BDDC

“Leverage is all about preference” – Zhu Su

Leverage Trading

The simple definition of leverage is to use (something) to gain maximum advantage. While discussing the finance and trading world, leverage results from borrowing capital, typically cash, to increase the firm’s asset base and potentially maximize return on investment (ROI). Since a leveraged trader is borrowing additional funds to increase the size of the initial investment, he/she can greatly increase the total profit (or loss), depending on which way the trade goes. With that being said, the use of leverage is considered a double-edged sword.

Types of leverage:

When trading with leverage, the levels of leverage are applied in multiples of the initial investment by the trader. The amount of leverage usable can be infinite but is typically capped off at 100x, depending on the exchange. For example, if a trader has $10,000 of collateral in their account and want to open a position worth $20,000, they must use 2x leverage. Using 100x leverage for the $10,000 of collateral will result in a position worth $1,000,000. With 2x leverage, potential gains and losses on the trade are double that if no leverage was used.

Advantages and Disadvantages:

From the previous two sections, it is probably already becoming clear as to the advantages and disadvantages of leverage trading. Below are some examples of both.

Advantages:

- Increased capital = increased profit and magnified returns
- Access to previously restricted markets (minimum $ amount required)

Disadvantages:

- Magnified losses if a trade goes the wrong way
- Potential for liquidation*
- The higher the leverage, the higher the risk/reward. Irresponsible use of leverage can result in large sums of money lost or your account going bust (going to $0).

For further interest:

Liquidation, Initial Margin and Maintenance Margin

Investopedia Definition

*Liquidation occurs when a trader’s open positions are automatically closed at market price because the trader no longer has enough collateral left in their account to support their leveraged positions. It occurs when the price of an asset of which the trader holds a position in reaches a liquidation level, or a chosen price set by the exchange depending on their maintenance margin.

Examples:

1)

Bob is looking to open a long position on an asset currently priced at $10. Bob has $5,000 of collateral in his account but wants to open a position worth $20,000. Therefore, he uses 4x leverage. Now let's say the price of the asset moves to $12, or an increase of 20%, after Bob opens his position. Bob's $20,000 position has now netted him an unrealized profit of $4,000, or $20,000 * 20%. However, Bob's ROI is much higher than 20% because his initial investment was $5,000. Therefore, Bob's ROI is 80%, or $4,000/$5,000. Bob now has $9,000 in his account if he chooses to take profit.

Now let's say price moves against Bob, from $10 when he opened a long, to $9 at the current time. That is a 10% decrease, meaning Bob's position of $20,000 has netted him an unrealized loss of $2,000, or 20,000 * 10%. Now Bob's ROI is much more than 10% since he loses $2,000 from his initial amount of $5,000, a 40% loss ($2,000/$5,000). If Bob chooses to close the position, his account will now only contain $3,000. If Bob did not decide to use leverage, this price movement would have only lost him $500 (5,000*10%).

2)

Nick is looking to open a short position on an asset priced at $20. He has $10,000 of collateral in his account and wants to open a position size of $20,000 using 2x leverage. If price decreases to $15, or a 25% decrease, Nick's account increases by 25%, or $5,000 to $25,000. His ROI is now 50% because his account went from $10,000 to $15,000.

Say that price moves against Nick, to $23. That is a 15% increase in price, meaning a 15% unrealized loss of Nick's $20,000 position, or an unrealized loss of $3,000. However, Nick's account takes a harder loss of 30% because his initial investment of $10,000 has now netted a loss of $3,000.