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Archegos Capital – What happened?

A little-known family office has sent ripples through global financial capitals after its failure to meet margin calls ignited an equity fire-sale totalling almost $30 billion.

The Backstory

Archegos Capital Management was set up as a single-family office in 2013 by a Mr Hwang to manage his own personal wealth. Previously, Hwang worked for a well-known hedge fund, Tiger Management. In 2012, Hwang pleaded guilty to insider trading of Chinese bank stocks and agreed to pay $44 million to settle civil allegations.

According to emerging reports, one of the main trading strategies of Archegos was long-short equities, pursued using derivatives such as contracts-for-difference (CFDs) and total return swaps (TRS).

CFDs allow traders to place a bet on the direction of a stock without actually buying or selling the underlying instrument. If the price rises, the seller pays the buyer the difference, and vice versa. Stripped down to its most basic form, a TRS is an agreement in which one party (in this case Archegos) makes payments based on a set rate, either fixed or variable, while the other party (e.g. brokers) makes payments correlated to the return of an underlying asset or assets. CFDs & TRSs both allow investors to take big, levered stakes without disclosing their positions publicly .

Archegos had assets of around US$10 billion but because of the use of such instruments to make large, levered bets, its real exposure to stocks resembled something closer to $50 billion. A lot of exposure was concentrated in US media names (e.g. ViacomCBS and Discovery) and Chinese Tech stocks (often via American Depositary Receipts (ADRs)).

The structure of the instruments meant that regulators weren't aware of Archegos' true exposure levels, while its structure as a single-family office meant it was not directly regulated.

What happened?

Last week, stocks that Archegos had large positions in suffered losses. Consequently, margin calls from big banks that had acted as prime brokers to Archegos were triggered. With Archegos unable to meet its margin calls, the lenders (i.e. the banks) were forced to liquidate its stock holdings at steep losses in a > $20 billion fire-sale that rippled across financial markets. For the purpose of illustration, on Friday ViacomCBS saw its share price crash 27% - with a trading volume of 211.9 million shares. The average trade volume is roughly 24 million.

According to reports, Nomura, Credit Suisse, UBS, Deutsche Bank, Goldman Sachs and Morgan Stanley all had dealings with Archegos.

Nomura, a prime broker for Archegos, has warned of a “significant loss” estimated at $2 billion from the unwind of the trades, while Credit Suisse said its loss resulting from this exit could be “highly significant and material” to its first-quarter earnings results. JP Morgan estimates that collectively, banks embroiled in the events could see $5 to $10 billion in losses.

Not all prime brokers will be hard hit by this episode, probably due to tighter risk management systems. It is reported that Goldman Sachs and Morgan Stanley are suffering limited losses, through the quick sale of Archegos assets.

The aftermath

The full impact of the Archegos debacle is yet to be seen.

What is clear is that the collapse of Archegos and the subsequent stock market calamity raises concerns about regulatory oversight, with a single player posing a threat to financial stability. Already, calls have been growing for tighter regulation in the lightly-regulated non-bank (i.e.

shadow banking) sector. In the US, Janet Yellen, the Treasury Secretary is scheduled to meet the Financial Stability Oversight Council this week and hedge fund activity is on the agenda. No doubt this story will inspire discussions. There are also concerns that the "family office" structure masks an "opaque world of leveraged trading strategies".

As with the Game Stop story when a “you only live once” mentality swept over markets, Archegos’ demise is another sign of the times. With key central banks keeping interest rates at ultra-low levels, cheap money is abundant. So much so, that a single player could borrow so much that it was able to affect global markets when things turned awry.

While this could be a perfect remake of the movie “Margin Call”, the event is not comparable in size to LTCM hedge-fund collapse, neither the Bear Stearns failure. The event, however, is a reminder that driving too fast on the highway is dangerous. Some portfolio management mistakes can be fatal, especially when those are cumulated. Mixing massive, concentrated exposures with high leverage and limited liquidity is a toxic potion.

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