

The Unintended Consequences of Leverage

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The past week has seen retail investors become the centre of attention as they have driven the share prices of certain companies up by more than 100% in a day. This in itself is not newsworthy to us, however the fact that they created significant losses for certain hedge funds has reminded us of the risks associated with such trading. This type of activity has become more common as technology has allowed new trading platforms to provide more investors with the tools to trade on a par with the professionals. Add to this the internet's democratisation of data and information and it is not a surprise that events such as those we experienced last week unfold.

Ultimately, your judgement and other people's willingness to trade with you at a price you see as fair will result in a profit or loss for each investor. The issue is that the price you deem fair may not be available if you are forced to sell.

A popular method to generate large returns is to purchase securities on margin. A margin account is money borrowed from a broker that is used to invest in a selection of securities. Trading on margin amplifies gains by allowing investors to buy more than they could do otherwise, but it also amplifies losses.

Consider an investor who purchases stock for £1,000, using £500 of his or her own money and £500 on margin. The stock rises to £2,000. Instead of doubling his money, which is the case if the initial £1,000 is all his, he triples it using margin. However, what happens if the total value falls to £300? In this scenario, the investor must pay back his broker the £500 for a total loss of £200 plus interest and commissions. Because of trading on margin, the investor's losses exceeded his original investment.

This scenario ultimately provides a geared upside and downside. When you get it right it is very lucrative, but when you are wrong, it is more painful. It is for this reason that the Robinhood trading platform had to raise over \$3bn from its investors last week as the cash it had to place on deposit to back these margin trades for its clients became larger as their holdings became more volatile. Can you imagine that? \$3bn extra to post on deposit!

We thought it important to highlight this market dynamic as when interest rates are at zero, investors will use leverage in the belief that they have no marginal cost of using their cash to trade. But in practice, investors using margin are required to make good their position with the broker when the price goes against them, often forcing them to sell their holdings at a loss. In reality, the true cost is only visible to those that lose their savings. Margin borrowing is very different to a loan from a high street bank which you pay back at a specified time, giving time to deal with the unexpected.

What we have witnessed in the past week in the US market is disturbing. If enough inexperienced retail investors have been sufficiently burned, the phenomenon may quickly die out. If not, regulators may have to intervene with tighter capital adequacy requirements for the professional institutions and that could have an unwelcome impact on the financial system in a different way. The scale of the emergency equity call which Robinhood had to make is an indication of the scale of the potential problem. Less headline-grabbing excitement in the equity markets would actually be a welcome thing.

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