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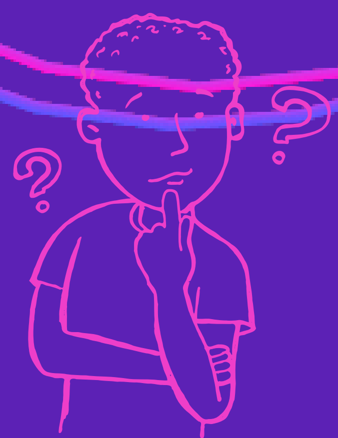
Lessons from Archegos Capital

A Quick story in 6 slides

Speculation+ Leverage = Downfall ?



Archegos Capital (AC), a New York based Family office caused some anxious moments on Wall Street last week for its inability to meet Margin calls by lender. Lets understand the story...

AC is a Family Office, implying it managed private money of its owners, with estimated networth of $10Bn

This is different from a Hedge Fund which is a pool of investors managed by a fund manager.

Unlike Hedge Funds, Family Offices have lower disclosure requirements.

AC went long* on various US and Chinese stocks with big bets on media.

This was done through dealers or Prime brokerages of marquee Investment Banks (IB), which are high end brokers.

The key stocks included Viacom CBS, Discovery, Baidu, Tencent. Other names that you will hear are RLX Tech and GSX Techedu.

But as the shares of these companies, especially Viacom and RLX tech, started falling, lenders called for additional margin.

Let us explain the transaction a little more..

* taking a position that stock will go up

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Now, there is a difference between Buying & Owning Shares and taking Positions. The key instruments being talked in ACs case are called Total Return Swaps (TRS).

This is how it works...

TRS is a derivative where the investor gets in a contract with a dealer and takes a position to this effect
'if a particular asset or stock goes up, I ll book the profit and if it goes down, I ll bear the loss".

But AC isn’t buying the stocks. The dealers take these positions on behalf of AC for settlement at an agreed date. They in turn ask AC to provide Margin money to cover for potential loss in case stocks go down.

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So effectively, AC has an 'economic interest' in these stocks but stocks are in the books of prime brokers/IBs. This also meant AC didn’t have to report these as part of its holding to regulator (SEC), even when the holding was significant (>5%)

Now how much margin can AC provide for such positions?

Maximum $10 Bn, isn’t it?

But AC borrowed heavily, some say upto $50 Bn, against the same underlying securities.

As the stocks started going down, the dealers asked for more margin. But AC couldn't as it was already over leveraged.

For brokers and lenders, the best strategy then is to quickly square off their positions, held on behalf of AC. The story unfolded thus....

Morgan Stanley Deutsche and Goldman Sachs, quickly liquidated these stocks, thereby minimising their losses. This of course led to further decline in shares from 25-30% and...

Some others like Nomura and Credit Suisse who held on, faced increased losses.
Nomura faces a possible $2 billion loss while Credit Suisse's loss are estimated to be upwards of $4 Bn.

We dont know why this happened but media reports suggest there was some agreement between all the dealers to go slow but some of them went fast!

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Any Lessons??

At FrankBanker we don't judge. Its for regulators to decide if everyone played by the book. But as bankers, lessons we must learn from these happenings.

1. Speculation can make one rich but can lead to quick downfall.
2. By adding over-leverage to the mix, we end up having potential suits being filed and conspiracy theories being written.

Sources: *Story based on our deep dive and assessment of new reports from multiple sources including Reuters, Bloomberg, CNBC, Financial Times, Wall Street Journal, SCMP, Livemint, Indian Express, Economic times.*

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