Lowenstein, Roger - When Genius Failed

Forth Estate, 2001, [Finance] Grade ★★★★★

This book is an overview of the rise and fall of a hedge fund called Long Term Capital Management (LTCM), 1994-1998. It gives the reader timeless knowledge of how the financial industry works from time to time. The author, Roger Lowenstein, has written several books, many critical of the financial industry and this is a master piece. In the 90's, LTCM pushed the financial markets to the brink, which required FED to step in and force a dozen banks to do a $4bn bailout. This is a book, to reread every year especially when things are good. Unfortunately the timeless conclusions of this book, was soon largely forgotten after it was written.

The book is very insightful from a lot of perspectives. It is part financial history of the dramatic macro event that unfolded during these years, but it's the detailed account of LTCM that makes it shine. With success often comes more risk, not just with individual funds, but also with investors as well as banks, were the latters' hunt for fees indirectly means higher leverage admitted. Everything is highly pro-cyclical. The book reads as easy as a thriller, and it's sometimes as scary as a serial killer on the loose in your favourite TV-show.

This is the story; Imagine that a few of the most respected people in the financial industry raised money for a new fund. Then assume that the fund is extremely successful, and then almost in a straight line, 1 dollar invested goes to 4 dollars in 4 years. How would you react? Most reacted with admiration, critical voices didn't exist. The fund, LTCM saw huge inflows, but soon decided to return money in order not to dilute them. The partners of the fund also decided to increase its own investment in the fund, through leverage. The world, as well as themselves, agreed they had found the financial holy grail. However, in the early 1998, they had already maxed out how they started to make money, and decided to pursue other ideas.

In the early days of the fund they did more of mathematical arbitrage with a lot of leverage, but as they grew larger, and the initial spreads didn't exist anymore they ventured far off the origins, into everything from pure directional bets to merger arbitrage. LTCM became so successful and big that it played out all brokers against each other and was successful in not having to post any collateral against its trades, basically having no real limits. The fact that the leverage, excluding a massive amount of derivatives, was 25x, didn't raise any concerns at this stage. But, in a few weeks in Sept 98, the fund lost 80%+. The remaining assets in the fund went down to $ 400 mln, and leverage went up to 250x. Add OTC products which brought gross exposures up to > $ 1 trn. At this point FED became worried about the entire financial system, forcing most banks to take over the fund, which helped the funds owner, but not its investors who were wiped out.

Among the conclusions of the book are how the belief in mathematical models lead into a theoretical world, where the very events that actually unfolded were so unlikely that it was no idea even considering them. In the epilogue, Mr Lowenstein draws some conclusions: don't be highly leveraged, don't believe in efficient markets (LTCM believed prices would go directly to where the models said) and don't believe in diversification - when volatility increases, correlation increases. To use the language of the recent financial crisis, risk on – risk off…

A final note: The founder of LTCM, John Meriwether, didn't give up. JWM Partners, had by Dec 1999, $250 million for a fund that would continue to carry out LTCM's strategies. The fund reached 3 bn of AUM in 2007, but then they lost 44% from September 2007 to February 2009 and the fund was shut down in July 2009.

Bo Börtemark, May 7, 2012