Margin trading increases buying power, enlarges risk

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Double gain, double pain. This is how the concept of margin trading can best be described. As the name suggests, margin trading enables you to trade with borrowed funds/ securities or, in other words, by paying only a part of the total investment amount. It is, in fact, a leveraging mechanism which enables you to take exposure in the stock market over and above what is possible with your own resources.

However, while margin trading increases your buying power, it enlarges your risk as well. In a way, amplifying your gains and losses to the same degree. That is why it is still not a recommended way of trading, although the lure of big money has always drawn investors into the lap of margin trading. So much so that an increasing number of small investors are now giving in to the temptation of this high-risk trading strategy which had traditionally attracted only short-term punters and deep-pocketed investors.

To understand the mechanism of margin trading more clearly, let's take the case of Sunil Mehra who buys 600 shares of XYZ Co at Rs 400, using the margin finance facility. Assuming his broker offers him 50% leverage on the transaction, Mehra effectively pays only half the total transaction amount (Rs 120,000 out of Rs 240,000) at the time of purchase.

The balance is borrowed from the broker/ bank. Now, if the share price rises to, say, Rs 450 after a few days, Mehra would be richer by Rs 30,000 (minus the interest that he would have to pay to the broker/ bank for the borrowed money) and the bank/ broker would gain to the extent of the interest amount on the funds borrowed. However, if the share price drops to Rs 360, Mehra would be incurring a loss of Rs 40 per share, exposing his financier to more risk if the share price were to plummet further.

"It is typically during such times that the broker is forced to make margin calls to clients, asking them to either deposit more money into their account or sell some of the securities in their account to meet the margin shortfall," says Ashish Kapur, CEO, Invest Shoppe.

Now if Mehra fails to make good the margin shortfall, his broker would sell his shares for the stipulated amount in consideration. Thus, apart from losing his investment, Mehra would also stand to lose the opportunity to make any profit in the future, were the share prices to recover.

However, if you look at the same transaction without the margin trading facility, you will realise that though it trims the profits, it effectively reduces the risk when the share price slides. If Mehra had not used the margin trading facility while buying shares, he would not have liquidated his holdings when the market corrected. It is another matter that unlike the previous transaction, he would have been able to buy only 300 shares.

Thus, given that margin trading can lead to inflated profits and losses, experts advise that it should be opted only by traders with a high-risk appetite. Risk-averse or general investors should better keep off from it.
Anyway, you are not allowed to dabble in margin trading on your own as market regulator Sebi, from time to time, has been prescribing eligibility conditions and procedural details for allowing this facility. Thus, for availing of this facility, you need to register, as prescribed by Sebi.

"You need to fill in the prescribed documents such as Margin Trading Letter, Margin Trading Agreement and New Finance Letter, apart from account opening and DP Form," says Trivikram Kamath, senior V-P & head of operations, finance and technology, Kotak Securities.

Also, only corporate brokers with a networth of at least Rs 3 crore are currently eligible for providing the margin trading facility to their clients. Before providing this facility, however, the member and the client have been mandated to sign an agreement for this purpose in the format specified by Sebi. The agreement provides the terms of margin trading, the extent of margin and other details.

The initial margin has been prescribed as 50% and the maintenance margin as 40%. Also, the 'total exposure' of the broker towards the margin trading facility should not exceed the borrowed funds and 50% of his 'net worth'. While providing the margin trading facility, the broker has to ensure that the exposure to a single client does not exceed 10% of the 'total exposure' of the broker.

For providing this facility, a broker may use his own funds or borrow from scheduled commercial banks or NBFCs regulated by the RBI. "However, the broker has not been allowed to borrow funds from any other source," says Kapur.
It has also been specified that the client shall not avail the facility from more than one broker at a time. Another significant point to note is that the facility of margin trading is available for Group 1 securities and those which are offered in IPOs. The list of scrips which are covered by this facility for NSE and BSE are limited (about 600). "Any scrip which is not included in the said list shall not be funded," says Kamath.

Thus, given the complexities of margin trading, you should invest only if you have an above average understanding of the market. "Otherwise your losses would be more than your gains," warns Naresh Varshney, associate director, Centrum Direct.

Systematic Trading Systems used with a lot of discipline is also one smart way to make money using margin trading facilities. The important aspect of this system is that human emotion is not involved in this and all buying and selling triggers are generated by a software which is based on a scientific analysis of historical market trends.

Whatever be the case, experts advise investors to put only that much money which they can afford to lose. This is just to ensure that one's life-long earnings are not wiped out through this process!