

Leverage the Killer

Most professional traders and money managers trade one standard lot for every \$50,000 in their account.

If they traded a mini account, this means they trade one mini lot for every \$5,000 in their account.

Let that sink into your head for a couple seconds.

If pros trade like this, why do less experienced traders think they can succeed by trading 100K standard lots with a \$2,000 account or 10K mini lots with \$250?

No matter what the [forex brokers](#) tell you, don't ever open a "standard account" with just \$2,000 or a "mini account" with \$250. The number one reason new traders fail is not because they suck, but because they are undercapitalized from the start and don't understand how leverage really works.

Don't set yourself up to fail.

We recommend that you have at least have \$100,000 of trading capital before opening a "standard account", \$10,000 for a "mini account", or \$1,000 for a "micro account".

So if you only have \$60,000, open a "mini account. If you only have \$8,000, open a "micro" account. If you only have \$250, open a "demo account" and stick with it until you come up with the additional \$750, then open a "micro account".

If you don't remember anything else in this lesson, I plead that you at least remember what you just read above.

Okay, please re-read the previous paragraph and ingrain it in your memory. Just because brokers allow you to open an account with *only* \$250 doesn't mean you should and I'm going to explain why.

I believe most new traders who open a forex trading account with the bare minimum deposit do so because they don't completely understand what the terms "[leverage](#)" and "[margin](#)" really are and how it affects their trading.

It's crucial that you're fully aware and free of ignorance of the significance of trading with leverage. If you don't have rock solid understanding of leverage and margin, I guarantee that you will blow your trading account.

Leverage Defined

The textbook definition of “leverage” is having the ability to *control* a large amount of money using none or very little of your *own* money and *borrowing* the rest.

For example, in forex, you can control \$100,000 with a \$1,000 deposit. Your leverage, which is expressed in ratios, is now 100:1. You’re now controlling \$100,000 with \$1,000.

Let’s say the \$100,000 investment rises in value to \$101,000 or \$1,000. If you had to come up with the entire \$100,000 capital yourself, your return would be a puny 1% (\$1,000 gain / \$100,000 initial investment). This is also called 1:1 leverage. Of course, I think 1:1 leverage is a misnomer because if you have to come up with the entire amount you’re trying to control, where is the leverage in that?

Fortunately, you’re not leveraged 1:1, you’re leveraged 100:1. You only had to come up with \$1,000 of your money, so your return is a groovy 100% (\$1,000 gain / \$1,000 initial investment).

Now I want you to do a quick exercise. Calculate what your return would be if you *lost* \$1,000.

If you calculated it the same way I did, which is also called the correct way, you would have ended up with a -1% return using 1:1 leverage and a WTF! -100% return using 100:1 leverage.

You’ve probably heard the good ol’ clichés like “Leverage is a double-edge sword.” or “Leverage is a two-way street.” Well...as you can see, these clichés weren’t lying.

Margin Defined

So what about the term “margin”? Excellent question my bright padawan learner.

Let’s go back to the earlier example:

“For example, in forex, you can control \$100,000 with a \$1,000 deposit. Your [leverage](#), which is expressed in ratios, is now 100:1. You’re now controlling \$100,000 with \$1,000.”

The \$1,000 deposit is “margin” you had to give in order to use leverage.

Margin is the amount of money needed as a “good faith deposit” to open a position with your [broker](#). It is used by your broker to maintain your position. Your broker basically takes your margin deposit and pools them with everyone else’s margin deposits, and uses this one “super margin deposit” to be able to place trades with the interbanks.

Margin is usually expressed as a percentage of the full amount of the position. For example, most forex brokers say they require 2%, 1%, .5% or .25% margin.

Based on the margin required by your broker, you can calculate the **maximum** leverage you can wield with your trading account.

If your broker requires 2% margin, you have a leverage of 50:1. Here are the other popular leverage “flavors” most brokers offer:

Margin Required	Maximum Leverage
5%	20:1
3%	33:1
2%	50:1
1%	100:1
.5%	200:1
.25%	400:1

Margin Call Example

Assume you are a successful retired British spy who now spends his time trading currencies. You open a mini account and deposit \$10,000. When you first login, you will see the 10,000 in the "Equity" column of your "Account Information" window.

Usable Margin

You will also see that the "UsedMrg" ('Used Margin') is "\$0.00", and that the "UsblMrg" ('Usable Margin') is 10,000, as pictured below:

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	\$10,000.00	\$10,000.00	\$0.00	\$10,000.00

Your Usable Margin will always be equal to Equity less Used Margin.

Usable Margin = Equity – Used Margin

Therefore it is the Equity, NOT the Balance that is used to determine Usable Margin. Your Equity will also determine if and when a Margin Call is reached.

As long as your Equity is greater than your Used Margin, you will not have Margin Call.
(Equity > Used Margin) = NO MARGIN CALL

As soon as your Equity equals or falls below your Used Margin, you will receive a margin call.

(Equity =< Used Margin) = MARGIN CALL, go back to demo trading

Let's assume your margin requirement is 1%. You buy 1 lot of EUR/USD.

Your Equity remains \$10,000. Used Margin is now \$100, because the margin required in a mini account is \$100 per lot. Usable Margin is now \$9,900.

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	\$10,000.00	\$10,000.00	\$100.00	\$9,900.00

If you were to close out that 1 lot of EUR/USD (by selling it back) at the same price at which you bought it, your Used Margin would go back to \$0.00 and your Usable Margin would go back to \$10,000. Your Equity would remain unchanged at 10,000.

But instead of closing the 1 lot, you, the adrenalin junkie chopsocky retired spy that you are, get extremely confident and buy 79 more lots of EUR/USD for a total of 80 lots of EUR/USD. You will still have the same Equity, but your Used Margin will be \$8,000 (80 lots at \$100 margin per lot). And your Usable Margin will now only be \$2,000, as shown below:

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	\$10,000.00	\$10,000.00	\$8,000.00	\$2,000.00

With this insanely risky position on, you will make a ridiculously large profit if EUR/USD rises. But this example does not end with such a fairy tale.

Let me paint a horrific picture of a Margin Call which occurs when EUR/USD falls.

The EUR/USD starts to fall. You are long 80 lots, so you will see your Equity fall along with it. Your Used Margin will remain at \$8,000. Once your equity drops below \$8,000, you will have a Margin Call. This means that some or all of your 80 lot position will immediately be closed at the current market price.

Assuming you bought all 80 lots at the same price, a Margin Call will trigger if your trade moves 25 pips against you.

25 PIPS!

Humbug! The EUR/USD pair can move that much in its sleep!

How did I come up with 25 pips? Well each pip in a mini account is worth \$1 and you have a position open consisting of 80 freakin' lots. So...

$$\text{\$1/pip} \times 80 \text{ lots} = \text{\$80/pip}$$

If EUR/USD goes up 1 pip, your equity increases by \$80.

If EUR/USD goes down 1 pip, your equity decreases by \$80.

$$\text{\$2,000 Usable Margin} \div \text{\$80/pip} = 25 \text{ pips}$$

Let's say you bought 80 lots of EUR/USD at \$1.2000. This is how your account will look if it EUR/USD drops to \$1.1975 or -25 pips.

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	\$10,000.00	\$8,000.00	\$8,000.00	\$0.00

As you can see, your Usable Margin is now at \$0.00 and you will receive a MARGIN CALL!

Of course, you're a veteran international spy, you've faced much bigger calamities. You've got ice in your veins and your heart rate is still 55 bpm.

After the margin call this is how your account will look:

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	\$8,000.00	\$8,000.00	\$0.00	\$0.00

The EUR/USD moves 25 PIPS, or less than .22% $((1.2000 - 1.1975) / 1.2000) \times 100\%$ and you LOSE \$2,000!

You blew 20% of your trading account! $((\$2,000 \text{ loss} / \$10,000 \text{ balance})) \times 100\%$

In reality, it's normal for EUR/USD to move 25 pips in a couple seconds during a major economic data release.

Oh I almost forget...I didn't even factor in the SPREAD!

To simplify the example, I didn't even factor in the spread, but I will now to make this example super realistic.

Let's say the spread for EUR/USD is 3 pips. This means that EUR/USD really only has to move 22 pips, *NOT* 25 pips before a margin call.

Imagine losing \$2,000 in 5 seconds?!

This is what happened to our popular British spy all because he didn't understand the mechanics of margin and how to use leverage.

The sad fact is...most new traders don't even open a mini account with \$10,000. Because our spy friend had at least \$10,000, he was at least able to weather 25 pips before his margin call.

If he only started off with \$9,000, he could only weather a 10 pip drop (including spread) before receiving a margin call. 10 pips!

More on Forex Leverage

Hopefully I've done my job and you now have a better understanding of what "[margin](#)" is. Now I want to take a harder look at "[leverage](#)" and show you how it regularly wipes out unsuspecting or overzealous traders.

We've all seen or heard [online forex brokers](#) advertising how they offer 200:1 leverage or 400:1 leverage. I just want to be clear that what they are really talking about is the **maximum** leverage you can trade with. Remember this leverage ratio depends on the margin required by the broker. For example, if a 1% margin is required, you have 100:1 leverage.

There is maximum leverage. And then there is your **true** leverage.

True leverage is the full amount of your position divided by the amount of money deposited in your trading account.

Huh?

Let me illustrate an example:

You deposit \$10,000 in your trading account. You buy 1 standard 100K of EUR/USD at a rate of \$1.0000. The full amount of your position is \$100,000 and your account balance is \$10,000. Your true leverage is 10:1 ($\$100,000 / \$10,000$)

Let's say you buy another standard lot of EUR/USD at the same price. The full amount of your position is now \$200,000 and your account balance is still \$10,000. Your true leverage is now 20:1 ($\$200,000 / \$10,000$)

You're feeling good so you buy three more standard lots of EUR/USD, again at the same rate. The full amount of your position is now \$500,000 and your account balance is still \$10,000. Your true leverage is now 50:1 ($\$500,000 / \$10,000$).

Assume the broker requires 1% margin. If you do the math, your account balance and equity are both be \$10,000, the Used Margin is \$5,000, and the Usable Margin is \$5,000. For one standard lot, each pip is worth \$10.

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	\$10,000.00	\$10,000.00	\$5,000.00	\$5,000.00

In order to receive a [margin call](#), price would have to move 100 pips (\$5,000 Usable Margin divided by \$50/pip).

This would mean the price of EUR/USD would have to move from 1.0000 to .9900 – a price change of 1%.

After the margin call, your account balance would be \$5,000. You lost \$5,000 or 50% and the price only moved 1%.

Now let's pretend you ordered coffee at a McDonald's drive-thru, then spilled your coffee on your lap while you were driving, and then proceeded to sue and won against McDonald's because your legs got burned and you didn't know the coffee was hot. To make a long story long, you deposit \$100,000 in your trading account instead of \$10,000.

You buy just 1 standard lot of EUR/USD – at a rate of 1.0000. The full amount of your position is \$100,000 and your account balance is \$100,000. Your true leverage is 1:1.

Here's how it looks in your trading account:

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	\$100,000.00	\$100,000.00	\$1,000.00	\$99,000.00

In this example, in order to receive a margin call, price would have to move 9,900 pips (\$99,000 Usable Margin divided by \$10/pip)

This means the price of EUR/USD would have to move from 1.0000 to .0100! This is a price change of 99% or basically 100%!

Let's say you buy 19 more standard lots, again at the same rate as the first trade. The full amount of your position is \$2,000,000 and your account balance is \$100,000. Your true leverage is 20:1.

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	\$100,000.00	\$100,000.00	\$20,000.00	\$80,000.00

In order to be “margin called”, price would have to move 400 pips (\$80,000 Usable Margin divided by (\$10/pip X 20 lots)

That means the price of EUR/USD would have to move from \$1.0000 to \$0.9600 – a price change of 4%.

If you did get margin called and your trade exited at the margin call price, this is how your account would like:

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	\$20,000.00	\$20,000.00	\$0.00	\$0.00

You would have realized an \$80,000 loss! You' would've wiped out 80% of your account and the price only moved 4%!

Do you now see the effects of leverage?!

Leverage amplifies the movement in the relative prices of a currency pair by the factor of the leverage in your account.

Here's a chart of how much your account balance changes if prices moves depending on your leverage.

Leverage	% Change in Currency	% Change in Account
100:1	1%	100%
50:1	1%	50%
33:1	1%	33%
20:1	1%	20%
10:1	1%	10%
5:1	1%	5%
3:1	1%	3%
1:1	1%	1%

Let's say you bought USD/JPY and it goes up by 1% from 120.00 to 121.20. If you trade one standard \$100K lot, here is how leverage would affect your return:

Leverage	Margin Required	Return (Gain)
100:1	\$1,000	+100%
50:1	\$2,000	+50%
33:1	\$3,300	+33%
20:1	\$5,000	+20%
10:1	\$10,000	+10%
5:1	\$20,000	+5%
3:1	\$33,000	+3%
1:1	\$100,000	+1%

Let's say you bought USD/JPY and it goes *down* by 1% from 120.00 to 118.80. If you trade one standard \$100K lot, here is how leverage would affect your return (or loss):

Leverage	Margin Required	Return (Loss)
100:1	\$1,000	-100%
50:1	\$2,000	-50%
33:1	\$3,300	-33%
20:1	\$5,000	-20%
10:1	\$10,000	-10%
5:1	\$20,000	-5%
3:1	\$33,000	-3%
1:1	\$100,000	-1%

The more leverage you use, the less “breathing room” you have for the market to move before a margin call.

You're probably thinking I'm a day trader, I don't need no stinkin' breathing room. I only use 20-30 pip stop losses.

Okay let's take a look:

Example #1

You open a mini account with \$500 which trades \$10K mini lots and only requires .5% margin.

You buy 2 lots of EUR/USD. Your true leverage is 40:1 ($\$20,000 / \500). You place a 30 pip stop loss and it gets triggered. Your loss is \$60 ($\$1/\text{pip} \times 2$ lots).

You've just lost 12% of your account ($\$60$ loss / $\$500$ account). Your account balance is now \$440.

You believe you just had a bad day. The next day, you're feeling good and want to recoup yesterday losses, so you decide to double up and you buy 4 lots of EUR/USD. Your true leverage is about 90:1 ($\$40,000 / \440). You set your usual 30 pip stop loss and your trade loses. Your loss is \$120 ($\$1/\text{pip} \times 4$ lots).

You've just lost 27% of your account ($\$120$ loss/ $\$440$ account). Your account balance is now \$320.

You believe the tide will turn so you trade again. You buy 2 lots of EUR/USD. Your true leverage is about 63:1. You set your usual 30 pip stop loss and lose once again! Your loss is \$60 ($\$1/\text{pip} \times 2$ lots).

You've just lost almost 19% of your account (\$60 loss / \$320 account). Your account balance is now \$260.

You're getting frustrated. You try to think what you're doing wrong. You think your setting your stops too tight.

The next day you buy 3 lots of EUR/USD. Your true leverage is 115:1 (\$30,000 / \$260). You loosen your stop loss to 50 pips. The trade starts going against you and it looks like you're about to get stopped out yet again!

But what happens next is even worse! You get a margin call!

Since you opened 3 lots with a \$260 account, your Used Margin was \$150 so your Usable Margin was a measly \$110. The trade went against you 37 pips and because you had 3 lots opened, you get margin called. Your position has been liquidated at market price.

The only money you have left in your account is \$150, the Used Margin that was returned to you after the margin call.

After four total trades, your trading account has gone from \$500 to \$150. A 70% loss! It won't be very long until you lose the rest.

Trade No.	Starting Account Balance	Number of Lots Used	Stop Loss Size (pips)	Trade Result	Ending Account Balance
1	\$500	2	30	-\$60	\$440
2	\$440	4	30	-\$120	\$320
3	\$320	2	30	-\$60	\$260
4	\$260	5	50	Margin Call	\$150

A four trade [losing streak](#) is not uncommon. Experienced traders have similar or even longer streaks. The reason they're successful is because they use low leverage. Most cap their leverage at 5:1 but rarely go that high and stay around 3:1.

The other reason experienced traders succeed is because their accounts are properly capitalized!

While learning [technical analysis](#), [fundamental analysis](#), building a [system](#), [trading psychology](#) is important, I believe the biggest factor on whether you succeed as a forex trader is making sure you **capitalize your account sufficiently** and **trade that capital with smart leverage**.

Your chances of becoming successful are greatly reduced below a minimum starting capital. It becomes impossible to mitigate the effects of leverage on too small an account.

Low leverage with proper capitalization allows you to realize losses that are very small which allows you to trade another day.

Example #2

Bill opens a \$5,000 account trading \$100,000 lots. He is trading with 20:1 leverage. The currency market moves on a regular basis anywhere from 70 to 200 pips in one day. In order to protect himself, he uses tight 30 pip stops. If the market goes 30 pips against him, he would be stopped out for a loss of \$300.00. He felt that was reasonable but he underestimated how volatile this market is and found himself being stopped out frequently.

After being stopped out four times, he'd had enough. He's decided to give himself a little more room, handle the swings, increases his stop to 100 pips.

Bill's leverage is not 20:1 anymore, his account is down to \$3,800 (his four losses at \$300 each) and he's still trading one \$100,000 lot. It's now over 26:1.

He decides to tighten his stops to 50 pips. He opens another trade using two lots and two hours later his 50 pip stop loss is hit and he losses \$1,000. He now has \$2,800 in his account. His leverage is over 35:1.

He tries again with two lots. This time the market goes up 10 pips. He cashes out with a \$200 profit. His account grows slightly to \$3,000.

He opens another position with two lots. The market drops 50 points and he gets out. Now he has \$2,000 left.

He thinks what the hell and opens another position. The market proceeds to drop another 100 pips and because he has \$1,000 locked up as margin deposit, he only has \$1,000 margin available, so he receives a margin call and his position is instantly liquidated.

He now has \$1,000 left which is not even enough to open a new position.

He lost \$4,000 or 80% of his account with a total of 8 trades and the market only moved 280 pips. 280 pips! The market moves 280 pips pretty darn easy.

Are you starting to see why leverage is the top killer of forex traders?

How Leverage Affects Transaction Costs

Besides amplifying your losses, [leverage](#) also has another way of killing you. It's a much slower kind of death, though, kinda like being constantly exposed to high levels of radiation. Most traders don't see it coming and by the time they notice it, they're dead.

This killer I'm talking about is the **associated transaction cost of using high leverage**.

Not only does leverage amplify your losses, it also amplifies your transaction costs as a percentage of your account.

Let's say you open a mini account with \$500. You buy five mini \$10k lots of GBP/USD which has a 5 pip spread. Your true leverage is 100:1 (\$50,000 total mini lots / \$500 account). But check this...you paid \$25 in transaction costs (($\$1/\text{pip} \times 5 \text{ pip spread} \times 5 \text{ lots}$)). That is 5% of your account! With one trade, and the market not even moving yet, you're already down 5%! If your trades lose, your account balance shrinks. As your account balance shrinks, your leverage increases. As your leverage increases, the faster your transaction costs eats away at the little money you have left. This is the slow and silent killer I'm talking about.

The higher your leverage, the higher your transaction cost as a percentage of your trading capital.

If you have a mini account, and open a trade with a 5 pip spread, which equals \$5 transaction cost, look at how the relative value of your transaction costs increases with more leverage.

Leverage	Margin Required (MR)	Cost as % MR
200:1	\$50	10%
100:1	\$100	5%
50:1	\$200	2.5%
33:1	\$330	1.5%
20:1	\$500	1%
10:1	\$1,000	.5%
5:1	\$2,000	.25%
3:1	\$3,300	.10%
1:1	\$10,000	.05%

Now you've learned how leverage can magnify your profits and losses, but also your transaction costs.

Leverage does not equal [margin](#).

Leverage is how many times you lever your whole account.

The maximum amount that you are allowed to lever is dependent on your margin requirement.

Don't Underestimate Leverage

Most beginners underestimate the potentially devastating damage [leverage](#) can wreak on their accounts. Understanding leverage enough to know when to use it and when NOT to use it is critical to your success!

Leverage is a very powerful tool but both old and new traders use it to destroy their trading capital simply because they take too lightly its destructive force or ignore it altogether. It's a pity, but the more of them the easier it is for us smart traders to make money. Sad but true.

[High leverage](#) is a favorite selling point for most [forex brokers](#). Yes they pitch that you can make a huge killing using huge leverage, but know you could easily be killed by huge leverage as well.

Brokers want you to trade with a short-term mindset. They want you to trade as much as possible as often as possible. It's the only way they make money. One or two pips are important to them. The more you trade the more they make on the spread. It's not in their best interest to tell you to let your trades run longer than the same day.

If you want to give yourself the best chance to succeed, first learn to trade profitably *without* leverage.

Play it safe. Protect your capital.

When you can make more pips more than you lose *consistently*, then, and only then, should you use unleash this weapon of mass destruction called leverage. Destroy traders (or your broker) taking the opposite side of your trade. Don't destroy yourself.

Forex trading should be treated as a job or business. Don't think that just because brokers allow you to use high leverage with a low minimum deposit that you can "make a quick <insert choice of currency here>" or "get rich quick". Approach the currency markets with respect.

Be realistic in your expectations and be willing to properly [educate](#) yourself.

If you don't, you will die.

Okay, not really, but your account will die.

Aside from “margin required”, you will probably see other “margin” terms in your trading platform. There is much confusion about what these different “margins” mean so I will try my best to define each term:

Margin required: This is an easy one because I just talked about. It is the amount of money your brokers requires from you to open a position. It is expressed in percentages.

Account margin: This is just another phrase for your trading bankroll. It’s the total amount of money you have in your trading account.

Used margin: The amount of money that your broker has “locked up” to keep your current positions open. While this money is still yours, you can’t touch it until your broker gives it back to you either when you close your current positions or when you receive a margin call.

Usable margin: This is the money in your account that is available to open new positions.

Margin call: If the equity in the account drops below your usable margin, a margin call will occur and some or all open positions will be closed by the dealing desk at the market price.