moneycontrol

Vital lessons for investors from the Archegos saga

By Nikhil Walavalkar

When legendary investor Warren Buffett termed derivatives as financial weapons of mass destruction, there is good enough reason to take care, before using them.

The forced fire sale of stocks held by Archegos Capital amounting to around $20 billion, made headlines. It is drawing global attention to the covert financial instruments – mainly derivatives – which was used to build large stakes in companies.

It was also occasion enough for a couple of large banks to issue profit warnings caused by this financial flap.

Though individual investors are unlikely to use the complex investment strategies involving sophisticated derivative instruments employed by the family office, a few lessons from this incidence cannot – and should not - be ignored by investors.

Leverage Kills

Derivatives introduce leverage. For example, by putting Rs 1 lakh on the table, you can take a position worth Rs 5 lakh, with a view to benefit from the move. But the flip side of the story is often ignored. If the price of the underlying moves in the opposition direction than envisaged, then the losses are likely to be five times as heavy.Says Amol Joshi, founder of Plan Rupee Investment Services, “Leveraged investments can bring down portfolio value if the stock prices move contrary to the investor’s expectations.”

Experts say using derivatives or borrowed funds for trading, is best avoided.

“Derivatives can be used only if you understand how they work. The tendency to use derivatives without understanding how they work generally hurts traders,” says Vishal Dhawan, Founder and Chief Financial Planner, Plan Ahead Wealth Advisors.

When interest rates are at a decadal low and many mid and small cap stocks have emerged as multi-baggers over the last one year, some naïve investors may want to borrow with a view to use those funds for trading. But that would be a mistake.

If the market turns, the leverage can hurt even the best of the portfolios in no time and if additionally, you have to pay agreed interest with the capital back to your lender, the losses are going to get worse.

Since the beginning of 2021, interest rates are on the rise. This could hurt the carry trade, which has caused momentum in some sectors. A combination of leverage and momentum can be dangerous if the prices take a U-turn.

Do not chase momentum

When stocks of companies in a particular sector start appreciating faster than the broad market, many investors are attracted. For example, healthcare stocks did extremely well in the first half of 2020, as did infrastructure stocks in 2006-2007.

Identifying the momentum early on and betting big on it is a strategy used by some sophisticated investors, with a few success stories in tow. But not all are lucky or skilled enough to make money, riding the momentum.

Archegos has - by investing stocks in an upward trajectory.

It is difficult to predict though, how far this momentum will last.

“Never chase a stock just because it is going up. Stock prices always see corrections for a variety of reasons. A stock may not only fall big, but also may take time to course correct,” is Amol Joshi’s sage advice.

Invest for long term

Trading on borrowed money is a trend that is attributed to the Archegos incidence. Many individual investors find it difficult to distinguish between trading and investments. While trading, you must cut your losses fast and if you are trading for the short term, then the time factor is against you.

In such a scenario, not many would be comfortable with swift movements in prices of underlying.

Says Dhawan: “Investments in equities are to be done with a long-term view. Derivatives or margin trading is for short term trading. You should not confuse trading with investing.”

In other words, when trading you are a long-term investor, time is on your side and if you are investing in good quality businesses, then compounding works in your favour.

Do not follow super investors blindly

Though Archegos traders were not in the public domain, there are many super investors who others wish to emulate – buy what they buy and sell what they sell. In market parlance it is termed as coat-tail investing or cloning.

The proliferation of social media has tempted many investors and traders to 'showcase' their investments and strategies. But what is visible may well only be the half-truth.

It is not necessary – nor possible – for everyone to understand all the actions of super investors.

Vinayak Savanur, Founder and CIO at Sukhanidhi Investment Advisors, counsels against following renowned investors blindly, as they too go wrong on their strategies.

Even if a particular strategy or a product is being marketed by such renowned investors with past performance to support the claim of success, do not jump for it. "Don't invest if you don't understand the product, strategy and the underlying risk," he adds, simply and succinctly.

When the markets turn, the super-investors may change their positions quickly, an information that you are likely to gather much later through regulatory filings. But by then, you may be saddled with tremendous losses.

Diversify

When a particular asset class and within that, a particular sub-segment does well, investors tend to allocate more money to it. Archegos also allocated sizable capital and borrowed money to take positions in technology names.

When the prices continue in an expected direction, they amplify gains, but when they take a turn, there is no place to hide.

You are better off investing across asset classes such as stocks, bonds, gold, and real estate. You should figure out an asset allocation by taking into account your risk appetite and financial goals.

Review it regularly and rebalance it from time to time. This should protect you in case of a sudden crash in a particular asset class. Too much concentration can hurt your portfolio returns – as umpteen experiences in the past have shown.