

An Introduction To Margin Trading

Investing on margin is a high risk strategy that if implemented prudently can reap substantial profits. An investor, however, must have a clear understanding of what margin trading entails as he can also risk losing his entire portfolio. Following is a brief introduction to margin trading.

Margin trading simply put is taking a loan from your broker to purchase stock that you otherwise would not have been able to with a limited amount of funds at your disposal. To open a margin account an investor is required to sign a contract called a *margin agreement*, which details all of the terms and conditions of the margin account including repayment terms on the loan and how interest is calculated. The investor is also required to make an initial deposit which is referred to as the *minimum margin*. This initial payment can be thought of as the minimum amount required to be deposited in order to open a margin account and start trading. The minimum margin can comprise of either cash or securities.

Once the account is opened, the investor has an *initial margin* requirement, which is the percentage of the purchase price of the stock that he must pay for with his own cash. In most cases the investor can margin up to 50 per cent of the value of the stock purchase but can choose to borrow less if he so desires.

Let us illustrate with a simple example. An investor would like to buy 100 shares of Company X which is selling for \$100 per share. The total value of the purchase is thus \$10,000. If the broker allows a margin of up to 50 per cent, then the investor would use \$5,000 of his own money (initial margin) and the broker would loan the investor the additional \$5,000. As previously indicated, however, the investor does not have to margin all the way up to 50 per cent and can choose to margin less, say 15 per cent or 25 per cent.

Now let us assume that the stock of Company X goes up to \$120 per share. Ignoring fees and commissions for simplicity, if the investor was to sell his Company X shares, he would make a profit of \$2,000 after paying back his broker. If the investor did not have access to the margin facility and only invested the \$5,000, he would have only made half of that profit. This simple example shows how an investor's buying power can be magnified. Bear in mind that when an investor sells stocks in his margin account, the proceeds from the sale first go to the broker as repayment on the loan until it is fully paid off. Any additional funds after the loan has been paid will then accrue to the investor.

Note that some brokers may not allow investors to margin up to 50 per cent. Also some brokers may even require that the investor deposit more than 50 per cent of the purchase price. In addition, some stocks may not even qualify to be traded on margin. An investor should be aware of all of the terms and stipulations set by his broker on his margin account by carefully reading the margin agreement.

An investor is required to keep a minimum balance on his margin account which is known as the *maintenance margin*. If the "balance" on the margin account falls below this requirement, the broker will make a *margin call* to the investor to deposit more funds into the account. If the investor does not take heed to the margin call, the broker has the authority to sell off stocks in the account in order to pay down on the loan facility and has the right to do so without even consulting the investor. The balance on the margin account can be defined as the value of the stocks in the account minus the amount owed to the broker.

Let us use the previous illustration above with the investor that held 100 shares of Company X, which he purchased at \$100 per share. If the market was on a downturn and the market value of the shares in Company X fell to \$75 a share, the market value of the stock in the margin account would be worth \$7,500. However, the balance on the account falls to \$2,500 (\$7,500 - \$5,000). Remember that the investor used \$5,000 of his own money and borrowed \$5,000 from his broker. If the maintenance margin was 25 per cent, that implies that the investor must have \$1,875 (25

per cent of \$7,500) worth of stocks in his account. Hence, in this scenario the investor is safe in that the \$2,500 can cover the maintenance margin of \$1,875. However, if the broker had a maintenance margin of 35 per cent, the maintenance margin would be \$2,625 which is greater than the balance on the account of \$2,500. In this scenario the brokerage will issue a margin call to the investor.

So why would an investor buy on margin? As previously mentioned, an investor can use margin to leverage his investment thereby increasing the possible return of his investment. Let us refer to our original example. Our investor purchased 100 shares of Company X at \$100 per share, using \$5,000 cash and \$5,000 margin. Under normal circumstances, the investor would only have been able to purchase 50 shares ($\$100 \times 50$) had he not invested on margin. If the stock of Company X rose 20 per cent to \$120 per share and the investor decided to sell his shares, he would receive \$12,000 (not taking into account any fees and commissions for simplicity). After paying back his broker the \$5,000 borrowed, our investor would have accumulated \$7,000, of which \$2,000 is profit. Even though the stock went up 20 per cent, the investor received a 40 per cent return on his investment. Of course the opposite holds true, and an investor could stand to lose a great deal, even more than was originally invested, should the value of the stock fall.

Due to the inherent risks, investors are cautioned to only invest on margin with risk capital and they should be aware of all of the associated risks before trading on margin.

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