Unbiased Financial Information Provided by Financial Wisdom.

Be Sure to Understand Brokerage Margin Loans

Most brokerage firms offer "margin loan" services to their customers. Margin loans are a form of borrowing from the brokerage firm using your stocks as collateral. Investors use margin loans most often to buy more stock without having to fully pay for it. This can work well if the market goes up, but have disastrous effects if the market goes down.

Examples of how margin works

Assume you want to buy 100 shares of a stock for $40. If you do not use margin, you send $4000 to the brokerage firm (ignoring commissions). If the stock goes up to $50, your gain is $10 per share or $1000 in total. On a percentage basis, you made 25%. If the stock goes down to $30, your loss is $10 or $1000 in total. On a percentage basis, you lost 25%.

Now let's assume you use the same $4000 and buy 200 shares. You borrow an additional $4000 through a margin loan. If the stock goes up the same $10 per share, you will have made $2000 or 50% on your actual cash investment. However, if the stock goes down $10 per share, you will have lost $2000 or that same 50% of your money.

You leverage your upside if the stock goes up, but also increase your risk if the stock goes down. In fact, if the stock goes down to $20 per share, you would have lost all your money. If it goes below $20 per share, you will have lost more than what you invested. "Leverage is a two-edged sword."

Know the margin rules

To open a margin account, the brokerage firm will require you to sign a margin agreement. Read it very carefully. The Federal Reserve Board, the New York Stock Exchange, NASD and your brokerage firm have rules about how margin works. Make sure you fully understand the agreement before signing it.

Most firms will require you to have a certain deposit in your account before you can use margin. Usually, you can borrow up to 50% of the purchase price when buying a stock. This is often called your "initial margin." Some firms may require more. Also, know that there are some securities that cannot be purchased on margin and some that require more than 50%.

After you buy a stock on margin, you are required to maintain a certain level of "equity" in your account. The equity in your account is the value of your account less the margin debt you owe the brokerage firm. Generally, you must maintain equity of at least 25% of the value of your account. This 25% is called the "maintenance requirement." Many firms require more, depending on the size of the account and type of securities owned.

The brokerage firm will charge you interest on the amount borrowed. Usually the interest rate is dependent on the size of your borrowing and is usually pegged to some published interest rate.

Margin calls

If your account falls below the maintenance requirement, the firm will generally make a margin call to require you to deposit more cash or securities into your account. If you are unable, or unwilling, to meet the margin call, the firm will sell securities to increase the equity up to or above the firm's maintenance requirement.

Remember though, the firm may not be required to make the margin call; they may be able to sell your securities without contacting you. Make sure you understand your margin agreement.

Recognize the risks
Using margin can be very risky. You can lose all your money or more than you invested. You will pay interest on your borrowings. Read and understand all the terms of the margin agreement.

Margin is not for everyone. In fact, it usually best left to the professional traders who fully understand the rules and who follow the markets constantly.