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Margin Trading Tutorial

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Introduction

Imagine this: you're sitting at the blackjack table and the dealer throws you an ace. You'd love to increase your bet, but you're a little short on cash. Luckily, your friend offers to spot you \$50 and says you can pay him back later. Tempting, isn't it? If the cards are dealt right, you can win big and pay your buddy back his \$50 with profits to spare. But what if you lose? Not only will you be down your original bet, but you'll still owe your friend \$50. Borrowing money at the casino is like gambling-on-steroids: the stakes are high and your potential for profit is dramatically increased. Conversely, your risk is also increased.

Investing on [margin](#) isn't necessarily gambling. But you can draw some parallels between margin trading and the casino. Margin is a high-risk strategy that can yield a huge profit if executed correctly. The dark side of margin is that you can lose your shirt and any other assets you're wearing. One of the only things riskier than investing on margin is investing on margin without understanding what you're doing. This tutorial will teach you what you need to know.

What Is Buying On Margin?

Buying on margin is borrowing money from a broker to purchase stock. You can think of it as a loan from your brokerage. Margin trading allows you to buy more stock than you'd be able to normally. To trade on margin, you need a [margin account](#). This is different from a regular [cash account](#), in which you trade using the money in the account. By law, your broker is required to obtain your signature to open a margin account. The margin account may be part of your standard account opening agreement or may be a completely separate agreement. An initial investment of at least \$2,000 is required for a margin account, though some brokerages require more. This deposit is known as the [minimum margin](#). Once the account is opened and operational, you can borrow up to 50% of the purchase price of a stock. This portion of the purchase price that you deposit is known as the [initial margin](#). It's essential to know that you don't have to margin all the way up to 50%. You can borrow less, say 10% or 25%. Be aware that some brokerages require you to deposit more than 50% of the purchase price.

You can keep your loan as long as you want, provided you fulfill your obligations. First, when you sell the stock in a margin account, the proceeds go to your broker against the repayment of the loan until it is fully paid. Second, there is also a restriction called the [maintenance margin](#), which 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. When this happens, it's known as a [margin call](#). We'll talk about this in detail in the next section.

Borrowing money isn't without its costs. Regrettably, marginable securities in the account are [collateral](#). You'll also have to pay the interest on your loan. The interest charges are applied to your account unless you decide to make payments. Over time, your debt level increases as interest charges accrue against you. As debt increases, the interest charges increase, and so on.

Therefore, buying on margin is mainly used for short-term investments. The longer you hold an investment, the greater the return that is needed to break even. If you hold an investment on margin for a long period of time, the odds that you will make a profit are stacked against you.

Not all stocks qualify to be bought on margin. The [Federal Reserve Board](#) regulates which stocks are marginable. As a rule of thumb, brokers will not allow customers to purchase [penny stocks](#), over-the-counter Bulletin Board (OTCBB) securities or [initial public offerings](#) (IPOs) on margin because of the day-to-day risks involved with these types of stocks. Individual brokerages can also decide not to margin certain stocks, so check with them to see what restrictions exist on your margin account.

A Buying Power Example

Let's say that you deposit \$10,000 in your margin account. Because you put up 50% of the purchase price, this means you have \$20,000 worth of [buying power](#). Then, if you buy \$5,000 worth of stock, you still have \$15,000 in buying power remaining. You have enough cash to cover this transaction and haven't tapped into your margin. You start borrowing the money only when you buy securities worth more than \$10,000.

This brings us to an important point: the buying power of a margin account changes daily depending on the price movement of the marginable securities in the account. Later in the tutorial, we'll go over what happens when securities rise or fall.

The Dreaded Margin Call

In the previous section, we discussed the two restrictions imposed on the amount you can borrow. First, the initial margin, which is the initial amount you can borrow. Second, the maintenance margin, which is the amount you need to maintain after you trade. These amounts are set by the [Federal Reserve Board](#), as well as your brokerage. Individual brokerages can have stricter limits, but the Federal Reserve Board sets a minimum initial margin of 50% and a maintenance margin of at least 25%.

Our focus in this section is the maintenance margin. In volatile markets, prices can fall very quickly. If the equity (value of securities minus what you owe the brokerage) in your account falls below the maintenance margin, the brokerage will issue a "[margin call](#)". A margin call forces the investor to either [liquidate](#) his/her position in the stock or add more cash to the account.

Here's how it works. Let's say you purchase \$20,000 worth of securities by borrowing \$10,000 from your brokerage and paying \$10,000 yourself. If the market value of the securities drops to \$15,000, the equity in your account falls to \$5,000 ($\$15,000 - \$10,000 = \$5,000$). Assuming a maintenance requirement of 25%, you must have \$3,750 in equity in your account ($25\% \text{ of } \$15,000 = \$3,750$). Thus, you're fine in this situation as the \$5,000 worth of equity in your account is greater than the maintenance margin of \$3,750. But let's assume the maintenance requirement of your brokerage is 40% instead of 25%. In this case, your equity of \$5,000 is less than the maintenance margin of \$6,000 ($40\% \text{ of } \$15,000 = \$6,000$). As a result, the brokerage may issue you a margin call.

If for any reason you do not meet a margin call, the brokerage has the right to sell your securities to increase your account equity until you are above the maintenance margin. Even scarier is the fact that your broker may not be required to consult you before selling! Under most margin agreements, a firm can

sell your securities without waiting for you to meet the margin call. You can't even control which stock is sold to cover the margin call.

Because of this, it is imperative that you read your brokerage's margin agreement very carefully before investing. This agreement explains the terms and conditions of the margin account, including: how interest is calculated, your responsibilities for repaying the loan and how the securities you purchase serve as collateral for the loan.

The Advantages

Why use margin? It's all about [leverage](#). Just as companies borrow money to invest in projects, investors can borrow money and leverage the cash they invest. Leverage amplifies every point that a stock goes up. If you pick the right investment, margin can dramatically increase your profit.

A 50% initial margin allows you to buy up to twice as much stock as you could with just the cash in your account. It's easy to see how you could make significantly more money by using a margin account than by trading from a pure cash position. What really matters is whether your stock rises or not. The investing world will always debate whether it's possible to consistently pick winning stocks. We won't weigh in on that debate here, but simply say that margin does offer the *opportunity* to amplify your returns.

The best way to demonstrate the power of leverage is with an example. Let's imagine a situation that we'd all love to be in - one that results in hugely exaggerated profits:

We'll keep with the numbers of \$20,000 worth of securities bought using \$10,000 of margin and \$10,000 of cash. Cory's Tequila Co. is trading at \$100 and you feel that it will rise dramatically. Normally, you'd only be able to buy 100 shares ($100 \times \$100 = \$10,000$). Since you're investing on margin, you have the ability to buy 200 shares ($200 \times \$100 = \$20,000$).

Cory's Tequila Co. then locks in Jennifer Lopez as a spokeswoman and the price of shares skyrockets 25%. Your investment is now worth \$25,000 ($200 \text{ shares} \times \125) and you decide to cash out. After paying back your broker the \$10,000 you originally borrowed, you get \$15,000, \$5,000 of which is profit. That's a 50% return even though the stock only went up 25%. Keep in mind that to simplify this transaction, we didn't take into account [commissions](#) and interest. Otherwise, these costs would be deducted from your profit.

The Risks

It should be clear by now that margin accounts are risky and not for all investors. Leverage is a double-edged sword, amplifying losses and gains to the same degree. In fact, one of the definitions of [risk](#) is the degree that an asset swings in price. Because leverage amplifies these swings then, by definition, it increases the risk of your portfolio.

Returning to our example of exaggerated profits, say that instead of rocketing up 25%, our shares fell 25%. Now your investment would be worth \$15,000 (200 shares x \$75). You sell the stock, pay back your broker the \$10,000, and end up with \$5,000. That's a 50% loss, plus commissions and interest, which otherwise would have been a loss of only 25%.

Think a 50% loss is bad? It can get much worse. Buying on margin is the only stock-based investment where you stand to lose more money than you invested. A dive of 50% or more will cause you to lose more than 100%, with interest and commissions on top of that.

In a cash account, there is always a chance that the stock will rebound. If the [fundamentals](#) of a company don't change, you may want to hold on for the recovery. And, if it's any consolation, your losses are [paper losses](#) until you sell. But as you'll recall, in a margin account your broker can sell off your securities if the stock price dives. This means that your losses are locked in and you won't be able to participate in any future rebounds that may take place.

If you are new to investing, we strongly recommend that you stay away from margin. Even if you feel ready for margin trading, remember that you don't have to borrow the whole 50%. Whatever you do, only invest in margin with your risk capital - that is, money you can afford to lose.

Conclusion

Here's the bottom line on margin trading:

You are more likely to lose lots of money (or make lots of money) when you invest on margin.

Now let's recap other key points in this tutorial:

- Buying on [margin](#) is borrowing money from a broker to purchase stock.
- Margin increases your [buying power](#).
- An initial investment of at least \$2,000 is required (minimum margin).

- You can borrow up to 50% of the purchase price of a stock ([initial margin](#)).
- You are required to keep a minimum amount of equity in your margin account that can range from 25% - 40% ([maintenance margin](#)).
- Marginable securities act as [collateral](#) for the loan.
- Like any loan, you have to pay interest on the amount you borrow.
- Not all stocks qualify to be bought on margin.
- You must read the margin agreement and understand its implications.
- If the equity in your account falls below the maintenance margin, the brokerage will issue a [margin call](#).
- Margin calls can result in you having to [liquidate](#) stocks or add more cash to the account.
- Brokers may be able to sell your securities without consulting you.
- Margin means [leverage](#).
- The advantage of margin is that if you pick right, you win big.
- The downside of margin is that you can lose more money than you originally invested.
- Buying on margin is definitely not for everybody.
- Margin trading is extremely risky.

We must emphasize that this tutorial provides a basic foundation for understanding margin. It is meant to serve as an educational guide, not as advice to trade on margin