

Explore the Lesser-Known Benefits of Borrowing on Margin

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It is often surprising to find so few investors and financial professionals that are aware of the possibilities and advantages of borrowing on margin (a practice I will refer to here as “margin”). Some consider margin taboo, or do not have a clear understanding of benefits, risks, drawbacks or mechanics. This will discuss the basics of the margin process for those looking for new ideas to manage cash flow.

WHAT IS MARGIN AND WHAT ARE THE BENEFITS?

Margin is the act of borrowing cash from a financial custodian by using current portfolio assets as collateral. The major benefits, if used responsibly and appropriately, are immediate liquidity, administrative simplicity, flexibility, and potential cost savings. Margin rates vary by custodian but are often lower than rates for mortgage or other bank loans, and may be further negotiated by advisory firms for their clients. Additionally, the Tax Cuts and Jobs Act of 2017 retained the margin interest expense deduction. This means that when following specific guidelines and uses, margin interest expense may be deducted against net investment income in certain circumstances. As always, please consult with your tax professional before proceeding.

WHO ARE IDEAL CANDIDATES FOR MARGIN?

Corporate executives, business owners, real estate developers, and other investors most often appreciate the flexibility, potential lower borrowing costs and tax savings. Margin may be best suited for those who have substantial collateral in a brokerage account and wish to solve or bridge liquidity issues.

HOW MUCH CAN BE BORROWED?

Margin capacity is calculated based on a percentage of the collateralized assets' fair market value. A general rule-of-thumb for the amount of margin capacity is to use 50% as the loan-to-value ratio. In dollar terms, an account with \$1 Million of assets as collateral could borrow a maximum of \$500k. The loan-

to-value ratio could vary by custodian and based on the type of asset being used as collateral. Using Charles Schwab as an example, the loan-to-value borrowing percentage differs based on whether the positions to be used as collateral are mutual funds, ETFs, individual bonds or stocks. Charles Schwab is also capable of aggregating assets across numerous accounts of the same registration for purposes of calculating margin capacity, with some exceptions.

WHAT ARE THE RISKS AND COSTS ASSOCIATED WITH MARGIN?

The stated risks are margin maintenance risk (the largest risk, and commonly referred to as a ‘margin call’), interest rate risk and cost.

A margin call, which is calculated and managed by the custodian, can occur when a margin balance exceeds the allowable loan-to-value ratio of collateralized assets. This can happen should the assets acting as collateral decrease greatly in value (calculated by the custodian). In the event of a margin call, the investor will immediately be required to add collateral to the account or sell positions acting as collateral to pay down the margin balance back to an allowable loan-to-value ratio.

Because margin calls most often occur during market drawdowns, the custodian's collateral requirements could obligate the investor to be a forced seller at an inopportune time, thereby locking in a sale at a low price. This risk has the greatest magnitude and is the reason that sufficient collateral cushion is required for any responsible strategy that utilizes margin.

For the costs, the margin interest rate is typically a floating rate that is tied to a benchmark rate such as the Federal Funds Rate, LIBOR, or Prime Rate. There is always a risk that any of the above standard rates increase (interest rate risk). This rate is stated in annual terms but the interest expense is typically debited monthly. Margin interest expense is often the only cost associated and there should be no closing costs or prepayment penalties.

WHAT ARE THE TAX IMPLICATIONS OF MARGIN?

The IRS may allow for the deduction of margin interest expense against net investment income if appropriate sequential steps are followed and the margin is used for investment purposes such as generating taxable interest, dividends, capital gains, or royalties. The payment of accrued margin interest expense should be completed during each calendar year. Because there are numerous other considerations and complexities, one best practice is to coordinate the mechanics with an experienced team of advisors and accountants in advance so that the requisite steps are followed for tax deduction, if applicable.

IS THERE A HASSLE FACTOR FOR USING MARGIN?

When compared to the process for obtaining a mortgage, home equity line of credit (HELOC), or other bank financing, the hassle factor of margin is minimal. Most investors that use margin are often surprised by and appreciate the relative ease of the margin process.

WHAT ARE SOME ADDITIONAL CONSIDERATIONS?

There are numerous pitfalls that offset the obvious benefits of margin borrowing. It is highly recommended to work with

professional advisors with extensive margin experience. In addition, using margin requires closely monitoring cash flows and allowing for substantial cushion for the margin balance versus collateral ratio to prevent a margin call. While this list is not comprehensive, here are a few other factors to consider:

- There should always be a disciplined plan to pay off the margin, established in advance.
- Be sure to size margin positions appropriately as part of one's overall debt and liquidity picture.
- Advanced scenario planning should help prepare for what actions to take should adversity arise in the form of increased margin interest rates or a significant market decline.
- Those considering margin to augment returns should heed the Warren Buffett warning about margin "an unsettled mind will not make good decisions."
- Carrying a margin balance at the maximum allowable loan-to-value rate is not recommended under any circumstances.
- Accounts can often be aggregated for purposes of calculating margin capacity. However, only assets from one entity can be used to aggregate margin. For example, a taxable joint account cannot be aggregated with an LLC account or trust account.
- Retirement and non-profit accounts are not eligible for margin.
- Margin is one of many tools that can fit into a comprehensive financial plan.

It is vitally important to understand prudent margin use in advance. When used sensibly it can be a valuable strategy to help achieve financial goals.

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