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Pitfalls of the Currency Casino

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Gain Capital hopes to attract more foreign-exchange traders. That might not be easy, considering that three-quarters of its retail clients lost money in 2010's second half.

Want to open a trading account for $500 or less? Fund your initial trade with a credit card? And then use leverage as high as 50-to-1 to vie against experienced traders at giant corporations and huge banks? No problem. Just enter the dicey and lightly regulated world of retail foreign-exchange trading. But don't be surprised if you depart from it with a lighter wallet.

Roughly three-quarters of individual investors who trade through forex firms like **Gain Capital Holdings** lose money, resulting in an estimated client-attrition rate of 15% to 25% a year, versus less than 5% at online stockbrokers. Along with its peers, Gain Capital (ticker: GCAP), which operates perhaps the industry's best-known Website, Forex.com, lets online traders buy and sell the greenback against the euro, yen and other key currencies around the clock, from Sunday through Friday. Guppies in a world dominated by whales, the folks who trade through these companies do an estimated $125 billion a day in daily trading, up from $10 billion a decade ago. Not a small number, but one that pales when contrasted with the $4 trillion in volume that courses through the global forex market each day.

AS CASINOS HAVE SHOWN, it pays to be the house. Gain's trading volume last year totaled $1.6 trillion. It and its rivals act as a market maker and take a small spread —averaging about $100 per $1 million, or 0.01%–when clients buy and sell currencies in what is an over-the-counter market. The minimum trade is $10,000. Gain gets 77% of its volume from self-directed individual investors; the rest comes from institutional accounts.

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Stuart Goldenberg for Barron's

Clients can open accounts with credit cards. Then, they can add leverage by trading currencies on minimal margin.

Gain and **FXCM** (FXCM), the two largest providers of retail foreign-exchange services, completed initial public offerings in late 2010. Both are now below their IPO prices. Investors have good reason to be wary of forex stocks, particularly Gain Capital's. The firm had a disappointing fourth quarter and could face a tough 2011 because of tightened leverage rules in the U.S. and Japan, the loss of a key customer and a regulatory change that will hurt a secondary business—trading metals for its clients.

Gain Capital, now around 7, went public at 9 and could drop further, perhaps approaching its tangible book value of $3.50 a share. Its stock-market value is almost $300 million. On the surface, the shares don't appear expensive, trading at about eight times estimated 2011 profits of 92 cents a share, up from an adjusted 90 cents last year. But the 2011 projection could be tough to hit; profits came in at just 10 cents a share in the fourth quarter.

The bull case for Gain is that it's a high-growth, high-margin business and, in Forex.com, has one of the most recognized brands. Fans think Gain will expand both internally and through acquisitions as currency trading ramps up globally. In a February conference call, CEO Glenn Stevens said that Gain aims to develop "forex as a viable alternative asset class." Right now, only about one million of the 100 million online brokerage accounts worldwide trade currencies. But continued expansion may be tough, given the extent of investors' losses.

Friday, Stevens told *Barron's* that he sees "multiple underpinnings" of growth as active traders around the world gravitate toward a "transparent and cost-effective" market.