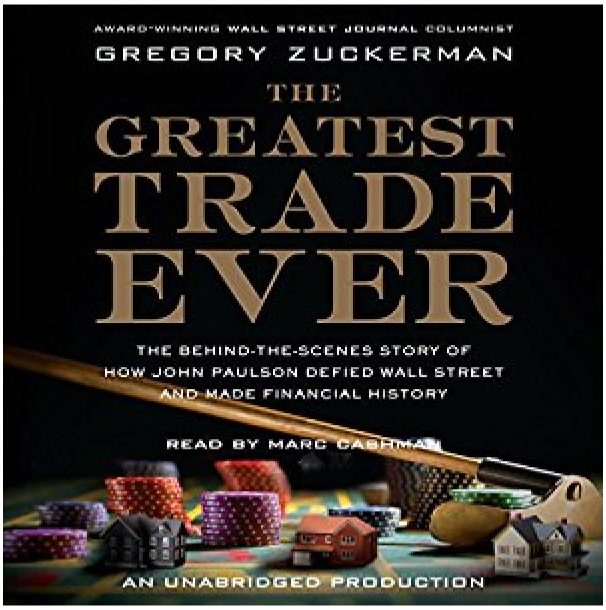
The Greatest Trade Ever: How John Paulson Defied Wall Street And Made Financial History



Synopsis

In 2006, hedge fund manager John Paulson realized something few others suspected--that the housing market and the value of subprime mortgages were grossly inflated and headed for a major fall.Â Paulson’s background was in mergers and acquisitions, however, and he knew little about real estate or how to wager against housing.Â He had spent a career as an also-ran on Wall Street. But Paulson was convinced this was his chance to make his mark. He just wasn’t sure how to do it.Â Colleagues at investment banks scoffed at him and investors dismissed him.Â Even pros skeptical about housing shied away from the complicated derivative investments that Paulson was just learning about.Â But Paulson and a handful of renegade investors such as Jeffrey Greene and Michael Burry began to bet heavily against risky mortgages and precarious financial companies. Timing is everything, though. Initially, Paulson and the others lost tens of millions of dollars as real estate and stocks continued to soar. Rather than back down, however, Paulson redoubled his bets, putting his hedge fund and his reputation on the line.Â Â Â Â In the summer of 2007, the markets began to implode, bringing Paulson early profits, but also sparking efforts to rescue real estate and derail him. By year’s end, though, John Paulson had pulled off the greatest trade in financial history, earning more than $15 billion for his firm--a figure that dwarfed George Soros’s billion-dollar currency trade in 1992.Â Paulson made billions more in 2008 by transforming his gutsy move.Â Some of the underdog investors who attempted the daring trade also reaped fortunes. But others who got the timing wrong met devastating failure, discovering that being early and right wasn’t nearly enough.Â Â Â Â Written by the prizewinning reporter who broke the story in The Wall Street Journal, The Greatest Trade Ever is a superbly written, fast-paced, behind-the-scenes narrative of how a contrarian foresaw an escalating financial crisis--that outwitted Chuck Prince, Stanley O’Neal, Richard Fuld, and Wall Street’s titans--to make financial history.From the Hardcover edition. --This text refers to the Paperback edition.

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Customer Reviews

This is an incredible book about John Paulson, and in general, the trade against the housing market. This is a great read for anyone who is interested in how an investment thesis is constructed and executed.There were two pleasant surprises of the book:1. Cast of Characters - How different investors, besides John Paulson, also saw the similar trade opportunity and went for it. As the crisis unfolded John Paulson, George Soros and a host of other investors were revealed to have been shorting the housing market. The surprise was learning about the host of other, "unknown" investors from a medical school dropout to a cocky Deutsche Bank trader to wealthy real-estate mogul to a recently graduated MBA, each of whom recognized the crisis before most others and were able to trade against the rest of the investment community.2. The transformation of John Paulson - He was initially described someone who was smart, but not as someone who always "had to be the best" or a natural leader; in other words he was not the classic alpha male. John Paulson was portrayed as a random i-banker with awkward communication skills, a weak handshake and an affinity for the NYC club scene. Many actually saw his career as stalled and unexceptional. The book is very good at showing how he transformed himself from a run of the mill finance professional to someone whose ambition grew and grew....and once he saw the opportunity he calmly executed his trade and transformed his life.(A small side note...this is also the one of the best books describing the technical terms of the housing crisis (e.g. CDS, MBS).)Finally, even though the ending is essentially known (the collapse of the housing market), the description and narrative of the sequence of events is riveting.A great read for anyone interested in finance, the markets, and the real estate crash.

"Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally." - John Maynard Keynes.If "The Big Short" theme was that Wall Street bond traders were corrupt and stupid and it was inevitable that they would blow up, "Greatest Trade Ever" covers the same ground but instead argues that it is nearly impossible to profit from a wildly out of consensus trade. Lewis opens his book with a quote by Tolstoy, which emphasizes that the experts could not be convinced because they know too much. Zuckerman instead opens with the Keynes quote above which explains why there are so few independent thinkers on Wall Street. The amazing thing about the subprime debacle was not that a few smart contrarians figured it out, but rather that so few did, and perhaps most amazing of all, the pain they endured during the process. (Although their massive, deserved riches may be a salve for those wounds).The Greatest Trade Ever is mis-named. It is not really a story about a trade, but about the fascinating few people that were able to make this trade. Zuckerman, in vivid detail, helps us to understand what drove these men to bet everything they had against the rest of the world. The book succeeds on several levels. It explains the actual mechanics of how traders spotted and profited from the subprime meltdown. On a very subtle level, it gives serious investors some amazing insights in successful investing, but it is no "how-to" book. Most important, it tells the stories of these fascinating people who rode the wave.The author compares these contrarian investors to people who climb K2 or surf Pipeline in Hawaii. In the investing world, there is no more treacherous challenge than betting against a mania. History is full of legendary investors who rode financial waves to their ruin, putting on gutsy financial trades against the crowd, only to suffer humiliating losses that sometimes haunted them for years.The author gives many examples of investors that bet against the herd and failed:Sir Isaac Newton went broke in shares of the South Sea Company, and said, "I can calculate the motions of the heavenly bodies, but not the madness of people." Legendary Value Investor Ben Graham lost 2/3 of his investments' value during the crash of 1929. Famed trader Jesse Livermore anticipated the 1929 crash and scored $100 million in profits by shorting shares. However, by 1934, he was bankrupt and six years later shot himself in the bar of the Sherry-Netherland hotel.Hedge-fund maven Michael Steinhardt, who made millions betting against overpriced stocks in the 1960s, bet against the market in the early 1990s, losing most of his clients. His bonds eventually rallied and he made $600 million for his fund. He said: "Betting against a bubble is dangerous, but it's one of the most rewarding things, it's truly a pleasure. In your mind you're going to be right ultimately; there's a certain virtue in being alone" he said afterward.A mania even beat the legendary Soros, who lost 20% in a few months on dot-com stocks. He said "the understanding of a bubble doesn't help you as an investor. Those that reach historic proportions go further than you would think." Even Peter Schiff who correctly predicted housing would stumble didn't make money because he played it wrong - underscoring the fact that an awareness of an investment bubble is only valuable when you know how to profit from it.The subprime bubble was very hard to short. Even Bill Gross bought a little CDS protection in 2006, which led to his fund trailing the rest of the pack. This made him so miserable that he had to take an unplanned 9-day vacation midway through the year, sitting around the house, sulking to his wife. "I couldn't turn on business television, I couldn't pick up the paper; it was just devastating. I couldn’t sleep at night," he said. And this is the so-called King of Bonds, a billionaire bond investor.What was the "Greatest Trade Ever?"The greatest trade ever was shorting subprime using CDS contracts on mortgage bonds. They were essentially insurance contracts on other bonds. If the bonds defaulted, you were paid. If not, you had to keep paying for the insurance, year after year.The cost was cheap relative to the upside, at only 1-2% of principal per year. But that money went out the door constantly. The amazing beauty of the trade was the way Paulson played it. He had the nerve to have $300 million a year going out the door, effectively a $14 billion bet against the rest of the world. There was a kind of divine sickness to this trade. What kind of person can do this, and do it with such overwhelming passion and greed?As if that first coup wasn’t enough, when the CDS started paying off, Paulson made massive short bets against Fannie Mae, Freddie Mac, the mortgage insurers, and even the Wall Street banks. It was the greatest trade ever followed by the second greatest ever, all in the space of 3 years. Meanwhile the rest of the world was against him - all of Wall Street, the Fed, and finally the US government.Wall Street always ultimately rips off clients in one way or another, treating them like rubes that they usually are. This just further shows the genius and sheer willpower of this trade. The client never comes out ahead when betting against Wall Street. They change the rules, make pricing opaque, take the skim, or do something to soak the clients. Yet in this amazing trade, a medium sized hedge fund with a lackluster record bet big against the crooked house playing with loaded dice and won anyway. The elegance, magnitude, sheer beauty of this coup is hard to overestimate. Even with the government taking billions from taxpayers to feather the nests of Wall Street, they were still insolvent. They were wrong, Paulson was right, and he won.The author interweaves the stories of the people that put on this trade, but he focuses most of his time on John Paulson.John Paulson.Paulson was out to earn money, even as a young kid. He used to buy packs of candy, break them up and sell the pieces individually at school for 5 cents each. Buffett did this with gum.An expert showed Paulson early in his career that adjusted for inflation, annual gains for housing were only 1.5%.Paulson had a hard time getting his fund started. "A salesman’s job starts when the customer says no," he was told. He reached out to everyone he knew, even mailing more than 500 mailers about his fund’s launch. He didn’t get a single response, even after waiving the $1 million minimum investment. Even bankers at Bear Stearns that he had worked with said no. A few didn’t even return his calls. Others set up meetings, only to cancel them. Even his old mentor wouldn’t invest. He had no luck with his successful business school peers either."I had lots of contacts and I thought money would pour in. Some people said they would give me money, but only if they got a piece of my business. It was humbling," he said.Instead, Paulson started his firm with $2 million of his own money. It took a full year to find his first client, an old friend from Bear Stearns, who gave him $500,000. The firm was just him and an assistant in a tiny office in a Park Avenue building owned by Bear Stearns and shared with other small hedge-fund clients.At times, Paulson became discouraged, because despite good (but uneven) investment performance, he still had few clients. He clung to a quote by Winston Churchill: "Never give up. Never give up."By late 1996, he still had only $16 million of assets, tiny in the hedge fund world. By the end of 1997, he had about $100 million. He lost 4% in 1998, and lost about half of his client assets, down to about $50 million by year-end.As his performance got better, investors discovered his firm. Assets surged to $3 billion in 2004. Meanwhile, Paulson turned more conservative, with plain suits, less profanity, eating healthier, gaining control over his emotions and temper.Despite his growing success, Paulson was not initially able to raise money for a new fund to short subprime. Zuckerman writes: "John Paulson’s perspective was so vastly different from that of most others on Wall Street that it was as if he had landed from a different planet." Paulson complained: "I don’t know why they don’t get it... this is the trade of a lifetime. They concluded that I was an inexperienced manager. I had to play dumb. But I got tired of people saying I was stupid or wrong."Paulson’s wife even felt the strain, asking him if he was having second thoughts. "It’s just a matter of waiting" he reassured her.The trade didn’t work for months, even after subprime started collapsing, because the firms would not mark the CDS properly. They were protecting their own books. Finally, it started working and working big! His credit fund climbed 66% in one month. Investors were incredulous and some thought it was a misprint, that it should have been 6.6%.At one point, during a meeting with two executives that wanted to buy a piece of Paulson & Company, Paulson was fidgety, like he was waiting for news. An hour into the meeting his trader Rosenberg knocked on the door, interrupting the group. He leaned into Paulson’s ear, whispering something. Then Paulson immediately rose, apologized and stepped out of the meeting. Ten minutes later, he returned, upbeat. He finally blurted out what was on his mind: "We just got our marks for the day. We made a billion dollars today."Paulson kept the trade on, because he knew it could go much further, despite almost doubling the money in the early part of the year. (Good lesson - if the trade is correct, don’t bail out too early.) Was his success enough to gain investors’ confidence in his strategy? No! A typical investor call was "If I could withdraw from your fund, I would. You’re crazy; you should realize your gains."Paulson’s funds gained $15 billion for investors in 2007. His credit funds had gains of 590% and 350%! He earned nearly $4 billion himself in that year, the largest one-year payout in the history of the financial markets.By late November 2008, Paulson had grown to manage a shocking $28 billion, making it one of the largest hedge funds on the planet. Even in that disastrous year, in which the S&P dropped 38%, he scored impressive gains of 30% for his funds. Paulson kept a low profile and still took a bus home on rainy days when he couldn't get a cab.In many ways, Paulson to this day hasn't changed; it's as if the trade never took place. He still arrives at his Manhattan office early, wearing a dark suit and a tie, and leaving around 6 p.m. for his short cab ride home. "I only need transportation to go to work in the morning and when I come home. It would be kind of a waste with nothing to do in between, as I rarely leave the office during the day," Paulson says, explaining why he doesn't have a car and driver.Paolo Pellegrini.Paolo Pellegrini was Paulson's analyst that did much of the analytical work on the short trade. He was co-manager of the credit funds. In his 40s when he started with Paulson, he was a middling performer on Wall Street until the "greatest trade ever." "I was 45 and had zero net worth," he recalls."Sometimes it's more fascinating for me to do everything on my own and recreate the wheel," he acknowledges. (Investing lesson - sometimes you can learn by going through the process) Paulson paid his about $175 million for his work in 2007. (Great pay, but pales in comparison to Paulson's $4 billion score in the same year)Rich Greene's Story.Rich Greene was a friend of Paulson, a big real estate investor, playing a "game of sexual catch-and-release with an assortment of willing women, including Russian models new to LA." He ultimately became the individual investor that made more money on a trade than any retail investor in history. The funny part is that Merrill Lynch would not let him do the trade, because they were afraid of being sued since they thought it was wrong. They relented only after he signed a form saying his trade was "unsolicited" with signatures of more than a dozen Merrill executives. (Meanwhile they were blowing up their firm betting the opposite way)He was discouraged many and nearly got out of his CDS contracts many times along the way. When the subprime bonds collapsed, but the CDS failed to go up in value, his stress multiplied. He made numerous calls to his broker, saying: "Prices have to fall - how can you not understand this - call me back - bye!" One day he ended the call crying "why? Why? WHY?"His friend, who made the same bet on a much smaller scale, said, "The truth is, when Greene thinks he's right, he puts the wad down. When I think I'm right, I'm not as sure."Finally, the trade worked, and by 2009, Greene was down to just $100 million in CDS protection, the valuable memento of a trade that netted him about $500 million in profit, one of the largest gains by an individual investor in Wall Street history.Dr. Michael Burry's story.Michael Lewis covers Dr. Burry's story in more detail than Zuckerman, but this accounting is also interesting and adds color to the other story. Dr. Burry was a trained doctor who quit medicine to do a form of value investing. He was funded by hedge fund manager Joel Greenblatt. He had excellent performance picking stocks until he drifted in style and put on the short subprime trade in size. In both Zuckerman and Lewis accounts, he is a beleaguered hero.He was raised poor, dressed in discount clothing from a local

Kmart. "I never had more than one or two friends, if that. I always was a bit of an outsider." Burry recalls.In June 2000, Greenblatt gave him a million dollars for 22.5% of the business. Burry used some of the proceeds to pay off his school loans. He started his fund, called Scion. By 2003, he was managing $250 million and making $5 million per year.After producing great performance for clients for 5 years, he put on the CDS trade and clients got impatient as he lost 18% in one year. Greenblatt demanded a face-to-face meeting with him after he announced that he would put the trades into a side pocket with a lock-up. (Only months earlier, Greenblatt had told a financial TV network that Burry was among the world's top investors.)"Cut your losses now. The trades could be a zero in the making." Actually, Greenblatt was facing his own pressures because his firm Gotham had received withdrawal requests from 20% of its investors. Days later, after meeting with Burry, Greenblatt's lawyers called Burry, threatening a lawsuit if he went through with the side pocket lock-up.Burry felt intense pressure and said at the end of 2006: "A money manager does not go from being a near nobody to being nearly universally applauded to being nearly universally vilified without some effect." (Another good lesson for hedge fund managers here: clients don't care about you at all - they only care about how much money they can make with you and if that changes, their attitudes will change. The earlier in the career that a manager learns this, the better.)Dr. Burry made it through 2007 with a gain in his funds of over 150%. His Scion fund itself grew by $700 million from gains in the year. His subprime trades had quadrupled in value, scoring gains of about $500 million over two years. He personally made about $70 million. He closed down his funds, bitter from lack of appreciation by clients.George Lippmann.George Lippmann is the Deutsche Bank bond trader that followed Burry's lead on shorting subprime by buying CDS protection. Zuckerman is much more complimentary about Lippmann than Michael Lewis was. Lewis describes him as a sleazy bond trader that took the idea from Burry and ran with it. Zuckerman goes into more detail, showing that even he had to fight to defend his contrarian opinion.Lippmann did this trade mainly for DB, and for his hedge fund clients, such as Philip Falcone of Harbinger, who did the trade after a quick one-hour pitch. (Falcone was one of the big winners of the subprime mess).Behind his back, he was called "chicken little" or "bubble boy" and even laughed at during conferences - bond traders laughed, saying, and "your crazy trade is losing money." As Michael Lewis highlighted, those with the most knowledge about the CDO bonds were the most easily duped. Lippmann began to avoid investors with deep knowledge of mortgages when he pitched his CDS trade - they were lost causes, relying on models that told them all would be fine. He ended up making large bonuses, but not nearly as much money as the others, because ironically, DB was hit with big losses on subprime.Andrew Lahde.Michael Lewis doesn't cover this interesting character, but Zuckerman does with detail.

Lahde was the manager of a very small fund that bet against subprime. He ended up making $10 million personally on the trade, quit the business, and wrote a "Jerry Maguire -like" manifesto decrying the industry and the Ivy League "idiots" that he felt he had personally outsmarted.Lahde was 35 years old when the fund he worked for shut down. He didn't rush back into work. He did apply for some jobs, but they didn't pan out because he was uninterested in junior positions.Lahde graduated from second-tier Michigan State with honors, with an interest in math and the stock markets. After college, he worked as a broker at TD Waterhouse, making only $30,000 per year as a broker. He was rejected by every business school he applied to for two years in a row. Finally, he was accepted to UCLA's second-tier program, the last student taken off their waiting list. At UCLA, he bristled at his more privileged classmates, some of whom graduated from prep schools and Ivy League universities but didn't seem bright to him. He was almost kicked out for getting an F in Human Resources class, which he blamed on his repeated challenges to the professor's weak arguments during class discussions. This angered him, since he was paying his own way, draining the savings from his earlier jobs, while most classmates were enjoying a free ride courtesy of their families.Then he landed a job at Roth Capital, "a third-tier investment bank in nearby Newport Beach known for raising money for small, usually obscure companies. He was miserable from day on, itching to invest money rather than sell securities to investors." He left and set up Lahde Capital in his 800 sq-ft. apartment. He didn't have much of his own money to invest, compounding matters. He was worth only about $150,000 and needed most of it to pay his firm's bills and his own living expenses. He did eventually raise $2 million from a few investors, but he was exhausted and quit. Finally, in November 2006, Lehman Brothers (ironic) allowed him to trade some CDS contracts. He raised another $1.5 million, was down to $100k of savings and owned CDS protection on only $17 million.He then redoubled his efforts on his marketing materials, writing and re-writing the presentation, repeatedly. He raised more money with it.Like everyone else, he was whipsawed when the ABX (the subprime index) fell yet recovered strongly, but kept in the trade. To cut his expenses, he rarely left his apartment, eating only tuna fish out of a can some nights.Finally, by late 2006, his residential-mortgage fund gained 1000%, or about $75 million in 15 months, one of the best runs in history. Lahde made $100 million on the trade for clients over this period and earned $10 million for himself.He capped off his success by writing his manifesto, which took Ivy League "idiots" to task. He explained why he was dropping out of the money game, and advocating the legalization of hemp. Zuckerman includes the entire manifesto in the book, including this funny part: "The evil female plant- marijuana. It gets you high, it makes you laugh, it does not produce a hangover...My only conclusion as to why it is illegal, is that Corporate America, which owns

Congress, would rather sell you Paxil, Zoloft, Xanax and other addictive drugs, than allow you to grow a plant in your home without some of the profits going into their coffers. This policy is ludicrous..."His manifesto was widely read on Wall Street, especially by hedge funds.Mortgage Mayhem- Subprime Collapse history.Zuckerman lays out the incredible story of the real estate bubble. Years from now (or maybe sooner), it will seem as crazy as the tulip mania in Holland.By 2005, 24% of all mortgages were down with no down payment, up from 3% in 2001. Over 40% had no documentation, up from 27%. An amazing 12% had no down payment and no documentation, up from 1% in 2001. Non-primes were 25% of all loans in the US, up from 1% a decade earlier. One-third of new loans were interest-only, up from less than 1% in 2000, and 43% of first-time buyers put no money down at all.Typical example: Alberto & Rosa Ramirez, a couple of berry pickers in California who each made $300 per week, bought a 4 bedroom, 2 bath home in Hollister for $720,000. They got their zero-down mortgage from New Century, with monthly payments of $5378, but the agent said they could refinance soon and "get payments down to $3000 or less."Like most manias, the so-called "experts" were the least likely to see how ridiculous things had become. Zuckerman has a long, enjoyable list of examples.Anthony Mozilo, the lizard-skinned CEO of Countrywide said down payments should be eliminated so more people could buy homes because "this is the only way we can have a better society." He called down payments "nonsense" because "it’s often not their money anyway." (Of course neglecting the moral hazard of walking away, and the risk to the bank/investors, which would be partially covered by the down payment, no matter whose money it was.)New Century: David Einhorn, who operates a big hedge fund was a big shareholder and on the board of this debacle.Barney Frank, ranking minority member of the House Financial Services Committee said this about Fannie Mae and Freddie Mac in September 2003: "I believe there has been more alarm raised about potential unsafety and unsoundness than, in fact, exists. I want to roll the dice a little bit more in this situation towards subsidized housing." ("Unsafety?" this is a made up word only a politician could utter.)Jamie Dimon - when asked by Greene about his subprime short trade didn’t even know what CDS were! Greene said to Dimon: "Hey, Jamie. My biggest position is shorting subprime credit through credit-default swaps. I’ve done four hundred million with you guys." Greene was taken aback- Dimon didn’t even know how to answer his question. The head of one of the biggest banks on Wall Street didn’t even know what a CDS was.Bear Stearns, the first firm to be insolvent due to holding subprime debt on their balance sheet said: "you guys are good customers and we’re concerned about you. You guys need to do more research on historical price appreciation."Dow Kim, head of Merrill’s investment banking vowed to do "whatever it takes" to stay number one in CDOs. In 2006, the firm racked up $700 million of fees by issuing $44 billion subprime CDOs, up from $14 billion the year before. Stan O’Neal paid himself $18.5M cash bonus and $48 million in total pay based on this foolishness. By the end of 2006, there were $1.2 trillion of subprime loans, 10% of the overall mortgage market. However, by creating so many synthetic CDOs there were actually $5 trillion of investments created based on the risky loans. O’Neal left wit h$161 million in his pocket, on top of $70 million that he took home during hi four-year tenure.Chuck Prince, CEO of Citi (who received $25.6 million in pay in 2006) said famously: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing." By June 2008, he would resign under pressure as the bank booked over $15 billion in losses, mostly from CDO investments. He left with $110 million, an office, an assistant, a car, and a driver.Bill Gross: "I think the global economy is sufficiently strong and the U.S. economy probably will avoid a recession."AIG FP’s Joseph Cassano, head of the division that wrote protection for billions of mortgage investments (and was subsequently bailed out by taxpayers to the tune of $85 BILLION!): "It is hard for us, without being flippant, to even see a scenario within any kind of realm of reason that would see us losing $1 on any of those transactions."Even George Soros, when Paulson argued that banks were in trouble and shared that he was shorting some of them. "I thought the risk-reward was better in other trades," Soros recalls.Even in Paulson’s moment of triumph, skeptics thought they knew better.

Heikin Ashi Charts to Day Trade S&P500 Futures and ETFs Heard on the Street: Quantitative Questions from Wall Street Job Interviews Private Equity at Work: When Wall Street Manages Main Street Trade Warriors: States, Firms, and Strategic-Trade Policy in High-Technology Competition GATS and the Regulation of International Trade in Services: World Trade Forum Today's Greatest Pop & Rock Hits: The Biggest Hits! The Greatest Artists! (Easy Piano) (Today's Greatest Hits) John Deere: Plow, Plant, Grow (John Deere (Parachute Press)) (John Deere (DK Hardcover))