Margin Trading and Leverage

This week's article looks at how debt plays an important part in wealth creation. More specifically, we shall look at two (2) key concepts within the capital markets: Margin Trading and Leverage. They are interconnected concepts that utilise debt for the purpose of wealth creation. It should be noted that both strategies carry significant risks, therefore investors must be mindful of their risk appetite before engaging in these investment strategies.

Margin Trading

The concept of Margin Trading is applicable to the trading of securities (i.e. equities, bonds, exchange-traded funds, etc.) via brokerage accounts. There are two types of brokerage accounts: Cash and Margin Accounts:

1. ***Cash Account:*** Under normal circumstances, when one usually trades in a security using a standard cash account, the investor must have the full amount needed to conduct the transaction. For example, you contact your broker because you wish to purchase 1,000 shares of Company Z. You are informed that the purchase price is $20 per share and total transaction fees are $250. Under such circumstances, you should have or will be required to deposit $20,250 (1,000 @ $20 = $20,000 + $250 in fees) in your brokerage account so that your broker can process the transaction.
2. ***Margin Account:*** When trading using a margin account, the investor receives a line of credit that allows him or her to purchase securities. Using the previous example, let's suppose that you have a margin account with a 50% requirement. In this example, you will be required to have or deposit $10,250 (50% of purchase amount i.e. $20,000 plus $250 in fees) in your brokerage account.

Margin Accounts increases the buying power of the investor, since they do not have to fund the full amount of the transaction from personal funds. However, this is a special facility, in essence, a loan, that is provided by brokerage firms. As such, the investor will have to pay interest on the amount borrowed ($10,000 in this case). While this activity is not very prominent in the local industry, it is very popular in international markets.

Before you start buying on margin, you must make a minimum cash deposit in your margin account. The Financial Industry Regulatory Authority in the United States mandates that persons have 100% of the purchase price of the investments they want to buy on margin or US$2,000 whichever is less.

Leverage

Leverage occurs when borrowed funds are utilised to expand an organisation's asset base; these assets are used to generate returns. Investors use leverage in an investment strategy where borrowed money is used to increase the potential return of an investment. The concept of Leverage is used by both retail or institutional investors. Investors use leverage in an attempt to increase the returns that can be provided on an investment.

Investing using Debt: Pros and Cons

Leverage and margin trading allow investors and firms to amplify the returns earned from an investment or project. The main advantage of using debt for investment purposes is the enhanced buying power via the borrowed funds. The investor can purchase more shares than they would have been able to purchase if they used their own funds.

Once the asset's return is greater than the interest rate paid on the loan, the investment is profitable. If we use our previous example, let's assume that the margin loan interest rate is 5% per annum. This means that the investor would pay $500 in interest on the outstanding $10,000 balance. If a year passes and the investor decides to sell the shares at $30 per share with total transaction fees of $250:

1. Under the Cash Account, the return on investment would be: $\frac{[(\$30{,}000 - \$20{,}000 - \$500)}{\$20{,}250} \times 100\% = 46.9\%$, where:
    a. $30,000 is the transaction value of the sale;
    b. $20,000 is the transaction value of the purchase;
    c. $500 is the value of the fees paid for both transactions (i.e. $250 each in this instance); and
    d. $20,250 is the total outlay by the investor for the purchase of the shares.
2. Under the Margin Account, the return on investment would be $\frac{[(\$30{,}000 - \$10{,}000 - \$10{,}000 - \$500 - \$500)}{\$10{,}250} \times 100\% = 87.8\%$, where:
    a. $30,000 is the transaction value of the sale;
    b. $10,000 is the amount put out by the investor towards the purchase under the margin trading facility;
    c. $10,000 is the loan amount to be repaid;
    d. $500 is the value of the fees paid for both transactions (i.e. $250 each in this instance);
    e. $500 is the interest paid for the one year (5% of $10,000); and
    f. $10,250 is the total outlay by the investor for the purchase of the shares.

However, the significant drawback of leverage and margin trading is that the downside risk (i.e. the risk of losses) is also greatly enhanced. Suppose the same shares were sold at $10 per share, the losses would be as follows:

1. Under the Cash Account, the loss on the investment would be: $\frac{[(\$10{,}000 - \$20{,}000 - \$500)}{\$20{,}250} \times 100\% = -51.9\%$.

2. Under the Margin Account, the loss on the investment would be: $\frac{[(\$10{,}000-\$10{,}000-\$10{,}000-\$500-\$500)}{\$10{,}250} \times 100\% =$ **-107.3%**, where:
    a. $10,000 is the transaction value of the sale;
    b. $10,000 is the amount put out by the investor towards the purchase under the margin trading facility;
    c. $10,000 is the amount needed to repay the margin trading facility;
    d. $500 is the value of the fees paid for both transactions (i.e. $250 each in this instance);
    e. $500 is the interest paid for the one year (5% of $10,000); and
    f. $10,250 is the total outlay by the investor for the purchase of the shares.

Margin Trading can be a useful investment tool for wealth creation once used correctly. We encourage investors to conduct research before making any investment decision (including the use of margin trading) and ensure consultation is done with a registered investment adviser and/or broker dealer before making an investment. A list of all registered investment advisers, companies, individuals and securities that are offered are available on the TTSEC's website, www.ttsec.org.tt.

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