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Term of the Week- Leverage

Leveraged trades involve borrowing money to place larger trades (while often highly speculative) than a party could otherwise do.

Leverage is a tool used to magnify any potential gains (provided the gains are greater than the interest cost on the borrowing), but this also magnifies any potential losses as the party is inflicted by the loss on the holding and the interest cost on the borrowing.

The use of leverage is common in derivative markets, currency markets and with some investment trusts. One of the main types of borrowers are hedge funds, partly due to the extremely small margins that hedge funds are trying to take advantage of with their complex trading strategies.

The lending party requires the borrower to keep a cash margin on hand in order to settle any daily moves in value. As the gain or loss on the trade changes, the margin needed varies as well.

This is important at the moment because we recently saw a rise in US treasury yields in response to President Donald Trump's 'Liberation Day' tariffs (usually in times of market stress treasury yields would fall, as bonds are perceived as a "safe haven" asset).

This happened in part because hedge funds, which are highly leveraged, quickly had to increase the amount of cash they held on margin with their lenders as their investment positions were experiencing large losses. To do this highly liquid US treasury securities were sold, pushing the yield up (although other factors will also explain this movement, this is in part expected to be one of the causes).

Leveraged Exchange Traded Funds (ETFs) are also commonly used to speculate on very short-term price movements (for example, the 3x Long Tesla Shares ETF, which aims to generate 3 times the daily return of Tesla). This leverage carries a high level of risk, as the following example shows.

Year to date the price of Tesla has fallen by around 26%. The leveraged ETF has fallen by 83% (3 times the daily movement). It would then take a return of 588% to regain the capital lost from this move.

In this volatile and quickly changing market environment, leverage is particularly risky as gains can quickly change to increasingly large losses and the ripple effect through the markets can result in major disruptions.

Robert Dougherty, Investment Specialist
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