



Margin Trading

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A. How Margin Works?

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C. Conclusion

Margin Trading

An investor who purchases securities may pay for the securities in full, from his own resources, or may borrow part of the purchase cost from a lender. The lender may be a bank or a broker. If the investor chooses to borrow the money from a broker he/she has to open a margin account. “Margin”, in this context, is borrowing money from a broker to buy securities and the securities themselves are used as collateral for the borrowed money. Investors generally use margin to increase their purchasing power so that they can own more stocks (or other securities) without fully paying for them. Margin exposes investors to the potential for higher losses when prices of the “marginied” securities go down and at the same time it is more profitable to investors when the prices pick up.

A. Understanding How Margin Works?

Assume an investor buys a stock for LE 50 and the price of the stock rises to LE 75. If the investor had bought the stock and paid for it in full, he will earn a 50 percent absolute return on this investment i.e. $(LE\ 75 - LE50) / LE\ 50$. However, using the same example if the investor bought the stock on margin - paying LE 25 in cash and borrowing LE 25 from the broker – the return earned will be 100 percent on the money invested i.e. $(LE\ 75 - LE\ 25 - LE\ 25) / LE\ 25$. Of course, the investor will still owe the brokerage firm LE 25 plus interest. Interest will differ from one broker to another, depending on the agreement between the broker and the investor, and is computed on the duration and the amount “marginied”.

The downside of using margin is that if the “marginied” stock price decreases, substantial losses can mount quickly. For example, if the investor bought the share for LE 50 on margin and it fell to LE 25 the investor will lose 100 percent, plus he/she must still come up with the interest payments owed to the broker.

In markets that allow margin trading, investors, who put up an initial margin payment for a stock, are required, from time to time, to provide additional cash if the price of the stock falls to or below a certain level. This is called the maintenance level. Conversely, if the stock price rises, then cash can be withdrawn from the account to conform to the maintenance level.

Example: Assume an investor buys LE 16,000 worth of stocks by borrowing LE 8,000 from his brokerage firm and pays the balance of LE 8,000 from his own

cash. If the market value of the stocks bought drop to LE 12,000, the value of equity in the investor's brokerage account will fall to LE 4,000 ($LE\ 12,000 - LE\ 8,000 = LE\ 4,000$). Thus the term equity, in this context, is defined as the market price less the amount borrowed to purchase the stock. If the investor's brokerage firm has a 25 percent maintenance requirement, the investor must have LE 3,000 worth of equity in his account ($25\ \text{percent of } LE\ 12,000 = LE\ 3,000$). In this case, the investor does have enough equity because the LE 4,000 worth of equity in the account is greater than the LE 3,000-maintenance requirement. However, if the investor's brokerage firm has a maintenance requirement of 40 percent, he would not have enough equity. The firm would require the investor to have LE 4,800 worth of equity ($40\ \text{percent of } LE\ 12,000 = LE\ 4,800$). The investor's LE 4,000 in equity is less than the firm's LE 4,800 maintenance requirement. As a result, the firm may issue the investor with a "margin call," since the equity in the investor's account has fallen by LE 800 below the firm's maintenance requirement. If the investor's account falls below its maintenance requirement, the brokerage firm generally will make a margin call to ask the investor to deposit more cash or securities into his account. If the investor is unable to meet the margin call, the brokerage firm will sell the securities to increase the equity in the investor's account up to the firm's maintenance requirement. If the investor does not meet the marginal call and the broker sells the investor's margined securities then the investor will lose the opportunity to recoup his losses should the prices of these margined securities bounce back.

B. Trading on Margin Can Be Very Risky and Is Not Suitable for Everyone
There Are A Number of Risks The Investor Has to Consider before Deciding to Trade Securities on Margin. These Risks Include The Following:

- Investors can not only lose their initial investment but may lose more.
- Investors must be ready to deposit additional cash or securities in their accounts on short notice to cover market losses.
- Brokerage firms may sell some or all the investors' securities without consulting them in order to pay off the margin loan made to them, if margin calls are not satisfactorily met.
- Margin accounts tend to exaggerate market movements that could be a systemic problem when markets are spiraling down.

Furthermore, investors must remember that the brokerage firm will charge them interest for borrowing money and this will also affect the total return on their investments. Thus investors must be sure to ask their broker whether it makes sense for them to trade on margin in context of their financial resources, investment objectives and tolerance for risk.

It is also good practice for investors to carefully review the margin agreement before signing it. This agreement explains the terms and conditions of the margin account. It also describes how the interest on the loan is calculated, the responsibilities assumed by the investor for repaying the loan, and the manner in which the securities purchased on margin serve as collateral for the loan. The investors must carefully review the agreement to determine the conditions under which the brokerage firm will sell their securities to collect the borrowed money.

According to the Capital Market Law No. 95/1992, margin trading was not allowed. However, a new chapter was added to the Executive Regulations of the Capital Market Law 95/1992 i.e. Chapter 9 in year 2002 that allowed margin trading based on certain rules. The margin trading rules set the conditions for opening a margin account i.e. the minimum amount the investor must deposit to open a margin account, the maximum amount that the broker can lend to the investor and brokers actions in case of market movements, specifically downward. The rules also set conditions for periodic review of the procedures by the regulatory authorities. It was decided by CASE that margin trading will not be implemented in the Egyptian market, until the draft membership rules are implemented by the Exchange.

From another perspective, banks in Egypt are allowed to lend their clients to buy stocks against pledging shares, but the policies and rules of the lending bank govern such lending.

C. Conclusion

margin trading involves more risk than cash accounts (full payment for the securities). Investors should be aware that they may lose more than the amount of money initially invested in case of a market down turn, margin trading will be more profitable to investors when the market picks up. Investors should think twice in view of their financial status, investment objectives and risk tolerance before engaging in margin trading.