Financial Market Losses

Long-Term Capital Management (LTCM)

Facts

Loss	Involved	Year
4.6 bn €	LTCM	1998

Instruments/positions involved

Fixed income instruments including US, Japanese, European, Latin American, Russian bonds; swaps, equity options, merger arbitrage, S&P 500 options

Story

- The US hedge fund Long-Term Capital Management (LTCM) was founded in 1994.
- Its partners included former traders from Salomon Brothers, leading scholars in finance, and former vice-chairman of the Federal Reserve. It raised around $1.2 billion starting capital.
- LTCM employed convergence trades for fixed income instruments to increase the return on its highly leveraged capital.
- Risk management concentrated on VaR modeling. However, LTCM only used limited historical data not including former periods of stressed marked conditions.
- In 1998, LTCM had $4.8 billion as capital, while off-balance-sheet positions with notional principal amounts were around $1.2 trillion.
- In May 1998, LTCM recorded a 6% loss, in June it was 10%, and in July 18%.
- When Russia defaulted on its debt in August 1998, LTCM lost $2 billion within one month.
- By the end of September 1998, LTCM's capital decreased to $400 million.
- The Federal Reserve arranged a 'bailout' of the hedge fund, and a 14-bank consortium put $3.6 billion in the fund in exchange for 90% of the ownership.
- By early 2000, the hedge fund was properly liquidated.

Timeline

1994
- LTCM founded
- LTCM gains around 20% return

1995
- LTCM gains around 42.8% return

1996
- LTCM gains around 40.8% return

1997
- Asian crisis
- Russia has fiscal deficit of 9% of its GDP
- LTCM returns its investors $2.7 bn
- LTCM gains around 17% return

1998
- Russia devalues ruble and declares debt moratorium
- LTCM is down 84%
- LTCM ownership changes

Facts

- Transparency of actual position
- Transparency of risk
- Transparency of P&L
- Criminal action involved
- Risk management issue
- Compliance issue

Takeaways

- Regulations should cover financial institutions, regardless of the number of their investors and their net worth.
- Rigorous risk analysis should include periods of stress as well as risks not covered in models.

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