Hello Everyone,

The name Long Term Capital Management (LTCM) probably doesn't evoke any thoughts or emotions for most of you. Twenty years ago, however, LTCM almost brought down the world's financial system…and, all who were involved remember it vividly.

Emerging Markets were the culprit back then. And, Emerging Markets are in the headlines today…with Turkey being at the bullseye.

Thus, over the next few missives, we'll see if there are any germane connections we can make between then and now.

Signed, Your Going-To-Miss-R-E-S-P-E-C-T-Aretha-Franklin Financial Advisor,

Greg

KKOB 08.17.2018 Long Term Capital Management

Bob: So, Greg, when I got the subject of today's report, I thought maybe the best way to sum up your topic was---man vs. machine.

Greg: I like that. So, today I am going to take you back to 1998 and a firm called Long Term Capital Management. Does that name ring any bells?

Bob: Not really. But, remember, I was on the Sports Animal back then.

Greg: That's right…for you, back then, it was batting averages instead of industrial averages. Anyway, 20 years ago, there was an outfit called Long Term Capital Management; and it was run by a bunch of Nobel Prize winning economists. And, these guys were on the cutting edge of using both algorithms and derivatives to make money. Thus, based on their reputations- and technology-- billions poured into their funds.

Bob: Wait. You've educated me on derivatives. A derivative is just a fancy word for a bet. It's like investing on 7 at the craps table in Vegas. And, I know, derivatives are leveraged up with borrowed money. And, weren't derivatives at the root of the Lehman crisis as well?

Greg: Exactly…and yes. But, you're getting to my punch line too early! So, back to our story. In 1994 & '95, Long Term's computer models said the best bets were in Emerging Markets like Viet Nam, Thailand, Brazil, the best bets were in Emerging Markets like Viet Nam, Thailand, Brazil, South Africa, and even Russia. So, they bet big there.

By '97 & '98, however, the cracks were appearing. These countries had all borrowed way too much money to fuel their growth. And, without going into the details, the more the dollar strengthened then, the harder it was for them to pay those loans...and the dollar was strengthening.

Bob: But, wouldn't the computers have accounted for that? I mean, that seems kind of basic.

Greg: They did…sort of. This is where the man vs. machine part comes in. The computer programs (the machines) all assumed if a country had ***the ability*** to pay their loans, they would pay. But, what if the country ***had the ability to pay, but not the willingness***? What if the leadership (the man part) just said, "Yes, we can pay you, but it will be too painful. You made an investment and lost. Sorry." In that scenario, the computer algorithms freak out.

Bob: And, that's what happened?

Greg: Yup. Russia did it. Outright default. They said, "We ***can*** pay, but we ***won't*** pay." And, LTCM's computer programs went, boom!

Bob: So, people lost money. But, that happens every day. And besides, it was all overseas. So, not to be harsh, but who cares?

Greg: Ahhh, my young investment grasshopper, you forgot about the derivatives. Mega banks worldwide were up to their eyeballs in derivatives on Long Term's bets. Hundreds of billions were at stake. And suddenly, the world's financial giants were staring into the abyss.

Thus, in September of '98, there was a little-known emergency meeting of 16 major banks. Firms like Goldman, JP Morgan, Chase, Barclays, Credit Suisse, & Deutsche Bank were all summoned. Something had to be done. And, the overriding question was, "How could just one firm (Long Term Capital Management) have put all of us at such great risk?"

Bob: Wait. Two things. How do you know this stuff? And next, this sounds like what happened with Lehman 10 years later.

Greg: First, I know because I have a friend, Miles Gordon, who was at those meetings. His stories are riveting. And second, yes, this was Lehman before Lehman. Back then though, the solution was for the banks themselves to pony up the dough to save the system—not the taxpayers.

Bob: So, the crisis passed, and life went on. And, today hardly anyone talks about it. So, why rehash it?

Greg: Here's why. The similarities between then and now are startling. Emerging market stress today? Check. Strengthening dollar? Check. Too much leverage and too much bad-debt? Check, check. And, trillions in derivatives exposure? Check. But, now it's all bigger. So, let's pick up the thread on Monday…because, if I'm right, there will be all kinds of investment opportunities.

Bob: Sounds good. Until then, how do people reach you?

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