The Big Short: Inside the Doomsday Machine Study Guide

The Big Short: Inside the Doomsday Machine by Michael Lewis (author)

(c)2015 BookRags, Inc. All rights reserved.

Contents

The Big Short: Inside the Doomsday Machine Study Guide....1

Contents....2

Plot Summary....3

Prologue and Chapter 1....5

Chapters 2-3....7

Chapters 4-5....10

Chapters 6-7....12

Chapters 8-9....14

Chapter 10 and Epilogue....16

Characters....17

Objects/Places....20

Themes....22

Style....24

Quotes....26

Topics for Discussion....28

Plot Summary

The Big Short: Inside the Doomsday Machine by Michael Lewis is a return to Lewis' financial roots. In this book, Lewis explores the stock market crash of 2008. Lewis examines the bond market and the move into subprime mortgage bonds that led to the crash that actually took place over the long months in 2007 when the housing prices suddenly dropped nationwide. In this character driven narrative, Lewis examines the group of people who saw the crash coming and either kept quiet to protect potentially large investments or were too shocked to speak up.

In the 1980s a shift occurred on Wall Street that allowed young men to walk in off the street and become multi-millionaires by advising others how to invest. With this shift came an interest in finding more diverse ways of investing and making money. Part of this shift was the creation of the mortgage bond. A mortgage bond was a bond that included hundreds of mortgages that were offered to the American public. To make these bonds easier to sell to investors, they were divided into what was called tranches, or different levels. Due to the fact that mortgages are not always paid off when expected, the tranches would offer on the lowest level the earliest pay offs with a high interest, while the higher tranches were the ones that would mature when expected and had a low interest.

In 2005, it occurred to a money manager to short mortgage bonds, which in effect means to bet against them being paid at the appropriate time. To do this, money manager Dr. Michael Burry approached multiple banks to buy credit default swaps, or CDSs. This was like a type of insurance against the default of these mortgage bonds. If the borrowers in these bonds paid their mortgages as expected, the investor, Burry, would lose out on a set amount of money he paid semiannually in premiums. However, if the borrowers defaulted on their loans, the investor stood to gain multiples of his basic investment.

At the same time Burry was discovering CDSs or subprime mortgage bonds, an insurance company called AIG FP was building and selling what was called collateral debt obligations, or CDOs. These were a collection of the lowest and riskiest levels of mortgage bonds bundled together. Once bundled together, these CDOs would often get a rating of triple-A from the rating companies, a rating that suggested there was little risk to the investment, rather than the triple-B rating that the lower tranches of the mortgage bonds would normally receive. This made these investments more exciting for buyers and easier to sell. Soon they were selling like crazy to banks and large investors in such a fashion that they spawned a new type of money manager called a CDO manager. However, it soon became apparent most of the banks and managers dealing in these CDOs did not truly understand the nature of the market or their own product.

In 2007, the housing market began to plummet. When this happened, many of these CDSs and CDOs began to pay out and many of the Wall Street banks discovered they had no realistic idea of what this meant. Morgan Stanley found itself in debt to Deutsche

Bank for $1.2 billion. Eventually the bank would take a hit of more than nine billion dollars due to the CDOs an enthusiastic bond trader sold through their bank.

As the mortgage bonds began to fail, the banks which had invested so greatly in the CDSs and the CDOs found themselves failing as well. In March of 2008, Bear Sterns went under. In September of 2008, Lehman Brothers was allowed to fail while the American government was arbitrarily rescuing other banks and encouraging the sale of still more. The mortgage crisis turned Wall Street on its head and changed it irrevocably.

Prologue and Chapter 1

Prologue and Chapter 1 Summary and Analysis

Michael Lewis, the author of previous financially based books, is also the author of The Blind Side, a non-fiction book about NFL star Michael Oher.

Prologue. Poltergeist.

Michael Lewis continues to be shocked that Wall Street would allow him, a twenty-four year old kid, to buy and sell stocks, paying him an unbelievable amount of money. Based on this experience, Lewis wrote his first book, Liar's Poker. Lewis thought his book would open eyes and change the way in which Wall Street did business. However, the book had the opposite effect of inspiring young men like himself to rush to Wall Street to do what Lewis did. In time Lewis realized that nothing would ever really change on Wall Street.

In 2007, Meredith Whitney, an analyst of financial firms for Oppenheimer and Co. announced that Citigroup had so mismanaged their affairs that it would slash its dividend or crash. When this prediction came true a short time later, Meredith Whitney became a long sought after analyst. Then, after the stock market crash in 2008, Lewis called Whitney and asked her who knew what was happening? Who benefited? Whitney gave Lewis a list of names that included her previous mentor Steve Eisman.

Chapter 1. A Secret Origin Story.

Steve Eisman was a corporate lawyer who realized he hated being a lawyer. Steve's parents worked for Oppenheimer and arranged to give Steve a job as an analyst. Steve, an outrageous man who has trouble filtering his thoughts and attitudes, quickly became loud and outspoken among the many other analysts at Oppenheimer. Then, when an Oppenheimer banker needed information on Aames Financial, a subprime mortgage lender, Steve volunteered and quickly became Oppenheimer's expert on subprime mortgage lenders — subprime meaning loans made to customers with less than perfect credit.

Steve's main concern was mortgage bonds. With mortgages, the borrower had the right to pay off the loan or there was the possibility of default, making the bond unpredictable. Other types of bonds are predictable and are known to be paid off within a specific time. To fix this problem with mortgage bonds, the bonds would be divided into pieces known as tranches. The first tranche consisted of mortgages that were paid first, giving the buyer of the tranche a higher interest rate to compensate for the early pay off. The second tranche would be the second group of payoffs that would have a slighter smaller interest rate, all the way to the final tranche that would have the lowest rate of interest, but the highest assurance that the investment would not end early by early payoff.

With the creation of mortgage bonds, mortgage companies became inspired to grow quickly and offer a great many loans to customers. This often led to mortgages being made to customers who were not as reliable in making their payments as others and to fraud on the part of the mortgage companies. With the help of accountant Vincent Daniel, Steve soon learned of some of the fraudulent actions of these mortgage companies and became outraged by them. Based on Vincent's work, Steve published a report in September of 1997 outlining the bad practices of the subprime mortgage lender. A short time later multiple subprime lenders were refused capital and quickly went bankrupt. By 2002 there were no more public subprime mortgage lenders, but there remained one consumer lending giant called Household Finance Corporation. Steve and Vincent discovered that this company was fraudulently selling fifteen year mortgages under the guise of thirty year mortgages, convincing consumers they were paying 7 percent interest when in reality they were paying more than 12 percent. Steve quickly discovered that there were no regulators interested in this fraud, leaving these companies free to cheat the poor of America.

Research into subprime mortgage lenders changed Steve Eisman's view of the world, even changing his political views. In 2004, Steve stopped working as an analyst and started his own hedge fund. At first Steve had trouble raising money, but when his wife threatened to move to Rhode Island to raise chickens, Steve redoubled his efforts and soon made a success of his new business. By 2005, Steve had gathered quite a group of investors around himself filled with people who believed as he did that no one on Wall Street knew what they were doing. At the same time, the subprime mortgage lenders were back, working harder than ever to cheat the American people by keeping their bad loans off their books and thereby making it appear as though they were making more money than they really were.

In these chapters, the author of the book explains his own disillusionment with Wall Street after working for an investment bank as a young man. The author believes that the financial system on Wall Street is essentially broken. For this reason, the author has set out to show what wrongs in the early part of this decade led to the stock market crash of 2008.

The author introduces the reader to Steve Eisman, a character who is either immediately hated or loved by those around him. Steve is the son of two financial brokers who got their son a job at Oppenheimer and Co. as an analyst when his career as a corporate lawyer left him unsatisfied. Almost immediately, Steve became embroiled in the subprime mortgage market as an analyst of mortgage bonds. In this first chapter, the author not only introduces Steve Eisman, but also explains what a subprime mortgage is and what mortgage bonds are. These two financial elements were huge contributors to the stock market crash of 2008 and Steve Eisman was one of the first to see the warnings on the walls.

Chapters 2-3

Chapters 2-3 Summary and Analysis

Chapter 2. In the Land of the Blind.

In 2004, money manager Michael Burry became interested in bonds. Burry had previously only invested in stocks, but became interested in bonds after reading a great deal about them and studying their prospectuses. As Burry became knowledgeable about mortgage bonds, he became aware that he had a tactical investment problem. Burry could not bet against mortgage bonds in the same way he could other bonds because he could not short houses, only house builders, but this was a risky investment. That is why Burry became interested in credit default swaps. These swaps were like an insurance policy with semiannual premium payments and a fixed term. In buying these swaps, Burry was guaranteed to only lose only the amount of the premium payments. However, if the credit went bad for some reason, Burry would make multiple times what he put into the swap.

Burry, who suffered from cancer as a toddler and lost his left eye to it, never felt comfortable in social situations. Burry was always something of a loner, even as he studied medicine and worked as a resident in neurology. Even as a medical resident, Burry remained interested in the stock market, an interest he developed as a child when his father once warned him to stay away from the stock market. Burry joined a thread on a social network and shared his thoughts on investing while learning what he could from others. Then Burry began what would later be called a blog, cataloging his investments and their results. This drew interest from Wall Street brokers without Burry's knowledge. Then, when Burry's father died, he quit medicine and became a money manager. When word of this decision got out, Burry was approached by Gotham Capital and White Mountains, both of whom provided Burry with capital to begin his new company. Burry had success immediately, picking stocks with surprising success and growing his investment capital despite several downturns in the market.

When Burry became interested in subprime mortgage bonds, he first had to get an ISDA agreement, a contract that would keep sellers from defaulting should the credit default swaps pay out. Before the agreement was completed, Burry made his first credit default swap with Deutsche Bank, buying six bonds at $10 million each. From there, Goldman Sachs gave him a list of bad mortgage bonds to choose from, then Bank of America agreed to a $5 million dollar deal and then Goldman Sachs offered him bonds at $100 million a deal. In a short time, Burry had credit default swaps on $750 million in subprime mortgage bonds. Burry was so excited by this that he wanted to begin a new hedge fund based on these bonds, but he could not sell it to his investors. In fact, many of Burry's investors were deeply unhappy with his new direction in investing their money. At the same time, many Wall Street banks became interested in what Burry was doing and some of them even called to ask if they could buy the swaps back, including Greg Lippman from Deutsche Bank. Burry sold Lippman back the $60 million he had

purchased from Deutsche Bank due to the fact that his relationship with the bank had grown negative, but decided to hold on to all the rest.

Chapter 3. 'How Can a Guy Who Can't Speak English Lie?'

On Wall Street, trading in stocks is a transparent business, therefore an investor can trust most brokers to be brutally honest about their trades. However, the bond business is different. The price of a bond fluctuates and it takes research to find out exactly what an investor might expect from the bond. For this reason, it is difficult for an investor to trust what might be said about any given bond. When Greg Lippmann came to Steve Eisman to sell subprime mortgage credit default swaps, Steve was skeptical. However, with all Steve knew about the subprime mortgage companies, the CDS (credit default swaps) seemed like a dream come true. Now Steve could bet against the subprime mortgages without needing to know when the mortgage market would crash. To add to Lippmann's credibility was his support team, Euguene Xu, a Chinese national who came in second in a math competition in China and spoke no English. Lippmann figured he could be trusted because he had no motive to lie.

American International Group Financial Products (AIG FP) was buying and selling CDSs on subprime mortgage bonds, providing the insurance large companies, such as Goldman Sachs, needed to feel secure in making bets that millions of insolvent Americans would repay their mortgage loans. This sale of CDSs grew AIG FP so quickly that it provided 15 percent of AIG's profits and spawned other companies doing the same thing. Soon all the CDSs AIG FP sold consisted primarily of subprime mortgages. At the same time, Goldman Sachs began taking the bottom tranches of their mortgage bonds and packaging them together to create CDOs (collateralized debt obligations) that they would present to the rating groups and have rated triple-A where before they would have been rated triple-B, the lowest rating. In this way, Goldman Sachs was essentially turning lead into gold. They were taking a lot of risky loans and making a pile of bonds that were rated triple-A and then taking the lowest rated of the remaining bonds and repacking them into triple-A CDOs.

Greg Lippmann saw what was happening and knew that getting into these investments should be a priority. Lippmann thought that if AIG stopped buying the bonds, the subprime mortgage bond market would collapse, making Lippmann a fortune. However, Lippmann's company told him he needed to bring in investors or lose the opportunity, but Lippmann had trouble selling his idea to investors. It was this need to quickly sell his idea that brought Lippmann to Eisman. For this reason, Lippmann went to AIG FP and sold them on buying CDSs, hoping to change the situation.

In chapter 2, the author introduces the reader to Mike Burry. Burry is an antisocial type of guy who spends a great deal of his time alone; therefore, he studies the investment markets closely and knows a great deal about investing. Although trained to be a doctor, Burry became a money manager and had a great deal of success with investing in stocks. When Burry decided to move into bonds, he began to explore mortgage bonds. Aware that mortgage bonds are a complicated investment and that it is often impossible to bet against them, as had become Burry's style of investing, he became interested in

credit default swaps, or a type of insurance against a large number of borrowers included in a mortgage bond defaulting on their loans. Burry's investment was minimal, but the rewards if the borrowers defaulted would be large. Burry was one of the first to make such an investment.

In chapter 3, the author goes on to explain how AIG FP, a large finance company, began selling CDSs, thus insuring the subprime mortgage bonds and taking on the risk that other companies wanted to avoid in the sale of these bonds. Over a short amount of time, a bond analyst at Deutsche Bank became aware of AIG FPs role in these swaps and realized that if AIG FP stopped selling these CDSs, the mortgage market would collapse and those holding the CDSs would come into a fortune. For this reason, Lippmann began selling the idea to investors, but had little success. At the same time, Goldman Sachs began repackaging the subprime mortgage bonds into CDOs that would get a higher rating than the original bond should have gotten and would sell better.

Chapters 4-5

Chapters 4-5 Summary and Analysis

Chapter 4. How to Harvest a Migrant Worker.

AIG FP did not get Lippmann's message as he assumed they had. Only one person, Gene Park, who worked in AIG FP's Connecticut office, began to investigate the CDSs his company was selling and came to the conclusion that these CDSs contained more subprime mortgage bonds than anyone knew. When Park tried to tell this to his boss, Joe Cassano, he was screamed at for it. Eventually, however, Cassano would come to agree with Park.

Lippmann continued to search for investors, but found it difficult. For this reason Lippmann pitched his ideas continuously to Steve Eisman. Steve and his team continued to be skeptical and began investigating on their own. As they investigated, they found patterns in the people and states that suffered the highest default rates. At first they did not understand the data, but later came to realize that the mortgage lenders were using FICO scores to alter the rating of their bonds. The lenders would mix poor FICO scores with higher FICO scores from customers who had little credit history and therefore a high FICO score. This led to such things as lending more than $700 thousand to a migrant worker who made only $14,000 a year.

Vincent Daniel went to a conference of subprime mortgage bond professionals and learned from a woman from Moody that her supervisors picked and chose which mortgage bonds would be triple-A rated despite her frequent recommendations that most of them be downgraded.

Chapter 5. Accidental Capitalists.

Charlie Ledley and his friend Jamie Mai began an investing company in Mai's garage with $110,000 and little knowledge of investing. Together the two men picked a company, the first being Capital One Financial, that was having some legal troubles and investigated, finally deciding that the legal trouble would blow over and their low stock would soon rally. This investment proved to be a wise one and the two men made more than half a million dollars. High on this success, the two men continued to make risky investments until they had grown their investment company to $30 million dollars.

Ledley and Mai took their company, Cornwall Capital Management, to New York where they began working with Ace Greenburg at Bear Sterns, although they never really spoke to or met Ace Greenburg himself. Then they met Ben Hockett, an employee of Deutsche Bank who made investments from his home in Berkeley Hills, California. Mai and Hockett became friends and Mai eventually convinced Hockett to come to work for Cornwall. With Hockett's help, Cornwall received an ISDA, making them eligible to buy

CDOs. However, even with the ISDA they had trouble finding someone willing to work with them.

Ledley and Mai did a great deal of research into CDOs and CDSs, but struggled to find anyone who could help them. In fact, during their research, Ledley and Mai discovered that many CDOs were comprised of triple-B rated mortgages being sold as triple-A, creating a situation that was essentially fraud. It also represented a great opportunity. Ledley and Mai bought multi-million dollar triple-A CDOs rather than the triple-B CDOs Burry and Eisman had bought and reached the conclusion that they had made a good investment.

In chapter 4, the author takes the reader down the road of investigation that Eisman and his team followed. They learned that the loans made to subprime borrowers were made in such a way that they were practically doomed to failure. The mortgage companies packaged their mortgage bonds in such a way that they appeared to be triple-A rating worthy, but in reality it was all an illusion created with manipulation of credit scores and personal documentation. This made investing in CDOs seem even more lucrative because there was no doubt that the mortgage bond market would collapse sooner rather than later. At the same time, the one company selling the majority of CDOs realized what they were doing and changed their practice. However, this did not cause the bottom to fall out of the market as Lippmann had thought it would, but only shifted the responsibility of the CDOs to other entities that would be discovered later.

In chapter 5, the author introduces the reader to another group of investors who discovered CDOs and began investing in them. Ledley and Mai were unusual investors who had made millions of dollars investing in unlikely stocks. Despite the thirty million these men made, however, they could not find a Wall Street bank to take them seriously. For this reason, they brought in another partner who opened many doors for them. Finally they were able to find a bank willing to work with them and began buying CDOs based on research that revealed fraud in the creation of the CDOs and offered a unique opportunity for them. However, like Eisman and several others, this group was left wondering why they were the only ones to see disaster on the horizon.

Chapters 6-7

Chapters 6-7 Summary and Analysis

Chapter 6. Spider-Man at The Venetian.

There was a conference in January of 2007 in Las Vegas for subprime mortgage bond salesmen and buyers. Eisman and his team attended, as did Ledley and Hockett. The first night, Eisman found himself attending a dinner thrown by Deutsche Bank. At the dinner, Lippmann intentionally sat CDO buyers next to people who sold them or were otherwise considered on the wrong side of the equation. Eisman was sat next to a man named Wing Chau, a CDO manager. During dinner, Chau described how he packaged and sold CDOs for Merrill Lynch. As Chau talked, Eisman realized that Chau had no idea what was in the CDOs that he was selling and that he knew very little about them. Not only this, but Eisman realized that Chau was selling CDOs that were synthesized from other synthesized CDOs, creating CDOs that were essentially repackaged CDOs. This conversation finally convinced Eisman that no one really understood what was happening with these mortgage bonds, almost guaranteeing disaster in the near future.

At the same time, Ledley found himself being courted by Bear Stearns and chiefly ignored by most of the other conference attendees. Ledley spent most of the conference speaking with everyone who would listen to him and trying desperately to find someone who would work with him. Among these people was a man from Wachovia who would eventually do business with Ledley's hedge fund.

As the conference continued, Eisman found himself less interested in the confrontation and controversy that was normally his style, and more interested in investigating the nuances of the mortgage bond business. This included speaking with analysts from the rating companies. These people revealed to Eisman that no one truly understood these CDOs. Each company gave Eisman stock answers and this seemed to reveal a real lack of understanding among these analysts. This led Eisman to begin shorting the stocks of these companies as well as many of the CDO managers.

Chapter 7. The Great Treasure Hunt.

After the Las Vegas conference, Ledley, Mai, and Hockett began buying millions of CDOs, anxious to buy as many as they could before it was too late. They were never able to buy as much as they wanted, but soon ended with more than two hundred million in CDOs. Ledley and Mai also took their concerns about the CDOs to the SEC, but failed to find anyone who understood the situation let alone cared about what was happening.

Also after the Las Vegas conference, Eisman and his group began paying close attention to the rating companies. This included meeting with Ernestine Warner, head of the surveillance department at Moody. They learned that the rating companies were

working with the same information the investors were, which meant they had little information. With further investigation, including a close look at the banks selling and investing in these CDSs and CDOs, Eisman came to the conclusion that none of them really appreciated the disaster awaiting them because of the high ratings the rating companies were giving these CDSs and CDOs. For this reason, Eisman thought that many of these banks would collapse when the mortgage market collapsed. Eisman began shorting these companies as well.

In chapter 6, Eisman and his team attended a conference in Las Vegas where he became curious about the mortgage bond business and what everyone knew about it. Eisman's eyes were opened by a CDO manager who knew little to nothing about the CDOs he sold. Eisman was shocked by this man's discussion of his job and the number of people involved who knew so little about what they were selling or what could happen to their investments.

At the same Las Vegas conference, Ledley and Hockett found themselves searching for someone who would take them seriously and sell them CDOs. The more Ledley, Mai, and Hockett learn about CDOs, the more they believed they were a good investment despite the fraud that was apparent in the design of the CDOs. This conference propelled these two investment groups and led them to make some of the most important investments of their careers.

In chapter 7, the reader learns of Eisman's investigation into the subprime mortgage bonds, CDSs, and CDOs. Eisman discovered that no one seemed to know anything about them, even those heavily invested in both sides of the coin. Not only this, but it was clear that the rating companies were keeping the bubble afloat by giving these CDSs and CDOs high ratings. Eventually Eisman knew that the bubble would burst and the companies with heavy investments in these mortgage bonds would fail while those who had shorted the mortgage bonds by buying the CDSs and CDOs would make lots of money. For this reason, Eisman not only bought the CDOs offered by Lippmann, but he also began to short the Wall Street banks involved in these bonds.

Chapters 8-9

Chapters 8-9 Summary and Analysis

Chapter 8. The Long Quiet.

During the first six months of 2007, Mike Burry found himself struggling with his investors. Burry, who had recently learned he had a type of autism known as Asperger's, found that his reports to his investors were appearing more and more bleak because of his heavy investment in subprime mortgage CDSs. Many of Burry's investors were unhappy with the losses reported by Scion Capital and were beginning to ask for their money back. Before, Burry had not worried about this because his investors signed a contract promising not to remove their money for a set amount of time. However, that time period was reaching an end for many of his investors, including Gotham, one of his original investors. Reluctant to lose out on what Burry was convinced would be a profitable investment, Burry decided to side pocket his CDSs to keep his investors from taking their money back. Many of the investors were angry about this and threatened lawsuits. Before this could come to fruition, however, Burry's CDSs began to make money. None of his investors apologized.

Chapter 9. A Death of Interest.

Howie Hubler at Morgan Stanley was a bond trader. Hubler decided to find a way to bet against mortgage bonds and in doing so began forming CDOs and selling them to what he thought were ignorant investors. Hubler anticipated making more than a billion dollars with these CDOs and was pleased when he found a great many buyers. Morgan Stanley was so impressed with Hubler that they made him a unique deal to keep him from moving out of Morgan Stanley and starting his own hedge fund. They gave Hubler his own money management firm within Morgan Stanley of which Hubler would own fifty percent. Hubler picked the elite of the elite of the Morgan Stanley bond department and moved up to the tenth floor.

Hubler was allowed to work as he pleased for a time, without interest from his bosses, including CEO John Mack. However, when the majority of bonds began to go bad and Lippmann called up Hubler asking for 1.2 billion dollars owed Deutsche Bank on the CDOs purchase from Hubler, Hubler's bosses became concerned. However, no one could agree how much the CDOs were worth and Morgan Stanley finally settled for $600 million. Later, Lippmann gave Hubler several chances to back out of the deal at a loss, but Hubler continuously refused until finally settling with Deutsche Bank for more than three billion dollars. In October, Hubler went on vacation and never returned. Morgan Stanley had lost more than nine billion dollars on Hubler's CDO deals. When asked how this could happen, it became apparent that no one at Morgan Stanley fully understood the CDO deals, including John Mack.

Suddenly concerned with Bear Sterns' ability to pay what they owed them, Cornwall Capital Management began quickly selling their CDOs. Ben Hockett, on vacation in England, hit the internet and quickly began selling the CDOs. They ended up making more than eighty million dollars from the deals. At the same time, Mike Burry also began selling his CDSs, making more than seven hundred and fifty million dollars for his investors. However, most of Burry's investors were still unhappy with him and chose to leave his fund anyway.

In chapter 8, the author takes the reader back to Dr. Mike Burry. Burry was still running Scion Capital with most of his investor's money in CDSs. The investors had grown restless losing money in an investment they never really understood. For this reason, Burry was forced to make a move that could be illegal to protect the investment and quickly discovered that it was a smart move.

In chapter 9, the author tells the story of how Howie Hubler created and sold CDOs for Morgan Stanly without fully understanding what he was doing, eventually losing Morgan Stanley more than nine billion dollars, one of the largest one time losses for a Wall Street firm ever. This loss was overwhelming, but what was ironic is that even the CEO of the company could not explain how it had happened. This seems to have been a theme to the entire mortgage boom and bust between the years 2005 and 2008.

Not everyone lost out, however. Both Cornwall Capital and Scion Capital made a great deal of money by owning and then selling their CDOs and CDSs at the right time.

Chapter 10 and Epilogue

Chapter 10 and Epilogue Summary and Analysis

Chapter 10. Two Men in a Boat.

On March 14, 2008, Eisman was invited to make a speech at a meeting for Bear Sterns that was meant to support the quickly flagging Wall Street firm. During his speech, Bear Sterns' stock began to plummet, falling more than twenty points in the few minutes it took him to make his speech. A short time later, Bear Sterns failed and was quickly followed by Lehman Brothers.

On September 18, 2008, the face of Wall Street changed. Stock prices plummeted as Lehman Brothers was allowed to fail. One of Eisman's partners had a panic attack as he tried to keep his eye on the investments his fund had made in shorting the Wall Street banks, investments that were quickly making them a great deal of money, while worrying that Morgan Stanley, who owned a percentage of their fund, would fail. At the same time, Charlie Ledley and his partners had the bright idea to set up a fund to sue the rating companies whom they blamed for the fiasco and give the money back to investors cheated in the deals. Michael Burry, who still felt as though he was not receiving the recognition he deserved for his foresight and lucrative investing, decided to quit as a money manager.

Epilogue. Everything is Correlated.

The author tells his readers about a lunch meeting he had with his former CEO at Salomon Brothers, John Gutfreund. Once hailed the King of Wall Street for taking his firm public, the first Wall Street firm to do so, Gutfreund openly blames the author for ruining his career. The author, however, points to Gutfreund's actions in taking Salomon Brothers public as the first step in a long line of actions based in the 1980s that led to the mortgage crisis that nearly toppled Wall Street — this, and the odd actions of the American government in bailing out these Wall Street firms with what amounts to billion dollar gifts paid for by the American people.

In chapter 10, the author sums up the climax of the mortgage crisis, showing the reader what happened when the CDOs and CDSs came due and no one really understood what it meant until it was too late. Most of the Wall Street banks would have failed if they had been forced to pay out all they owed and most still did not fully understand what it was they had done. Those who made money from the deal often suffered guilt and tried to do their best to make up for what they had done. However, once again the one group taking the hit the hardest was the American public. First it was the American public who suffered by accepting mortgage loans they could not afford and defaulting on their loans, losing their homes. Then the American people were forced to pay for the gamble Wall Street made and failed to live up to.

Characters

Steve Eisman

Steve Eisman worked as an analyst at Oppenheimer and Co. when he began to research subprime mortgage companies. This information showed Eisman how willing big corporations were to exploit and cheat poor Americans and how the regulators failed to be interested in this open fraud. This caused Eisman to take a lifelong interest in these companies.

After he stopped working as an analyst and began his own investment company, Eisman found himself approached by a man named Greg Lippmann. Lippmann worked for Deutsche Bank. Lippman had learned about subprime mortgage CDOs and was attempting to find investors for them. Lippman's plan was a brilliant one to Eisman, offering him an opportunity to short the subprime mortgage companies without having to worry about timing.

Eisman began buying CDOs, but he also began investigating the banks, CDO managers, and rating companies that dealt in these CDOs. With what he learned, Eisman began shorting the stock of all these entities with the knowledge that eventually the bottom would fall out of the subprime mortgage industry and they would all fail or at least struggle. Eisman would eventually make a great deal of money shorting these entities and buying the CDOs.

Dr. Michael Burry

Michael Burry was a doctor who struggled with personal relationships and felt uncomfortable in most situations. Burry had a fascination with computers that led to an interest in financial investing. Burry quit medicine and became a money manager, beginning his own hedge fund. While investing the money from his fund, Burry became interested in subprime mortgage bonds. This interest led to an investigation into CDSs. Burry eventually became one of the first investors to buy CDSs in the subprime mortgage bond industry. Although Burry's investors were unhappy with this investment, Burry stuck to his guns and would eventually make a great deal of money for his investors.

Greg Lippmann

Greg Lippmann was an employee of Deutsche Bank when he got wind of Michael Burry's interest in CDSs. Investigating Burry's actions, Lippmann became excited by this avenue of investment and began searching for investors interested in investing with him. Lippmann was pressured by his company to find more investors or give up on his ideas. For this reason, Lippmann aggressively recruited investors, including Steve Eisman.

Charlie Ledley

Charlie Ledley was a thirty year old college graduate who had little experience in the stock market when he moved to California to create a hedge fund with his friend, Jamie Mai. Cornwall Capital Management would have some great successes with their first few investments, including an investment in Capital One Financial at a time when the company was facing a large loss due to legal trouble.

Charlie Ledley would become interested in subprime mortgage bonds and CDOs in 2006 when he and his partner attempted to move their hedge fund into the bigger markets. Charlie Ledley would attend a conference in Las Vegas and learn all he could about these CDOs, eventually buying more than two hundred million dollars worth of CDOs. It would prove to be a wise investment.

Jamie Mai

Jamie Mai was an uncertain, awkward man who had worked strange jobs out of college, such as delivering yachts to rich customers. When Jamie Mai had a large savings account, he talked his friend, Charlie, into joining him in creating a hedge fund that would consist of only the two of them. Together they made several good investments that made them more than thirty million dollars. Jamie and Charlie wanted to grow their company and moved to New York where they found it difficult to find a Wall Street firm that would take them seriously. However, they eventually got their foot in the door thanks to Jamie's friend and second partner, Ben Hockett.

Ben Hockett

Ben Hockett worked for Deutsche Bank, first in Tokyo and then from his home in California. Ben had grown unhappy with his work for Deutsche Bank. About this time, Hockett met Jamie Mai. Mai was running his own hedge fund and talked Hockett into joining it. Due to his strong ties to Wall Street, Hockett was able to help Mai's hedge fund get an ISDA, a contract they needed to make large trades on Wall Street. Due to this, Mai's hedge fund was able to buy triple-A rated subprime mortgage CDOs.

Howie Hubler

Howie Hubler was a bond trader for Morgan Stanley when he became interested in finding a way to bet against subprime mortgage bonds. Hubler began creating CDOs and selling them to investors that he saw as fools who had no idea what it was they were buying. However, it turned out that Hubler did not fully understand what it was he was selling. Hubler thought he could make more than a billion dollars for his company, but in the end his company lost more than nine billion dollars, one of the single largest losses for a major Wall Street firm.

John Mack

John Mack was CEO of Morgan Stanley at the time Hubler was selling CDOs. Mack was well respected and thought to be well informed on bond trades because he was once a bond trader himself. However, Mack obviously had no clue what Hubler was up to and could not explain it when the entire episode was over and his company had lost more than nine billion dollars.

Ace Greenburg

Ace Greenburg was a celebrated name on Wall Street through his affiliation with Bear Sterns. When Cornwall Capital Management moved to Bear Sterns, their account was handled by Ace Greenburg who was partially retired, but still handled special accounts. However, Ledley and Mai never met Greenburg except for one brief encountered in which they felt they were meeting an actor posing as Ace Greenburg rather than the real man.

Michael Lewis

Michael Lewis is the writer of this book. Lewis worked on Wall Street when he was twenty-four years old. Lewis was so shocked and outraged by what he saw on Wall Street that he wrote a book about it called Liar's Poker. This book was inspired in part by Lewis' continuing disbelief when it comes to the way in which Wall Street is allowed to conduct its business.

Objects/Places

Tranches

Tranches are divisions of mortgage bonds in which the mortgage bonds are divided into pieces. The lower tranches consist of mortgages that are more than likely to be defaulted upon or paid off early and include a higher interest rate. The higher the tranches are, however, the less likely the borrower will default and the lower the interest rate, with the highest tranche consisting of mortgages that will more than likely mature as expected.

CDS

CDS (credit default swaps) is like insurance on a bond that pays out only if the borrower defaults on his loan. For example, in the subprime mortgage bonds an investor could buy a CDS for a low tranche on a mortgage bond and pay premiums semiannually. If the mortgage borrowers whose mortgages are held by that bond pay their mortgages as expected, the investor only loses the premiums. However, if the mortgage borrowers default on their mortgages, the investor receives multiples of the premiums, making CDS a safe and often lucrative investment.

FICO Scores

FICO, named for the Fair Issac Corporation, score is a cumulative number that suggests a consumer's credit risk. The highest score available is 850, the lowest 300. The average American FICO score is 723.

CDO

A CDO, or collateral debt obligation, is a collection of one hundred different mortgage bonds, usually the riskiest that are combined to create a new group of bonds that could take the low rated bonds and reclassify them at a higher rate.

ISDA

ISDA, or International Swaps and Derivatives Association, is a group that formalizes the terms of new securities. An investment corporation needs a contract through ISDA in order to trade in securities that are traditionally only bought and sold between large investing bodies.

Moody's and Standard & Poor's

Moody's and Standard & Poor's are the two major rating agencies that rate the risk of securities. It was Moody's as well as Standard & Poor's who rated many of the CDS as triple-A even though many of them contained as much as 95 percent of subprime loans, loans that had previously been given the lower triple-B rating.

Mortgage Bonds

Mortgage bonds are bonds that are made up of mortgages sold to consumers by banks. These bonds are relatively new because bonds rely on a predictable time table, but many mortgages are either paid off early or are defaulted upon, causing them to end sooner than predicted. For this reason, banks began breaking mortgage bonds into tranches to make them more appealing to investors.

FrontPoint

FrontPoint is the name of the investment group Steve Eismann formed after quitting his job as a bond analyst.

Cornwall Capital Management

Cornwall Capital Management is the name of the investment group begun by Charlie Ledley and Jamie Mai.

Scion Capital

Scion Capital is the name of Mike Burry's investment group.

Oppenheimer and Co

Oppenheimer and Co is the name of an investment bank where Steve Eisman's parents worked and got him a job as an analyst. This is also where Meredith Whitney worked when she predicted the need for Citigroup to slash their dividends or crash in 2007.

Deutsche Bank

Deutsche Bank is an investment bank on Wall Street where Greg Lippmann worked in the bonds department.

Themes

Investing

Investing is the act of buying stock in a company and gaining a profit should the price of the stock go up before you sell it or losing money should the price go down. The same is true in bonds, but the difference is that the investor does not always have a clear idea of how much a bond is worth because unlike stock prices, the price of a bond is not shown on a ticker tape display and updated every few seconds.

Trading bonds is supposed to be a safer way to invest. However, when someone dreamed up the mortgage bond, no one fully understood the implications of the different elements of each mortgage that was then packaged with a hundred others. The use of FICO scores to rate the risk of a mortgage bond could be misleading since FICO scores rarely show the entire picture of a person's credit risk. Other factors also impact the chances that a particular mortgage bond will fail or mature as expected.

The basis of this book is the actions of investors and brokers. The brokers were not always honest about the mortgage bonds and the investors rarely understood what it was they were buying. It is in this way that the author uses the theme of investing to show the reader how the stock market crash of 2008 happened and how it might have been avoided.

Fraud

The author of this book points out fraud on the part of banks in several places in this book. The first time he mentions fraud is when Eisman investigates subprime mortgage lenders and discovers that they lied to the American consumer in many ways that would have been considered fraud had any regulatory agency been interested. However, many were not.

The author also points out fraud when he discusses how the Cornwall Capital Management hedge fund discovered in their research into mortgage bonds that the way the bonds were packaged and sold was blatant fraud. The banks would often repackage bonds in different CDOs over and over again in such a way that they were selling something that was essentially synthetic and therefore useless. These synthetic CDOs would then be rated higher than they should have been simply because of how they were packaged. It is these things that make fraud a theme of the book.

Character Oddness

The author points out in his book that the three main groups of investors who saw the mortgage crisis coming and made money from it were odd. One man was unkind and often had trouble filtering his thoughts and opinions, often offending people who were

much more powerful than himself. However, this honesty often won him the knowledge he needed to succeed in his career.

Another of the investors was a man who had had cancer as a child and was missing an eye, something he blamed for his trouble relating to people and succeeding in social situations. However, this man would later realize that he suffered from Asperger's syndrome, a form of autism.

Finally the last group of investors the author showcases in his novel is a couple of young men with little to no knowledge of investing who one day decided to form their own hedge fund. These young men are awkward and ill equipped for the job, but soon find a great deal of success in their chosen field.

This group of investors is all odd, somehow creating a profile of the type of person who did well in a time of crisis, who saw crisis come and did little to stop it and later wondered how history would perceive them. It is this that makes character oddness a theme of the book.

Style

Perspective

The author of this book was once a broker on Wall Street. This experience led the author to feel somewhat bitter about the actions of those who work on Wall Street and to hope the book he wrote about his experiences would change the way people work on Wall Street. Instead, the author's first book became something of a how-to manual for young men like himself. It is with this outlook that the author investigates and reports on the stock market crash of 2008.

The author's perspective in this book is somewhat subjective due to his own experiences on Wall Street. However, the author reports the facts of the stock market crash of 2008 with as much truth as he could discover in the stories of the people who were there and knew what was happening. The author takes the perspective of those who saw the crash coming and moved to make money off of it, rather than a more indirect look at the facts from Wall Street's point of view. For this reason, the reader is offered a fascinating story, but it is a story that could be told in a different way and is therefore somewhat slanted to fit the author's ideas of the corruption on Wall Street.

Tone

This book is told with a character-driven narrative that gives the book a somewhat complicated tone. At some points the tone of the book is comical, a light tone that is almost entertaining. At other points in the book, however, the author uses a drier tone, especially when explaining the complicated mortgage bond system.

The tone of the book is different from other books about finance in that the author focuses more on the people who populate his book than simply their actions. The author gives the reader background on the most important characters in his scenario, offering a lighter tone as he describes the oddness of these characters and the motives that led to their actions during the events he is describing in the book. For this reason, this book tends to be a more reader friendly book for those unaccustomed to the inner working of the financial world that exists on and near Wall Street.

Structure

The book is divided into ten chapters with a prologue and epilogue. Each chapter has a unique title and is approximately twenty pages long. The author tells his story in a linear fashion, beginning at times more than ten years before the stock market crash that is the climax of his book. The book is told with a combination of writing styles, including a narrative that remains close to the characters important to the events being described and a drier narrative that focuses on the complicated aspects of the mortgage bond system.

The structure of the book is overly simplistic in order to help the reader understand a complicated system that even those involved in the mortgage bond system did not understand. The author goes out of his way to involve the reader in the lives of the main characters in the book so that the reader will come out of the experience of reading his book with not only an understanding of the events that led to the stock market crash of 2008, but also of the motives of those who saw the crash coming and made money from it. For this reason, the structure of this book is important to the reader's overall understanding of the book and vitally important to this book.

Quotes

"The willingness of a Wall Street investment bank to pay me hundreds of thousands of dollars to dispense investment advice to grown-ups remains a mystery to me to this day." Prologue, pg. xiii

"The big fear of the 1980s mortgage bond investor was that he would be repaid too quickly, not that he would fail to be repaid at all." Chapter 1, pg. 7

"The credit default swap would solve the single biggest problem with Mike Burry's big idea: timing. The subprime mortgage loans being made in early 2005 were, he felt, almost certain to go bad." Chapter 2, pg. 30

"Rather than cave to the pressure, Lippmann instead had an idea for making it vanish: kill the new market." Chapter 3, pg. 83

"The more they examined the individual bonds, the more they came to see patterns in the loans that could be exploited for profit." Chapter 4, pg. 97

"A smaller number of people—more than ten, fewer than twenty—made a straightforward bet against the entire multi-trillion-dollar subprime mortgage market and, by extension, the global financial system." Chapter 5, pg. 105

"The CDO manager's job was to select the Wall Street firm to supply him with subprime bonds that served as the collateral for CDO investors, and then to vet the bonds themselves."
Chapter 6, pg. 141

"In a portfolio of less than $30 million, Cornwall Capital now owned $205 million in credit default swaps on subprime mortgage bonds, and were disturbed mainly that they didn't own more." Chapter 7, pg. 163

"The first half of 2007 was a very strange period in financial history." Chapter 8, pg. 194

"In the murky and curious period from early February to June 2007, the subprime mortgage market resembled a giant helium balloon, bound to earth by a dozen or so big Wall Street firms." Chapter 9, pg. 209

"All that remained was to observe the speed of the spark, and the size of the explosion." Chapter 9, pg. 225

"But the biggest lag of all was right here, on the streets. How long would it take before the people walking back and forth in front of St. Patrick's Cathedral figured out what had just happened to them." Chapter 10, pg. 252

"The people in a position to resolve the financial crisis were, of course, the very same people who had failed to foresee it: Treasury Secretary Henry Paulson, future Treasury Secretary Timothy Geithner, fed Chairman Ben Bernanke, Goldman Sachs CEO Lloyd Blankfein, Morgan Stanley CEO John Mack, Citigroup CEO Vikram Pandit and so on." Epilogue, pg. 260

Topics for Discussion

What is a subprime mortgage? What is a mortgage bond? Why is it important that the reader understand these elements before understanding the events that led to the 2008 stock market crash? What is a CDS? What is its purpose? What is a CDO? What is the difference between a CDS and a CDO?

Who is Steve Eisman? What is his role at Oppenheimer and Co? How does he become familiar with the subprime mortgage industry? What is his opinion of this industry? How does he come to this conclusion? What influences his opinions? Why does Eisman leave his job at Oppenheimer? What does Eisman eventually find himself doing for a living?

Who is Michael Burry? What is odd about his social skills? Why does Burry become a doctor? Why does he quit? How does Burry get into investing? What does Wall Street think about Burry's skills as an investor? Why does Burry become interested in subprime mortgage bonds? What does he begin to invest in? What happens to these investments?

Who is Charlie Ledley? Jamie Mai? Ben Hockett? Why do they have trouble finding Wall Street banks willing to work with them? Why do they want to work with these banks? What do they do when they finally find a Wall Street bank willing to work with them? What happens with this investment? What is different about their investment as compared to those of Burry and Eisman?

Why does the author talk about the personal lives of Eisman and Burry? What does it matter to the crisis of 2008 that Burry has Asperger's? Why does it matter that Eisman's infant son died or that he became a nicer person after the crisis of 2008? How does the author leave the reader in regards to these characters? Are these characters heroes or villains?

What might have happened had all the major Wall Street banks failed in 2008? What would have happened to the world economy? What did the American government do to stop this? Did they do the right thing? What has happened since the time the author wrote this book? Is Wall Street the same as it was before, or has the crisis changed it irrevocably? Explain.

Why does the author blame the Wall Street of the 1980s for a crisis that took place in 2008? Why does the author meet his old CEO for lunch? What does the author want to say to him? What does the old CEO think is the cause of the crash in 2008? Who is right? How do their theories compare? How are they different?