

THE BUY SIDE: INVESTING

Buying on margin: The long and the short of it



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SEPTEMBER 13, 2008

Debt, said newsletter writer Jim Grant, is always repaid - either by the borrower or by the lender.

This explains much of what is taking place in the market today: Borrowers can't pay their debt, so their lenders must - either by selling out the borrowers' assets, or by selling their own. The first is foreclosure; the second is what happened to Bear Stearns, due to its involvement in subprime mortgages. Mortgages are levered debt. So is most private equity (once called levered buyouts). Banks are leveraged. But other parts of the market are leveraged in ways you may not realize.

As I am sure you know, borrowing to invest is also called buying on margin. If the investment works, you make more money. If it doesn't, you lose more, and if you can't afford to put up more cash, the broker will sell your stock. This is the notorious margin call.

When it takes place, you in effect lose control of your investment: You still own it, but the broker can sell it - at whatever price it can bring. When many such margin calls take place, they can cause the market to plunge. This is what has been taking place the past month.

Print Edition - Section Front

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Now for the less simple part: Who are those investors who buy on margin? Contrary to popular belief, it's not only individual investors. Much of margin buying is done by hedge funds, brokers, banks and other investing institutions. The recent market plunge was rumoured to have been pushed along due to forced selling by funds, whose investors wanted out at any price. But the forced selling was not always due to clients wanting out; some was also due to selling by levered funds who thought they were long/short hedged, but really weren't. And just in case you do the same and think you are hedged but really aren't, let me explain. To do so we must examine hedge funds' risk control.

Mutual funds usually buy only long and use no leverage. But many hedge funds not only lever their capital for buying, but also use borrowed funds to sell stocks short against their long positions, claiming they thereby are being market neutral. For example, some funds are called 130/30 - 130 per cent long, 30 per cent short, for a 100 per cent long exposure but with extra oomph due to the more intense use of capital. But I've also heard of some U.S. funds that are 120/100, using options and derivatives to lever the capital beyond the traditional margin limits. They claim that even though they borrow a lot, they are less risky, because of the long-short near balance. But are they really less risky? Of course not.

In running a hedge fund, aside from the individual risk control of KYS (know your stock), there are three global risk-control parameters: cash ratio, long/short ratio and market exposure.

It is that last parameter that causes much of the forced selling now, not just client redemptions. Say you have \$1,000. If you

bought stocks for \$600, you have 40-per-cent cash. If you bought stocks for \$1,200, you have minus-20-per-cent cash, or are levered 20 per cent. This is simple. But what if you bought stock for \$600, then sold short \$600 worth of other stocks? Even though you received cash for your short, it is pledged cash, so you no longer have 40-per-cent cash. You have minus-20-per-cent cash.

So yes, theoretically you are hedged with 0-per-cent market exposure, since your longs are equal to your shorts. But in effect you are still 120 per cent exposed to the market, because who says all your picks are right? Your longs could go down and your shorts up, and you could be wrong on both sides. So those funds that are 120/100 are in effect exposed to the market 220 per cent.

If both their longs and shorts go against them, they can go down very fast, and get margin calls due to their own overleverage -even before clients asked for one dollar back. Now, there are not many funds like that, but there are some. At the extreme are the mathematical arbitrage funds, like the infamous Long Term Capital that went bust in the 1990s. It was super levered - its Nobel-prize winning principals figured only on the long/short ratio, not on the long/short sum.

Many U.S. investment banks are also just like levered hedge funds. And as is always the case with bad ideas, I have heard of individuals that borrow against their long portfolios to go short as a hedge, thinking they are thereby more immune to the market's moves. They aren't. Especially in this market, which is heart-stoppingly volatile - the most volatile I've seen since the ides of October, 1987.

So, if you ever thought of balancing your longs with shorts, make sure that the sum doesn't exceed your capital. Investment - long or short - is risky enough even without the extra risk of leverage. And those who go for broke often get there.

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