Making Money When Others Are Losing It: A Book Review

THE BIG SHORT BY MICHAEL LEWIS

By Mary Pat Campbell

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"Equities in Dallas!" brayed the Salomon Brothers backbenchers in the book that put Michael Lewis on the map, *Liar's Poker*.

A book cram-packed with characters and detailing the insanity of putting millions of dollars in the hands of kids fresh out of college with very little to back them but personality made for a rollicking good tale. It included themes of shaky assets built on questionable lending practices of banks, described the asset class of mortgage-backed securities and took a detour into Michael Millken's junk bond shenanigans, as well as talking about how a market could explode due to regulatory change. Many characters are described as having simple dumb luck, harnessed to larger-than-life personalities, though not really understanding the business or risks they were undertaking…just a matter of time before disaster inevitably occurred.

Of course, the events of *Liar's Poker* occurred in the benighted pre-internet days of the 1980s. Lessons learned, yadda yadda.

In *The Big Short*, what is essentially a sequel to his first foray into book-writing, Michael Lewis comments that he was surprised by the reception of his initial book. In *Liar's Poker*, Lewis explicitly emphasized his befuddlement over the behavior of firms like Salomon Brothers, overpaying under-experienced young men to play with other people's money without little more than gut feel for what they were doing. Okay, let's admit it—they had no gut feel for anything. You can't get gut feel, aka intuition, without extensive experience. The people Lewis wrote about were fresh out of college, with "animal spirits" and dollar signs in their eyes—but little insight into what they were doing. Lewis recounted episodes of his confusion, attempting to drum up business but then realized that the glee of his "colleague" on the trade comes from the ignorance of the client.

Lewis thought that his entrée to the world of financial journalism would put people off from the sausage factory of high finance. I guess if he had stuck around he would have been relegated to Equities in Dallas, because when you are talking about young idiots making big bucks, no matter how bad this looks ethically, you're going to spur the imaginations of ambitious people seeking to hit the big time. This population is not thin on the ground, most especially in America. Lewis had commented repeatedly on how aghast he was to hear how many people were inspired to enter investment banking due to his writing of how rotten (and lucrative!) the system was.

It seems Lewis learned something from his freshman endeavor, and the focus of *The Big Short* makes an interesting contrast to his earlier business classic. Instead of focusing on the consensus people, the yes-men who were the BSDs[1], in *The Big Short* Lewis focuses a great deal on geeks and contrarians. He cannot deny how much money was being made by shady operators throughout the credit crisis, but he lionizes those who discovered the credit bubble a few years before it popped.

In many ways, the book represents an arms war in terms of information and it definitely challenges the concept of the efficient market hypothesis (EMH). I hew to an extremely weak form of the EMH: I, Mary Pat Campbell, will not be able to outperform the market by playing in it. But Lewis gives examples of people who actually put in the work of analyzing cash flows and fundamentals—people who could see the very obvious weakness of the credit market backing a variety of consumer debt vehicles, though most especially the consumer debt vehicle yclept the subprime mortgage.

If you have been confused by the various papers that were generated before and after the credit crisis regarding credit default swaps, CDOs, and all sorts of assets leveraged off of more familiar fixed income instruments, Lewis provides a very good plain language description of these financial instruments. To give you a flavor, here is his description of a relatively simple credit default swap:

> "A credit default swap was confusing mainly because it wasn't really a swap at all. It was an insurance policy, typically on a corporate bond, with semiannual

> premium payments and a fixed term. For instance, you might pay $200,000 a year to buy a ten year credit default swap on $100 million in General Electric bonds. The most you could lose was $2 million: $200,000 a year for ten years. The most you could make was $100 million, if General Electric defaulted on its debt any time in the next ten years and bondholders recovered nothing. It was a zero-sum bet: If you made $100 million, the guy who had sold you the credit default swap lost $100 million."

I will not give the game away for this book review—Mr. Lewis deserves to get his royalties from this work (guilt trip: we're actuaries! We can afford to buy his book!), but I want to point out a few lessons. Yes, there are lessons of human interaction that may be of interest to the Management & Personal Development Section—you will find that many of the people who made money off of shorting the subprime market are rather abrasive and/or antisocial types. The difficulties these people had in convincing others that they were right about a credit bubble about to burst and the relative insouciance of the investment bankers rolling up the credit default swaps for those shorting the funds makes for much psychosocial rumination.

But the bottom line message I got was to beware market consensus. Also, one must keep checking assumptions, whether implicit or explicit. It can be a difficult exercise, but the downside can be disastrous.

The issue we often have as numbers-oriented people is realizing how often the numbers can get distorted in the presence of actual people and their less-than-optimal behavior. One concocts beautiful liability models, and determines optimal behavior—and wouldn't you know it, policyholders manage to figure out a way to behave so that both they and the insurance companies get damaged! Forget about zero-sum games, these can be negative value games. In *The Big Short*, Lewis focuses specifically on subprime mortgages, and the various financial instruments that had been spun off from them. All sorts of assumptions were wrapped up in the edifice of pricing and risk management of these instruments, but we have seen before how assumptions can completely destroy institutions such as Equitable Life in the UK. While reading the setup before things start turning and turning in the widening gyre, I feel like the movie-goer wanting to shout "No! Don't open the door! The call is coming from inside the house!" We know how the story ends. It can come across as a good yarn, we know what had happened.

But these hindsight tales do us no good unless we can transfer them to our prospective actions. Do we have the intestinal fortitude to tell others that the course they want to set out on can wipe out their entire holdings? Are we willing to stand up against the cries that "This time it's different!" or "Laissez les bon temps roulez!"

It does get to be difficult—actuaries have been trying to break out of the stereotype as being the people who always say "No!", not allowing for the pursuit of profitable opportunities. But if there are no other professions willing to tell others to draw back from the precipice, we are not true risk managers.

That said, for those who have played Tiresias, bearing bad tidings that no one wants to heed—the book gives us the realization that we can profit off of the willful stupidity of others in the financial industry. Perhaps Lewis will find this as unpalatable as the result of *Liar's Poker* spurring on ever more people to seek profits through financial shenanigans.

If that does happen, at least Lewis can't say he was surprised.

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END NOTES

[1] Check the Wikipedia entry for *Liar's Poker* for the terminology—for those who have not been exposed to Lewis's writings, I've got to warn that there's a lot of what I call "New York City language", and I doubt I could get away with including it in SOA publications.