



Economy and Society >

Volume 32, 2003 - Issue 3

2,279 | 178 | 10
Views | CrossRef citations to date | Altmetric

Original Articles

Long-Term Capital Management and the sociology of arbitrage

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Pages 349-380 | Published online: 02 Dec 2010

Cite this article <https://doi.org/10.1080/03085140303130>



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Abstract

Arbitrage is a key process in the practice of financial markets and in their theoretical depiction: it allows markets to be posited as efficient without all investors being assumed to be rational. This article explores the sociology of arbitrage by means of an examination of the arbitrageurs, Long-Term Capital Management (LTCM). LTCM's 1998 crisis is analysed using both qualitative, interview-based data and quantitative examination of price movements. It is suggested that the roots of the crisis lay in an unstable pattern of imitation that had developed in the markets within which LTCM operated. As the resulting 'superportfolio' began to unravel, arbitrageurs other than LTCM fled the market, even as arbitrage opportunities became more attractive, causing huge price movements against LTCM. Three features of the sociology of arbitrage are discussed: its conduct by people often personally known to each other; the possibility and consequences of imitation; and the limits on the capacity of arbitrage to close price

discrepancies. It is suggested that by 1998 imitative arbitrage formed a 'global microstructure' in the sense of Knorr Cetina and Bruegger.

Keywords:

Arbitrage

Economic Sociology

Imitation

Long-Term Capital Management (LTCM)

Globalization

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