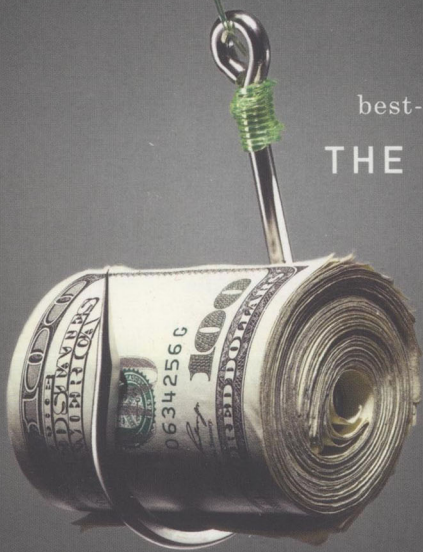


#1 NEW YORK TIMES BESTSELLER

best-selling author of  
THE BLIND SIDE



# MICHAEL LEWIS

## THE BIG SHORT

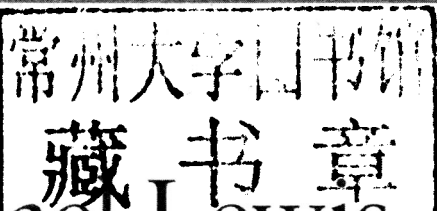
INSIDE THE DOOMSDAY MACHINE

WITH A NEW AFTERWORD

# The Big Short

INSIDE THE DOOMSDAY MACHINE

Michael Lewis



W. W. NORTON & COMPANY

NEW YORK LONDON

Copyright © 2011, 2010 by Michael Lewis

All rights reserved

Printed in the United States of America

First published as a Norton paperback 2011

For information about permission to reproduce selections from this book,  
write to Permissions, W. W. Norton & Company, Inc.,  
500 Fifth Avenue, New York, NY 10110

For information about special discounts for bulk purchases, please contact  
W. W. Norton Special Sales at [specialsales@wnnorton.com](mailto:specialsales@wnnorton.com) or 800-233-4830

Manufacturing by Courier Westford

Book design by Lovedog Studio

Production manager: Anna Oler

Library of Congress Cataloging-in-Publication Data

Lewis, Michael (Michael M.)

The big short : inside the doomsday machine / Michael Lewis.—1st ed.

p. cm.

ISBN 978-0-393-07223-5 (hardcover)

1. United States—Economic conditions—2001-2009. 2. Global Financial Crisis,  
2008–2009. 3. Financial crises—United States—History—21st century. I. Title.

HC106.83.L5 2010

330.973—dc22

2010004804

ISBN 978-0-393-33882-9 pbk.

W. W. Norton & Company, Inc.

500 Fifth Avenue, New York, N.Y. 10110

[www.wwnorton.com](http://www.wwnorton.com)

W. W. Norton & Company Ltd.

Castle House, 75/76 Wells Street, London W1T 3QT

2 3 4 5 6 7 8 9 0

More Praise for  
The Big Short  
by Michael Lewis

“Lewis brilliantly takes us inside the subprime mortgage industry. . . . [He] has accessibly and expertly described a broken financial system that rewards bad decisions and fraudulent alchemy (turning garbage into gold), then shifts the inevitable losses to the strapped U.S. taxpayer.”  
—Chuck Leddy, *Boston Globe*

“If you read only one book about the cause of the recent financial crisis, let it be Berkeley author Michael Lewis’s *The Big Short* . . . [which] manages to give us the truest picture yet of what went wrong on Wall Street—and why.” —Steven Pearlstein, *Washington Post*

“[A] rollicking narrative: a tale of beleaguered little guys betting against monster banks and fund managers, and, in the end, winning. . . . This is an assiduously reported and beautifully written book. There aren’t many reasons to be happy about the global financial crisis, but here’s one: that it brought Michael Lewis back to his roots, to produce what is probably the single best piece of financial journalism ever written.”  
—Felix Salmon, Reuters blog /  
*Barnes & Noble Review*

“No one writes with more narrative panache about money and finance than Lewis. . . . [An] entertaining new book. . . . Lewis does

a colorful job of introducing the lay reader to the Darwinian world of the bond market.” —Michiko Kakutani, *New York Times*

“In *The Big Short* best-selling author Michael Lewis delivers fascinating tales of how a few professional investors foresaw the collapse of the subprime mortgage market and then pocketed millions from their big bets.” —USA Today

“If you think you understand how and why our economy fell apart and haven’t read *The Big Short*, you’re wrong. The book is that important. Even more amazing, Lewis is such a good and entertaining writer that he’s able to hold your attention while explaining what credit default swaps, collateralized debt obligation, and the mysteriously un-acronymized ‘tranches’ are and why they matter.” —Bob Lewis, IS Survivor Publishing

“Lewis’s book is as personal, entertaining, and startling as anything he’s written . . . a chilling example of what happens when buyers fail to heed ‘let the buyer beware.’ ” —Mark Lenz,

*Daily Telegraph* (Adrian, MI)

“Few works have shaped a legislative debate quite like Lewis’s story about investors who made a killing by betting on the housing crash. . . . The book has created a kind of defining counternarrative of the economic collapse.” —Marin Cogan, Politico.com

“Michael Lewis adds to his impressive collection of beautifully written books of nonfiction with a fascinating tale.”

—G. Pascal Zachary, *San Francisco Chronicle*

“Best-selling author Michael Lewis creates a gem of a story . . . set in the late stages of the recent housing bubble, a period already chronicled in more than 100 nonfiction titles published in the past 18 months. But Lewis finds an ingenious new path. To treat his new

book as another Wall Street exposé doesn't begin to do justice to the audacity of the story.”

—George Anders, *Forbes*

“The fastest-selling nonfiction book in America right now—an instant No. 1 on Amazon—is *The Big Short*, by the journalist Michael Lewis. An even better storyteller than Stieg Larsson.”

—Frank Rich, *New York Times*

“Lewis turns the crisis into a true financial thriller that screams of Wall Street's greed, recklessness, deceit, incompetence and hubris. Readers from generalists through specialists will find this fast-paced, engaging account both illuminating and disturbing. Highly recommended.”

—*Library Journal*

“It is a testament to Lewis's writing skill that although everyone knows how things have turned out, *The Big Short* still crackles with tension and intrigue. A fine narrative about how the engines of greed, steered by the forces of amorality and stupidity, have driven us all off the cliff.”

—*Utah Daily Herald*

“It's the economy . . . the hows and whys behind its fall are the subjects of this humorous—yes, *humorous*—account.”

—*Booklist*

“In narrative, Lewis, as ever, doesn't disappoint: He gets inside the heads of his fascinating characters and vividly describes the complex financial structures they built and destroyed.”

—Tim Fernholz, *American Prospect*

“Its narrative has the same seat-of-your-pants, almost breathless feel [as *Liar's Poker*].”

—TJ, *Entertainment Weekly*

“The story of the crash is, overwhelmingly, a tale of failure. But Lewis managed to find quirky investors who minted fortunes by making unpopular, calculated bets on a financial meltdown. . . .

[He] constructs a story that is funny, incisive, profanity-laced and illuminating—full of difficult-to-like underdogs whose vindication and enrichment we end up cheering.”

—*New York Times Book Review*

“Lewis is the rare writer who can tackle a subject arcane enough to make your eyes glaze over, and make it read like a thriller. . . . A fantastic read.”

—Michael Mechanic, *Mother Jones*

“Lewis does an extraordinary job elucidating the perils of shorting the very bonds that buoyed the American economy after September 11 and made a fortune for every firm on the Street. . . . His renowned eye for color is as sharp as ever.”

—Michael Osinki,

*Bloomberg Businessweek*

“Lewis brings his gifts for narrative and his usual quest for value into the ultimate minefield: explaining how the American economy was collapsed by Wall Street’s failure to distinguish wealth from value.”

—Kevin Horrigan, *St. Louis Post-Dispatch*

“Lewis has a knack for illuminating abstraction via masterfully chosen human examples.” —Anand Chokkavelu, *The Motley Fool*

“*The Big Short* is a rollicking read. . . . Somehow Michael has taken the bewildering events leading up to the financial crisis and found a breezy story to tell, one with a handful of vivid characters whose common virtue is the ability to smell a rat.”

—Joel Achenbach, *Achenblog*, *Washington Post*

# The Big Short



Also by Michael Lewis

*Home Game*

*Liar's Poker*

*The Money Culture*

*Pacific Rift*

*Losers*

*The New New Thing*

*Next*

*Moneyball*

*Coach*

*The Blind Side*

EDITED BY MICHAEL LEWIS

*Panic*

*For  
Michael Kinsley*

*To whom I still owe an article*

The most difficult subjects can be explained to the most slow-witted man if he has not formed any idea of them already; but the simplest thing cannot be made clear to the most intelligent man if he is firmly persuaded that he knows already, without a shadow of doubt, what is laid before him.

—Leo Tolstoy, 1897

## PROLOGUE

# Poltergeist

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. I was twenty-four years old, with no experience of, or particular interest in, guessing which stocks and bonds would rise and which would fall. Wall Street's essential function was to allocate capital: to decide who should get it and who should not. Believe me when I tell you that I hadn't the first clue. I'd never taken an accounting course, never run a business, never even had savings of my own to manage. I'd stumbled into a job at Salomon Brothers in 1985, and stumbled out, richer, in 1988, and even though I wrote a book about the experience, the whole thing still strikes me as totally preposterous—which is one reason the money was so easy to walk away from. I figured the situation was unsustainable. Sooner rather than later, someone was going to identify me, along with a lot of people more or less like me, as a fraud. Sooner rather than later would come a Great Reckoning, when Wall Street would wake up and hundreds, if not thousands, of young people like

me, who had no business making huge bets with other people's money or persuading other people to make those bets, would be expelled from finance.

When I sat down to write my account of the experience—*Liar's Poker*, it was called—it was in the spirit of a young man who thought he was getting out while the getting was good. I was merely scribbling down a message and stuffing it into a bottle for those who passed through these parts in the far distant future. Unless some insider got all of this down on paper, I figured, no future human would believe that it had happened.

Up to that point, just about everything written about Wall Street had been about the stock market. The stock market had been, from the very beginning, where most of Wall Street lived. My book was mainly about the bond market, because Wall Street was now making even bigger money packaging and selling and shuffling around America's growing debts. This, too, I assumed was unsustainable. I thought that I was writing a period piece about the 1980s in America, when a great nation lost its financial mind. I expected readers of the future would be appalled that, back in 1986, the CEO of Salomon Brothers, John Gutfreund, was paid \$3.1 *million* as he ran the business into the ground. I expected them to gape in wonder at the story of Howie Rubin, the Salomon mortgage bond trader, who had moved to Merrill Lynch and promptly lost \$250 million. I expected them to be shocked that, once upon a time on Wall Street, the CEOs had only the vaguest idea of the complicated risks their bond traders were running.

And that's pretty much how I imagined it; what I never imagined is that the future reader might look back on any of this, or on my own peculiar experience, and say, "How quaint." How *innocent*. Not for a moment did I suspect that the financial 1980s would last for two full decades longer, or that the difference in degree between Wall Street and ordinary economic life would swell to a difference in kind. That a single bond trader might be paid \$47 million a year and feel

cheated. That the mortgage bond market invented on the Salomon Brothers trading floor, which seemed like such a good idea at the time, would lead to the most purely *financial* economic disaster in history. That exactly twenty years after Howie Rubin became a scandalous household name for losing \$250 million, another mortgage bond trader named Howie, inside Morgan Stanley, would lose \$9 *billion* on a single mortgage trade, and remain essentially unknown, without anyone beyond a small circle inside Morgan Stanley ever hearing about what he'd done, or why.

When I sat down to write my first book, I had no great agenda, apart from telling what I took to be a remarkable tale. If you'd gotten a few drinks in me and then asked what effect the book would have on the world, I might have said something like, "I hope that college students trying to decide what to do with their lives might read it and decide that it's silly to phony it up, and abandon their passions or even their faint interests, to become financiers." I hoped that some bright kid at Ohio State University who really wanted to be an oceanographer would read my book, spurn the offer from Goldman Sachs, and set out to sea.

Somehow that message was mainly lost. Six months after *Liar's Poker* was published, I was knee-deep in letters from students at Ohio State University who wanted to know if I had any other secrets to share about Wall Street. They'd read my book as a how-to manual.

In the two decades after I left, I waited for the end of Wall Street as I had known it. The outrageous bonuses, the endless parade of rogue traders, the scandal that sank Drexel Burnham, the scandal that destroyed John Gutfreund and finished off Salomon Brothers, the crisis following the collapse of my old boss John Meriwether's Long-Term Capital Management, the Internet bubble: Over and over again, the financial system was, in some narrow way, discredited. Yet the big Wall Street banks at the center of it just kept on growing, along with the sums of money that they doled out to twenty-six-year-olds to

perform tasks of no obvious social utility. The rebellion by American youth against the money culture never happened. Why bother to overturn your parents' world when you can buy it and sell off the pieces?

At some point, I gave up waiting. There was no scandal or reversal, I assumed, sufficiently great to sink the system.

Then came Meredith Whitney, with news. Whitney was an obscure analyst of financial firms for an obscure financial firm, Oppenheimer and Co., who, on October 31, 2007, ceased to be obscure. On that day she predicted that Citigroup had so mismanaged its affairs that it would need to slash its dividend or go bust. It's never entirely clear on any given day what causes what inside the stock market, but it was pretty clear that, on October 31, Meredith Whitney caused the market in financial stocks to crash. By the end of the trading day, a woman whom basically no one had ever heard of, and who could have been dismissed as a nobody, had shaved 8 percent off the shares of Citigroup and \$390 billion off the value of the U.S. stock market. Four days later, Citigroup CEO Chuck Prince resigned. Two weeks later, Citigroup slashed its dividend.

From that moment, Meredith Whitney became E. F. Hutton: When she spoke, people listened. Her message was clear: If you want to know what these Wall Street firms are really worth, take a cold, hard look at these crappy assets they're holding with borrowed money, and imagine what they'd fetch in a fire sale. The vast assemblages of highly paid people inside them were worth, in her view, nothing. All through 2008, she followed the bankers' and brokers' claims that they had put their problems behind them with this write-down or that capital raise with her own claim: *You're wrong. You're still not facing up to how badly you have mismanaged your business. You're still not acknowledging billions of dollars in losses on subprime mortgage bonds. The value of your securities is as illusory as the value of your people.* Rivals accused Whitney of being overrated; bloggers accused her of being lucky. What she was, mainly, was right. But it's true that she

was, in part, guessing. There was no way she could have known what was going to happen to these Wall Street firms, or even the extent of their losses in the subprime mortgage market. The CEOs themselves didn't know. "Either that or they are all liars," she said, "but I assume they really just don't know."

Now, obviously, Meredith Whitney didn't sink Wall Street. She'd just expressed most clearly and most loudly a view that turned out to be far more seditious to the social order than, say, the many campaigns by various New York attorneys general against Wall Street corruption. If mere scandal could have destroyed the big Wall Street investment banks, they would have vanished long ago. This woman wasn't saying that Wall Street bankers were corrupt. She was saying that they were stupid. These people whose job it was to allocate capital apparently didn't even know how to manage their own.

I confess some part of me thought, *If only I'd stuck around, this is the sort of catastrophe I might have created.* The characters at the center of Citigroup's mess were the very same people I'd worked with at Salomon Brothers; a few of them had been in my Salomon Brothers training class. At some point I couldn't contain myself: I called Meredith Whitney. This was back in March 2008, just before the failure of Bear Stearns, when the outcome still hung in the balance. I thought, If she's right, this really could be the moment when the financial world gets put back into the box from which it escaped in the early 1980s. I was curious to see if she made sense, but also to know where this young woman who was crashing the stock market with her every utterance had come from.

She'd arrived on Wall Street in 1994, out of the Brown University Department of English. "I got to New York and I didn't even know research existed," she says. She'd wound up landing a job at Oppenheimer and Co. and then had the most incredible piece of luck: to be trained by a man who helped her to establish not merely a career but a worldview. His name, she said, was Steve Eisman. "After I made the



Citi call,” she said, “one of the best things that happened was when Steve called and told me how proud he was of me.” Having never heard of Steve Eisman, I didn’t think anything of this.

But then I read the news that a little-known New York hedge fund manager named John Paulson had made \$20 billion or so for his investors and nearly \$4 billion for himself. This was more money than anyone had ever made so quickly on Wall Street. Moreover, he had done it by betting against the very subprime mortgage bonds now sinking Citigroup and every other big Wall Street investment bank. Wall Street investment banks are like Las Vegas casinos: They set the odds. The customer who plays zero-sum games against them may win from time to time but never systematically, and never so spectacularly that he bankrupts the casino. Yet John Paulson had been a Wall Street customer. Here was the mirror image of the same incompetence Meredith Whitney was making her name pointing out. The casino had misjudged, badly, the odds of its own game, and at least one person had noticed. I called Whitney again to ask her, as I was asking others, if she knew anyone who had anticipated the subprime mortgage cataclysm, thus setting himself up in advance to make a fortune from it. Who else had noticed, before the casino caught on, that the roulette wheel had become predictable? Who else inside the black box of modern finance had grasped the flaws of its machinery?

It was then late 2008. By then there was a long and growing list of pundits who claimed they predicted the catastrophe, but a far shorter list of people who actually did. Of those, even fewer had the nerve to bet on their vision. It’s not easy to stand apart from mass hysteria—to believe that most of what’s in the financial news is wrong, to believe that most important financial people are either lying or deluded—without being insane. Whitney rattled off a list with a half-dozen names on it, mainly investors she had personally advised. In the middle was John Paulson. At the top was Steve Eisman.