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BOOK REVIEW

Mark Kritzman, Senior Editor

THE BIG SHORT—INSIDE THE DOOMSDAY MACHINE

By Michael Lewis
Norton, 2010, Hardcover

(*Reviewed by Javier Estrada, IESE Business School, Barcelona, Spain*)

Ever since he wrote his classic *Liar's Poker* it has been clear that Michael Lewis is a gifted writer. In *The Big Short*, his latest book, Lewis produces another entertaining and captivating story, a behind-the-scenes look at the unraveling of the credit crisis as seen through the eyes of some of its players.

Interestingly, rather than focusing on some of the market's well-known players, such as John Paulson (who made $15 billion in a single year betting against the housing market, as chronicled in Gregory Zuckerman's *The Greatest Trade Ever*), Lewis focuses on several people you most likely never heard of. These include, among others, Steve Eisman, a portfolio manager at FrontPoint; Michael Burry, founder of Scion Capital (also featured in Zuckerman's book); Greg Lippmann, a bond trader at Deutsche Bank; Jamie Mai and Charley Ledley, founders of Cornwall Capital Management; and Howie Hubler, a bond trader at Morgan Stanley.

In a nutshell, Lewis' story goes as follows: As property prices started rising at an unprecedented rate, banks started to lend money to less and less qualified borrowers. This led to the now-infamous subprime loans, most of which started with a low (teaser) rate that rose substantially after a couple of years. These loans were later packaged into mortgage bonds, and eventually repackaged into CDOs (collateralized debt obligations). The fact that the loans that made up the mortgage bonds that made up the CDOs were, *presumably*, largely uncorrelated led the rating agencies to assign investment-grade ratings to CDOs made up of lower-quality mortgage bonds. These investment-grade instruments offered returns slightly better than Treasuries, but that still made them attractive in an environment of low interest rates. Thus, banks, investment banks, and rating agencies, all encouraged by the fees obtained from the new game in town, "conspired" to keep the machine going. Until, of course, the inevitable happened.

What is the inevitable? That property prices simply could not keep increasing at unsustainable rates forever. And they did not. Eventually they started to fall, at pretty much the same time that teaser rates came to an end and much higher ones kicked in. This led to massive defaults in loans, mortgage bonds, and CDOs, and the rest is history. And part of that history is that some market players figured out that sooner or later the moment of reckoning will come and found creative ways to profit from the doom.

Michael Burry, a former resident in neurology at Stanford Hospital, was one of the very first who tried to find a way to bet against specific mortgage bonds. As luck (or lack of it) would have it, his Asperger's disease led him to an obsessive passion for reading mortgage bond prospectuses that nobody bothered to read, and eventually figured out that these bonds were bound to default as soon as the teaser-rate periods ended. He first bought \$60 million of credit default swaps (protection) in May, 2005, and by July had amassed \$750 million, all of them at prices that reflected a negligible probability of default. The market had not yet visualized the future that Burry was correctly forecasting.

Greg Lippmann, a bond trader at Deutsche Bank, went around the country presenting his "Shorting Home Equity Mezzanine Tranches" talk, in which he showed that since 2000 people whose homes rose in value between 1% and 5% a year were four times more likely to default than those whose home prices rose by 10%. In other words, prices did not even need to decrease to start a massive round of defaults; they only needed to stop rising at the pace they had been going the past few years.

Jamie Mai and Charley Ledley founded Cornwall Capital Management with \$110,000 held in a Schwab account and run the company out of a garage in Mai's Berkeley house, which doubled as Ledley's bedroom. They were some of the very first to notice that the presumed lack of correlation among the loans in a mortgage bond was an illusion, and therefore that rating a CDO better than the mortgage bonds it held inside created a tragedy waiting to happen, as well as a profit opportunity. Their insight enabled them to turn their \$110,000 into \$120 million when the market crashed.

Of course, there had to be losers on the other side of these and many other trades discussed in the book, and Lewis tells us about them too. Needless to say, AIG was in the middle of the mess through its AIG FP unit, which eventually led the Fed to extend a loan of over \$180 billion so that the company could make good on derivatives contracts with financial institutions. And so was Howie Hubler, a bond trader at Morgan Stanley, who left behind a loss of more than \$9 billion, the single largest trading loss in the history of *Wall Street*, according to Lewis.

There are obviously many more companies (inevitably, Goldman Sachs had a role to play) and people whose roles are intertwined into Lewis' story, but I will not bore you with details. I will go as far as saying that if you want to find out more about the earthquake that hit us, whose aftershocks we are still feeling (and probably will for years to come), it will be worth your time to read Lewis' account. He may not tell us the whole story, but the story he does tell us is compelling and instructive. More likely than not, Lewis has produced another classic.