

Understanding Margin Trading

The greater the risk the greater the return! This is one of the key principles you need to keep in mind for margin trading. Margin trading is in fact a tool that can be used to generate a larger return on an equity investment than you would have been able to achieve on your own.

What investing on margin actually entails is borrowing money from your broker. When a margin account is set up, you are required to deposit a certain percentage of the value of the stock you wish to purchase. The following example explains how it works.

If there is a stock trading at \$5.00 which is at a very attractive price for that share, you may wish to make an investment. If you opened a margin account that allowed you to borrow up to 50 per cent of the purchase price of a stock and deposited \$5,000.00, you would have been able to acquire 2,000 shares (\$10,000 worth). If 45 days later, you then sold these shares at \$7.00, the money in your account would be \$14,000.00. Assuming an interest rate of 9 per cent on the portion that was borrowed, you would have received \$8,943.75 (net of interest) which would translate to a return of 78.88 per cent. Ordinarily, if you had invested \$5,000.00, you would have only been able to acquire 1,000 shares. If you then sold the shares at \$7.00, your return would have been 40 per cent (excluding commission and transaction charges).

From this example, the percentage of the value of the stock you had to deposit was 50 per cent. This deposit is known as the initial margin. In addition, an initial investment is usually required which is known as the minimum margin.

It is also important to note that interest is charged on the amount borrowed from the firm to purchase the stocks. These charges would of course increase the longer the money is borrowed and so your debt level will increase over time. For example, \$5,000 held at 9 per cent for 45 days would cost you \$56.25 compared to a 60 day term which would have cost \$75.00. Hence, it is prudent to use this type of account for shorter term investments as a longer term investment will cost you more and would therefore require a greater return. It is also important to note that the buying power of a margin account would be governed by the price of the share on the margin.

There are also sometimes restrictions on which stock can be bought on margin. In the United States for example, the Federal Reserve Board regulates which stocks qualify to be traded on margin. In that market customers are not allowed to purchase penny stocks or initial public offerings on margin because of the high risks involved with these companies. These rules are born to protect both the client and the company because as we all know, just as a stock can go up, it can also come down.

In order to ensure that the equity in a customer's margin account is sufficient to cover large changes in the price of a stock, a maintenance margin is also imposed. A maintenance margin is the minimum account balance you must maintain before your broker will force you to deposit more funds or sell stock to pay down your loan. For

instance, using the previous example, if something were to happen negatively to the Company and its price fell to \$4.50 (market value \$9000), this would mean that the total value of the shares would now be \$9,000. Therefore the equity in your account would now be \$4,000 ($\$9000 - \5000). If the firm's maintenance margin was 25 per cent (\$2,250) there would be no need to deposit money into the account. However, if the maintenance margin was 45 per cent (\$4,050), the broker may issue a margin call and \$50 would have to be deposited into the account.

It is important to note that if you are unable to satisfy the margin call, the broker has the right to sell securities held in your account (as the shares are held as collateral) in order for the maintenance margin to be satisfied. In some cases a broker may not have to necessarily notify the client before he takes such action.

This being said the major advantage of margin trading is leveraging. Once the stock/portfolio on margin increases in value, leveraging has the distinction of amplifying your profit. As can be seen from the earlier example, a 50 per cent margin account allowed the client to buy up to twice as many stocks than he would have been able to acquire without this facility. In addition, his return was 78.88 per cent under the margin account compared to 40 per cent without the margin account. Hence in this example, it is unequivocal that the margin account was able to reward the client with a much greater return than he would have ordinarily received.

Without a doubt, just as the margin account can propel a greater return, it can also result in a big loss with money possibly being owed to the broker. This is what makes buying on margin such a high risk investment. For instance, if in the first example the price fell by \$2.00 instead of rising \$2.00, in an ordinary account you would have a loss of 40 per cent (the value of the portfolio will now be \$6,000). However, in the margin account if you sell the stock and pay back the broker \$5,000, you would end up with \$1,000.00 ($\$6,000 - \$5,000$). That is an 80 per cent loss plus commissions and interest which is twice as much as what would have been lost in an ordinary account. In addition, there is also the chance that you may lose more than the money that was originally invested. For example, if the price of the share fell by 50 per cent, it would have cost you your entire investment plus interest and commissions.

Additionally, in an ordinary account, all losses are paper losses until you decide to sell. Hence, if you feel that any fall in price is temporary and the company is still fundamentally strong, you may opt to hold on to your shares in the hope of a rebound. However, in the case of a margin account, the broker has the power to sell off your securities if the share price declines. Thus, the client realizes the loss and chances of benefiting from a future upward movement in the price are lessened.

It should be clear by now that careful consideration must be given when deciding to invest using a margin account. This type of trading should preferably be done with your risk capital, that is, money that you can afford to lose. It is also good to remember that you do not have to borrow the entire amount of money that you are allowed.

It is of utmost importance to read the margin agreement and to understand all implications of signing such a document. You should fully understand the risk you are taking in choosing such an investment. In addition, you should speak to your broker before deciding in which stocks to invest. You should also understand the usual price movements of a company and the best fundamental price range at which to get into and out of such an investment.

Figure 1

	Ordinary Cash Investment	Trading on 50 per cent margin
Initial Investment	\$5,000	\$5,000
Buying Power	\$5,000	\$10,000
Situation (a)		
Value of Portfolio rises by 40 per cent	\$7,000	\$14,000
Gain on Selling after 45 days (9% interest)	\$2,000	\$8,944
Situation (b)		
Value of Portfolio falls by 40 per cent	\$3,000	\$6,000
Loss if Sold after 45 days (9% interest)	\$2,000	\$4,056
<i>*NB Calculations do not include commission and transaction charges</i>		

In conclusion, Figure 1 shows a comparison of some of the situations that can occur using a margin account compared to an ordinary cash account. Also remember, that in a margin account, your securities are held as collateral and you broker may opt to sell them if margin calls are not satisfied. All in all, while margin trading can allow you to make handsome profits, it can also put you into debt. Margin accounts can be extremely risky and are not for everyone. It is therefore important that you understand your risk tolerance before venturing into this type of trading. WISE currently offers eligible clients a margin trading facility on International Equity accounts.