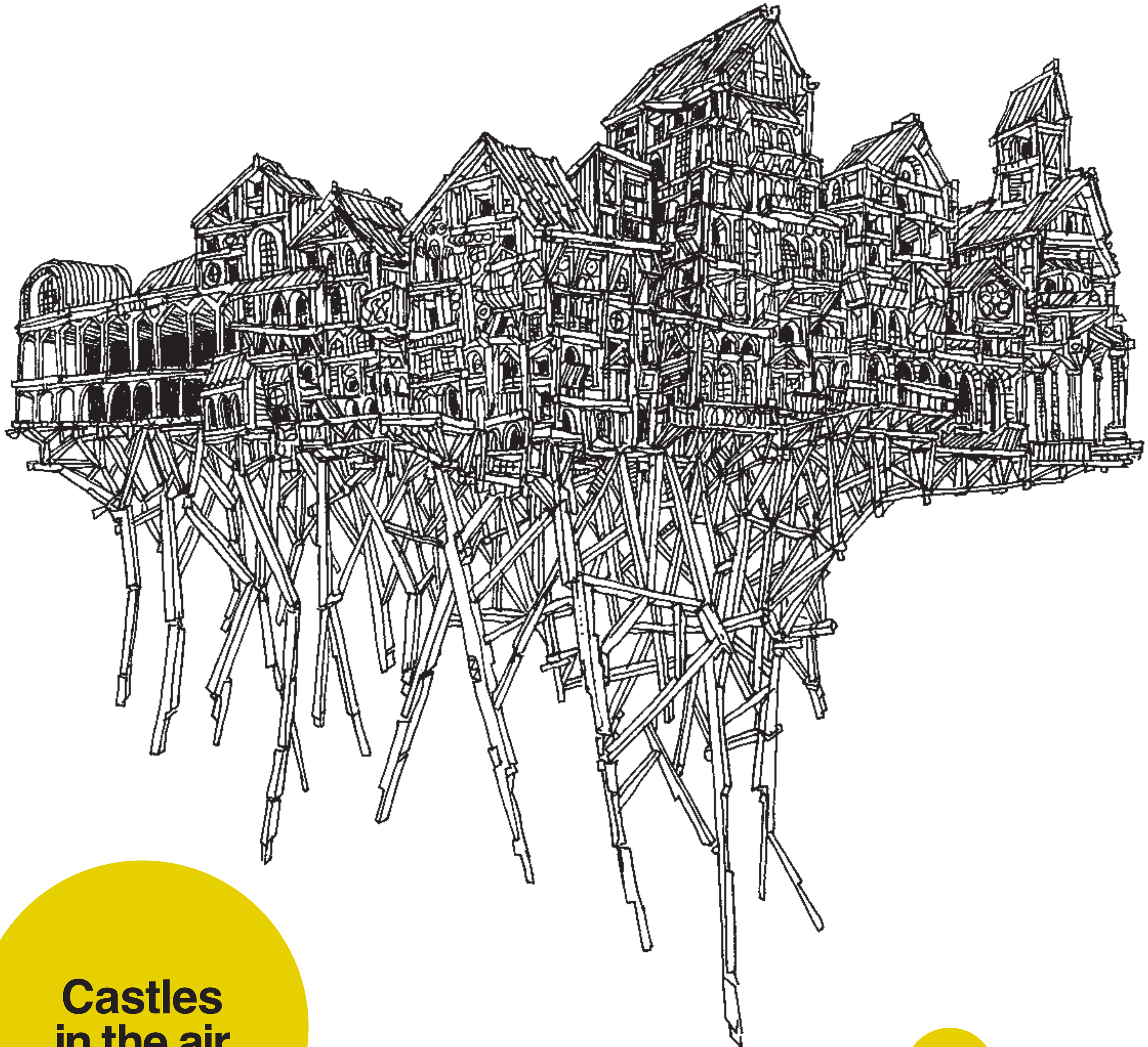


Castles in the air

3C design & production

Illustrations by: *Vasco Mourao*

Castles in the air

preface

Castles in the air is the theme and idea behind the images for the editorial section in this year's Annual Report. The articles featured explore some of the fragilities underlying the global investment scenario and look at some difficult but constructive options to secure the future.

Dylan Grice in *Popular Delusions* sets out the case for holding gold as an insurance policy in "environments characterised by monetary mischief".

Grice looks at economic history where governments such as the Roman Empire, the Weimar Republic and the Thatcher government struggled (with different strategies and outcomes) with the need to contract expenditure and adopt strict fiscal policy to restore economic health and sustainability. He concludes that unless there is a crisis of magnitude (and that is not inevitable), a majority opinion and political will to accept that painful measures are unavoidable, will gold fulfil its purpose and value.

"These articles are timely and relevant for investors ... "
— Kerr Neilson

The second article, the interview between Erik Schatzker and Michael Lewis offers a personal insight into the world of Wall Street, tracing the seeds of the global financial crisis back to the eighties where a culture of short-term greed emerged combining with growing complexity in financial instruments and traders' efforts to profit at the expense of customers.

Lewis's focus on specific players in the sub-prime crisis, those who became aware of the risk of the effects of credit defaults and traded them for vast profits provides readers an interesting insight into the psychology of investing. Of broader significance is Lewis's analysis of the current scenario where reform and change are vital to develop a system which is robust and responsible in serving a global economy.

These articles are timely and relevant for investors in the immediate post GFC period and particularly as political parties vie for popular support. We commend these articles for their intelligence and interest.

Kerr Neilson
Managing Director, *August 2010*

popular delusions

When to sell gold

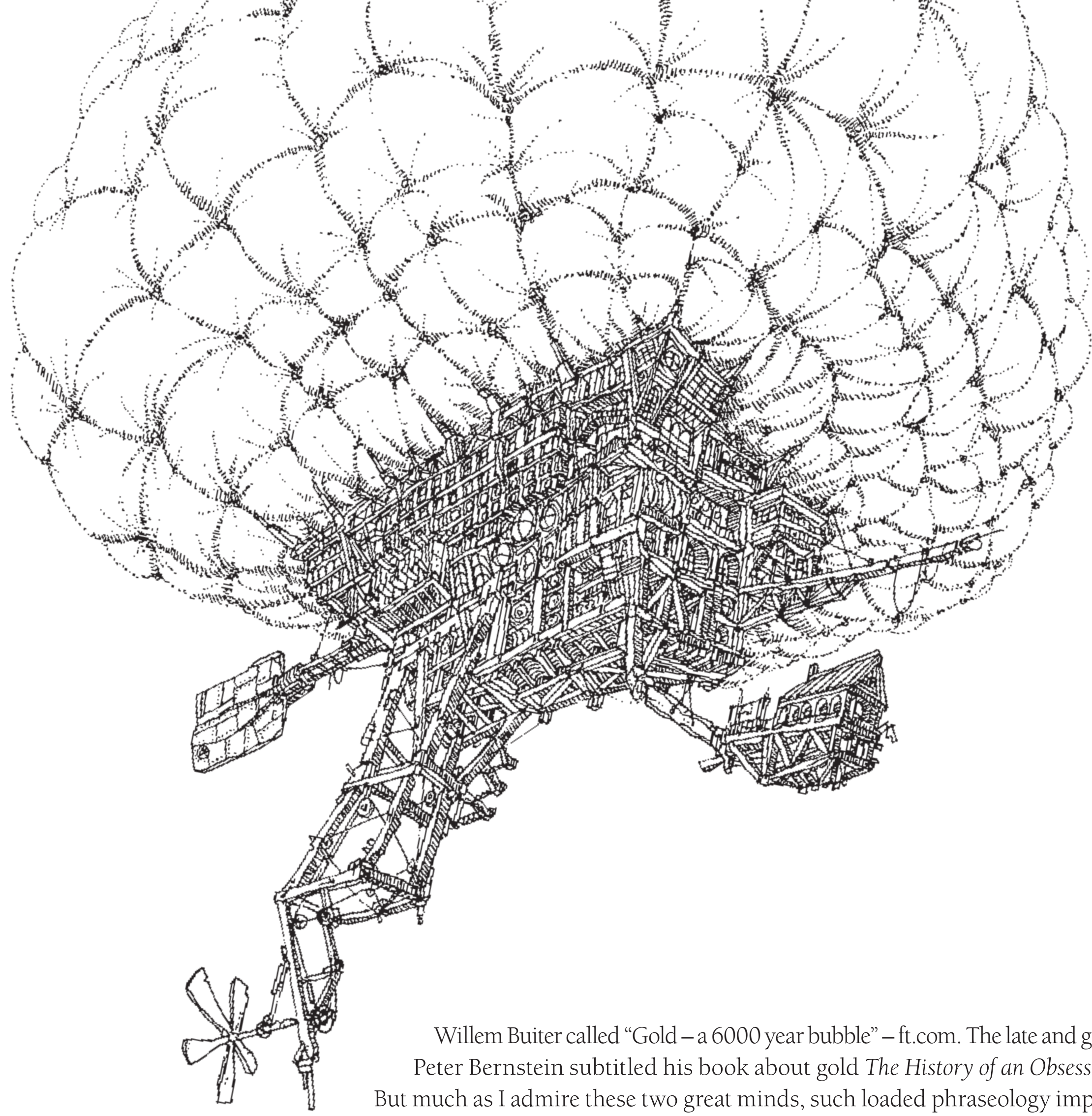
JP Morgan once said he'd made his fortune by selling too soon. We spend much time thinking about what to buy and when to buy it, when in fact knowing when to *sell* is more important. The case for owning gold is clear enough, but when should we look to sell?

By: Dylan Grice
from Société Générale
Cross Asset Research
Strategy Document
23 March 2010

Some would say the time to sell is now. Gold just isn't the misunderstood, widely shunned asset it was a few years ago. Isn't the gold bull market now long in the tooth, with better opportunities to be found elsewhere? I can understand this view. Had you bought stocks at the bottom of the bear market in 1974 and held them for ten years you'd have seen them go from being hated to being loved. And as the number of mutual funds exploded you could have plausibly argued that since stocks were no longer the deeply contrarian plays they'd been, they should be sold. But you'd have missed spectacular gains over the next 15 years because the social contrarian indicators said nothing as to how favourable underlying conditions were for risk assets.

Though developed market governments are insolvent by any reasonable definition, it's far from *inevitable* that this insolvency will precipitate an extreme inflationary event … it's just that it *might* … And although I've wondered aloud if Ben Bernanke is in fact the reincarnation of Rudolf von Havenstein – the tragic president of the German Reichsbank who presided over the Weimar Hyperinflation – I don't think he *actually* is … it's just that he, and other central bankers, might be closer than they think …

Gold, like all other commodities, is *inherently* speculative. Unlike well chosen stocks which you buy to hold to take advantage of their wealth-compounding properties, you only ever buy commodities to sell later. With this in mind, when should you sell gold?



Willem Buiter called "Gold – a 6000 year bubble" – ft.com. The late and great Peter Bernstein subtitled his book about gold *The History of an Obsession*. But much as I admire these two great minds, such loaded phraseology implies there to be something irrational about owning gold and I think that's just plain wrong. The fact is that there is a fundamental need for a medium of exchange. Early civilisations used pebbles or shells. Prisoners have used cigarettes.

Having a medium of exchange makes life easier than under barter economy and societies have always organised themselves around the best monetary standard they could find. Until industrialisation of the paper printing process, that happened to be gold, which is small, malleable, portable and with no tendency to tarnish. Crucially, it's also relatively finite and this particular characteristic (in combination with the others) can be very useful in environments characterised by monetary mischief.

> **“There is nothing mystical about gold and I don't consider myself a gold bug”**
> — *Dylan Grice*

I view it primarily as insurance against such environments. It's a lump of metal with no cash flows and no earnings power. In a very real sense it's not intrinsically worth anything. If you buy it, you're forgoing dividend or interest income and the gradual accumulation over time of intrinsic value since a lump of cold, industrially useless metal can offer none of these things. That forgone accumulation of wealth is like the insurance premium paid for a policy which will pay out in the event of an *extreme* inflation event.

Is there anything else which will do that? Some argue that equities hedge against inflation because they are a claim on real assets, but most of the great bear market troughs of the 20th century occurred during inflationary periods. A more obvious inflation hedge is inflation linked bonds, but governments can default on these too. More exotic insurance products like sovereign CDSs, inflation caps, long-dated swaptions or upside yield curve volatility all have their intuitive merits. But they all come with counterparty risk. Physical gold doesn't.

Indeed, during the “6000 year gold bubble” no one has defaulted on gold. It is the one insurance policy which will pay out when you really need it to.

There is nothing mystical about gold and I don't consider myself a *gold bug*. In fact, I'm not sure I'd even classify gold as an ‘investment’ in the strictest sense of the word. Well chosen equities (not indices) will act as wealth-compounding machines and are likely to make many times the initial outlay in real terms over time. These are ‘investments’ because so long as the economics of each business remain firm, you don't want to sell. As they say in the textbooks, you ‘buy to hold.’ But gold isn't like that. Like all commodities, it's intrinsically speculative because you only buy it to sell it in the future.

The reason I own gold is because I'm worried about the long-term solvency of developed market governments. I know that Milton Friedman popularised the idea that inflation is “always and everywhere a monetary phenomenon” but if you look back through time at inflationary crises – from ancient Rome, to Ming China, to revolutionary France and America or to Weimar Germany – you'll find that uncontrolled inflations are caused by overleveraged governments which resorted to printing as the easiest way to avoid *explicit* default (whereas inflation is merely an *implicit* default). It's all very well for economists to point out that the cure for runaway inflation is simply a contraction of the money supply.

It's just that when you look at inflationary episodes you find that such monetary contractions haven't been politically viable courses of action.

Economists, we find, generally don't understand this because economists look down on disciplines which might teach them it, such as history, because they aren't *mathematical* enough. True, historians don't use maths (primarily because they don't have physics envy) but what they do use is common sense, and an understanding that while the economic laws might hold in the long run, in the short run the political beast must be fed.

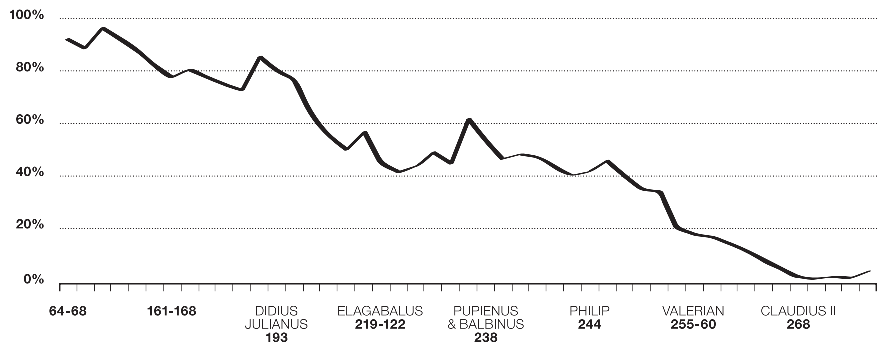
I wrote about the Weimar Hyperinflation a few weeks ago and showed, for example, that Rudolf von Havenstein (Reichsbank president) was terrified of pursuing such a monetary contraction because he was so fearful of the social consequences rising unemployment and falling output would elicit. But the agonizing dilemma he faced, identical in principle if not in magnitude to that faced by policy makers today, is as old as money itself.

In the 3rd century AD, as the Roman Empire became too large and unwieldy, its borders were consolidated and the great imperial expansion halted. Though necessary, this consolidation posed problems. While the Empire was in growth mode, driven by military conquest which strengthened public finances, the army paid for itself. It was an asset on the national balance sheet. But when that territorial growth was halted, a hole was created in the budget as while the army was still needed to defend the borders, it was no longer self-funding because there was no territorial expansion.

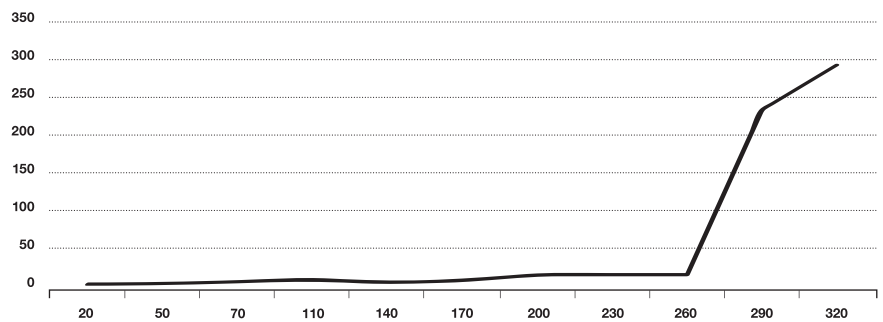
Roman emperors discovered that contracting expenditure to fit with new lower revenues was a difficult feat to pull off. So rather than contract military spending, public works or public entertainment – long-term necessities which were painful in the short run – they opted to buy time using successive currency debasements. Ultimately, this culminated in what would become the world's first of many *fiscally* driven inflation crises (see charts on following page).

> **"Paring overstretched government balance sheets has never been easy"**
> *— Dylan Grice*

1 **Silver content of a Roman denarius**
Source: *http://www.tulane.edu/~august/handouts/601cprin.htm*

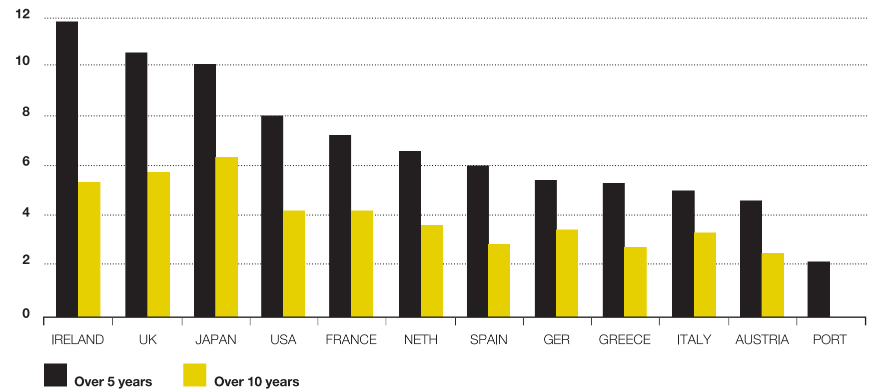


2 **Egyptian wheat price, drachmas per artaba**
Source: *http://www.tulane.edu/~august/handouts/601cprin.htm*



Two thousand years ago, the fiscal sobriety so clearly needed in the long run was subordinated to the short-run requirement to buy time. Hence the age-old short-term temptation to debase the currency and hope no one notices. Paring overstretched government balance sheets has *never* been easy. As the Romans should have done in the third century, developed market governments today will have to come clean to their citizens that since keeping the welfare promises they've made over the years will bankrupt them, those promises are going to have to be 'restructured' and government expenditure substantially tightened.

3 **Fiscal contractions required over 5 year and 10 year periods to stabilise government debt ratios at 2007 levels (%PA)**
Source: *Cecchetti, Mohanty, Zampolli (BIS conference paper, 2010)*



"These draconian fiscal policies wouldn't have been possible five years ago"

— Dylan Grice

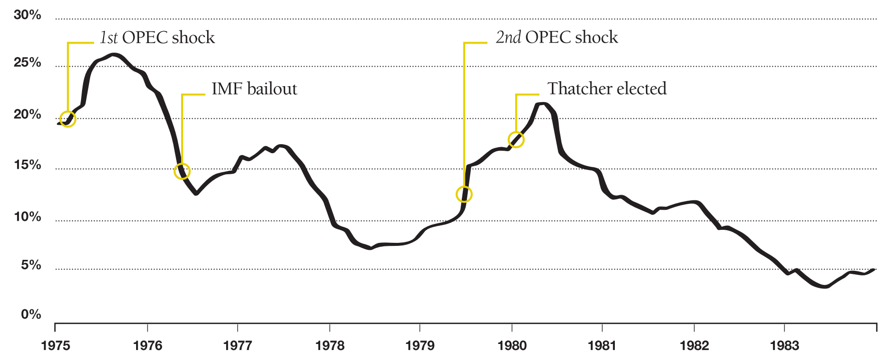
But governments aren't ready to take that step at the moment (the chart on the previous page shows just how painful the required measures could be). Indeed, the pressing fear among policy makers today remains that stimulus might be removed too soon. In the UK, policy makers refused to *"risk the recovery we've fought so hard for"* to quote PM Gordon Brown ("fought so hard for"!). In the US, lawmakers have just expanded the most inefficient health care system on the planet (according to Peter Peterson – ft.com there are five times as many CT scans per head in the US as there are in Germany, and five times as many coronary bypasses as in France). It has been promised that the increase will be deficit-neutral (which I doubt) but even if it is, current period deficits aren't the correct way to look at health and pension obligations which should be examined on an actuarial basis (and if expanding the program is so difficult, wait until they try contracting it!)

But they will face up to these problems one day, because they must. And the good news is that there are precedents for policy makers adopting the policy of short-term pain for long-term gain. In the UK in the 1970s, for example, the country tired of lurching from one crisis to the next, of militant trade unions and of high inflation. Eventually, they elected Margaret Thatcher who promised to control inflation and smash the unions even if the short-term pain would be severe. She did, and it was. But the rest (despite 364 economists petitioning her that such drastic measures threatened social stability – How 364 economists got it totally wrong – Telegraph) is history.

The key point to bear in mind is that she was elected with a mandate for short-term pain which hadn't existed five years earlier. *The political winds had changed.*

Ireland swallowing bitter fiscal medicine today offers a similar example. I've been over there a couple of times in the last few months and it's heartbreaking. Its economy has contracted by nearly 10% since the peak of the credit bubble and my friends in Dublin tell me that, unofficially, house prices are down 60-70% from their peak. Unemployment has spiked to around 15%. The striking thing about being there, though, is that while no one is happy about them, and there have been strikes in protest at the distribution of the pain (which, in passing seems to be a feature of the political climate during such crises) on the whole there seems to be an understanding that such measures are unavoidable. **These draconian fiscal policies wouldn't have been possible five years ago. *But the political winds have changed.***

4 **UK inflation in the 1970s**
Source: *SG Cross Asset Research*



What causes the political winds to change? A government crisis. In 2008, Ireland came very close to going the way of Iceland. They had their crisis. And historians today still refer to the "inflation fatigue" in Britain by the end of the 1970s. This was our crisis. So what we learn from these experiences and others like them is that a fiscal crisis is required to force a majority acceptance of the implications of an overleveraged government.

But the political winds in *countries with central banks* are a long way from blowing in the direction of fiscal rectitude. And while it's true that more people are at least talking about it, talk is very cheap and no one is yet close to walking the walk. Such steps remain politically unpopular because we haven't had our crisis yet. Given the clear unsustainability of government finances and the explosive path government leverage is on, a government funding crisis is both inevitable and necessary. Dubai and Greece are merely the first claps of thunder in what is going to be a long emergency.

Eventually, there will be a crisis of such magnitude that the political winds change direction, and become blustering gales forcing us onto the course of fiscal sustainability. Until it does, the temptation to inflate will remain, as will economists with spurious mathematical rationalisations as to why such inflation will make everything OK (witness the IMF's recent recommendation that inflation targets be raised to 4%: IMF Tells Bankers to Rethink Inflation – WSJ).

Until it does, the outlook will remain favorable for gold. But eventually, majority opinion will accept the painful contractionary medicine because it will have to. That will be the time to sell gold.

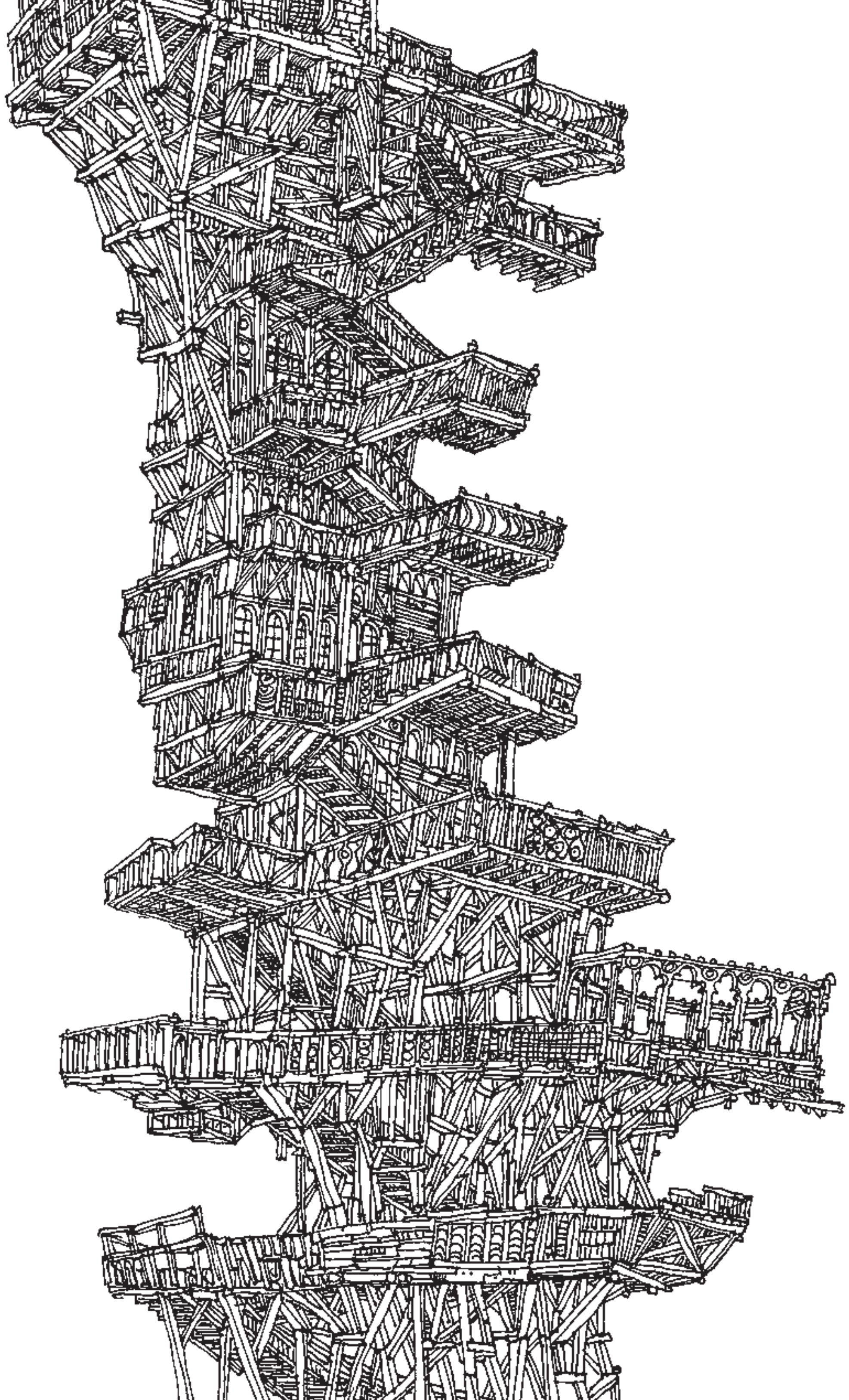
What causes the political winds to change? A government crisis.
— Dylan Grice

Dylan Grice *Société Générale Cross Asset Research from Global Strategy Document,* 23 March 2010, *Popular Delusions.*

THE big short

TV interview
Erik Schatzker
with Michael Lewis

Interviewee: Michael Lewis
Title: Author *The Big Short*
Channel: Bloomberg US **Date:** March 15, 2010
Time: 9 PM ET **Duration:** 41 minutes 35 seconds
Interviewer: Erik Schatzker



ES **Hi, I'm Eric Schatzker here in the Bay area talking to author, Michael Lewis. The man behind *Liar's Poker*, *Moneyball* and *The Blind Side*. For his newest book, *The Big Short*, Michael spent a year in hedge fund land looking for the small handful of people who anticipated the subprime mortgage collapse. He wanted to know why – why they spotted the catastrophic bubble that everyone else missed.**

ML This is one of the great mysteries of the last few years in finance and there emerges on the scene this really, really smart trade: buying credit default swaps on subprime mortgage bonds. With a limited downside, you're buying insurance on subprime mortgage bonds. Limited downside – you're paying a couple percent premium a year for a bet that maybe it's not sure to pay out, but the odds are better than 50:1 they will. It's a really obvious smart bet and many thousands of investors could have made this bet. Not individual investors, for the most part, but a lot of institutional investors could have made this bet. In the end, only about a dozen make it in a huge way. Most of them are outsiders, are people who are kind of on the fringe of, certainly on the fringe of, the credit markets. They're not people who are bond market people. They are people who, for the most part, were stock market people, who sort of craw-fished into it because they could see that the stocks that they were trying to understand were going to be driven by this event that was going on in the subprime mortgage market.

So they had to understand the subprime mortgage market and then the more they came to understand it, the more appalled they were about how that market worked; and the more appalled they became, the more they began to think, well, I really ought to bet against it. In each case, I mean, I learned something about investing from this book because I've always thought of it as kind of an antiseptic event and kind of a purely intellectual event and it was pretty clear to me in each case these characters had an emotional/psychological dimension to them that enabled them to get where they are.

ES **You note early on in the book that John Paulson made more money than anyone had ever made so quickly on Wall Street, so why not make him more a part of the story?**

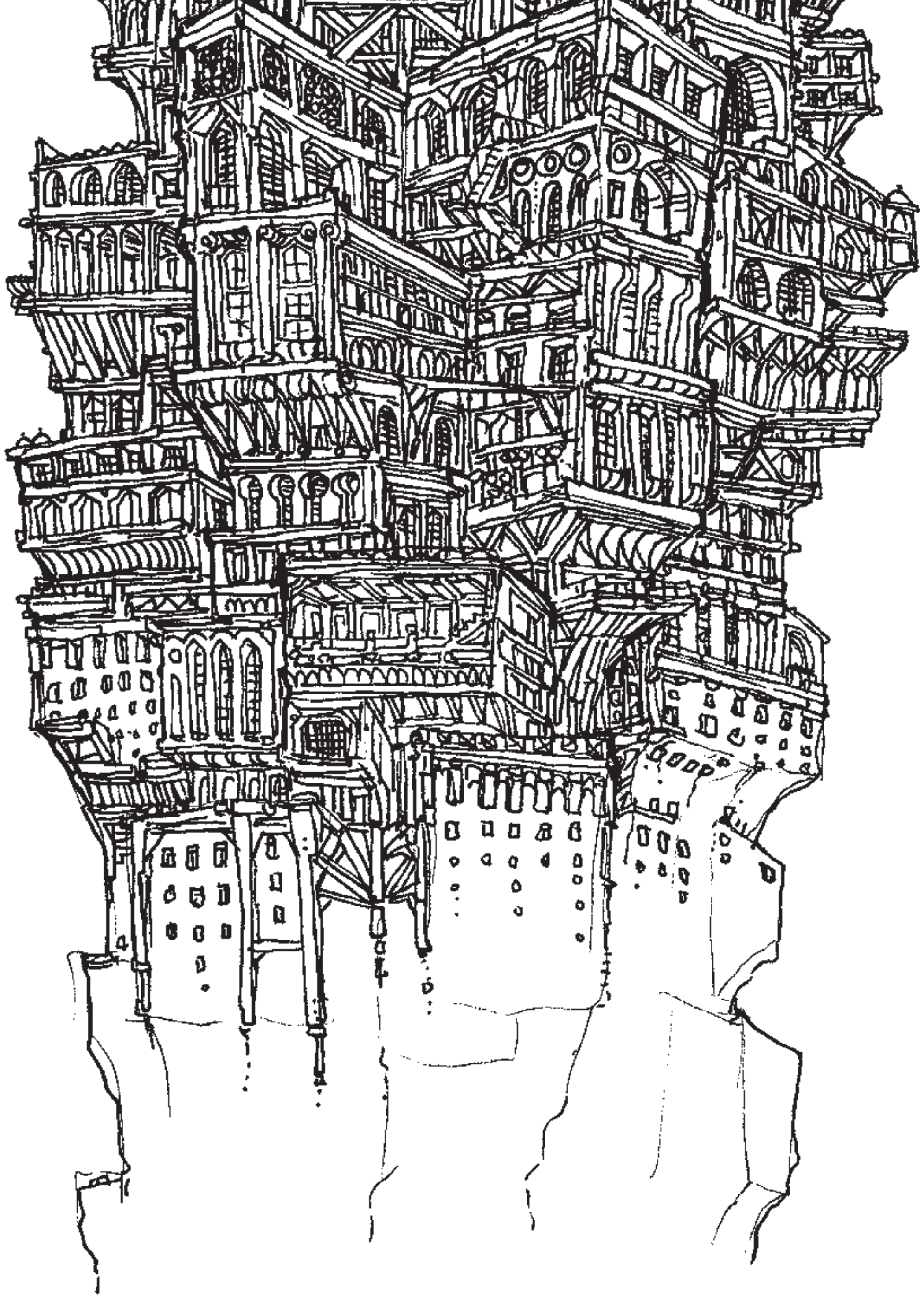
ML I spent time with him and he's very, he was very friendly. I mean, I could have made him part of the story very easily, but I had a purpose for this story and the purpose was I wanted to explain to the reader what on earth had happened; and to do that, it helped that the characters themselves had to learn about these markets, that they didn't understand these markets to begin with. So the reader could learn with them.

John Paulson happened to be just oddly positioned inside the financial markets, in that he was one of the few people who made his living shorting bonds and looking for bonds to short – and he was also, his motives were, to me, less interesting. He's much more of a purely economic animal and so he didn't have a great distance to travel to get to the trade. The people who I was interested in were the people who had kind of laid it all on the line: where they'd start off thinking, yeah, nice little trade and it ended up, essentially if this didn't work out, their careers were over. And Paulson had very cleverly, but from a characterological point of view less interestingly, structured his financial life so that he was going to kind of win either way.

ES **They're not protagonists, but you do identify some of the people on Wall Street who figured out the subprime bubble early: Greg Lippmann from Deutsche Bank, for example; Gene Park at AIG Financial Products. I'm curious, why no central character from Goldman Sachs, because it was Goldman that created the synthetic CDO in the first place.**

ML That's right. I mean Goldman's in the book in a big way. I suppose if they would have let me speak honestly to Jonathan Egol, the trader there, or Andy Davilman, the salesman who bought credit default swaps from AIG, but put AIG into the subprime mortgage market, I might have developed them further as characters. But Goldman – the last thing they want is someone like me writing about Goldman Sachs. They're very careful about what they'll divulge.

The people inside the Wall Street firms who are more interesting to me were the people who had first tried to – seen the opportunity and there weren't many. I mean, Greg Lippmann is the exception. Goldman Sachs was shrewd in finding AIG to be the turkey at the table and shrewd in getting them to insure subprime mortgage bonds, but Goldman Sachs was not set up, when they were doing that, to make money if the subprime mortgage bond market collapsed. If the subprime mortgage bond market had done what it was supposed to do and it collapsed maybe a year or a year and a half earlier than it did, Goldman would have been buried. They were long. So they were the dumb money too.



So they weren't that interesting for that reason. The one guy who was really interesting as kind of smart money inside a Wall Street firm was Greg Lippmann. I mean Lippmann was a Deutsche Bank asset-backed trader, who was at war with his own firm, because the whole rest of the firm is long in the market and he's saying this is going to be a disaster and Lippmann was the proselytizer of the trade. I mean, the bond market is the Wild West. What goes on in the bond market would never be allowed to go on in the stock market. Investors in the bond market know that if Goldman Sachs or Deutsche Bank come to you and wants to sell you something, you don't want to buy it. And so that Greg Lippmann is running around selling the single greatest trade in the history of the bond market and nobody believes him, it tells you something about the bond market. They don't, he can't get the message across because of where he comes from.

Then the other, broadly-speaking, character on Wall Street who was interesting to me was – who was in a big way the dumb money on the other side. Nowhere else on Wall Street was there a single trader, I don't think, making a directional bet on the subprime mortgage market who lost as much as Howie Hubler did at Morgan Stanley. He lost $9.4 billion. Now, I don't think anybody's ever done that on Wall Street and that this guy had done it and he was basically anonymous was amazing to me.

ES **Michael Lewis says it's just wrong how a single Wall Street firm could do so much to fuel the subprime bubble. Find out which one when we come back.**

[BREAK]

ES **When it comes to picking the biggest villain in the mortgage meltdown, there's a lot to choose from. Michael Lewis narrows it down to one firm.**

ML If I had to put my finger on one person or one kind of person, one role player in this crisis, who I would like to string up or rather I'd like to have him just have to answer questions honestly to the public, I think it would be the people who I know knew better. It would be – I would like for the people who designed synthetic CDOs at Goldman Sachs and persuaded AIG to insure them, to essentially take all the risk in the subprime mortgage market in 2005. I would like for them to explain what they thought they were doing. There was nothing illegal about what they did. It was just exploitative. It was just wrong, but they were smart enough and their position in the society was elevated enough that you would have thought that they would have paused and said – I have some responsibility here not to do this or to prevent this from happening, not to actually make it happen.

So I hold there is a very obvious status structure on Wall Street. Ratings agencies aren't even in it, but at the very top of the status structure is Goldman Sachs – certain traders at Goldman Sachs and hedge funds – and when the people at the top set such a bad example, everything else in a weird way follows from it. And I'd like the genuine elites to explain why they behaved in the way they did, because I think in the end, if you're going to get back to a saner relationship between our financial system and the rest of the economy, the rest of the society, you have to have people at the very top of that structure who have some sense of social obligation. And they don't right now. It's a question of how do you restore that. I think you restore it with shame, with a sense of you should be ashamed that you did not behave in the way you should have behaved.

ES **Does that make Goldman evil?**

ML Evil's too strong a word. I think the system is evil and the system is capable of, now obviously capable of, and likely to do great wrong and the rules in the system need to be changed. One of the things I learned writing the book and it just reinforced what I kind of always expected was how amazingly powerful incentives are. And you just can't ignore them and you've got to be very careful about the incentives that you give people and people are just badly incentivized and they're badly incentivized inside Goldman Sachs and I'm sure individually they're all great. They're all smart. I'm sure they're…

ES **In some cases, delightful.**

ML Absolutely. Maybe not at the end of their careers, but certainly at the beginning. And so it's not that these are bad people and it's a mistake to say – oh what you need to do is get rid of some bad people and put some good people in – because if you put the good people into the same system, they'll become bad people. They're badly incentivized.

ES **So what happens though if the rules of the game aren't changed?**

ML The popular thing to say is – oh it's all going to happen again – but if it does all happen again, it's going to happen in such a different way: it's going to require an elaborate explanation to show people how it all connects up. But it will all happen again.

But the bigger problem is what is Wall Street supposed to do? It is not a creator of wealth. It is a handmaiden to creators of wealth. It occupies essentially a parasitic, but usefully parasitic, relationship with the rest of the society. It's totally out of control. It is not making America a great place. It's making America a worse place right now and so that's the problem, that finance needs to occupy a healthier, more productive relationship with the rest of society and it isn't just an economic relationship.

It's also – it's got the social cultural component to it that it is not healthy: that our financial system has rules in it that enable the returns to individual traders that it enables. And it leads half the smartest kids from the best schools wanting to be more than anything else in their lives bond traders or investment bankers. It's a waste of talent. The wrong economic signals are being sent by the system that's in place. I think if the rules are changed in some obvious ways, the returns to the finance sector would decline and the talent would find more useful avenues of endeavor.

ES **Michael Lewis knows as much about trader psychology as any author, but even he was surprised about what he learned writing *The Big Short*. We'll have that when we come back.**

[BREAK]

ES **Writing *The Big Short*, Michael Lewis got close to the most toxic trades in history. They taught him something critical and frightening about the culture of Wall Street.**

ML In the Wall Street firms, I should have known it, but I didn't know it. I didn't know quite how cynical they could become, just how detached from their original purpose they could get and this surprised me because the Solomon Brothers I left in 1989 was a fractious, violent, bawdy, interesting place, but there was a personal attachment that people felt to the institution.

People were angry with me for writing the book because they thought I had betrayed Solomon Brothers. The Wall Street that I walked back into to do *The Big Short*, it wouldn't occur to anyone that you could betray your Wall Street firm because there isn't that relationship: that relationship doesn't exist anymore. Everybody's a free agent.

There's no sense of loyalty to an institution or a cause greater than yourself or all that stuff. And so what I learned was just how purely financial and commercial the place had become and how denuded of essentially what it was denuded of is the partnership sentiment. There was the residue of the partnership sentiment that was still hovering around Solomon Brothers when I got there because it had been a partnership not that long ago. And that had been completely replaced by this new antiseptic, raw financial relationship and it was curious to see that people could function in that environment and feel like that was a satisfying thing to be doing with their lives.

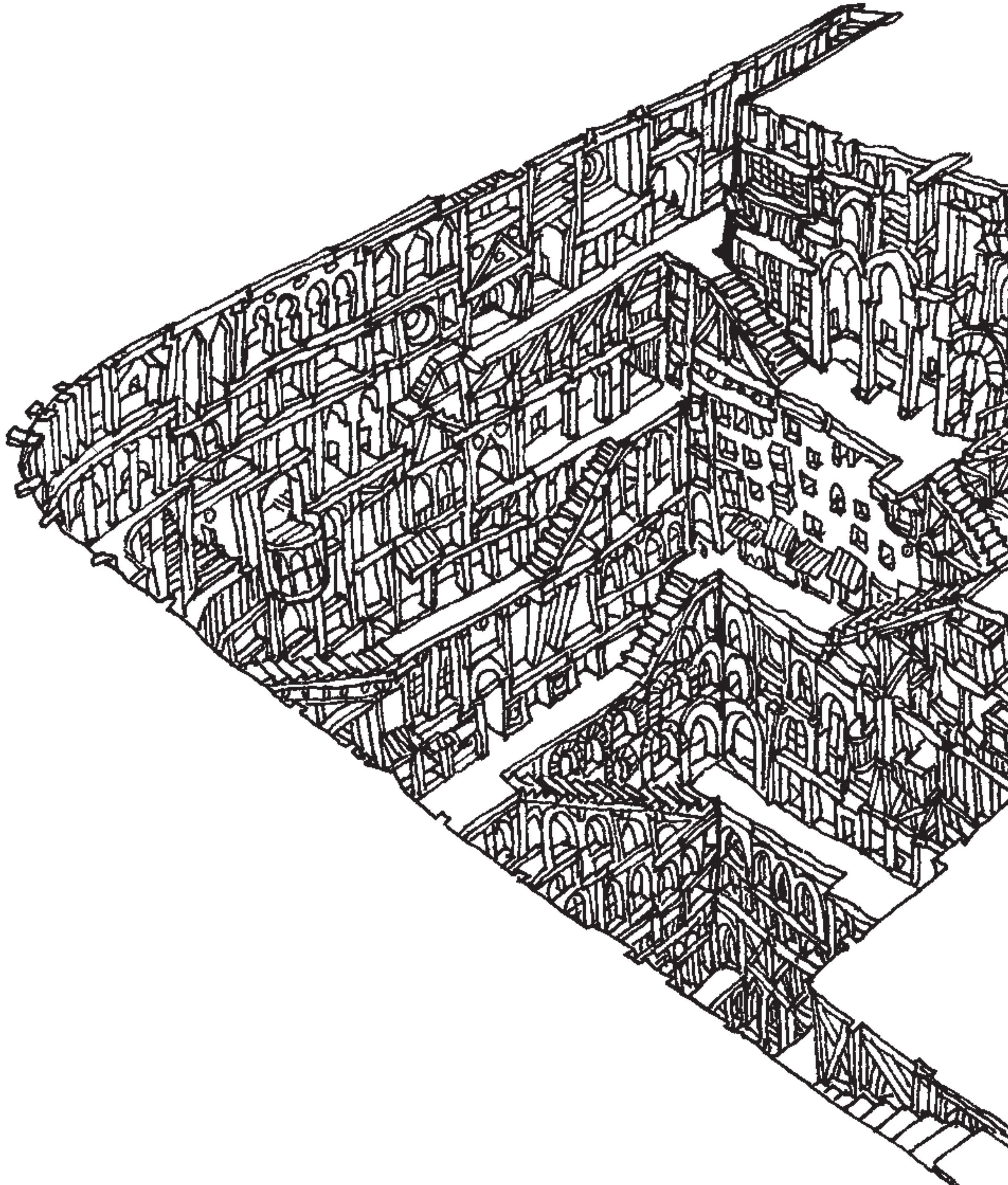
ES **A lot of people would say the most jaded, the most cynical, out there would say that there never ever was a golden age of investment banking even when the firms were privately held. It was all partners' capital inside. Do you agree with that?**

ML Well, golden age might be a bit strong, but I think there were much saner structures.

ES **The incentives were organized.**

ML The incentives were organized much more properly. The right incentive now is the hedge fund incentive. It's the, I mean there are things that are screwed up about it, but typically the person who runs the hedge fund has all his money in his own hedge fund and that's kind of how it's got to be and he's on the hook for losses.

The problem now is there's no long-term greed. It's all short-term greed. It's not institution building or career building. It's quick kills. And so I do think that that aspect of the business, that approach to finance, is a healthier, more golden age-like approach than what we have now. I'm not arguing that investment banks were ever perfect institutions. That's silly. I'm just saying that there's a smarter way to organize them.



ES **Did you learn anything about Wall Street that you didn't know before in the course of reporting this book?**

ML Yes, I did. I mean if I hadn't learned a lot, I wouldn't have been interested in doing it, but I learned first about investing. It was very interesting to me to see just how personal investing decisions can be, just how in the end a lot of it comes back to who you are as a person, that you're guided by all sorts of things that I wouldn't have thought would have informed investment decisions. So just how human the financial markets were on the buy side was really interesting to me.

There were several layers to the interest, but I can remember the first thing that grabbed me was I was shocked that these big firms that used to essentially be the smart money at the poker table had become the dumb money and I was really curious how that had happened. I was curious, I had watched them change over the years and adapt to the world in ways that enabled people to continue to get paid large sums of money in them. The outrageous behavior that I describe in *Liar's Poker*, that didn't exist. The places got much more corporate, much more sanitized, all in the service of preserving the paychecks.

ES **Next, Wall Street subprime's strategy finds a new home, overseas.**

[BREAK]

ES **The story of toxic derivatives didn't end with subprime mortgages. It's still unfolding today, in Greece.**

ML The parallel gets even more elaborate because Goldman Sachs appears to advise the Greek government on how to disguise its level of indebtedness. So it feels as if Wall Street went into entire countries and persuaded them to take out subprime mortgage loans, in effect, or help them, enable them in taking out subprime mortgage loans.

So, yes, we're living through this period where we're reckoning with the real consequences of financial engineering: financial engineering gone wrong. And the very small bore version of this was the financial engineering that enabled some poor schmuck in Chico, California, who had no income, to buy a $1 million house and the big version of this is Greece.

ES **To what degree should we point the finger at derivatives? Would any of this have happened if derivative contracts did not offer unlimited opportunities to take risk?**

ML I have a friend who says derivatives are like guns. Guns don't kill people, people do. It's not the derivatives. It's the way people use them and that is true. It's true that in better hands there's no reason derivatives by themselves would cause problems. Derivatives are just ways of carving up the risk and redistributing it. It's also true that there is no way the misallocation of capital that occurred in the last few years would have occurred without derivatives. That you need – the only way it happens is it's so complicated, people can't understand it. And so they were a necessary ingredient to this catastrophe.

ES **But not single-handedly responsible.**

ML But not single-handedly responsible. So I do think that more generally, not just derivatives, but financial innovation now needs to be regarded with skepticism. That we've come through an age where people just assume that anything that was invented on Wall Street must be good for the rest of the society because someone was making money from it; that all innovation led to great efficiency. We can now see examples of innovation that led to greater inefficiency.

So the question is how do you parse this innovation and decide what's good and what's bad. It was insane, the credit default swaps were not regulated as insurance and that they aren't. It's insane that they're not, that everything, every new security that's created is not traded on screens with a clearing house so people can see what the prices should be. The problem is it's totally hidden, that nobody knows, people could tell you who owns the subprime mortgage loans. They can't tell you who's on the other side of the credit default swaps. No one knows which firms are on the wrong side of this bet. There's no exchange. They're private transactions between consenting adults and no one knows how much of it there is. This creates uncertainty.

If you want to know why the panic happened in 2008, it was because no one knew who had what losses and the reason no one knew who had what losses is there were all these private transactions of enormous, indeterminate size that were undisclosed.

ES **It wasn't so long ago that Wall Street was a hidden world where what traders bought and sold didn't matter to the rest of us. Not any more. When we come back, Michael Lewis explains why.**

[BREAK]

ES **Welcome back. Michael Lewis started his career at Solomon Brothers in the 1980s. I wanted to know, 25 years later, how did Wall Street become so dangerous?**

ML I think the seeds of this catastrophe go back to the '80s and that the source of a lot of the problems are peoples' incentives being screwed up. It's not right or it's certainly not satisfying to say – oh Wall Street's just greedy, got too greedy and that was the problem. Wall Street's always greedy. People who go to work on Wall Street are greedy. That's why they go to Wall Street. They don't go to Wall Street because they have a calling in finance. I mean a handful of people do, but for the most part, people go there because that's where the money is and they want money. You're not going to change that.

What changes are the rules that channel the greed or the system that channels the greed. So the greed came to be channeled in very short-term ways. So people became very short-term greedy, greedy for the next quarter, greedy for the next bonus rather than greedy for a long and lucrative career. What caused that? Firms ceasing to be partnerships is the beginning of it. That a Wall Street firm that is investing its own money, the people inside it – it's their money that's at stake – are going to behave very differently from people who are a public corporation who are using shareholders' money. No partnership would have ever allowed itself to own billions of dollars of triple A rated CDOs backed by subprime, just wouldn't have happened because they would have scrutinized it in a different way. Nobody will say that on Wall Street or say that's true. They'll say we behaved just as we would have as if it was our own money, but they don't, nor would you expect them to.

People are very – it's amazing how powerful incentives are. Two, the business got intellectualized in the 1980s. The proximate cause of the intellectualization was the Black-Scholes' option pricing model, but just generally it got more complicated and so as it got more complicated, it got harder and harder for normal people to understand it and easier and easier for smart people to persuade dumb people to do things they shouldn't do and easier and easier for smart traders to disguise what they were doing from their bosses because it's so complicated. That was absolutely necessary.

One of the signature traits of this crisis is that the people on the top of the firms clearly didn't know what their firms were doing; that they were buffaloed by people underneath them. And they all feel betrayed by their employees when they're speaking privately about them. But this is why they could be because the business got too complicated for the people who ran them. Finally and this is a really big one and related to the other two. The relationship between Wall Street and its customers, the legitimate business of Wall Street is to allocate capital. The traditional businesses on Wall Street, the traditional capital allocation businesses have gotten less and less profitable. All these new markets, these financial innovations is a response, in part, to Wall Street's need for profits and profits drying up and say old-fashioned stock broking because you can now go on the internet and buy a stock and pay a tiny commission rather than call your guy at Merrill-Lynch and pay a fat one.

So Wall Street, if you look at how firms make their money, especially if you have been inside one of them, you realize that increasingly, especially in the bond markets where more of the profits are than in the stock markets, Wall Street has come to increasingly trade against its customers rather than on their behalf. It's acting not as an intermediary, but essentially as a big proprietary trading fund. It is using its customers to get itself out of the positions it doesn't want to be in, to take the stupid side of a smart trade they want to do, so on and so forth. There is a poisonous interface between these big firms and their customers in the bond market and everybody now takes it for granted. It shocked me when I saw it in 1987, 86-87, but it's now just normal. It's thought to be normal and that is the minute you're starting to think – the way I make money is exploiting the idiocy of my customers – is the minute you start creating securities that are designed to explode, that you could be on the other side of.

The minute you're thinking less like a handmaiden to productive enterprise and a useful allocator of capital, you're becoming the jerk in the zero sum game and they become the jerks in the zero sum game. So you back away from it all and you say – look at what these people did. And the shocking thing is is what they did was legal – and you say how do you change the rules? What do you do here?

One of the things you obviously do is you have to destroy this notion that it's okay to trade against your customers. You have to say maybe what you say is you can be a firm like Schwab that has customers, but you don't trade in anything for yourself or you can be a hedge fund, but you can't be both. Because the minute you start to trade against the customers is the minute you start designing things that aren't good for the customers. And the minute you start designing things that aren't good for the customers, you start designing CDOs filled with subprime mortgage bonds. You start to misallocate capital. You're trying to misallocate capital and that's crazy.

It's insane. But it is the normal on Wall Street and so breaking it up, as you can see, changing it is going to be a violent act because it's become so assumed, it's so deeply embedded as the assumption of this is how the business is.

ES **Want to know what gets Michael Lewis really worked up?**

ML It's outrageous. If the markets had been allowed to function, if the government had not stepped in to rescue these firms, they'd all be out of business, all of them.

[BREAK]

ES **I'm getting a sense of Michael Lewis right now and what he thinks and there's quite a bit of you in the epilogue to this book. You talked about the fantastic handouts given to the TARP recipients, how they were unnaturally selected for survival and how it was shocking for the Fed to buy mortgage-backed securities. Are you personally outraged?**

ML Yes. Because it's outrageous. And absolutely, you know, well they are, if the markets had been allowed to function, if the government had not stepped in to rescue these firms, they'd all be out of business, all of them. They're all failed. There are different degrees of idiocy. Maybe Goldman Sachs doesn't fail because it has lots of subprime mortgage bonds on its books. It fails because it's got credit default swaps with people who do. But, nevertheless, it fails. Because of the position they occupy in the financial system, they can't be allowed to fail. I think that, all right you can forgive. That step I can forgive. I completely understand. I can understand the way, how the decisions that were made in the midst of the crisis were necessarily self-contradictory, ad hoc, hard to understand in retrospect, all the rest, but now we're out of that.

What I find outrageous is that the people who were in positions of influence and power, when the crisis occurred were, by definition, people who didn't see it coming. They were, by definition, ignorant at what was going on right under their noses and that they are, that there's been so little change in that regime, is a little outrageous to me.

I think it's outrageous that essentially the US government took the position, unlike say the UK government, that these firms were so central to our way of life that not only could we not let them fail, but we can't even suggest their creditors take a hit; that essentially they're failed institutions that we need to prop up so we are going to gift them money until they get out of their problems, which they appear to be doing now. That's what we've done though, we've gifted the money.

In the beginning, we gifted the money in very overt ways, direct investment in the firms or buying their securities or whatever at inflated prices or whatever, those obvious ways, but now their ability to tap the Fed for money at 0% and reinvest the money in agency bonds and take the spread is a form of the gift. So it's outrageous that they are essentially being gifted out of their problems and that their view is that their employees deserve a large chunk of the rewards of those gifts. I think that, but it's outrageous.

On the other hand, it's understandable because they have a way of life that has existed for 30 years on Wall Street. It's very hard to change peoples' habits especially if they don't have to change and they've proved that they don't have to change. I think that the end result of this, however, is just to stoke the political anger. It is going to change the system. So I think that in the end, in a weird way, the behavior of the Wall Street firms currently is the best friend that reform has because they're not doing a very good job of disguising their interest in the rest of the world.

ES **The firms that survive may be even stronger now than they were before and a whole lot of the people, the traders, for example, who lost their jobs, are back, employed by the firms that survived, so where is the justice?**

ML It's not over. We're living through this big transition right now, I think, but Wall Street has changed dramatically and Wall Street's relationship to the rest of the world has changed dramatically and the way people view Wall Street has changed dramatically. These firms have gone from being unquestioned masters of the universe and unquestioned kind of upper class that everyone aspired to be, to being essentially enemies of the people, inside of the last two years.

I mean, they do have a lot of political influence and there is natural resistance and impediment to changing the rules of their road, but there is also on the other side of that, enormous anger and cynicism that is going to find a political expression and you can't expect democracy to move as quickly as finance. Financial markets panic. They change very rapidly. Democracy moves very slowly. In 1929, the markets collapsed. It wasn't until 1933 that Glass-Steagall is introduced. It took several years to have proper hearings in Congress. The reason for that is that the engine for democratic change is elections and elections don't happen every day.

ES **There's something about Michael Lewis that sets him apart from other writers. When we come back, the author tries to handicap his own success.**

[BREAK]

ES **What is it about Michael Lewis that makes him different? What's the thread he followed from Wall Street to Silicon Valley to baseball and football and back to Wall Street again? I wanted to know.**

ML My own explanation for why I've always been interested in this and interested in why anybody would pay me a lot of money to advise people what to do with their money. That was the beginning of *Liar's Poker*. I think it's that I grew up in a city, in a culture in New Orleans that had experienced enormous status collapse and it was experiencing it and things that I cherished and valued were no longer valued or being less and less valued by the world and things that made for a happy life were less and less valued in the world and I think that as I enter adulthood when I'm in my late teens, early 20s, I am perplexed by what people think is important and valuable – so I'm probably drawn to that subject in part for that reason. But other than that, I don't have a self-conscious obsession with the subject.

ES **If you had to handicap it, what would you say has been the key to your success?**

ML Sloth, let me tell you, this is not completely a joke. Indolence more than sloth, that I think the fact that I am inherently a little lazy. And you may not believe this, but if you just ask my wife she will tell you that it means that I have to be really roused to do anything. I have to be really interested. I don't write a book because I need to write a book – because I really don't need to write a book. I write a book because I'm really interested in it. So that really helps. It really helps that it's not exactly a lack of ambition, but a kind of – I'd rather be laying in bed reading a book or watching TV or playing with my kids. It helps to have to be roused to action rather than just be always ready for action. I think it's helped me that I have a pretty low threshold of boredom and if I'm not humored and interested by it, then I just drop it.

ES **Were you surprised by the commercial success of *The Blind Side* both as a book and now as an Oscar-winning movie?**

ML I was so taken with the story that I couldn't believe it took so long for the movie industry to be interested in it and it did and it only got made accidentally. It got made because of the intercession of Fred Smith – the head of FedEx has a movie company. He knew the story personally. He lives in Memphis and he made it happen, I think is what happened. So I can't say – I wish I could – I was really surprised. I'll say this about it: that when I wrote it, it was very different from anything I had written and I was surprised my publisher didn't give me more grief about writing it. They were wonderful about it and they probably shouldn't have been and we found it, in the first instance, a hard book to sell. It did not sell well as a hardback. It's sold well now because of the movie, but, if anything, I was surprised I didn't do a better job selling it when it came out. I thought it would be better than it did.

ES **Well, nobody expected Michael Lewis to write a tearjerker.**

ML Me neither and I still cry when I see it, so how does that work? But it's also very, I mean, the movie may be a little less so, but there's a lot of humor. It's a pretty funny story. At the same time, and funny enough.

ES **Tragic-comic in a way.**

ML Well, but this is actually, I think, something that's basically universally true, is that in some weird way, all emotions are the same; that the presence of humor makes it even easier to evoke tears; that crying and laughing, you're feeling something – and this is a story in which you felt so much, which is why I thought it would be a movie because Hollywood's naturally attracted to that sort of story. But I felt so much of it when I was writing.

Sandra Bullock from the movie: This team is your family, Michael. When you look at him…

ES **With the Oscar success of his book, *The Blind Side*, Hollywood beckons. Coming up, Michael Lewis and I talk about his other movie prospects.**

[BREAK]

ES **Michael Lewis wrote *Liar's Poker*, *Moneyball*, and *The Blind Side*. More now from our conversation about his newest book. You hope *The Big Short* gets made into a movie?**

ML Well it got bought. Paramount and Brad Pitt bought it. This is what I've learned about the movie business so far. It is pointless to hope it does anything because you have no control over it. I'm not even sure it has control over itself, so it's like this raving lunatic wandering the street. You don't want to hope things for it because your hopes are just going to be dashed. I try to keep my emotions detached from it and not get too worked up about it. Of course, it's better if it gets made into a movie than not because even if it is made into a crappy movie, more people will read the book. So, sure, and I actually don't care whether it's a crappy, I mean I'd like it to be, of course, it's better if it's a good movie than a crappy movie, but I'd rather make a crappy movie than no movie at all because it drives traffic to the book.

ES **If it did get made into a movie, have you given any thought to whom you'd like to see play certain characters?**

ML I have, I think, Philip Seymour Hoffman should play Steve Eisman. That he's so perfect for it that it's just not true. I think Matt Damon should play Michael Barry. They even look a little alike, but Matt Damon, I think he could do Asperger's well and he hasn't done it yet and everybody should do Asperger's once.

ES **At least once in your career.**

ML Right, then there are these three – essentially kids that they're in their early 30s – but they're sort of young men with a Schwab account and I think I would cast them out of the Judd Apatow universe of actors.

ES **Seth Rogan?**

ML Yeah, Seth Rogan in the super bad guy and Jonah Hill and I would cast essentially comic actors in that role.

ES **Would you want to go back to writing about things that people never saw before, people never heard of before and, as a result, gave your audience kind of a strategic roadmap for what was going to happen?**

ML Yes, it bothered me about *The Big Short* that it wasn't – that the greatest financial crisis in the history of the world was not a secret. I would like it to have been a secret. But, on the other hand, it's nice that the subject is obviously important. I can't generalize about where I'm going to find a story. It just so happened that I found what I thought was a really riveting story inside this big event. So it wasn't the whole event. It was this very narrow story inside the event and having said that, it still bothers me a little bit that the event's so obvious. Any idiot can write a book about the financial crisis. So I would like to, all things being equal, I'd rather nobody had ever heard what I'm writing about because there's a freshness to that and you feel like you can invent the world in some way that you can't do if everybody, your reader comes with so much baggage to a story about the financial crisis that they don't bring to a story about a poor boy no one's ever heard of. So all things being…

ES **They talk to you and nobody was paying attention.**

ML That's right. So all things being equal, I'd rather farm land that's not being farmed, but all things are never equal and I actually don't know exactly what I'm going to do next.

ES **Michael Lewis started his latest book, *The Big Short*, with a mixture of fascination, curiosity and awe. How could so few people have spotted the financial meltdown and made so much money doing it? He walked away with a sense of outrage and a conviction that something on Wall Street has to change or we'll surely end up with another crisis. I'm Erik Schatzker, thanks for watching.**

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