Long Term Capital Management

Short Term Memories

by Dale R. Kluga

Kluga is president of GALCO, Great American Leasing Company, LLC, located in Chicago, Illinois.

History Repeats Itself

Mysteriously absent from the group of esteemed presenters was the renowned head of our investment banking group. My fellow graduating class of panicked trainees were more than disappointed by his lack of appearance.

Rumors were rampant. The Fed was quickly syndicating a bailout plan in order to avoid additional failures in the financial system. The media went nuts broadcasting damaging messages, including our impending bankruptcy. The heir apparent was rumored to have suffered a nervous breakdown or heart attack.

The head of our bond & treasury group was forced to the clerks funding desk and was frantically negotiating our survival with bankers having an unprecedented financial relationship with our "bright" institution. We were smack in the middle of a crisis with historic proportion.

My timing was impeccable. A young banker, I had recently married and was planning to start a family. I just traded in my reliable, but unchallenging accounting position for a career in banking with an industry leader who was about to collapse. The year is 1984. The failing institution is Continental Illinois National Bank. The similarity to the Long Term Capital Management crisis is eerie. History had just repeated itself albeit in the new era of hedge funds, sophisticated interest rate swaps and computer modeling.

Both management teams garnered tremendous respect on Wall Street. Well educated executives ran Long Term Capital. Visionary bankers at Continental had created a successful decentralized approach to banking. *Institutional Investor* declared the bank as the best managed company in the United States.

Both institutions gambled with sophisticated computer models, which manipulated historical data. The data was accurate but the assumptions were faulty.

Continental's failure was primarily due to the naive belief that our $13 billion in overnight funding would continue without interruption. We rationalized our position by proclaiming that this volatile funding source was in substance, "long term capital," although in form it was obviously short term in nature. All it took was an international oil crisis and a few irresponsible, cowboy bankers and we were history.

Fast forward to the Long Term Capital Partners debacle. Again caused by false assumptions of a similar nature. Instead of short term funding, it was short-term speculation on interest spreads. The villain in both cases was an international economic crisis combined with faulty and aggressive assumptions. Both failures were backed up by the most sophisticated analysis and computer modeling available to mankind. Technology so sophisticated that it can intimidate even the most assertive board member attempting to question the underlying assumptions.

Both failures utilized state of the art computer modeling as a crutch to justify aggressive and irrational assumptions. A back to basics approach to contingency analysis is warranted. Also, we need to keep sight of historical events when exercising good, old-fashioned judgmental analysis. Models should be used as simple tools and not as intimidating methods of justifying empirical theories.

Computer models continue to serve as an excuse to justify aggressive assumptions. Take consumer credit. Before issuing millions of credit cards to the general public, had card issuers plugged 1.4 million consumer bankruptcies into their models? Highly unlikely.

Long Term Capital Management will probably suffer the overregulated fate similar to Continental. However, one thing seems certain; history always repeats itself. Too bad our memories and computer models aren't as reliable as good old-fashioned history.◆

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