Chargin’ at the Margin

by Bill Dickneider

I hope this message keeps many of you from making the same mistake I made,” wrote 24-year-old Leticia on an Internet message board.” Here’s what she wrote.

Leticia’s Lament

When I started working full-time a few years ago, I began to invest in a small portfolio of stocks. A few months ago I bought shares of a fast-growing technology company. Sure enough, the stock went up. I wanted to buy more shares, but I didn’t have enough savings.

That’s when I heard about buying stocks on margin. I opened a margin account with my broker and signed a margin agreement. I could then buy a dollar’s worth of stock for only 50 cents of my own money. My broker loaned me the other 50 cents, so I was able to buy twice as many shares. The shares I bought with my own money backed the loan. My broker called the shares collateral because the broker could sell them if I couldn’t repay the loan.

Sure, I had to pay interest on the loan and would also have to pay back the borrowed money. But I figured it was worth it because any increase in the stock’s price would go to me, not to my broker. That would be true for the shares I bought with my own money and also for the shares I bought with my broker’s loan. So I could use the broker’s money to magnify my gains.

But I failed to look at the other side of the margin coin. Just as I would receive all the gains if my stock goes up, so also would I receive all the losses if it goes down. I forgot that margin buying can magnify losses, just as it can magnify gains.

I remembered this when my “winning” stock suddenly sank. I thought of the margin agreement I had signed when I opened the account. Regulations of the federal government and the stock markets require that margin accounts always have enough equity to back the broker’s loan. Equity is the value of all cash and shares in my account minus the broker’s loan. The minimum maintenance requirement means that equity must always equal at least 25 percent of the current market value of the stocks bought on margin. Some brokers have higher requirements. Mine

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Magnifying Margin

Leticia deposited $2,000 and borrowed another $2,000 from her broker to buy $4,000 of stock. She expected the stock’s price to rise by 50%. If the price of a share goes up by 50%, the total value of all the stock in Leticia’s account will rise by $2,000 (50% x $4,000 = $2,000). All of that gain will belong to Leticia, so her equity will rise to $4,000. A 50% rise in the stock made her equity rise by 100%.

But the stock’s price went DOWN by 50%. So the total value of all the shares fell by $2,000. The loss belonged entirely to Leticia, so her equity shrank to nothing. A 50% fall in the stock made her equity fall by 100%.
requires a minimum of 30 percent equity for the stock I bought.

I didn’t have any cash in my margin account, so the equity backing the loan consisted entirely of the shares I bought with my own money. When my “winning” stock became a loser, my equity shrank like a new pair of jeans in a hot dryer. It was even worse. Imagine opening the dryer and discovering that your jeans had shrunk away to nothing. That’s what happened to me. In what seemed like a nanosecond, a huge decline in the stock wiped out every penny of my equity.

So my broker sent me a margin call, which asked me to rebuild my equity by depositing more cash in my account. But I didn’t have any cash, so my broker had to sell my shares to repay the loan.²

Margin On

Leticia wishes she had been more careful when buying on the margin. The dictionary defines margin as the edge or border of something, such as the edge or border of this page. In margin buying, the margin is the amount an investor must deposit up front (on the front “edge” of a stock purchase) when borrowing from a broker to buy stock. For example, Leticia wanted to buy $4,000 worth of stock on margin. She first had to deposit $2,000 of equity (cash) before her broker would loan her the other $2,000. In a sense, the margin is like a minimum down payment.

The Federal Reserve sets this minimum, which today requires investors to provide 50 cents of equity for each dollar of stock bought on margin. Since 50 cents is half of a dollar, the minimum margin requirement is one-half or 50 percent. For this reason, buying on margin means buying stock by putting in at least 50 percent of the total as your own money and borrowing the rest from a broker.

Market Margin

Leticia’s experience shows the advantages and disadvantages of margin buying. If margined stocks go up, gains are magnified. If they go down, losses are magnified too. What’s more, the amount borrowed from a broker need never be repaid, although the interest meter continues to tick on the unpaid loan in the margin account.

Because of its advantages, many customers use margin accounts to borrow from their brokers.

But the amount they borrow is relatively tiny – less than two percent of the market value of all companies listed in the stock markets. Still, margin credit has increased in recent years. For example, the chart above shows that it has grown faster than stock prices during the last few years.

Has the growth of margin credit fueled the growth of stock prices? Evidence suggests that margin credit more likely follows the market instead of leading it. For example, an economist at the Federal Reserve Bank of San Francisco writes, “the data do not suggest that, in general, the growth of margin credit fuels the stock market. Rather, the data are consistent with investors reacting to the rise in stock prices by borrowing more against stocks and, likewise, reacting to a fall in stock prices by borrowing less.”³

Footnotes

1 Regulations also require a minimum margin deposit of $2,000 to open a margin account.
2 If a customer can’t provide additional cash as equity, a broker can sell shares in the account, even without the knowledge or consent of the customer. If other stocks are in the account, the broker may sell these shares in place of, or in addition to, shares of the falling stock.