

Buried in the recent Financial Crisis Inquiry Report (2011) are two observations, which when juxtaposed highlight the essential question of the financial crisis. First, the report gives a sense of the magnitude of the crisis when it quotes Ben Bernanke saying that of “13 of the most important financial institutions in the United States, 12 were at risk of failure within a period of a week or two” (p. 354). Second, with respect to subprime mortgages, the widely trumpeted cause of the crisis, the report notes that “Overall, for 2005 to 2007 vintage tranches of mortgage-backed securities originally rated triple-A, despite the mass downgrades, only about 10% of Alt-A and 4% of subprime securities had been “materially impaired”—meaning that losses were imminent or had already been suffered—by the end of 2009” (p. 228-29). Putting these two observations together is difficult. Triple-A tranches of subprime were not all worthless as has been oft asserted, quite the opposite. Yet, Bernanke essentially points out that the financial system was insolvent. How can these two facts be reconciled?

The two books reviewed here do not answer this question. But, they make progress. Their take is that a small band of wacky outsider characters were able to see the coming crash and profit from it, while greedy, corrupt, Wall Street types were not. Here’s how Zuckerman puts it: “A few savvy investors—most with little relative experience in real estate, derivatives, or mortgage investing—anticipated a historic housing and financial collapse. Their remarkable success begs the obvious question: Why did this unlikely group predict the crumbling of the housing market and the resulting pain felt around the globe, even as the experts were stunned by the developments?” (p. 283). The story that is told though is more that David defeats the Wall Street Goliath, but it is how they did it that is fascinating.

The two books contain a lot of information about financial instruments and financial markets and are very successful at conveying the gestalt and some of the emotional atmospherics of the period just before and during the crisis. Both authors explain how credit default swaps work. Zuckerman also explains the appearance of the ABX index which allowed for efficient derivative trading of subprime risk. The ABX index was linked to various rated tranches of subprime securitizations. They point out that collateralized debt obligations were motivated by a need to dump triple-B rated tranches of subprime securitizations, which were otherwise hard to sell. Both authors have done an enormous amount of field work, interviewing participants, learning how financial products work, and figuring out how to convey that information. Michael Lewis, for example, lucidly explains tranching with an analogy to the

* Full disclosure: I worked as a consultant for AIG Financial Products from 1996-2008 and know various people discussed in these two books.
floors of a skyscraper—“The buyer of the second tranche—the second story of the skyscraper. . .”, making trancheable easily understandable. So, for readers who want an introduction to some of the intricacies of capital markets that have developed over the last thirty years, these books both do a commendable job introducing and explaining financial products and markets to readers.

Perhaps more importantly the authors get readers who have never been on a trading floor or experienced the gut-wrenching high and lows of risk close to the action. Most people have no direct experience of risks in financial markets and know little of how trading and structuring is done. There are many “risks” other than the standard deviation of returns. Academics now are starting to think about “risk” in the context of financial markets; see, e.g., Lo et al. (2005) and Bossaerts (2009). In these books the fear and exhilaration jumps off the pages.

The two books cover many of the same characters. There is Michael Burry, the Stanford-trained doctor with Asperger’s syndrome who becomes a hedge fund operator after picking stocks on the side during his residency. And there is Greg Lippmann, a flamboyantly dressing Deutsche Bank trader, who takes his message that the subprime market is going to crash outside his bank because inside they don’t believe him. In Lewis’ book, there is a hilarious scene when Lippmann goes to hedge fund operator Steve Eisman’s office for the first time and alludes to how much he is paid (see p. 63). Zuckerman’s book focuses on John Paulson who ran a small-time, seemingly lost, hedge fund, until he figures out that the subprime market is vulnerable if house prices do not rise. He figures this out with the help of Paolo Pellegrini, a down-on-his-luck former HBS classmate. Pellegrini had been fired from two previous banking jobs and divorced twice. Paulson, a hard party-goer until he marries his administrative assistant, once rids his bike thirty miles to a meeting. And there are other characters as well.

Zuckerman spent 50 hours interviewing Paulson, who makes a fortune on his trades during the crisis and becomes a star. Lewis apparently did not have access to Paulson and focuses on Steve Eisman, a curmudgeonly hedge fund operator. The dramatis personae who are the heroes are lovingly portrayed with all their foibles and quirks. Wall Street banker types are never presented as individual people. They are in the background, grouped together as “Wall Street,” doing stupid, greedy things.

You feel badly for some of these characters. Michael Burry struggles with a glass eye and Asperger’s syndrome. “His glass eye, he assumed, was the reason that face-to-face interaction with other people almost always ended badly for him” (Lewis, p. 32). When we starts to put on short subprime trades, his investors turn against him, and even when he is finally succeeding with his hedge fund, his investors are hostile. He becomes embittered and seems to believe that he never got his due even today. Same with Pellegrini, as Zuckerman describes here:

In January 2008, Paulson and Pellegrini visited Harvard University, their alma mater. Pellegrini was excited about the trip and looked forward to explaining to the students how the firm had anticipated the credit crisis. But when they got there and the class settled into their seats, Paulson approached the dais and addressed the group by himself, while Pellegrini watched from the back of the room. Later, Pellegrini helped his boss answer some questions from students, but it stung Pellegrini that he wasn’t invited
to address the class. Paulson’s shadow never seemed so huge. “It was humiliating to me,” Pellegrini recalls. (p. 261-62)

Similarly, Deutsche Bank executives and other traders ridicule Lippmann’s ideas about subprime collapsing, snickering and laughing at him. The moral that minority viewpoints should be protected, even if it comes from an odd person, seems like the lesson, although this seems difficult for large organizations.

Zuckerman is the more clinical of the two authors, describing Paulson’s trades in a bit of detail, while Lewis extols the anti-social habits of his characters, as if this explains how they came to have their insights. The characters in the books are entertaining and interesting people. But, I don’t think it’s true that they saw something that others did not. Many saw the coming crisis. This was the subject of intense debate, starting in 2005. But, they made money and others lost money.

There are some mistakes in the books, differentiating between realized losses and mark-downs, and some names are misspelled. A bigger problem is that the losers are not in the story. The losers probably didn’t want to tell their stories. They are the hedge funds that got in too early and lost money. There are the institutions that were on the other side of the short trades of Paulson and the others. And there’s the banks themselves who also have stories to tell, but they will never be told. My perspective on this—and all else here— is no doubt colored by my experience at AIG Financial Products, where I was a consultant for twelve years starting in 1996. My views on the crisis, poorly narrated compared to these books, are in my book *Slapped by the Invisible Hand: The Panic of 2007*.

Some of the most interesting material in the books concerns how hedge funds operate. Opening a hedge fund is problematic. The founder has a secret. Either the secret is that the founder has no new ideas. Or, the founder’s secret is a new idea. If the founder has no new idea, that cannot be revealed. If the founder has an original idea, he also can’t share it with investors because they might steal it. “Competitors might figure out the trade for themselves and buy the same insurance, driving up the cost. That made Paulson reluctant to provide details of his trade. It was a stance that made it more difficult to raise money” (Zuckerman, p. 127-8). Indeed, Paulson’s friend Jeffrey Greene does steal the idea. Michael Burry has the same problem: “If I describe it enough it sounds compelling, and people think they can do it for themselves. . . If I don’t describe it enough, it sounds scary and binary and I can’t raise the capital” (Lewis, p. 58). And, when Lippmann fails to convince Deutsche Bank to put on a large short position, and goes out to spread the idea, he’s asked: “if it’s such a great idea, why don’t you set up a hedge fund . . .[and Lippmann thinks] It’d take me six months to set up a hedge fund” (Lewis, p. 93). Burry later has the related problem that he can’t intellectually convince his investors, even when he wants to explain his strategy.

Hedge funds are not long-lived firms; they are built around founding personalities, like Eisman and Paulson, and other examples in the two books. One view of this is that hedge funds attract larger-than-life personalities because somehow these people are better at taking risk. This seems to be a theme of another recent and interesting book, *More Money Than God: Hedge Funds and the Making of a New Elite*, by Sebastian Mallaby. Indeed, many hedge fund founders are portrayed in this way. But, Paulson
somehow doesn’t seem to come from this model. And, the problem of not being able to convey the secret creates the need for some way to market the hedge fund (by SEC rules hedge funds can’t publicly market themselves). Perhaps presenting yourself as a social misfit is good marketing.

The main strategy of the characters in the book is to short the subprime market using credit default swaps (CDS). The discovery that CDS could be used to short securitized subprime bonds was a major insight. In particular, Paulson and Burry got two things right. First, CDS are linked directly to bonds, not to a company, so the short can be directly linked to the risk, that subprime-related securitizations were problematic, rather than to companies that might survive a subprime blow-up. Secondly, shorting with CDS is fundamentally different from shorting stocks. Shorting stocks exposes the short-seller to enormous risks because the stock must be purchased back at some point to cover the short position, and the price might have risen a lot in the meantime. With CDS, however, there is a bound on the cost of the short and a maturity. The investor buys protection for a fixed price; it does not go up. It is a negative carry trade because the investor only makes money if the object of the insurance deteriorates, which might not happen. Still Paulson was lucky. “Paulson also had good fortune on his side: By the time he determined that the housing market was in a bubble in the spring of 2006, prices had begun to flatten out, making it the perfect time to bet against the market. Others who had come to a similar determination much earlier were licking their wounds because they had placed wagers against real estate too early and suffered as it climbed further” (Zuckerman, p. 121). Another hedge fund investor, William Ackman, got it wrong, focusing on bond insurer MBIA in 2002. “You can be totally right on an investment but wrong on the timing and lose a lot,” said Ackman (Zuckerman, p. 117).

Paulson did not see the size of the coming crisis. Nor did the others. At one point, having put on a large position, Paulson and his team thought they had made a fatal mistake because with their trades the “firm had bet against [subprime mortgages that] were handed out before 2006, and were for homes that already had appreciated in value” (emphasis added; Zuckerman, p. 159). They traded out of those positions and into later vintages, thinking they dodged a bullet. This was a widespread view, that subprime vintages prior to 2006 were much safer; it was supported by the data, as Paulson and Pellegrini found out. But, when the crisis came, there was no distinction between pre- and post-2006 vintages. Everything went down in value, including bonds linked to the earlier subprime vintages! Moreover, bonds completely unrelated to subprime risk, like triple-A bonds linked to credit card receivables, auto loans – everything went down in value! Paulson was right in targeting subprime, and he got the timing right. But, like everyone else, he got the magnitude of the crisis wrong. The tidal wave was much, much bigger than anyone expected. Thus, as late as March 2007 after house prices had already been in decline, Bernanke testified before Congress that “the problems in the subprime market were likely to be contained.”

Why did everything go down in value? That’s the question I posed at the outset. How did a small amount of subprime mortgages cause a systemic financial crisis? It remains unanswered by these authors. Zuckerman says the “guilt for the most painful economic collapse of modern times is shared by

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a long cast of sometimes unsavory characters. Ample amounts of chicanery, collusion, naiveté, downright stupidity, and old-fashioned greed compounded the damage” (p. 41). At the end of his book he says the most of the usual explanations, e.g., bonuses and “toxic products,” are simplistic and overstated. But, he has no explanation. The epilogue of Lewis’ book mentions incentives—“they’re still wrong”—but this is the first time any explanation - -other than greed and stupidity-- is put forward, and there is nothing more said. Perhaps these books came out too early for serious answers. Many observers have since come to a better, if still incomplete, understanding of what happened. The answer to what caused the crisis got short shrift in these books and so the question remains.

References

