



Investment Insights

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The perils of margin investing

Over the past few years, we've all undoubtedly heard stories of the investors who lost "everything they had" or maybe even owed their brokerages money as a result of their stocks declining precipitously in value. Chances are, these situations were perpetrated by the use of "margin" when investing. As the stock markets begin to rebound, and investors begin to again feel comfortable with buying stock, it is a good time to look at the perils of investing on margin.

Let's start by defining what investing on margin is. Here's a simple example: Suppose you have \$10,000 to invest, and you want to buy some shares of Microsoft. Your research indicates to you that Microsoft has the potential to double over the next two years. If it does double, your \$10,000 will grow to \$20,000. However, you can also borrow additional money at the time of purchase to buy even more Microsoft. This is called "buying on margin". In most cases, you can borrow up to 50% of the value of the stock from the brokerage firm. So in this case, you could actually use your \$10,000 to purchase \$20,000 of Microsoft stock. If the shares then double, your \$10,000 will be worth \$30,000 (\$40,000 minus the \$10,000 you borrowed). Margin magnifies the gain on your investment.

The downside of using margin is clear when the markets decline, as they did in 2000-2002. Margin can also magnify the downside. As in the above example, suppose you used your \$10,000 and a \$10,000 margin loan to buy the \$20,000 of Microsoft. Imagine this time the stock declining by 50% (which actually did happen in the short period of January 2000 to September 2000). In this situation, your entire \$10,000 investment would be wiped out. The remaining \$10,000 value of the Microsoft stock would be liquidated to cover the amount you owe to the brokerage firm.

Many large investment firms are now offering margin loans for purposes other than buying more stock. Borrowing against stock positions to buy a home or car is a common proposition. In this situation, it can be even more dangerous for the investor to use margin as a market decline might result in not only their investment portfolio becoming worthless, but also could mean losing their home if the stock market decline was severe enough.

During the speculative run up in the stock market in late 1999- early 2000, margin buying hit record levels. Unfortunately, the rapid decline in the markets in mid-late 2000 wiped out the accounts of many margin buyers. With this experience fresh in investor's minds, one would expect margin buying to be much less common today. However, the National Association of Securities Dealers announced that margin loans have quadrupled this year, hitting a record \$26 billion in July. New York Stock Exchange-regulated firms have seen a 10% increase this year in margin loans, with a total of \$148.5 billion outstanding as of July.

Many market pros view these numbers as a sign that the market is again seeing a lot of speculative buying. It is very important for all investors to know the upside and downside of using this strategy as the temptation once again presents itself. The past few years have been tough ones for most stock market investors, but one from which many lessons can be learned to make everyone a more successful investor in the future. The lesson of the perils of margin buying should not be forgotten. It is a lesson that is too expensive to re-learn.

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