Long-Term Capital Management, L.P. (B)

On December 31, 1997, Long-Term Capital Management, L.P. ("LTCM" or "Management Company") distributed approximately $2.7 billion of capital to investors in the fund that LTCM managed, Long-Term Capital Portfolio, L.P. ("the Fund"). Following a high return for 1997—25.3% gross of fees and 17.1% net of fees—the Fund's NAV had swelled to $7.5 billion, and the share of the Fund held by LTCM principals and employees had grown to $1.9 billion.

LTCM had notified investors in September, 1997 that it would be reducing investor capital in the Fund at year-end. In a letter to investors, LTCM explained that it had decided:

> … (1) to distribute 1997 profits and 1996 profits and earnings thereon to strategic investors; (2) to distribute to other investors all of their profits and earnings thereon; and (3) to return other investor capital that was contributed subsequent to December 31, 1994. Excepted from this policy are Management Company and related investors.

The firm explained its reasoning:

> As previously reported, the Fund has for some time been closed to new investment from non-Management Company investors with the exception of compelling cases of strategic value that would accrue from additional investment. From inception, the Fund has implemented its investment strategies subject to a constraint on its level of risk and subject to the requirement of maintaining adequate liquidity capital. The Management Company believes that these two constraints are not binding currently and the Fund has excess capital. This has occurred, primarily, because of a substantial increase in the capital base from the larger-than-expected, past realized rates of return, and high reinvestment rates elected by the Fund's investors. Therefore, it has become necessary to reduce the amount of capital significantly to bring the Fund's capital base more in line with its risk and liquidity needs.
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> There is, of course, no method for reducing the excess capital that would fully satisfy all of our investors. The selected method distinguishes investors who add strategic value to the Fund and who had the confidence to step forward and support the Fund during its first year of operation.

Professor André F. Perold prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.