

# When Genius Failed

The rise and fall of  
Long Term Capital Management



Roger Lowenstein

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**When Genius Failed: The  
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Term Capital Management**

«HarperCollins»

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**When Genius Failed: The Rise and Fall of Long Term Capital Management / R. Lowenstein — «HarperCollins»,**

Charts are best viewed on a tablet. Picking up where Liar's Poker left off (literally, in the bond dealer's desks of Salomon Brothers) the story of Long-Term Capital Management is of a group of elite investors who believed they could beat the market and, like alchemists, create limitless wealth for themselves and their partners. Founded by John Meriweather, a notoriously confident bond dealer, along with two Nobel prize winners and a floor of Wall Street's brightest and best, Long-Term Capital Management was from the beginning hailed as a new gold standard in investing. It was to be the hedge fund to end all other hedge funds: a discreet private investment club limited to those rich enough to pony up millions. It became the banks' own favourite fund and from its inception achieved a run of dizzyingly spectacular returns. New investors barged each other aside to get their investment money into LTCM's hands. But as competitors began to mimic Meriweather's fund, he altered strategy to maintain the fund's performance, leveraging capital with credit on a scale not fully understood and never seen before. When the markets in Indonesia, South America and Russia crashed in 1998 LTCM's investments crashed with them and mountainous debts accumulated. The fund was in meltdown, and threatening to bring down into its trillion-dollar black hole a host of financial institutions from New York to Switzerland. It's a tale of vivid characters, overweening ambition, and perilous drama told, in Roger Lowenstein's hands, with brilliant style and panache.

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**ROGER LOWENSTEIN**  
**WHEN GENIUS FAILED**  
**The Rise and Fall of Long-Term Capital Management**  
FOURTH ESTATE • *London*

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Fourth Estate

An imprint of HarperCollinsPublishers

1 London Bridge Street

London SE1 9GF

[www.harpercollins.co.uk](http://www.harpercollins.co.uk)

First published in Great Britain by Fourth Estate in 2001

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Source ISBN: 9781841155043

Ebook Edition © DECEMBER 2013 ISBN: 9780007375790

Version: 2018-07-31



## **Dedication**

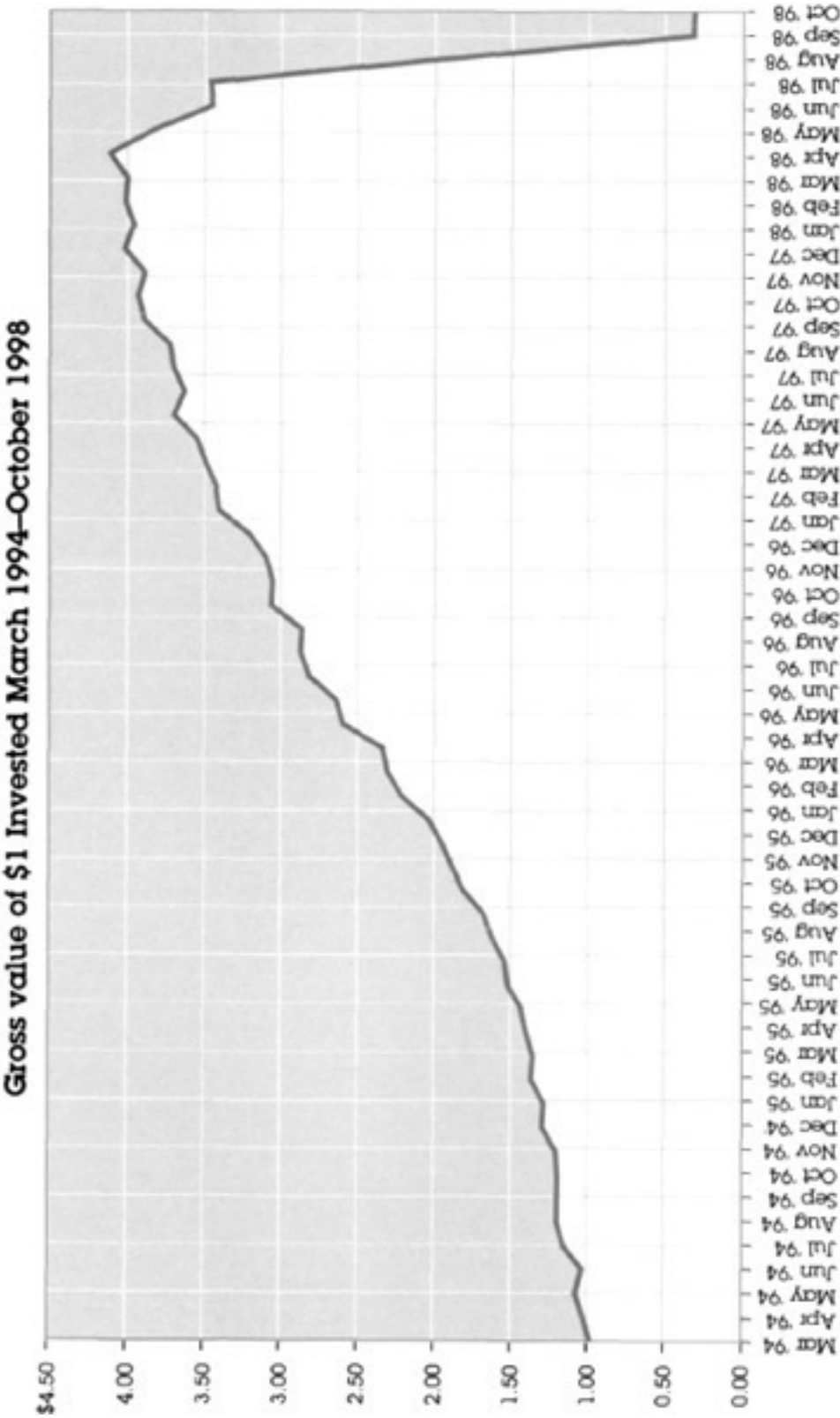
*To Maury Lasky and Jane Ruth Mairs*

## Epigraph

Past may be prologue, but which past?  
–HENRY HU

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## Introduction

The Federal Reserve Bank of New York is perched in a gray sandstone slab in the heart of Wall Street. Though a city landmark building constructed in 1924, the bank is a muted, almost unseen presence among its lively, entrepreneurial neighbors. The area is dotted with discount stores and luncheonettes—and, almost everywhere, brokerage firms and banks. The Fed's immediate neighbors include a shoe repair stand and a teriyaki house, and also Chase Manhattan Bank; J. P. Morgan is a few blocks away. A bit farther to the west, Merrill Lynch, the people's brokerage, gazes at the Hudson River, across which lie the rest of America and most of Merrill's customers. The bank skyscrapers project an open, accommodative air, but the Fed building, a Florentine Renaissance showpiece, is distinctly forbidding. Its arched windows are encased in metal grille, and its main entrance, on Liberty Street, is guarded by a row of black cast-iron sentries.

The New York Fed is only a spoke, though the most important spoke, in the U.S. Federal Reserve System, America's central bank. Because of the New York Fed's proximity to Wall Street, it acts as the eyes and ears into markets for the bank's governing board, in Washington, which is run by the oracular Alan Greenspan. William J. McDonough, the beefy president of the New York Fed, talks to bankers and traders often. McDonough wants to be kept abreast of the gossip that traders share with one another. He especially wants to hear about anything that might upset markets or, in the extreme, the financial system. But McDonough tries to stay in the background. The Fed has always been a controversial regulator—a servant of the people that is elbow to elbow with Wall Street, a cloistered agency amid the democratic chaos of markets. For McDonough to intervene, even in a small way, would take a crisis, perhaps a war. And in the first days of the autumn of 1998, McDonough did intervene—and not in a small way.

The source of the trouble seemed so small, so laughably remote, as to be insignificant. But isn't it always that way? A load of tea is dumped into a harbor, an archduke is shot, and suddenly a tinderbox is lit, a crisis erupts, and the world is different. In this case, the shot was Long-Term Capital Management, a private investment partnership with its headquarters in Greenwich, Connecticut, a posh suburb some forty miles from Wall Street. LTCM managed money for only one hundred investors; it employed not quite two hundred people, and surely not one American in a hundred had ever heard of it. Indeed, five years earlier, LTCM had not even existed.

But on the Wednesday afternoon of September 23, 1998, Long-Term did not seem small. On account of a crisis at LTCM, McDonough had summoned—"invited," in the Fed's restrained idiom—the heads of every major Wall Street bank. For the first time, the chiefs of Bankers Trust, Bear Stearns, Chase Manhattan, Goldman Sachs, J. P. Morgan, Lehman Brothers, Merrill Lynch, Morgan Stanley Dean Witter, and Salomon Smith Barney gathered under the oil portraits in the Fed's tenth-floor boardroom—not to bail out a Latin American nation but to consider a rescue of one of their own. The chairman of the New York Stock Exchange joined them, as did representatives from major European banks. Unaccustomed to hosting such a large gathering, the Fed did not have enough leather-backed chairs to go around, so the chief executives had to squeeze into folding metal seats.

Although McDonough was a public official, the meeting was secret. As far as the public knew, America was in the salad days of one of history's great bull markets, although recently, as in many previous autumns, it had seen some backsliding. Since mid-August, when Russia had defaulted on its ruble debt, the global bond markets in particular had been highly unsettled. But that wasn't why McDonough had called the bankers.

Long-Term, a bond-trading firm, was on the brink of failing. The fund was run by John W. Meriwether, formerly a well-known trader at Salomon Brothers. Meriwether, a congenial though cautious midwesterner, had been popular among the bankers. It was because of him, mainly, that the bankers had agreed to give financing to Long-Term—and had agreed on highly generous terms. But

Meriwether was only the public face of Long-Term. The heart of the fund was a group of brainy, Ph.D.-certified arbitrageurs. Many of them had been professors. Two had won the Nobel Prize. All of them were very smart. And they knew they were very smart.

For four years, Long-Term had been the envy of Wall Street. The fund had racked up returns of more than 40 percent a year, with no losing stretches, no volatility, seemingly no risk at all. Its intellectual supermen had apparently been able to reduce an uncertain world to rigorous, cold-blooded odds—on form, they were the very best that modern finance had to offer.

This one obscure arbitrage fund had amassed an amazing \$100 billion in assets, virtually all of it borrowed—borrowed, that is, from the bankers at McDonough's table. As monstrous as this indebtedness was, it was by no means the worst of Long-Term's problems. The fund had entered into thousands of derivative contracts, which had endlessly intertwined it with every bank on Wall Street. These contracts, essentially side bets on market prices, covered an astronomical sum—more than \$1 trillion worth of exposure.

If Long-Term defaulted, all of the banks in the room would be left holding one side of a contract for which the other side no longer existed. In other words, they would be exposed to tremendous—and untenable—risks. Undoubtedly, there would be a frenzy as every bank rushed to escape its now one-sided obligations and tried to sell its collateral from Long-Term.

Panics are as old as markets, but derivatives were relatively new. Regulators had worried about the potential risks of these inventive new securities, which linked the country's financial institutions in a complex chain of reciprocal obligations. Officials had wondered what would happen if one big link in the chain should fail. McDonough feared that the markets would stop working; that trading would cease; that the system itself would come crashing down.

James Cayne, the cigar-chomping chief executive of Bear Stearns, had been vowing that he would stop clearing Long-Term's trades—which would put it out of business—if the fund's available cash fell below \$500 million. At the start of the year, that would have seemed remote, for Long-Term's capital had been \$4.7 *billion*. But during the past five weeks, or since Russia's default, Long-Term had suffered numbing losses—day after day after day. Its capital was down to the minimum. Cayne didn't think it would survive another day.

The fund had already asked Warren Buffett for money. It had gone to George Soros. It had gone to Merrill Lynch. One by one, it had asked every bank it could think of. Now it had no place left to go. That was why, like a godfather summoning rival and potentially warring families, McDonough had invited the bankers. If each one moved to unload bonds individually, the result could be a worldwide panic. If they acted in concert, perhaps a catastrophe could be avoided. Although McDonough didn't say so, he wanted the banks to invest \$4 billion and rescue the fund. He wanted them to do it right then—tomorrow would be too late.

But the bankers felt that Long-Term had already caused them more than enough trouble. Long-Term's secretive, close-knit mathematicians had treated everyone else on Wall Street with utter disdain. Merrill Lynch, the firm that had brought Long-Term into being, had long tried to establish a profitable, mutually rewarding relationship with the fund. So had many other banks. But Long-Term had spurned them. The professors had been willing to trade on their terms and only on theirs—not to meet the banks halfway. The bankers did not like it that the once haughty Long-Term was pleading for their help.

And the bankers themselves were hurting from the turmoil that Long-Term had helped to unleash. Goldman Sachs's CEO, Jon Corzine, was facing a revolt by his partners, who were horrified by Goldman's recent trading losses and who, unlike Corzine, did not want to use their diminishing capital to help a competitor. Sanford I. Weill, chairman of Travelers/Salomon Smith Barney, had suffered big losses, too. Weill was worried that the losses would jeopardize his company's pending merger with Citicorp, which Weill saw as the crowning gem to his lustrous career. He had recently

shuttered his own arbitrage unit—which, years earlier, had been the launching pad for Meriwether's career—and was not keen to bail out another one.

As McDonough looked around the table, every one of his guests was in greater or lesser trouble, many of them directly on account of Long-Term. The value of the bankers' stocks had fallen precipitously. The bankers were afraid, as was McDonough, that the global storm that had begun, so innocently, with devaluations in Asia, and had spread to Russia, Brazil, and now to Long-Term Capital, would envelop all of Wall Street.

Richard Fuld, chairman of Lehman Brothers, was fighting off rumors that *his* company was on the verge of failing due to its supposed overexposure to Long-Term. David Solo, who represented the giant Swiss bank Union Bank of Switzerland, thought his bank was already in far too deeply; it had foolishly invested in Long-Term and had suffered titanic losses. Thomas Labrecque's Chase Manhattan had sponsored a loan to the hedge fund of \$500 million; before Labrecque thought about investing more, he wanted that loan repaid.

David Komansky, the portly Merrill chairman, was worried most of all. In a matter of two months, Merrill's stock had fallen by half—\$19 billion of its market value had simply melted away. Merrill had suffered shocking bond-trading losses, too. Now its own credit rating was at risk.

Komansky, who personally had invested almost \$1 million in the fund, was terrified of the chaos that would result if Long-Term collapsed. But he knew how much antipathy there was in the room toward Long-Term. He thought the odds of getting the bankers to agree were long at best.

Komansky recognized that Cayne, the maverick Bear Stearns chief executive, would be a pivotal player. Bear, which cleared Long-Term's trades, knew the guts of the hedge fund better than any other firm. As the other bankers nervously shifted in their seats, Herbert Allison, Komansky's number two, asked Cayne where he stood.

Cayne stated his position clearly: Bear Stearns would not invest a nickel in Long-Term Capital. For a moment the bankers, the cream of Wall Street, were silent. And then the room exploded.

## **THE RISE OF LONG-TERM CAPITAL MANAGEMENT**

## 1 MERIWETHER

IF THERE WAS one article of faith that John Meriwether discovered at Salomon Brothers, it was to ride your losses until they turned into gains. It is possible to pinpoint the moment of Meriwether's revelation. In 1979, a securities dealer named J. F. Eckstein & Co. was on the brink of failing. A panicked Eckstein went to Salomon and met with a group that included several of Salomon's partners and also Meriwether, then a cherub-faced trader of thirty-one. "I got a great trade, but I can't stay in it," Eckstein pleaded with them. "How about buying me out?"

The situation was this: Eckstein traded in Treasury bill futures—which, as the name suggests, are contracts that provide for the delivery of U.S. Treasury bills, at a fixed price in the future. They often traded at a slight discount to the price of the actual, underlying bills. In a classic bit of arbitrage, Eckstein would buy the futures, sell the bills, and then wait for the two prices to converge. Since most people would pay about the same to own a bill in the proximate future as they would to own it now, it was reasonable to think that the prices *would* converge. And there was a bit of magic in the trade, which was the secret of Eckstein's business, of Long-Term Capital's future business, and indeed of every arbitrageur who has ever plied the trade. Eckstein didn't know whether the two securities' prices would go up or down, *and Eckstein didn't care*. All that mattered to him was how the two prices would change relative to each other.

By buying the bill futures and shorting (that is, betting on a decline in the prices of) the actual bills, Eckstein really had *two* bets going, each in opposite directions.\* Depending on whether prices moved up or down, he would expect to make money on one trade and lose it on the other. But as long as the cheaper asset—the futures—rose by a little more (or fell by a little less) than did the bills, Eckstein's profit on his winning trade would be greater than his loss on the other side. This is the basic idea of arbitrage.

Eckstein had made this bet many times, typically with success. As he made more money, he gradually raised his stake. For some reason, in June 1979, the normal pattern was reversed: futures got *more* expensive than bills. Confident that the customary relationship would reassert itself, Eckstein put on a *very* big trade. But instead of converging, the gap widened even further. Eckstein was hit with massive margin calls and became desperate to sell.

Meriwether, as it had happened, had recently set up a bond-arbitrage group within Salomon. He instantly saw that Eckstein's trade made sense, because sooner or later, the prices *should* converge. But in the meantime, Salomon would be risking tens of millions of its capital, which totaled only about \$200 million. The partners were nervous but agreed to take over Eckstein's position. For the next couple of weeks, the spread continued to widen, and Salomon suffered a serious loss. The firm's capital account used to be scribbled in a little book, left outside the office of a partner named Allan Fine, and each afternoon the partners would nervously tiptoe over to Fine's to see how much they had lost. Meriwether coolly insisted that they would come out ahead. "We better," John Gutfreund, the managing partner, told him, "or you'll be fired."

The prices did converge, and Salomon made a bundle. Hardly anyone traded financial futures then, but Meriwether understood them. He was promoted to partner the very next year. More important, his little section, the inauspiciously titled Domestic Fixed Income Arbitrage Group, now had carte blanche to do spread trades with Salomon's capital. Meriwether, in fact, had found his life's work.

Born in 1947, Meriwether had grown up in the Rosemoor section of Roseland on the South Side of Chicago, a Democratic, Irish Catholic stronghold of Mayor Richard Daley. He was one of three children but part of a larger extended family, including four cousins across an alleyway. In reality, the entire neighborhood was family. Meriwether knew virtually everyone in the area, a self-contained world that revolved around the basketball lot, soda shop, and parish. It was bordered to the



east by the tracks of the Illinois Central Railroad and to the north by a red board fence, beyond which lay a no-man's-land of train yards and factories. If it wasn't a poor neighborhood, it certainly wasn't rich. Meriwether's father was an accountant; his mother worked for the Board of Education. Both parents were strict. The Meriwethers lived in a smallish, cinnamon-brick house with a trim lawn and tidy garden, much as most of their neighbors did. Everyone sent their children to parochial schools (the few who didn't were ostracized as "publics"). Meriwether, attired in a pale blue shirt and dark blue tie, attended St. John de la Salle Elementary and later Mendel Catholic High School, taught by Augustinian priests. Discipline was harsh. The boys were rapped with a ruler or, in the extreme, made to kneel on their knuckles for an entire class. Educated in such a Joycean regime, Meriwether grew up accustomed to a pervasive sense of order. As one of Meriwether's friends, a barber's son, recalled, "We were afraid to goof around at [elementary] school because the nuns would punish you for life and you'd be sent to Hell." As for their mortal destination, it was said, only half in jest, that the young men of Rosemoor had three choices: go to college, become a cop, or go to jail. Meriwether had no doubt about his own choice, nor did any of his peers.

A popular, bright student, he was seemingly headed for success. He qualified for the National Honor Society, scoring especially high marks in mathematics—an indispensable subject for a bond trader. Perhaps the orderliness of mathematics appealed to him. He was ever guided by a sense of restraint, as if to step out of bounds would invite the ruler's slap. Although Meriwether had a bit of a mouth on him, as one chum recalled, he never got into serious trouble.<sup>1</sup> Private with his feelings, he kept any reckless impulse strictly under wraps and cloaked his drive behind a comely reserve. He was clever but not a prodigy, well liked but not a standout. He was, indeed, average enough in a neighborhood and time in which it would have been hell to have been anything *but* average.

Meriwether also liked to gamble, but only when the odds were sufficiently in his favor to give him an edge. Gambling, indeed, was a field in which his cautious approach to risk-taking could be applied to his advantage. He learned to bet on horses and also to play blackjack, the latter courtesy of a card-playing grandma. Parlaying an innate sense of the odds, he would bet on the Chicago Cubs, but not until he got the weather report so he knew how the winds would be blowing at Wrigley Field.<sup>2</sup> His first foray into investments was at age twelve or so, but it would be wrong to suggest that it occurred to any of his peers, or even to Meriwether himself, that this modestly built, chestnut-haired boy was a Horatio Alger hero destined for glory on Wall Street. "John and his older brother made money in high school buying stocks," his mother recalled decades later. "His father advised him." And that was that.

Meriwether made his escape from Rosemoor by means of a singular passion: not investing but golf. From an early age, he had haunted the courses at public parks, an unusual pastime for a Rosemoor boy. He was a standout member of the Mendel school team and twice won the Chicago Suburban Catholic League golf tournament. He also caddied at the Flossmoor Country Club, which involved a significant train or bus ride south of the city. The superintendents at Flossmoor took a shine to the earnest, likable young man and let him caddy for the richest players—a lucrative privilege. One of the members tabbed him for a Chick Evans scholarship, named for an early-twentieth-century golfer who had had the happy idea of endowing a college scholarship for caddies. Meriwether picked Northwestern University, in Evanston, Illinois, on the chilly waters of Lake Michigan, twenty-five miles and a world away from Rosemoor. His life story up to then had highlighted two rather conflicting verities. The first was the sense of well-being to be derived from fitting into a group such as a neighborhood or church: from religiously adhering to its values and rites. Order and custom were virtues in themselves. But second, Meriwether had learned, it paid to develop an edge—a low handicap at a game that nobody else on the block even played.

After Northwestern, he taught high school math for a year, then went to the University of Chicago for a business degree, where a grain farmer's son named Jon Corzine (later Meriwether's rival on Wall Street) was one of his classmates. Meriwether worked his way through business school as an analyst at CNA Financial Corporation, and graduated in 1973. The next year, Meriwether, now

a sturdily built twenty-seven-year-old with beguiling eyes and round, dimpled cheeks, was hired by Salomon. It was still a small firm, but it was in the center of great changes that were convulsing bond markets everywhere.

Until the mid-1960s, bond trading had been a dull sport. An investor bought bonds, often from the trust department of his local bank, for steady income, and as long as the bonds didn't default, he was generally happy with his purchase, if indeed he gave it any further thought. Few investors actively traded bonds, and the notion of *managing* a bond portfolio to achieve a higher return than the next guy or, say, to beat a benchmark index, was totally foreign. That was a good thing, because no such index existed. The reigning bond guru was Salomon's own Sidney Homer, a Harvard-educated classicist, distant relative of the painter Winslow Homer, and son of a Metropolitan Opera soprano. Homer, author of the massive tome *A History of Interest Rates: 2000 BC to the Present*, was a gentleman scholar—a breed on Wall Street that was shortly to disappear.

Homer's markets, at least in contrast to those of today, were characterized by fixed relationships: fixed currencies, regulated interest rates, and a fixed gold price (\$35 an ounce). But the epidemic of inflation that infected the West in the late 1960s destroyed this cozy world forever. As inflation rose, so did interest rates, and those gilt-edged bonds, bought when a 4 percent rate seemed attractive, lost half their value or more. In 1971, the United States freed the gold price; then the Arabs embargoed oil. If bondholders still harbored any illusion of stability, the bankruptcy of the Penn Central Railroad, which was widely owned by blue-chip accounts, wrecked the illusion forever. Bond investors, most of them knee-deep in losses, were no longer comfortable standing pat. Gradually, governments around the globe were forced to drop their restrictions on interest rates and on currencies. The world of fixed relationships was dead.

Soybeans suddenly seemed quaint; *money* was the hot commodity now. Futures exchanges devised new contracts in financial goods such as Treasury bills and bonds and Japanese yen, and everywhere there were new instruments, new options, new bonds to trade, just when professional portfolio managers were waking up and wanting to trade them. By the end of the 1970s, firms such as Salomon were slicing and dicing bonds in ways that Homer had never dreamed of: blending mortgages together, for instance, and distilling them into bite-sized, easily chewable securities.

The other big change was the computer. As late as the end of the 1960s, whenever traders wanted to price a bond, they would look it up in a thick blue book. In 1969, Salomon hired a mathematician, Martin Leibowitz, who got Salomon's first computer. Leibowitz became the most popular mathematician in history, or so it seemed when the bond market was hot and Salomon's traders, who no longer had time to page through the blue book, crowded around him to get bond prices that they now needed on the double. By the early 1970s, traders had their own crude handheld calculators, which subtly quickened the rhythm of the bond markets.

Meriwether, who joined Salomon on the financing desk, known as the Repo Department, got there just as the bond world was turning topsy-turvy. Once predictable and relatively low risk, the bond world was pulsating with change and opportunity, especially for younger, sharp-eyed analysts. Meriwether, who didn't know a soul when he arrived in New York, rented a room at a Manhattan athletic club and soon discovered that bonds were made for him. Bonds have a particular appeal to mathematical types because so much of what determines their value is readily quantifiable. Essentially, two factors dictate a bond's price. One can be gleaned from the coupon on the bond itself. If you can lend money at 10 percent today, you would pay a premium for a bond that yielded 12 percent. How much of a premium? That would depend on the maturity of the bond, the timing of the payments, your outlook (if you have one) for interest rates in the future, plus all manner of wrinkles devised by clever issuers, such as whether the bond is callable, convertible into equity, and so forth.

The other factor is the risk of default. In most cases, that is not strictly quantifiable, nor is it very great. Still, it exists. General Electric is a good risk, but not as good as Uncle Sam. Hewlett-Packard is somewhat riskier than GE; Amazon.com, riskier still. Therefore, bond investors demand a

higher interest rate when they lend to Amazon as compared with GE, or to Bolivia as compared with France. Deciding how much higher is the heart of bond trading, but the point is that bonds trade on a mathematical *spread*. The riskier the bond, the wider the spread—that is, the greater the difference between the yield on it and the yield on (virtually risk free) Treasuries. Generally, though not always, the spread also increases with time—that is, investors demand a slightly higher yield on a two-year note than on a thirty-day bill because the uncertainty is greater.

These rules are the catechism of bond trading; they ordain a vast matrix of yields and spreads on debt securities throughout the world. They are as intricate and immutable as the rules of a great religion, and it is no wonder that Meriwether, who kept rosary beads and prayer cards in his briefcase, found them satisfying. Eager to learn, he peppered his bosses with questions like a divinity student. Sensing his promise, the suits at Salomon put him to trading government agency bonds. Soon after, New York City nearly defaulted, and the spreads on various agency bonds soared. Meriwether reckoned that the market had goofed—surely, not every government entity was about to go bust—and he bought all the bonds he could. Spreads did contract, and Meriwether's trades made millions.<sup>3</sup>

The Arbitrage Group, which he formed in 1977, marked a subtle but important shift in Salomon's evolution. It was also the model that Long-Term Capital was to replicate, brick for brick, in the 1990s—a laboratory in which Meriwether would become accustomed to, and comfortable with, taking big risks. Although Salomon had always traded bonds, its primary focus had been the relatively safer business of buying and selling bonds for customers. But the Arbitrage Group, led by Meriwether, became a principal, risking Salomon's own capital. Because the field was new, Meriwether had few competitors, and the pickings were rich. As in the Eckstein trade, he often bet that a spread—say, between a futures contract and the underlying bond, or between two bonds—would converge. He could also bet on spreads to widen, but convergence was his dominant theme. The people on the other side of his trades might be insurers, banks, or speculators; Meriwether wouldn't know, and usually he wouldn't care. Occasionally, these other investors might get scared and withdraw their capital, causing spreads to widen further and causing Meriwether to lose money, at least temporarily. But if he had the capital to stay the course, he'd be rewarded in the long run, or so his experience seemed to prove. Eventually, spreads always came in; that was the lesson he had learned from the Eckstein affair, and it was a lesson he would count on, years later, at Long-Term Capital. But there was a different lesson, equally valuable, that Meriwether might have drawn from the Eckstein business, had his success not come so fast: while a losing trade may well turn around *eventually* (assuming, of course, that it was properly conceived to begin with), the turn could arrive too late to do the trader any good—meaning, of course, that he might go broke in the interim.

By the early 1980s, Meriwether was one of Salomon's bright young stars. His shyness and implacable poker face played perfectly to his skill as a trader. William McIntosh, the Salomon partner who had interviewed him, said, "John has a steel-trap mind. You have no clue to what he's thinking." Meriwether's former colleague, the writer Michael Lewis, echoed this assessment of Meriwether in *Liar's Poker*:

He wore the same blank half-tense expression when he won as he did when he lost. He had, I think, a profound ability to control the two emotions that commonly destroy traders—fear and greed—and it made him as noble as a man who pursues his self-interest so fiercely can be.<sup>4</sup>

It was a pity that the book emphasized a supposed incident in which Meriwether allegedly dared Gutfreund to play a single hand of poker for \$10 million, not merely because the story seems apocryphal, but because it canonized Meriwether for a recklessness that wasn't his.<sup>5</sup> Meriwether was the priest of the *calculated* gamble. He was cautious to a fault; he gave away nothing of himself. His background, his family, his entire past were as much of a blank to colleagues as if, one said, he had "drawn a line in the sand." He was so intensely private that even when the Long-Term Capital affair was front-page news, a *New York Times* writer, after trying to determine if Meriwether had

any siblings, settled for citing the inaccurate opinion of friends who thought him an only child.<sup>6</sup> Such reticence was a perfect attribute for a trader, but it was not enough. What Meriwether lacked, he must have sensed, was an *edge*—some special forte like the one he had developed on the links in high school, something that would distinguish Salomon from every other bond trader.

His solution was deceptively simple: Why not hire traders who were *smarter*? Traders who would treat markets as an intellectual discipline, as opposed to the folkloric, unscientific Neanderthals who traded from their bellies? Academia was teeming with nerdy mathematicians who had been publishing unintelligible dissertations on markets for years. Wall Street had started to hire them, but only for research, where they'd be out of harm's way. On Wall Street, the eggheads were stigmatized as "quants," unfit for the man's game of trading. Craig Coats, Jr., head of government-bond trading at Salomon, was a type typical of trading floors: tall, likable, handsome, bound to get along with clients. Sure, he had been a goof-off in college, but he had played forward on the basketball team, and he had trading in his heart. It was just this element of passion that Meriwether wanted to eliminate; he preferred the cool discipline of scholars, with their rigorous and highly quantitative approach to markets.

Most Wall Street executives were mystified by the academic world, but Meriwether, a math teacher with an M.B.A. from Chicago, was comfortable with it. *That would be his edge.* In 1983, Meriwether called Eric Rosenfeld, a sweet-natured MIT-trained Harvard Business School assistant professor, to see if Rosenfeld could recommend any of his students. The son of a modestly successful Concord, Massachusetts, money manager, Rosenfeld was a computer freak who had already been using quantitative methods to make investments. At Harvard, he was struggling.<sup>7</sup> Laconic and dry, Rosenfeld was compellingly bright, but he was less than commanding in a classroom. At a distance, he looked like a thin, bespectacled mouse. The students were tough on him; "they beat the shit out of him," according to a future colleague. Rosenfeld, who was grading exams when Meriwether called and was making, as he recalled, roughly \$30,000 a year, instantly offered to audition for Salomon himself. Ten days later, he was hired.<sup>8</sup>

Meriwether didn't stop there. After Rosenfeld, he hired Victor J. Haghani, an Iranian American with a master's degree in finance from the London School of Economics; Gregory Hawkins, an Arkansan who had helped run Bill Clinton's campaign for state attorney general and had then gotten a Ph.D. in financial economics from MIT; and William Krasker, an intense, mathematically minded economist with a Ph.D. from—once again—MIT and a colleague of Rosenfeld at Harvard. Probably the nerdiest, and surely the smartest, was Lawrence Hilibrand, who had *two* degrees from MIT. Hilibrand was hired by Salomon's research department, the traditional home of quants, but Meriwether quickly moved him into the Arbitrage Group, which, of course, was the heart of the future Long-Term Capital.

The eggheads immediately took to Wall Street. They downloaded into their computers all of the past bond prices they could get their hands on. They distilled the bonds' historical relationships, and they modeled how these prices should behave in the future. And then, when a market price somewhere, somehow got out of line, the computer models told them.

The models didn't *order* them to trade; they provided a contextual argument for the human computers to consider. They simplified a complicated world. Maybe the yield on two-year Treasury notes was a bit closer than it ordinarily was to the yield on ten-year bonds; or maybe the spread between the two was unusually narrow, compared with a similar spread for some other country's paper. The models condensed the markets into a pointed inquiry. As one of the group said, "Given the state of things around the world—the shape of yield curves, volatilities, interest rates—are the financial markets making statements that are inconsistent with each other?" This is how they talked, and this is how they thought. Every price was a "statement"; if two statements were in conflict, there might be an opportunity for arbitrage.

The whole experiment would surely have failed, except for two happy circumstances. First, the professors *were* smart. They stuck to their knitting, and opportunities were plentiful, especially in newer markets such as derivatives. The professors spoke of opportunities as *inefficiencies*; in a perfectly efficient market, in which all prices were correct, no one would have anything to trade. Since the markets they traded in were still evolving, though, prices were often incorrect and there were opportunities aplenty. Moreover, the professors brought to the job an abiding credo, learned from academia, that over time, *all* markets tend to get more efficient.

In particular, they believed, spreads between riskier and less risky bonds would tend to narrow. This followed logically because spreads reflect, in part, the *uncertainty* that is attached to chancier assets. Over time, if markets did become more efficient, such riskier bonds would be less volatile and therefore more certain-seeming, and so the premium demanded by investors would tend to shrink. In the early 1980s, for instance, the spreads on swaps—a type of derivative trade, of which more later—were 2 percentage points. “They looked at this and said, ‘It can’t be right; there can’t be that much risk,’” a junior member of Arbitrage recalled. “They said, ‘There is going to be a secular trend toward a more efficient market.’”

And swap spreads did tighten—to 1 percentage point and eventually to a quarter point. All of Wall Street did this trade, including the Salomon government desk, run by the increasingly wary Coats. The difference was that Meriwether’s Arbitrage Group did it in *very* big dollars. If a trade went against them, the arbitrageurs, especially the ever-confident Hilibrand, merely redoubled the bet. Backed by their models, they felt more *certain* than others did—almost invincible. Given enough time, given enough capital, the young geniuses from academe felt they could do no wrong, and Meriwether, who regularly journeyed to academic conferences to recruit such talent, began to believe that the geniuses were right.

That was the second happy circumstance: the professors had a protector who shielded them from company politics and got them the capital to trade. But for Meriwether, the experiment *couldn’t* have worked; the professors were simply too out of place. Hilibrand, an engineer’s son from Cherry Hill, New Jersey, was like an academic version of Al Gore; socially awkward, he answered the simplest-seeming questions with wooden and technical—albeit mathematically precise—replies. Once, a trader not in the Arbitrage Group tried to talk Hilibrand out of buying and selling a certain pair of securities. Hilibrand replied, as if conducting a tutorial, “But they are priced so *egregiously*.” His colleague, accustomed to the profane banter of the trading floor, shot back, “I was thinking the same thing—‘egregiously!’” Surrounded by unruly traders, the arbitrageurs were quiet intellectuals. Krasker, the cautious professor who built many of the group’s models, had all the charisma of a tabletop. Rosenfeld had a wry sense of humor, but in a firm in which many of the partners hadn’t gone to college, much less graduate school at MIT, he was shy and taciturn.

Meriwether had the particular genius to bring this group to Wall Street—a move that Salomon’s competitors would later imitate. “He took a bunch of guys who in the corporate world were considered freaks,” noted Jay Higgins, then an investment banker at Salomon. “Those guys would be playing with their slide rules at Bell Labs if it wasn’t for John, and they knew it.”<sup>9</sup>

The professors were brilliant at reducing a trade to pluses and minuses; they could strip a ham sandwich to its component risks; but they could barely carry on a normal conversation. Meriwether created a safe, self-contained place for them to develop their skills; he adoringly made Arbitrage into a world apart. Because of Meriwether, the traders fraternized with one another, and they didn’t feel the need to fraternize with anyone else.

Meriwether would say, “We’re playing golf on Sunday,” and he didn’t have to add, “I’d like you to be there.” The traders who hadn’t played golf before, such as Hilibrand and Rosenfeld, quickly learned. Meriwether also developed a passion for horses and acquired some thoroughbreds; naturally, he took his traders to the track, too. He even shepherded the gang and their spouses to Antigua every year. He didn’t want them just during trading hours, he wanted all of them, all the time. He nurtured

his traders, all the while building a protective fence around the group as sturdy as the red board fence in Rosemoor.

Typical of Meriwether, he made gambling an intimate part of the group's shared life. The arbitrageurs devised elaborate betting pools over golf weekends; they bet on horses; they took day trips to Atlantic City together. They bet on elections. They bet on anything that aroused their passion for odds. When they talked sports, it wasn't about the game; it was about the *point spread*.

Meriwether loved for his traders to play liar's poker, a game that involves making poker hands from the serial numbers on dollar bills. He liked to test his traders; he thought the game honed their instincts, and he would get churlish and threaten to quit when they played poorly. It started as fun, but then it got serious; the traders would play for hours, occasionally for stakes in the tens of thousands of dollars. Rosenfeld kept an envelope stuffed with hundreds of single bills in his desk. Then, when it seemed that certain bills were cropping up too often, they did away with bills and got a computer to generate random lists of numbers. The Arbitrage boys seemed addicted to gambling: "You could never go out to dinner with J.M.'s guys without playing liar's poker to see who would pick up the check," Gerald Rosenfeld, Salomon's chief financial officer, recalled. Meriwether was a good player, and so was Eric Rosenfeld (no relation), who had an inscrutable poker face. The straight-arrow Hilibrand was a bit too literal. He was incapable of lying and for a long time never bluffed; mustachioed and eerily intelligent, he had a detachment that was almost extrahuman. Once, when asked whether it was awkward to have a wife who worked in mortgages (which Hilibrand traded), he answered flatly, "Well, I never talk to my wife about business."

The Arbitrage Group, about twelve in all, became incredibly close. They sat in a double row of desks in the middle of Salomon's raucous trading floor, which was the model for the investment bank in Tom Wolfe's *The Bonfire of the Vanities*. Randy Hiller, a mortgage trader in Arbitrage, found its cliquish aspect overbearing and left. Another defector was treated like a traitor; Meriwether vengefully ordered the crew not to even golf with him. But very few traders left, and those who remained all but worshiped Meriwether. They spoke of him in hushed tones, as of a Moses who had brought their tribe to Palestine. Meriwether didn't exactly return the praise, but he gave them something more worthwhile. His interest and curiosity stimulated the professors; it challenged them and made them better. And he rewarded them with heartfelt loyalty. He never screamed, but it wouldn't have mattered if he had. To the traders, the two initials "J.M."—for that was his unfailing sobriquet—were as powerful as any two letters could be.

Though he had a private office upstairs, Meriwether usually sat on the trading floor, at a tiny desk squeezed in with the others. He would chain-smoke while doing Eurodollar trades, and supervise the professors by asking probing questions. Somehow, he sheathed great ambition in an affecting modesty. He liked to say that he never hired anyone who wasn't smarter than he was. He didn't talk about himself, but no one noticed because he was genuinely interested in what the others were doing. He didn't build the models, but he grasped what the models were saying. And he trusted the models because *his* guys had built them. One time, a trader named Andy who was losing money on a mortgage trade asked for permission to double up, and J.M. gave it rather offhandedly. "Don't you want to know more about this trade?" Andy asked. Meriwether's trusting reply deeply affected the trader. J.M. said, "My trade was when I hired you."

Meriwether had married Mimi Murray, a serious equestrian from California, in 1981, and the two of them lived in a modest two-bedroom apartment on York Avenue on the Upper East Side. They wanted children, according to a colleague, but remained childless.

Aside from Mimi, J.M.'s family was Salomon. He didn't leave his desk even for lunch; in fact, his noontime was as routinized as the professors' models. Salomon did a china-service lunch, and for a long time, every day, a waiter would waft over to Meriwether bearing a bologna sandwich on white bread, two apples, and a Tab hidden under a silver dome. J.M. would eat one of the apples and randomly offer the other to one of the troops as a sort of token. The rest of the gang might order

Chinese food, and if any sauce leaked onto his desk, J.M., his precious territory violated, would scowl and say, “Look, I guess I’m going to have to give up my desk and go back to my office and work there.”

A misfit among Wall Street’s Waspish bankers, J.M. identified more with the parochial school boys he had grown up with than with the rich executives whose number he had joined. Unlike other financiers in the roaring eighties, who were fast becoming trendy habitués of the social pages, Meriwether disdained attention (he purged his picture from Salomon’s annual report) and refused to dine on any food that smacked of French. When in Tokyo, he went to McDonald’s. Ever an outsider, he molded his group into a tribe of outsiders as cohesive, loyal, and protective as the world he had left in Rosemoor. His cohorts were known by schoolboy nicknames such as Vic, the Sheik, E.R., and Hawk.

Although J.M. knew his markets, his reputation as a trader was overwrought. His real skill was in shaping people, which he did in singularly understated style. He was awkward when speaking to a group; his words came out in uneven bunches, leaving others to piece together their meaning.<sup>10</sup> But his confidence in his troops was written on his face, and it worked on their spirits like a tonic. Combined with the traders’ uncommon self-confidence, Meriwether’s faith in them was a potent but potentially combustible mix. It inflated their already supreme self-assurance. Moreover, J.M.’s willingness to bankroll Hilibrand and the others with Salomon’s capital dangerously conditioned the troops to think that they would always have access to more.

As Arbitrage made more money, the group’s turf inevitably expanded. Meriwether, eclipsing rivals such as Coats, gained command over all bond trading, including government bonds, mortgages, high-yield corporate bonds, European bonds, and Japanese warrants. It seemed logical, for the group to apply its models in new and greener pastures. But others in Salomon began to seethe. J.M. would send one of his boys—Hilibrand or Victor Haghani—to Salomon’s London office or its Tokyo office, and the emissary would declare, “This trade is very good, but you should be ten times bigger in it.” Not two times, but *ten* times! As if they *couldn’t* fail. Hilibrand and Haghani were in their twenties, and they might be talking to guys twice their age. Then they started to say, “Don’t do this trade; we’re better at this than anyone else, so we’ll do all of this trade on the arbitrage desk.”

Hilibrand was particularly annoying. He was formal and polite, but he struck old hands as condescending, infuriating them with his mathematical certitude. One time, he tried to persuade some commodity traders that they should bet on oil prices following a pattern similar to that of bond prices. The traders listened dubiously while Hilibrand bobbed his head back and forth. Suddenly he raised a hand and sonorously declaimed, “Consider the following hypothesis.” It was as if he were delivering an edict from on high, to be etched in stone.

Traders had an anxious life; they’d spend the day shouting into a phone, hollering across the room, and nervously eyeballing a computer screen. The Arbitrage Group, right in the middle of this controlled pandemonium, seemed to be a mysterious, privileged subculture. Half the time, the boys were discussing trades in obscure, esoteric language, as if in a seminar; the other half, they were laughing and playing liar’s poker. In their cheap suits and with their leisurely mien, they could seemingly cherry-pick the best trades while everyone else worked at a frenetic pace.

The group was extremely private; it seemed to have adopted J.M.’s innate secretiveness as a protective coloring. Though any trader is well advised to be discreet, the professors’ refusal to share any information with their Salomon colleagues fueled the resentment felt by Coats and others. Though Arbitrage soaked up all of the valuable tidbits that passed through a premier bond-trading floor, it set up its own private research arm and strictly forbade others in Salomon to learn about its trades. One time, the rival Prudential-Bache hired away a Salomon mortgage trader, which was considered a coup. “What was the first thing he wanted?” a then-Pru-Bache manager laughingly remembered. “Analytics? Better computer system or software? No. He wanted locks on the filing cabinet. It reflected their mentality!” Driven by fanatical loyalty to Meriwether, the Arbitrage Group nurtured an us-against-them clannishness that would leave the future Long-Term dangerously remote

from the rest of Wall Street. Hilibrand became so obsessed with his privacy that he even refused to let Salomon Brothers take his picture.<sup>11</sup>

As other areas of Salomon floundered, Arbitrage increasingly threw its weight around. Hilibrand pressed the firm to eliminate investment banking, which, he argued with some justification, took home too much in bonuses and was failing to carry its weight. Then he declared that Arbitrage shouldn't have to pay for its share of the company cafeteria, because the group didn't eat there. True to his right-wing, libertarian principles, Hilibrand complained about being saddled with "monopoly vendors," as if every trader and every clerk should negotiate his own deal for lunch. The deeper truth was that Hilibrand and his mates in Arbitrage had little respect for their mostly older Salomon colleagues who worked in other areas of the firm. "It was like they were a capsule inside a spaceship," Higgins said of J.M.'s underlings. "They didn't breathe the air that everybody else did."

Hilibrand and Rosenfeld continually pressed J.M. for more money. They viewed Salomon's compensation arrangement, which liberally spread the wealth to all departments, as socialistic. Since Arbitrage was making most of the money, they felt, they and they alone should reap the rewards.

In 1987, the raider Ronald Perelman made a hostile bid for Salomon. Gutfreund feared, with ample justification, that if Perelman won, Salomon's reputation as a trusted banker would go down the tubes (indeed, Salomon's corporate clients could likely find themselves on Perelman's hit list). Gutfreund fended Perelman off by selling control of the firm to a distinctly friendly investor, the billionaire Warren Buffett. Hilibrand, who weighed everything in mathematical terms, was incensed over what he reckoned was a poor deal for Salomon. The twenty-seven-year-old Wunderkind, though unswervingly honest himself, couldn't see that an intangible such as Salomon's ethical image was also worth a price. He actually flew out to Omaha to try to persuade Buffett, now a member of Salomon's board, to sell back his investment, but Buffett, of course, refused.

J.M. tried to temper his impatient young Turks and imbue them with loyalty to the greater firm. When the traders' protests got louder, J.M. invited Hilibrand and Rosenfeld to a dinner with William McIntosh, an older partner, to hear about Salomon's history. A liberal Democrat in the Irish Catholic tradition, J.M. had a stronger sense of the firm's common welfare and a grace that softened the hard edge of his cutthroat profession. He shrugged off his lieutenants' occasional cries that Arbitrage should separate from Salomon. He would tell them, "I've got loyalty to people here. And anyway, you're being greedy. Look at the people in Harlem." He pressed Salomon to clean house, but not without showing concern for other departments. Thoughtfully, when the need arose, he would tell the chief financial officer, "We have a big trade on; we could lose a lot—I just want you to know." In the crash of 1987, Arbitrage did drop \$120 million in one day.<sup>12</sup> Others at Salomon weren't sure quite what the group was doing or what its leverage was, but they instinctively trusted Meriwether. Even his rivals in the firm liked him. And then it all came crashing down.

Pressed by his young traders, who simply wouldn't give up, in 1989 Meriwether persuaded Gutfreund to adopt a formula under which his arbitrageurs would get paid a fixed, 15 percent share of the group's profits. The deal was cut in secret, after Hilibrand had threatened to bolt.<sup>13</sup> Typically, J.M. left himself out of the arrangement, telling Gutfreund to pay him whatever he thought was fair. Then Arbitrage had a banner year, and Hilibrand, who got the biggest share, took home a phenomenal \$23 million. Although Hilibrand modestly continued to ride the train to work and drive a Lexus, news of his pay brought to the surface long-simmering resentments, particularly as no other Salomon department was paid under such a formula. As Charlie Munger, Buffett's partner and a Salomon director, put it, "The more hyperthyroid at Salomon went stark, raving mad."

In particular, a thirty-four-year-old trader named Paul Mozer was enraged. Mozer had been part of Arbitrage, but a couple of years earlier he had been forced to leave that lucrative area to run the government desk. Mozer had a wiry frame, close-set eyes, and an intense manner. In 1991, a year after the storm over Hilibrand's pay, Mozer went to Meriwether and made a startling confession:



he had submitted a false bid to the U.S. Treasury to gain an unauthorized share of a government-bond auction.

Stunned, Meriwether asked, “Is there anything else?” Mozer said there wasn’t.

Meriwether took the matter to Gutfreund. The pair, along with two other top executives, agreed that the matter was serious, but they somehow did nothing about it. Although upset with Mozer, Meriwether stayed loyal to him. It is hard to imagine the clannish, faithful J.M. doing otherwise. He defended Mozer as a hard worker who had slipped but once and left him in charge of the government desk. This was a mistake—not an ethical mistake but an error in judgment brought on by J.M.’s singular code of allegiance. In fact, Mozer was a volatile trader who—motivated more by pique than by a realistic hope for profit—had repeatedly and recklessly broken the rules, jeopardizing the reputation of Meriwether, his supervisor, and the entire firm. It must be said that Mozer’s crime had been so foolish as to be easily slipped by his superiors. Quite naturally, Meriwether, now head of Salomon’s bond business, hadn’t thought to inquire if one of his traders had been lying to the U.S. Treasury. But J.M.’s lenience after the fact is hard to fathom. A few months later, in August, Salomon discovered that Mozer’s confession to Meriwether had itself been a lie, for he had committed numerous other infractions, too. Though now Salomon did report the matter, the Treasury and Fed were furious. The scandal set off an uproar seemingly out of proportion to the modest wrongdoing that had inspired it.<sup>14</sup> No matter; one simply did not—could not—deceive the U.S. Treasury. Gutfreund, a lion of Wall Street, was forced to quit.

Buffett flew in from Omaha and became the new, though interim, CEO. He immediately asked the frazzled Salomon executives, “Is there any way we can save J.M.?” Meriwether, of course, was the firm’s top moneymaker and known as impeccably ethical. His traders heatedly defended him, pointing out that J.M. had immediately reported the matter to *his* superior. But pressure mounted on all involved in the scandal. McIntosh, the partner who had first brought Meriwether into Salomon, trekked up to J.M.’s forty-second-floor office and told him that he should quit for the good of the firm. And almost before the Arbitrage Group could fathom it, their chief had resigned. It was so unexpected, Meriwether felt it was surreal; moreover, he suffered for being front-page news. “I’m a fairly shy, introspective person,” he later noted to *Business Week*.<sup>15</sup> The full truth was more bitter: J.M. was being pushed aside—even implicitly blamed—despite, in his opinion, having done no wrong. This painful dollop of limelight made him even more secretive, to Long-Term Capital’s later regret. Meanwhile, within the Arbitrage Group, resurrecting J.M. became a crusade. Hilibrand and Rosenfeld kept J.M.’s office intact, with his golf club, desk, and computer, as if he were merely on an extended holiday. Deryck Maughan, the new CEO, astutely surmised that as long as this shrine to J.M. remained, J.M. was alive as his potential rival. Sure enough, a year later, when Meriwether resolved his legal issues stemming from the Mozer affair, Hilibrand and Rosenfeld, now the heads of Arbitrage and the government desk, respectively, lobbied for J.M.’s return as co-CEO.\*

Maughan, a bureaucrat, was too smart to go for this and tried to refashion Salomon into a global, full-service bank, with Arbitrage as a mere department. Hilibrand, who was dead opposed to this course, increasingly asserted himself in J.M.’s absence. He wanted Salomon to fire its investment bankers and retrench around Arbitrage. Meanwhile, he made a near-catastrophic bet in mortgages and fell behind by \$400 million. Most traders in that situation would have called it a day, but Hilibrand was just warming up; he coolly proposed that Salomon double its commitment! Because Hilibrand believed in his trade so devoutly, he could take pain as no other trader could. He said that the market was like a Slinky out of shape—eventually it would spring back. It was said that only once had he ever suffered a permanent loss, a testament to the fact that he was not a gambler. But his supreme conviction in his own Tightness cried out for some restraining influence, lest it develop a reckless edge.

Doubling up was too much, but management let Hilibrand keep the trade he had. Eventually, it *was* profitable, but it reminded Salomon’s managers that while Hilibrand was critiquing various

departments as being so much extra baggage, Arbitrage felt free to call on Salomon's capital whenever it was down. The executives could never agree on just how much capital Arbitrage was tying up or how much risk its trades entailed, matters on which the dogmatic Hilibrand lectured them for hours. In short, how much—if, sometime, the Slinky did not bounce back—could Arbitrage potentially lose? Neither Buffett nor Munger ever felt quite comfortable with the mathematical tenor of Hilibrand's replies.<sup>16</sup> Buffett agreed to take J.M. back—but not, as Hilibrand wanted, to trust him with the entire firm.

Of course, there was no way Meriwether would settle for such a qualified homecoming. The Mozer scandal had ended any hope that J.M. would take his place at the top of Salomon, but it had sown the seeds of a greater drama. Now forty-five, with hair that dipped in a wavy, boyish arc toward impenetrable eyes, J.M. broke off talks with Salomon. He laid plans for a new and independent arbitrage fund, perhaps a hedge fund, and he proceeded to raid the Arbitrage Group that he had, so lovingly, assembled.

\* In practical terms, those who go short sell a security they have borrowed. They must return the security later—by which time, they believe, the price will have declined. The principle of buying cheap and selling dear still holds. Short sellers merely reverse the order: sell dear, *then* buy cheap.

\* The Securities and Exchange Commission filed a civil complaint charging that Meriwether had failed to properly supervise Mozer. Without admitting or denying guilt, Meriwether settled the case, agreeing to a three-month suspension from the securities industry and a \$50,000 fine.

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