**Dummies: Buying Stock on Margin**

*Definition:* Margin means buying securities, such as stocks, by using funds you borrow from your broker. In essence you will be using leverage( using borrowed money to increase your profit) to maximize your gain when price rises.

*Motivating Example:* Buying stock on margin is like buying a house with mortgage. If you want to buy a house at a purchase price of $100,000, you put down 10%, thus your equity (the part you own) is $10,000 and you borrow the remaining $90,000 with a mortgage. If the value of the house rises to $120,000 and you sell, you will make a profit of 100% (closing costs excluded). The $20,000 gain on the property represents a 200% gain on the purchase price of $100,000, since you real investment is $10,000( the down payment), percent gain is (20,000 / 10,000) \* 100 = 200%.

*Marginal Outcomes:* Suppose you think that a particular stock, Stock A currently trading at $40 per share is going to go up in value. You want to buy 100 shares, but you only have $2,000. You can borrow the $2,000 from your broker on margin, however there can be different outcomes:

*Stock Price Goes Up:*

This is the best outcome for you, if Stock A goes to $50 per share, your investment will be worth $5,000, while your outstanding margin loan will be $2,000. If you sell, the total proceeds pay off the loan and leave you with $3,000, your profit is $3,000 - $2,000 = $1,000. Since your initial investment was $2,000, your profit is a solid 50% because ultimately your $2,000 principal amount generated a $1,000 profit.

If however you did not buy on margin and instead paid the $4,000 upfront, without your margin loan, your $4,000 investment will generate the same profit of $1,000 but this is a 25% gain/ profit.

Using margin, you will double the return on your money.

*Stock Price Goes Down:*

If the stock neither falls or rises, although it may seem like a neutral situation, you still have to pay interest on your margin loan with each passing day.

If your stock pays high dividends such as a high dividend then that money can be used to pay of the interest on the margin loan

If the stock price goes down, buying on margin can go against you. If the price of Stock A plummets to $28, then the market value of your shares is $2,800, while your outstanding margin loan will be $2,000.

This is disastrous, when you purchase a stock on margin, you must maintain a balanced ratio of margin debt of equity of at least 50%. In your case, this ratio exceeds 50% of your stock investment, (2000 / 2800 \* 100) = 71% , you will get a *margin call*, this is when the broker contacts you to ask you to restore the ratio between the margin loan and the value of the securities.

If you cannot come up with other securities to restore the balance, you will be forced to sell . If you sell, the total proceeds pay off the loan and leave you with $800. Your loss is $800 - $2,000 = -$1,200. Since your initial investment was $2,000, your percentage loss is -60%, in essence you lost 60% of your money.