Hedge Funds and the Collapse of Long-Term Capital Management

Franklin R. Edward

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Abstract

The Fed-engineered rescue of Long-Term Capital Management (LTCM) in September 1998 set off alarms throughout financial markets about the activities of hedge funds and the stability of financial markets in general. With only $4.8 billion in equity, LTCM managed to leverage itself to the hilt by borrowing more than $125 billion from banks and securities firms and entering into derivatives contracts totaling more than $1 trillion (notional). When LTCM's speculations went sour in the summer of 1998, the impending liquidation of LTCM's portfolio threatened to destabilize financial markets throughout the world. Public policy response to LTCM should focus on risks of systemic fragility and ways in which bank regulation can be improved.

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