AN OVERVIEW OF MARGIN TRADING TO INVESTORS IN STOCK MARKET

What is margin trading?

Margin trading means buying stocks with borrowed money. A client who has a portfolio of stocks could borrow money upto a predetermined value of the portfolio using existing stocks and stocks purchased (using borrowed money) as co-lateral. This simple means leverage a portfolio to earn higher returns using debt as a means of funding your additional investments.

This mode of financing stock purchases is particularly, advantages in a bull market when financing constrains could hamper or stall growth of portfolios. In a declining market this mode of financing could confront investors into difficulty since they would not be able to service the margin using sales proceeds less the shares purchase unless those shares are bought at the lowest levels where profit taking could be possible when there are short term upward trends in the market.

Lending against stock as co-lateral was initially, started by commercial banks. They started off by lending upto 50% - 60% of the market value of the portfolio pledged to them. However with the emergence of the margin trading institutions also began financing upto 100% - 150% of the portfolio value for only purchase of stocks. The importance of commercial banks only as a source of finance for stock purchases has diminished. But even presently many financing institutions lend on margin trading would apply the 50% limit in the value of the portfolio as a credit limit.

Margin Trading Process

The client approaches a margin trading institute to finance purchase of stocks. The client could either furnish cash or portfolio of stocks as co-lateral. Margin trading institute generally grants 100% of the value of the portfolio (either cash or stocks). Based on the margin agreed upon by the client and the margin provider the client will have to sign the tripartite agreement with the client, margin provider and the stock broker. Once the margin trading account (slash account) is opened in the Central Depository System (CDS) and transferred to the personal portfolio in the slash account before finance the stock purchases. The slash account is open under the name of the financier/ the borrower where the main account holder is the financier.

Role of the Financier in Margin Trading

- Administration work of the portfolio and Daily valuation
- Intimate the amount that can be utilized by the client on daily basis to the Stock broker
- Maintain the line of communication with the client – specially under declining market conditions
- Make Margin Calls if required when the value of the portfolio is declined

Role of the Stockbroker

- Remitting of all sale proceeds to Margin Provider
- Carry out purchases only with prior approval regarding the margin limits on stocks acceptable to margin provider
- In case of purchases of unacceptable stocks or beyond limit of the margin, the Broker should ensure such payment for purchase of shares made by the client.

Role of Client

- Complying to the conditions
- Cooperate & facilitate the Financiers Margin at 50% or above at all times.
- Purchase stocks which are acceptable to the financier
- Meet Margin Calls immediately

What is Margin Call?

The main criteria for margin trading is that the security cover has to be two times of the amount financed as per the regulations given by the Securities and Exchange Commission of Sri Lanka. In a declining market, if the value of co-lateral falls below two times the margin provider is compelled to execute a margin call. Then the client is obliged to infuse cash or stocks to top-up the co-lateral position to the required level else within one day notice. The margin provider can liquidate part of the portfolio in order to maintain the margin level as a step to regularise the security position.

Benefits to the client

- Increased buying power for higher returns
- Exploit market fluctuations by quick purchase decisions more than the funds available with the client
- Flexibility to utilise the funds as and when required
- Tedious documentation part, settlement and banking on time will be carried out by the margin provider

Risks involved

In a situation where stock market decreases continuously and the security cover drops below two times the margin provider shall be forced to sell the portfolio if the client did not respond to the margin call with cash or additional shares as security. At this point the margin provider could sell most saleable shares which may be the most valuable shares in the portfolio. This could lead to drop in portfolio value to the investor.

Conclusion

Margin Trading is one of the commonly used methods to increase the returns of the share portfolio when limited funds are available by the investor. This method is profitable in a rising

market but in the falling market margin investor can lose if a decision is not made wisely considering the fluctuations that could take place in the market.

Source: Merchant Bank of Sri Lanka PLC - Corporate Advisory & Capital Markets Division