Buying on Margin

Ready for Next

Buying on margin allows an investor to buy securities partially with his or her own funds and partially with funds borrowed from a broker. To buy on margin, an investor must open an account, called a margin account, with a broker. The investor deposits a portion of the purchase price into the account. This deposit is known as "margin," hence the term "buying on margin." The investor can then borrow the balance of the purchase price from the broker. The newly purchased securities are kept in the margin account as collateral until the investor sells the stock and/or repays the loan, including whatever interest is owed.

USING LEVERAGE

When you buy on margin, you're using leverage to increase your purchasing power. Leverage magnifies the results of your investment decisions. It can lead to profits or losses that are greater than if you had invested your own money exclusively. As a result, it is a more aggressive strategy than non-leveraged equity investing.

Example: You already hold 1,000 shares of XYZ Corp., which you purchased for $20 per share. The stock's most recent closing price also is $20 per share. You believe XYZ Corp. shares will double over the next year. You decide to purchase 1,000 additional shares of XYZ Corp. using your margin account and funds loaned to you by your broker. The margin rate in this hypothetical example is 8%. One year later, the stock is at $40 a share as you predicted. Excluding commissions, your total position is worth $80,000 (1,000 shares + 1,000 shares = 2,000 shares, 2,000 shares x $40/share = $80,000). Your cost is $41,600, broken down as follows: $20,000 (your original cash investment for the first 1,000 shares) plus $20,000 (principal owed to your broker for the margin loan) plus $1,600 owed to your broker in margin interest (ignoring compounding in this simple example). Your total profit is $38,400 (the $80,000 value of your 2,000 shares minus your $41,600 in costs, not including commissions). That $38,400 profit represents a much higher, leveraged rate of return on your deployed capital of $20,000 as compared to the return – $20,000 – you would have had on the position had you simply bought the stock outright.

However, the risks associated with buying on margin are high. If the price of the securities bought on margin does not rise but falls instead, an investor can lose more than the amount deposited to the margin account. Also, in order for the trade to be profitable, your return on the shares purchased with the margin loan must exceed the interest owed to the broker plus trading commissions.

Caution: *Using the same example above, if XYZ Corp. declines to $10 a share, you have doubled your capital losses in addition to still having to pay the margin interest. In this example, your loss would be $21,600 (excluding commissions). The $21,600 includes a loss of $10/share x 2,000 shares – all of your deployed capital – plus the margin interest of $1,600 you owe the broker. By comparison, had you not doubled your position using the borrowed funds, your loss would have been limited to $10,000 (excluding commissions) and you would still have half of your deployed capital. In addition, as your stock's value falls, you would likely have to meet a margin call (see below), which would require you to add money to your account to meet margin maintenance requirements. Alternatively, you might have to sell the position before you wish to in order to stay within your broker's margin guidelines.*

This strategy is typically used by sophisticated investors who have a high tolerance for risk. Investors who are considering using this strategy should clearly understand how a margin account works, the restrictions that may be imposed, the tax ramifications, and especially the risks associated with trading securities in a margin account.

Note: An investor can also borrow stocks or other securities on margin (rather than borrowing funds to purchase securities). This is typically done when executing a short sale. In this situation, the investor sells the shares at the current market price, hoping to buy back the shares at a lower price and return the shares to the lender. Short selling carries even higher risk than buying on margin (see **RISKS** below).

HOW IS IT DONE?

To buy on margin, an investor must first open a margin account with a broker; you must meet certain financial requirements to qualify for a margin account. The investor must sign a margin agreement and disclosure documents. The account is subject to the margin rules (see below for more on this). The investor can borrow money from the broker to buy stock (and the broker can loan securities to the account in a short sale) using the value of the margin account as collateral.

Caution: *The broker can also loan out securities in the investor's margin account to other investors without the investor's knowledge.*

The general rule is that the value in the investor's margin account must equal at least 50% of the purchase price (e.g., $1,000 of stock or cash held in a margin account allows the investor to borrow $1,000). The broker then buys the securities for the investor on the open market and deposits the securities into the investor's margin account. The securities are held in the margin account as collateral for the loan until the investor repays the loan. Interest is charged on the loan, and the investor will also be charged the usual commissions and fees associated with any securities purchase or sale. The investor pays back the loan when the securities are sold.

The broker is required to provide the investor with written terms of the margin loan, including the interest rate that will be charged and how that interest will be computed. The broker must also provide the investor with periodic statements that detail transactions in the account, including interest charges.

MARGIN REQUIREMENTS

The Federal Reserve Board, the Securities and Exchange Commission, the Financial Industry Regulatory Authority, and the New York Stock Exchange impose many rules on margin accounts. Additionally, individual brokers may also impose their own (stricter) rules, and margin requirements on certain securities may vary.

Securities that can be bought on margin

Not all securities can be bought on margin. In general, securities that can be bought on margin include the following:

- Listed common and preferred stocks
- Municipal bonds
- Federal government bonds, notes, and bills
- Over-the-counter securities on the Federal Reserve Board's margin list
- Convertible bonds (if convertible into a marginable security)
- Corporate bonds (if rated Baa or higher by Moody's Investors Service)

Some securities may not be bought on margin, but may be "marginable" (i.e., they may be used as collateral); for example, mutual funds that have been owned in full for 30 days.

Minimum margin

Minimum margin refers to the initial amount an investor must deposit into a margin account before he or she can begin to trade on margin. Generally, an investor must deposit $2,000 to open a margin account, but some brokers may require more.

Initial margin

Once the account is open and operational, an investor may borrow up to 50% of the purchase price for new purchases (per Federal Reserve Board Regulation T).

Maintenance margin

After an investor buys stock on margin, the investor is required to keep a minimum amount of equity in his or her margin account. The equity in a margin account is the value of the securities in the account less how much is owed to the broker. The rules require an investor to have at least 25% of the total market value of the securities in a margin account at all times. Many brokers have higher maintenance requirements, typically from 30% to 40%, and sometimes higher depending on the type of stock purchased.

Example: John purchases $16,000 worth of securities by paying $8,000 in cash and borrowing $8,000 from his broker. Some time later, the market value of the securities in John's account falls to $12,000, and the equity in John's account falls to $4,000 ($12,000 – $8,000). John's broker has a 25% maintenance requirement, so John must have $3,000 in equity in his account (25% of $12,000). In this case, John has enough equity because the $4,000 in equity in his account is greater than the $3,000 maintenance requirement.

Example: Now say John's broker has a maintenance requirement of 40%. In this case, John does not have enough equity. John's broker requires John to have $4,800 in equity (40% of $12,000). John's $4,000 in equity is less than the broker's $4,800 maintenance requirement. As a result, John's broker may issue a "margin call," because the equity in John's account has fallen $800 below the broker's maintenance requirement.

WHAT IS A MARGIN CALL?

If an investor's margin account falls below the broker's maintenance requirement, the broker may make a margin call, demanding that the investor deposit (usually immediately) more cash or securities into the account or sell some securities. If the investor is unable to meet the margin call, the broker may sell any and all of the investor's marginable securities to increase the equity in the margin account so that it meets or exceeds the broker's maintenance requirement.

RISKS

Investors can lose more than their investment

One downside of using margin is that if the stock price decreases, substantial losses can mount quickly. For example, assume the price of a stock bought for $50 falls to $25. If an investor fully paid for the stock, the investor loses 50% of his or her investment per share. But if an investor bought on margin, he or she loses 100% of the original investment; i.e., 50% of the price of the shares fully paid for and 50% of the price of the shares bought on margin. In addition, the investor must pay interest on the loan. As a result, you can lose more funds than you deposit in the margin account.

Caution: *Borrowing securities on margin to execute a short sale exposes the investor to even greater risk than buying securities on margin. Whereas an investor who actually owns shares of a company can lose no more than 100% of the investment, there is essentially no limit to the potential losses for a short seller, because there is no limit to how high a stock price might go. If a stock price rises quickly, an investor who borrowed shares at a lower price may be forced to buy shares at much higher prices in order to return the shares to the lender. In addition, as the stock price rises, the investor may be forced to add additional funds and/or securities to his or her account in order to meet margin requirements.*

Risk of margin call

If the price of the securities bought on margin declines, or the equity in the investor's margin account otherwise falls below the broker's maintenance requirements, a margin call may be issued. Policies vary from broker to broker. It's important to understand the margin agreement with your broker and keep the following risks in mind:

- The broker can force the sale of securities in the investor's account to cover the margin deficiency. The investor will also be responsible for any shortfall in the account after such a sale.
- The broker can force the sale of securities or other assets in an investor's margin account or sell the investor's securities or other assets without contacting him or her. Though most brokers will attempt to notify their customers of margin calls, they are not required to do so. Even if notification is provided, the broker can still take necessary steps to protect its financial interests, including immediately selling the securities without further notice to the investor.
- The investor is not entitled to choose which securities in the margin account are liquidated or sold to meet a margin call — the broker has the right to decide which securities to sell in order to protect the broker's interests.
- The broker can increase its maintenance requirements at any time and is not required to provide investors with advance notice. These changes in policy often take effect immediately and may result in the issuance of a maintenance margin call.
- Investors are not entitled to an extension of time on a margin call. While an extension of time to meet margin requirements may be available to investors under certain conditions, an investor does not have a right to the extension.

MANAGING RISK WITH LIMIT ORDERS AND STOP ORDERS

Investors sometimes use limit orders or sell stop orders (sometimes referred to as a "stop-loss" order) to help manage the level of risk they face. Such orders can be especially useful when buying on margin. When an investor places a "market order" with a broker, the broker will purchase the ordered stock at the prevailing market price, regardless of what that price is. A "limit order," on the other hand, is an order to buy or sell only when a stock reaches a certain price or better. Investors sometimes use limit orders hoping to buy a little below (or sell a little above) the current market. Investors may also use them to be sure that they don't get blind-sided by a sudden move in the market.

Example: XYZ stock is currently selling for $11 per share, but the price has been slipping lately. Jane believes the intrinsic value of the stock is at least $11 per share, and she feels that any price less than $11 would be a bargain. Jane places a limit order with her broker to buy the stock for any price up to $10.

A stop-loss order is an order to sell stock at a price lower than the current market price. Investors use stop-loss orders to predetermine the maximum loss they may suffer on the stock.

Example: Jane buys XYZ stock for $50 per share but is only willing to take a $3 per share loss on the stock. Jane places a stop-loss order with her broker to sell if the stock drops to $47 or below.

Caution: *A stop-loss order does not guarantee that the investor's losses will be limited to the stop-loss price. If the stock price drops suddenly, the investor's stock will be sold at the current market price even if it is below the stop-loss price. Brokers may charge a higher fee for limit orders and stop-loss orders than for market orders.*

TAX CONSIDERATIONS

Margin interest may be tax deductible

The interest that you pay on margin loans that relates to taxable investments may be tax deductible up to the amount of net income earned from investments (any excess amount can be carried forward). The investment interest expense deduction is calculated on IRS Form 4952, and the deduction is itemized on Schedule A of Form 1040. Generally, you cannot deduct interest on margin loans to the extent the loan is used to purchase tax-exempt securities.

Caution: *Where a margin account holds dividend-paying stock, certain considerations apply. Qualified dividends paid to individual shareholders from domestic corporations (and qualified foreign corporations) are taxed at long-term capital gains tax rates rather than as ordinary income. Those rates are 0%, 15%, and 20%, depending on your marginal tax rate. However, for purposes of the deduction for investment interest (which is limited to net investment income), investment income is not considered to include qualified dividends subject to tax at capital gains rates. Individuals may elect to treat such dividends as investment income for purposes of deducting investment interest but doing so makes the dividends ineligible for taxation at capital gains rates.*

The return and principal value of stocks fluctuate with changes in market conditions. Shares, when sold, may be worth more or less than their original cost. Investments offering the potential for higher rates of return also involve higher risk.

Margin accounts can be very risky and are not appropriate for everyone. Before opening a margin account, you should fully understand that: you can lose more money than you have invested; you may have to deposit additional cash or securities in your account on short notice to cover market losses; you may be forced to sell some or all of your securities when falling stock prices reduce the value of your securities; and your brokerage firm may sell some or all of your securities without consulting you to pay off the loan it made to you.

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