

Know Your Risks in Margin Trading

Margin Trading - A Temptation to Leverage on Trading Limits

Normally to buy shares, you need to have a sufficient limit to provide for 100% of the order value, while to sell shares, you need to have shares in your demat account. However, in margin trading, funds are blocked only to the extent of applicable margin % of the order value allowing you to leverage on your trading limits. Investors generally use margin to increase their purchasing power so that they can own more stock without fully paying for it. But margin exposes you to the potential for higher losses. Here's what you need to know about margin.

How Does Leveraging Works

Let's say you buy a stock for ₹60 and the price of the stock rises to ₹75. If you bought the stock in the "Cash" Segment and paid for it in full, you'll earn a 25% return on your investment. But if you bought the stock on margin (say 33.33%) paying only ₹20 in cash - you'll earn a 75% return on the money you invested.

The downside of using margin is that if the stock price moves unfavorably, losses can mount quickly. For example, let's say the stock you bought for ₹60 falls to ₹39. If you fully paid for the stock, you'll lose 35% of your money. But if you bought on margin, you'll lose more than 100%.

Beware of Additional Margin requirements - You Can Lose Your Money Fast

Your margin positions are continuously monitored and once the mark-to-market (MTM) loss exceeds a certain threshold MTM loss percentage, if the effective margin available is less than the margin required to maintain the position, a call for additional margin is made for the difference.

If the limit is not sufficient to meet the call for additional margins, the broker may close out your position.

Always remember that the broker may not be *required* to make a margin call or otherwise tell you that your margin has fallen below the required level. The broker has the legitimate right to close out the open margin position at any time (*without consulting you*) in case you do not satisfy the additional margin requirements. Therefore, once you buy/sell stock on margin, do not exhaust your trading limit in full. Maintain sufficient free limit to provide for additional margin as and when required.

Effect of Price bands

In case of margin scrips which have a daily price band of (+ or -)20%, under broker square off mode, all the open buy positions will be squared off in case the last traded price on the Exchange crosses minus(-) 16% with respect to its previous trading day's closing price and all the open sell positions will be squared off in case the last traded price on the Exchange crosses plus(+) 16% with respect to its previous trading day's closing price. Similarly, under the client square off mode as well, the open positions may be squared-off at a certain percentage (at the discretion of I-Sec and the percentage may vary from stock to stock) of downwards price movement from the previous trading day's closing price of the stock.

However, in case of margin scrips which do not have a price band (e.g. derivative scrips), if the mark to market loss on the open margin position exceeds 16% then an automated call will be made to recover the entire loss from the available trading limits of the customer. In case the entire amount is recovered then the position will not be squared off. In case the entire amount is not recoverable then the open positions will be squared off irrespective of the stock's % fall/gain with respect to its previous trading day's closing price.

Limited period to Close out Leveraged Positions

All margin positions have to be closed out before the end of the settlement. In respect of heavily leveraged positions (where you do not have adequate funds/securities to take/give deliveries,) you shall have to square off your positions even if that entails a substantial loss. You may lose the chance to recoup your losses if the market bounces back in subsequent settlements.

If any margin positions are left open beyond the stipulated time on the last day of settlement, the broker can compulsorily close out the positions. **No guarantees of closing out**

There is no guarantee that your open positions will be closed out automatically. If for some reason, the positions still remain open at the end of settlement, the onus is on you to arrange funds/securities for the settlement of the position. If you fail to do so, you shall be fully liable for the consequences (auction/penalty/interest) of the same.

Recognize the Risks Beforehand

Margin trading carries risk and therefore may not suit every investor. Before trading on margin, you should ensure that:

- You have understood the trading and settlement mechanism of the exchange and your compulsion to follow the margin trading rules
- You can lose more money than you have invested
- You have to keep sufficient trading limits as cushion to fund additional margin as and when called for.
- You have to square off of your margin position in time
- You would not be tempted to over leverage your positions.

Last but not the least

You can protect yourself by knowing how margin trading works. Judge for yourself whether it is prudent for you to trade on margin in light of your financial resources, investment objectives, and tolerance for risk.