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BOOK REVIEW

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THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE

Michael Lewis
(*Reviewed by*
Craig W. French for the JOIM, March 2016)

Around 1990 I came across a delightful book, "Liar's Poker", by Michael Lewis. This story nudged my interest in the field of finance. After reading it, I took on an internship for a wonderfully contrarian gentleman, Jim Fraser, a local financial advisor and money manager. Perhaps more importantly (and luckily for me), Jim was a publisher of previously out-of-print Wall Street books in my hometown of Burlington, Vermont. "Liar's Poker" had only recently been published, yet it was as compelling as the collection of rare antiquarian books with which Jim paid me for the internship. And so in a sense, I have Michael Lewis to thank for inspiring me to drive my old Land Rover to Philadelphia in the fall of 1992 to study finance at the Wharton School.

While Penn professors taught me about MPT, CAPM, Black Scholes and all that, one day on a whim—back when the Penn bookstore was located in the space now occupied by Huntsman Hall—I purchased a copy of Richard Thaler's "The Winner's Curse". This book introduced me to several anomalies and paradoxes of economics, as well as to the subject of behavioral finance generally. By 1999 I was working at Goldman Sachs in the Asset Management Division, and that year Professor Thaler predicted in his AIMR Perspectives article "The End of Behavioral Finance" that "...in the not-too-distant future, the term 'behavioral finance' will be correctly viewed as a redundant phrase." He was correct ...although perhaps just a little early.

In 2012 I had been working in the alternative asset management industry for more than a decade and had interviewed hundreds of hedge fund managers as part of my firm's due diligence process. It felt comfortable to read Lewis' latest book, "The Big Short"; like a baseball player might feel reading "Moneyball", I suppose. Many of the stories and characters were familiar to me. I enjoyed an insider's view as I read this easily digestible tale about the financial collapse of 2007–09. And in 2015, a quarter century after I first read Lewis' blockbuster "Liar's Poker", The Big Short came out as a Hollywood movie. The Paramount film recently won the Oscar Award for Best Writing, Adapted Screenplay. The big treat, for me, in the film

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was seeing Professor Thaler cast alongside Selena Gomez in a dual cameo, explaining synthetic CDOs in a casino through a simple analogy: a $10 million blackjack bet and the hot hand fallacy.

"The Big Short"—both the book and the movie—treats us to Michael Lewis' familiar and entertaining storytelling style. We learn how the overvalued real estate market in the U.S. led to the financial crisis of 2008. The crisis was fueled by an overheated market in mortgage bonds and their derivatives, including collateralized debt obligations and credit default swaps. It led to the destruction of nearly $2 trillion of wealth. The story is told through the lens of several hedge funds who took "Big Short" positions by buying credit default swaps. The protagonists include former Oppenheimer analyst Steve Eisman of FrontPoint (renamed "Mark Baum" and played by Steve Carell in the film), Michael Burry at Scion Capital (played by Christian Bale in the film), Greg Lippmann at Deutsche Bank (renamed "Jared Vennett" and played by Ryan Gosling in the film), and Charles Ledley and Jamie Mai at Cornwall Capital (renamed "Charlie Geller" and "Jamie Shipley" and played by John Magaro and Finn Wittrock, respectively).

However, John Paulson, arguably the biggest short of them all on this particular macro thematic trade, is not a primary character in the story at all. Paulson's story is well known, and was documented in Greg Zuckerman's book "The Greatest Trade Ever". The quality of "The Big Short" does not suffer from the omission of Paulson's story, in my view.

Secondary, less fortunate characters also appear: One is Howie Hubler of Morgan Stanley's Global Proprietary Credit Group, who bought $2 billion of CDS on Alt-A CDOs while writing $16 billion of CDS on AAA CDOs, leading to the largest trading loss in history, of $9 billion. This was nearly twice the loss later incurred by J.P. Morgan's "London Whale", Bruno Iksil in 2012 as well as twice the loss earlier incurred when genius failed at LTCM in 1998. Also featured, less than admirably, is Wing Chau of Harding Advisory LLC, a CDO manager that was later charged by the SEC with allowing the hedge fund Magnetar to effectively select collateral for the CDO Octans I, structured and marketed by Merrill Lynch, while taking short positions on the mortgage-backed securities in Octans I. The CDO failed in April 2008, leaving investors with $1.1 billion in losses. Merrill's current parent company BofA later paid $132 million to resolve claims that the company misled investors about Magnetar's role in two CDOs, including Octans I. Chau unsuccessfully sued Lewis in 2011, claiming that the book portrayed him and other CDO managers as "crooks or morons," and suggested he was incompetent.

"The Big Short" is a story about underdogs who beat the system at the expense of investment banks. They are smart, hardworking analysts who predict the housing crash and profit from the economic collapse. The film in particular does an excellent job with its exposition of the "blind" S&P ratings analyst (pointing to the skewed incentives of agencies being paid by the companies they rate) and the mate-searching SEC staffer (illustrating the "revolving door" in the career paths of government regulators and the industry they later join). Some aspects of the film are clearly the fictions of Hollywood, such as the scene in which Goldman Sachs employees whisper to each other while meeting with Mike Burry in a Goldman conference room—rude protocol that I never witnessed during my own time working at the firm, and not part of their "culture of success". Another farfetched scene is when Greg Lippmann explains MBS to the

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Front Point team with a Jenga game, come on! Although I have to admit, it is a fun scene to watch if you can just suspend your disbelief for a few minutes. On the other hand, I thought some other devices in the film worked well, including the cameos of Margot Robbie in a bubble bath explaining mortgage bonds, Anthony Bourdain in the kitchen explaining CDOs, and Richard Thaler with Selena Gomez in a casino explaining synthetic CDOs.

Reflecting, it is not clear to me that the actions of Dr. Burry at Scion were ethical—although he was portrayed as a hero, we have to ask ourselves, "Do the ends justify the means?" When a hedge fund manager tells investors they will do one thing (invest in stocks) and then does another (bets the house on custom-made CDS from investment banks), and gates the fund when irate investors want their money back, this is simply wrong, regardless of accuracy in the investment thesis. Dr. Burry wrote in a 2010 New York Times op-ed that "By mid-2005, I had so much confidence in my analysis that I staked my reputation on it. ...I purchased credit default swaps... on billions of dollars' worth of both subprime mortgage-backed securities and the bonds... Suspecting that my Wall Street counterparties might not be able or willing to pay up when the time came, I used six counterparties to minimize my exposure to any one of them." Ask yourself, if one investment bank would not be willing to settle with a small fund like Scion, why would six provide "diversification"? It is likelier that if any of them had an incentive to renege, they all would have – indeed, they all did. Correlation benefits tend to disappear when you need them most. In fact, the banks nearly succeeded in squeezing Scion out by holding pricing stale as long as possible. The argument could be made that the main difference between Michael Burry and Howie Hubler (aside from the betting strategy) was that Burry got lucky. Neither the book nor the film make this argument.

"The Big Short" has been a #1 New York Times bestseller, was awarded The Los Angeles Times Book Award and also the Robert F. Kennedy Human Rights Book Award. The book is every bit as great of a read as Lewis' earlier masterpieces, "Liar's Poker" and "Moneyball". The film has won a host of critical awards, capped by its Academy Award for Best Adapted Screenplay in 2015. It is a great, readable (and watchable) story about the causes and roots of the financial crisis of 2008. Readers interested in a broad view of the crisis from several perspectives might also like to supplement "the Big Short" with Zuckerman's "The Greatest Trade Ever" and Sorkin's "Too Big to Fail". Congratulations to Professor Thaler in particular for his continued success in getting behavioral finance into the mainstream. I highly recommend "The Big Short"—both the book and the film—it is entertaining, illuminating and can be enjoyed by everyone.

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