Progress Report on the Role of Communication during the Lifetime of Long-Term Capital Management

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Introduction

Long-Term Capital Management (LTCM) was a hedge fund that was extremely successful in the early 1990s, but a series of unexpected events led to its abrupt downfall. While most commentary focuses on the technical aspects of LTCM, this report will examine the role of communication during the hedge fund’s lifetime. We will look at the ways in which LTCM’s internal and external communication with its clients and counterparties affected its success and failure. Specifically, we will analyze how LTCM’s communication practices changed over time in response to the changing financial environment.

During the rise of LTCM, not only was there limited communication between LTCM’s traders, but LTCM was also unwilling to disclose much information to its investors. However, during the downfall of LTCM, LTCM had to reveal its positions and trades to the public in an attempt to raise capital and to save the fund from failing. It should be noted that the purpose of this report is not solely to attribute LTCM’s downfall to flaws in its communication practices. Instead, this report aims to identify communicative events, such as lack of communication and excessive communication, which contributed to LTCM’s downfall.

In studying LTCM and its communication practices, we read and analyzed a variety of documents that offer differing perspectives on both the technical and social aspects of LTCM. We categorized the documents we read as either a primary document or secondary document, and provided a brief synopsis of each document. Based on the documents, we performed a preliminary analysis on LTCM’s internal and external communication both prior to and during its downfall. We ensured that we are on track with the assignment by making a timeline of the deliverables and setting up interim due dates.

Background of LTCM

To analyze the communication practices at LTCM, it is important to have a well-informed understanding of the founding, the rise, and the downfall of LTCM.

The Founding of LTCM

To better understand the communication practices at LTCM, it is helpful to know about the background of LTCM’s initial group of partners and its founding principles. Lead by John Meriwether and a highly skilled arbitrage group from Salomon Brothers, LTCM was founded on many of the mathematical models and trading strategies that made Salomon profitable. LTCM’s primary strategies were convergence and...
relative-value arbitrage, which exploited price differences in the market. Since the financial community implemented similar strategies and used the same mathematical models, Meriwether felt investment banks were rife with leaks and could not be trusted. Thus, when placing orders for each leg of a trade, LTCM would use a different broker (Lowenstein 2000, 48). LTCM disclosed minimal information to banks, making it difficult for banks to form close, ongoing working alliances with LTCM. Instead, LTCM’s initial group of partners had an exclusive and intimate alliance among themselves.

While LTCM had experienced traders, its management had serious flaws. Instead of having independent risk managers that granted approval to traders to initiate trades, LTCM’s partners monitored themselves. The partners were dogmatic in getting the trades they wanted, often leading to relentless arguments until one party deferred (58). When such conflicts arose, Meriwether adopted a tolerant regime, failing to intervene and impose accountability, leaving each partner to be his own regulator.

**The Rise of LTCM**

When LTCM began trading in 1994, it sought high rates of return by investing and trading in a variety of financial instruments. Within a few years, LTCM held a prominent position among hedge funds, as it brought in above-normal returns, primarily on interest rate spreads, for its investors. LTCM’s advantage did not come from the mathematical models it used, but from the experience its traders had in reading the models (59). LTCM also had better financing than its counterparts, securing all its repo financing and derivative facilities on generous terms, as banks had no difficulty rationalizing their terms. Many of the banks’ heads liked Meriwether personally and LTCM had connections to powerful traders globally (47). Since LTCM was set up as a hedge fund and limited its investors to a small group of high-net worth individuals, LTCM was strategically structured to avoid the financial regulations imposed on more traditional investment vehicles (Greenspan 1998, 1046). Because of the lack of regulation, LTCM often did not provide its investors details about how their money was invested, except for broad generalities (Lowenstein 2000, 57). As such, risks were rarely disclosed, and with LTCM’s record of success to date, its traders was confident in hedging and leveraging further.

**The Downfall of LTCM**

As LTCM’s capital base grew, it began to undertake more aggressive trading strategies, employing more leverage and increasing its risk exposure. However, during this time, the Russian government defaulted on its bonds, causing risk aversion to rapidly increase, which led to a flight-to-quality with investors suddenly preferring safer and more liquid assets. As investors moved towards safer assets, such as Treasury bonds, the profits that LTCM expected to see as the value of the bonds converged turned into major losses as the value of the bonds diverged (Lowenstein 2000, 145). The value of LTCM’s portfolio rapidly declined as spreads continually widened.

With LTCM’s financial health deteriorating, banks that once “shoveled” money at LTCM began tightening their credit lines and issued margin calls (152). Because LTCM did not have capital available to meet these obligations, LTCM was under pressure to sell off its portfolio and realize its losses. As it sought capital, LTCM was forced to disclose information about its portfolio to investors and the financial world.
With information about LTCM no longer secret, LTCM’s competitors, who held similar investments, began to sell those investments off, “not to attack LTCM, but to save themselves” (164). Due to the rapid sell off of investments by LTCM’s competitors and the continuous adverse price movements in the market, LTCM’s situation increasingly worsened. Eventually, to prevent the chance of severe and prolonged disruptions to the financial markets, the Federal Reserve Bank of New York intervened and arranged for a $3.6 billion capital infusion into LTCM.

**Preliminary Analysis of LTCM’s Communication**

Based on our research and preliminary analysis, we have divided Long Term Capital Management’s communication into internal communication and external communication. The three components we chose to analyze are LTCM’s internal culture and communication, LTCM’s external communication prior to its downfall, and LTCM’s external communication during its downfall.

**Internal Culture and Communication**

LTCM had a laid-back culture and gave traders autonomy over their trades as long as they were profitable. Its primary founder, John Meriwether, was described as “a quiet, introverted man with a head for numbers and a love of chance” (Morgenson 1998, 1). Meriwether’s hands-off management style resulted in a lack of communication within the organization on the details and riskiness of each trade. LTCM’s partners roamed free and recklessly traded their ideas without concern for the overall balance of their positions. For example, Victor Haghani, one of the senior traders, had overwhelming control over trading activities, which led him to take unnecessarily risky positions. “Haghani felt he could never lose; he pushed and pushed his partners until he got away” (Lowenstein 2000, 128). Another example is Larry Hillibrand, who, as a partner with one of the highest stakes in LTCM, aggressively pursued risky strategies and many times ignoring his colleague’s advice and suggestions (127). For example, Hillibrand ignored the model presented to him by his equity research analyst, Alain Sunier, which led Hillibrand to push the size of his position to a hefty $2 billion, a disproportionate size relative to the rest of the fund’s positions.

Members of LTCM were successful traders _individually_, but not as a group. What the traders failed to realize is that the style of trading they were used to as individual traders was not suited for fund management, where the emphasis is on position balance and cooperation among traders. An investment fund needs to balance its various positions so that the strategies work together and reduce the overall risk exposure the firm faces. A typical fund has a management committee that assesses the trades that traders propose not only on their profitability, but also on how the trades would affect the fund’s overall portfolio. In LTCM’s case, the management committee was essentially dysfunctional, as weekly meetings were “scripted” and any opposition to the trades was dissolved by threats from the traders to quit (Lowenstein 2000, 128).

With individual traders running free with their own ideas and a lack of strong central management, LTCM was internally disorganized and a disaster waiting to happen.
External Communication

Long Term Capital Management’s external communication underwent a significant change from its inception to its downfall. Prior to its downfall, LTCM was extremely protective of its strategies and rarely disclosed any of its activities to investors, banks, or the general public. During its downfall, as LTCM struggled to remain solvent, it was forced to disclose more and more information about its activities to its lenders. As the firm continued to struggle, competitors used the newly gained information about LTCM’s activities to their advantage and further exacerbated LTCM’s losses.

External Communication Prior to LTCM’s Downfall

In finance, many successful trades come from simple ideas, and these ideas are often kept in secrecy. Revealing these ideas would not only attract other competing traders to replicate the same strategy, but would also make a trader’s positions prone to attack by others. When the founders of Long Term Capital Management made presentations in cities all around the world to attract potential investors, the founders were unwilling to divulge much information with regards to their strategy (Lowenstein 2000, 33).

To investors, LTCM operated like a black box. Despite the lack of information that LTCM disclosed and its uncommon investment terms, LTCM’s annual returns were so alluring that the fund attracted many hungry investors (Lowenstein 2000, 36). LTCM charged higher fees than average funds and required investors to commit their investment for at least 3 years. The conditions LTCM imposed on its investors were unusual and further contributed to the shroud of secrecy around LTCM’s operations. LTCM also rarely disclosed its activities or risks to investors, which prevented investors from even knowing about potential problems that may have existed within the firm.

External Communication During LTCM’s Downfall

In the summer of 1998, the Russian Government defaulted on its government bonds, causing the price spread between the US treasury bonds and the European bonds to unexpectedly widen. LTCM, which had bet on the spread converging, was suddenly faced with margin calls from many of its banks and lenders. As LTCM struggled to negotiate with the banks due to its increasing liquidity problems, the banks demanded more information on LTCM’s trades. Gradually, LTCM’s positions were revealed. As the problem worsened, banks demanded more and more collateral, which forced LTCM to sell off many of its positions. Competing traders at other firms, used the information gathered about LTCM’s positions to their advantage and traded against LTCM, further exacerbating LTCM’s losses (Lowenstein 2000, 164).

Description of Methods and Tasks

Due to the vast volume of documents regarding LTCM, we classified our readings into primary documents and secondary documents. We drew key ideas for our preliminary analysis through the primary documents and supported these ideas with evidence from the secondary documents. In this section, we break down the main ideas in each document and present our efforts on assigning and completing tasks, our communication with one another, and our timeline for submitting our work.
Primary Documents

As of October 22, 2010, each team member completed the four required readings: Mackenzie (2003), Perold (1999a), the President’s Working Group on Financial Markets (1999), and Lowenstein (2000). Mackenzie (2003) forms the basis of our analysis of communication in the financial market, Perold (1999a) provides a short analysis of the events leading to LTCM’s downfall, the President’s Working Group (1999, 10-22, 29-31) provides insight from a government standpoint into communication within the financial market, and chapters 1, 2, 7, 8, and 9 from Lowenstein (2000) serve a supporting role to illuminate the details surrounding LTCM culture and communication. Below follows a list of the primary documents we read and a brief description of each document’s relation to our analysis.


Mackenzie’s article delineates that the downfall of LTCM was not attributed entirely on the firm’s high leverage and risky investments, but was ultimately the result of an intrinsically social process. Imitation amongst financial institutions caused a buildup of risk-taking amongst financial firms, resulting in a catastrophic downfall of the financial market. Mackenzie further establishes the idea of a superportfolio by presenting examples to support the claim, such as financial turmoil following 9/11 that did not result in widespread failure of the financial market.


Perold gives a concise account of the events that lead to LTCM’s downfall and the choices LTCM made to rescue the fund. It elaborates on the management’s meeting on Sunday, August 23, 1998, where they evaluated the situation based on their knowledge of the fund. Perold’s article enables us to make a sound evaluation of LTCM’s internal communication system.


This document contains the letter to investors from Meriwether on September 2, 1998 regarding the impact on LTCM’s net asset value of the market condition in August 1998. It outlines the performance of LTCM from its management’s perspective, which allows us to juxtapose with the perspectives of the investors and the Federal Reserve in the other documents.


We used primarily chapters 1, 2, 7, 8, and 9 of Lowenstein’s book for additional details that were not provided in the other documents. Lowenstein gives a detailed account of both internal and external communications that can be observed during the rise and the fall of LTCM. He elaborates on how LTCM interact with different counterparties, investors, and the Federal Reserve, and LTCM’s attempt to control information within the fund’s partnership.

This report gives essential information about LTCM’s portfolio and vulnerability, and explores the relationships between LTCM and its counterparties. It provides an in-depth look at communication between financial institutions, and contends that LTCM’s downfall was not only a result of the risk and degree of leverage it undertook, but also a result of the lack of scrutiny exercised by its counterparties and investors.

**Secondary Documents**

Aside from the four core documents, there are a number of supporting documents which serve to further illuminate the impact of communication as a component of LTCM’s downfall. Anthony and Jessica read Gladwell (2002), Jessica and Sophia read Greenspan (1998), Sophia and Joseph read Haubrich (2007), and Joseph and Anthony read Isa (2007). The duality included in assigning readings helps to ensure that there are always two sets of eyes going over each reading to make sure we engage all key points in each analysis. Mackenzie (2006) presents many of the same arguments as his 2003 work, and was read in parts by each of the 4 members. Below follows a list of the secondary documents we read and a brief description of each document’s relation to our analysis.


Gladwell tells the story of Nassim Taleb, a trader who makes his trades on the basis that events such as the ones causing LTCM’s downfall will happen. Taleb will lose money 99 times out of 100 but in that 1 out of 100 times, he makes a lot of money. The article serves as a counterpoint to traders operating in the “socially accepted” way in finance, where large catastrophic events are often overlooked.


This document examines the relationship between hedge fund performance and managerial social capital based on data collected from top 25 hedge funds. The result of the research shows that the social networking and career of the managers does impact the fund’s performance, which supports the claim of MacKenzie (2003) that the industry is inherently social.


In Greenspan’s statement to Congress, he describes the downfall of LTCM and its impacts on the economy from the Federal Reserve Bank’s perspective. He provides an in-depth discussion of Federal Reserve Bank’s decision to refinance LTCM.

This policy discussion paper discusses whether it is necessary to recapitalize LTCM and the alternative offer from Warren Buffet. It provides the point of view of the policy makers on the role of the Federal Reserve after the downfall of LTCM.


Mackenzie’s 2006 book gives much of the same information as his 2003 article, but does provide key insight into Meriwether’s understanding of relationships as an inherently important component of finance.

Project Management

We separated the progress report into four sections: introduction, background, preliminary analysis, and description of methods and tasks. Jessica wrote the introduction, which serves as a concept map for the entire report and the background, which provides a context of LTCM’s communication practices. Anthony then dove into a preliminary analysis of LTCM, analyzing the organization’s communicative practices. Sophia and Joseph were responsible for writing the section on description of methods and tasks, which includes a study of relationships between the documents to support the team’s analysis, tasks the team completed for the progress report, and an analysis of team communication, especially in using Wiggio to aid our communication efforts.

Our team has been using Wiggio from the beginning of the semester, but it was not until we started our case-study assignment that we truly began to use Wiggio extensively in communicating with one another. We used Wiggio as a repository for all the documents we read, and uploaded our progress report onto the site to share. We could download the progress report, make changes, and then re-upload the report as a method of revising and reviewing the report. We then picked a date to get together and, as a group, went through the changes and finalized the report. Wiggio has greatly helped our team in communicating with one another, and as such, enabled us to more efficiently analyze LTCM and create our progress report.

The Gantt chart, in figure 1 below, was created after we used Wiggio to consolidate our schedules and to communicate a deadline that works best for all members. We broke down each deliverable into several tasks and allocated time for each task. The Gantt chart was used to help us keep track of our progress and to ensure that all tasks were completed in a timely manner. We will continue to use the Gantt chart to ensure completion of subsequent deliverables.
### Progress Report

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#### Figure 1. Gantt chart of tasks and their respective deadlines.

### References


