Leverage

If you study the investment style of Warren Buffett, you will probably find that he uses leverage, and that he advocates not to do that. It seems paradoxical, but in fact it is not.

For example in his 1962 letter he states: “I believe in using borrowed money to offset a portion of our workout portfolio, since there is a high degree of safety in this category in terms of both eventual results and intermediate market behavior.” And then we have a 2012 study from AQR Capital Management that says that the real secret behind Warren Buffett's stellar track record is not great stock selection, it’s portfolio leverage.

In his early years, Munger was also happy to borrow money to accelerate his returns. It has been stated that he did enormous trades with borrowed money, like British Columbia Power, which was selling at around $19 and being taken over by the Canadian government at a little more than $22. Munger put not just his whole partnership, but all the money he had and all that he could borrow into an arbitrage on this single stock – but only because there was almost no chance that this deal would fall apart. You could easily question if Munger’s success by then was a result of his extreme genius or just pure luck.

Warren Buffett is very clear about the dangers of using leverage: "Leverage is the only way a smart guy can go broke. History tells us that leverage all too often produces zeroes, even when it is employed by very smart people." (LTCM and Lehman Brothers).

The mistake many investors make is that they try to emulate Buffett’s use of leverage with a margin account. That’s a very dangerous approach for using leverage. “Margin trading is dangerous, because the person giving you credit can wipe you out at the bottom tick, just because he feels nervous. Berkshire avoids that stuff, where someone else can sell your securities, because they feel nervous.” – Quote Charlie Munger.

Instead, Buffett prefers the following alternative sources of leverage: float, and deferred taxes. These alternatives are cost-free, have no covenants or due dates attached, and thus are much safer sources of leverage. Unless you have an insurance company in your backyard, you will not be able to emulate that. Buffett will not receive any margin calls and if you use a margin account, you are subject to the risk of margin calls.

You might argue that you can use hedging techniques for limiting the downside risks of using leverage in a margin account. That doesn’t make it less dangerous, and it is certainly not easy. And here is my argument against it. Everybody makes mistakes now and then. Perhaps you remember the very experienced derivatives trader Nick Leese? If you make a hedging mistake during times of severe market turbulence, the results can be disastrous and wipe you out for good.

What happens when the stock exchanges shut down in response to a panic? During the panic of 1873 (by then nearly 10.000 businesses failed), there was a 10-day closure followed the failure of Jay Cooke & Company bank. If that happens, you will not have access to your margin account to prevent margin calls (add cash, add hedging, roll over options, etc). Your broker won’t hesitate to just close your account if you violate their adjusted margin rules. Some investors have been shocked to find out the hard way that the brokerage firm has the right to sell their securities that were bought on margin—without any notification, and at times, leaving their customers in personal bankruptcy.

Brokers use “sophisticated” liquidation software to automatically close down accounts that violate the margin rules. And brokers can and must adjust the margin requirements during times of turbulence. There are several law suits against brokers that accuses the broker e.g. of unlawful management of a number of portfolio margin accounts. And there is an example of a brokerage firm’s system for selling securities from clients’ accounts to pay margin debt that backfired leaving a fund with hefty losses.

Now you might think this will not happen to you, because you are a professional. Recently I received an erroneous warning on a margin cushion: ”-100% remaining”. Just think about that for a moment. It happened as a result of a problem the broker had with “position display” and there were no financial consequences. This was a software problem during times of market stability. Try to imagine what could happen during times of market turbulance, when markets move up and down very, very nervously? Or what happens to

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this liquidation software when a cyber security incident hits the brokers trading platform?

Buying stocks on margin is one of those things that might appear on the surface to be a great way to make money. Investing on margin is essentially investing with borrowed money. This inherently risky method of investing can lead to total bankruptcy and ruin your financial, personal, and business life.

Even if the account blows up, you are on the hook for the money immediately. No payment plan. No negotiating terms. If you don't pay, the broker can haul you into court to start getting judgments to seize your other holdings, ultimately requiring you to throw yourself at the mercy of a bankruptcy judge.

During the Crash of 1929 proceeding the Great Depression, maintenance requirements were only 10% of the amount of the margin loan! If an investor wanted to purchase $20,000 worth of stock, he would only be required to deposit $2,000 upfront. This wasn't a problem until the market crashed, causing stock prices to collapse. When brokers made their margin calls, they found that no one could repay them since most of their customers' wealth was in the stock market. Thus, the brokers sold the stock to pay back the margin loans. This created a cycle that fed on itself until eventually prices were battered down and the entire market demolished. It also resulted in the suspension of margin trading for many years.

There are many examples of entire retirement accounts that were wiped out and some investors talked about contemplating suicide.

You should read Buffett's latest Letter to Shareholders, where he stresses once again his aversion to leverage. A stock market crash can happen anytime. No one can tell you when. The light can at any time go from green to red without pausing at yellow. When the market starts to go down, a lot of people overreact and start to panic. An unsettled mind will not make good decisions.

Seth Klarman (who doesn't have an insurance company in his backyard as far as I know) once said: I side with those who are unwilling to incur the added risks that come with margin debt. Avoiding leverage may seem overly conservative until it becomes the only sane course.

Cordially,

Peter

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