Posted to the Gilder forum - January 1, 2000

Margin and Cash Management

Glad you asked!

Otto:

There are two ways to use margin. For cash management and for speculation. There is nothing wrong with speculation but I don't do it and I don't recommend it.

To use it as speculation, you borrow the maximum or close to the maximum that your broker will lend you based on the value of your portfolio. It should be close to 50% of your "marginable" holdings. If your stocks go up, you make extra profits based on the leverage. If your stocks go down, past the "margin call level," about 60% of the amount of the margin loan, then you get a margin call. If you don't pay up in three days the brokerage sells some of your stocks and reduces your margin loan. Of course, your stocks will be sold at the worst possible moment and you take a loss.

Cash management is a way to put your money to the best use. If you have a lot of cash sitting around in a savings account at 4% while your portfolio is galloping at 100%, you are wasting your resources. If you were to invest all your cash then you would be in the ideal (non speculative) situation. But your income and expense stream does not necessarily go in lock step with your investment needs and margin is a way to bridge this difference in flows (strange metaphor!).

Just in time inventory, the real secret weapon of Michael Dell, is just cash management. Dell does not spend a single cent extra on inventories. Suppliers are practically forced to put a warehouse next to the Dell factory door to guarantee immediate delivery when Dell places an order. And Dell only orders what it needs to assemble the machines customers have ordered.

You need to figure out what is the maximum loan you can take out on your portfolio without getting a margin call. I figure it is 25% of the portfolio because the portfolio would have to drop by more than 50% before you get a margin call. I limit my margin to a maximum of 20% of the portfolio and it usually is less than 10%.

Being retired, I don't have income, so my cash management will be a bit different than yours if you have an income, but you'll get the picture.

I pay my expenses with a credit card and then I pay the credit card with a check drawn on my portfolio so that I don't (usually) pay the credit card any finance charges. This raises my margin level. As I rotate my portfolio, I make sure that I buy a bit less than what I sell so as to lower my margin level. As you can see, margin becomes a cushion between my expenses and my harvesting the portfolio. The use of the credit card increases the "float" by around 15 to 20 interest free days.

You should get a check book and a debit card from your broker. They are great cash management tools.

Hope this helps,

Denny