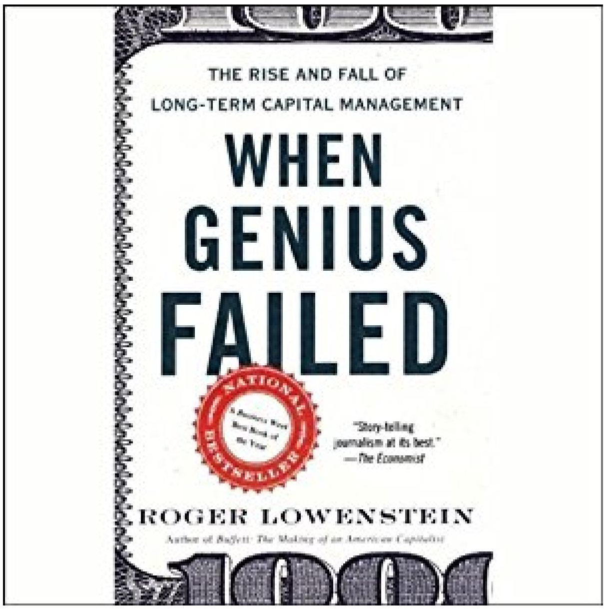
When Genius Failed: The Rise And Fall Of Long-Term Capital Management



Synopsis

Picking up where Liar’s Poker left off (literally, in the bond dealer’s desks of Salomon Brothers) the story of Long-Term Capital Management is of a group of elite investors who believed they could beat the market and, like alchemists, create limitless wealth for themselves and their partners. Founded by John Meriweather, a notoriously confident bond dealer, along with two Nobel prize winners and a floor of Wall Street’s brightest and best, Long-Term Captial Management was from the beginning hailed as a new gold standard in investing. It was to be the hedge fund to end all other hedge funds: a discreet private investment club limited to those rich enough to pony up millions. It became the banks’ own favourite fund and from its inception achieved a run of dizzyingly spectacular returns. New investors barged each other aside to get their investment money into LTCM’s hands. But as competitors began to mimic Meriweather’s fund, he altered strategy to maintain the fund’s performance, leveraging capital with credit on a scale not fully understood and never seen before. When the markets in Indonesia, South America and Russia crashed in 1998 LCTM’s investments crashed with them and mountainous debts accumulated. The fund was in melt-down, and threatening to bring down into its trillion-dollar black hole a host of financial instiutions from New York to Switzerland. It’s a tale of vivid characters, overwheening ambition, and perilous drama told, in Roger Lowenstein’s hands, with brilliant style and panache. --This text refers to an out of print or unavailable edition of this title.

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Customer Reviews

A somewhat didactic narrative history of the hedge fund Long Term Capital Management. Nicholas Dunbar covers the same subject in his book "Inventing Money." Both books present a blizzard of details about who did what and when. Too much detail. The general reader would better served by a medium sized article. Nevertheless if you’re a finance buff interested in the nitty-gritty then read both books. Dunbar has a physics background and his book is more technical, while Lowenstein comes from journalism and his narrative flows better.LCTM began operating in 1994, set up by John Meriwether formally head of the bond-arbitrage group at Solomon Brothers. He put together a star-studded cast that included three (1997) Nobel prize winners in economics. Their basic strategy was something called convergence arbitrage. In essence this strategy says buy two bonds that you think will track one another. Go long on the cheap one and short on the other; you make money if the spread narrows. In theory you are protected from changing prices as long as the two vary in the same way. To make the big bucks LCTM was after they took a gigantic number of highly leveraged arbitrage positions all over the world. To get high leverage you borrow for the position, like buying a stock on margin. LCTM got really high leverage by avoiding something called the "haircut," which is an extra margin of collateral banks usually demand, but forgave LCTM. Why would banks they do such a thing? Because they were blinded by the glitter of the cast, and in some cases the banks themselves were investors in LCTM. By 1997 convergence arbitrage opportunities in bonds began to dry up, everyone was doing it. So LCTM applied their strategy to stocks. Find two stocks that will track on another and go long and short with borrowed money. This is not easy. Stocks are less amenable to mathematical analysis than bonds, and after all these were the bond guys from Solomon, they were out of their depth. You might ask how can you borrow most of your stock position when the Federal Reserve requires 50% margin (Regulation T). Answer: don’t really buy the stocks, instead buy derivative contracts that simulate stocks, an end run around Regulation T. Even with all this leverage LCTM would claim that the fund was no more risky than the stock market, meaning a stock index. In 1998 the markets went against LCTM, with the "flight to quality" (US government bonds) as investors panicked. The fund suffered from what reliability engineers call "common mode error." Spreads got wider not narrower across the board, and LCTM’s capital base began to shrink as their positions lost money. At a certain point they would have to start liquidating positions, and the market impact of such large scale selling would cascade across their portfolio. The fund would "blow up."The above gives a flavor of the material Lowenstein provides, only in much greater detail. If that’s what you want, buy the book. Is this a tale of human folly or just plain bad luck? Answering that question is not easy, one needs to grasp a large amount of technical finance theory, and understand what happened in the particular case of LCTM. This book will help.

A couple of years ago I read Nick Dunbar's account of the LTCM collapse "Inventing Money", and a friend recently lent me this book. They make an interesting comparison.Dunbar - a physicist by trade - is more interested in the theoretical economics that went into the risk arbitrage fund in the first place and how this came unstuck. He gives a long description of the Black-Scholes model, what it says, and how it was used to pull off the risk "free" trades which made Long Term so much money for three or four years.Lowenstein, by contrast, barely mentions either the Black-Scholes model (he barely touches on option pricing at all, as a matter of fact) or the Italian convergence trades which eventually blew the gaffe on the fund, but instead tells the human story, exposes the inevitable egos, and indulges in more than a little smuggery (this book is long on wisdom after the fact) in dissecting the naivety of the LTCM hedging and trading strategy and the people who ran it.As long as he sticks to the egos and the posturing, When Genius Failed is a dandy read: the negotiations amongst the Wall Street top brass as the fund is going under rate with anything served up in Barbarians at the Gate, and as this is a large part of the book, it rips along quite nicely.But the schadenfreude grates: One of the lessons of the whole fiasco was that the smart money is with the guy who can predict the future: any old mug can be a genius with hindsight. Lowenstein spends a lot of his time wisely pointing out what the traders should have done.Additionally, Lowenstein employs some metaphors which indicate he might not have much of a grip on his subject: for one, he states "a bit of liquidity greases the wheels of markets; what Greenspan overlooked is that with too much liquidity, the market is apt to skid off the tracks." It's a poor metaphor, because it isn't excess liquidity which causes markets to skid, rather, it's the sudden disappearance of it. As this is the fundamental lesson of the Long Term story, it's a bad mistake to make for the sake of a smart-alec aphorism.Similarly, in the epilogue states, with regard to the putative diversification in the fund "the Long-Term episode proved that eggs in separate baskets *can* break simultaneously". Again, this conclusion is not supported by the text, which observes several times that in a market crash, liquidity drains and the correlation risk of instruments in the market goes to one: that is to say, it turns out all your eggs are in the same basket after all. Diversity wasn't the problem; the problem was you wrongly thought you had it.For these reasons I prefer Dunbar's more academic work: it may not be such a sizzling read, but nor does it misguidedly kick a fund when it's down.

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