Capital Mismanagement

Nobel prizes and billions of dollars don't always equal success

By James K. Galbraith

One day in the early fall of 1975 I sat in the office of Rep. Henry S. Reuss (D-Wis.), Chairman of the House Banking Committee, for whom I then worked, along with Governor Hugh Carey of New York and Felix Rohatyn, Peter Goldmark, and David Burke of Carey's emergency team. Our purpose was to nail down a legislative plan to prevent the impending bankruptcy of the city of New York.

Toward the end of the meeting, Reuss asked me whether I had anything to add. "What about the windfall problem?" I asked. New York City bonds were trading at 30 cents on the dollar (or so I recall). When the bill went through, they would jump and anyone who bought them as we spoke would make a fortune. Carey turned to Rohatyn, "What about that, Felix?" Rohatyn shrugged, "Well, he's right."

Little did I know. The speculator existed, and his name, as we learn from Roger Lowenstein's genial account of Long-Term Capital Management, *When Genius Failed*, was John Meriwether. The New York crisis marked the takeoff of Meriwether's career, which went from bailout to bailout over 23 very exciting years.

WHEN GENIUS FAILED: The Rise and Fall of Long-Term Capital Management
By Roger Lowenstein
Random House, $26.95

When Genius Failed is a very good account of LTCM: clear, entertaining, informative, and judicious. The narrative has drama; the fate of the financial world was briefly at stake. It has complexity; there are serious issues of mathematics, statistics, and social science behind this story. Most of all, there is here a haunting portrait of our financial culture, where very ordinary people control extraordinary amounts of money.

Meriwether, pathologically self-effacing, emerges not unsympathetically in Lowenstein's portrait, except of course that he was crazily unsuited to running a financial firm. It is the other partners who fascinate, above all the professors Robert Merton and Myron Scholes, the fund's "philosophical fathers." The professors, we learn here, were peripheral to trading operations (Scholes, a "lesser partner" was "forever angling for more money"), but they were central to the marketing campaign. In this respect, their shared 1997 Nobel Memorial Prize didn't hurt at all.

Long-Term's basic strategy was to bet on the eventual convergence between the prices of extremely similar assets (the archetypal case being 30-year Treasury bonds issued today, "on the run," and the same bonds issued six months ago, "off the run"). By buying the cheap and selling the dear, convergence would bring a profit no matter the common movement of bond prices. In principle, it was a low-risk strategy, with tiny returns on each trade. And Long-Term made up the difference by leverage—by borrowing 10, 20, 50 times capital.

Leverage multiplies risk, but Long-Term believed that the underlying risk was so low that multiplication by leverage would not matter. This belief stemmed from a critical assumption: that the spreads between two essentially identical assets would be randomly distributed under a normal (bell) curve. Thus, the probability of a spread between highly similar assets moving too far in the wrong direction—of the cheap asset falling in price while the dear one rose, would be very slight and could be precisely calculated from the historical record.

Lowenstein presents the statistical issue competently, given that his own understanding is not deep and he expects his readers to have none at all. But he underplays a key issue. Economists have known for decades that the assumption of normality in the distribution of future events is false, particularly in financial markets. In 1937, John Maynard Keynes made the distinction between risk and incalculable uncertainty the foundation stone of his theoretical revolution. But Merton, Scholes, and the others came from a branch of economics that had rejected Keynes. That was their first mistake.

Worse, the fact that the distribution of asset returns is not normal was well known even in Chicago's financial-theory circles in the 1960s. Scholes' teacher Eugene Fama knew it; the case was first made to Fama by the mathematician Benoit Mandelbrot, father of fractals. Asset returns, Mandelbrot argued, follow a Pareto-Lévy distribution. They have (as Lowenstein puts it) "fat tails." Infinite variance. This means that catastrophic events are likely to happen all the time.

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Fama and Mandelbrot should have rung down the curtain on the "efficient-markets hypothesis" 30 years ago. But economists would not give it up. Dumping the bell curve would have meant abandoning the use of econometrics in finance, and hence nullifying a vast body of published work. Careers would have been compromised, academic empires diminished. And then along came Merton and Scholes, who forgot the difference between an academic game and real life.

They also did not notice a key fact about their own operation. By buying cheap and selling dear, they were always betting on convergence. In this arcane way, all of their trades—no matter what they were superficially about, whether Italian bonds or common stocks and options—shorted the asset perceived to be safe and bought the asset perceived to be risky. As Lowenstein puts it: "It apparently did not occur to Rosenfeld that since Long-Term tended to buy the less liquid security in every market, its assets were not entirely independent of one another." And so they exposed themselves to the classically Keynesian event: a flight to quality. In 1998, the event occurred. Spreads all went the wrong way. LTCM lost all its capital in about five weeks.

This was inevitable. A few weeks after the debacle, I debated a Finance Department colleague in Texas on LTCM. He described the operation as being like a bet on Secretariat at the Belmont, to show. A sure thing, in other words. Do it with two dollars, you'll win a nickel. Borrow a billion and do it, and you're a hedge fund.

The analogy seemed exact to me, and I said so. But there was a twist. The LTCM assumption was that the very same Belmont, the third jewel in the Triple Crown, could be raced again, day after day after day. The second time, the third time—it isn't the same race. And if you double your bets every time, on the assumption that it is, bankruptcy is certain.

Who was the genius, then? Not Merton, an "evangelical" devotee of the bell curve. Not Scholes, a dapper and fast-talking marketing man. Not the computer gurus, who couldn't see the larger context of their operations and didn't think they needed to know. Not the top traders, impetuous, volatile, and seduced into directional bets on Russian bonds with no historical data.

No, the genius here was John Meriwether himself. It was Meriwether who saw a way to package academic celebrity, infatuation with the new technology of computerized investing, and his own aloofness into the creation of a firm that would snow the big money men in New York, Paris, and Zurich, bringing in the hundreds of millions of dollars of loans needed to leverage LTCM's trades. This was a masterpiece of manipulation.

And of course, when the big bankers realized they'd been had, they were vengeful. Lowenstein traces the unraveling of LTCM, and darkly hints that Goldman Sachs undermined the firm deliberately by selling identical positions while it was reviewing LTCM's books, driving up losses and making the firm easier to acquire. Only an effective intervention by a low-paid bureaucrat—Peter Fisher of the New York Federal Reserve—kept the banks together long enough to cobble together an orderly liquidation in the autumn of 1998.

Lowenstein criticizes the Federal Reserve for intervening, and so failing "to send the markets a needed dose of discipline." But here he is quite wrong. The Fed's job is not to teach lessons, but to keep the system afloat. It cannot have known exactly what the unraveling of LTCM's trillion-dollar exposure on the open markets might have meant. And as to lessons, if Lowenstein's account of the bankers is correct, the Fed would have been utterly foolish to suppose any of them were capable of learning. Lowenstein's criticism of Alan Greenspan, who has repeatedly defended the derivatives business on the hyper-ludicrous grounds that lenders supervise it closely, is more on the mark.

That, of course, is the enduring dilemma of the LTCM fiasco. These people who run the money world really aren't all that good.

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Political Booknotes

Unbalanced Czech Book

By Gregg Easterbrook

MOHANDAS GANDHI—WHAT A jerk! Mother Theresa, Martin Luther King Jr., Dorothy Day, Elizabeth Cady Stanton, Thomas Merton, Thomas Jefferson, Albert Schweitzer: a rogue's gallery of egocentric charlatans. People have said as much about everyone on that list, and now comes John Keane, a professor of politics at Westminster University in England, to add Václav Havel to the hall of shame. You may foolishly view Havel as a playwright, spirited dissident, and democratic hero to a peace-loving nation. *Václav Havel: A Political Tragedy in Six Acts* reveals the shocking underside. Havel drinks too much, smokes too much, had too much sex, is vain, and, as president of his country, he made mistakes! Take this man away and string 'im up.

Overstatement? *Václav Havel* begins by complaining that its subject is too well thought-of by the world though he is guilty of "knavery" and though "the harsh fact is that most of the citizens of President Havel's republic think less of him than they did a year ago." Keane cautions readers that "I have never believed in heroes" and then goes on to relate that when he first met Havel, in 1984, "he didn't look much like a hero to me." This Havel was "exhausted, overweight, depressed" and had trouble operating the stick shift of his car. He also seemed more interested in getting hold of a bottle of whisky than in talking to John Keane. Oh, and he'd just been released from five years in prison, did we mention that? And yet imagine that he would prefer whisky to being interviewed! What a jerk!

Keane declares, "Gone are the days when it could be assumed that biography was about recording the facts ... my account of Havel's life is unavoidably 'factional.'" Funny, I was not aware that the days of fact-based biography were gone or that resorting to "factional" techniques (whatever they may be) was "unavoidabl[e]." But at least the author gives fair warning.

VACLAV HAVEL: A Political Tragedy in Six Acts
by John Keane
Basic Books, $27.50

After its declaration of intent to destroy its subject, *Václav Havel* holds to form. The description of Havel's birth, for example, finds ominous portents in an old family movie ("inexpertly shot," the book jabs) in which parents and relatives fuss over the baby so much as to give the impression of "a child whose early months were not only coddled but *crowned*." Keane seems unaware that it is standard for parents to fuss over babies in lavish fashion.

The tale continues downhill from there. Along the way, *Václav Havel* offers considerable scholarly detail on the postwar history of Czech politics and culture, a subject which Keane has studied closely. But he always comes back to what a crummy guy Václav is. He smokes incessantly. (A common health failing in the old Eastern bloc.) He drinks to excess. (Many numbed themselves against communism with brandy, including many of the chief communists.) He once got so totally, falling-down plastered on a Prague winter's night that he tumbled into an icy canal and would have perished in drunken oblivion but for valiant bystanders. While earning crowns by publishing maudlin tributes to his wife and fellow dissident, Olga, he was openly fooling around and, just a year after her death, married a tomato young enough to be his daughter. (Havel stayed with Olga for 45 years, including through her lengthy illness.) He pretended to take the presidency of the country reluctantly, but actually desperately desired the job and maneuvered to keep it out of the hands of Alexander Dubcek, his rival for most-admired Czechoslovakian. Plus his plays are overrated and he liked to be photographed with airhead celebrities.

Keane's bill of attainder may be true so far as it goes, but it is rarely leavened with acknowledgment of Havel's accomplishments. Born in 1936, to live first under Nazi invaders and then Soviet totalitarians, Havel grew up believing in freedom as the highest ideal. Raised under social and political systems that despised free thought, he nevertheless became a genuine artist, and also helped cultivate art in others. Given the chance to live well and let others bear the sacrifice of dissent, he instead defied authority, mostly through the Charter 77 movement, enduring many trips to prison. (Keane seems to see the prison years as a career move on Havel's part; it's easy to think that once the danger is over.)

In the theater, Havel produced at least decent work. In letters, his 1979 essay "The Power of the Powerless," predicting that communism would crumble simply because people hated it, is among the shining works of political thought—it certainly displayed a better understanding of human nature than anything the communist thinkers wrote. Presiding over the Velvet Revolution, though of course far from its only important player, Havel was a force for peaceful democracy. And regardless of whether history determines the separation from Slovakia to have been the right or wrong course, Havel helped it happen without any of the bloodshed, confiscation, or recriminations that have characterized nearly all the national divisions of history.

Keane is right to contend that the world's reserve of admiration for Havel has not been adjusted for the fact that the last couple years of his presidency have been undistinguished—though with the Czech economy continuing to improve, the country's basic trajectory seems positive. Whether Havel brought it on himself with dissolute living or was simply the victim of bad genes, his health has become so poor that he no longer belongs in public affairs. This April, he publicly implored Madeleine Albright, who was born in Czechoslovakia, to return and assume its presidency. This isn't half as crazy as it sounds, and not just because European nations are accustomed to importing rulers; it shows that even in decline, Havel has his country's best interests in mind. And as for Keane's repeatedly stated complaint that Havel cannot be a great fig-

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