INSIGHT

THE GREATEST WEALTH IS **YOUR PEACE OF MIND...**

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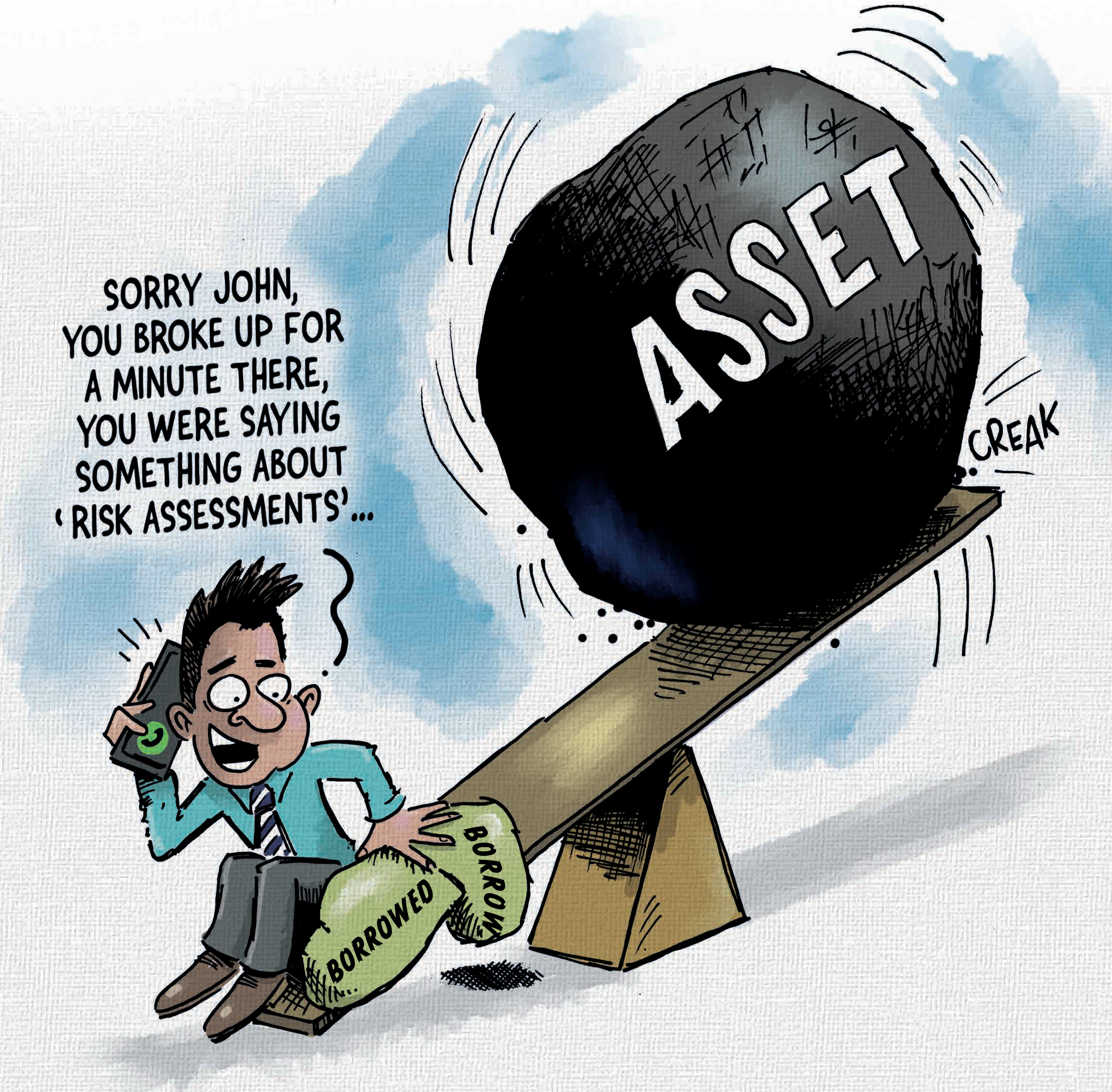
WEALTH MANAGEMENT

Leverage: not without risk



Leverage: not without risk

Leverage, often referred to in investing as a 'double-edged sword', is another word for borrowing money to own more of an asset. Much like a mortgage on a house, it enables individuals to own a higher value of an asset they would otherwise be unable to own, but it does run the risk that the value falls such that one ends up owing more than one owns (coined 'negative equity' in the housing world). This is never a good place to be.

Our systematic approach is 'long only' (as opposed to taking an element of short positions, which requires borrowing) and unlevered. This means that the investments are owned without inherent borrowing within the funds themselves. Of course, we do believe debt is a powerful tool that corporate finance departments and governments can use to raise capital to fund future growth and we recognise the importance of borrowing in capital markets, but we don't generally believe that this is a risk worth taking at the fund or portfolio-level. Markets can be scary enough at times like Q1 2020, without magnifying the downside further through leverage.

The potential upside of highly leveraged strategies is magnified returns which can leave investors drooling. The downside could be 100%, or more. As you might have spotted in the press, the family office Archegos Capital Management has been made all too aware of this[1] with the recent unwinding of their leveraged bets which has left some banks, which provided the capital to Archegos, nursing heavy multi-billion pound losses[2].

The reader will be well-aware that borrowing is commonplace in the housing market, with interest rates now at historically low levels. For example, 2-year fixed-rate mortgages are now at around 1.6%[3]. Some will remember times in the 1970s and early 1990s when rates were 10 times this. Although mortgage rates are cheap, few are able to borrow 'on margin' on such favourable terms and for most the potential downside of such an approach outweighs the potential benefit.

Although curtailed slightly of late, the rise of retail investors over the past 12 months has been significant and has come with cheaper access to leverage through the trading of financial derivatives. With one of the common questions asked by those 'YOLO-ing their stimmies' (i.e. investing their US stimulus cheques) into such investments being "what is the stock market?"[4] one is led to believe these investors are not pursing a 'risk-comes-first' approach. Unfortunately, many will learn a painful and costly lesson.

Our default approach is to invest in unlevered long-only strategies. Our risk-focused approach to portfolio construction means that our Investment Committee regularly reviews the risk exposures of your portfolio and seeks to mitigate or avoid those that are unwanted or typically go unrewarded. In general, leverage is one of those.

End notes

1.
Economist, April 3rd 2021. “Margin call of the wild: Archegos, a family office, brings Nomura and Credit Suisse big losses”. Also, for a good insight into the backstory: https://www.bloomberg.com/news/features/2021-04-08/how-bill-hwang-of-archegos-capital-lost-20-billion-in-two-days

2.
Succinctly summed up in this meme https://twitter.com/CP2Close/status/1379143105794822147?s=20

3.
Average at 75% LTV. UK Parliament: House of Commons Library, 10th March 2021. “Household Debt: Key Economic Indicators”

4.
Ft.com, 9th March 2021. “Rise of the retail army: the amateur traders transforming markets”

Other notes and risk warnings

Use of Morningstar Direct© data

Risk warnings

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