



Lesson 2 Pips, Lots, Leverage & Margins

The forex world is filled with its own unique terms and concepts. Here are some of the most common you need to know:

Pips

A *pip* is similar to a tick or point in stocks, futures, or other markets. It stands for *percentage interest point* and is the smallest individual unit of trading in forex. The pip is always the right-most digit of any forex price quote.



Exactly how much an individual pip is worth depends upon the currency being traded. The Euro is measured out to four decimal places, thus each pip is equals 1/100th of a cent. The Yen, on the other hand, is measured out to two decimal places, thus one pip is one cent. That's not to say that each pip is worth 1/100th of a cent in profit – to calculate this, we need to introduce two other terms, *lots* and *leverage*.

Euro Yen

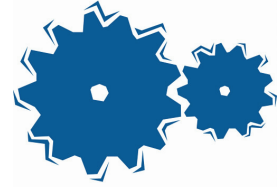
Lots



Banks and other liquidity providers trade currency in lots. A *standard lot* is 100,000 (100K) units of the currency being traded, while a *mini lot* is 10,000 (10K). Since those amounts would make trading prohibitive for the average trader, brokers introduced a concept called *leverage*.

Leverage

Leverage allows you to control more currency in a trade than you have deposited in your account. This is where the real power of forex trading lies, but one needs to be careful as leverage is also very much a double-edged sword. It can work against you just as easily as it works for you.



With 100:1 leverage, you need 1 unit of currency to control 100 units in the market. Thus, it would only take 100 units to control 1 mini lot (10K) in the market, or 1000 units to control 1 standard lot (100K). With 200:1 leverage, you would need 50 units to control 1 mini lot, and 500 units to control 1 standard lot.

Profit, therefore, is a factor of your leverage \times the amount and size of lots being traded \times the amount of pips price moves in your favor. Loss, likewise, is calculated in the same way when price moves against you.

In the simplest example, if you buy 1 mini lot of the EUR/USD currency pair (see lesson 1 for an explanation of pairs), your account equity would increase or decrease by \$1 for each pip of movement. If you buy 1 standard lot, then your account would increase or decrease \$10 with each pip of price movement.

It is a good idea to spend some time trading on a demo account and experiment with different lot sizes on different currency pairs in order to get an idea of the movements and their resulting gain or loss on your account balance.

Trading on Margin

The *margin* is the amount of collateral required to maintain your open positions. Unlike stocks and commodities, there are no margin calls in forex (when a broker requires you to deposit additional funds in order to cover losses on open positions if there are sudden and unexpected price movements) – this can be both good and bad.

On one hand, your account is protected from losing more than you originally deposited, as all open positions will be automatically closed if your account falls below the required margin requirements. On the other hand, all open positions will be automatically closed if your account falls below the required margin requirements.

Therefore, it is always a good idea to keep track of how much margin is required to maintain each open position, as well as the sum total margin required by all currently open positions. Luckily, your trading software tracks these amounts for you automatically.

In the above example, if you buy 1 mini lot of the EUR/USD pair for 1.50 at 100:1 leverage, then you will need \$150 of your account in margin to maintain that open position. If price moves against you by 1 pip, you will need \$151. And if price moves against you by 10 pips, you will need \$160.

If, on the other hand, you buy 1 standard lot of the EUR/USD pair for 1.50 at 100:1 leverage, then you will need \$1500 of your account in margin to maintain that open position. If price moves against you by 1 pip, then you will need \$1510. And if price moves against you by 10 pips, you will need \$1600.

As with calculating profit, it is a good idea to try out different amounts on different currency pairs in a demo setting first in order to get a feeling for how margin moves with price, and how it can affect the open and available balances of your account.