Note on Capital Budgeting

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Long-Term Capital *Mis*management

**HOW THE PERFECT FORMULA TO ELIMINATE RISK MADE PHENOMENAL PROFITS . . .
AND LOSSES . . .**

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What was LTCM?

Founded in February, 1994 by John Meriwether and 11 other principals

Over three years, $ 1Billion in capital that LTCM began with had grown to $7.1 Billion

By 1998, LTCM was bankrupt and at one point managed to loose $4.5 Billion in less than two months

Unique Characteristics of LTCM's Rise and Fall

No laws were broken and no-one went to prison
No-one was fined or censured
No LTCM employee was indicted for fraud
No internal or regulatory authority audit report ever highlighted any risk, or operational concerns

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LTCM's Strategies

- "Not trying to find a needle in the haystack; Rather, it was trying to find a haystack of needles"
- Identify Imperfections in the market
- Exploit spreads of asset prices and Yields
- Create a market-neutral portfolio
- Minimal use of Equity Capital Risk taker

Major Trades

Convergence Trades

Securities were incorrectly priced relative to one another LTCM would take long positions on the under priced security and short positions on the overpriced security

The four main types of trades:

- Convergence among U.S., Japan, and European Sovereign bonds;
- Convergence among European sovereign bonds;
- Convergence between on-the-run and off-the-run U.S. government bonds;
- Long positions in emerging markets sovereigns, hedged back to dollars

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