Margin Debt and Leverage in the Stock Market

March 2021

This report is designed to give investors a snapshot into the current state of the market. Our analysis will deliver insight about how many retail investors and institutions are currently positioned in the market, and what it means.

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Looking Back at 2020

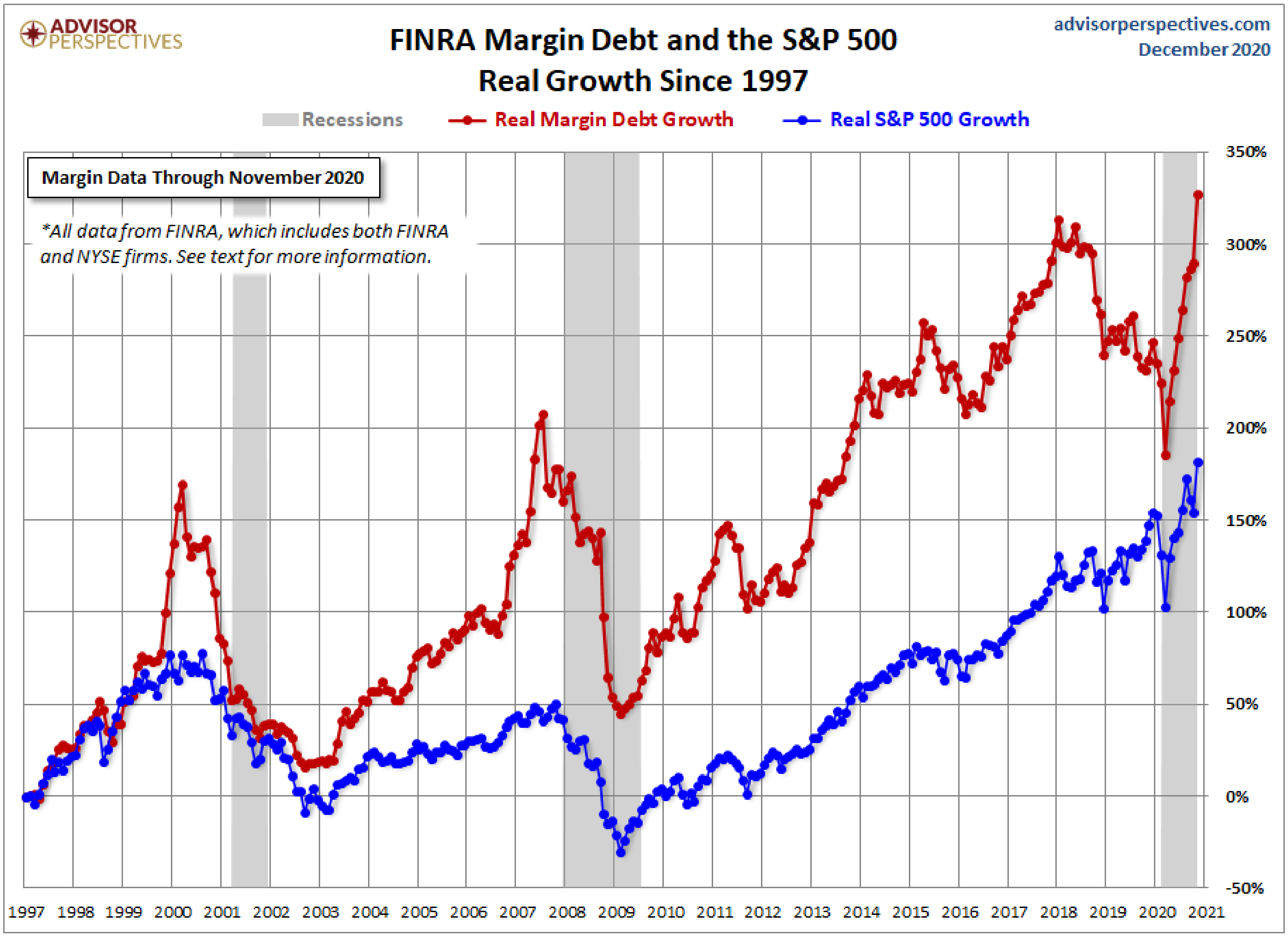
2020 was year when most people stayed invested despite the significant COVID-related drop in March. However, it was also a year when retail trading and individual investors had a significant impact on the market. With over 300 million Americans confined to their homes with little to occupy their time, many turned their attention to the stock market. We saw extreme market activity in 2020, with record highs to a record plunge, to record highs again. As new retail investors piled into the market, optimism grew sending equities soaring. Retail investors now account for more than 20% of daily trading volume, and since 2019 average daily volume of equity trades has increased from 7 billion to 14.7 billion.[1] There are silver linings to this; individuals are breaking into a historically institutionally dominated space and educating themselves about how to invest for their future. There are more IRA millionaires than ever before and most retail investors and traders experienced a lucrative year in 2020.[2]

However, as the market continues to hit new all-time highs, one might begin to question how much longer this is sustainable? Market performance in 2020 has sent both new and veteran investors into a euphoric state which has raised confidence and led many to utilize margin.

Margin trading is the process of borrowing money from a brokerage firm to purchase or short sell securities. By borrowing capital, the individual or institution is taking on a form of debt and leveraging their account in hopes of earning higher returns. Regulation T set the initial margin minimum at 50%, which means an investor can take on margin debt worth 50% of their total account value.[3] Once a position is open, the brokerage sets a maintenance margin requirement meaning the investors equity must remain above that ratio to avoid a *margin call.*

In November and December of 2020, margin debt rose a combined $119 Billion, which is by far the largest month-to-month increase ever recorded. According to FINRA, which regulates brokers and exchanges, margin debt has surged over 60% since March of 2020, to a record $778 billion.[4] Currently in the market we can see the impacts of this transpiring. Equities are being pushed higher by speculators who are completely indifferent to valuations and focused only on others buying the same things at higher prices. A lot of this chasing is happening with borrowed money, from margin debt all the way to borrowing against homes and credit cards.

Below you will see a chart that shows the relationship of the S&P 500 growth and margin debt growth.



Margin debt is highly correlated to the market, but it is not necessarily a forward-looking indicator. It is not an indicator of what is coming, but rather a concurrent or lagging indicator that helps us understand the state of the market. Stock market leverage is an accelerant. When the market rises and investors feel confident, they borrow money to buy more stocks, which creates more buying pressure and sends prices higher.

However, stock market leverage can also act as an accelerant on the way down. In the event of a market correction, panic selling can take place which will drive asset prices down. The common misconception is that panic selling is a choice. In a market where margin debt is at record levels and investors are heavily leveraged, this selling can be *forced*. If the market is dropping and investors start receiving margin calls but cannot meet the call, the brokerage firm is required to liquidate the investor's position. There is a reason record margin debt often precedes market crashes as displayed on the chart.

To further explain how this phenomenon works; if equity in a margin account falls below the maintenance margin requirement, a margin call will be issued. Once a margin call is issued the investor is required to deposit more cash or liquidate positions to cover the balance that is due. If the investor takes no action, the brokerage is permitted to liquidate assets to cover the balance. This is when leverage works as an accelerant on the way down. In this scenario, a small negative shock to the market can trigger a wave of forced selling from highly levered institutions and retail investors. This will create a feedback loop of selling pressure and a depression in asset prices. As asset prices fall, a vicious feedback loop is formed and will force levered investors and institutions to continue selling. As they keep selling, prices will be driven down further which can cause an all-out market freefall. This is sometimes referred to as a fire sale. A leverage induced fire sale is the culprit behind the stock market crash of 1929, 1987 and played a role in exacerbating the 2008-2009 Global Financial Crisis.[5]

One can think of this record level of margin debt as a mountain. As we continue to climb higher one thing remains true; any fall can be longer and more excruciating.

Now may be as good a time as any to reflect on your portfolio and prepare for the future. This type of leverage induced crash might not happen this year or next, but it's always better to be prepared than suffer the consequences.

[1] Pisani, Bob. "Trading Volume Is up from 2020's Breakneck Pace as Retail Investors Jump In." *CNBC*, CNBC, 22 Jan. 2021, www.cnbc.com/2021/01/22/trading-volume-is-up-so-far-from-2020s-breakneck-pace-as-retail-investors-get-even-more-active.html.

[2] Pisani, Bob. "There's Now a Record Number of 401(k) and IRA Millionaires, According to Fidelity." *CNBC*, CNBC, 13 Feb. 2020, www.cnbc.com/2020/02/13/fidelity-there-is-now-a-record-number-of-401k-and-ira-millionaires.html.

[3] "Margin Account Requirements." *Margin Account Requirements | FINRA.org*, www.finra.org/rules-guidance/key-topics/margin-accounts.

[4] "Margin Statistics." *Margin Statistics | FINRA.org*, www.finra.org/investors/learn-to-invest/advanced-investing/margin-statistics.

[5] "How Leverage Turns Market Corrections into Crashes." *Yale Insights*, 24 Apr. 2019, insights.som.yale.edu/insights/how-leverage-turns-market-corrections-into-crashes#gref.

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