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A Tale of Risk

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In 1973, Shirley Bassey wrote the timeless piece “Diamonds are Forever”. Diamonds can indeed survive harsh conditions through the aeons because their unique properties make them one of the hardest materials on the planet. In many ways, excessive leverage is the polar opposite of diamonds because it is fragile and given enough time, it will collapse on itself.

The recent implosion of Archegos Capital, a Family office that lost around $8 billion in a few days is another cautionary tale on the perils of leverage. Like any story, it has two sides. One from the point of view of the borrower and another from the lender.

The borrower in this case was a family hedge fund, Archegos Capital. The fund used swaps, a complex financial instrument, to get large concentrated and leveraged exposures to some US media and Chinese stocks. This previously successful fund was taking on risks it did not need to take in order to acquire wealth that it did not need either. What is the difference to one’s quality of life if you have $8 billion or $16 billion in the bank?

The Greek mathematician Archimedes famously said, “Give me a lever long enough and a fulcrum on which to place it, and I shall move the world”. Financial leverage, just like its mechanical cousin, the humble lever, is a magnifier. Financial leverage magnifies returns and losses. And since losses are asymmetric (a 50% loss and a 50% gain are not the same) even a small loss with large amounts of leverage is a recipe for disaster.

Some of the stocks the fund owned started falling at the end of March. The fund was forced to “post margin” i.e. pay up to the banks who lent the money. This caused further forced selling until the fund was in a position where it had successfully wiped-out years of good returns in a few days.

The second part of the story is more central to how we make decisions at Tacit. The unravelling of Arhcegos points out some of the hidden risks embedded in the large banks after more than a decade of low interest rates which has forced them into higher risk activities to maintain their profitability.

We have contemplated investing in global financials because of their low valuations They are also a natural hedge against inflation because an increase in interest rates also increases their earning power. However, as banks have struggled to make money in this low-rate environment, some may have gotten involved in riskier strategies that will only become unearthed after chaos strikes. This calls for extra caution on our part. Even though valuations look cheap, they may be cheap for a reason.

To conclude, we will leave you with our rendition of Bassey’s piece, concerning leverage instead of diamonds.

Leverage is not forever,

It will come back around and bite you,

Its wrath can destroy and smite you,

It will leave you in need and its almost guaranteed,

to desert you