WHOSE MONEY IS IT ANYWAY?
MARGIN INVESTING AND BORROWING IN BULL AND BEAR MARKETS

by: Harry S. Miller

During the bull market years leading up to the Spring of 2000, many individual investors broke new ground with their portfolios, doing things that they had never done previously. With the markets steadily climbing higher, many investors for the first time moved from diversified mutual funds to buying individual stocks. Many for the first time were willing to spend $220 for a single share of a company's stock. And many investors, for the first time, began to use margin to leverage their portfolios to increase their invested assets.

The additional leverage offered by margin loans significantly increased the potential for investing gains, however, it also accelerated portfolio downturns once the markets hit their peaks and the bubbles began to burst. For some, the successes (and excesses) of margin investing that led to double digit returns in 1999 and 2000, resulted in complete portfolio sellouts and outstanding margin calls during 2001 and 2002.

In decades past, many people thought that margin investing was only for those highfliers who truly "played the market." But as technological changes and a broader access to information have prompted individuals to become more active in their own investment accounts, many see margin as an investing tool for the common man. Any fear or unease that these individual investors might have once had with borrowing thousands of dollars on margin, secured by the value of stocks that are exposed to the market, has now worn off.

Margin investing is not for everyone, and the appropriate level of risk for any individual portfolio must reflect the investment objectives, financial needs, and personal comfort level of the investor. There may be very good reasons to maintain a margin account. For example, a brokerage account that is used both for carrying investments and paying regular living expenses -- perhaps through a credit card or check writing feature tied to the account -- might benefit from the added flexibility that margin offers. The investor does not need to closely watch his cash balance every day to ensure that there will be funds to pay his bills. If the cash runs out, he can cover his bills with margin funds and either add funds or sell securities at his convenience to readjust his cash and margin balances.

On the other hand, there are many questionable -- and perhaps ill-advised -- reasons for investing on margin. Some individuals who suffered losses in the market might see margin as a way to "get back in the game" and make back their losses. The problem is that such an investor is playing with money that he does not own and which he will have to pay back to the brokerage firm regardless of how the market turns and his investments fare.

Investing with borrowed funds creates a significantly higher level of risk, and that is true whether the funds are borrowed through a margin loan or from some other source. An all-to-common reaction to dramatic market losses in the last several years has been for individual investors to prop up account values by borrowing money from other sources, such as home equity loans or even cash advances from credit cards. Such an investment strategy, if ever advisable, would be so for only the most aggressive investor. If any broker or investment advisor were to recommend this aggressive strategy, he likely would be running afoul of the federal regulations governing margin, not to mention the sound fundamentals of securities investing.

Investors also should be aware of recent changes in the financial services world, which to a certain extent have blurred the once clear lines between brokerage firms and banks. Many full-service brokerage firms now offer other financial products such as home mortgages, lines of credit, and other forms of loans. Many of these financial products may include some variation of margin borrowing. For example, a brokerage firm might offer a home mortgage with no down payment as long as the homebuyer pledges and maintains a securities portfolio of a certain minimum value with the firm. The homebuyer essentially is using the value of his pledged securities to satisfy the down payment requirements. Although there is no actual loan of funds for the down payment, there is a form of forbearance, and the homebuyer's securities, as well as his house, are leveraged in exchange.

A broker or financial services professional may be able to offer helpful advice about using margin, however, every investor should keep a couple of points in mind. First, brokers generally are not afraid of margin, and they may deal with margined accounts so regularly that they are likely to discount the significant risks inherent in margin investing. An investor on margin always must consider the possibility that he could lose the full value of his securities as well as the full value of the margin he has used.

Second, consider that a broker is likely to increase his own compensation if he persuades his client to invest on margin. If the broker is paid by commission, a margin loan will increase the level of buying and selling in the account. If the broker's compensation is based on the amount of assets he has under management, then that figure will increase as well with a margin loan. Finally, the firm and perhaps the broker also will benefit from the margin interest that the investor will pay out of his account each month for the borrowed funds.