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Navigating Financial Rough Seas

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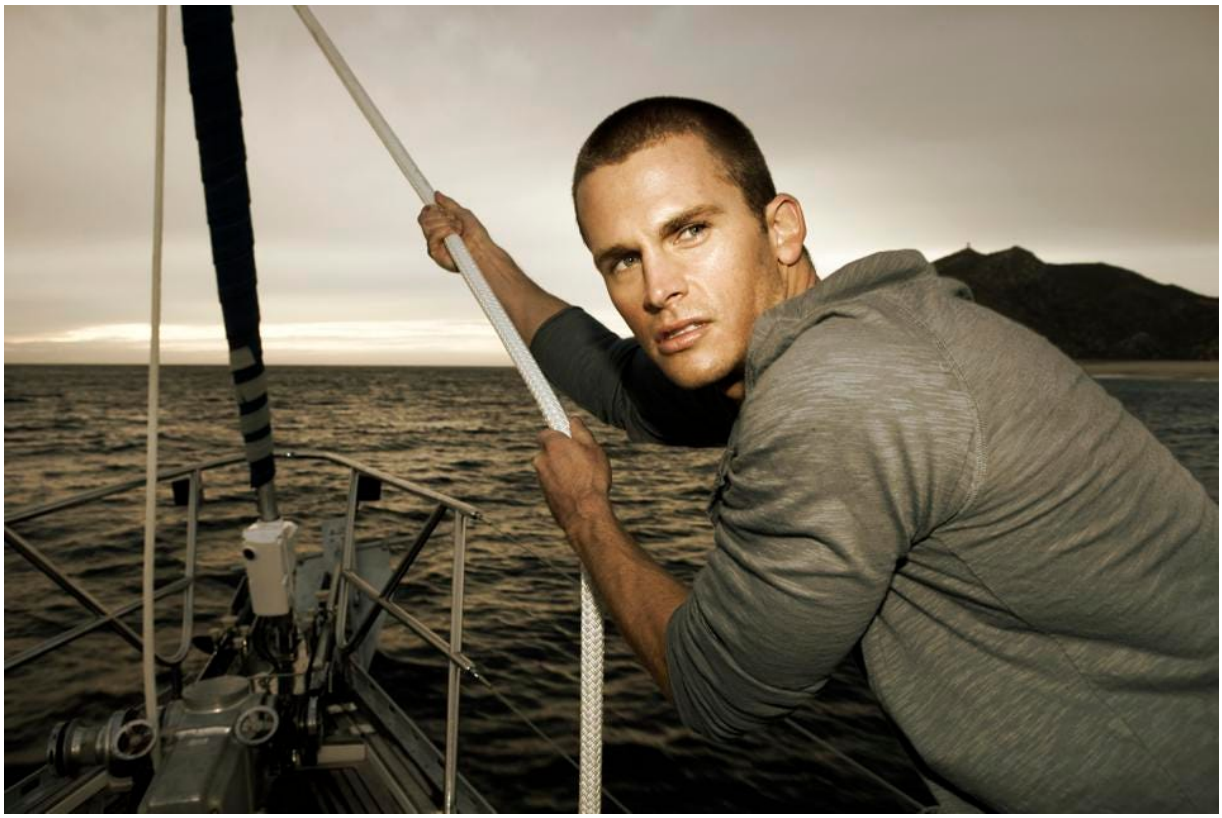

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As a navigator charting the best course to win offshore sailing races, I place enormous faith in sophisticated data analysis software designed to maximize the boat's speed and minimize distance. Downloading the latest weather forecasts is a key part of this analysis, and after studying the results and considering all the possible scenarios, my role is to choose a path and communicate that decision to the crew.

But what, say, if crew members are seasick, forcing you to guide the boat through calmer waters? What if the crew is tired? What if what you see when you step out on deck appears to contradict what the meteorological forecasts are telling you?

The lesson drawn here is simple even if the solutions aren't always easy to come by: Blindly relying on data analytics alone can easily lead one astray. And it is a mistake that has played out in financial markets far too often and, I believe, may partly explain the tidal wave that sank Bill Hwang's Archegos Capital Management hedge fund back in March. The ripple effects buffeted Swiss lender Credit Suisse Group AG and Japan's Nomura Holdings Inc., as well as media stocks such as ViacomCBS and Discovery. In the recent aftermath, Credit Suisse announced executive departures, proposed dividend cuts and took a $4.7 billion charge.

I certainly believe in strong risk analytics, and the guardrails they provide are a core part of FINCAD's business. But confidence in decision making has to be holistic and emerge from your own experiences (and those of the folks on your team) as well, and based on seasoned judgments, financial acumen, understanding fast-changing situations and, to be sure, what you see out of your own eyes.

During the global financial crisis of 2008, many people were overly reliant on quantitative models and analytics without paying enough attention to human factors, those "this-doesn't-feel-right" instincts.

Leading up to its collapse, the firms involved with Archegos shouldn't have felt right either, in my opinion.

The dynamics around the debacle involved a complex and risky derivative strategy built around so-called total return swaps, which let investors gain exposure to a pool of underlying securities, without directly holding the underlying assets of those stocks on their books. Instead, a counterparty is responsible for swapping the asset returns, typically for a set margin on Libor (London Interbank Offered Rate), a common global benchmark.

You can certainly understand the appeal of adding total return swaps to the investment manager toolkit. Managers are constantly pressured to seek higher potential returns relative to otherwise traditional investments, such as bonds and equities alone. And getting around certain requirements for reporting stock trades opens up a range of specialized and proprietary opportunities for these investment managers and their clients. When market conditions change rapidly — and in a favorable direction — it can be advantageous to lock in total return swap rates, which exchange interest-linked benchmark returns to equity performance returns. Last year, as federal lending policies pushed down interest rates and helped prop up equity prices, this proved to be a profitable strategy.

Unfortunately for Archegos, and the institutions that were badly damaged in the hedge fund's downfall, total return swaps resulted in a darker outcome. Financial markets were rattled when, to avoid the risk of owning stocks they didn't want, firms such as Goldman Sachs, Morgan Stanley and Deutsche Bank AG swiftly liquidated their positions in Archegos, reportedly to the tune of some $30 billion.

It became a game of who could get out first, and Credit Suisse was slower to bail than the others, culminating in those monster-sized losses. It's since been reported that Credit Suisse's exposure to investments involving Archegos exceeded $20 billion.

I don't know firsthand how Credit Suisse and other institutions may have applied analytics to manage these total return swap risks, but as top-tier companies, I'm sure the firms' analytics are bulletproof. But I have to

wonder if they ever had a conversation discussing the possibility that the analytics shouldn't be their fail-safe.

In the end, because Archegos was so highly leveraged, when prices started to plummet, the firm was pressed to post collateral it didn't have, and the house of cards fell apart.

Robust analytics are critical whether you're racing sailboats or navigating financial waters. But it is imperative that to achieve good risk management, you don't solely follow the numbers. Whatever is happening on deck can often be at odds with what the computer is saying is happening. That's when your own judgment is crucial.

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