TOPIC: MARGIN BORROWING

One form of credit typically available to investors is margin borrowing. When you borrow "on margin," you borrow money from the brokerage firm that holds your investment securities, and in turn pledge the securities as collateral for the loan. Most exchange-traded stocks, mutual funds, and individual bonds can be borrowed against, but margin borrowing is prohibited for securities held in IRA or most other tax-deferred accounts. Margin loans operate more like a line of credit, as they do not have specific maturity or due dates, and there is no required monthly payment for either principal or interest. The brokerage firm loan you money, and in turn charges a floating interest rate tied to the "broker's call" interest rate, which represents the broker's cost of funds when borrowing against exchange-traded collateral. Brokers typically charge you an interest rate that is quoted as some amount above the current broker's call rate (usually 0-2.25% above broker's call). The broker's call rate itself is usually lower than most other short-term interest rates, such as T-bills or the prime rate.

How It Works in Practice

Here's how it works in practice. Let's assume you have stocks and stock mutual funds with a current market value of $100,000 in your brokerage account. You would like to purchase additional stocks, but don't have cash. The broker will lend you $100,000 so that you can purchase an additional $100,000 worth of stock. You now have $200,000 of stocks at market value, of which $100,000 is your "equity" in the stocks, and the $100,000 is a margin loan. In this case, you have established an initial 50% margin position, since 50% of your total market position represents your equity. In fact, this 50% initial margin is a limit set by the Federal Reserve Board. You could borrow less than $100,000, but could not borrow more.

What happens if your securities suddenly appreciate 30% in value to $260,000? Your margin loan is still $100,000, but now your equity in your securities has risen by the amount of the $60,000 total appreciation to $160,000. On your $100,000 initial investment, you now have $160,000, or a 60% return on a 30% appreciation in securities prices. This multiplier effect on your return is a consequence of the leverage employed, and is one of the primary reasons why investors may choose to use it. But this opportunity for increased return comes at a price.

What if instead your securities drop 30% in value to $140,000? You still owe $100,000, but your initial $100,000 equity absorbs all of the drop and is now worth only $40,000, or a return on your initial $100,000 of -60%! The opportunity to multiply gains comes at the risk of multiplying your losses as well. Furthermore, your $40,000 equity now represents only 28.6% of the total securities market value. You will receive a "margin call" from your broker, because your equity has dropped below the "maintenance margin" limit set by most brokers of 30% (brokers and stock exchanges are free to set the maintenance margin limit, and 30% or 35% is typical.) A margin call means that you are required to restore your equity above the maintenance margin limit by either 1) depositing more cash or securities in your account, or 2) selling some of your existing securities in the margin account, with the sale proceeds used to reduce your margin loan. If you do not do either within a few days, the broker will automatically sell some of your securities until the maintenance margin is reestablished, thus forcing you to sell in a declining market. When margin requirements were much less strict, back in the 1920's, these type of forced margin sales were in large part responsible for many fortunes being lost during the market crash of 1929.

Margin borrowing does not have to be used to purchase additional securities. Most brokers will allow you to borrow against your securities, and take cash from your account to be used for your own purposes. However, the initial margin and maintenance margin limits will still be applied, and serve as a restriction on how much borrowed cash you can take out.
Establishing and Using a Margin Account

Margin loans are extremely easy to set up and use. You establish the privilege to use margin borrowing by signing an agreement with your broker, either when you initially establish your account, or it can be added later. There is no cost to set up the margin borrowing feature, and no interest is incurred until you actually borrow. Furthermore, since your securities are held as collateral, there is no examination by the broker of your financial situation in order to approve or reject you for margin borrowing. A margin loan is initiated by simply buying some more securities, or by withdrawing cash, in an amount exceeding the available cash balance in your brokerage account. Interest charges start to accrue immediately on the amount that is borrowed at the applicable margin loan rate. An interesting feature and benefit of margin loans is that, unlike most other forms of credit, the margin interest rate charged by the broker typically declines at specified dollar breakpoints as the loan size increases.

Margin loans are floating rate loans, but without any specific maturity or due date, or minimum monthly payments. Margin rates move in tandem with the broker's call rate, which in turn is a short-term rate which reacts almost immediately to any change in policy of the Federal Reserve. If the Federal Reserve moves to either increase or decrease short term interest rates, you will see the same change the next day in your margin rate. However, you are not required to payback your margin loan by a specific date, or pay any of the interest accruing on the loan by a certain point, provided the maintenance margin requirement is always satisfied.

Tax Deduction for Margin Interest

Margin interest is considered investment interest if it is incurred to either buy or hold investment securities, and as such may be taken as an itemized deduction for Federal and state income tax. If you borrow on margin and buy more securities, it qualifies as being used to "buy" securities. If you are borrowing and removing cash from your account for other purposes, the interest may still qualify as deductible if you can show that incurring the margin loan allowed you to continue to "hold" securities that otherwise would have been sold to raise cash.

The interest deduction may be limited in a given year if the margin interest expense incurred exceeds the net investment income from all sources for that year (investment income includes interest income, dividends (not taxed at 15%), short term capital gains, and short term capital gains distributions). For example, if you incur $5,000 of margin interest expense, but have $6,000 of investment income, the full $5,000 margin interest may be deducted. If, however, you only had $4,000 of investment income, $1,000 of the margin interest would not be deductible. This problem can be addressed in either of two ways to restore the deduction. You may choose, in the current year, to recharacterize some long term capital gains or long term capital gains distributions as "short term," thus adding to your investment income amount. Although this may allow you to take the full deduction for the margin interest, the recharacterization also subjects that portion of your income to higher ordinary income tax rates rather than the lower long term rates that would have applied. Alternatively, you can carry forward indefinitely to future years the unused deduction, in this case $1,000, and take the deduction against investment income in a later year. In all cases, that portion of margin interest attributable to tax exempt securities (such as municipal bonds) held as collateral for the margin loan is not deductible. Furthermore, margin interest that is incurred in order to buy tax exempt securities is not deductible.

Strategies for Margin Borrowing

Margin borrowing can often serve as an extremely convenient and low-cost, tax deductible source of short term cash. As described earlier, it is extremely easy to establish margin borrowing privileges, and borrowing itself can be invoked or terminated by nothing more than simply buying or selling a security in your account, or by writing a check against your account or depositing cash back into it. Therefore, it can be an ideal source of cash for which you have a short-term need, i.e. where you expect to be able to replenish the borrowed cash soon, and don't want to incur the
commission and tax costs of liquidating, then repurchasing securities in your account. If you have checkwriting privileges on your account, margin serves as a form of overdraft protection, ensuring that a check written exceeding your cash balance will still be honored, with the amount of the overdraft treated as a margin loan. It can also serve as a backup source of emergency cash reserve rather than maintaining excess cash reserves in low interest-bearing cash equivalents.

Margin borrowing can alternatively be used as a long-term borrowing vehicle in order to obtain more leverage, or market exposure, in your investment portfolio. It may also be used to extract money from an investment portfolio you don’t want to sell (for example, highly appreciated, concentrated securities) in order to buy other securities and achieve greater diversification.

When used for long-term purposes, you must be confident that the expected incremental return on your investments purchased on margin will exceed the cost of the margin interest, on an after-tax basis. You must also be prepared to assume the risks described earlier in the event of market drops, where multiplying losses combined with margin calls can create serious financial problems. In most cases, it is wise to borrow less than the margin limits allow in order to further reduce the possibility of a margin call in a severe market drop.

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