

Long Term Capital Management  
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9 May 2009

The demise of the hedge fund Long Term Capital Management (LTCM) in 1997 is a story of folklore.<sup>1</sup> How could an investment team headed by world renowned Wall Street traders and the brightest minds in finance fail so terribly? This report will answer the key questions: What is a hedge fund? Who were the principals behind LTCM? What drove LTCM to bankruptcy? How was the catastrophe resolved? What did we learn from this fiasco? In light of the world's current financial crisis, the practice and pitfalls of players like LTCM in the financial market remains controversial.

Hedge funds receive a lot of attention in the financial news. People are enamored with the extraordinary wealth opportunities they represent. Indeed, hedge fund managers rank among the richest people in the world.<sup>2</sup> In 2008, the top hedge fund manager, Jim Simons, earned approximately 2 billion dollars.<sup>3</sup> Simons has a PhD in mathematics and literature from Berkley and was a successful mathematician before he turned to managing money. He founded the investment management company Renaissance Technologies in 1992. Today, he is ranked by Forbes as the 55th-richest person in America. In 2006, the Financial Times named him the "smartest" billionaire.

What is a hedge fund? A hedge fund is an investment fund open to a small number of investors that is permitted to undertake a wider range of investment and trading activities compared to other investment funds.<sup>4</sup> The general public typically invests in a "mutual fund," which is a highly regulated investment scheme that pools money from many investors. A hedge fund is different in that it involves a select number of people in a private investment partnership. Hedge funds are for the rich. You are required to have at least \$200,000 in annual income or \$1 million in net worth (house

excluded) and the minimum investment in most funds is \$250,000. Most importantly, since they are “private” investment vehicles, hedge funds enjoy few restrictions on what they do. Compared to a mutual fund, they are exempt from regulations governing short selling, derivative contracts, leverage, fee structures and the liquidity of interests in the fund. A hedge fund can take long and short positions, use structured products and invest in any market segment where it foresees an opportunity.

Hedge fund managers typically charge fees of “2 and 20,” – meaning a management fee of 2% of the fund's asset value each year plus a performance fee of 20% of the fund's gains. In contrast, many mutual funds advertise minimal total costs of less than 1% of the fund's asset value. The aim of a hedge fund is to offer a positive return with limited risks under all market conditions. Since hedge funds are more flexible in the way they invest, they claim they can match the return of the typical mutual fund or benchmark stock index (e.g., the S&P500) with much less risk or volatility. The industry may have managed around \$2.5 trillion at its peak in the summer of 2008, but has dropped off in the current financial crisis.

Sociologist, author, and financial journalist, Alfred W. Jones is credited with the creation of the first hedge fund in 1949.<sup>5</sup> Known, as the Father of hedge fund, he recognized that stock prices moved partly because of the overall market and partly because of the asset itself. Based on that he theorized that one would want to buy stocks that are expected to beat the market and sell short stocks that are expected to be weaker than the market. Jones balanced his portfolio by buying assets whose price he expected to be stronger than the market and selling short assets he expected to be weaker than the market, which in turn neutralized the effect of overall market movement. With this approach, the price movements due to the overall



market would be cancelled out, because if the overall market rose, the loss on shorted assets would be cancelled by the additional gain on assets bought and vice-versa.

Because the effect is to “hedge” that part of the risk due to overall market movements, this became known as a hedge fund. In addition the term equity market neutral was coined by Jones and defined as a market neutral by the balance between long and short positions.

Several different market-neutral strategies exist with the same aim to profit in both bull and bear markets. Fixed income arbitrage aims to exploit pricing inefficiencies between related fixed income securities and convertible arbitrage exploits pricing inefficiencies between convertible bonds and stocks. The strategy of a credit long/short is similar to that of long/short equity but in credit markets instead of equity markets. In addition, one can use statistical models to gauge in equity market neutral strategies, known as statistical arbitrage. Another popular approach is volatility arbitrage which exploits differences in implied and expected volatility.

Below is a ranking of hedge funds in the last year with the top funds controlling significant amounts of capital:<sup>6</sup>

<b>Rank</b>	<b>Firm</b>	<b>Total Capital (\$ millions)</b>
1	Bridgewater Associates	38,600
2	JPMorgan Asset Management	32,893
3	Paulson & Co.	29,000
4	D.E. Shaw & Co.	28,600
5	Brevan Howard Asset Management	26,840
6	Man Investments	24,400
7	Och-Ziff Capital Management Group	22,100
8	Soros Fund Management	21,000
9	Goldman Sachs Asset Management	20,585
10	Farallon Capital Management	20,000
10	Renaissance Technologies	20,000

The central player in LTCM was John Meriwether.<sup>7</sup> He did his undergraduate