Should Investors Fear Margin Debt?

SYNOPSIS

- The margin debt story is viewed by some as a predictive indicator for a future equity market crash.
- Margin debt can exacerbate a sell-off, but there is no statistical evidence that margin debt levels can predict an equity market decline.
- Although the use of margin debt is never recommended for individual investors, ignore the fear mongering around such a meaningless data point.

AUTOCORRECTED

A few hours after the Dow Jones Industrial Average broke the 20,000 level, I grabbed my iPhone, pulled up the web browser, and conducted a search for the story I was sure would grab headlines.

Anytime the stock market reaches new highs, the financial news agencies reach into their cabinet of fear and panic and dust off the cautionary tale of rising margin debt. This story tends to pop up online within a few hours after the stock market reaches "historic" milestones, but this time there was very little mention.

I stood there perplexed. Had the media fallen asleep at the wheel, or had they finally decided to kill a story that has done nothing but scare investors and prevent so many from profiting in this bull market?

I then looked back down at the search results and eventually realized that neither was the case. The autocorrect feature on my iPhone, for some unknown reason, changed "margin debt" to "margarine debt" in the search box.

Putting aside the blinding confusion as to why technology deemed that "margarine debt" made more sense than "margin debt," I reran the search correctly and was then bombarded with precisely what I had initially expected. Article after article about how margin debt is at an all-time high and how it will lead to a major market crash immediately filled the screen.

…the margin debt level today… tells an investor nothing good or bad about the future of equity prices.

Since the media clearly feels that this story still has legs, let's spend some time cutting them out from under the fear mongering by dispelling any fears over margin debt.

MARGIN DEBT EXPLAINED

Margin debt is money borrowed by investors to purchase stocks in a portfolio. The logic here is that if a loan to an investor runs 5%, and this investor believes that a stock could return 20% a year from today, then why not use someone else's money to invest for a 15% (20% - 5%) profit?

Debt can be very dangerous when used haphazardly, so those who use scare tactics to sell email newsletters concocted an argument long ago that goes something like this…

As investors accumulate more debt that is being used to buy more stocks, the valuations of stocks are pushed up to stratospheric levels. Margin loans use investors' existing stock portfolios as collateral, so the problem is that if stocks begin to sell off because these valuations can no longer be supported, then the value of the collateral falls.

If the value of the collateral falls, a "margin call" will eventually trigger, where investors must put up more collateral or pay back the loan. The easiest and most likely way to accomplish this task is to sell stocks to raise cash in a falling market.

Effectively, a margin call throws gasoline on a fire and drives the broader market down even further to the point where we are all living in tents, and our financial system reverts to bartering for goods and services (cue the "gold bugs").

What makes matters worse is that the chart below appears to indicate a very strong relationship between the level of margin debt and the S&P 500's performance.

and in this case, doing the same should view margin debt as a percentage of the S&P 500 (see Chart B - Margin Debt % of S&P 500).

On a relative basis, margin debt has consistently stayed between 1.6% – 2.2% of the value of the S&P 500 index since 2007. Hence, margin debt has not increased when compared to the assets that margin debt is supporting.

Second, the amount of margin debt should intuitively rise and fall with the stock market because investors want to own more stocks in a rising market and less in a weak one.

A - Margin Debt v. S&P 500 performance

Source: Bloomberg

The chart above is the basis for most fear mongering, but investors should ignore it for two reasons.

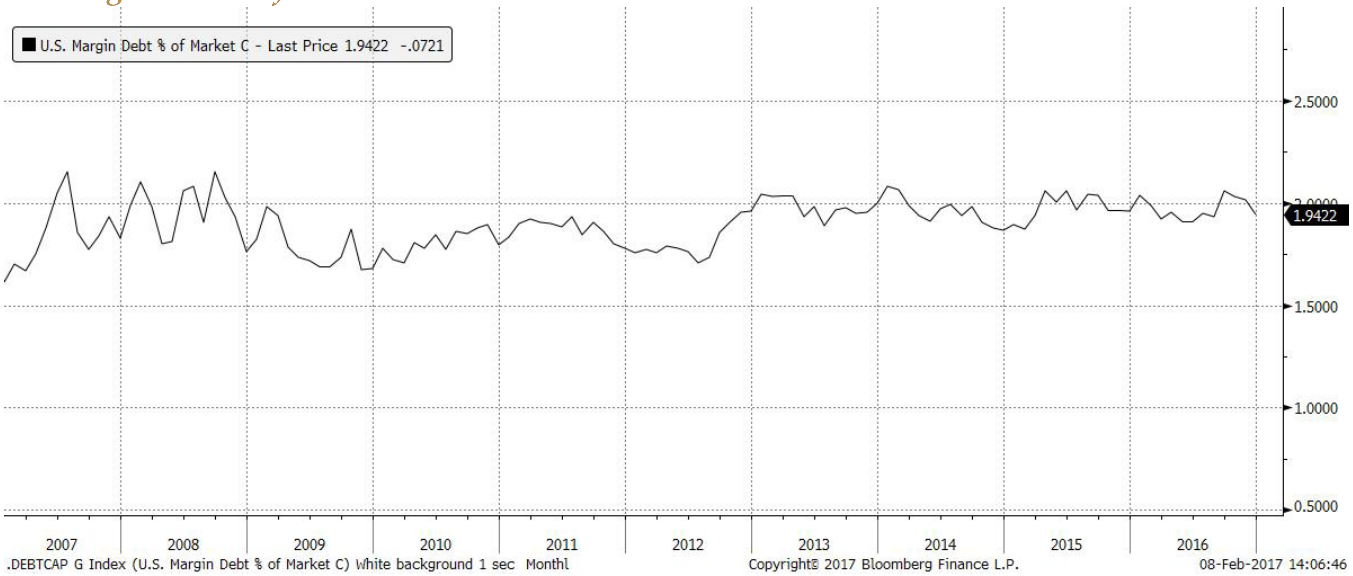
First, absolute levels of debt are meaningless, so it's important to put the debt in context by comparing it to the asset it supports. For example, a $100,000 loan for a $2 million house is far less risky than a $1.9 million loan for the same house. If the buyer were to default, the bank could sell the house and most likely collect $100,000 much faster than $1.9 million.

An amount of debt should be viewed relative to assets. Banks do this every day when consumers apply for a mortgage. They compare the amount of the loan to the value of the house, often referred to as "loan-to-value,"

However, nothing in this chart indicates that there is even an ounce of predictive power in the red line versus the blue. If there were any indication, there would be a visible lag between the two lines or statistical relationship hidden in the data.

NOTE: The data is rather technical, but for those skilled in reading statistical results, the R-squared for the absolute and relative margin debt level to future S&P 500 performance are both below 0.10. In English, that means that from a statistical point of view, there is no relationship whatsoever between the two.

B - Margin Debt % of S&P 500



Source: Bloomberg

Said another way, the margin debt level today, whether absolute or relative, tells an investor nothing good or bad about the future of equity prices.

IMPLICATIONS FOR INVESTORS

This story never seems to want to go away, so the next time the market hits another all-time high, just remember that margin debt is completely irrelevant.

What's funny about margin debt fear mongering is that it will eventually appear to be right but for all the wrong reasons. Since the relative amount of margin debt to the S&P 500 remains constant over time, a drop in the stock market will equate to a proportionate drop in margin debt.

Those who write these email newsletters will then point to the first chart above and claim victory once again as both lines fall over time. However, what they will fail to prove is that the amount of margin debt was the cause of the crash.

The bottom line is that a high level of margin debt has no predictive powers for the stock market, and since it has remained constant on a relative basis for so long, it's best just to ignore it entirely.

Sincerely,

Mike Sorrentino, CFA
Chief Strategist,
Global Financial Private Capital
mikeonmarkets.com