Adding Leverage To Your Forex Trading

by Selwyn Gishen

In the foreign exchange markets, it is common to find leverage of 100:1 or even more. However, just because the market maker or broker may offer you leverage as high as 100:1, it doesn't mean you have to use all the leverage available. In fact, if you are a savvy trader, you will only use high leverage when you can calculate and manage the risks associated with the high leverage to your advantage. We'll show you how this is profitable without being problematic.

Margin and Leverage Basics

Using money borrowed from a broker/dealer to purchase securities or foreign exchange is known as "buying on margin". A trader will usually place a certain amount of money in his or her brokerage account and the broker will use that money as a deposit to allow the trader to buy securities or foreign exchange contracts valued at a multiple compared to the deposited amount.

Leverage is the use of other people's money to buy or sell contracts or securities. If a broker offers a 20:1 leverage, it means he is willing to allow the trader to borrow 20-times the amount of money in the account to make a trade. So, if a contract is worth $10,000 and the broker is offering 20:1 leverage, a trader will only need to have $500 in his or her account to purchase the contract worth $10,000. If the value of the contract goes to $11,000, the trader will make a profit of a $1,000. This would represent a return of 10% on the contract purchase price, but a return of 200% on equity. (For background reading, see Forex Leverage: A Double Edged Sword and Leverage's "Double-Edged Sword" Need Not Cut Deep.)

The extreme amounts of leverage that are common in the forex markets occur because the forex is the largest and most liquid market in the world, making it very easy to get into and out of a position. This allows a trader to control, with a certain certainty, how much he or she is willing to lose on a trade. Because it is possible to exit a position quickly and efficiently, forex brokers allow their clients to benefit from high leverage.

Forex Vs. Stocks and Futures Markets

Leverage in the forex markets is much higher than in most other markets. For example, if you trade equities, you will be able to borrow twice the amount of money you have in your account. In the case of futures, you may be able to borrow 20-times the amount of funds you have in your account. In the forex markets, because the leverage is so high, the broker or market maker will require you to sign an agreement specifying how a losing position will be dealt with. Because a highly leveraged account poses a greater risk for both the market maker and the trader, there is usually a mechanism in the agreement that will allow the market maker to automatically liquidate a trader's position if it

loses 75% of the margin or deposit. To safeguard the broker/market maker and to ensure that the trader does not have to add extra funds to the account, the losing position will be automatically closed at a certain point in time if the losses on that position threaten to be more than the amount of money available in the trading account.

Traders should read the agreements they have with their market makers very carefully in order to understand how a losing leveraged position will be addressed.

Should a Trader Use All the Margin Available?

Generally, a trader should not use all of his or her available margin. A trader should only use leverage when the advantage is clearly on his or her side. For, example, a trader should plan a trade and know exactly where to exit the trade if the market moves in the desired direction. Once the amount of risk in terms of the number of pips is known, it is possible to determine how much money will be lost if the trader's stop-loss is hit. As a general rule, this loss should never be more than 3% of trading capital. If a position is leveraged too much, so that the potential loss could be, say, 30% of trading capital, then the leverage should be reduced until the potential loss is no greater than 3%. Each trader will have his or her own risk parameters and may want to deviate either more or less than the general guideline of 3%. (For more insight, read Limiting Losses.)

Another thing for the trader to note is that the larger the amount of money one has for trading, the easier is it to use leverage safely. Because a leveraged position can lose money just as quickly as it can make money, a trader should have enough funds to act as a cushion against any drawdown or adverse moves without the risk of being automatically liquidated and losing the bulk of his or her trading capital.

The specific risk of leverage is the fact that traders use borrowed money to buy or sell a contract. Unless the market is making a favorable move, losses will be magnified by the amount of leverage employed.

How Should a Trader Calculate How Much Margin to Use?

Suppose that you have $10,000 in your trading account and you decide to trade 10 mini USD/JPY lots. Each move of one pip in a mini account is worth approximately $1, but when trading 10 minis, each pip move is worth approximately $10. If you are trading 100 minis, then each pip move is worth about $100. Thus, a stop-loss of 30 pips could represent a potential loss of $30 for a single mini lot, $300 for 10 mini lots and $3,000 for 100 mini lots. Therefore, with a $10,000 account and a 3% maximum risk per trade, you should leverage only up to 30 mini lots, even though you may have the

ability to buy or sell more than that. (For more, see Forex Minis Shrink Risk Exposure and Finding Your Margin Investment Sweet Spot.)

Conclusion

Trading in the forex markets offers many potentially profitable opportunities. Using leverage can magnify these opportunities to a very large degree. Using leverage requires a complete understanding of risk management and the use of properly defined stop-loss orders in the market. It also requires that traders be disciplined enough to follow the rules necessary for taking advantage of leveraged markets. Leveraged positions can be a trader's best friend or his or her worst enemy - it all depends on mindset and trading habits. Good traders are disciplined and adhere to their risk management rules.

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