Views from the Desk

Updates in the Equity and Fixed Income Market

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Update on Archegos and its Impact on Markets

Archegos was a family office in the U.S. which was using leverage to get large exposures to equity positions. They were able to get such large positions in these equities using swaps which gave them exposure to these stocks, without physical ownership. This leveraged derivative strategy was considered an alterative strategy and was very risky. Archegos was carrying a leverage ratio of 3:1. There were about six or seven banks (the most exposed were Nomura and Credit Suisse) who had their prime broker involved in these swaps. When Archegos could not make their margin calls, these banks with loan exposure to Archegos were forced to liquidate their holdings. We don't know yet the extent of the damage to the exposed parties. Alternatives are a broad asset class. They can include real estate, long short hedge funds, market neutral; these are all much different than a leveraged hedge fund such as Archegos. Archegos was classified as a family office which has much looser regulations. ETFs are governed by 81-102 regulations. Benefit of ETFs: transparent, liquid. Overall an ETF is much more regulated than the strategy that Archegos employed. When investing in alternatives, the key to focus in on is the transparency of the fund or strategy. Archegos was not transparent with their clients about their total exposure or the risk they were taking on. Even within liquid alts in the ETF regime, there are limits on leverage, and must be transparent which are important considerations.

Will U.S. Banks ETFs Be Impacted by Archegos?

The impact on the **BMO U.S. Banks Index ETF (ZBK, ZUB)** will be limited. Impact of the Archegos fall was contained to the prime brokerages of the exposed banks. ZBK is well diversified and a good portion of the portfolio are regional banks and their exposures to the prime brokerage business is limited. Within ZBK, only two companies were involved: Goldman Sachs and Wells Fargo. These banks got wind of Archegos' downfall early and unwound positions earlier than other banks. The banks which were hardest hit were international banks Nomura (Japan) and Credit Suisse (Switzerland). These two banks had more exposure to the stocks and took the longest to unwind their positions. ZBK doesn't hold these banks because they are international. The current economic environment is positive for banks. A steeper yield curve is good for the banks, especially the regionals for their lending business.

SPACs

A Special Purpose Acquisition Company (SPAC) is an alternative way for a company to list on the exchange, as an alterative to an IPO. With a SPAC you don't know what you're going to be investing in. You are investing in a shell account with cash, and a management team. IPOs take about 2-3 years for the full process to take place. A SPAC takes 2-3 months so can be more efficient. The SPAC universe has gotten bigger but an investment manager looking to manage a SPAC fund may have issues with scalability. It is essentially a shell company trading on the exchange, a pile of cash looking to invest in something. It is a way to bring private companies public. As SPACs acquire private companies, some will start to fit in with ETFs.

Balanced ETFs

The **BMO Balanced ETF (ZBAL)** has returned 9.8% (annualized) since its inception just over two years ago. For comparison, the broad Canadian market has returned 11.7% during this time, but ZBAL is 40% fixed income. Therefore, ZBAL has provided about 85% of returns with two thirds of the volatility. ZBAL holds 9 ETFs- so it provides instant global diversification to global fixed income and equity markets. Advisors are using this as a one ticket solution. Good single position for small portfolios but also a great core holding for larger portfolios.

Prefs

Prefs have been a story about rising rates. The five year is moving up quite a bit. This has been a tail wind for the asset class. But interest rates are just part of the story. As yields rise, investors are looking for ways to protect against duration risk. YTD there have been $90 million flows into pref share ETFs (not including direct investment or mutual funds) in Canada. Prefs are being redeemed, and so we are seeing an increase in demand but a slow draw down in supply which tends to be good for asset prices. Tier One capital bonds removed a lot of the downside risk. If interest rates were to fall, it would be cheaper to refinance these issues. So even if rates drop, these prefs will continue to trade at par.

Source: Bloomberg, All returns and data points March, 2021.
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