

Marginal thinking: Looking into securities-based lending

Currently, the Fed permits broker/dealers to lend up to 50% of a margin account's market value, provided that the investor has at least \$2,000 of equity. This policy, in force since 1974, permits investors substantial leverage, effectively doubling gains or losses on a fully margined position. Used on a volatile stock, a maximum margin greatly magnifies the risk—wiping out an investor's equity when the stock price drops by 50%.

To ensure repayment of their loan, brokers set a maintenance margin requirement, issuing a margin call for additional cash or securities or selling the holding when the investor's equity drops below a set percentage. The stock markets require a 25% minimum maintenance margin, but brokers may demand higher limits.

The danger that margin hawks foresee is that a sharp market decline will be accelerated by a wave of forced selling from margin calls. They would like to see the Fed raise margin requirements moderately. Indeed, some advocate raising initial equity requirements more drastically for those who would leverage their day-trading accounts.

On the other side, economists point to research indicating that past changes in margin requirements had no measurable effect on market volatility. Margin borrowing, in their view, rises in response to a rising market, not the other way around.

Is a margin account right for you?

Stock-secured credit can be far more than a tool for investment leverage. Brokerage clients borrow against their investment portfolios for a variety of purposes. They may wish to diversify a concentrated stock holding or pay for a child's or grandchild's college education. They may finance the purchase of a car, boat, aircraft or home, or the costs of launching a new business. Using securities as collateral provides a host of significant advantages:

- Capital can be liberated from a highly appreciated investment holding with no liability for capital gains tax.

- The interest rate is generally close to prime—well below those of consumer loans and most credit cards.

- Interest paid on loans used to purchase investments is tax deductible to the extent of realized investment gains (with any excess carried over to future tax years).

- There's no requirement for income verification, no complex paperwork and no fixed repayment schedule. The amount and terms of the loan depend solely on the quality and liquidity of the securities pledged to secure it.

All in all, a holding of investment securities can be your most convenient and efficient source of credit. Your investment advisor can help put it to work for you.

Sensible leverage

For clients seeking to leverage their investments, we can extend margin loans under Federal Reserve Board requirements. On those who choose this course, we urge caution. It's important to recognize that risk rises even faster than the potential extra return. This is because interest costs reduce gains and increase losses.

Opening a margin account, you may want to keep the following suggestions in mind:

1. Keep your margin leverage within reasonable limits. If you have 80% or 90% equity in your investments, there's little chance that you'll face a margin call or forced sale in even the roughest markets.

2. Buy only conservative stocks on margin. Companies with steady and growing earnings may have their ups and downs, but their downs will never be as dramatic as those of no-profit technology stocks.

3. Use stop-loss orders. You may avoid big losses by setting a price at which you want the stock to be sold. You then can readjust this price upward to lock in gains as the stock price rises. Be aware, however, that your position will be sold automatically if the price drops to your stop-loss target. When the stock price is declining rapidly, there can be no guarantee that your target price will be realized.

4. Pay down the loan as you would any other debt to maintain your buying power as future opportunities arise.

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Any developments occurring after January 15, 2007, are not reflected in this article.