Qtrade Investor

Guide to margin trading

Margin trading means trading using borrowed money. It's a strategy used by both professional and self-directed investors. This short guide aims to introduce you to the basic concepts and get you started.

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Guide to margin trading

Margin trading is the practice of borrowing money from a brokerage to trade in stocks or other types of securities. Stocks held in your account are used as collateral for the loan, and the brokerage charges interest for the duration of the loan. In the investment world, buying stocks using borrowed money is known as trading 'on margin.'

When the price of a stock is rising, trading on margin allows investors to use leverage to increase their gains. However, when stock prices fall, losses mount much more quickly.

This guide provides:

1. A definition of margin trading
2. Margin trading examples and scenarios
3. Explanation of margin accounts
4. A "quick start" guide to margin trading
5. A guide to opening a margin account
6. Margin trading best practices and guidelines
7. Sample Qtrade Investor margin requirements
8. A glossary of margin trading terms

For further help with margin accounts or margin trading with Qtrade Investor, please speak to one of our investment representatives. Call 1.877.787.2330 or 604.605.4199, or send an email to info@qtrade.ca.

What is margin trading?

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Example:

Sam holds 1,000 shares in XYZ Inc. and would like to buy 500 more. Rather than use her own cash to buy the additional shares, she opts to borrow from her broker, using her original 1,000 shares as collateral for the loan.

Within her margin account Sam buys 500 shares in XYZ Inc. at $50 per share.

Scenario 1: price rises to $60 per share

Sam sells the 500 shares one month later at $60 per share*.

She pays her broker back the $25,000 she borrowed plus one month's interest**, which amounts to $125, or 25 cents per share.

This leaves profits of $9.75 per share.

Sam's account is now worth $64,975 ($60,000 stock in XYZ Inc. plus $4,975 profit from her margin trade).

Scenario 2: price falls to $40 per share

Sam sells the 500 shares one month later at $40 per share*.

She pays her broker back the $25,000 she borrowed plus one months' interest** which equates to $125, or 25 cents per share.

This leaves a loss of $10.25 per share to be paid from her existing XYZ Inc. stock.

Sam's account is now worth $34,875 ($40,000 stock in XYZ Inc. minus a $5,125 loss from her margin trade).

* These scenarios do not account for the cost of trading commissions.

** For this illustration, interest is calculated at 6% annually. To find out current interest rates for Qtrade Investor margin accounts, call **1.877.787.2330** or **604.605.4199**, or send an email to info@qtrade.ca.

Quick start to margin trading

1. Understand the risks of trading on margin (start by reading this guide).
2. Open a margin account.
3. Add/buy stock to be used as collateral.
4. Confirm your “buying power” — the amount you can borrow. This depends on the amount and type of stock you hold (see the table on page 9) and is usually in the range of 70% to 50% of the market value of your stock collateral.
5. Place an order.
6. Closely monitor your position.

Margin accounts

In order to trade on margin, you need to open a margin account. You can’t trade on margin within a cash account or within a registered account such as a TFSA, RSP, RIF, or RESP.

When you open a margin account, you will start by depositing a minimum amount of cash or margin-eligible securities. Your broker will lend you a portion of the market value of those assets, which act as collateral to secure the loan. The brokerage charges interest on the borrowed funds as long as the loan is outstanding.

People most commonly borrow on margin in order to purchase stocks, although other securities can also be purchased, including ETFs, mutual funds, bonds, and options. You can also use a margin account to short sell stocks.

Definitions

Margin excess: the amount of funds available in your account that are above the margin requirement. Those funds are available to purchase new securities or to add to an existing position. See page 10 for more margin trading definitions.

Margin scenarios

Here are further possible scenarios with several potential outcomes.

Let's say you've been following XYZ Inc. and you believe its market value is likely to increase. The company's stock currently trades at $50 per share. You'd like to buy 100 shares, but you only have $3,000 available to invest. You could just buy 60 shares. But you decide to borrow $2,000 from your broker on margin, and you purchase 100 shares for a total of $5,000.

Falling stock price

Margin trading can work against you if the stock price goes down. Imagine that shares of XYZ Inc. fall to $45. The market value of your position will be $4,500. You've invested your $3,000 principal, and borrowed $2,000, so if you pay off your margin loan, your equity falls to only $2,500. You're down $500 and you're still accruing interest on your $2,000 loan.

You don't necessarily need to do anything, not yet anyway. But notice that your margin ratio has changed. You've borrowed $2,000 to buy an asset that is now worth $4,500. So your margin has fallen to about 55%. You'll need to keep a close eye on this situation and understand your broker's margin requirements. If the stock price continues to fall, you may get what's known as a "margin call." (See the sidebar: "Meeting the call").

Rising stock price

Let's say that your analysis of XYZ's prospects turns out to be correct. The stock goes up to $60 per share. Your position is worth $6,000, while your margin loan is $2,000. If you sell that position, and pay off your margin loan, you'll have $4,000. You started with $3,000, so you're up $1,000, or 33%. Pretty good.

If you had only purchased 60 shares, and sold them at $60, you would have $3,600, which is a 20% gain. Still good, but not as good as the outcome you generated by trading on margin. With your margin loan, you used leverage to increase your return.

(Keep in mind that those outcomes do not include loan interest and trading commissions, which will lower your returns.)

Meeting the call

You would receive a "margin call" if you had purchased stocks on margin, and the value of your account decreased to the point where your margin was below the minimum margin required by your broker. Your broker will ask you to take prompt action in order to restore the required margin. In order to "meet the call," you'll need to put more cash and/or more margin-eligible securities into your brokerage account. If you can't come up with more securities, or cash, then you would need to sell some of your stock and apply the proceeds to your margin loan – at least enough to restore the balance. If you do not act promptly, your broker will sell enough of your stock to put the account into positive margin.

Example: boosting your returns using margin

	Cash only	Using margin
Securities purchased at $50 share price	Buy 60 shares for $3,000	Buy 100 shares for $5,000
Margin credit	$0	$2,000
Proceeds from selling at $60 share price	$3,600	$6,000
Amount remaining after loan payback	n/a	$4,000
Gain*	$600	$1,000
Return on investment	20%	33%

*(Calculation does not include loan interest and trading commissions.)

If the stock price is unchanged

Margin loans, when used well, can work in your favour. However, you are taking on a debt which must eventually be paid off. In the meanwhile, as with any loan, you'll pay interest on the outstanding debt, regardless of whether the stock price of XYZ Inc. goes up, down, or sideways.

Worst case

If the price of your stock plummets drastically, you can end up with a margin loan that exceeds the market value of the stock. Even selling all the stock wouldn't raise enough to repay the loan. Regardless of how much the value of your securities declines, you are still responsible for repaying the loan. Leverage is a double-edged sword: it can increase gains on the upside, but it can also amplify your losses on the downside.

Traders' tip

Margin and leverage are concepts that go hand-in-hand. Leverage is a double-edged sword: it can increase gains on the upside, but it can also amplify your losses on the downside.

Margin requirements

A minimum margin must be maintained. Margin requirements are set by investment industry regulations, and by your brokerage's risk management policies.

Let's say that the margin requirement for XYZ stock is 50%. And imagine that since you originally purchased your 100 shares at $50, the stock price has fallen to $39. At that point, your loan will be 51%, and your margin will be 49% of the market value of the stock. Since your account has less than the minimum margin, you may get a margin call from your broker, asking you to take prompt action in order to restore the required account margin.

In order to meet the call, you'll need to deposit more cash and/or more margin-eligible securities into your brokerage account. If you can't come up with more securities, or cash, then you would need to sell some of your XYZ stock and apply the proceeds to your margin loan – at least enough to restore the balance. Unfortunately, that would mean realizing a capital loss on the sale of those stocks. If you receive a margin call, and you do not act promptly, your broker will sell enough to put the account into positive margin.

Margin trading best practices

If you decide to buy on margin, take a careful, disciplined approach. Margin trading entails additional risks associated with market volatility, and requires a high level of attention, perhaps even monitoring stock prices on a daily basis. Keep these best practices in mind:

Maintain a margin buffer in your account

Don't be fully leveraged — try to keep your margin well above the broker's requirement. For example, if the required margin is 50%, try to keep enough cash or margin-eligible securities in your account to maintain the margin at 60% or more. That minimizes the chance of a margin call.

Maintain a diversified portfolio

Maintaining a diversified portfolio in your margin account reduces the risk that a single security's drop in value will trigger a margin call.

Monitor your positions

If the markets become uncertain or negative, vigilantly monitor your margin positions.

Consider using stop-market or stop-limit orders

Stop-market and stop-limit orders can be used to restrict potential losses.

A stop-market order will automatically trigger the sale of your shares once the share price falls to a pre-set level — the stop price. The order is filled at the market price.

In the case of a stop-limit order, you set two prices: the stop price and the limit price. Once the share price falls to the stop price, the order is converted to a limit order. Your shares will be sold only at your specified limit price or better.

Take time to educate yourself before using any stop-market and stop-limit orders, so that you understand the potential consequences. For example, stop-market orders will not necessarily limit your losses to the stop price: in a volatile market, your actual sale price could be well below your stop price. In a stop-limit order, it may not be possible for the broker to execute the order before the price falls below your limit price. Also keep in mind that in volatile markets, stock prices can fall quickly but then recover quickly. In that case, using a stop order could cause you to sell at a loss and miss out on the recovery.

Factor in your interest payments

As with any loan, you pay interest when you purchase securities on margin. Rates are competitive, but the interest still reduces your profits. If you're starting out with margin trading, consider buying stocks of large, stable companies that have a track record of paying a good dividend. If the dividend yield meets or exceeds the interest rate on your margin loan, then the stock pays its own way.

Traders' tip

If you decide to buy on margin, take a careful, disciplined approach. Margin trading entails additional risks associated with market volatility, and requires a high level of attention.

Guidelines to be aware of

- A margin account that has a very large margined holding in one security or one sector, and little or no diversification in other holdings or sectors, can be deemed to be "concentrated." As a result, the loan value of the security may be reduced.

Get started with margin training: Step-by-step guide

1. Complete our online application from your desktop or mobile device.
2. Read our Customer Service and Disclosure Document, which provides the terms and conditions governing your margin account, and acknowledge that you've read and understood it.
3. Fund your account using an Electronic Funds Transfer or bill payment from your banking account; or by transferring assets from another investment account.
4. Start investing!

For questions about margin accounts or margin trading, or about margin requirements and interest rates, speak to one of our knowledgeable investment representatives. Call 1.877.787.2330 or 604.605.4199, or send an email to info@qtrade.ca.

Sample Qtrade Investor margin loan value

Exchange-listed equity price	Margin	Loan amount
$3.00+ and on IIROC-approved list $5.00+	30%	70%
$3.00–$4.99	50%	50%
$2.99 or less	100%	Ineligible

Margin trading definitions

Buying on margin: borrowing money from your broker in order to purchase securities.

Buying power: in a margin account, the maximum dollar amount of securities that you can purchase without having to deposit additional funds; you must have sufficient buying power in your account at the time your margin order is placed (also see Margin excess).

Collateral: assets pledged to guarantee a loan, and which may be collected in case of default.

Limit order: an order that sets the maximum or minimum at which you are willing to buy or sell a particular stock.

Margin account: a brokerage account that allows you to borrow funds from your broker. The cash and securities in your account act as collateral for the loan. The broker charges interest on the borrowed money.

Margin call: a requirement to act when your account has exceeded the amount it can borrow. This can occur if the market value of the securities in your account falls, so that your margin falls below the requirement. In that case, you will need to either deposit more cash or marginable securities in your account, or sell some of the stock.

Margin deposit: the amount of funds that you contribute toward the purchase of securities in a margin account.

Margin excess: the amount of funds available in your account that are above the margin requirement. Those funds are available to purchase new securities or to add to an existing position (also see Buying power).

Margin loan: the amount that you borrow from your broker in order to buy securities. You pay interest on the loan as long as it is outstanding. Normally, there is no requirement to repay the loan until the stock is sold. While the value of your security may go up or down, the amount you owe the brokerage should remain the same.

Margin requirement: because the value of the marginable securities and cash in your account serves as collateral for your loan, you are required to maintain a certain minimum ratio between the amount borrowed and the current market value of the securities in the margin account. Margin requirements are set by securities industry regulators and by the risk management policies of the individual brokerage.

Marginable securities: securities that are permitted to be used as collateral for a margin account.

Non-marginable securities: securities that are not permitted to be used as collateral for a margin account.

Short selling: selling securities that you do not own. You "borrow", with the intent to buy it back later at a lower price.

Stop-limit order: an order where you set a stop price and a limit price. Once the stop price is hit, the order converts to a limit order, to be filled only at the limit price or better.

Stop-market order: an order that becomes executable once a pre-determined price (stop price) is hit; at that point the order is filled at the market price.

We’re here to help

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