
Lewis, Michael - The Big Short*W.W. Norton & Company, 2011, [Finance] Grade* ★★★★★

Twenty years ago, young and quitting bond trader Michael Lewis stumbled out of Salomon Brothers convinced that he had seen the peak of financial folly unwound. He was clearly wrong, but the book he wrote about his experience, *Liar's Poker*, launched a hugely successful writing career where *Moneyball* recently made a great movie. *The Big Short* is Lewis most important writing yet. It's one of only a handful of books that ten years from now still will be important in describing the subprime crisis. It's a story so spectacular that it could be bluntly dismissed if it wasn't also all too true. Let's hope Lewis this time describes the peak of financial folly.

Even though the reader will get a good grip of collateralized debt obligations (CDOs) and Credit Default Swaps (CDSs), instruments with huge market values 2006 that few of us knew existed, this is not a top down analysis. The book tells its tragicomic story by presenting a few of the characters who invested money on that the world one day would wake up from the madness. I say characters since we are not talking about the well-known investors like John Paulson, but instead a rather quirky bunch of small hedge fund managers where perhaps the oddest one is a one-eyed manager with Asperger's syndrome. All and all it wasn't more than 20 investors in total who took large positions shorting the subprime market. In the end they turned out to be the wisest persons around. We get to follow their way up to the point where the market crashes.

One perpetual question these persons put as events unfolded was "who's on the other side?" i.e. who is betting money on that everything will just remain fine? The answer they got from the investment banks was mostly "Düsseldorf", meaning "dumb money" (pension funds etc.). IMF estimated that the total losses in the crisis was 1 trillion USD and even though Düsseldorf took some losses it turned out that the dumb money mostly were the investment banks themselves as they kept most of the opposite positions on their books. When this was realized the crisis went from a subprime one to

a liquidity driven bank run that almost broke the US financial system.

In reality however the crisis was more of a derivative crisis. CDSs were basically insurance on something neither the seller nor the buyer of the CDS had to own. That is they were speculation vehicles that something would turn out bad. Buying a CDS was like shorting a CDO (and vice versa for the seller) but as it was synthetic the instruments didn't need new loans to end customers to be created. In this way the same crappy loans could be multiplied over and over and over again. This is how subprime loans sliced up and securitized almost could destroy the world economy. The investment banks had short term financing, equity of perhaps 3 percent and the balance sheet positively stuffed with synthetic junk bonds rated triple A by the rating agencies. What were they thinking!? Well, they were not – thinking, that is.

Anyone who's ever read a Michael Lewis book would agree that he's a very accomplished storyteller. *The Big Short* is no exception, it is financial wisdom of the highest literary standard. Presenting the events through the eyes of those in the center of the storm gives a new perspective. It's also obvious that Lewis is highly frustrated with the moral of the story. The thing is that not only the main characters of this book came away very rich, most of those on the other side of the trade also made tons of money. Howie Hubler at Morgan Stanley for example lost USD 9 bn on his positions (the largest ever loss on a single trade) walked away with his previous salaries untouched and since the US taxpayer bailed out the investment banks most of the responsible persons are still there as if nothing had happened. That's moral hazard for you.

It's obvious that the investment banks believed their own lies and never understood what they actually had on their balance sheets. When you are too busy making money it's hard to find time to listen to the skeptics. Read this book and you will be wiser than that.

Mats Larsson, April 15, 2012