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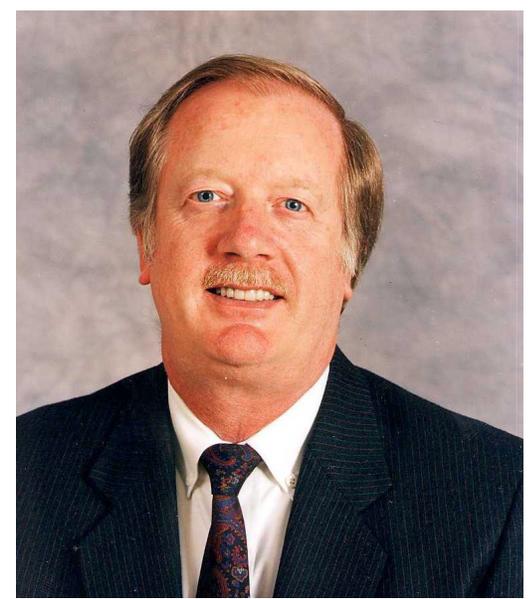
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### Expert Advice

## Understanding Leverage: It's Under Your Control As an Investor

By Lawrence G. McMillan

Lawrence McMillan is the author of *Options as a Strategic Investment*, which has sold over 160,000 copies. He currently edits and publishes The Option Strategist, a derivative products newsletter covering equity, index, and futures options. He also has a unique daily letter, Daily Volume Alert, which selects short-term stock trades by looking for unusual increases in equity option volume.



Lawrence G. McMillan

**M**ost traders realize that leverage is available through margin accounts, futures, and options, but give it little thought in terms of constructing strategies or even in terms of developing broader trading plans – i.e., business plans. In this article, we'll take a look at some of the common ways that leverage is used.

### Stocks On Margin

Let's start out by agreeing on just what leverage is. In the context of investments it is the controlling of capital to increase the rate of return (and also to increase

the risk) of the investment. As mentioned, margin is one way – probably

*“In this article, we'll take a look at some of the common ways that leverage is used...In the context of investments, leverage is the controlling of capital to increase the rate of return (and also to increase the risk) of the investment.”*

the simplest way – of using leverage. At the current time, the margin rate

is set at 50%. This rate is set by and controlled by the Fed – just as rates, such as the Fed Funds Rate, are. In theory the Fed controls three major rates: Fed Funds, reserve requirements, and the margin rate. The margin rate has been set at 50% since 1974, when it was lowered from 65%. The fact that it hasn't been changed since then would lead one to believe that the Fed no longer considers the control of margin rates to be necessary (especially since the Fed didn't raise margin rates when its own Chairman chided the investing public for "irrational exuberance").

Since the use of margin will come up later in this article, a quick example may be useful for those not familiar with buying stock on margin:

*Example:* XYZ stock is selling at \$60 per share. An investor wants to buy 300 shares, which would cost him \$18,000 in a cash transaction. On margin, the rate of 50% means that your broker can loan you (a maximum of) 50% of the cost of the stock; he will then also charge you interest on that loan, at the margin interest rates of that particular brokerage firm (currently about 9%

Future	Historic Volatility	Stock	Historic Volatility
Crude Oil	27%	Sears Hldg	31%
Soybean	27%	Broadcom	27%
Copper	22%	Phelps Dodge	34%
Cotton	19%	Amgen	19%
Gold	12%	Newmont Mining	28%
T-Bonds	8%	Walgreen	16%
Euro FX	7%	IBM	13%
S&P 500	9%	\$SPX	9%

at most brokers). So the actual investment breaks down like this, ignoring commissions:

Your investment:	\$9,000
Margin (broker's loan):	<u>9,000</u>
Total Investment	\$18,000

Leverage is generally defined as:

Total investment you control /  
Your actual investment

In this example, then, your leverage would be:

$\$18,000 / \$9,000 = 2\text{-to-}1$  (2:1)

Hence, buying stock on margin gives you leverage of 2-to-1. Among other things, this

means that your rates of return will be doubled – on both gains and losses. So, if the stock drops by 50%, you will lose 100%. Just to verify that, note that if the stock falls to 30 (from 60), the 300 shares would have lost \$9,000 – your entire investment. Brokerage firms don't mind your losing your *own* money, but they strongly object to your losing *theirs*. Hence, they will ask for more margin if the stock falls far enough, usually when their loan becomes 70% or more of the remaining worth of the stock you own (that is called *maintenance margin*).

When you *short* a stock, you

automatically do it on margin (stock cannot be shorted in a cash account), and the same leverage figures apply.

### Controlling Leverage

Before moving on to other examples of leverage, it is important to understand that *leverage is under your control as an investor*. You can control how much money you invest in a trade. For example, you could have bought that 300 shares of XYZ at 60 in your margin account, but instead of borrowing \$9,000, you could have (arbitrarily) decided to invest \$15,000 of your own money –

***“Buying stock on margin gives you leverage of 2-to-1. Among other things, this means that your rates of return will be doubled – on both gains and losses.”***

thus borrowing only \$3,000 from the broker. That would reduce the leverage ratio to 6:5 (\$18,000 / \$15,000). In fact, you could have put up the whole \$18,000 if you wanted and eliminated any leverage altogether.

Without getting into the reasons *why* you would want to do this, suffice it to say that it *can* be done. Thus, leverage is under your control.

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This will be especially important in later examples, where leverage gets much higher.

## Futures

Futures trading scares many investors. They feel it is far too risky for them. This is perhaps true to a point, but attitudes like that imply that this investor doesn't understand how leverage can be used, nor does he understand futures.

In reality, futures are generally much less volatile than stocks. In **Table 1** are some current, actual 20-day volatilities of futures and popular stocks. Note that even the most "feared" commodities, such as Crude Oil and Soybeans, aren't really all that volatile. Also note how individual stocks *related* to commodities are much more volatile than the commodity itself (Newmont/Gold and Phelps Dodge/Copper).

So what gives futures the reputation of being "scary?" Leverage,

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that's what. Futures have always been traded with very low margin requirements – 10% or lower in many cases. If you only put up 10% margin to "control" something, then your leverage is 10:1. That means, among other things, that a 10% decline in the futures price will completely wipe out your initial investment, exposing you to losses of many times your initial investment.

We'll talk more about that later, but first we'd like to present a table that shows the leverage available in various futures contracts (**Table 2**). We cite margin requirements at Man Financial, which is where we do our futures trading. Their data is avail-

**Table 2**

Futures	Contract Price	Contract Size	Contract Dollars	Margin Required	Margin %	Leverage (x:1)
S&P 500	1220	250	305000	19,688	6.5	15.5
Corn	210	50	10500	810	7.7	13.0
Soybeans	620	50	31000	2,498	8.1	12.4
T-Bonds	116.5	1000	116500	1,553	1.3	75.0
Gold	441	100	44100	1,350	3.1	32.7
Copper	169	250	42250	2,700	6.4	15.6
Coffee	99	375	37125	2,800	7.5	13.3
Crude Oil	65.7	1000	65700	7,087	10.8	9.3
Natural Gas	9.72	10000	97200	8,775	9.0	11.1
Cotton	48	500	24000	1,680	7.0	14.3
Euro FX	122.5	1250	153125	3,105	2.0	49.3
IBM Futures	82	100	8200	1,640	20.0	5.0

able at [www.manfutures.com](http://www.manfutures.com).

In Table 2, the current price and the contract size are used to determine the "Contract Dollars" – the amount of investment one would have to make if he were to pay for this contract in cash. The margin requirement is that of Man Financial, from which we can compute the "Margin %" (Margin Required divided by Contract \$'s) and then the Leverage.

Consider the first line, which details the Chicago Merc's flagship S&P 500 futures contract. The futures are trading at a price of 1220. Those futures are worth \$250 per point of movement. Hence, the contract size is then  $1220 \times 250 = \$305,000$ . So when you buy this futures contract, you "control" \$305,000 worth of that index. However, the margin requirement is only \$19,688 – or 6.5% of the actual contract size. Think of this as buying stock at 6.5% margin instead of the 50% margin that you would have to put up to buy the individual stocks in a regular margin account. A

margin percentage of only 6.5% gives you leverage of 15.5 to 1 (the last column). That's a *lot* of leverage.

Peruse the table, observing the other contracts. Note that the leverage is *huge* for T-Bonds and for the Euro. These are not volatile commodities (see Table 1), so margin requirements are extremely low – and thus leverage is very high.

Even the IBM Single Stock Futures can be bought on 20% margin, giving leverage of 5:1.

These leverage numbers in the right-hand column are what give futures their "scary" reputation. But leverage is totally within control of the investor. Suppose that you wanted to own some crude oil, and you were not comfortable simulating it by buying a package of oil stocks. You *could* by a Crude Oil futures contract and advance the entire amount (in the form of T-Bills, say) – if you had \$65,700 available to invest in that manner. Then you would have no leverage (your leverage would be 1:1). Or, if you wanted to take the same sort of risk of owning Crude Oil that you would if you owned a stock, then you'd put up \$32,850 for 50% margin (2:1 lever-

age). The point is that you can control the leverage yourself – thus making it feasible to treat these commodities as investments more on a plane with stock ownership.

**Options**

Futures are a derivative. Other derivatives – mainly options – are available for a trader to use as leverage as well. Futures trade up and down like stocks do (in fact, when describing futures to a novice, we often say they behave like

**Table 3**

IBM Price	Stock Move	Option Value	Option Move	Leverage
50	-39%	0	-100%	2.6
80	-2%	0	-100%	41.0
90	10%	10	100%	10.0
100	22%	20	300%	13.7
120	46%	40	700%	15.1

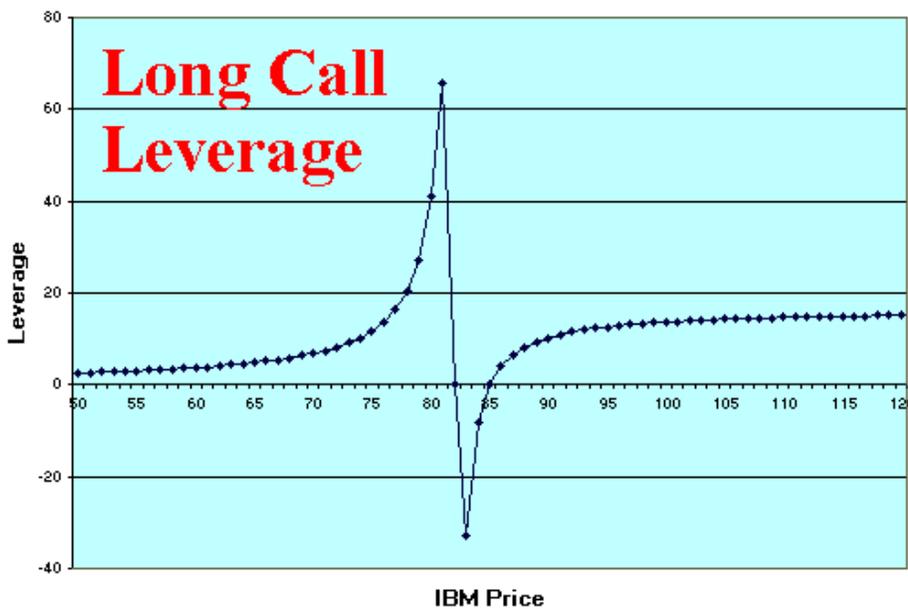


Figure 1. Graph of Leverage vs. Price for IBM Jan 80 long call options

“stocks with an expiration date” – not like options at all). Options have the unique feature of a striking price, which limits risk for holders.

It is not as easy to calculate the leverage feature for options as it is for futures or for stocks bought on margin. Consider this example:

*Example:* IBM is at \$82. You can buy the Jan 80 call for 5. What is your leverage? The answer is, “It depends on what the stock does.” **Table 3** shows the leverage is different, depending on where the stock is when you exit your trade. Thus, the leverage in a long option is not constant.

**Figure 1** shows the “Leverage” computation for all prices of IBM from 50 to 120. Regardless of how you slice it, there is plenty of leverage from owning option. At 120, for example, the option has increased by 700% while the stock is up 46%.

Other option strategies have leverage too, but when the risk is not well-defined (as in the sale of a naked option), then it is more difficult to determine. In the case of a naked call option, one would make money if the stock fell and lose money if the stock rose – hence the results are inverse to the stock movement. The initial margin requirement for a naked IBM Jan 80 call, trading at 5, would be  $30\% \times 82 + 5 = 29.6$ . While the margin requirement varies from there, for this simplistic example we’ll use that as the “investment.” With that as-

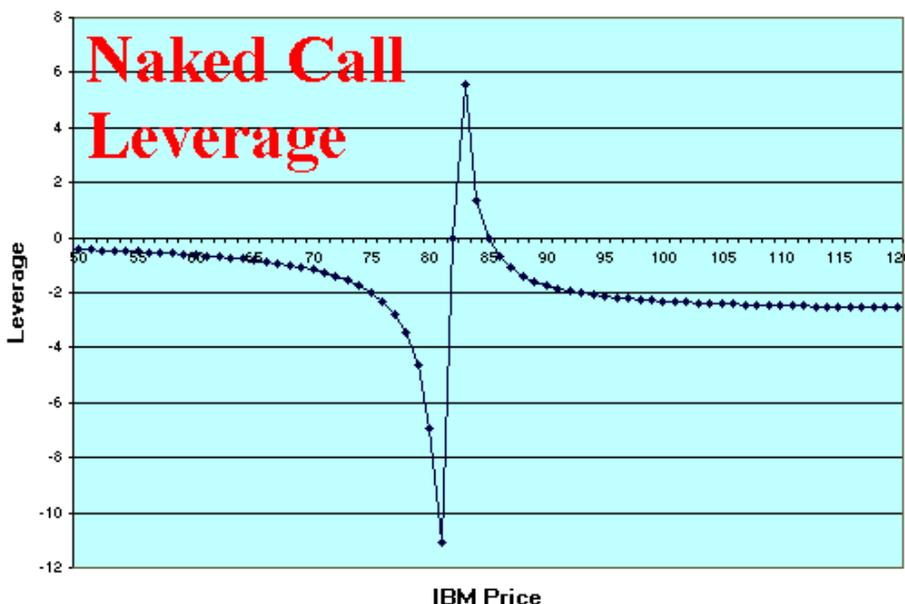


Figure 2. Graph of Leverage vs. Price for IBM Jan 80 naked call options

sumption, the leverage from selling naked options is not nearly as great as that from buying options (**Table 4**).

Ironically, the leverage is not as great as one might expect in naked options, because of the relatively large initial investment. In fact, as the stock moves higher, the investment increases, so the leverage would actually be lower than shown in **Figure 2**.

### Using Leverage in a Strategy

It is often the case – especially with options – that one can construct a strategy in more than one way.

*“Figure 1 shows the “Leverage” computation for all prices of IBM from 50 to 120...there is plenty of leverage from owning options. At 120, for example, the option has increased by 700% while the stock is up 46%.”*

For example, rather than shorting stock, one could construct a position of “long put, short call” where the options have the same terms (same expiration date and striking price). Leverage might not be the primary factor in using the synthetic short

stock position (i.e., the options), but it certainly plays a role.

Rather than requiring 50% of the stock price as initial margin for the short sale, the option position requires only roughly 30% of the stock price (for the naked put). Thus, a leverage factor of 1.67 is available. Of

course, one might be more influenced by the fact that the option strategy does not require borrowing of stock nor does it require an uptick to establish the position. Those might be more important than the leverage.

**Table 4**

IBM Price	Stock Move	Option Value	Opt Pft ÷ 29.60	Leverage
50	-39%	0	16.9%	-0.4
80	-2%	0	16.9%	-6.9
90	10%	10	-16.9%	-1.7
100	22%	20	-50.7%	-2.3
120	46%	40	-118.2%	-2.6

### Conclusion

Leverage is neither good nor bad, it just is. One should be aware of leverage, noting if it is available in the strategy he is pursuing. He should also understand that leverage can be reduced with the infusion of more capital (investment) into a position.

The Option Strategist, by Lawrence G. McMillan, is published twice monthly. The newsletter covers equity, index, and future option recommendations and strategy, as well as an educational article. [www.OptionStrategist.com](http://www.OptionStrategist.com)

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### STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

Stock	Ticker	Split	Approx. Date	Stock	Ticker	Split	Approx. Date
Denbury Resources	DNR	2:1	11/08/05	Met-Pro Corp.	MPR	4:3	11/16/05
Fastenol Co.	FAST	2:1	11/14/05	Brown & Brown Inc.	BRO	2:1	11/29/05
Barnwell Inds.	BRN	3:1	11/15/05	Hologic Inc.	HOLX	2:1	12/01/05

#### Trading Suspended:

America West Holdings (AWA), Delphi Corp. (DPH), Delta Airlines (DAL), E.piphany Inc. (EPNY), Gillette Co (G), Providian Financial (PVN), Tasty Baking Co. (TBC), U.S. Airways Group (LCC)

#### Name Changes:

Greg Manning Auctions (GMAI) to Escala Group (ESCL)  
Southern Peru Copper (PCU) to Southern Copper Corp (PCU)  
WebMD Corp (HLTH) to Emdeon Corp (HLTH)

Market Review

# Inflation Talk and Higher Interest Rates Take Their Toll on the Market

**I**t is usually a good sign when the markets take bad news well, but not such a good one when they don't. For most of last month the markets didn't take the bad news well...and with reason.

In speeches early last month some Federal Reserve governors said inflation is rising to the upper end of its "acceptable" range, and pressures are still building. Translation: interest rates will rise further, maybe even faster, than what was built into the market.

All the inflation talk and higher interest rates took a toll on the market. In the first half of October, the S&P 500 fell 4.2% and the Nasdaq Composite fell 5.3%. The market rebounded later in the month and most indexes closed down about 1.6% for the month. Interestingly, the low came during AIQ's annual Fall Seminar. That wasn't the first time that has happened!

As always, there were some winning and losing groups in the market. Oil prices fell so Transportation was the best performing sector and Energy was the worst performing. Transportation gained 5% while Energy fell 11%. Other winning sectors were Financial Services gaining 4%, Retailing up 3%, Banking up 2%, and Health Care up 2%.

The October selling was strong enough to bring the S&P 500's

## S&P 500 Changes

Changes to the S&P 500 Index and Industry Groups:

Lennar (LEN) replaces Gillette Co (G). LEN is added to the Homebuilding (HOMEBUIL) group.

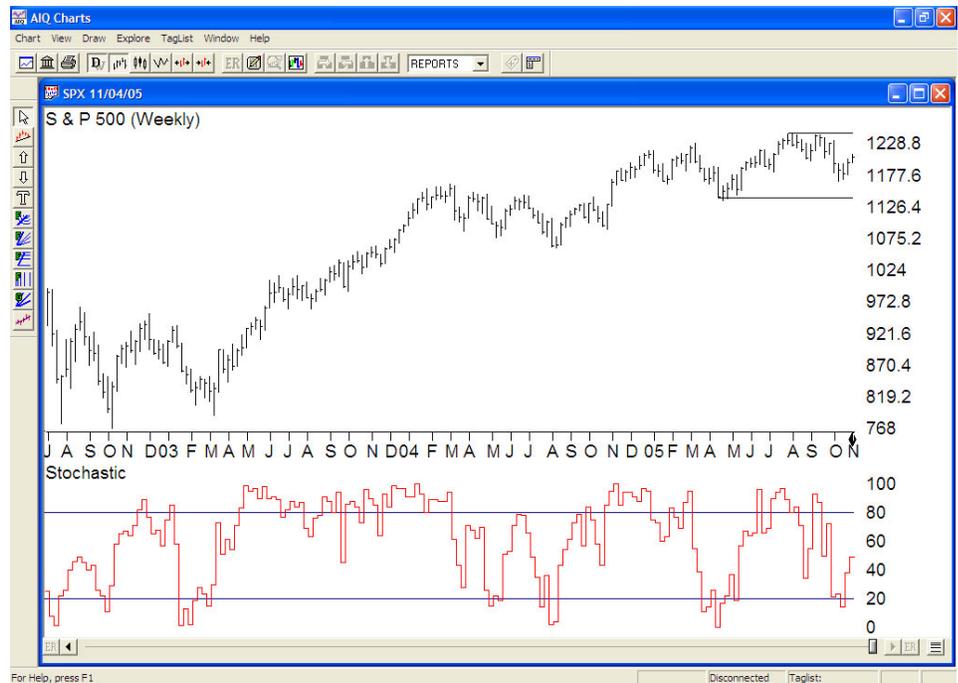


Figure 1. Weekly chart of S&P 500 index with Stochastic indicator displayed.

weekly Stochastic to an oversold reading (Figure 1). Because this is a weekly chart, this indicator often only hits oversold territory a couple times a year. It is hard to act on these signals, however, because the market never looks good when the indicator is oversold.

The Nasdaq's weekly relative strength indicator (RSMD SPX) fell in September and most of October. At month's end, this indicator was beginning to move sideways. It would be bullish if this indicator reversed direction and began to trend higher.

Volatility finally increased in October. From October 19 through

October 31, the Dow was about unchanged but there were five days where the average moved more than 100 points.

***"The October selling was strong enough to bring the S&P 500's weekly Stochastic to an oversold reading...It is hard to act on these signals, however, because the market never looks good when the indicator is oversold."***

Still, the market remains in its narrow, two-year range. Not until investors begin to anticipate either an improvement or deterioration in one or more of today's negatives (high energy prices, rising interest rates, falling confidence, slowing growth, etc.) will stocks break above or below the range.

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