Chapter 2

The Biggest Short

An interview with Jim Chanos

By Steven Drobny

Definition of ‘Short Selling’

The sale of a security that is not owned by the seller, or that the seller has borrowed. Short selling is motivated by the belief that a security's price will decline, enabling it to be bought back at a lower price to make a profit. Short selling may be prompted by speculation, or by the desire to hedge the downside risk of a long position in the same security or a related one. Since the risk of loss on a short sale is theoretically infinite, short selling should only be used by experienced traders who are familiar with its risks.

SOURCE: Investopedia

I met Jim Chanos thanks to this book. He downloaded the first serialized chapter, an interview with Kyle Bass, on the day it was released. From there, I invited him to speak at one of my events, which he accepted. And he was brilliant. It is rare to find a manager who can blend a solid macro framework with granular expressions in individual names, long or short. Chanos has done it far more consistently on the short side than the long – which is even rarer.

He then invited me to attend his Bears in Hibernation event which is a sort of annual “Short Sellers’ Ball” during the winter in Miami. It was there that I saw him in his natural habitat, with
other short-sellers talking about stocks that have flawed business models, are overvalued, or are outright frauds. And it was there that I realized in a world of eclectic short-sellers, Chanos is quite simply King of the Shorts, a position he has held since the early 1980s. And now, after a roaring bull market from 2009 to 2014, fueled by quantitative easing and other unorthodox central bank policies, bears in general, and dedicated short sellers in particular, are becoming an endangered species. Yet Chanos has persevered.

As Chanos himself likes to say, short sellers are often classified as guys in dark hats coming to rain on everyone else’s parade. But short sellers play an integral role in the efficient functioning of markets because they assist the price discovery process. This is especially so in the era of QE. Despite the tabloid image, Chanos is a gentleman and a scholar. He is the real deal; an investor who’s seen it all before and who knows a lot about a lot of things.

This is the definitive Jim Chanos interview, and it reads like a walk through the history of financial market blow-ups and frauds. I certainly learned a lot during this conversation, and hope that you will as well. And the timing couldn’t be better as volatility is injected back into markets. Now just might be time for bears and short sellers to shine once again.

How did you become a short seller?

I must have been dropped on my head at birth! Actually, I was fascinated with the stock market from the time I was a kid. My dad piqued my interest in it. During college at Yale University, I dabbled in the options market and stock market. Then I started out in investment banking in Chicago in 1980.

How did you get to Chicago from Yale?

After graduation, I took a job at Blyth, Eastman Dillon & Co., which was converting to Blyth Eastman, Paine Webber. Within a year-and-a-half, I knew I did not want to be in investment banking. I was fascinated by it but could not stand doing deal books and sitting in on presentations, advising McDonald’s whether to issue debt at 14 percent or 12.75 percent.

The equity market was what interested me. The next year, I was offered a job as a generalist securities analyst at Gilford Securities, a Blyth spin-off founded by three of its partners. I jumped at the chance. The first stock I was asked to look at was a fast-growing company called Baldwin-United Corporation, formerly Baldwin Piano Company. It had morphed into financial services in the early 1980s and became quite the stock market darling. In fact, in 1982 it was Merrill Lynch’s favorite stock.
Merrill’s number one favorite stock?

Yes. It had a charismatic CEO who had sold pianos door-to-door. If you can sell pianos door-to-door, you can probably sell anything. At the time, they were buying a company our clients had positions in, called Mortgage Guaranty Insurance Company, or MGIC, based in Milwaukee. It was the original mortgage insurance company, run by a guy named Max H. Karl. It was clear to me and to the risk arbitrage community that Baldwin was using insurance company proceeds to fund acquisitions. That was unheard of then and, for the most part, still is today.

They domiciled their insurance companies in Arkansas, whose regulations were, shall we say, behind the times. The Street began to think this was a deal too far and MGIC stock traded at a big discount to the bid. The deal actually ended up closing. They got approval to use insurance company money along with a lot of bank debt. The more I looked at Baldwin, the more I could not figure out how they were making money.

At the time, in March 1982, there was a Financial World article by Rhonda Brammer, a great journalist who went on to write for Barron’s. Her article questioned Baldwin’s earnings. An odd quote from Baldwin’s CFO caught my eye, so I asked my boss if I could spend time figuring the company out, even though the deal was closing. He agreed and we put out a sell report on August 17, 1982. For stock market historians, that was the absolute bottom of the bear market that started in 1966. Depending on your perspective, it could also be considered the start of an 18-year bull market.

My timing was impeccable. We made a reasonably well-documented case on why Baldwin was playing games with their numbers and was fundamentally overvalued, highly levered, and had regulatory issues. The stock went down a couple of points and then just about tripled almost immediately. That was my introduction to short selling.

When Baldwin collapsed in late 1982, I was an analyst; I had no predisposition to be a short seller. But the firm’s hedge fund clients began asking what else we were looking at. That was when the light bulb went off—I realized I could carve out a niche looking at institutional sell ideas.
When the stock tripled in your face, presumably Gilford clients lost a lot of money and you were a laughing stock?

I was more than that. The New York partner threatened to fire me. But Bob Holmes, the Chicago partner, basically made my career in that moment. He vouched for my work, explaining that it was based on publicly available documents from the state of Arkansas. We examined letters from the consultant they had hired telling them they were insolvent and needed hundreds of millions of dollars more in their insurance companies.

As the stock relentlessly went up in this great bull market, we had the smoking-gun documents. Bob not only stood behind me but supported a second, even more damning report we put out in early December 1982.

Then, either on Christmas Eve or the day before, Bob Holmes called and said I was about to get the best Christmas present ever. He told me that Arkansas seized Baldwin’s insurance companies. Ultimately, it became the biggest financial bankruptcy in United States history until that time.

It shook Wall Street. Merrill Lynch wrote off about $700 million dollars of the legal exposure they had for selling the annuities. It was my first glimpse of the inherent conflicts between investment banking and research because the firms that were selling the most annuities from Baldwin were
the most bullish. The firms that were not selling annuities either did not cover the stock or were raising similar questions to me. It was quite a stock to cut your teeth on.

Did your reports play a part in the shutdown?

I don’t think so because I was tipped off to the availability of those damning documents. An anonymous insurance analyst called me up in the summer of 1982. Arkansas had realized after the MGIC deal approval that it had gone too far and that the company was going to be levered using policyholder money to make uneconomic acquisitions.

They had hired Richard Stewart, the former Superintendent of Insurance of New York, to advise them. He immediately saw what was going on and began writing letters, in May or June of 1982. Those were in place in public filings before I wrote my first report.

You experienced an entire career in your first year.

They are not all like that.

How important are tips in short-selling, like the anonymous tipster in that story? Presumably now that you are a brand, you get a lot of tips, some of which are good and some bad.

Yes. But let me be clear: we know the difference between someone with an interesting idea and someone with an agenda. And of course you steer clear of anyone with fiduciary responsibility to the company.

You always question something when it is not generated internally. On the other hand, people from outside have tipped us off in prophetic ways. Either way, you check out every lead just as you would on the long side.

Did you decide to become a short seller after that experience?

I worked on the sell side for a few more years. After Baldwin, I moved to New York and did the same thing for Deutsche Bank from 1983 to 1985. But the leadership in Frankfurt decided not to renew my contract after a front-page article in The Wall Street Journal described me as a ringleader in a conspiracy. It said that a group of about 10 companies were being unfairly maligned by traders – hedge funds and short sellers – and that I was to blame.

At the time, a client wanted me to run a portfolio of ideas as a hedge to their long exposure, but I could not do it because I was an analyst. I told him that the company was showing me the door on January 1, and he offered to seed me that October. That is how Kynikos Associates LP started. The post-script to that article was that 9 of the 10 companies mentioned were either charged with fraud or went bankrupt.
So the client gave you money to hedge his long side and you did all the shorts?

Correct. I brought my boss from Deutsche Bank in as a partner. I was basically still a neophyte about the back-office set-up, so I did the stock picking and he did all of the trading and back-office functions.

Were you confident in your abilities to pick all these shorts?

Given that I was doing it in the bull market of the 1980s, I was well aware of the risks. We had more than our share of stocks rally in our face. I had no predispositions that it was going to be easy; I felt I needed help.

Six months into the venture my partner decided that running a short-only fund was not for him. He was a traditional Wall Street guy who had worked on trading desks his whole life. I asked him what else he wanted to do for me, but he told me his accountant advised him to take a tax loss, so he sold me his half for $1. At that point, in 1986, it was just myself and a secretary. That was the best trade of my entire life.

Best trade from the long side!

Exactly. We are still friends and we joke about it because he has been very successful and probably a lot happier.
So here we are in 1986, you were a lone short seller—a bad guy maligned by The Wall Street Journal - in the middle of a raging bull market.

Yes. I was operating privately with one client for whom we shorted two groups of companies. The Drexel Burnham Lambert complex of junk bond borrowers, where we realized they were all interrelated much more than the Street did, and the commercial real estate bubble that was being blown up because of laxity in Savings & Loan lending. However, the major thing that occurred, which the Street did not recognize, was the Tax Reform Act of 1986.

**How did you realize the importance?**

It was obvious in hindsight. They did it to nail the real estate industry. Tax shelters were a big deal back then. You could get multiples of the amount you put up as a write-off against ordinary income. If you bought a leveraged building with a group and borrowed a lot of money to buy the building, you could theoretically put up $100,000 in year one and get a 3-to-1 write-off on your ordinary income.

Of course, recapture on the back-end was a problem, but no one ever worried about that because they just kept pyramiding their tax shelters. Then, in 1986, Reagan changed the tax law disallowing passive losses against ordinary income, which changed everything, except that real estate still had two years’ worth of gestation. The Japanese were buying Rockefeller Center and Pebble Beach. And every Texas real estate developer thought that the Japanese were going to buy their strip mall.

It sounds like the business plan of every venture-funded tech start-up today – build quickly and then sell to Apple, Amazon, Facebook, or Google.

Backed by S&L, easy lending, commercial lending, we had a commercial real estate bubble that kept expanding until about 1988 or 1989. It then completely collapsed and brought on the S&L banking crisis of 1990-91. Those were two very good areas to be short as the market raced up in 1986 and ultimately peaked in 1987.

**Did you lose money in 1986 and 1987?**

No. We made money in 1986 and basically broke even in the first nine months of 1987. I look back at 1985-1990 as the golden era of fundamental short selling because there was little correlation in the markets. It was still an institutional market back then, and if companies disappointed or if someone pointed out an accounting problem, institutional investors left it alone. There was a lot of alpha generation on the short side. Throughout the 1980s, most fundamental short sellers were making money on their short book on an absolute basis.

This changed in the early 1990s – from 1991 to 1995, the movie played in reverse. But the earlier period was fantastic. Accordingly, money flowed in because people saw that they could be short stocks and make money, even in rising markets, which was the Holy Grail. We started with $15
million and by 1990 had $660 million. At that point, I was among the top 10 largest hedge funds in the world. That is how small the industry was.

Tell me about the back half of 1987. Did you do well in the stock market crash?

Yes, we did extremely well in 1987. But people forget that the market ended flat for the year. It had a big rally for eight months and then peaked at the end of August. The stock market crash was the end of the move, not the beginning. I remember vividly being at my brother’s wedding in Wisconsin the weekend it peaked, thinking that the market would never go down.

By September my performance was back to flat on the year and the October crash put us up. What really scared me in October of 1987 was that after Monday’s crash, on the Tuesday and Wednesday of that fateful week, there was a lot of concern about not getting paid, that brokerage firms would have to liquidate. That was a wake-up call that really helped us to protect ourselves later during the crisis in 2008.

It was my first lesson in the fact that if you do not watch your balance sheet correctly as a short seller, you are an unsecured creditor of a brokerage firm. It was a quick education in the importance of prime broker and credit relationships and how, for example, it was preferable to be in the US rather than London from this perspective.

That lesson also shaped my understanding of how fragile the system was. I believe the system was much closer to going down in two days in 1987 than at any point in 2008. People think I am crazy when I say that. But people who remember those two days remember that we were worried that the clearing system was not going to work and that people were not going to get paid. I was worried that I was not going to get paid our profits.
Would you say that you were lucky in 1987 because you were short for stock-specific reasons, as opposed to making a big market call?

It was not a market call because we had the mandate to be short. What was more interesting to us was just how fast things fell apart in the late summer. Our stuff started gapping down as the market rolled over. I knew then that something was wrong; the crash was the culminating move. I covered a lot of stuff on Monday, Tuesday, and Wednesday of that week because at the bottom, the market went from 3,000 to 1,300 in six or seven weeks. It was a stupendous move. It was also an education in the reality of running money and how important your back office and prime broker relationships are.

Did your investors redeem money at the end of 1987 because you were up, they were down and they needed the money?

No, it was the opposite. My first client and I had a deal whereby the exclusivity wore off on October 1, 1987. Actually, a bunch of people who wanted to give me money but could not ended up giving me money in the fourth quarter of that year. The money came in stages. I got lucky. Sometimes it is better to be lucky than smart.

1988 was a breakeven year, despite the market being up about 15 percent. In 1989, the market was up about 30 percent and we were up 30 percent. It was one of those monster alpha years because the Drexel Burnham companies and the commercial real estate market both began to crack. It happened just before the failed bid in the fall of 1989 by United Airlines’ parent company to acquire UAL Corporation, which heralded the beginning of the bear market from 1989 to early 1991.

Again, the real junk started going down about three months beforehand. Integrated Resources, a real estate syndicator financed by Drexel Burnham, which was one of our big shorts, could not roll its commercial paper over in June 1989. That was the signal that Drexel could no longer take care of all the companies in their stable.

UAL announced an LBO in the third quarter of 1989 and they could not get the deal financed. That ended the whole LBO wave, which had been another thing driving stocks up during the 1980s. It was a phenomenal period. Then 1990 was a brutal bear market; everything that was built up on leverage in the late 1980s unwound in 1990 on the back of the Drexel bankruptcy. 1990 was a great year for us.

In 1990, you were one of the largest hedge funds in the world, though most people did not know about hedge funds. Were you still considered a bad guy by the WSJ and others?

I have always been a good guy!
Short selling was becoming more accepted because of performance. I was not the only one, and some others were running more money than me. But it was still impossible at that time to raise institutional money; it was mostly high net worth families and individuals.

In terms of public perception, short sellers were still seen as wearing black hats. It was considered a backwater and was not as accepted as today, which was fine with us. There was no systemic call for restricting short selling, as we saw in 2008.

During the 1990s, you were up and down, right?

1991 to 1995 was terrible for me. It was the 1980s in reverse; nothing worked. There were a few good stories, but the market was just highly correlated. NASDAQ and/or the Russell 2000 were up 80 percent or some enormous figure in 1991. For the first few years of that bull market, everything worked and there was no place to hide. We lost money right in line with whatever the market was up.

If the market was up 20, you were down 20?

Exactly. Suddenly, we were producing no alpha, and losing money on an absolute basis. In 1994, we had a respite: the Federal Reserve raised rates. The first six months of that year were the best of my life. All of a sudden the speculative stuff that had been going on for three years hit an air pocket. We were up 50 percent in six months and ended up 40 percent that year.

Then, in 1995, a simple piece of fee engineering saved my business. At that point, we were running less than $200 million dollars, a fraction of what we had been managing at the peak. A client who had been with me since shortly after we launched suggested that they would add more capital, but that we should structure it on a relative fee basis, meaning that I should be benchmarked inversely against them in an agreed upon basket of indices.

That was brilliant and it changed our business overnight. It was clear that the markets were getting increasingly correlated, at least for a while, so rather than worry about market direction, we were only concerned about how our stocks were doing relative to the markets.

Did you do a total return swap on the market?

No. The client had enough embedded long exposure that that they did not tell us whether they were hedging or just using their longs. It was a matter of bookkeeping, but it suddenly took market risk away. Eighty percent of our capital was being run that way by the late 1990s.

The market went up relentlessly in the late 1990s, and was taking down one short seller after another. But we were actually having fantastic alpha years because our stocks were not going up anywhere near as much as the market was. In fact, some of them were going down. It was an eye opener because I realized that it was a better way to run money, and the clients loved it.
Did the shift to targeting alpha against an index change the way you approach markets and short selling?

At that point, we began to understand the real secret to the business. I told people that as a portfolio manager, I was passionate about stocks but from a businessman’s perspective, I was in the insurance business. That is the way to think about it, because a good portfolio of well-chosen fundamental shorts will dramatically underperform the market over time. If you actually can make some money on an absolute basis, which we have over 30 years, you are in effect a market insurance policy that is paying premiums. At the end of the day, if that performance persists, the world should beat a path to your door.

Additionally, the hedge fund market changed in the 1990s. It went from funds-of-funds, Swiss private banks, and wealthy individuals to an institutional market. That really picked up pace after the dotcom blow up. One of the problems I always had with high net worth clients was that short selling is tax inefficient. It has always been a problem. I always warn people about that.

Once we saw tax exempt and international investors take their place, that problem suddenly vanished because they were not paying taxes anyway. In a sense, US pension funds or offshore clients are the ultimate short selling clients because they need the hedge, and there are no tax inefficiencies to what they do.

We began a traditional hedge fund in 2003, our opportunity fund. In our core short-only, which remains the vast majority of our assets, we tell people not to put us in their alternative basket, but rather use us as a contra-weight to their long equity account. Having us on the short side will allow them be more aggressive on the long side. Instead of going from 45 percent equities to 40 percent, they might stay at 45 percent and give us 5 percent. That is a pretty compelling argument.

Tell me about the period from the end of the 1990s to the spring of 2000.

That was a crazy period. We started my Miami group in 1998 and called it “Bears in Hibernation,” not just a play on winter and bears in Miami, but because we truly felt that bears were in hibernation on the Street. I will never forget the February 2000 get-together: A number of people were battered and bruised and 2000 took off right where 1999 left off. A lot of stocks doubled in January, doubled again in the first half of February, and then doubled again in second half of February.

One of our guys gave a short sale idea for a stock at $200 that had been up from $20 or so in 1999. By the end of the conference two days later, it was at $300. Two weeks after that, in the first week of March, it was at $400. It ended up at $4 or $2 in 2002.

Many of the ideas people gave in the third week of February were up 40 to 100 percent by their peak two weeks later. Soon thereafter, a lot of them were down huge. It showed us where we were in the parabola. At that time we had price risk but not time risk because stocks were going up so fast.
Did you make a lot of money shorting tech names in 2000?

We did not. Avoiding dotcoms was one reason why we generated a lot of alpha from the mid- to late 1998 to early 2000. Instead, we were in more eclectic names like Lucent Technologies and the CLECs. We were interested in companies that actually provided the picks and shovels, such as those laying the fiber optic cable. We had some dotcom exposure but it was mostly on the infrastructure side.

Were you afraid of shorting tech?

We did not know how high those names could go. For a while, with the exception of companies like MicroStrategy and others who were playing clear accounting games, there was not a lot to latch onto. From 1996 to 1998, we were famously short AOL, our biggest disaster, which went from 10 to 80. We saw it as an accounting fraud, saying they would never make money because they were capitalizing marketing costs and their churn was much higher than they were reporting. In fact, when Time Warner bought them, they found that out the hard way and took huge write-offs, but it was too late to help us.
We had a healthy understanding of where stocks could go in crazy markets and how to size the positions. Despite going from 10 to 80, AOL cost us 5 or 6 percentage points over two years in aggregate because it was never more than a 1 percent position. Being able to size positions appropriately helped us more recently as well.

Companies like Lucent Technologies, Alcatel, and Global Crossing were leveraged, as was MCI WorldCom. We could see that they were levered and in fact they were not in the dotcom business. They were utility businesses that were bunched in with the dotcoms. It was a much safer place to be. In many cases, they went down just as much because they were leveraged unlike dotcoms.

Then, in late 2000, we stumbled on a little company called Enron. That was the next chapter.

**When you find a name like Enron, does it become a crusade?**

Enron was one of the easiest shorts we ever did. People are surprised when we say that. We started shorting it around $60 in November 2000. In January, it peaked at $80, but the first shorts we did were very small in size. Then it went straight down right through the bankruptcy. There were many rallies in between, but it was not one of these great wars. It was never a bull-bear struggle.

We were one of the few shorts in it even in 2001, then people came piling in. The stuff we found was hiding in plain sight as well. I have been involved in a lot more rigorous battles where companies are hiding stuff and aggressively playing games. Enron was not like that. Once you knew what you were looking for, it was easy to figure out.

**How did you find the idea originally?**

A friend of mine who was a Dallas money manager called me up and asked if I had seen the “Heard on the Street” column by Jonathan Weil, in the Texas edition of *The Wall Street Journal*. I had not, so he faxed it to me. It said that the energy merchant banks had gotten approval by the SEC to use mark-to-model accounting for their derivatives books.

Many accounting professors were worried, given that there was not a transparent marketplace for electricity and other things that Enron and Dynegy were trading. In the hands of an unscrupulous management team, they could make the assumptions on the length of the contract, volatility, and other characteristics, and book whatever they wanted. And that is exactly what Enron did.

Ironically, back in 1982, Baldwin-United was playing accounting games not too dissimilar to this. When they sold an annuity, they could estimate the duration of the policy, the spread they would earn over the life of the policy, and because they paid up front, they could book the commission up front as well as the present value of future profits. Of course, Baldwin made wildly aggressive assumptions on duration and spread, so the more they sold, the more they lost, and yet the more they booked in profits.
As soon as I looked at Enron, I saw an exodus of executives leaving. There was huge insider selling at the company throughout 2000. It had all these classic short selling checklist signs: opaque accounting, odd disclosures in the footnotes about entities set up by Enron executives to trade with Enron, etc. We now know those were the infamous Raptors and LJM Partnerships. When you spent a little time with Enron, it was clear that something was wrong and people were voting with their feet. We just did not know until the end that it was outright fraud.

**Take me through the trade structuring. You find Enron from one little news article and you dig in. Are you slowly building the position? How do you size it? Do you begin piling on once it starts to crack?**

It depends on the news flow. People tend to think too discretely on the short side. There is a lot of asymmetry between the short side and the long side. I have found that out over the last 30-plus-years. That does not solely have to do with the fact that you have to borrow the stock or that tax rates are different. Many are rooted in behavioral finance. One of the differences is that even really smart hedge fund managers think too discretely about their short positions and not as much as about their long positions.

They will obsess far more with movements on the short side, dollar-for-dollar, than they will on the long side. Part of it is the fear in the back of every manager’s head that stocks can go up infinitely but you can only make 100 percent on the short side; stocks can only go to zero. My reply to that has always been: *I have seen more stocks go to zero than infinity.*

You obviate a lot of that with portfolio management. We have a portfolio of shorts, historically 40 to 50 names in the US. The most a position can be in any of our funds is 5 percent. Typically alarm bells go off at 4 percent. We will not manage with stop losses because as Enron and others have demonstrated, almost every great idea we had was volatile and would stop you out at some point. If I get out, I am not a good enough trader, emotionally, to say I can get back in. That is hard to do.

Again, in the absence of news or changes in the fundamentals, we adjust the position to a target band if the market price changes. For Enron, if we started a position, maybe 1 percent in November 2000, and it went to 33 percent against us, and was 1.3 percent, I do not think we added to it at that point, at $80. But when it rolled over, and more information came out in early 2001, we sized it to a 2 percent position when it was back in the $50s.

The tip-off came in mid-August. The stock had gone down to $35 and we had not changed it much. Now it was back down to about a 1.3 percent position. Then, out of the blue, Enron CEO Jeff Skilling announced that he was resigning for personal reasons. The Street being the Street took that as bullish, thinking that this overly aggressive guy was gone. The stock went up 5 points that day to $40.

I looked at it completely differently. CEOs do not abruptly resign for personal reasons. Resignations are well orchestrated. Companies get a successor in place and lay the groundwork.
I thought: the rat is leaving the sinking ship; he sees this. At that point, we doubled our position, and it turned out to be the right thing to do.

That is a textbook example of when the process works correctly, as opposed to AOL, when it did not. It all depends on news flow. In this case, we had incremental news that we processed correctly and the Street processed incorrectly. In other cases, the market will move these positions, and given that we have 40 or 50 names in a US portfolio, we are always adjusting things. The great masses are mucking about in the absence of news developments. Every day, there are some that are working and some that are killing you.

In a portfolio of shorts, you are constantly trying to figure out how to optimally allocate capital, just as you would on the long side. That takes away a lot of the embedded fear people have that shorts can go against you. Of course they can. But if it is one of 40 or 50 names, it is part of a portfolio approach. We are not managing this thing in a vacuum like the long guys. It is part of an overall approach.

What is your target outperformance of the index?

I want to maximize alpha. I cannot give you the exact number, but we have done low single digits nominal performance in our flagship U.S. fund from 1985, which is still running. If you compare
that to the market and rebalance it monthly, which is how we do it in our managed accounts, the alpha is in the mid-teens. There are years of high 20 percent returns and even low 30s, as well as years of zero returns.

**Is that what you want out of insurance products?**

It is what you have gotten historically, but past performance is no guarantee of actual returns. The long-term graph of the alpha goes up and to the right, but it goes up and to the right and then goes flat, repeatedly.

You could also look at a blend of the S&P500, Russell and Midcap Indices. If you just took 50 percent of your capital and bought that and put 50 percent with us, you get the exact same returns as the market but you cut the volatility in half. Again, it gets to the same point. If you threw our numbers into an optimizer, it would tell you that you should give a huge amount of money to us. I am patiently waiting for that day to come.

**What would you say if CalPERS wanted to give you half of their plan assets? They run approximately $300 billion and have a long-term correlation to the S&P500 of approximately 0.94 so it would seem to make sense.**

That will never happen so we do not have to think about it. And of course $300 billion would eliminate the alpha opportunities. While there is a capacity constraint, it has never been an issue with us. We run a global portfolio now and our recent peak was around $7 billion. Now we are under $4 billion, so it does not matter. Nobody wants to give a short seller money when they should. Then, ironically in 2008, we were a source of funds because of the gating everywhere else. It is a nice problem to have but we are not going to have a capacity problem in my lifetime.

**In some ways you are the only short seller left standing now.**

I am one of a few, because many investors will say that they have short exposure in their long/short managers. The problem with that is you have just abrogated the asset allocation decision to your managers. Asset allocation is the one thing that pension fund heads and their consultants should be paid for. When they give money to long/short funds, as they found out to their consternation in 2008, hedge fund managers who had navigated 2000 to 2002 pretty well through both shorts and longs, did not perform well in 2008 because they got increasingly net long. So there were funds with very few short positions when they needed them in 2008. Then every time there were these vicious rallies when people had just gotten short, they covered, thinking the bull market had started again and the market went down. Guys were down 40, 50 or 60 percent, yet their investors thought they were running balanced books.

I am worried that we are seeing that again right now, that the short side was such an anchor in 2012 and 2013 that people feel they will get to it if they need to.
I view macro and short selling as skill-based or alpha businesses, whereas equity long/short hedge funds tend to be more of a “marketing of beta” business. I am always amazed that investors will pay 2 and 20 for a manager that is always net long.

I have been saying that for 20 years. It is interesting because I run an alpha-based business and I am more sensitive to it than others. I sit on investment committees and I see it as an investor who advises these funds. When I ask why a lot of hedge fund compensation is simply embedded market risk, I get very uncomfortable, squirming, dodgy answers. Or no answers at all.

**Look at 2013. It is crazy to see managers who were up 15 percent command huge checks, when the S&P was up 30 percent.**

True, particularly since they were not balanced completely. They were 90 percent long and 30 percent short, or something like that. Not much alpha has been created by hedge funds, and what was created has been taken by fees. This has been the case for a long time. In a way, short sellers might still be one of your great bargains out there, at 1 and 20 percent of the alpha. That is the closest I will get to a marketing pitch.

**Have you ever been bullish?**

In our short-only business, we try to always be short, because the clients want that as an insurance product. There are times, however, like 2009 and early 2010, when I told clients that we felt the US was getting their act together and that there were things to do on the long side, but that we found a great shorting opportunity in China. There are times when we see less to do and times when we see more. Interestingly, we were net long in our hedge fund in 2008, and made some money, and we were net short in 2009 and made money.

I am not a great market timer, clearly. On the other hand, there have been times in the firm’s history when we were a bit less short. If our mandate is around 90 or 95 percent, there have been times when we were in the 70s and low 80s because we did not see many opportunities. There have been other times when we tried to stay around 95 or 100 percent because in our course of looking for stocks and ideas, we saw more ideas than we had capital to take advantage of. There are other times where you just have to look a little harder for the ideas. Generally that is when things are cheaper.

**Besides buying your management company for a dollar, what is your best long trade?**

In the recent cycle, we had luck buying General Motors’ secured paper in the bankruptcy. We were short GM, which illustrates our skill with our opportunity fund. I always chide the White House and others when they talk about the auto bail out—there was no auto bail out. Actually, the auto recap was exactly how capitalism is supposed to work. They went bankrupt, management was fired, and the board was released. All the junior securities were basically wiped out.
Everyone forgets that the government provided debtor-in-possession financing guarantees. The government only came in after they filed for bankruptcy. Everyone is upset that the employees got some seniority but employees get preferences in many bankruptcies. The auto industry was a good example of what the financial industry should have gone through in 2008. Having said that, we knew the credit very well from having been short. When the wreckage hit, we saw that a lot of paper was actually secured — babies being thrown out with the bath water.

We bought a lot of the bank debt in 2009. The GM paper is one reason we had a really good year in 2009 even though we were slightly net short. We also did very well in 2011 on our China trade, when we were long casinos and short property; we owned the Macao casinos, which performed well even though the property shorts did not. That was one of our better trades on the long side in the last few years.

**Lately, you are probably best known for being a China bear, but you have been wrong for years.**

That is what everybody says but it has been the best place to be short for the last four years. People think I expect scenes from 1907 San Francisco: dazed citizens surrounded by buildings crumbling in fires. We are not saying that. We are saying that China’s economic model is completely flawed, and at this point, broken. This inexorable, liberal use of credit to finance investment and real estate has to end.

When we started shorting China in late 2009, the Shanghai market was at 3300. Now it is about 2200. A lot of leveraged companies have gone down even more. Given that every other market has gone parabolic on the upside, I will take it. Our criticisms, while valid in 2010, are even more valid today. When we became vocally negative China, we were considered complete lunatics for even thinking there was something wrong, but now it is a more accepted view. People are now just debating the nature of the debt concerns.

Having said that, it is amazing that China is still building. For all the concerns and the discussion that the government is going to have to reform, they are not doing anything. Fixed asset investment and real estate just plod on.
How do you know? Do you travel to China? How do you research China?

I have never been to Mainland China. My mother told me years ago, “Never go to a fight you are invited to.” But as we sit here today, two of my best analysts are there. We have teams there all the time.

Do they go there with a different business card?

They of course travel under their own names. We do tell them not to accept any laptops or thumb drives. The Chinese government has quite graciously invited me to come, actually, and the PBOC has invited me a few times. In fact, I have met a number of senior Chinese government officials and enterprise executives who are well aware of my views.

I think they are concerned. One of the problems with China, and where I differ with bullish friends, is that the bulls believe the Chinese government will not only reform, but sees all these things, and will effortlessly pull the right levers and generate a soft landing. I point out that they are putting far too much faith in well-educated, well-meaning technocrats in Beijing. All the activity is happening at the local level.
There are more layers to the bureaucracy than they think. The seven guys in Beijing do not have as much control as some assume. The real disconnect is that China is a much more diffuse economy, still very levered, but not merely in the thrall of those seven men in Beijing.

**Do you see a similar thing with the US with the unquestioned faith in a small group of people at the Federal Reserve?**

Yes. Jim Grant has the best saying on the Fed: It cannot change things as they are but it can change things as they appear. That is a wonderful way to put it. The zero interest rate policy and quantitative easing that is now being followed by other central banks has changed the way that we look at risk and financial assets. But it does so in a way that does not change the reality.

By definition, that raises the risks in the system. We all believe – even bears – that there is an implied put, that no one will ever let us lose money in the financial markets. In the late 1990s, people felt then that there was no way the Fed would let the market go down, but ultimately it did go down. And in 2007 and 2008, history repeated.

Those are two very bad spills in what has become a transformational Fed policy of the past 15 years. Yet people still think that they cannot seriously lose money in their equity portfolios. That is a very bad working assumption.

**Do you think the Fed’s mandate is to create bubbles?**

The Fed will tell you that their two mandates are full employment and controlling inflation. A shadow third mandate is using asset prices to fulfill the first two parts of the mandate.

My problem with that is when you create a bubble economy of booms and busts, particularly with financial assets, you tend to suck in the least intelligent, those with the least ability to weather the ups and downs. Every time we get a run-up in asset prices, retail investors jump in, whether they are buying houses at the top in 2006, or stocks at the top in 1999. Who knows what they are buying now, mostly bonds. Then, just when they feel it is safe, you kill them.

Whereas the 1 percent can take these swings and not change their lifestyle, we keep impoverishing the middle class, which are asset owners drawn-in by this policy. Anything that does that might not be a good policy.

**Back in December, you said it is time to get short because risks have increased. You mentioned retail as a sign of the end. Are they getting into the stock market right now?**

I do not know. Clearly they were not there for a long time, but it appears that retail is more heavily present in the market in the second half of 2013 and first quarter of 2014. I do not think they are in at levels that match their involvement in early 2000. But then again, it may take a generation to reach those levels again. You still have 30 million households that invest directly – that is a lot of people. It is a vestige of the late 1990s market. An awful lot of people are involved
and financial literacy is much greater, at least in terms of market movement. Are they devoting more to equities? I do not know for sure, but I think so.

**If everything is overvalued and official policy is creating bubbles, where are bubbles right now?**

Here is an easy one: China. The bubble is one reason we are so bearish there. Everybody is convinced that real estate only goes up in China. But you are creating way too many condos that are being bought with not only life savings but levered money. Plus, there is a complete and utter faith that the Chinese government will never let people lose money. That one is staring us all in the face.

**How do you play China?**

You play it by being short the developers, commodities such as iron ore and copper, and the miners. As I say, they are still building, so commodity demand looks okay.
Do you ever go into currencies like the Aussie dollar?

Generally, no. But we are certainly looking at the RMB right now. If there is a homerun trade like short subprime on leverage, it is probably being short the RMB on a leveraged basis. If we are right, the Chinese government is going to have to print a lot of RMB to re-inject liquidity into the banking system.

In China, do you have one position on, or a few?

In our global short fund, China is around 23 percent of our exposure and that is as high as it has been. They are primarily traded in Hong Kong, and we have commodity plays that trade in Australia, Brazil, and the US. The commodity trades might be another 6 percent.

What are you looking for right now as the catalyst?

The catalyst is happening. It is a slow constant addition of debt, coupled with issuing equity to dilute the shareholders and constant underperformance. I do not know that we are going to get a Lehman moment where everything will be down 40 or 50 percent in a month, but the slow erosion of equity value is just being ground down by the debt above. That has been happening for the last four years.
What do you think about all the excitement around the Alibaba initial public offering?

The problem with Alibaba and almost all these Chinese companies is you do not own the assets. Your asset is called a variable interest entity (VIE), which is an agreement with a company that they will share the profit with you. You do not actually own the software code or distribution centers. You only have a piece of paper with another company.

Also, remember this: Alibaba was named Alibaba because it was supposed to open the cave of riches when you say, “Open sesame.” Or so says Jack Ma. I would also point out that Alibaba himself was a thief who committed murder to hide his crimes when he stole other thieves’ gold from the cave. If something bad happens, you cannot say you were not warned.

It is interesting to us that Alibaba’s retail operation is so successful and fast-growing. Being the real estate bear that I am on China, I have to ask: If Internet retail is growing that fast, why is China going to put up regional shopping malls over the next five years equal to all the mall space in the US? One of those people will get it really wrong. I have a feeling it is the regional mall folks.

Did you catch the sub-prime housing trade in the US?

Yes, we were short credit, sub-prime names, residential mortgage issuers, and commercial property developers. We started shorting them in 2005. Being in Miami, we simply counted the cranes. Everybody forgets the Miami market actually rolled over first, after the two hurricanes in the fall of 2005. Miami prices were the first in the country to drop. The rest of the country softened a year later.

We had a front row seat being short things like WCI Communications, Corus Bank, AIG, and a number of other companies. While we did not buy any Credit Default Swaps or short any of the actual paper of the CDOs, we were short a number of the companies who were involved in this like Dexia in Belgium, who were intimately involved. My two partners Chuck Hobbs and David Glaymon did an amazing job of finding ground zero in the listed equity markets, like the Irish banks. Glaymon has a credit background, which helped tremendously in looking at some of these equities.

Again, we looked at places that had gone crazy in terms of credit extension on the back of real estate. At the peak, new residential construction in the US was 6 percent of GDP — it is normally 2 or 3 percent. It was a big driver. In China, by the way, the official number is 12 but the real number is closer to 20 percent. To put the current China bubble in perspective, it dwarfs what happened in the West.

How did you know when the housing bubble had finally cracked?

A seminal moment came for us in 2007. Paul Singer of Elliot Management Corporation and I were asked to brief the G7 in Washington. The Germans, who you could call anti-hedge fund, chaired the meeting. They called hedge funds the “private equity locusts.” They were quite concerned
that the next financial disaster would be hedge funds. Bob Steel, who was Under Secretary for Domestic Finance, asked us to give the hedge funds’ side of the story on a Sunday afternoon in the last presentation of a three-day conference. You can imagine how happy everyone was to sit there when they wanted to get out of town. When we took the floor, Paul Singer gave an amazing 30-minute talk about how AAA was not AAA. Very simply but strongly, he walked everybody through how the CDO structure worked and how people were looking at misleading historical numbers.

At this point, by the way, the ABX contract had already gone from 100 to 75 and then to 80. HSBC had announced US credit problems in February, and New Century had blown up. Already there were signs that structured finance was a ticking time bomb and Singer laid it all out.

Then I got up and pointed out that most of the largest financial institutions in the world had just started reporting their Level 1, Level 2, and Level 3 assets under the new accounting regulations. I told them what the Level 2 and Level 3 assets were for some of the largest banks and investment banks in the world. I said that if Singer was right, these institutions were all insolvent, so I would short them. You are going to have problems with these entities that you are regulating right now in their exposures, I said. Hedge funds are not going to be the problem, the problem will be banks and investment banks.

The German finance minister said, “Thank you very much. Any questions?” There were about 35 bankers there, including Mario Draghi, Gordon Brown, and Timothy Geithner. And nobody had any questions. I looked down the table to Paul and Paul looked back and just shook his head, as if to say, “Why do we bother?”

By April of 2007, you could see the train coming down the tracks, but there was not one word of concern in that room. Bernanke had just put out a speech saying that it would be contained. Paul clearly showed them that there was a transmission mechanism in place here and that these guys all owned large amounts of Level 2 and Level 3 assets relative to tangible book.

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**Chairman Ben S. Bernanke**  
*The economic outlook*  
Before the Joint Economic Committee, U.S. Congress  
March 28, 2007

Although the turmoil in the subprime mortgage market has created severe financial problems for many individuals and families, the implications of these developments for the housing market as a whole are less clear. [...] At this juncture, however, the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained.

While these things were, in many cases, 30-to-1, with some of the banks, they were 10-to-1 or 8-to-1 in the amount of Level 3 assets to tangible book. You did not have to assume much to realize they were already insolvent by the summer of 2007. Two months later, Bear Stearns hit.

**Take me through 2007 and 2008. Presumably, they were very good years for you?**

Yes. 2007 was like 1989. The markets were flattish and we had a monster year because, again, the stuff all broke before 2008. It was the same pattern of the 1989/1990 credit crisis where the bad stuff started going down first. The overall market masked it.

**What about the short selling bans?**

Right after Bear Stearns went down, a lot of the bankers went to Washington to meet with Treasury Secretary Hank Paulson and the New York senators, Hillary Clinton and Chuck Schumer. We know from the record that they asked for two things: a relaxation of mark-to-market accounting and a short selling ban. They did not ask for a capital forbearance or for their apologies to be accepted for screwing up the country. That told me where the banks’ heads were.

When the short ban went into effect, we were pretty much down to tag ends in our financials. We had covered them from July to September because at that point most of them were down 80 or 90 percent. The Fannie Mae seizures and Lehman pretty much sealed the deal. At that point we just did not think the risk/reward was worth it. We were still in the Irish banks, Dexia, and a few others, but at that point we covered most of our US banks and entities where we were short real estate.

Because of this, it did not hurt us. The bans were short-lived. Stocks rallied for about three days and then rolled over again. It showed us that the governments were willing to go to great lengths to prevent price discovery. To us, the scarier part was the first pseudo-ban, which the SEC put into effect in July. Everybody forgets this — before the outright bans, the SEC put out a list of stocks that you had to pre-borrow before you shorted in July 2008. All that did was focus the market on the companies that the government was most worried about.

Suddenly, those stocks began to underperform dramatically. The other thing everybody forgets is that in the case of Lehman Brothers and Bear Stearns, as well as Fannie and Freddie, those stocks were borrowable up until the day they collapsed. I know that Dick Fuld and Alan Schwartz talked about naked shorting, but there was none of that; you could short all you wanted because there was never a borrow issue in those stocks.
Short sellers are an easy target for people to cover up their own shortcomings. That is why it is amazing that you have gone from the man with the black hat to the good guy who is sought out by governments and politicians.

Bryan Burrough wrote this great *Vanity Fair* piece where he recounted the last days of Bear Stearns. He said that on the Sunday following March 15, a group of hedge funds celebrated the demise of Bear Stearns, at a champagne brunch in New York City. I was a Bear Stearns client. We did not short a share of Bear Stearns because we have a rule not to short anyone we do business with.

In fact, the day they collapsed we still had $500 million of deposits at Bear, unlevered of course. I spoke to Bryan about that later and told him that the article was harmful because it perpetuated a narrative that there was a conspiracy of short sellers. Most of the shorting and the CDS purchasing of financials in 2008, was by other financials, who were hedging their counterparty risk. I asked him where the brunch was, and who attended. He said, “That was just a story I heard on the Street.”

Welcome to another asymmetry of the short side. Couple that with the CEO of HBOS, one of the big British lenders, who called for an investigation of short sellers’ conspiracy to drive down his
stock price in the summer of 2008. The FSA publicly said it found no evidence of that. Of course, HBOS was one of the big banks that ultimately failed.

**CalSTRS also came out and backed the banning of short sales.**

Yes. I was in London during the height of the Lehman crisis, and the Archbishop of Canterbury came out and said he equated short sellers to the devil or some wild thing. Later it came out that the Church of England had all kinds of money with hedge funds and commodity traders. He back-pedaled when it was pointed out that commodity traders are often short as well as long.

**Have you ever been sued?**

Yes, it comes with the territory. We were defendants in the 2011 lawsuit brought by Fairfax Financial. We were dropped from that, but I cannot comment further. And there have been a bunch of nuisance lawsuits throughout the years, none of which have been successful.

**I would think there would be more.**

When Baldwin United threatened us because of our report, we had a combative attorney in Chicago who said, “You always have the process of discovery as a defendant. You really do not want a short seller going through your files.” I will always remember that. We keep our comments to facts, and our opinions about those facts.

Short sellers are protected by the constitution just like everybody else. No one can trade on information they know would be false. Our information almost always comes from company filings. Regulators can restrict your ability to express opinions in the market, but they cannot restrict your opinions.

**Have you ever had death threats?**

No, but private investigation firms have had thick files on me since the Drexel Burnham days. When I first moved to New York City, I lived in a townhouse on 92nd Street. One day, the building super from across the street knocked on my door and said he caught a man rooting around in the garbage. The man told the superintendent he was a police officer but ran away when asked to see a badge. I found out later it was a well-known private detective hired by Drexel to discredit us when we were shorting those companies. In fact, some writer quoted the private investigator in a profile as saying, “Chanos lives a nice, quiet yuppie existence.” I always felt that was an insult.

**From 2005 to 2008, why did you not do the famous CDS subprime trade?**

We did not do CDS for a variety of reasons, but the main one of which was, what happens if we are right and the world comes to an end? I will never forget when Alan Best, our head of stock loan, who has been on the Street since 1968, said, “We might not get paid.” I said, “Keep it in cleared equities. We will do just fine.”
My biggest concern was getting paid. My view was if I took a counterparty risk that was not cleared, where I did not already have the cash and I had a deal with Investment Bank XYZ to pay me, that the bank would not be around to pay. That might have happened if it were not for the government protecting AIG and therefore Goldman Sachs and others. The big short might not have gotten paid unless you cashed it out well before.

It was a legitimate concern of ours because we saw enough transmission risk in the system via our work in AIG, Dexia, and the others, that we could not be sure that a structured deal would pay out. To this day, I argue that the real bail-out was in that area. Do you remember when Goldman implied that they had hedged out their AIG risk? Well, to whom? If AIG went under, your counterparty was not going to be good, either.

There were other reasons, too, having to do with the ethics, which have subsequently come out, but mostly it was about getting paid.

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Miami real estate, along with a lot of other stuff that collapsed from 2007 to 2009, has come roaring back. In some ways you could say the Fed policy is to support the 1 percent. What are your thoughts on Miami real estate now?

I should have bought more of it!
All financial centers have rebounded. I told CNBC viewers in 2010 to buy Miami and sell Beijing. That was a pretty good idea; but I only did half of it. Construction has now returned to Miami. I am not a player in the Miami real estate market by any means. We are not at the crazy levels we saw in 2005, 2006, but give it another year or two and we might be.

Forgetting China for a second, that is happening in the London and Canadian markets. We are starting to get construction in New York, which is high-end stuff. People are also underestimating how much that flight capital has driven these bubbles. It is not just hedge fund people. Money is leaking out of China, Russia, and the Middle East. In many cases, that fuels both art and real estate.

That is worth watching, too. When the US put the first financial restrictions on the Putin group, the market took a pretty good hit. Suddenly the ability of very wealthy people to steal money from their countries might be under scrutiny from the West. That is something we want to keep an eye on looking forward.

What are your thoughts there? You said the bad stuff went down first in 1989 and 2007. Here we are on April 16, 2014, and the S&P is flat for the year.

The Dotcom 2.0s are leading the way down.

By the way, we saw this in 2011, too, so who knows. 2011 was a pretty good year on the short side, despite being otherwise a bull market. At that time, many hedge funds struggled. Everybody forgets that in 2011, Netflix went from 300 to 50. Some of the darlings that have gotten clobbered lately, really got hit in 2011. It was the advent of the European crisis and there was generally risk-off for a good stretch of 2011 and 2012. We all forget that because 2013 was so good. I do not know that this presages anything broadly but clearly there has been at least one incidence of momentum stocks being clobbered during this bull market.
Is now the time to get short?

It has been an okay year so far, but it is not over. Since the end of 2013 we have been telling clients that they should probably start being more cautious. There are enough risks out there with valuation, issuance, financial engineering, and leverage in the global economy, that it is probably time to take some chips off the table. And if you do not want to take some chips off the table, put on some shorts against them. That is our current advice.

What if China cracks?

Then you might have the event that tips the world into a recession. It is the second largest economy in the world. Since the top of the credit cycle in 2007, global nonfinancial debt has gone from roughly $70 trillion to $100 trillion, and China is half of that increase – it has gone from $9 trillion US to $25 trillion.

China accounts for half of all new debt put on globally since the last peak, though it is only 12 percent of the global economy. If you are looking for the credit event or credit transmission, you have to look at China. You will see all of the excesses we saw in the West from 2005 to 2007 and then some.

Who owns all of that debt?

A lot of the debt is in the Chinese banking system: the trust companies, the so-called shadow bank system, insurance companies. In effect, it is controlled by the state. Like any bubble, the state is not going to bail out all of it. That is the problem.

You are kind of like the Forest Gump of financial disasters. You seem to have been around and seen virtually every crisis or crash over the past three decades. What is the biggest miss of your career?

I completely missed Japan in the late 1980s. We were too focused on the US commercial real estate bubble, which Japan was helping. Everyone forgets that Japan in the late ’80s was almost like the Fed today – globally, they were a monstrous source of easy credit. They were blowing up asset bubbles in Asia and the US, including the property and art markets.

Japan was this huge center of financial speculation that was spilling out into all these other global markets. While I saw what they were doing, I missed Japan itself. I missed the credit bubble within the complex of Japanese banks, property companies, and trading companies. For people like Julian Robertson, that trade turned out to be a tremendous structural short. If I had been in, it would have helped alleviate a lot of my pain. That was our biggest professional miss ever.
It was an input to your process, but you forgot to look back out?

I failed to look at the complete source and the impact on the source. China has done that more recently, exporting asset value and helping us keep our rates and deflation low. This time I remembered that I have to look at the source.

So missing Japan led you to China?

Yes, in some ways. In terms of macro, I saw what was happening and why, but I never connected the dots to the Japanese banks and property companies.

People consider you an equity guy or short seller, not a macro guy. How much do you think about macro and how much does it inform your process?

We are not macro guys, but it is clear from our portfolio structures that we end up in de facto macro trades. China is a good example at the moment. In the teeth of the global financial crisis and recession, the mining sector reported record profits. They were one of the few areas with growing profits. I knew the answer was China, but I did not appreciate why.

But then my team began putting some numbers together. My real estate guy said that China had 5.6 billion square meters of high rise buildings under development – half residential, half office. I was sure he mistakenly said meters instead of feet – but he had triple checked it, and it was in fact 5.6 billion square meters which equates to 60 billion square feet.

We took a thesis on mining and commodity prices and looked to see if something was going on, similar to Japan in 1989. We looked at the Chinese credit system. As we did our work at each level of the investment thesis, we realized that we had a macro trade on.

A macro guy might have a viewpoint and then look for the right companies to play it. We came at it from the other side of the telescope. We looked at the companies and then realized what drove those companies’ balance sheets and income statements. We have occasionally ended up in de facto macro trades like residential real estate credit from 2005 to 2007, the dotcom build out, and now China.

Do you have any thoughts on ETFs?

Yes, we have some views, but we prefer to keep the bulk of them to ourselves. There are some structural issues in some of the focused ETF vehicles, in the way they are constructed and the way they settle. I will leave it at that.
I am thinking more about transmission mechanisms and market impacts in the way portfolio insurance did in 1987.

In 1987, we definitely saw this cascading effect, and people could not figure out where the futures selling was coming from – it was unending, but it was driven by the program trading. Like a lot of financial innovation, we knew they were there, but we did not know the impact they would have under duress. You wonder if ETFs are one of those things that have worked on the upside but will also have an effect on the downside.

**Have you been affected by high-frequency trading (HFT)?**

We do not trade often, but my trading desk is aware of it. They are scalping us for half a penny here or a penny there. Spreads have narrowed, as everybody points out, but spreads would have narrowed without HFT but we only turn over our portfolio once a year, which is glacial by hedge fund standards.

My concern with HFT is a simple one: there is always one group of traders that has the book. It used to be specialists, and then it was market makers. However, at least in the case of specialists and to some extent with market makers, they had a mandate to be contra-cyclical. In times of duress, specialists were supposed to be buying, and in times of euphoria, they were supposed to be shorting. They did not always do it, but that was the deal.

HFTs have inserted themselves inside the market. It concerns me that the entity with the fiduciary responsibly to me and my clients – i.e., the broker or the exchange – is giving up order flow data in aggregate. I worry that they are abrogating their fiduciary responsibility. It is a small incremental tax for us, but it is not material, even though it probably should not be happening.

**What is the craziest thing you have ever seen in markets?**

During 2000, after the dotcom boom had crested, there was still a lot of residual euphoria. We were short a company called 3Com that had bought another company we were short called US Robotics, which made modems. Buried in US Robotics was a subsidiary called Palm Computing, which made PalmPilots, which were essentially the first smartphones. The market saw that potential and, suddenly seeing the stock price go down, decided to spin out 20 percent of PalmPilot in an IPO. We did the numbers and realized that at the filing price, Palm’s total enterprise value was going to be greater than all of 3Com.

This happened often at this time, but this was going to be in the billions, not the hundreds of millions. The IPO range numbers were at $25 to $28. Well, right before the IPO, they raised the dollar value twice. It ended up at $36 or $38—at that price, Palm was going to be worth roughly 150 percent of 3Com.

The day of the IPO, we told our brokers that as soon as Palm was borrowable we wanted to short it and buy 3Com. That morning, on the front page of The New York Times, above the fold, was an
article by Floyd Norris that described how stupid people were going to buy this Palm IPO at $36 when they could buy it at two thirds of that price by buying 3Com.

You would have to be crazy to do that, right? I told the desk to forget it, thinking it would not work. The first trade was either $70 or $80 and it got up to $130 or $150 that day. 3Com went up too, but not as much. Even after Floyd Norris told you how to do the trade, this spread persisted for another day or two. On day two or three, the prime broker called and got us 10,000 shares. From the minute we got the phone call, when the stock was veering up, it still took six weeks to normalize.

I love that example. Markets are efficient, generally speaking. But William F. Sharpe, in his Nobel Prize-winning speech on the capital asset pricing model, made one giant proviso: *Markets are only efficient with frictionless short selling.*

We all know that even in a good market, short selling is not frictionless. People who do not have an existing position should also be able to set prices; that is what short selling really is. But in a case like that, you could not borrow the shares until a couple of days later, and once you could, inexorably the valuations got back into true.

It took time because the borrow came out in dribs and drabs. That to me was one of the great signs of market inefficiency. The trade was pointed on the front page of *The New York Times*, yet people still ignored it for days and days on end.

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**About the Book**

This is the second chapter to be released from Steven Drobny’s upcoming book *The New House of Money*. The remaining chapters will be released serially over time and will be available for download at [www.drobnycapital.com](http://www.drobnycapital.com). An introduction to the book is also available online. *The New House of Money* follows Steven’s two previous critically acclaimed books (*Inside the House of Money* and *The Invisible Hands*) which provide thought provoking and candid views into the global macro investment community. The book, to be compiled and released in hardcover in 2015, will reveal the insights of a select group of global macro hedge fund managers, some of whom are well known and others who are—as of yet—undiscovered.

Steven Drobny is the founder of Drobny Capital, a full-service asset management, investment advisory, and consulting firm focused on fundamental, discretionary hedge fund strategies. The firm helps pensions, endowments, family offices, asset managers and other institutional investors run better businesses and build more effective investment portfolios through thoughtful and strategic use of external allocations to global macro and commodity hedge fund managers. For more information about Steven or Drobny Capital, please visit [www.drobnycapital.com](http://www.drobnycapital.com).