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Manage leverage to be a better speculator

I consider myself more of a speculator than a trader.

A speculator is defined as a market participant who attempts to gain from anticipated changes in the prices of financial instruments, so he works at deriving quick profits from short-term asset acquisition.

For many, speculation and trading may well mean the same thing. There is indeed only a thin line separating the two. Both may, at times, employ some level of leverage to magnify the gain on their positions. The difference lies mainly on the expected time frame of holding a position. A trader, as the name suggests, may trade more frequently, while a speculator may hold on to his position for a longer period.
It is conceivable that the expected holding period of an investment may influence the level of leverage deployed, as the fluctuation of an asset class is definitely less in a day compared to say, a month. We seldom find a market index gaining or losing more than 2% a day, while it may be common for said index to rise or fall more than 5% in a single month.

Trading is not in my blood, simply because most of my investment decisions are based on logic. The classic trader mantra, on the other hand, is “sell first, ask later”. This means if your investment breaks a price barrier which you had set based on certain systematic technical indicators, you react first by squaring your position or adding on to your position before asking any questions. The reason for the move is not so important to a trader as long as the trend is supported by solid volume.

Trading is also a full-time job, whereas you can dabble in speculation on an "as-and-when" basis. Your personal financial circumstances would also affect your effectiveness as a speculator. I believe that my relatively stable and well-paying job, as well as having a considerable pile of cash reserves, has allowed me to perform better when speculating. This is because I can sleep well at night, knowing that I can afford to lose all of my speculative capital without affecting my family’s lifestyle.

If you plan to become a speculator, you must first be willing to risk wiping out all of your speculative capital. Therefore the decisions you make when it seems likely that the trends that you are betting against will continue unabated and threaten to wipe out your entire capital, will usually determine your success as a speculator.

To enable you to make the “right” decision during these moments of extreme anguish, when, for example, 30 percent of your speculative capital has been wiped out so far, managing your pre-determined leverage level at the outset of your taking on a position is of utmost importance. After all, leverage is a double-edged sword.

Now, I have strong opinions regarding various investment themes. However, deciding on the leverage level to engage any of the themes is usually the first and most important decision that I need to make, before I start doing anything. Why is it so important to manage your leverage? Because excessive leverage may wipe you out early even if your original assessment of the market eventually comes true. In short, the often extreme volatility of the markets is why I am strongly against excessive leveraging.

For example, let us assume that immediately after the Lehman Brothers collapse, the Straits Times Index (STI) had plunged to 1,800 points, and you decided to catch the rebound by engaging a five times leverage to go long on SIMSCI futures (which track the STI quite closely). You would have been wiped out a couple of months down the road when the STI dropped to around 1,400 points. However, if you had decided to employ just three times leverage, you would have made a whopping 160% return one year later when the STI rebounded to around 2,800 points.

When the market assessment and outlook are the same, whether you end up being been totally wiped out or making a killing essentially depends on the initial leverage decision you make. This is the point I want to make about being overexposed to an asset class or a market sector with high leverage. The narrower the sector that you are betting on, the more dangerous leverage will be.

It may be all right for you to use a three times leverage on the STI. However, using it on a specific stock would be a very different story. At times, I may consider shorting an index like the S&P or NASDAQ or STI with a two or three times leverage. However, shorting individual stocks is a “no no” for me as the risk is simply too high, even without any leverage. The reason is that it is much easier for predatory players to manipulate a particular stock price, rather than the entire market.

And the size of the market matters as well. It is definitely easier to move the STI in a particular direction rather than the S&P for example, which is over 20 times bigger.

For the average speculator like myself, I usually prefer some diversification with low leverage. This is because I have seen investors (including myself) time and again being right about the future performance of an asset class, but failing to convert this view into any capital gain because of poor leverage management.

Leverage is indeed a dangerous beast. It cannot make a bad investment good, but it can definitely turn a good investment bad. Worse, it will limit your staying power, and transform a temporary whipsaw into a permanent capital impairment. So when you wish to speculate, always make sure you do so with the appropriate level of leverage.