

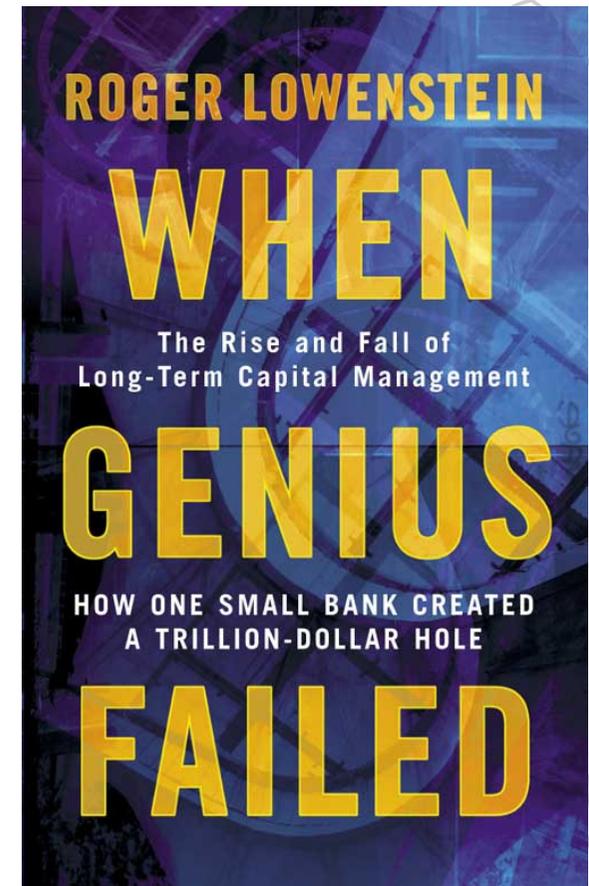
When Genius Failed Roger Lowenstein

The Rise and Fall of Long-Term Capital Management.

How one small bank created a trillion dollar hole © 2001

Finance journalist Lowenstein details the roller coaster-ride LTCM took from its first \$1.25b fund raising in 1994 to its peak of \$140b of assets* in the spring of 1996 then on to its complete collapse in August 1998. This famous hedge fund used extraordinary amounts of leveraged debt to “vacuum up nickels that others couldn’t see” - which later proved to be just in front of a steam-roller. LTCM’s leadership famously included Liar’s Poker’s John Merriwether and Nobel Prize winning, Harvard professors Myron Scholes and Robert Merton.

This story is an important one for those investing in hedge funds and explains why, without warning, successful funds can simply “blow up” and destroy years of created value. It also reminds us about the risk “outlier” or one-off events pose to portfolio returns.



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*and also \$1t of derivatives all financed off a \$4b equity base

About hedge funds and LTCP's investors

Hedge funds 101

Hedge funds are supposed to be tame. Name derived from expression to “hedge one’s bet”

Australian Alfred Winslow Jones started the first partnership/fund in 1949 buying stocks he thought were cheap and selling stocks he thought over-priced aiming to be market neutral (ie. net return would depend on picking of stocks not the rise or fall of the overall market)

Hedge funds today are private, largely unregulated investment pools using a structure probably dating back to Benjamin Franklin. Allow 99 investors of \$1m each or 500 investors of \$5m total. Through feeder funds these rules can be bypassed.

There were 200 hedge funds on record in the 1960’s; 3,000 in 1990s and now there are more than 30,000. Most funds operate under secrecy to protect trading strategies. It also enables unsuccessful managers to re-enter the market. An elite image also helps justify high fees.

LTCP's financiers

“LTCM had the equivalent of Michael Jordan and Muhammad Ali on the same team” allowing them to raise a record amount of funds from ...

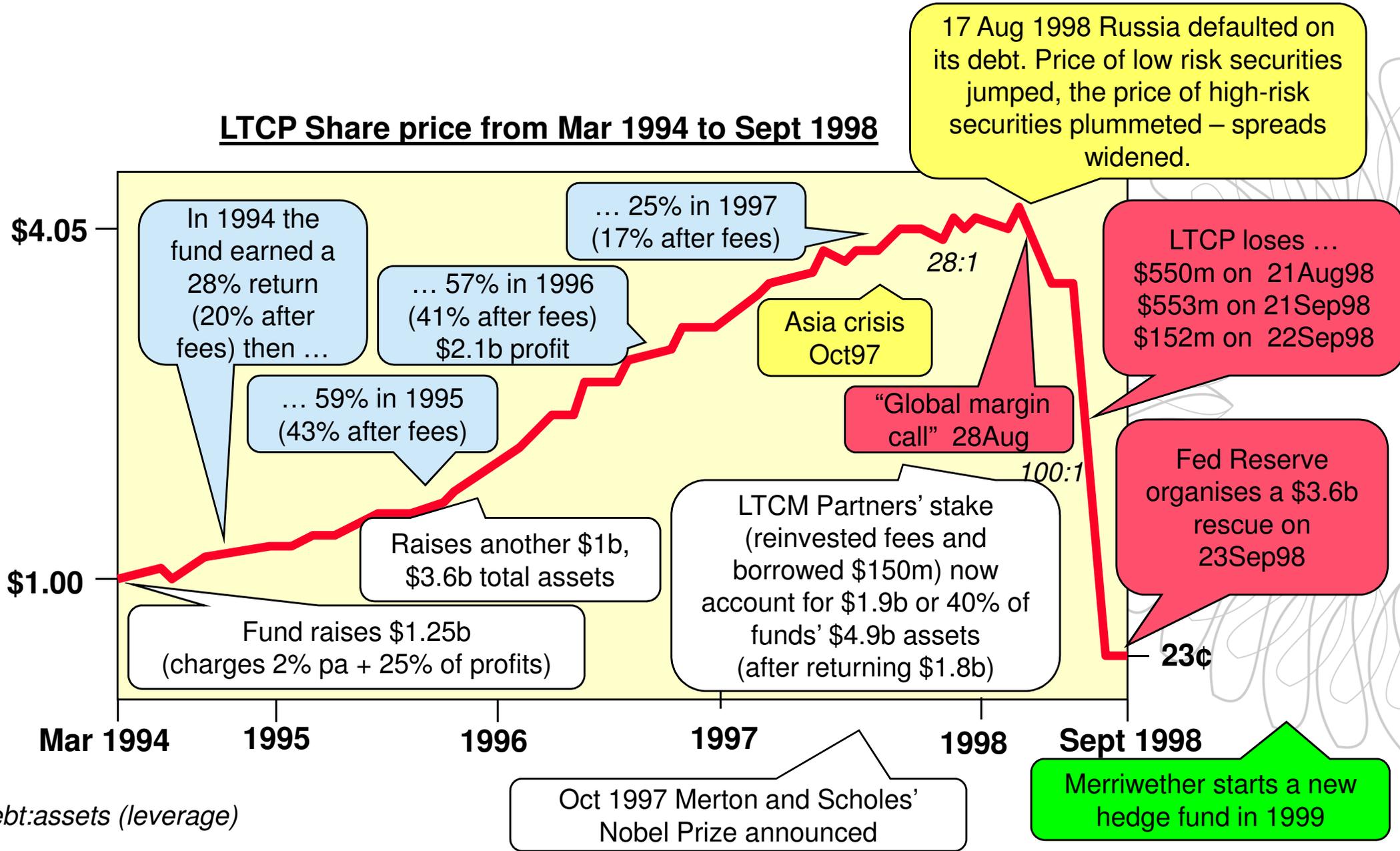
- Paine Webber, Prudential Life, Black & Decker, Continental Insurance, Univ of Pittsburgh, Paragon Advisers, St John’s Uni, Yeshiva Uni, Phil Knight (Nike CEO), McKinsey partners, Dresdner Bank, Republic NY Corp, Liechtenstein Trust, Bank Julius Baer, Brazil’s Banco Garantia, HK Land & Dev Auth., Singapore Investment Corp., Banks of Taiwan and Bangkok, Kuwaiti state pension fund, Italy’s central bank,

Merrill Lynch, Goldman Sachs, JP Morgan, Morgan Stanley, Lehman Brothers, Paine Webber and more lean to LTCM on unusually generous terms also acting as counterparties on trades and as brokers

The rise and fall of the LTCP

(P: portfolio, run by LTCM, M: Management)

LTCP Share price from Mar 1994 to Sept 1998



Debt:assets (leverage)

Oct 1997 Merton and Scholes' Nobel Prize announced

Merriwether starts a new hedge fund in 1999

How did LTCM invest?

LTCM preferred to invest in bonds which could be valued using sophisticated mathematical models

- **“Partners excelled at identifying mis-priced risks and hedging out other risks”**

They earned a tiny spread on thousands of trades, magnified by extraordinary leverage

- **“leveraging its tiny margins like a high-volume grocer, sucking up nickel after nickel and multiplying the process a thousand times”**

Spread being the difference in yield between a safe bond and a riskier version which they believed would shrink over time as markets become more efficient and mis-pricing eliminated

- **One of their first trades was buying and shorting \$1**b** each of 30 yr US T-bills issued six months apart priced with a spread of 0.12% (7.36 and 7.24% yields). LTCM’s net cost was a few bps (0.01%) a month to hold this position until profiting when the spreads narrowed**

Safety was enhanced by spreading their bets around the world (or so they thought)

Competitors learned to trade similarly and it became difficult to find opportunity for the growing fund. LTCM was then forced to broaden its approach to other strategies including:

- **Merger arbitrage (betting on companies merging and capturing the small discount between the share price and deal price)**
- **Directional trading (betting on predicting the future, eg. shorting Japanese bonds)**
- **Yield curve arbitrage (betting on changes in the price of bonds with different maturity)**
- **Emerging market and S&P500 stock investment (stock picking)**
- **Equity pairs (betting on mis-pricing of companies listed in different exchanges, eg. Shell listed in the UK and in Holland)**

Why did LTCP fail?

Russia's loan default caused bond spreads to increase across the world, creating massive trading losses for LTCP in all its markets – overall market was surprised central banks let a nuclear power default

Credit availability declined and LTCM couldn't sell out of its positions to meet their "margin call"

Failure was accelerated when other Wall St firms traded against LTCM after learning of its distress

- "LTCP was a bloated whale surrounded by hungry piranhas"

The extent of LTCMs losses were so large (eg. 7,000 derivative positions totalling \$1.4T, 60,000 bond trade positions) that Federal reserve intervention was required to maintain overall system stability

- "Ironically only a very intelligent gang could have put Wall St in such peril. Lesser men wouldn't have gotten the financing"

LTCM's equity in LTCP fell from \$1.9b to nil in five weeks. The managements original \$150m stake was also funded by borrowings such that 90+% of their personal wealth was destroyed

- Some outside investors had funds returned 6 months earlier in order to allocate fixed capacity to LTCM. They earned 18% pa over their four years (slightly less than the return on the S&P500)

LTCP failed because its strategy was flawed. Spreads reflect risk and not always mis-pricing. "Fat tail" or outlier events were not properly anticipated by "Gaussian" mathematical models

- "Astonishing profits looked less impressive in the light of the losses that followed. As with an insurer who collects heady premiums but gives them back when a big storm hits, LTCP's profits (and collected fees) were not "earned" but borrowed against the day when the cycle would turn. No investment – wunderkinds included – can be judged on the basis of a half cycle alone"
- "LTCM proved that eggs in many baskets can break simultaneously ... fooled itself into thinking it was diversified ... the fund made the same bet on lower-rated bonds in every permutation possible"

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- providing high quality advice
- being free of institutional ownership conflicts
- being remunerated only by our clients, refusing all commissions and rebates
- making education an important part of our offer

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We regularly review interesting writing on wealth topics that we think our clients will find useful

Our summaries are of the authors' views and we encourage you to read their work to learn more

These should not be considered personal advice as your needs and circumstances will vary

Please contact us or your personal advisor to explore further how you can *Make Work Optional™*

If you have received this from a friend and would like to receive future summaries directly, please send us your email address