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Buying On Margin For Bigger Returns and Bigger Losses

Round about the latter part of a bull market, we start to hear recommendations for buying on margin. Financial Planners start touting the benefits, pointing to how much a persons gains could have been improved in recent years, if they had been using leverage. And they are right, but in a correction, the losses are also magnified.

First, for those who do not know what we are talking about, let us explain what buying on margin is. Normally when we invest, we use our own money. So if we had $10,000, and we got a return of 10 percent, we would make $1,000. However, if we doubled the investment, we could also double the income to $2,000. To do this, we borrow the additional $10,000 to double the investment, which should double the return. We can do this by putting up the investments as security. Since, we have $20,000 of securities backing up the loan, the lender will be happy to loan $10,000. This can be arranged through a broker, bank or other financier. So when we say that we bought on margin, it essentially means that we only put up some of the money, and that we borrowed the rest.

In the long run, if we have a sound portfolio, this can be very effective. As historically, a good portfolio of equities will produce a return greater than the cost of borrowing. If we take the above example and assume a 6 percent borrowing rate. Your total return on the investment that returned 10 percent would equal $2,000. After paying interest of $600, your net return is $1,400 or 14 percent on the amount of cash that you put up. This beats the $1,000 or 10 percent. The problem is that markets do not always go up.

If the market dropped 10 percent, then your loss would also be increased. In the above case instead of losing $1,000, or 10% you would have lost $2,600 (10% of 20,000 plus $600 interest) or 26 percent of your original investment. Not a very happy prospect. Also, because you are levered, you may not feel that you can afford to lose, in which case you will be more likely to sell when you should have been buying. Or the lender might want their money back, since you have less collateral, forcing you to sell and miss the good times.

So, as you can see, buying on margin, if done right, gradually over time, and in amounts where you can afford to wait out market declines, can enhance your returns. Be careful though, or you may only be enhancing your broker's returns.

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