Thoughts about LTCM (Long Term Capital Management)
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- During distressed times, however diversified a fund may be, all their trades become positively correlated. This is what happened with LTCM. They thought that they were pretty well diversified but one crisis triggered the other and all their trades became positively correlated.

- Sometimes to generate alpha, hedge funds try to put up exotic trades where they don't have any expertise. They should understand that with their position sizes, they can move markets. So if they don't know much about the relevant markets, they should remain away from it. I get a feeling that to make money, LTCM somehow ventured into the unknown territory which was a last nail in the coffin. They were trying to profit from large positions in risk - arb when they had no business or expertise to do so.

- LTCM was a very special case. Because of their large clout (Nobel prize winners and math geniuses), they were able to shell money from a lot of Investment Banks. They were never worried about their haircuts, which specially gave them the luxury of affording huge leverage positions and also to keep their losing positions for the time they wanted.

- Related to the above point, if there are substantial margin requirements and haircuts, traders tend to remain disciplined. At some point of time, they know that they have to cut losses because they don't have the luxury to replenish their margin for ever. (on the other hand if there are no margin requirements, everybody is lax)

- Very smooth returns should cause suspicion in the investor's mind. This specially happens if the fund trades in a lot of illiquid securities and the marks are not well defined in those securities. These returns also tend to have a high degree of auto - correlation. Although, returns for a well managed (in terms of risk) fund can be auto correlated, but this definitely demands some inspection.

- Mathematical models are always true (I firmly believe in this), but markets are not. The markets are made up of mortals and some of them have to be wrong. Therefore, even though the market may ultimately go in the right direction and the funds may profit from their models, but before that they will have to survive the noise created by these wrong mortals. Markets can remain illogical for more time than one can remain solvent. So on the contrary, this statement does seem more sensible, “Markets all always correct and it is the individual participants that are wrong, for there won’t be markets if there are no losers”.
