FEATURE | SATURDAY, APRIL 24, 2010

Living on the Margin, at a Discount

By **ANDREW BARY**

Interactive Brokers is shaking up Wall Street's lucrative margin-lending business by offering much lower rates than conventional institutions.

A LITTLE-KNOWN SECURITIES FIRM IS SHAKING up Wall Street's lucrative margin-lending business by letting individuals borrow at an institutional rate as low as 0.50%, way below the published margin rates of such large online brokers as Schwab, Fidelity and TD Ameritrade.

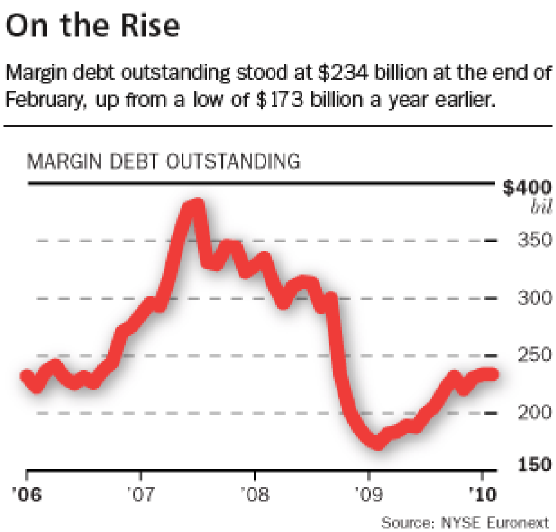
Enlarge Image

Tim Foley for *Barron's*

The firm, **Interactive Brokers** (IBKR), has been advertising its margin rates in *Barron's* and The Wall Street Journal, with apparent success. The firm, whose Website is highly automated, had $4.4 billion in margin loans outstanding on March 31, compared with $1.8 billion a year earlier.

Margin lending, which allows clients to borrow against the value of their securities, can be highly profitable, due to wide spreads and minimal credit risk. This is helping online brokers offset declining commissions, typically less than $10 a trade. Industrywide, margin lending totaled $234 billion in February, down from a peak of $381 billion in July 2007, but up from $173 billion in February 2009.

Federal Reserve margin rules generally limit a loan to 50% of a security's purchase price. However, "portfolio" borrowing, offered by Interactive Brokers and others, lets investors borrow more than 50% of their holdings at a firm, based on a real-time analysis of the pledged securities' value and risk.



MARGIN BORROWING MAGNIFIES losses or gains on stock purchases. If a security falls, the person who pledged it as collateral can face a margin call -- a demand for cash, to make up the shortfall. Interactive Brokers is for sophisticated investors who don't need hand-holding. Steve Sanders, a senior vice president there, says margin balances are updated constantly. If they get too low, the clients' securities are sold -- pronto. At many firms, investors get a few days to post additional collateral.

Many wealthy investors use margin borrowing instead of personal loans or home-equity credit lines because of relatively low rates and attractive terms; repayment can be delayed indefinitely, if the investor has sufficient collateral.

Given the low rates from Interactive Brokers, some investors are borrowing cheaply and investing in higher-yielding assets, primarily high-dividend stocks and exchange-traded funds, to earn a positive spread. Interactive Brokers' ads even highlight a screen of 495 stocks paying dividends of 5% or more.

One investor has used margin loans from Interactive Brokers to buy two junk-bond exchange-traded funds, the **SPDR Barclays Capital High Yield Bond ETF** (JNK) and **iShares iBoxx High-Yield Corporate** Bond (HYG), now yielding 9%. This produces a positive spread around eight percentage points, although that probably will narrow whenever the Federal Reserve boosts short rates.

Another benefit: Interest on margin debt can offset investment income for tax purposes.

Typically, large online brokers' posted margin rates range from 4% to 8%. The business is very profitable because brokerages take investor cash balances on which they pay next to nothing and lend it at an average rate of 5%. TD Ameritrade made $78 million in the first quarter on margin lending, making it one of its largest profit centers.

BUT ANYONE WITH A SIZABLE ACCOUNT might be able to negotiate a discount. We've heard that TD Ameritrade was willing to lend at less than 4%, below its stated 7%, to someone with $250,000 in his account, and that Fidelity would go down to 1.5% on a margin loan over $500,000 for someone with a few million bucks in his account.

Big Differences

Here's a sampling of the interest rates charged by some brokerages to investors with margin-account balances of various sizes.

	MARGIN RATE ON		
Firm	**$25,000**	**$100,000**	**$500,000**
Interactive Brokers	1.71%	1.21%	1.21%
Fidelity	7.58	6.575	3.75
Schwab	8.00	6.875	6.75
Etrade	7.64	6.14	4.14
TD Ameritrade	8.50	7.25	7.00
optionseXpress	6.25	5.00	4.50
Scottrade	7.25	6.50	5.75

Margin rates at full-service brokers are comparable to those at online brokers, although full-service firms don't post rates publicly. Full-service brokers also will negotiate, especially with well-heeled clients. Because brokers usually make nothing on margin borrowings, they have no incentive to have clients pay a lot, and should be their advocates. JPMorgan Securities will lend at about one percentage point above the London Interbank Offered Rate, now 0.30%, to clients with good credit and sizable assets. And private bankers are always eager to lend to wealthy clients.

Interactive Brokers lends at 1.71% for margin loans of less than $100,000 and at 1.21% for loans of $100,000 to $1 million. The 0.50% applies to incremental borrowings above $3 million. The Interactive Brokers margin rate is pegged to the federal-funds rate, the key short rate controlled by the Fed. Lately, it has been about 0.20%.

Warren Buffett isn't a fan of margin debt. His view is that good investors don't need it and bad investors can get killed by it. But if you're going to use margin debt, you might as well get the lowest rate.

E-mail comments to **editors@barrons.com**