5 Important Margin Loan Considerations

A Biltmore Capital Advisors White Paper

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Margin loan offered by an unaffiliated broker-dealer FINRA/SIPC member. Individuals must qualify through Biltmore Capital Advisors and their custodian. Margin lending involves a certain amount of risk including but not limited to margin calls caused by a sudden decrease of portfolio assets or an interest rate spike. In the case of a margin call additional securities would be required in the account or the loan must be paid down using proceeds of existing securities or outside funds. To lock interest rates, SWAP transaction are used. Investors must have a good understanding of a SWAP and meet certain net worth minimums for these transactions to be implemented.

1. Variable Interest Rate Structure

While global interest rates are near record lows, so are the costs to borrow against your portfolio via margin loans. Most margin loans are based off an interest rate index such as LIBOR, plus a certain spread that the lender will add. As the index adjusts, so will your margin rate, making it a variable loan structure. Clearly the risk here is that as the interest rate index rises, so does your borrowing cost.

Many factors should come into consideration such as fixed rates vs. floating rates, how long the loan will be outstanding, expectation of future interest rate increases, ability to pay down the loan, and more. For larger loans, you may have the ability to lock an interest rate through an interest rate swap. This is a vehicle, available to investors of a minimum net worth, which allows them to lock rates for up to 30 years.

For longer dated maturities, you should weigh—with your advisor—the pros and cons of locking in an interest rate, using a floating rate, or even diversifying interest rate structures by letting some of the loan float, e.g., lock a portion of the loan for 5 years, and letting the rest adjust.

2. Added Risk Within A Portfolio

Margin loans carry a level of risk that you don't have with a traditional mortgage. Margin loans are regulated by the SEC and there are various percentages which you can borrow against as it relates to your underlying portfolio collateral. Typically for many stock market positions, the percentages are lower than relatively more conservative investment grade bonds. The risk within a margin loan is that the value of your portfolio can fall below a certain level putting you into a "margin call". When clients fall into a margin call, you have a limited amount of time to either deposit more securities or pay down the loan. If neither option is available, the bank has the right to liquidate your securities to pay down the loan.

For risk management purposes, many people may open up a home equity line of credit on their home, enabling them to pay off some of the margin loan if they experience downward pressure on the portfolio. We don't recommend individuals fully leveraging themselves because of the margin call risk involved.

Risk can be minimized by the composition of the portfolio and an advisor should be involved when discussing the portfolio versus the amount of debt that can be withdrawn.

3. Paying Off Higher Interest Bearing Loans

Margin can be used to pay off other forms of debt including mortgages, home equity loans, credit cards, student loans, car loans and business debt. NO payments are required as long as there is room on the credit facility, and there are no prepayment penalties. This added savings can help reduce expenses in retirement, or might enable you to pay off debt much more quickly, assuming interest rates continue to be low.

4. Deductibility

It's important to speak with your tax advisor about the deductibility of margin loans and potential upsides and downsides relative to a traditional loan or mortgage. Depending on what you use the money for, some individuals can deduct the interest on a margin loan.

Typically, if the loan is being used to purchase securities, families may have the opportunity to deduct the interest expense against their investment income. Other families may deduct the interest expense against rental income if they used the loan to buy investment property. We always advise clients to speak with their tax advisor to understand the impact of their specific situation.

5. Timeline and Closing Cost vs. Traditional Loans

Margin loans can be advanced in 7-10 days, potentially even sooner. Most traditional loans (mortgages and traditional bank loans) require credit checks and appraisals which can take up to 90 days to complete. Additionally, if appraisals don't come in at required levels, the deal can fall apart.

Margin lending only depends on the amount of collateral you have in your account, and the type of collateral (i.e. the portfolio mix of stocks, bonds, and mutual funds). Closing quickly with an all-cash offer can make the offer more attractive to potential sellers. Money can be wired, checks written against the account, money links set up between accounts, etc.