ASSET MANAGEMENT

The Archegos Saga

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The Archegos margin call rattles banks

What exactly transpired?

Archegos Capital, a family office managed by Bill Hwang (formerly a part of famous hedge fund Tiger Management, and who was later charged with insider-trading fraud in 2012) had taken bets on a number of stocks using borrowed money, and pledging shares as collateral with investment banks / brokers.

Archegos is believed to have entered into highly leveraged over-the-counter derivatives / swaps with the broker banks. Archegos is believed to have entered into 'contracts for difference' (CFD) instruments. In a CFD, a fund takes a position in a stock using a bank as an intermediary. If the trade is in profit on the settlement date, the difference is paid by the bank to the fund. The fund takes a leveraged exposure by paying a small margin, allowing it to earn higher profits than if it had taken a fund-based bet, while the bank earns a commission for such services. When the going is good, everyone is happy. But when it isn't, it comes down to the fund's ability to make good with collateral. Archegos's inability to do so has triggered a sell-off by banks.

For example, ViacomCBS, one of the stocks in which Archegos had exposure, fell 9% following the announcement of secondary offering of shares. This led to a margin call on Archegos as some of its positions started going bad. When Archegos was unable to meet the margin calls, Goldman Sachs Group and Morgan Stanley dumped the shares Archegos had pledged with them as block trades (a block trade is a high-volume transaction in a security that is privately negotiated and executed outside of the open market for that security), leading to a fire sell-off. This led to shares of portfolio companies like Viacom, Discovery and Baidu nosediving (overall portfolio of companies block-traded dropped close to ~46% in the last week).

The block trades are estimated to be worth around US$20 Bn by its prime brokers. The stocks impacted by this huge sell-off prompted Nomura and Credit Suisse to disclose that they face potentially significant losses on their exposure.

How did Archego gain such huge exposures of close to US$50 Bn on its estimated US$5-10 Bn AUMs?

- One of the reasons is using borrowed funds and derivative instruments where the investor is required to post only a small portion of the exposure as margin. This allows funds to leverage up the cash they hold and increase their positions - potentially magnifying returns. On the flipside, in such transactions, the client has to immediately bring in additional money if the stock prices fall since it leads to a fall in the value of the margin, leading to a margin call. This happened in the case of Archegos - some of the stocks it invested in fell sharply. This is why the global banks are facing huge potential losses

- Additionally, the CFD and swaps used by Archegos were over the counter, i.e traded privately, instead of through public exchanges, making them opaque
- Thirdly, Archegos was registered as a family office, which attracts lesser monitoring and reporting requirements than a hedge fund. Family offices do not have to disclose their owners, executives or how much they manage. This approach still makes sense for small family offices, but here, Archegos had swollen to a size of a hedge fund, hence posing a risk to the broader market.

Who were the banks / brokers dealing with Archegos and their losses?

Archegos partnered with Nomura Holdings Inc., Morgan Stanley, Deutsche Bank AG and Credit Suisse Group AG as its prime brokers. This incidence, Nomura believes will wipe out all of its profits for second half of the financial year. The bank estimates losses to be around US$2 Bn. Its shares closed 16% down, their worst ever one day fall.

According to Credit Suisse, this sell-off might have highly significant and material impact on its first-quarter results, though the quantum wasn't disclosed. Its shares sank 13.8%, its steepest decline since March 2020.

Morgan Stanley's shares fell by 4%. Nomura and Credit Suisse are believed to be the hardest hit due to this incidence.

UBS and Deutsche Bank's exposure in this case may not be material.

Archegos' portfolio holdings which experienced sharp sell-offs?

Stocks which the banks dumped include Viacom CBS inc., Discovery Inc., GSX Techedu, Baidu Inc, IQIYI Inc among others. Surprisingly, all these stocks soared this year, leading to many traders questioning the rise.

On 26th March, Friday, shares of Viacom CBS and Discovery tumbled around 27% each. US listed Chinese companies such as Baidu and Tencent Music dropped as much as 33.5% and 48.5%, respectively, in a single trading day.

So far, only the stocks in Archegos' portfolio have been impacted. Major equity indices in US, Asia and Europe have not been affected.

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