Margin Loans for Investing

Readers who have read my book *Building Wealth in the Stock Market* (previously as *The Aggressive Investor*) will know that my investment plan is never to borrow money to invest in shares. I never have and I never will. Partly, this is because of the extreme financial risk involved when my investment plan is already highly focussed mainly on stocks. The stocks in which I invest are smaller and more volatile than the big blue chips. It is also because my income is now solely driven by investing my capital in “retirement”, so protection of capital is a paramount objective for me. As I have been saying for years, everyone’s investment plan must be drawn up to reflect who they are in the widest sense. It should also be adjusted as circumstances change.

That said, borrowing on margin to invest in stocks may be an acceptable increase in risk for an investor in the early decades of their working career, when losses might be recovered from savings from their employment or business income. Nevertheless it should never be forgotten that a margin loan is a dangerous instrument if used incorrectly, or if the investor is caught heavily margined in a bear market, especially in stocks that are not investment grade (make profits, pay dividends and have low debt). For those who don’t think bear markets happen very often, let me remind you there has been at least one bear market in most decades since 1900.

With a margin loan, the investor borrows from a financial institution to buy stocks. The lender holds title to the stocks as security for the loan. This means that the stocks must be acceptable to the lender as security, so will be restricted to a select list. The lender will also stipulate a loan to value ratio that determines the maximum that may be borrowed against to shares. The maximum ratio is typically 70%, but this ratio may be changed unilaterally (usually downward) by the lender at any time. If this happens, and it usually happens in difficult, volatile and declining markets, the borrower must put up more security or sell some of their holdings, usually at a bad time.

The other risk is that the loan to value ratio remains unchanged, but the shares bought with the margin loan decline in price, taking the amount borrowed above the loan to value ratio. In this situation, the stocks will have lost value and be in a downward trend. The borrower will receive a margin call from the lender and has only a short time to either put up more security or sell some of their holdings at what is a bad time by definition.

It might be asked why borrow to invest on margin? The simple reason is that it magnifies the return on the investor’s own capital when stocks rise in price, because that gain comes from their own funds plus the borrowed funds. However, there is an equal downside: if stocks fall in price, the losses come from both the borrower’s own capital and the borrowed capital, so the loss is much greater as a percentage of the borrower’s funds. In a bad situation, the loss could exceed the borrower’s capital so the loss is total and a further debt will remain to be paid.

One of the ways to make investing on margin a bit safer is to never go as high as the loan to value ratio. It is better to start at 10-20% loan to value ratio and work on that for a complete bull-bear cycle before thinking of increasing the loan to value ratio.

However, that is getting ahead of myself in this discussion. In my opinion, it is close to insane for anyone to borrow to invest in stocks unless they have first proven their skills by managing only their own funds through a complete bull-bear cycle. If and only if, the investor has a good return on that period should investing on margin be considered.

Here is a list of some other risks involved in investing using margin loans:

- Finding extra cash at short notice to cover margin calls
- Selling some investments at short notice and maybe at a bad time to meet margin calls
- Providing extra shares to the lender as security rather than meeting margin calls
- Selling some of the stocks at short notice if the lender drops them off the approved list
- Meeting an unexpected margin call if the lender reduces the loan to value ratio

The really silly thing that some investors do is to borrow against their home to fund a margin loan. If things go against them, a heavily margined portfolio, even of blue chip stocks, can lose more than the borrowed amount. This could even mean selling the home to pay off the debt.

My final word is to borrow very conservatively and to not even think of investing on margin until the investment method to be used has been tested with real money through a bull-bear cycle. Personally, I would never meet a margin call. I would sell the stock. A margin call tells you that at least one of the margined investments has gone wrong. As in all investing, the first loss is usually the smallest loss.

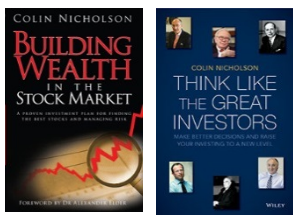
To read more of my work

Previous Articles

All my previous articles for the free website are now on the *Educational Articles* page on the Free Resources menu. They are now listed alphabetically by title with a brief description of their contents.

Books

I have written two books, both of which are available for purchase from the ***Buy Books*** menu:



Building Wealth in the Stock Market – A proven investment plan for finding the best stocks and managing risk

Think like the Great Investors – Make better decisions and raise your investing to a new level

Members Website

Follow my thinking on my own investments, disclosure of my portfolio as I go, weekly market scans, weekly market charts and analysis plus many more articles about investing and analysis

I am one of the very few investors who publishes their investment results each year, which I have done since 2000 – see the Investment Returns page on the About Colin menu on the website