Fear Mongers Love To Talk About Margin Debt

SYNOPSIS

- Record margin debt seems to make the headlines every few months, and fear mongers are quick to point out that this is a predictive indicator of a future equity market crash.
- Margin debt can exacerbate a sell off, but there is absolutely no statistical evidence that margin debt levels can predict an equity market decline.
- Although the use of margin debt is never recommended in a conservative portfolio, investors are urged to ignore the rampant fear in such a meaningless data point.

Fear Mongers Love This One

Up until 2003 or so, the challenge in this business was getting access to the information you needed to make informed investment decisions. Today, the real challenge is sifting through all the garbage available in order to prevent mistakes predicated upon easily accessible, yet poor/misguided information.

One of the favorite subjects from fear mongers, which surfaces every few months, is the margin debt level, particularly right after the broader equity market hits all-time highs. In fact, if you perform a Google search on the subject, you will be bombarded with warnings that the relationship between rising margin debt and a stock market crash is practically a sure thing.

Let's walk through why these warnings are severely flawed and provide no value to investors.

Margin Debt Explained

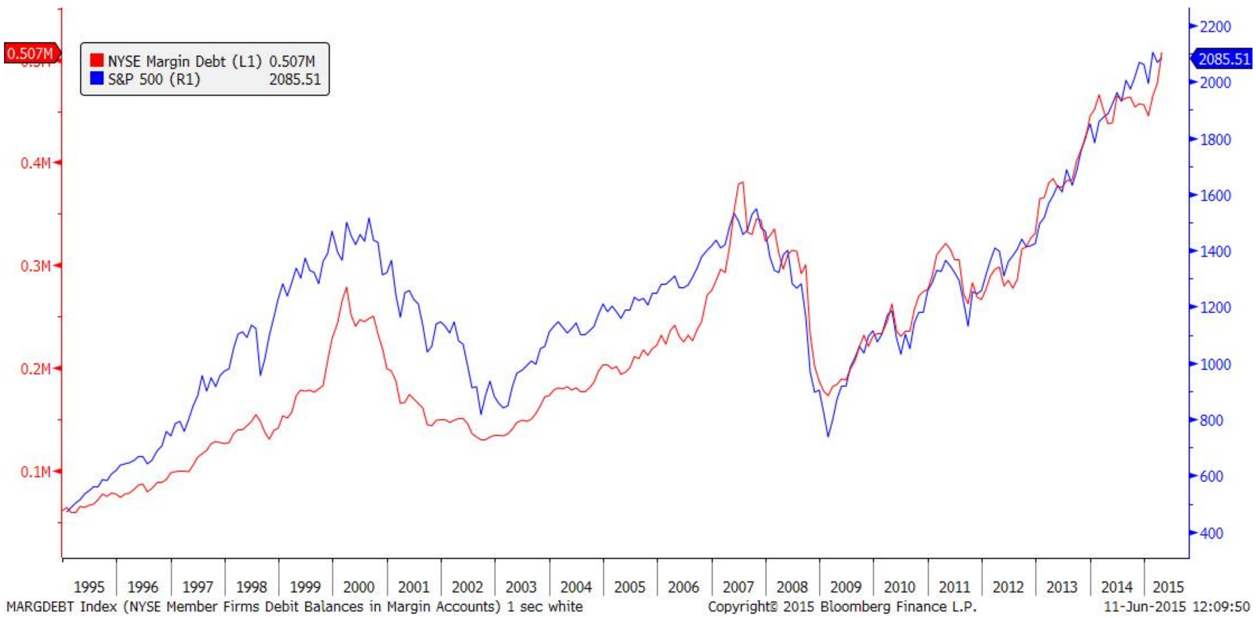
Margin debt is money borrowed by investors to purchase stocks in a portfolio. The logic here is that if a loan to an investor runs 5%, and this investor believes that a return of higher than 5% is possible in a rising market, then why not use someone else's money to invest for a profit?

Debt can be very dangerous when used in excess, so the fear mongers' argument appears to be sound upon first glance. It goes something like this…

As investors accumulate more debt that is being used to buy more stocks, the valuations of stocks is pushed up to levels that may cause stocks to appear to be overvalued. 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, then investors must put up more collateral or pay back the loan (a.k.a. a "margin call"). The easiest and most likely way to accomplish this task is to sell more stocks to raise cash. In essence, this margin call exacerbates the selling of stocks and drives the broader market down even further.

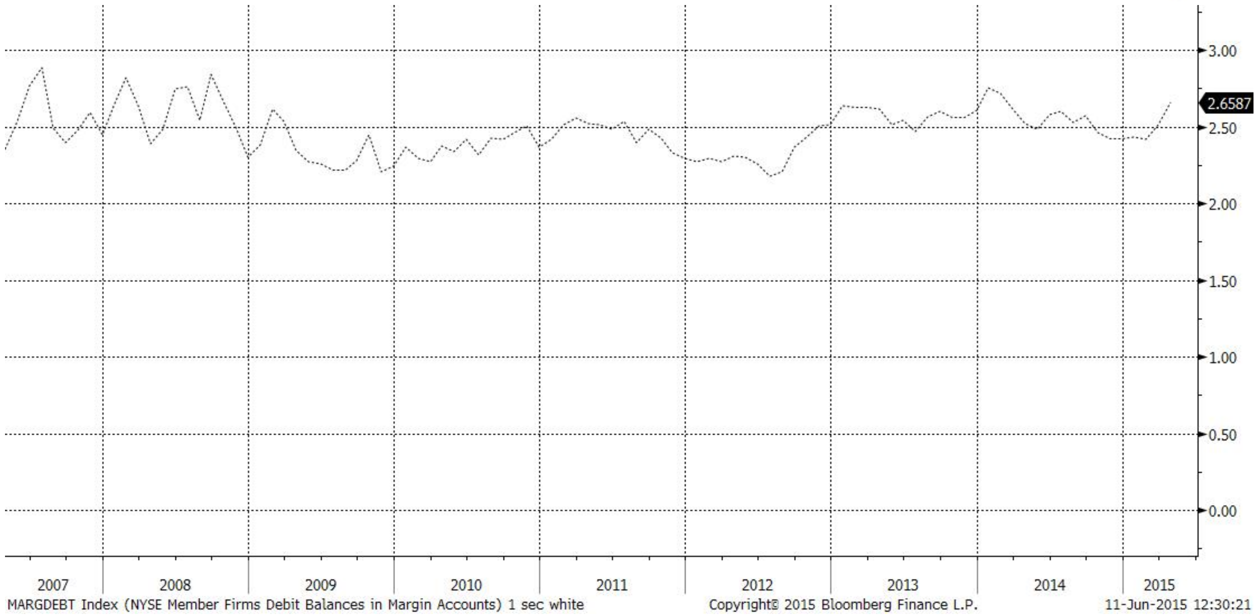
What makes matters worse is that upon first glance, there appears to be a very strong relationship between the level of margin debt and the S&P 500's performance (see below).



However, these movements are more coincidence than anything else, and margin debt levels should be ignored by investors for two key reasons.

First, absolute levels of debt are practically meaningless, so it's important to put the debt in context of the value that the debt is supporting. For example, a $20,000 loan to a college student with no income is very different than the same loan to someone who earns $2 million a year.

Debt must always be viewed relative to assets, and in this case, we should view margin debt as a percentage of the S&P 500 (see below).



On a relative basis, margin debt has consistently stayed between 2.0% – 2.5% of the value of the S&P 500 index since 2007. Hence, margin debt <u>has not increased when compared to the assets that margin debt is supporting</u>.

Second, the only insight offered by rising/falling absolute levels of margin debt is how the stock market has done in the past. This makes sense – as the market rises/falls, so should margin levels rise/fall. However, over the past 20 years, <u>there has been no predictive power of absolute or relative margin levels on future S&P 500 prices</u>.

NOTE*: The data supporting this conclusion is rather technical, but for those skilled in reading statistical results, the R-squared for the absolute and relative margin debt level are both below 0.10.*

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

Implications for Investors

The fear mongers have been pointing to margin debt levels for years now, and those who have listened to the fear and panic have watched equities hit all-time highs more times that I can count since 2011.

What's funny about their argument is that they will eventually appear to be right but for all the wrong reasons. An equity market correction/crash is measured from a top in the market down to the bottom. Since the relative debt level remains consistent, the margin debt will fall with the broader market, which will make their argument finally seem correct.

However, they are still very wrong because the catalyst for the crash will not be margin debt (unless the debt relative to the value in the S&P 500 were to dramatically surge above the 2.0 – 2.5% range).

The bottom line is that a high level of margin debt has no predictive powers for the stock market. Margin debt can exacerbate a selloff as investors are forced to meet margin calls, but only after the selloff/crash has begun. It may sound like I am splitting hairs a bit here, but these are two very different concepts.

Sincerely,

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