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Long-Term Capital s short-term memory

By Bruce I. Jacobs

In the annals of Wall Street fiascoes, the near demise and federally strong-armed rescue of the bond arbitrage hedge fund Long-Term Capital Management LP may be likened, in its hubristic overreaching, to the rise and fall of the junk-bonded Masters of the Universe in the 1980s or, in its incestuous tangle of financial relationships, to the Resolution Trust savings-and-loan bailouts of the same decade. The crisis also brings to mind some vivid, often ironic similarities to portfolio insurance, which so devastated the equity markets in 1987.

Not least of the connections is, of course, the presence of Myron Scholes and Robert Merton. In the foreground as partners of LTC, these two Nobel laureates played dominant background roles in portfolio insurance as the creators, with the late Fischer Black, of the option pricing models that underlie the strategy. But the more salient connection, and the greater lesson, is to be found in the way both the portfolio insurance and Long-Term Capital debacles played out, allowing a small number of operators to become significant threats to the stability of global markets.

Portfolio insurance vendors, with a marketing blitz based on the seeming ability of sophisticated finance theory to remove risk from equity investing, were able to attract enough capital from institutional investors to amass a U.S. equity market stake amounting to about 3% of the market s capitalization.

LTC also relied on complex financial mathematics, not to mention the imprimatur of the Nobel awards committee. It also was able to draw on the extraordinary marginability of modern derivatives contracts to leverage the capital of an extremely small number of participants (a few billion dollars) into a worldwide portfolio with reported notional exposure of some $1.25 trillion. (The magnitude of this amount came as a shock to market observers, and even to LTC limited partners, just as the amount of equity assets covered by portfolio insurance shocked most investors in October 1987.)

While sizable, such positions are not necessarily destabilizing. But they do have the potential to create their own liquidity vacuum. This is especially true when the investments are driven by a model that requires like responses to like stimuli. In 1987, all portfolio insurance strategies called for selling as the market fell. With such trend-following trading, portfolio insurance was in and of itself destabilizing.

With arbitrage models such as LTC's, buying and selling also comes as a mechanistic response to given changes in spreads. Unlike portfolio insurance, however, arbitrage should be a stabilizing influence, narrowing perceived mispricings between markets. But as long as the mispricings grow, counter to arbitrageurs' bets, new infusions of capital are needed to meet margin calls. In their absence, the strategies must be unwound. When the strategies themselves constitute a large enough fraction of the market (and are mirrored by others, especially hedge funds, following similar strategies), their instantaneous unwinding can devour market liquidity.

LTC's problems may well have been exacerbated by the tendency, in times of crisis, for correlations between global markets to spike upward, reflecting not only real economic linkages between markets, but psychological ones as well. Fear begets more fear. We saw this in 1987 and again in 1997. Such episodes can spell disaster for strategies reliant on seemingly stable long-term historical relationships and for strategies that depend for risk reduction on diversification across international markets.

When markets failed to conform to LTC's models, margin calls effectively stopped out the strategies (or would have, had the Fed not intervened). The market's abrupt decline in 1987 stopped out portfolio insurance strategies just when they were needed most. Ironically, LTCs strategies may have become unviable, in practice at least, just at their moment of greatest promise. If (and this remains a big if) markets do eventually revert to longer-term norms, wider spreads now could signal bigger profits tomorrow.

Had LTC not been bailed out, it is likely we would have seen forced selling similar to that caused by portfolio insurance in 1987 and by margin calls in 1929. Given the links forged by derivatives between hedge funds and investment and commercial banks, and between different asset markets and different countries markets, this selling indeed might have roiled the global financial system. The systemic risk much talked about in connection with the growth of the derivatives markets might have become a reality.

The bailout itself, however, creates its own set of problems. Not the least of these is the potential for further government intrusion into financial markets. This would provide a truly ironic conclusion to the story, given the Chicago School free-market dogma of LTC's academic partners.

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