Trading Basics Series

HOW DO I TRADE STOCKS.COM

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Using Margin

Margin: Borrowing Money To Pay for Stocks

Margin is an incredibly cheap way to borrow money from your broker to help bolster your trading account to increase profits. For example with Questrade their rate for margin borrowing to buy US securities is 4.75% per annum. So for every $1000 you borrow you pay $3.95 per month or 13 cents a day for the privilege. It does come with inherent risks though, so I thought I should give you the very scary side of margin so that you understand what it means to use margin.

I personally do use margin, at all times and I do not get margin calls as described below because I use strict risk management. Read on to scare yourself silly about margin – better to know the facts!

In the US, maximum margin allows you to double your buying power, as most brokerages will give you approximately $1 to trade with for every $1 you put into your account in cash. For day traders (holding no positions overnight) often brokers will give you $3 for every $1 in cash you have in your account. (Note that U.S. Securities and Exchange Commission (SEC) Rules state that you need to have $25,000 in cash to be able to day trade). In Canada, exclusively Canadian only brokers such as Questrade allow you 3 times your money, so for every $1 you have in your account they will add $2 more. As far as I know all US Based brokers that operate in Canada under a .ca domain such as Interactive Brokers and ThinkorSwim stick to the US margin rules of 2 times your money.

Also note that if your money is in an IRA, 401K or RSP tax free savings account, then you do not have access to margin.

Definition of margin: “Margin" is borrowing money from your broker to buy a stock and using your investment as collateral. Traders use margin to increase their purchasing power so that they can own more stock without fully paying for it. But margin exposes us to the potential for higher losses. Here's what you need to know about margin.

Understand How Margin Works

Let's say you buy a stock for $50 and the price of the stock rises to $75. If you bought the stock in a cash account and paid for it in full, you'll earn a 50 percent return on your investment. But if you bought the stock on margin – paying $25 in cash and borrowing $25 from your broker – you'll earn a 100 percent return on the money you invested. Of course, you'll still owe your firm $25 plus interest.

The downside to using margin is that if the stock price decreases, substantial losses can mount quickly. For example, let's say the stock you bought for $50 falls to $25. If you fully paid for the stock, you'll lose 50 percent of your money. But if you bought on margin, you'll lose 100 percent, and you still must come up with the interest you owe on the loan.

In volatile markets, investors who put up an initial margin payment for a stock may, from time to time, be required to provide additional cash if the price of the stock falls. Some investors have been shocked to find out that the brokerage firm has the right to sell their securities that were bought on margin – without any notification and potentially at a substantial loss to the investor. If your broker sells your stock after the price has plummeted, then you've lost out on the chance to recoup your losses if the market bounces back.

Recognize the Risks

Margin accounts can be very risky and they are not suitable for everyone. Before opening a margin account, you should fully understand that:

- You can lose more money than you have invested;
- You may have to deposit additional cash or securities in your account on short notice to cover market losses;
- You may be forced to sell some or all of your securities when falling stock prices reduce the value of your securities; and
- Your brokerage firm may sell some or all of your securities without consulting you to pay off the loan it made to you.

You can protect yourself by knowing how a margin account works and what happens if the price of the stock purchased on margin declines. Know that your firm charges you interest for borrowing money and how that will affect the total return on your investments. Be sure to ask your broker whether it makes sense for you to trade on margin in light of your financial resources, investment objectives, and tolerance for risk.

Read Your Margin Agreement

To open a margin account, your broker is required to obtain your signature. The agreement may be part of your account opening agreement or may be a separate agreement. Be sure to carefully review the agreement before you sign it.

As with most loans, the margin agreement explains the terms and conditions of the margin account. The agreement describes how the interest on the loan is calculated, how you are responsible for repaying the loan, and how the securities you purchase serve as collateral for the loan. Carefully review the agreement to determine what notice, if any, your firm must give you before selling your securities to collect the money you have borrowed.

Know the Margin Rules

The Federal Reserve Board and many self-regulatory organizations (SROs), such as the NYSE and FINRA, have rules that govern margin trading. Brokerage firms can establish their own requirements as long as they are at least as restrictive as the Federal Reserve Board and SRO rules. Here are some of the key rules you should know:

Before You Trade – Minimum Margin

Before trading on margin, FINRA, for example, requires you to deposit with your brokerage firm a minimum of $2,000 or 100 percent of the purchase price, whichever is less. This is known as the "minimum margin." Some firms may require you to deposit more than $2,000.

Amount You Can Borrow – Initial Margin

According to Regulation T of the Federal Reserve Board, you may borrow up to 50 percent of the purchase price of securities that can be purchased on margin. This is known as the "initial margin." Some firms require you to deposit more than 50 percent of the purchase price. Also be aware that not all securities can be purchased on margin.

What is "Marginable"

Each equity (stock) can have a different minimum margin requirement, so some stocks allow you to borrow full margin against it, while others (e.g. leveraged ETF's) do not allow for full margin, as per the rule change in 2009 after the market crash. So there is often no way of knowing how many shares you can buy of a particular security when using margin. So if you're buying power says that you can buy 500 shares of something and when you try and buy 500 shares it comes back with insufficient funds, this is the reason why. And you may have to lower the amount of stocks little by little to get the max amount your margin can buy. Finally also note that penny stocks (under $5) are often un-marginable as they are so volatile.

Amount You Need After You Trade – Maintenance Margin

After you buy stock on margin, FINRA requires you to keep a minimum amount of equity in your margin account. The equity in your account is the value of your securities less how much you owe to your brokerage firm. The rules require you to have at least 25 percent of the total market value of the securities in your margin account at all times. The 25 percent is called the "maintenance requirement." In fact, many brokerage firms have higher maintenance requirements, typically between 30 to 40 percent, and sometimes higher depending on the type of stock purchased.

Here's an example of how maintenance requirements work. Let's say you purchase $16,000 worth of securities by borrowing $8,000 from your firm and paying $8,000 in cash or securities. If the market value of the securities drops to $12,000, the equity in your account will fall to $4,000 ($12,000 - $8,000 = $4,000). If your firm has a 25 percent maintenance requirement, you must have $3,000 in equity in your account (25 percent of $12,000 =

$3,000). In this case, you do have enough equity because the $4,000 in equity in your account is greater than the $3,000 maintenance requirement.

But if your firm has a maintenance requirement of 40 percent, you would not have enough equity. The firm would require you to have $4,800 in equity (40 percent of $12,000 = $4,800). Your $4,000 in equity is less than the firm's $4,800 maintenance requirement. As a result, the firm may issue you a "margin call," since the equity in your account has fallen $800 below the firm's maintenance requirement.

Understand Margin Calls – You Can Lose Your Money Fast and With No Notice

If your account falls below the firm's maintenance requirement, the bad news is your firm generally will make a margin call to ask you to deposit more cash or securities into your account. The good news is that if you are unable to meet the margin call, Big Jimmy will not show up at your door with a baseball bat, but your firm will sell your securities to increase the equity in your account up to or above the firm's maintenance requirement. How much notice you are given is up to the individual broker and the seriousness of the loss in the value of the stock. Generally speaking margin calls are avoidable with good money management stops. At HowDoITradeStocks.com, we use good money management, so we are unlikely to ever get a margin call. And if we do, we can easily remedy it by selling a few shares.

Always remember that your broker may not be required to make a margin call or otherwise tell you that your account has fallen below the firm's maintenance requirement. Your broker may be able to sell your securities at any time without consulting you first. Under most margin agreements, even if you're firm offers to give you time to increase the equity in your account, it can sell your securities without waiting for you to meet the margin call. So get in touch with your broker right away or take action as soon as you can. They will give you time to remedy it if you communicate with them. As I say some are more forgiving than others. Here in Canada, Questrade is very forgiving and MBTrading similarly, I believe will give you 48hrs to fix the issue.

Conclusion

In conclusion, I cannot recommend that you personally use margin in your account. We set up the DPR Management tool to only give you results based on your cash. There are multiple reasons for this. One of which is that it is your responsibility to decide if you are going to trade margin with the risks that come with it. I personally want to leverage as much of my money as possible, so I use margin all the time.

If you want to use margin when using the DPR Tool you can increase the amount you put into capital field to increase the amount of shares the tool will calculate for you to buy.

Source:

http://www.sec.gov/investor/pubs/margin.htm - Margin: Borrowing Money To Pay for Stocks