LEVERAGE, PROFIT AND LOSS AND FOREX SPREAD EXPLAINED

What is a Lot in Forex?

A lot is actually a very simple concept. It is a 'bundle' of units within your trade. In other words, it's the size of the trade you are making. The simplest way to picture this is through the example of beer. Beer will typically be bought in a six-pack. Now, you can purchase as many of those six-packs as you want, but you can't split the pack. That's how lots work, only for Forex trading, the 'six pack' is the bundle of currency allotted to the trade.

Typically, the smallest lot you can trade is the 'micro lot', which represents 1000 units of currency. Nano lots of 100 do exist, but are not typical. Then there is Mini lots at 10 000 and the standard lot of 100 000. You can then trade any size you want, as long as it is a multiple of the relevant chosen lot size. This is where a lot [no pun intended] of the art of Forex trading comes in. Of course, the more lots you have, the more potential for winning you have, and the more gains will reflect positively in your favor, but it does increase risk too. This means that a lot of getting the 'right' trade size will come down to how you balance your lots to best increase gains while minimizing unacceptable risks. This will come down to the risk you find acceptable, calculated as a percentage, the pip costs and the stop point you set.

LOT	NUMBER OF UNITS
Standard	100,000
Mini	10,000
Micro	1,000
Nano	100

As you may already know, the change in currency value relative to another is measured in **"pips,"** which is a very, very small percentage of a unit of currency's value.

To take advantage of this minute change in value, you need to trade large amounts of a particular currency in order to see any significant profit or loss.

Let's assume we will be using a 100,000 unit (standard) lot size. We will now calculate some examples to see how it affects the pip value.

1. USD/JPY at an exchange rate of 119.80: (.01 / 119.80) x 100,000 = $8.34 per pip

2. USD/CHF at an exchange rate of 1.4555: (.0001 / 1.4555) x 100,000 = $6.87 per pip

In cases where the U.S. dollar is not quoted first, the formula is slightly different.

1. EUR/USD at an exchange rate of 1.1930: (.0001 / 1.1930) X 100,000 = 8.38 x 1.1930 = $9.99734 rounded up will be $10 per pip

2. GBP/USD at an exchange rate of 1.8040: (.0001 / 1.8040) x 100,000 = 5.54 x 1.8040 = 9.99416 rounded up will be $10 per pip.

As the market moves, so will the pip value, depending on what currency you are currently trading.

What is leverage?

Traders use leverage to get bigger returns from small investments. They only provide part of the capital needed to open a position, but this cash deposit is then magnified – or 'leveraged' – so the profit or loss is based on the total value of the position. If all goes well, the final return could be much greater than your initial cash stake. But if it all goes wrong, then so could your losses.

People often talk about leverage as a way of gaining a large exposure to a market with a small outlay. It's built into some financial products such as options and other derivatives, and Contracts for Difference (CFDs) are well-suited to leveraged trading.

A separate definition of leverage refers to the size of a company's debts compared with its equity. If a company, a property or an investment is described as 'highly leveraged', it means that item or entity has more debt than equity.

Lots of talk about 'what is leverage' comes in the context of discussions about the 2007-09 financial crisis, where leverage was a big issue. It got a bad name when it became closely associated with risky behavior that helped cause the crash, but its reputation has since recovered somewhat.

For example, if the allowed leverage is 100:1 (or 1% of position required), and you wanted to trade a position worth $100,000, but you only have $5,000 in your account.

Your broker would set aside $1,000 as down payment, or the "margin," and let you "borrow" the rest. Of course, any losses or gains will be deducted or added to the remaining cash balance in your account.

The minimum security (margin) for each lot will vary from broker to broker.

In the example above, the broker required a one percent margin. This means that for every $100,000 traded, the broker wants $1,000 as a deposit on the position.

How do I calculate profit and loss?

Now that you know how forex is traded, it's time to learn how to calculate your profits and losses. When you close out a trade, take the price (exchange rate) when selling the base currency and subtract the price when buying the base currency, then multiply the difference by the transaction size. That will give you your profit or loss.

Price (exchange rate) when selling the base currency – price when buying the base currency X transaction size = profit or loss

Let's look at an example

Assume you buy Euros at $1.2178 per Euro and sell Euros at $1.2188 per Euro. The transaction size is 100,000 Euros. To calculate your profit or loss, you take the selling price of $1.2188, subtract the buying price of $1.2178 and multiply the difference by the transaction size of 100,000.

($1.2188 – 1.2178) X 100,000 = $100

In this example, you would have a $100 profit from this transaction.

Let's try it again using a different currency

Assume you buy British pounds at $1.8384 and sell them at $1.8389. The transaction size is 10,000. What is your profit or loss?

When you think you know the answer, advance to the next screen.

By following the formula we discussed earlier, you should be able to determine that you would see a $5.00 gain from this transaction.

($1.8389 – $1.8384) X 10,000 = $5.00

Now you try it.

If you sell 100,000 Euros at $1.2170 per Euro and buy 100,000 Euros at 1.2180 per Euro, would you have a profit or loss on the transaction and how much would it be?

Take the selling price of $1.2170 and subtract the buying price of $1.2180 and then multiply the difference by 100,000.

($1.2170 – $1.2180) X 100,000 = –$100

If you calculated a loss of $100, you calculated correctly.

You can also calculate your unrealized profits and losses on open positions. Just substitute the current bid or ask rate for the action you will take when closing out the position. For example, if you bought 100,000 Euros at 1.2178 and the current bid rate is 1.2173, you have an unrealized loss of $50: ($1.2173 – $1.2178) X 100,000 = –$50

Similarly, if you sold 100,000 Euros at 1.2170 and the current ask rate is 1.2165, you have an unrealized profit of $50: ($1.2170 – $1.2165) X 100,000 = $50

If the quote currency is not in US dollars, you will have to convert the profit or loss to US dollars at the dealer's rate.

Let's look at an example using a USD/JPY spread. If you lost 50,000 Japanese yen on the transaction and the dealer's rate is $.0091 for each yen, what is your loss in dollars? By multiplying the transaction size (50,000) by the dealer's rate ($.0091), you will find that your loss is $455.

50,000 X $.0091 = $455

Let's take other examples using different instruments

You hold a position on FT100 index 1 Lot long. Price was opened at 7357.200 and you carried his trade to the next day and got charged overnight fee of $1.3. The trade finally closed at 7367.300

If we take into consideration that FT100 its British index and let's say your account currency is USD, we must convert its price to USD by multiplying the closing spot rate where the trade closed.

Therefore, unrealized profit: ((7367.200 – 7357.300) *(1*1)) *1.30400) = (1000pip * 0.01) – 1.3 – 5.44 → 13.04 – 1.3 = $11.74

You hold a position on USOIL index 1 Lot long. Price was opened at 51.050 and you carried the trade to the next day and got charged overnight fee of $10.3. The trade finally closed at 52.050.

Therefore, unrealized profit: ((52.050 – 51.050) *(1*1) → (200pip * 10) – 10.3 → $1989.7

You hold a position on BTC/USD 1 Lot long. Price was opened at 9599.200 and you carried the trade to the next day and got charged overnight fee of $2.3. The trade finally closed at 9593.200.

Therefore, unrealized profit: ((9599.200 – 9589.200) *(1*1) → (1000pip * 1) – 2.3 - → $7.7

Remember that you must also subtract any dealer commissions or other fees from your profits or add them to your losses to determine your true profits and losses. Also, remember that the dealer makes

money from the spread. If you immediately liquidate your position using the same spread, you will automatically lose money.

Bid-Ask Spread

Bid-Ask Spread is typically the difference between ask (offer/sell) price and bid (purchase/buy) price of a security. Ask price is the value point at which the seller is ready to sell and bid price is the point at which a buyer is ready to buy. When the two value points match in a marketplace, i.e. when a buyer and a seller agree to the prices being offered by each other, a trade takes place. These prices are determined by two market forces -- demand and supply, and the gap between these two forces defines the spread between buy-sell prices. The larger the gap, the greater the spread! Bid-Ask Spread can be expressed in absolute as well as percentage terms. When the market is highly liquid, spread values can be very small, but when the market is illiquid or less liquid, they can be large.

Let's assume you are watching Company XYZ's stock. If the bid price is $50 and the ask price is $51.50, then the *bid-ask spread* is $1.50. Typically, a trader or specialist on the floor of the New York Stock Exchange would quote the bid-ask spread as follows: 50-51-1/2 100x50 100,000

The last number (100,000) denotes the number of Company XYZ shares traded since the market opened. Note that online trading systems might refer to the bid-ask spread as "BxA." There may be several bid prices and several ask prices for a security at any point in time. However, only the best bid (that is, the highest price offered for a security) and the best ask (that is, the lowest price asked for a security) are used to calculate the bid-ask spread. Note that the number of shares wanted and the number of shares offered for sale may be different. This means that an investor may only be able to purchase 5,000 of a desired 10,000 XYZ Company shares at $51.50 if there are only 5,000 shares for sale at that price.