RICHARD MORRISH

"Choose wisely Dr. Jones, choose wisely."

Richard Morrish discusses the benefits of 'choosing wisely' when using leverage as a trading tool. Leverage is a double-edged sword that can create impressive gains very quickly or devastating losses in the same short time.

Walter Donovan: "We're only one step away."
Indiana Jones: "That's usually when the ground falls out from beneath your feet."

Lines taken from *"Indiana Jones and the Last Crusade"* (1989)

I doubt that Indiana Jones had much time for trading the financial markets. Those of us that do trade are driven to do so by the hope of discovering potential treasure, lured by the lustre of some financial 'Holy Grail.' Although the risks that we face in trading may not be quite as apparent as a room full of poisonous snakes or the odd Angel of Death encountered by Dr. Jones and his friends, we must be aware of the choices we make and the risk that each choice entails. We must look to "Choose Wisely."

I often lecture new entrants to the Forex market and I occasionally present the following situation to delegates.

Imagine that there are two rooms and in each room there is a pile of gold. In Room One, there are 200 gold ingots stacked to the roof, while a more modest 20 gold ingots are piled at the end of Room Two. Both piles of gold are accessible and have been won in the past. So, based on this knowledge, which room would you choose?

Naturally, the majority pick the room with the largest stack of gold because it has been achieved before and there is more of it. This is human nature and market nature of greed. So is greed bad? The easy answer to this question is 'No!' Greed is a natural part of market functionality. The expression of fear and greed is often used in financial markets and as such is a well-known and accepted part of the system. The fear element is the controlling point of greed and it is this part that does not get shown until the greed part has been applied.

Now, we return to the two rooms filled with gold. You are poised to enter Room One to get your gold but before you enter, the catch to this room over Room Two is given to you. The floors of both rooms are shrouded in darkness and each is littered with holes that drop into the abyss. In Room One, there are two hundred holes, each big enough for you to fall through into the abyss, thus ending your chances of reaching the gold bars. However, in Room Two, there are just twenty holes of similar size that stand between you and your goal. So, which room would you like to enter now? Normally, most people switch rooms at this point because the dangers of each room have been explained. The brave, the foolhardy and the experienced tend to remain steadfast in their choice of Room One. The last comment is very important because the brave will always take the risk, the foolhardy fail to see the risk and the experienced understand the risk. This is a part that we will return to later.

The two rooms represent 'leverage,' which is the key to quick returns and depth of markets. All institutions use 'leverage' whether they are banks, hedge funds or private individuals. So, what is 'leverage?' This is the amount of trading size you can apply using margin. For example in Forex trading, using 'leverage' of 200 to 1, you can take a $20 million position while having just $100,000 of trading capital. Naturally, this is a way to create large returns quickly from a relatively small capital base. It is also a major ingredient in a recipe for financial disaster for both experienced and new traders. Though the pile of gold at the end of the room is large, so is the risk.

Leverage is probably the most overlooked aspect in the financial markets. Certainly, if we look at the subprime and Bear Stearns disasters that triggered the first rumblings in the current crisis, leverage was one of the primary issues. It is possible to obtain amazing degrees of leverage in all markets, but these levels are very carefully set in recognised exchanges like the futures markets. It was an over-leveraged position in a non-transparent market that became the nightmare for Bear Stearns because with leverage, an all-important aspect is transparency in a market. In markets with limited liquidity (depth of market) and limited transparency to pricing, leverage in large amounts is very dangerous. Yet, Bear Stearns on a limited degree of leverage, managed to get themselves into vast amounts of difficulty because of this aspect to leverage.

Most leverage is set against what one would expect as normal degrees of daily pricing action. For example, the bond markets normally have a leverage rate in futures of 1.5% to 2% of value movement as a margin rate or leverage of 75 to 1 or 50 to 1. Even though these are high leverage rates, the majority of traders never take positions that would place them on 100% margin.

In the Forex market, it is common to have leverage rates of 200 to 1 in small accounts and 100 to 1 in large accounts. While it is attractive to trade with this degree of leverage, it only takes a 0.5% move in price for small accounts and a 1% move in price for the large accounts to lose everything. The current Forex markets even in the major cross rate pairs, views moves of 0.5% in a day as normal and 1% to 3% in carry trades as normal, too. Thus, the risks are exceptionally high when employing such leverage, unless the trader is exceptionally good and understands the risk involved.

The type of trading employed largely determines the application of leverage. In the Forex markets, most trading is intraday and employing high leverage to this kind of trading is not so dangerous, so long as the trader understands risk/reward. Personally, I use a 3 to 1 reward/risk ratio in all trading activities, whether it is day trading or position trading. In easy terms, my expected returns must be at least 3 times greater than the risk I am taking. Under this framework, if a trader wishes to make $6,000, he must not be expecting to lose more than $2,000. As this ratio moves lower, the trading activity becomes more like gambling. When the risk/reward ratio is down to 1 to 1, the activity is simply casino trading – red and black.

What level of leverage is most sensible? Most professional day traders tend to use a maximum leverage of 20 to 1 on intraday trading (or 5% margin) while position traders tend to use 5 to 1 or 10 to 1 leverage, depending on their aggressiveness. Most hedge funds trade on leverage between 3 to 1 and 5 to 1 with banks even lower on the

Strategic trading in FOREX and Outlook of KLCI Markets

Date : 18th October 2008 Time : 9am - 5pm Venue : Hilton Kuching, Sarawak, Malaysia

OBJECTIVES :

- Eradicate trading ignorance in financial market fallacies.
- Introduction to market entry with highlighted risk managment.
- Educate on selective local market instruments & development of individual retirement portfolio in Malaysia.
- Comprehend & control risk levels in different markets.
- Self-access on financial planning based on market overview.

APPLICATION :

- Train employees to understand Forex, money market relatively to the well being of company's financial system.
- Equip employees to become well-versed in domestic economic knowledge and wealth management.
- To control and forecast in near-future trends of Malaysia markets.

SYLLABUS :

- Overview in global FOREX markets operation on 4 major currencies.
- Fundamentals vs. price factors in market variables.
- Leveraged trading vs. foreign currency investments offered through banks.
- Strategic trading in FOREX markets with controlled risk.
- Introduction & revision of KLCI market specifications.
- Instruments selection & entry into Malaysia markets.
- 5 ways to invest in Malaysia's growth market vs. current predictions.
- Set up retirement funds & initiate individual / corporate wealth-plan.

WHO SHOULD ATTEND :

- Individuals who wish to create potential financial income from short-mid term maturity.
- Corporate personnel who wish to control investment risk vs. economic outlook.
- Traders & investors who desire to learn personal / corporate money management.

DAR Wong

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- Weekly columnist (The Borneo Post) & Writer for The Trader's Journal, Pulses magazine.

Reference:

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scale as capital preservation is critical.

Why use lower levels of leverage? The easy answer to this question is that it means when a trade goes wrong, the damage incurred is not as brutal as it is when higher leverage is employed. Conversely, profits are also smaller. However, the fact of trading is that most people win 75% of all their trades. It is the employment of high leverage that takes traders out when a trade goes wrong.

This is where we started when we looked at entering a room with either 200 or 20 all- consuming holes. With two hundred holes in the room, you are more likely to fall into the abyss than when compared to the room with twenty holes, even if you are Indiana Jones!

We explained that there are three kinds of traders that would stay at the door of Room One – the brave, the foolhardy and the experienced. The brave see the risks but are prepared to keep trying regardless of the higher risk. The foolhardy simply do not understand the risk, period. The experienced individuals have refined their skills in markets from lower levels of leverage and take the occasional foray into this room because they are more certain of the outcome and have taken precautions to protect against the downside risk.

It is in our experience, better to seek smaller rewards and build one's success, rather than gamble in a room where the chances of failure are high. This will help refine your skills over time and with a degree of safety, so that one day you may be able to brave the big risk room when you are more certain of the risk. Leverage removes more traders from financial markets on a daily basis than anything else – especially in the current market environment of high volatility in all asset classes. High leverage is a path to failure for the inexperienced trader – bear it in mind next time you are tempted to enter Room One!

Richard Morrish is Head of M I G's Research Department. He has been a trader for the last 23 years for international banks, hedge funds and himself. A regular contributor to CNBC for the last five years, Richard has also lectured on global macro hedge fund strategy and technical analysis. He has traded all asset classes from Forex to bonds to commodities. He is regarded as one of the leading technical trading proponents in the United Kingdom and one of the most accurate predictors of the markets. His charismatic style simplifies trading to its core elements, and he is a freeman and liveryman of the City of London, with 30 years experience in the City, and the LSE and LIFFE.

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