

LEVERAGE AND MARGIN

This module explains leverage and gearing and compares spread bets with non-gearred investments. Additionally, there are a number of examples showing how our margin requirements work and we explore how Stops can be used to reduce margin.



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LEVERAGE AND MARGIN

If you were to buy shares, through a stockbroker or any other traditional share-dealing service, you would have to pay the full purchase price of the shares.

For example, let's say that you decide to purchase 5000 shares of Vodafone at a price of £1.79. Ignoring commission, you have to pay $5000 \times £1.79 = £8950$ in order to make the purchase – in other words, the full value of the shares.

With spread betting, this is not the case: you do not have to put up the full value of the underlying shares (or the underlying value of whichever instrument you are dealing). Instead, you typically put up only a small portion of the underlying value. This is known as the deposit or initial margin.

In the case of Vodafone, the margin required is just 5% (the initial margin is 5% for a selection of the more liquid stocks from around the world, including more than 50 UK shares. Most FTSE 100 and FTSE 250 shares require a margin of 10%, however, while less liquid or more volatile shares may have higher margin requirements).^{*} So for the same value of Vodafone shares, if you do the deal as a spread bet instead, you only need to put up $5/100 \times 8950 = £447.50$ as a deposit.

^{*}Subject to the total size of your bets on a given share being below a certain (substantial) size. We margin higher rates once the total size of your position for a given share exceeds a certain threshold. To give you an idea of the kind of sizes we are talking about, Vodafone is margined at 5% provided your bet size is less than £7250. In other words, this tiered system of margining tends to affect those dealing in very large sizes and not those dealing in small or medium sizes. More details can be found on our website.

LEVERAGE AND MARGIN

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TO REITERATE:

With the physical share deal you take ownership of 5000 shares and pay £8950.

With the spread bet you take a position of equivalent size (a bet of £50 per penny movement replicates the exposure of owning 5000 shares) and deposit £447.50.

Both deals offer you exactly the same exposure: if Vodafone goes up by 1p, each of the 5000 shares bought via the stockbroker are worth 1p more, so that the whole holding increases in value by 5000p, which equals £50. The spread bet is for £50/point (where one point = one penny), so that for the same 1p increase in the price of the share, the spread bet makes you £50.

GEARING

The spread bet is geared: it offers a greater exposure for the amount of money that you outlay. To put it another way: gearing allows you to control a much more expensive asset for a low (or zero) cost.

Gearing has the effect of magnifying profits and losses. This is best illustrated by continuing with our example to see how the profit or loss of the position, relative to the initial outlay, is affected by movements in the share price. Throughout the example, commission and spread will be ignored for simplicity's sake.

SCENARIO 1: VODAFONE GOES UP

Let's say that Vodafone rises in price, as you had hoped, and you decide to take your profit, selling at £1.84, after a net rise of 5p.

With the physical holding, you dispose of your 5000 shares, receiving £1.84 for each share that you sell. The proceeds from the sale are therefore $5000 \times 1.84 = \text{£}9200$.

The shares cost you £8950 in the first place, so that you have realised a profit of $\text{£}9200 - \text{£}8950 = \text{£}250$.

Expressed as a percentage of your initial investment this is: $250 / 8950 \times 100 = 2.8\%$. While this is a solid return, it's not particularly spectacular.

Let's compare this with the spread bet. A 5-point gain at £50/point equals £250, the same amount of profit in absolute terms as the physical purchase. When we consider this as a percentage of the amount of money that is required to place the spread bet, however, the difference is marked. The margin required is £447.50, meaning a profit of $250/447.50 \times 100 = 55.9\%$

When the profits are considered as a percentage of the outlay, the spread bet offers returns that are many times greater than the ungeared physical investment.

GEARING

CONTINUED

SCENARIO 2: THE BET MOVES AGAINST YOU

Let's say that you don't grab your profit as in the first scenario, but instead decide to hold your position. The share price gives back its gains little by little, until eventually the position moves into the red. After it has gone 3.5p against you, you decide that you have had enough and cut your losses. You sell out to close your position.

The amount of loss for both types of position is £175 (5000 shares x £0.035/share).

This represents approximately a 1.9% loss on your investment placed through the stockbroker (175/8950) but a much larger 39.1% loss of the margin placed for the spread bet. This effect, whereby losses and gains are effectively magnified relative to the amount of money that you have outlaid, is also known as leverage.

GEARING

CONTINUED

RISKS OF SPREAD BETTING

So is spread betting more risky than buying and selling shares in the conventional manner?

From a certain point of view, yes it is.

In scenario 2 above, had you been gearing up beyond your means, using all your disposable income as the margin requirement, you would undoubtedly have been taking a terrible risk.

It should be pointed out, however, that both positions in the examples above – the physical investment and the spread bet – had exactly the same exposure. The ultimate downside for both was £8950. Neither position could lose more than that amount. The spread bet simply required a smaller outlay in order to achieve that exposure. From this point of view, you could argue that the spread bet was no more risky than the conventional share trade.

If you were to compare the £50/point bet you could take for margin of £447.50 with buying £447.50 worth of shares, however, the spread bet would be more risky. In this setting there is no comparison. The spread bet is a position 20 times larger, owing to the leverage bestowed by the 5% margin requirement.

For this reason you should always make sure that you are fully aware of your total underlying exposure. With most spread bets your potential losses are not restricted to the margin you have put down.

MARGIN

Precisely because it is possible to accrue losses that exceed the amount you have deposited with us, when a position moves against you we may often have to ask you to send us more money. This is more properly known as variation margin, but is frequently simply referred to as margin.

Before we move further into discussing such issues as when and how much money needs to be sent as margin, let's first consider the case of bets that sidestep this issue.

You can only be asked for margin on positions for which your deposit does not cover the total risk. That is to say, there are certain types of bet for which there is a set limit on your risk; as long as you have deposited enough to cover that risk, it follows that you cannot be margined any further. Specifically, these are Limited Risk bets and any Up Bet on an Option (an Option is a type of derivative. We offer spread betting on a wide range of Options and you can find more information in the **Other markets** section of our website).

So, if you are only ever placing limited risk bets or buying options, each bet will require a certain margin, which is equal to the maximum loss possible on that bet. As long as you have that amount on your account, you will never be asked to send further funds, even in the worst-case scenario.

Let's look at a quick example of a limited risk bet, in order to illustrate this point.

EXAMPLE 1

MARGIN REQUIREMENTS FOR LIMITED RISK BETS

The DAX is near a recent low of 11500 and, in your opinion, the index looks like a good buy from a technical point of view. You make up your mind to take a long position, but are wary of the fact that the trend has generally been in the other direction of late, and therefore don't want to commit yourself too heavily. A limited risk bet seems like a sensible way to put a cap on the downside risk involved.

You place a £2/point buy on March Germany 30, a bet which settles on a specific date in March against the level of the DAX. You open your bet at 11506 placing your guaranteed Stop 50 points away at 11456. Your maximum risk is £100 – that's guaranteed – but there is no ceiling on your profit. This way, if the index drops 200 points you'll only lose your £100, but if it moves 200 points the other way you stand to make several times that amount.

The margin required for the bet is equal to the risk: £100. You transfer the money over using your debit card. Now – unless you move your Stop further away – you cannot be margined further, as your £100 covers everything.

Over the next few weeks, the downward trend of the markets in general – including the DAX – continues. Eventually the March Germany 30 sails through your Stop, quickly establishing new lows at 11358. Your position is closed at your Stop level and you lose the £100 that you deposited.

Even if the Germany 30 had 'gapped' (ie closed at a level above your stop then reopened at a price below it, effectively creating a gap between the two price levels), your trade would still have been closed out at the level you specified with your guaranteed Stop.

As we saw in Module 2, as well as limited risk bets which have guaranteed Stops, we also offer non-guaranteed Stops. The situation is a little bit more complicated for a position which has a non-guaranteed Stop. In short, the margin required is larger than the margin that would be required if the Stop was guaranteed. The maximum possible loss is not restricted to the margin, although you will not be asked for variation margin whilst the bet is open (obviously if you remove the Stop you may be asked to send margin). How margins work for bets with non-guaranteed Stops is looked at in more detail after the next section in this module.

INITIAL MARGIN

We have looked at the bets where you can't be asked for margin beyond your initial margin. Let's now focus on all the other types of bet, for which you put up a margin representing only a portion of the risk.

We have touched on the margin requirements for share bets, which are a set percentage (dependent on which share you are dealing) of the underlying value of the bet. Usually this percentage varies from 5% to 25%, but for very illiquid shares, or special cases such as unusually large bets, the percentage may be higher (although such incidences are extremely rare).

Shares are actually the exception to the general rule with their percentage-based margins, as most other bets are set a margin factor specific to the type of market. To work out the margin required for a particular bet, you simply multiply the margin factor by the bet size.

Margin factors are determined by the volatility of the market in question, as well as by the amounts that exchanges demand for contracts of a similar kind in the underlying markets. Daily markets tend to have smaller margin factors, as the position is likely to be held for a shorter period.

Margin factors for our bets can be found online in the Margins section of our website. You can also look up a bet's margin factor by clicking the 'information' icon on a market's chart in our dealing platform.

MARGIN EXAMPLES

You take a £5/point Up Bet on June US Tech 100 (a bet that settles on a set date in June against the price of the NASDAQ 100). The margin factor for US Tech 100 futures is 0.5%. Trading at a price of 4550, your margin requirement would be $0.005 \times £10 \times 4550 = £227.50$.

You place a £10/point Down Bet on the US 500. The margin factor for the US 500 is 0.5%. Trading at a price of 2076, your margin requirement would be $0.005 \times £10 \times 2076 = £103.80$.

You buy £10/point of December BP at a price of 438. BP is margined at 5%. The underlying value of your bet is $£10 \times 438 = £4380$. You must deposit 5% of £4380, which is £219.

MARGIN

With margined products, for example if you were trading futures contracts on an exchange, you would be margined (i.e. asked to send further funds) as soon as a position moved against you. We follow a similar method.

Because the margin required for a bet represents only a portion of the total risk of that bet, it is important for you to provide additional funds swiftly in the event of your positions moving against you (if you do not have surplus funds on your account that cover the adverse movement).

Should further funds be required, we will endeavour to contact you by email.

In order to protect your equity, should your positions move against you by a significant portion of the funds in your account, we may automatically close out some or all of your positions.

MARGIN

CONTINUED

LET'S LOOK AT AN EXAMPLE:

Above we said that buying £10/point on December BP at a price of 438 would require a margin of £219.

Let's say you have £600 deposited on your account. This covers the margin requirement and leaves you with a surplus of £381.

If BP drops to 414 your running loss is $438 - 414 = 24$ points.

At £10/point this means you are running a loss of £240.

You are monitoring the position online and decide to top up your account with the running losses. You instruct us to take £240 from your debit card and we transfer the full running loss of £240.

As the underlying value of your position has decreased, your margin requirement has also decreased.

The underlying value is now $414 \times 10 = £4140$. The margin required is therefore 5% of £4140 which is £207.

This means your account stands as follows:

Balance:	£840
Margin requirement:	-£207
Running loss:	-£240
Surplus:	£393

If BP suddenly drops significantly, so that your account is running a loss that accounts for a substantial proportion of your cash balance, we may automatically close your positions.

VARIATION MARGIN

We may contact you by email to request margin, but responsibility for ensuring your account is adequately funded ultimately lies with you.

You can monitor the state of your account, (including your cash balance, margin requirement and running losses) in real time using our dealing platform.

If you do not fund your account sufficiently, we reserve the right to scale back or close your positions as appropriate to market circumstances (the above is a general guide aimed at giving you a feel for our margining process. For a definitive, legal account of our margining process, please see our Customer Agreement).

It is in your interest as it keeps you aware that a position is moving against you and that you are dealing on a geared basis – in short, you are less likely to let a position become a runaway loss if you are being asked to put up the funds for it.

It is also in your interest for us to behave in a responsible manner in obtaining margin with the same approach from our other clients. You could be dealing with the most reliable counterparty in the world, but if markets have trended strongly in one direction and your counterparty is not collecting margin from clients who have losing positions, you should be worried: somewhere along the line something will have to give. This is why all exchanges operate with reasonably tight, sensible margining policies.

It is in our interest to make sure that clients are dealing within their means – the last thing we want is for someone to get themselves into a losing position that they cannot afford.

If you have paid us margin, and the position moves back in your favour, you are, of course, entitled to take back any surplus funds on the account.

MARGIN REQUIREMENTS WHEN USING NON-GUARANTEED STOPS

We have established that when using guaranteed Stops (ie in limited risk bets), the margin requirement is the total risk – which is always the bet size multiplied by how many points the Stop has been placed from the opening level of the bet.

Bet size multiplied by Stop distance is also a component of the margin requirement for positions with non-guaranteed Stops. This component is called the 'risk margin'.

We also found that the margin if you take a position without a Stop is equal to the bet size multiplied by the margin factor (typically represented as a percentage of the underlying value of the position).

Because non-guaranteed Stops may be subject to slippage and market gaps, the margin requirement for a position with such a Stop requires more margin than just the risk margin. The extra amount is a percentage of the margin that the position would have required if it did not have any Stop at all. This component is called the 'slippage margin'.

MARGIN REQUIREMENTS WHEN USING NON-GUARANTEED STOPS

CONTINUED

So, for positions with non-guaranteed Stops:

Margin requirement = risk margin + slippage margin

where:

Risk margin = bet size x Stop distance

Slippage margin = slippage factor x bet size x
margin factor x price

The slippage factor is a percentage and is set at 30% for most shares and can be up to 50% for other markets. You can look up the slippage factor in our dealing platform by clicking on the 'information' icon on a market's chart.

MARGIN REQUIREMENTS WHEN USING NON-GUARANTEED STOPS

CONTINUED

EXAMPLE

Let's look at placing a bet on the price of Spot US dollar versus Canadian dollar (USD/CAD) and how placing a non-guaranteed Stop on the position can reduce the margin.

You sell £2/point of Spot USD/CAD at a rate of 12850. The margin factor for Spot USD/CAD is 0.5%. The margin is therefore $0.005 \times 12850 \times £2 = £128.50$.

You then place a non-guaranteed Stop 20 points away.

The risk margin = bet size x Stop distance
= $£2 \times 20 = £40$

The slippage factor for USD/CAD is 50%

Slippage margin = slippage factor x bet size x margin factor
x price
= $50/100 \times £2 \times 0.005 \times 12850 = £64.25$

Total margin = risk margin + slippage margin
= $£40 + £64.25 = £104.25$
= $£104.25$

So by placing the non-guaranteed Stop 20 points away you have reduced the margin from £128.50 to £104.25.

SUMMARY

By now you should:

- Know what is meant by 'gearing' and 'leverage'
- Be able to work out what the underlying exposure is for a given bet
- Understand how our margin requirements are calculated
- Be familiar with the term 'margin'
- Have a feel for how Stops can be used to reduce margin requirements

Spread bets and CFDs are leveraged products. Spread betting and CFD trading may not be suitable for everyone and can result in losses that exceed your deposits, so please ensure that you fully understand the risks involved.

Please note that although the material contained within our introduction programme is updated regularly to ensure accuracy, the information given is subject to change, often without notice, and therefore may not reflect our most current offering. Our examples are for illustrative purposes only and do not reflect events in the markets. The information is for guidance only and we accept no liability for its accuracy or otherwise.

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