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The World Of Family Offices: Archegos' Default

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INDUSTRY OVERVIEW

Family offices are wealth management advisory firms that serve ultra-high-net-worth (UHNWI) individuals. The recent years have been considered the Golden Age of Family Offices. In an era in which wealth is becoming even more concentrated, the number of family offices strongly increased between 2017 and 2019, and they are now more than 7,000. Reports estimate that the assets under management stood around $5.9tn in 2019. The average dimensions of a family office are of $1.6bn. Despite the size of their investment, family offices tend to operate below the regulatory radar. Unlike pension funds or hedge funds, they do not manage external money. This means that they often answer only to the family, apart from sanctions compliance and anti-money laundering rules. The surge of family offices came in the 2000s, from 2000 to 2010 the number of family offices increased by 33% and after 2010 by another 35%. There are three main strategic approaches that family offices take: preservation (19% of all the offices), balanced (56%), growth (25%). The average portfolio leverage in 2018 was 17%, in 2019 and 2020 14%. On average, Family offices are broadly diversified. The 35% of the total assets is allocated in alternative asset classes of which 16% (of the total) in Private Equity, 14% in Real Estate, 5% in hedge funds. The 59% in tradition asset classes of which 13% (of the total) in Cash, 17% in Fixed Income, 29% in Equities.

Figure 1 – Average portfolio diversification of Family offices
Source: Financial times (UBS Evidence Lab)

FAMILY OFFICES AND HEDGE FUNDS

The importance of family offices has grown year by year, becoming a profitable replacement to hedge funds for wealthy family asset administration. Many billionaires including George Soros, John Paulson and John Arnold have decided to end their hedge fund experience to start family offices. As the number of family office is growing very fast, the number of new hedge funds has decreased from 2012 to 2019. In 2019 liquidations outpaced new funds entering the market, shrinking the number of active funds in the industry to 16,256. The overall hedge fund industry is of $3.6tn according to HFR (Hedge Fund Research) $2.3tn less then the Family offices. Currently, the largest family offices are Walton Enterprises LLC with AUM $169.2bn, Bezos Expeditions with AUM $107.8bn and Cascade Investment with AUM $51bn. On the other hand, the largest hedge funds that are Bridgewater Associates with AUM $138bn, Renaissance Technologies with AUM $133bn and Man Group with AUM $117.7bn.

Family offices investment strategy was usually conservative, focusing on maintaining the wealth accumulated. Back then, it was hedge funds that adopted the most aggressive approach, using derivatives and other contracts to increase their leverage. Hedge funds in 2019, on average, returned 6.96% compared to an average return of 5.4% of Family offices.

A key factor that involves both family offices and hedge funds is regulation. In the U.S., the Dodd-Frank Act signed by former President Obama after the financial crisis, strengthened regulations for the financial industry. However, family office were exempted from SEC strict rules on disclosure. The tightening regulation that is over hedge funds has increased their operational costs, making family office structure more attractive. In addition, family offices don't have a fiduciary duty to limit their trading and they don't have to relate with external investors while hedge fund have to. These two features are decisive in Bill Hwang's fall from grace.

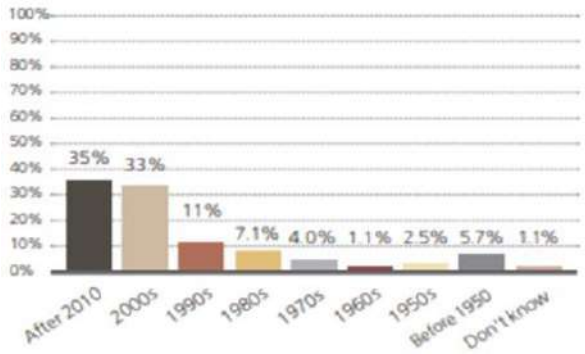

Figure 2 – New Family offices per decade Source: UBS Global Family office report 2019

BILL HWANG

Sung Kook "Bill" Hwang is a so-called Tiger cub, an investor trained by Julian Robertson, the founder of Tiger Management hedge fund. Mr. Hwang developed his experience working for Robertson's firm till 2001 when he decided to found Tiger Asia Management LLC. The firm reach to run more than $5bn, focusing on Asian internet and media stocks. In 2012 Tiger Asia declared the intention to liquidate its assets and return outside capital to investors. However, later that year the firm was accused of insider trading regarding Chinese bank stocks and agreed to pay $44mln to settle civil allegations by U.S. securities regulators. Mr. Hwang was barred from managing public money for at least five years. Regulators formally lifted the ban last year. At the age 48, Bill Hwang decided to turn Tiger Asia into his family office calling it Archegos Capital Management. The name he chose, "Archegos", translated from Greek means "leader" or "prince of Christ", which underlines his Christian faith that he discovered during his regulatory issues.

ARCHEGOS CAPITAL MANAGEMENT

It is estimated that Archegos Capital Management have managed about $10bn of Mr. Hwang's own money. However, its positions, that were unwound Thursday and Friday, approached $30bn thanks to leverage Archegos obtained from banks. The firm invested in large public companies in the U.S., in particular technological stocks: Archegos strategy consisted in acquiring big positions of an asset, leading to a bullish pressure. To do so, the firm collaborated with several investment banks using contracts such as total return swap. This financial instrument allows a fund to take on the profits and losses of basket of stocks without owing them in exchange of making payments to an investment bank based on fees and an interest rate. Then the bank, which owns the basket of stocks, makes payments to the fund based on positive return of them, while the fund must pay the bank an amount related to negative returns plus the accorded fees if the underlying assets falter.

Through this type of contract Archegos was able to increase its leverage, taking larger positions than its cash would have afforded it to. In addition, the firm could maintain its anonymity even if it is estimated that Archegos held more than 10% of multiple companies' shares. In fact, the SEC has stated so far that investors do not have to disclose positions in total return swaps unless they have voting power over underlying shares.

Prime brokers offer this riskier type of contracts because they are in desperate search for profits. With the introduction of post-crisis regulation, it is more expensive for them to trade on their own account, and it is difficult to take profits from unleveraged asset managers. In addition, more and more investors are moving to low-commission digital platforms. Because of that, banks are trying to make money from fees and commissions paid by fast-trading hedge funds or family offices for derivatives and other contracts as total return swaps.

WHAT HAPPENED?

Monday 22nd of March ViacomCBS, one of the largest holdings of Archegos whose price had increased by 150% in 2021, announces that new shares would be sold. The offering led to strong pressure on the stock whose price decreased by 30.14% from Monday to Wednesday. Archegos concentration strategy backfired. Indeed, facing great losses Mr. Hwang had to sell also other stocks. Rumors of the Family office selling its positions spread across the market, and from Tuesday 23rd to Wednesday 24th Discovery's price, another

important holding falls of 13.59%. Margin calls hit the family office, this mechanism is activated when the value of an investor's margin account (a loan collateralized by securities purchased and cash) falls below the lender's required amount, more stocks had to be sold. Consequently, other holdings plunged, notably Baidu fell of 21.79% from Tuesday 23rd to Thursday 25th. The 25th Archegos had a meeting with the main banks that supported it to try to control the situation and to work together to unwind its trades over one month. Morgan Stanley, Goldman Sachs, Credit Suisse, and Nomura had different views. The representatives of Morgan Stanley and Goldman Sachs predicted that the market would have understood and that a fire sale would have occurred in the next few days. There was no agreement and Friday 26th Goldman Sachs and Morgan Stanley began selling to try to reduce the losses. Fire sales continued, ViacomCBS's price decreased by 27.31% that day, and Discovery's by 27.45%. Overall, the fire sales caused by Archegos' default are estimated to more than $20bn worth of equities.

Figure 3 – Stock price of ViacomCBS and Discovery Source: Yahoo Finance

CONSEQUENCES

Nomura and Credit Swiss were slower to liquidate Archegos positions after the failure of the attempt to coordinate the process. The estimated losses for Nomura account to more than $2bn. Credit Suisse reported losses of $4.7bn pushing the bank to a first quarter loss of $960mln. Just last month the bank had to face the collapse of Greensill Capital, a company to which the bank was significantly tied. The Swiss bank had to hold off its $1.5bn shares buyback program and cut its dividend by 66%. From the start of March, the bank's share price fell of approximately one quarter. The group'schief risk and compliance officer Lara Warner, and the head of the investment bank Brian Chin were fired. The clients of Credit Suisse are in any case strongly concerned about the risk management process and some lost faith in the strategies adopted by the bank.

The default of Archegos exposes the poor risk management of some banks, that provided excessive leverage for speculative bets. Also, the poor regulatory oversight of the interactions between banks and Family Offices. Regulations will probably get tighter on family offices now and in any case, banks will be more careful when dealing with Family Offices, decreasing leverage even if this leads to less profits.

Figure 4 – The crash of Nomura and Credit Suisse Source: Economist (Bloomberg)

"The big problem is, what is a family office? It could be an entrepreneur selling a business who asks his bankers to invest the money, a multifamily office where families organize their affairs together, or a third- party firm that manages the assets of family offices. Because there is a lack of a decent definition there is no regulatory grip over it"

Bart Deconinck, Chairman ZEDRA Group

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