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Leverage, Volatility, and Market Discipline

Recent developments in South Korea have revived an important lesson for investors: leverage can enhance returns, but it can just as easily magnify losses, erode flexibility, and turn a sound investment idea into a survival risk. The episode involving single-stock leveraged products is not just a Korean story; it is a reminder that in investing, conviction alone is not enough. The structure through which a view is expressed matters just as much as the view itself. This discussion examines how leverage changes portfolio mathematics, why risk tolerance should not be confused with risk capacity, and why disciplined investors must treat leverage as a structural risk rather than a simple return-enhancement tool.

Over the past several months, market developments in South Korea have offered investors a timely reminder that leverage is not merely a tool for enhancing returns; it is also a mechanism that can alter the conditions of survival. The recent rise of single-stock leveraged products in the Korean market, followed by regulatory intervention, underscores a broader and enduring principle in portfolio management: an investment thesis and an investment structure are not interchangeable.

What this episode illustrates is not unique to Korea.

Across markets, investors repeatedly discover that being right on direction is not enough if the financing structure is fragile. Leverage may improve outcomes in favourable conditions, but it also compresses the margin for error. In that sense, leverage should be understood less as a return-enhancement technique and more as a balance-sheet commitment with nonlinear consequences.

A useful analogy is that leverage resembles fire: in controlled form, it can be highly productive; in excess, it can become destructive. The issue is not whether fire has utility. The issue is whether it is contained.

The Korean leveraged-product episode: a cautionary case study

The recent experience in South Korea is especially instructive because it demonstrates how leverage can be embedded in a product that appears, on the surface, to be accessible and familiar.

A leveraged ETF trades like a conventional ETF, but the mechanics beneath the surface are materially different. Many such products aim to deliver a multiple of the **daily** return of the underlying asset. That daily reset is critical.

Consider a stylised example.

Suppose an index and a 2x leveraged ETF both begin at 100. If the index rises 10% to 110, the ETF rises 20% to 120. If the next day the index falls 10%, it declines to 99, while the ETF falls 20%, to 96. If the same pattern is repeated again, the index ends near 98.01, while the leveraged ETF falls to approximately 92.16.

The index has fallen by less than 2% over the period, but the leveraged product has lost almost 8%. The gap is not due to error in the product; it is a consequence of **volatility decay** and the compounding effects of daily rebalancing.

Chart 1: How the portfolios move (four consecutive days)

Source: Indosuez Wealth Management.

This is why single-stock leveraged products deserve particular caution. A single stock combines leverage with concentrated idiosyncratic risk. Earnings surprises, regulatory developments, geopolitical shocks, and shifts in market sentiment can all produce sharp overnight moves. In a highly leveraged structure, these moves can rapidly become solvency events.

The Korean case ultimately prompted regulatory tightening. The broader lesson, however, is more enduring: **regulatory approval does not imply economic safety**. Investors should understand not only the intended exposure, but also the mechanics of rebalancing, financing, derivative usage, tracking error, liquidity, and spread behaviour.

Leverage changes the mathematics of loss

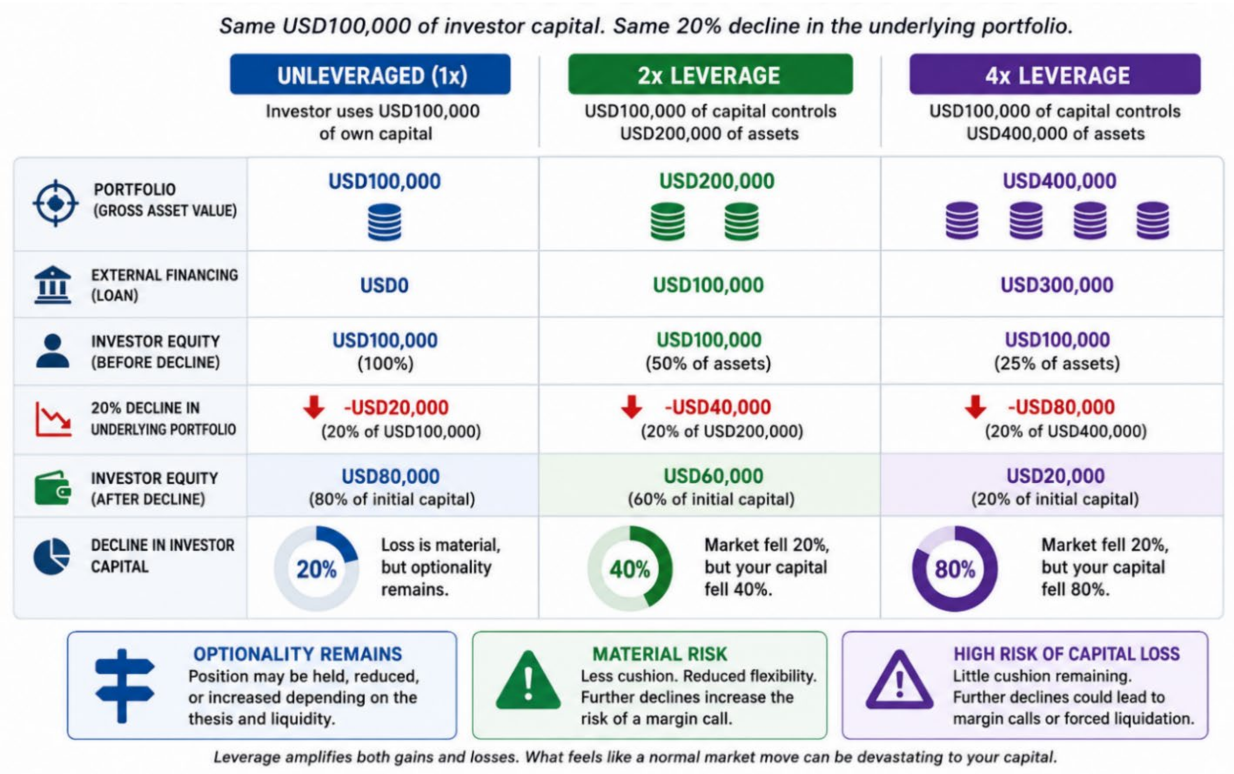
To understand the mechanics, consider an investor with USD 100,000 of capital.

In an unleveraged portfolio, a 20% decline reduces capital to USD 80,000. The loss is material, but the investor retains optionality. Painful, but manageable. The investor retains flexibility to hold, rebalance, or wait for a recovery.

Under 2x leverage, the same USD 100,000 controls USD 200,000 of assets, with USD 100,000 financed externally. A 20% decline in the underlying portfolio now generates a USD 40,000 loss, reducing equity to USD 60,000. The market has fallen 20%, but the investor's own capital has fallen 40%.

At 4x leverage, the consequences are more severe. A 20% decline in the underlying portfolio results in an USD 80,000 loss, leaving only USD 20,000 of equity. A relatively ordinary market correction has therefore destroyed 80% of the investor's capital.

Chart 2: The impact of a 20% decline under different leverage levels



Source: Indosuez Wealth Management.

This simplified framework omits financing costs, transaction fees, and, crucially, changes in margin requirements. That omission matters in real life.

Leverage introduces path dependency: as asset values decline, collateral weakens; as collateral weakens, lenders may require additional margin; and if additional collateral cannot be posted in time, positions may be liquidated.

In practical terms, the sequence is straightforward:

Leverage → amplified losses → declining collateral → margin call → forced liquidation

The principal danger, therefore, is not simply that leverage magnifies losses. It is that leverage can eliminate the investor's ability to remain invested long enough to be right.

Risk tolerance and risk capacity are not the same

One of the most persistent misunderstandings in investing is the conflation of risk tolerance with risk capacity.

Risk tolerance refers to an investor's willingness to endure volatility. Risk capacity refers to the investor's actual ability to absorb loss without impairing financial objectives or liquidity needs.

The distinction is essential. Risk tolerance is behavioural. Risk capacity is financial.

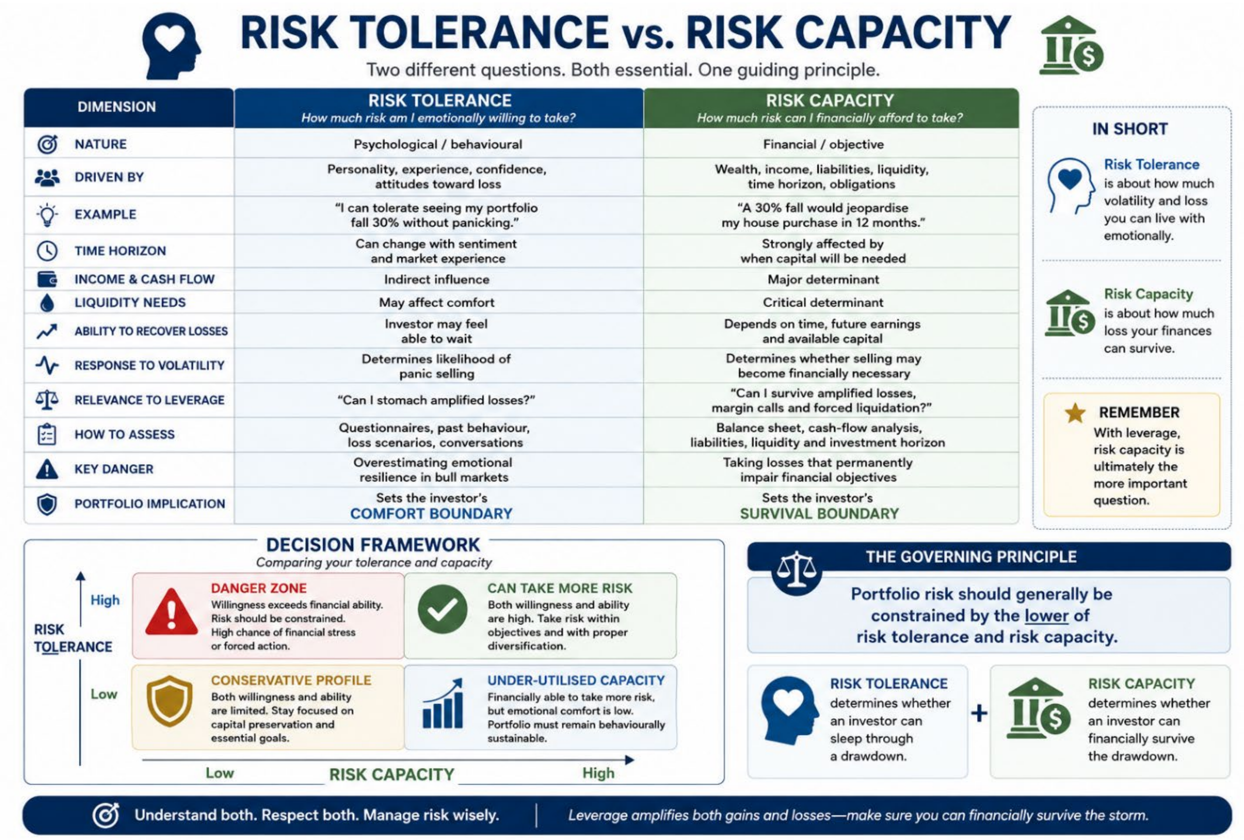
An investor may be psychologically prepared for volatility while remaining financially unable to withstand a large drawdown, a margin call, or an adverse liquidity event.

Before employing leverage, investors should be able to answer a small number of questions with clarity:

1. Can I afford to lose the full amount committed without compromising essential financial goals?
2. Do I understand the maximum plausible loss, not merely the expected return?
3. Could I meet a margin call immediately, without resorting to forced asset sales or additional borrowing?
4. What would happen to my wealth if the underlying position fell 20%, 30%, or 50%?
5. Do I fully understand the structure, including financing costs, reset mechanics, margin rules, and liquidation provisions?

If the answer to any of these questions is uncertain, leverage is unlikely to be appropriate.

Chart 3: Risk tolerance vs. Risk capacity



Source: Indosuez Wealth Management.

Leverage should be assessed in the context of volatility and position size

Another common error is to focus narrowly on the leverage multiple itself. A position levered 2x is not inherently comparable to another 2x position. The relevant question is not merely how much leverage is used, but **what is being levered, how volatile the underlying asset is, and how large the position is relative to the investor's total wealth**.

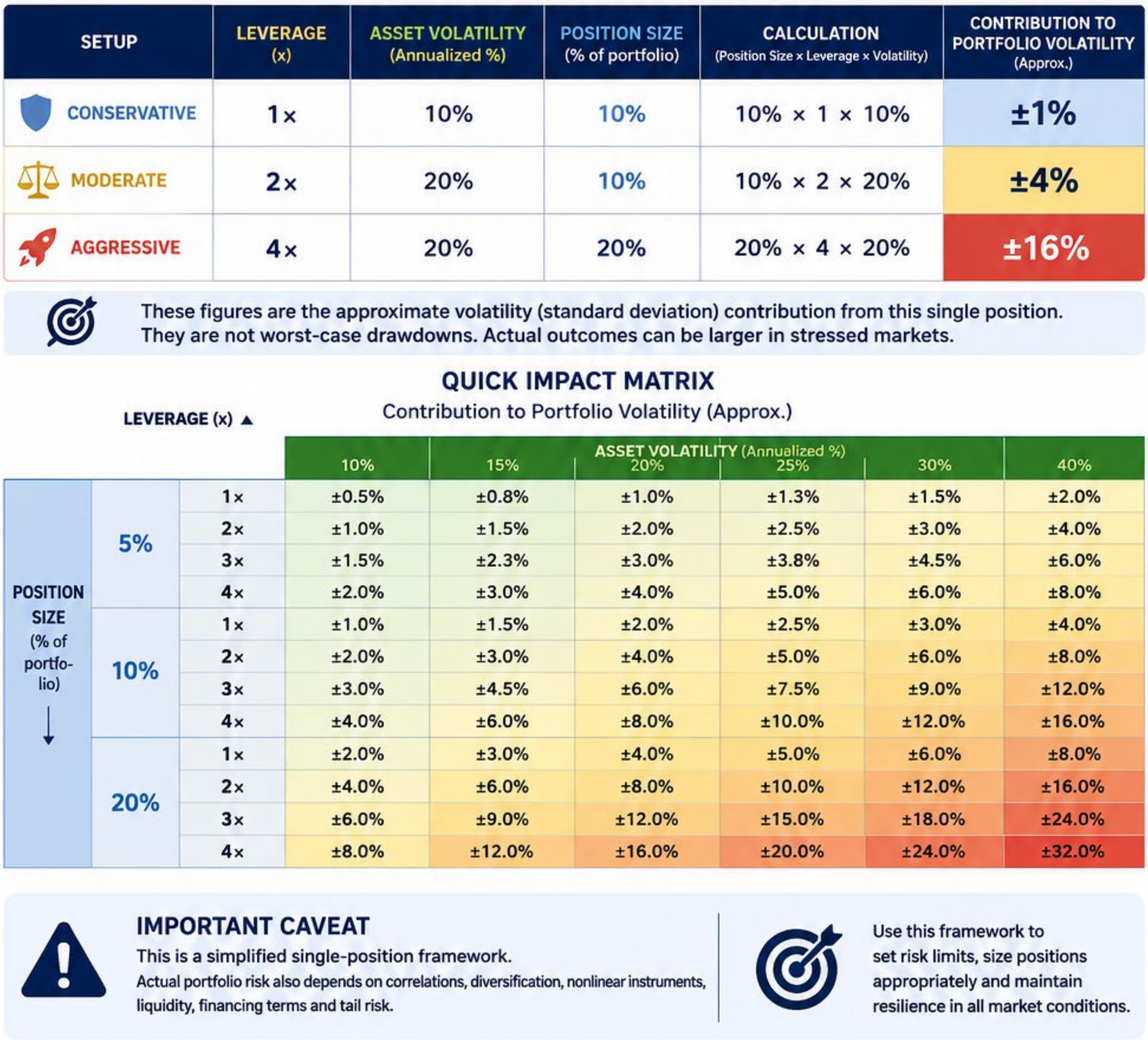
In practice, the risk of a leveraged position is better understood through the interaction of three variables:

Leverage (L) × volatility (σ) × position size (S)

A 3x leveraged instrument representing 0.5% of total wealth may be less consequential than a modestly levered position that represents a large share of an investor's liquid assets. For that reason, investors should think in terms of **portfolio leverage**, not just instrument leverage.

A disciplined approach is to define **maximum acceptable losses** under stress scenarios before entering a position, rather than after volatility has already increased.

Chart 4: Examples: How the formula works



SETUP	LEVERAGE (x)	ASSET VOLATILITY (Annualized %)	POSITION SIZE (% of portfolio)	CALCULATION (Position Size × Leverage × Volatility)	CONTRIBUTION TO PORTFOLIO VOLATILITY (Approx.)
CONSERVATIVE	1×	10%	10%	10% × 1 × 10%	±1%
MODERATE	2×	20%	10%	10% × 2 × 20%	±4%
AGGRESSIVE	4×	20%	20%	20% × 4 × 20%	±16%

These figures are the approximate volatility (standard deviation) contribution from this single position. They are not worst-case drawdowns. Actual outcomes can be larger in stressed markets.

QUICK IMPACT MATRIX

Contribution to Portfolio Volatility (Approx.)

POSITION SIZE (% of portfolio)	LEVERAGE (x)	ASSET VOLATILITY (Annualized %) 10%	15%	20%	25%	30%	40%
5%	1×	±0.5%	±0.8%	±1.0%	±1.3%	±1.5%	±2.0%
	2×	±1.0%	±1.5%	±2.0%	±2.5%	±3.0%	±4.0%
	3×	±1.5%	±2.3%	±3.0%	±3.8%	±4.5%	±6.0%
	4×	±2.0%	±3.0%	±4.0%	±5.0%	±6.0%	±8.0%
10%	1×	±1.0%	±1.5%	±2.0%	±2.5%	±3.0%	±4.0%
	2×	±2.0%	±3.0%	±4.0%	±5.0%	±6.0%	±8.0%
	3×	±3.0%	±4.5%	±6.0%	±7.5%	±9.0%	±12.0%
	4×	±4.0%	±6.0%	±8.0%	±10.0%	±12.0%	±16.0%
20%	1×	±2.0%	±3.0%	±4.0%	±5.0%	±6.0%	±8.0%
	2×	±4.0%	±6.0%	±8.0%	±10.0%	±12.0%	±16.0%
	3×	±6.0%	±9.0%	±12.0%	±15.0%	±18.0%	±24.0%
	4×	±8.0%	±12.0%	±16.0%	±20.0%	±24.0%	±32.0%

IMPORTANT CAVEAT

This is a simplified single-position framework.
Actual portfolio risk also depends on correlations, diversification, nonlinear instruments, liquidity, financing terms and tail risk.

Use this framework to set risk limits, size positions appropriately and maintain resilience in all market conditions.

Source: Indosuez Wealth Management.

Margin calls are not a risk management framework

For investors using conventional margin, it is important not to view the margin call itself as a risk-management tool. A margin call is a funding mechanism, not a defensive strategy.

By the time a margin call occurs, the investor's flexibility is often already limited. More prudent warning signs include:

- position sizes (S) that have expanded materially after market gains,
- rising portfolio volatility (σ),
- increasing correlation among holdings (ρ),
- tighter funding conditions,
- weaker market liquidity, and
- reduced capacity to source collateral quickly.

There is also a behavioural warning sign. If the investor's implicit strategy becomes, *"I just need the market to recover before I am forced to sell,"* the portfolio may already be overleveraged.

It is also important not to assume that margin terms remain stable. In periods of heightened volatility, lenders and brokers often tighten requirements, precisely when investors are least able to accommodate them.

Deleveraging is often about solvency, not conviction

Following sharp market declines, it is common to hear that the "weak hands" have already been removed and that the market is therefore ready to recover. That conclusion is often premature.

In a genuine deleveraging cycle, selling is not primarily driven by valuation views. It is driven by balance-sheet constraints. **Investors facing forced liquidation may need to sell not only their weakest positions, but also their most liquid and highest-quality holdings**, simply because those are the easiest assets to convert into cash.

This is one reason why stress episodes can appear counterintuitive. High-quality assets such as large-cap equities, gold, or other liquid instruments may fall alongside speculative assets. In such environments, investors should pay as much attention to financing conditions as to valuations.

Indicators of stabilisation may include narrowing credit spreads, improved short-term funding conditions, reduced stress in repo and Forex swap markets, and a normalisation in the volatility term structure. High volume and sharp intraday reversals may also signal that forced selling is being absorbed.

Conviction should not be confused with leverage

Perhaps the most important distinction is between **conviction and leverage**.

A powerful long-term theme — whether in artificial intelligence (AI), biotechnology, energy transition, or another structural trend — may encounter prolonged periods in which market prices diverge materially from the underlying investment thesis. Without leverage, a 30% drawdown is unpleasant, but it may remain survivable if the investor has sufficient time and capital. **With leverage, the same drawdown can become a liquidation event**.

Leverage therefore transforms a long-duration thesis into a short-duration survival test.

That is the core lesson connecting recent episodes in Korea with leveraged deleveraging elsewhere. Investor sophistication may differ, but the mathematics is universal.

Three principles follow.

First, **match the vehicle to the horizon**. If the investment thesis requires several years to mature, avoid structures that depend on near-term price stability.

Second, prefer **stomach volatility** over **liquidation volatility**. An unleveraged position may be uncomfortable, but it generally preserves choice. Excessive leverage transfers that choice to the lender or broker.

Third, recognise that **good enough can already be exceptional**. If an investment can deliver strong returns without leverage, there is no obligation to amplify the outcome further. The temptation to turn an attractive return into a spectacular one can also turn a survivable risk into a catastrophic one.

Charlie Munger's warning remains relevant*: "There are three ways a smart person can go broke: liquor, ladies and leverage."*

The recent experiences in South Korea, together with broader episodes of forced deleveraging across markets, remind investors that financial innovation has not altered this fundamental truth. Leverage is not inherently undesirable. But it must always be treated as a structural risk, not a stylistic choice.

Or, put differently: *fire is useful. But no responsible investor should build a fire so large that a single unexpected gust can burn down the house.*

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