brokers step in with the perfect solution and offer us the "additional capital" needed to fund the trade.

They do this by introducing "Margin Trading."

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“IF YOU PLAN YOUR TRADE SO THAT YOU ARE RISKING A SMALL AMOUNT OF CAPITAL ON EACH TRADE, VERY HIGH LEVERAGE WILL NOT HAVE A NEGATIVE EFFECT. ON THE CONTRARY, LOW LEVERAGE CAN SEVERELY HAMPER A TRADER’S POTENTIAL FOR PROFIT”

Margin allows a trader to purchase a contract without the need to provide the full value of the contract. Hence, for a $100,000 position (1 lot), on 1% margin, the trader is required to “put down” only $1,000.

The leverage provided on a trade like this is 100:1 (100,000/1,000). Here’s the formula:

So for 1% margin, leverage is 100:1. Hence, a trader can control $100,000 with just a sum of $1,000. For a leverage of 400:1, the trader only needs to “put down” 0.25% margin. This means that a standard lot of $100,000 can be controlled with only $250.

MARGIN REQUIRED	TOTAL VALUE OF TRANSACTION / MARGIN REQUIRED

The table below gives us a quick reference on how margin and leverage co-exist as two peas in a pod:

MARGIN REQUIRED	MAXIMUM LEVERAGE
5%	20:1
3%	33:1
2%	50:1
1%	100:1
0.5%	200:1
0.25%	400:1

Although high leverage gives the impression that the trade is risky, the “perceived risk” is significantly less when one considers that currency prices usually change by less than 1% during intraday trading. If currencies fluctuated as much as equities, brokers would not be able to provide as much leverage.

What? Now wait a minute.

I thought Forex has high volatility and that it fluctuates more than equities?

Let me explain.

In Forex, the currency movements are so small on an intraday basis that a new term called “pips” had to be introduced. A pip is the smallest movement in a currency price. This could be the second or fourth decimal place of a price, depending on the currency pair. However, these movements are really just fractions of a cent. For example, when a currency pair like the EUR/USD moves 100 pips from 1.5100 to 1.5000, it is just 1 cent (or $0.01) of the exchange rate.

Let’s look at a recent example to drive home the point. On 1st April 2010, the price of EUR/USD was 1.3580. On 1st May 2010, the price of EUR/USD was 1.3380. Consider also that this was during a period where the markets were very volatile because of the problems in Greece.

Now, as volatile as the movements were, it was “only” a movement of 200 pips, or a mere 2 cents. Would you trade a stock that moved just 2 cents in 1 month?

So you see, the reason why brokers can afford to give high leverage in the Forex market is because, intraday movements in the Forex market are minute.

This is why currency transactions must be carried out in big amounts, allowing these minute price movements to be translated into decent profits when magnified through the use of leverage. It is the provision of leverage that allows traders to earn significant profits in the market.

However, leverage can also work against investors. For example, if the currency moves in the opposite direction of what a trader believed would happen, leverage would greatly amplify the potential losses. To avoid such a catastrophe, Forex traders usually implement a strict trading style that includes the use of a “Stop Loss.”

Now that we understand the definition and utilisation of leverage, how do we deal with the fact that leverage “kills” a trader’s account?

In reality, the issue isn’t leverage, it is poor risk management. High leverage only reduces the amount of capital required to initiate a position. Great traders know that they will never risk more than 3% of their capital on any trade. Your job is to employ sound risk management by not risking more than 3% of your capital on any one trade.

As an example, if you start with a capital of USD10,000 then a 3% risk means that you will not lose more than USD300 of your account on that trade. Hence, it really doesn’t matter if you trade with 100:1 leverage or 500:1 leverage. It wouldn’t be any “riskier” if you used a higher leverage provided you used proper risk management.

Proper risk management means planning your entry point, profit target and stop loss before placing the trade. Your lot size is then calculated accordingly so that you never risk more than 3% of your capital on the trade.

The point is that leverage is not the enemy. If you plan your trade so that you are risking a small amount of capital on each trade, very high leverage will not have a negative effect. On the contrary, low leverage can severely hamper a trader’s potential for profit because the trader may not have enough capital to enter a full position and/or multiple positions at the same time. On a 10:1 leverage, a trader would have to put down $10,000 to initiate 1 lot as opposed to just $1,000 had he employed a 100:1 leverage.

In summary, leverage is a good thing. It is there to help you. Leverage is an imperative tool that all successful traders use to grow their account consistently. Now shouldn’t we do the same? To quote Archimedes, 220BC: “Give me a lever long enough and a fulcrum on which to place it, and I shall move the world.” **SI**

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