9-200-010
REV: OCTOBER 4, 2004

ANDRÉ F. PEROLD

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

On September 2, 1998, LTCM sent the following letter to Fund investors.

September 2, 1998

By Telefacsimile

To Investors in the
Investment Vehicles of
Long-Term Capital Portfolio, L.P.

Re: Impact on Net Asset Value of August Market Conditions

Dear Investor:

As you are all too aware, events surrounding the collapse in Russia caused large and dramatically increasing volatility in global markets throughout August, capped by a last-day decline in the Dow Jones Industrial Average of 513 points. The resulting dislocations in markets and greatly increased uncertainty have driven investors to safer and more liquid assets. With increases in both risk and liquidity premia, investment funds widely, many Wall Street firms, and money-center banks have reported large trading losses with resulting sharp declines in their share prices. Investors everywhere have experienced large declines in their wealth.

Unfortunately, Long-Term Capital Portfolio ("Fund") has also experienced a sharp decline in net asset value. As you know, our formal procedure for releasing our official net asset value normally takes about ten days after month-end. Following our usual practice to give you an early estimate of the Fund's performance, it is down 44 percent for the month of August, and 52 percent for the year-to-date. Losses of this magnitude are a shock to us as they surely are to you, especially in light of the historical volatility of the Fund. The losses arising from the event-driven major increase in volatility and the flight to liquidity were magnified by the time of year when markets were seasonally thin.

The losses in August occurred in a wide variety of strategies, distributed approximately 82 percent in relative-value trades and 18 percent in directional trades. Emerging markets across both trade

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categories accounted for 16 percent of the month's total losses in the Fund. Within emerging markets, holdings involving Russia accounted for less than 10 percent of total losses.

A distinguishing characteristic of the Fund's investment philosophy has always been that its returns are generally expected not to exhibit systematic correlation with the returns on global bond, stock, and currency markets. August saw an accelerating increase in the demand for liquidity in nearly every market around the world. Consequently, Government bonds have been the best performers, while small-cap common stocks and other relatively illiquid and risky instruments such as high-yield bonds have performed poorly. Many of the Fund's investment strategies involve providing liquidity to the market. Hence, our losses across strategies were correlated after-the-fact from a sharp increase in the liquidity premium.

The majority of the Fund's risks are in our core investment strategies; that is, convergence, relative-value and conditional convergence trades in the U.S., Japan, and the larger markets of Europe. Although we have hedged risk-exposure components that were not expected to add incremental value to performance, large divergences in August occurred in many of our key trading strategies that resulted in large losses. The use of leverage has accentuated these losses.

With the large and rapid fall in our capital, steps have been taken to reduce risks now, commensurate with our level of capital. We have raised the risk-return tradeoff requirements for positions. Risk and position reduction is occurring in some strategies that do not meet the new standard. This is a prudent step given the level of capital and uncertainties in the market place.

On the other hand, we see great opportunities in a number of our best strategies, and these are being held by the Fund. As it happens, the best strategies are the ones we have worked on over many years. We will focus on these high expected return-to-risk positions and, thereby we can manage them more aggressively.

A cornerstone of our investment management philosophy is the availability and efficiency of financing to support the long horizon for many of our investment strategies. Our capital base is over $2.3 billion, and it is quite liquid. Our financing is in place, including secured and unsecured term debt and long-dated contractual arrangements. These term arrangements provide time to reduce our positions, if needed, as markets become more settled. We continue to work closely with counterparts.

Investors in the Fund provide long-term equity capital that can only be withdrawn in multi-year stages at each year-end. This capital allows the Fund to secure stronger term financing and contractual agreements. It also provides greater flexibility to adjust positions, given changes in the level of its capital. The first date that any investors can withdraw capital is year-end 1998 and that potential withdrawal is less than 12 percent of the capital of the Fund. The principals of LTCM represent over a third of the capital of the Fund. To provide a solid foundation for the Fund and to capitalize on the materially richer investment-opportunity set, LTCM is in the process of seeking to raise additional capital.

The poor performance of the Fund, year-to-date and especially in August, has been very disappointing to us all. However, I would ask in assessing performance going forward, that you keep in mind that the Fund's relative-value strategies may require a relatively long convergence horizon. The expected horizon for convergence on our trades can range from six months to two years, or even longer. Implementation of these strategies involves large positions that take significant time to accumulate and to reduce efficiently. The convergence return pattern of these core strategies normally implies that the day-to-day volatility is much greater in proportion to time than the month-to-month or year-to-year volatility of their performance. This does not imply, however, that the reported short-term performance of the Fund is in any way an inaccurate or invalid measure of actual returns. The market-to-market valuations on positions in the Fund reported to you are always derived from actual dealer and broker quotations.

The Fund returned approximately $2.7 billion of its capital at year-end 1997 when it appeared that the existing investment opportunities were not large and attractive enough to warrant its retention. Many of the trades had converged producing profits and were being unwound. Over the past several months, however, those trades that had converged once again diverged. The Fund added to its positions in anticipation of convergence, yet largely because of last month's market events, the trades diverged dramatically. As a result, the opportunity set in these trades at this time is believed to be among the best that LTCM has ever seen. But, as we have seen, good convergence trades can diverge further. In August, many of them diverged at a speed and to an extent that had not been seen before. LTCM thus believes that it is prudent and opportunistic to increase the level of the Fund's capital to take full advantage of this unusually attractive environment.

With limited exceptions, the Fund has been closed to new investment since July, 1995. Many of you have asked to add to your investment in the Fund. Since it is prudent to raise additional capital, the Fund is offering you the opportunity to invest in the Fund on special terms related to LTCM fees. If you have an interest in investing, please contact Richard Leahy at Long-Term Capital Management for further information.

I cannot close without telling you about the remarkable performance of the LTCM employees during this particularly difficult month. Over the first four years of the Fund, we had the great good fortune of consistent return performance resulting in larger-than-expected returns with lower-than-expected volatility. We expected that sooner or later that this good fortune could not continue uninterrupted and that we as a firm would be tested. I did not anticipate, however, how severe the test would be. I am happy to report the magnificent performance of our employees operating as a team – administration, technology, operations, legal and strategists – coordinated across our Greenwich, London, and Tokyo offices during this extreme period. August has been very painful for all of us, but I believe that as a consequence, LTCM will emerge a stronger and better firm.

Sincerely,

John W. Meriwether
Chief Executive Officer &
Chairman of the Management Committee