when genius failed - the rise & fall of long term capital management

By Roger Lowenstein
Random House
264 pages

review rating
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This book was loaned to me by the CEO of a "Hedge Fund", which is odd, when one considers what happened here. I confess, after the first 20 pages it sat gathering dust, but Christmas has permitted completion.

Roger Lowenstein is clearly an excellent journalist with a high reputation in the US. However, this book reads as a journalistic work, and no matter how well researched, such work can never achieve the same depth as flows from the pen of great practitioners. The likes of Henry Kaufman and Burton Malkeil write with incredible hands-on professional experience and command. They are the masters of their universe, and this immediately comes through. Lowenstein has been highly acclaimed for this book, and with justification. But, it reads as a well researched project, often with emphasis on individuals and their background, which sometimes appears otiose and unduly journalistic. Do we really need to know that Kormansky (Merrill Lynch chairman) is "half Russian Orthodox Jewish, half Irish Catholic, and 100 percent The Bronx"?

That said, this book will give the reader an interesting insight into the hedge fund world – or at least one variety of such funds. It does hold a lesson for the investor, and it does illustrate how severe capital markets can be on those who consider that they have reduced markets to any form of precise science or mathematical analysis. This is a tale of mice and men, but on a gargantuan scale of both hubris and quantum of money.

The text essentially falls into three parts: from whence the leading characters came and who they are; how they marketed, grew and managed "Long Term" (the fund, whereas most speak of "LTCM" which is in fact the management company: Long Term Capital Management); and finally, why it collapsed and how implosion was managed in such a way as to minimise market impact – which could have been highly dangerous and disruptive.

The central player, John Meriwether (or "JM") was the head of the "Arbitrage Group" at Salomon's, and those who have read Kaufmann's book (reviewed this web site) and Liar's Poker (Michael Lewis) will soon understand the background, and how this bond market dealing/hedging team within Salomon's was replicated in the establishment of Long Term. From very early days, JM was the "priest of the calculated gamble", for he took a dispassionate and methodical approach to bond trading, based on analysis and his inherent belief in the pricing of bond market "spreads" (the margin over US treasuries for given issuers), and the pattern of reversion to the mean over time. Thus, Lowenstein, explains that JM's reputation for a $10 million single hand bet of poker with Gutfreund at Salomon's, was out of character and not emblematic of his true approach to bond trading.

Meriwether was well educated (MBA Harvard) and could see value in recruiting the brightest and best for his trading desk – to be arbitrageurs. Unlike other Wall Street houses of the time, JM made a direct pitch to academia, and recruited MIT trained Harvard Business School professors (Rosenfeld) and MIT PhDs (Haghani and Hilibrand) – and this group was to follow him into Long Term, which he established in 1993. There is a good explanation of the human/professional bonding within the Arbitrage Group that became incredibly successful within Salomon's. So much so that an "us-against them" clannishness developed, underpinned by total loyalty to JM and a belief within the group that they were invincible and masters of the bond market.

Prompted by a regulatory scandal, Meriwether resigned from Salomon's, and Warren Buffet took over as interim CEO. The Arbitrage Group was devastated by such departure, arguments over money then worsened, and the scene was set for the launch of Long Term/LTCM, which JM worked on in 1993 with the help of Merrill's. He then followed the same path in recruitment, but this time needed real cachet and went a leg higher by signing up Harvard's Robert C. Merton as a consultant – the leading scholar in finance and considered to have genius status. Then followed Myron Scholes of Black and Scholes fame – the revolutionary option pricing model. This was an incredibly formative period in finance and investment, and Long Term had captured the cream who themselves had links to such luminaries as Eugene F. Fama and Merton H. Miller. Scholes, it was said, was part to the "Random Walk Cosa Nostra", for he totally subscribed to the efficient market hypothesis, which holds that markets and market participants are rational, and that asset prices ultimately reverted to intrinsic value – again, part of the underlying philosophy which was to undo Long Term when the bond market did what it was not supposed to do!

This powerful, famous and brain heavy crew, raised $1.25 billion as capital in 1994 and opened for business. This is fairly amazing in itself, when one considers that the capital was circa AUD$2 billion in 1993, for what was essentially a cash box! It is here that the book becomes weak in explaining trading operations, not because Lowenstein does not understand what they were doing, but because it would probably have taken another 200 pages to do it justice. In essence, LTCM (the management company) used the fund capital to leverage into the bond market using sophisticated financial models for guidance, which it would generally use to go both short and long.

This was achieved using a variety of derivatives, and this arbitrage sought to exploit the “spread” in pricing. For mere mortals, entering this market would have required the commitment of capital through payment of margin or collateral – called a “haircut”. The imposition of a haircut naturally imposes a trading limit, and hence a limit on leverage, as capital is used up. JM simply refused to accept any haircut, and quite literally the sky was then the limit. Long Term soon started to build a portfolio that entailed exposure of 20 or 25 times its capital (using the spread), but more staggeringly, the actual principal asset exposure built to some $140 billion – a very sizeable chunk of the entire global bond market! There is an interesting exposition of how this implacable haircut refusal was imposed on global banks, which simply put businesses development ahead of prudence, as they could not “afford” to be out of the game. Not only that, many of such banks were LTCM investors, eg UBS.

Fund returns soon built to expectation, and investors were happy and clamoured to put in more capital. We gain some insight into how LTCM expanded globally, and how it exploited the bond market in less efficient markets, including Italy and Russia. Lowenstein then builds his case on the doubting side, by reference to the questioning of other academics of the obsequious adherence to financial models which made no allowance for market irrationality. We learn of the views then expressed by Famma, and – for those with some pre-understanding of bell curves – there is a broad explanation of the “outliner” problem – the location of freak occurrences, the like of which would ultimately undo LTCM. But, as the text well explains, JM and his new team were riding high (Merton and Scholes became Nobel laureates) and returns just rolled in; until two developments occurred: firstly, numerous impersonators or competitors entered the market and bond spreads contracted; and secondly, LTCM came up against market capacity constraints. Its growing capital base demanded more exposure to maintain leverage (and in fact, due to diminishing spreads, leverage had to be increased if profit/return was to be maintained!), and yet there was insufficient counterparty exposure available in the market.

There is a broad brush explanation of the firm’s reaction to these problems. It decided to return some capital to investors, which peaked at $7 billion – almost as much as Merrill Lynch at the time. This caused an outcry from investors, as the (by then) fabulously rich LTCM partners (eg, Hilibrand said to be $500 million at the peak), would hold their capital, and external investors were “forced” to take some money back. This, perversely, became a Godsend for investors in hindsight. Secondly, and incredibly, LTCM strayed into equities, by such trifling deals as a $2.3 billion outlay in Royal Dutch/Shell – 50% long on Shell and 50% short on Royal Dutch, with the expectation of contracting spreads – an exposure so large, like many of their other transactions in both bonds and now in equities, that it caused serious liquidity issues to surface. The next step was into “merger arbitrage” which is not fully explained, but broadly involves betting on consummation of takeover and merger offers, once announced in the market. The book is weak on detail/structure of these deals, and the reader is left in some incredulity that a group of expert bond (ie, fixed interest) traders, could ever imagine that they could apply the same mastery to the equity market, which does involve a whole swag of different and more troublesome considerations. This straying from the knitting was soon to cost them dearly. Finally, in 1998, in a further attempt to maintain profitability and returns, the fund began to short large amounts of “equity volatility”, the mechanics of which are not that well explained, particularly as it is observed that such trades would be indecipherable to “999 out of 1,000 Americans”.

However, you will learn the unfortunate truth that, again, this is a form of derivative trading, the strategy for which is founded upon the dubious prophesy that history will faithfully repeat/replicate itself.

With these troubling developments, we are then taken into the swirling events of 1998/9 that ultimately caused the undoing of LTCM: the Asian crisis, the Russian Bond default, and the turmoil in the equity and bond markets that followed, when fixed interest spreads blew out – not to unprecedented levels (ie, this had happened before), but well outside forecasts of the fabled LTCM models. Thus, the market moved against LTCM positions, and they were effectively doomed a soon as this tide turned, due to position size and illiquidity – buyers just dried up.

The best section of this book is the last 100 pages which takes us through the collapse and the industry “rescue” plan that was promoted and encouraged by the Federal Reserve – using the New York Reserve. Here is a picture of many leading investment bankers and the torrid negotiations, all of which rings true and is entertaining. It is miraculous that the rescue was achieved at all, given the money at stake and the complexities – and the rooms of lawyers grappling with them. Lowenstein takes us through all this with convincing thoroughness, and there are revealing insights into the involvement of George Soros and Warren Buffet, as only these powerful players could have saved LTCM without the banks. Ultimately, it was the banks that came to the party, if reluctantly so.

With losses mounting daily from ballooning spreads and failed merger arbitrage bets, the funds capital shrank, billion by billion. Due to these losses, to illiquidity and the impossibility of selling down, one estimate was of 100:1 leverage. From peak to trough after the bank bailout (ie, injection of $3.65 billion of equity), Long Term lost $5 billion, until Alan Greenspan cut US interest rates for the second time. In the final wash up, it was a tragedy for the partners, as the wizards of Wall Street personally lost $1.9 billion, and fourteen banks took control – prompted by the fear, that a LTCM meltdown might cause unprecedented market disruption, that could even undo them. They could not stomach the fear of peering into this shadow.

Entertaining and informative, but lessons for investors? No direct Australian insights or steps to follow, just the same old lesson that never seems to be fully understood (at least not, this time, by Nobel Prize winners in Economic Science and their PhD trading masters): that there will always be “outliner” events – those events which fall into the “fat tail” of the bell curve which illustrates probability/standard deviation. Or, as Taleb more colourfully puts it: black swan events do happen. More simply still, in investment and capital markets, there is no guarantee at all that history will repeat itself, especially when viewed over relatively short time bites of a decade or so.

MARTIN EARP
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