NORTHSTAR
FINANCIAL PLANNERS INC.

FEBRUARY 2022

FINANCIAL PLANNING NOTES
CLIENT NEWSLETTER

IN THIS ISSUE:

MARGIN LOANS

"Neither a borrower nor a lender be."

If the above quote from Polonius to his son, Laertes, in Shakespeare's *Hamlet* is true, then being both the borrower *and* the lender might well be doubly foolhardy. But as a financial tool, it is worth knowing that most brokerage accounts allow the account owner to take out a **margin loan** and withdraw money from the account by borrowing rather than selling investments.

A margin loan can be useful when you have a short-term need for cash, with a high degree of certainty regarding the future cash flows you will need to pay the loan back. A classic example might be when the timing for a new home purchase and the sale of your existing home is off. You've bought a new home and need money for the down payment, but your current home is still on the market. When you sell, you'll have more than enough to pay off the loan. Would borrowing against your investments be a good alternative in that situation?

As with most investing decisions, there are advantages and disadvantages. Let's start with advantages:

- One of the biggest pros to borrowing from your account rather than withdrawing is **you can remain fully invested** and won't miss a big market surge. After all, that's why we invest in the first place: to capture gains that occur in markets that rise over time. We invest and stay invested, through all kinds of markets, market conditions, and economic cycles because we can't predict when we will receive the premiums we expect as our reward for investing.
- Because you are not selling assets in your account, taking a loan **eliminates the possibility of realizing taxable gains.** If you are certain you're going to put the money back in the account quickly, it might make sense to avoid realizing gains only to end up buying those same assets you just sold (and paid taxes for selling) a short time later.
- From an expense point of view, borrowing from your brokerage account might be the **cheapest way to access money.** You will have a small savings from not having to sell securities in your account, but the larger savings, compared with other collateralized loans such as a mortgage or home equity line of credit (HELOC), is the absence of closing costs, that long sheet of seemingly endless expenses: application fees, processing fees, credit check fees, documentary stamps, title insurance, and many others. Anyone who has been through a house closing knows how those costs add up. With a margin loan, you have none of those expenses.
- And speaking of credit checks, when you're borrowing from your own account, not only is there no credit check, but the amount you borrow **doesn't appear on your credit report** as an open account. That means no impact on your credit score.

Ready to open that margin account? Hold on! Let's go over the drawbacks:

- Even though you are borrowing your own money, you still have to **pay interest on the loan.** And no, that interest doesn't go to you. It goes to the custodian of your account (such as Charles Schwab or TD Ameritrade). And typically, the rates aren't necessarily better, maybe even a little higher, than a mortgage or HELOC. Better than borrowing on your credit card? Definitely! But otherwise probably not the best alternative.

- You are permitted to borrow only a specific percentage, typically no higher than 50% of your account balance. If you borrow up to or close to the limit and the value of your account falls, you could be subject to a **margin call**, a demand from the lender that you immediately repay some or all of the loan balance. If you don't have the cash on hand to meet the call, securities in your account will have to be sold. That forced sale might also trigger the realized taxable gains you were trying to avoid from Point #2 above. And yet another possible outcome of the margin call sale: You're probably selling into a down market. That's the most likely explanation for why you've gotten the margin call in the first place—a market downturn has caused a large decrease in the value of your account. Selling in that situation creates a classic "buy high, sell low" scenario, which is a recipe for financial failure.
- Unless you've won the lottery and elected the annuity payout option, **you can never be 100% certain of future cash flows.** The example of "mis-timed" home sales I gave at the open is a great case in point. You borrow money for the down payment on a home on which you're about to close, and when you sell your home, you'll pay off the loan. But anyone who's been in that situation knows what the big, big risk is: You can't be sure when you are going to sell and how much gain you'll realize when you do. Even if you have an offer or a contract and a closing date set, anything can happen and often does. A buyer can fail to obtain a loan or get cold feet and crash your "quick loan" plan. The residential real estate market may be on fire now, but we've all seen those Zillow listings that have been up for months or even a year or more. If you end up in that situation, the loan hanging over your head may drive you to reduce the list price on your home for a quick sale rather than waiting to get top value, a decision that could cost you dearly.
- A margin account is not a formal loan contract and is subject to **terms of the lending institution that can change at any time.** This not only applies to the interest rate but the percentage you are permitted to borrow. If the interest rate changes, your debt service will rise. If the institution decides to lower the maximum loan percentage and not grandfather in existing loans, you could instantly be in a margin call even without a market downturn.
- Finally, whether on your credit report or not, **debt is debt.** A margin loan will decrease your net worth (depending on what you use the money for) and increase your expenses as you pay the debt service.

So all of that leads us to a few key decision points in determining whether a margin loan is the best decision:

- How much do you need as a percentage of the value of the account? Margin calls are driven by the value of the account you take the loan from. Any other investment accounts, including IRAs or other brokerage accounts, do not count in the calculation. You want that percentage of loan-to-account value to be as far from the maximum allowed as possible to allow for the possibility of significant losses to occur and still not trigger a margin call.
- How long will it take to pay back, and how certain are the future cash flows to pay it back? If you borrow $50,000 and feel comfortable that you have cash flow to repay $5,000 each month, you should have the loan repaid within a year. But as discussed above, the amount owed is certain. Future cash flows need to be "handicapped" based on how sure of a sure thing they are. If it's income from your job, how stable is your income, your position, and your company? If it's real estate income, how stable and "locked in" are your tenants? Imagine a worse-case scenario (loss of job, loss of tenants) and figure out if you have a backup plan to pay off the loan.
- What is your interest rate vs. expected return on money left invested? If you are paying 3% on the money borrowed and have your money invested a bit aggressively with an expected annualized return of 8%, that makes borrowing look like a better decision than if the interest rate is 6% and your expected investment return is 5%. But with those numbers, you must also weigh the risk that the aggressively invested account will be more volatile and could have a larger decline in falling markets, leading to the potentially disastrous margin call discussed above.

One other factor to consider: This discussion pertains only to brokerage accounts such as taxable individual, joint, business, and trust accounts. You can't take a loan from an IRA, and while some company-sponsored retirement plans such as a 401(k) might allow margin loans, there are big disadvantages to doing that, which we have discussed in past articles and, I'm sure, will address again in the future.

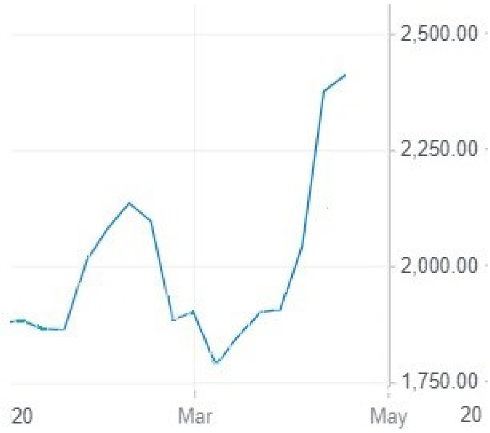
If all of this sounds like a lot—of course it is! And that's why your Northstar advisor is there for you if you want to have a discussion.

—Steve Tepper

A PEAK ... OR A CLIFF?

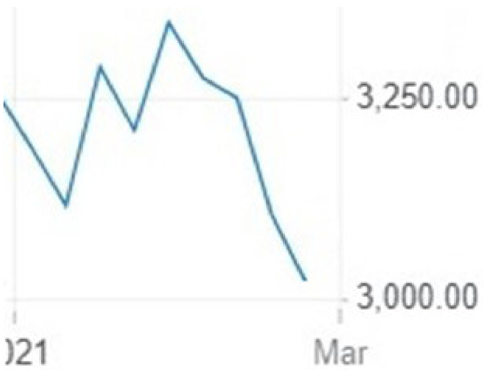
Let's take a very quick quiz. Look at the following two stock charts one at a time—wait, no peeking! And within three seconds give your first impression of where you think the stock is heading. These are actual graphs of one stock's recent price.

Here's **Graph #1:**



That's a very big price rise in a very short time—just a few weeks. Where's it going next? Quick! Your three seconds are up!

OK, hold that answer for a second and let's do one more. Try **Graph #2:**



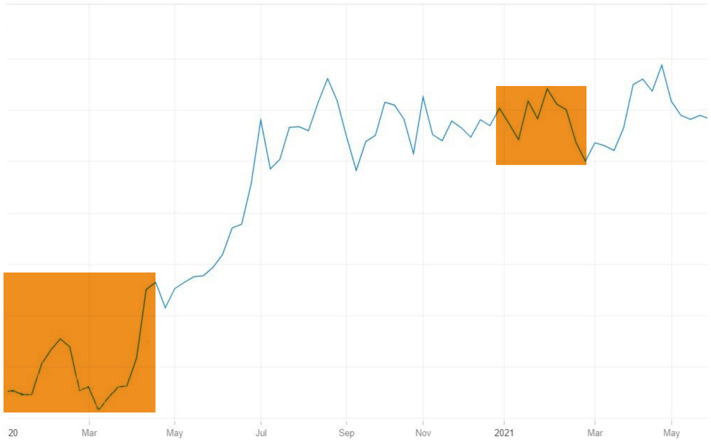
A big drop in price in just as short a period. What next? One, two, three. Time's up!

If you're like most investors, you saw in Graph #1 a stock that has rallied hard, rocketed up, hit a peak, and is poised to fall off a cliff. In Graph #2, you probably saw a stock that has fallen in price below its most recent low price and is likely to plummet from there.

So what we just did was called technical analysis. A very simple form of technical analysis, but technical analysis nonetheless. Without knowing or caring what the company is or what the market conditions are, we just looked at charts of stock prices and used them to try to determine what the stock price will be in the future.

Can that work? Sure! Does it always work? Of course not! Does it work enough to make money consistently if used as an investment strategy? We have found no evidence it does.

In this particular, admittedly cherry-picked case, it would have been a "less than successful" strategy. Both of these mini graphs are clipped from the last two years of returns for Amazon stock. Here's the full graph, from Yahoo Finance, with the mini graphs highlighted:



Graph #1 is from the beginning of the chart at the start of 2020, when Amazon shares were selling at bargain-basement prices around $1,750 per share. By April, with the whole country shopping from home, the price shot up to around $2,400. Was that a cliff? Nope. As much as it looked like one in the breakout clip, the stock continued to rally, and by August, the price was up about $1,000 per share from that perceived peak in April.

The second graph comes from the beginning of 2021. The price zigzagged a bit, then dropped down to around $3,000 per share. Did that signal a continued decline? Not even at all. The dip was erased in about a month, and

WHO WE ARE

ALLEN P. GIESE, ChFC®, CLU®, ChSNC®
President, Investment Advisor Representative

STEVE TEPPER, CFP®, MBA
Vice President, Chief Operations Officer, Investment Advisor Representative

GARY S. GLANZ
Director of Business Development, Investment Advisor Representative

FELIPE MEJIA, CFP®
Senior Advisor, Investment Advisor Representative

CHARLES THOMAS
Associate Advisor, Investment Advisor Representative

GARY C. GONZALEZ
Investment Advisor Representative

STACY SAAVEDRA
Director of Client Services

RICHARD LOTTIER III
Client Service Specialist

LIAN TEPPER
Client Service Specialist

NORTHSTAR
FINANCIAL PLANNERS INC.

(954) 693-0030
1250 S. Pine Island Road, Suite 275
Plantation, FL 33324

northstarplanners.com
info@northstarplanners.com

by July, the share price was around $3,700.

Of course, it's obvious to say as a Monday morning quarterback that betting against Amazon stock would have been a mistake the last two years. But the implication of the failure of technical analysis is pretty evident.

First, it throws away the assumption that a stock is properly priced at any given time based on all known information, trading at a level where the number of buyers and sellers is equal, and where tomorrow's new information (unknown to us today) has the same probability of causing the stock to rise or fall.

Second, the same information can be used to justify a decision to sell or buy depending on how the analyst interprets it. Some analysts trade with the trend. They will buy into the rising price in Graph #1 and sell against the falling price of Graph #2. Other traders are contrarians: They will see a rapid movement in one direction as evidence the stock is about to move the opposite way, and so they might sell based on Graph #1 and buy based on Graph #2.

So each type of trader would end up right once and wrong once.

But for the average investor, it's worse than that. It is easy and very tempting to look at stock market charts and see doom and gloom coming no matter what the shape of the chart or direction of the price. Rising prices can't continue and falling prices can't be stopped! That belief system would keep many investors out of markets altogether! And that would make long-term financial success difficult.

—Steve Tepper