The Big Short- Inside the Doomsday Machine
Michael Lewis

Comforting answer to the biggest question I had: How to short this mania?

The Quicken loan ads I heard on my car radio in 2005 rattled me every time I heard them. Who could be so stupid as to make adjustable-rate loans, with no money down, resetting to God knows what rate after only two years? Whose money was being lent, and who would be so stupid as to take such a mortgage?

I have been watching the preternatural rise of home builders such as Pulte, Toll Brothers and others for several years. It made no conventional sense. Where could the demand be coming from? Now I understood. The houses were being pushed on people too naïve to know better, or with nothing to lose by buying them. It was a disaster in the making, a train wreck. In 2005 I asked my friend Denny how to short this thing. Neither of us could figure it out.

And that was as far as it went for me, the general optimist in the casual investor. I did not connect the dots to see how it would wreck the economy, or to see how to make big money on it. Other people did, and Michael Lewis tells their story in a gripping fashion. What do we learn?

Even before the application of Michael Lewis' gift for hyperbole, the players were a distinctively odd group. A one eyed victim of Asperger's syndrome who never left his home office in California, and sussed the whole thing out by pure logic. A trio of misfits from Berkeley who did not want to do anything conventional with their lives, and did the same. A couple of frenetic Jewish traders in the financial markets New York City whose wild eyed prophecy that the financial world was crashing got them branded as nuts.

What these guys did, and virtually nobody else, was to pry into the guts of the esoteric instruments that were used to financial this crisis: collateralized debt obligations (CDOs) and credit default swaps. When they got to the bottom they determined that not even they could understand them. They had the chutzpah, after many attempts and many questions, to conclude that if they couldn't understand them, and nobody could explain them, they must simply be a scam. These were guys who were willing to say that the emperor had no clothes and were willing to bet big money on it.

What the CDOs did was to bundle large groups of mortgages into a package and sell the rights to the income streams generated by those mortgages. The genius was to package them into tranches, the most risky mortgages paying a higher returns than the supposedly less risky ones. The second part of the genius was to have the rating agencies, Moody's, Standard & Poor's, and Fitch, rate these packages of debt. The rating scheme assumed that the risks of default for each individual loan were statistically independent. There would be only a 30 percent correlation between the default risk of any two loans. This to a statistician would mean that the default of one loan would only have nine percent explanatory power for the default of another loan in the package. All of this looks absurd in retrospect, but it meant that the majority of such collateralized debt packages could be AAA rated.

The coveted AAA rating meant that such loans could be held by very conservative investors, among them, it becomes clear among the smoldering ruins, a vast number of European banks, but also, to a surprising large degree, the American banks that generated this toxic mess. The executives did not understand the financial legerdemain going on at the working levels, and actually believed the ratings that their underlings had worked so assiduously to get from the poor, dumb, underpaid workers at the rating agencies.

There was tremendous incentive to keep the party going. Everybody was making money, and passing the risk downstream. These incentives led to increasingly loose criteria for originating loans. You know the terms: "Liar Loans" in which there was no credit verification, and "Ninja" loans: no income, no job, no assets. And, increasingly, adjustable-rate loans which would reset in two years. These were the Quicken loans, virtually guaranteed to go into default. Perversely, the default would mean more money for the loan originators who would at a minimum have a chance for more fees in refinancing the mortgage, and at best repossessed and resell the property. It is a process that was called at the time "Loan to Own." Make a loan in which the lender cynically projects owning the property when the borrower defaults.

Lewis's protagonists saw the impending disaster, but they had the same frustration I did, not seeing a way to short it. One could short the homebuilders, and one could short the big investment houses such as Lehman and Bear Stearns, but it was difficult to short actual mortgages, and they were the pure play. Not, however, entirely! The big investment houses had their own device for spreading risk. It is called a credit default swap. It is essentially an insurance policy. If the lenders in a certain packet of CDOs were to default above a certain rate, the insurance would pay off. AIG was the biggest of the firms to write such policies, and they wrote them only for their peers in the financial community. Retail investors need not apply.

A part of Lewis' drama is how the small players whose tales he tells managed to acquire such insurance, making this bet against the market, even though they did not own any such CDOs, in other words, did not own anything which might merit ensuring. His gift as a storyteller is to lead the casual reader through these canyons of machinations and somehow understand the journey and appreciate the suspense along the way. He also chronicles quite clearly the duplicity and self-dealing of the large financial firms, refusing ever to give the small guys a fair shake.

It was interesting to me to see that the big-name short-sellers on Wall Street, in particular Rocker partners, with whom I have had some contact, did not figure out exactly how to play this. They knew which way the market would go, but got themselves into trouble through naked shorts of Bear Stearns and Lehman Brothers. They attempted to use brute force, as opposed to the elegant approaches used by Lewis'heroes.

There is much more to the story than Lewis chooses to tell, but it would detract from his highly readable narrative and focused storyline. This product is exactly what he wanted: the kind of book that I would pick up at noon and spend until midnight finishing. A gripping story, impeccably told.