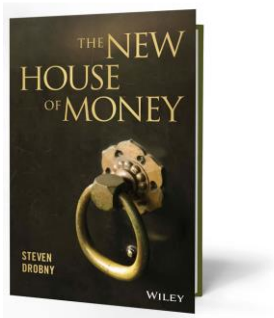
The New House of Money

A new book by Steven Drobny



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Chapter 1

Don't Mess With Texas

An interview with Kyle Bass

By Steven Drobny

Kyle Bass lived in relative obscurity until 2007, when he burst on the global hedge fund scene with a huge bet on subprime mortgages. Some might argue that outsized bets befit his Texan origins. But everything Bass does seems larger than life and goes against the conventional tide.

Bass is an outlier by any stretch of the imagination. Born in Miami, Florida, he was raised in Dallas, Texas and attended Texas Christian University in Fort Worth. Following a brief stint at Prudential Securities, he joined the Dallas office of Bear Stearns on the retail side of the business, not exactly the epicenter of global finance. Nevertheless, he became a senior managing director at 28, before leaving to run Legg Mason's Dallas office.

It's been an inside joke on Wall Street for years that getting assigned to do "equities in Dallas" was the most dreaded spot for anyone in an investment bank's training program. But toiling away in Dallas, far from the bars of New York where everyone else was talking about their views and positions, gave Bass exactly the kind of removed perspective he needed in order to see what might be the biggest trade in history.

Fast-forward to today and few coming out of Harvard or Yale want to sign up for an investment bank training program in the first place. With the Volcker Rule and Dodd-Frank legislation, the free-wheeling days of yore are gone forever, and with them the entire model of investment banking has changed. Equities in Dallas, or more specifically, an institutional quality hedge fund in Dallas is indeed the place to be.

Bass started Hayman Capital Management in 2005, something he had planned from his early days in the business. Although at the time this surely must have seemed crazy, with hindsight his timing was impeccable, as a small, Dallas-based hedge fund proved the perfect vantage from which to see the world with perfect clarity. Early in his career, Bass focused across a range of products and instruments – not just equities – looking up and down company capital structures to determine the best way to express trades. His trades ranged from highly liquid expressions to more special situations, all of which were impacted by broader macro forces.

This interview was first conceived at the Barefoot Economic Summit, which I first attended in 2011 at Kyle's ranch. Always the value investor, Bass is quick to note that he and some friends bought it at a very distressed price in the dark days of early 2009. The Barefoot Economic Summit, Texas (BEST) is a surreal mix of some of the most powerful hedge fund managers, investors, academics, pundits, Special Forces personnel, and other assorted characters. Macro managers tend to be a pessimistic bunch, and the Barefoot gathering is no exception. But if the end of the world were to be ushered in, Kyle might well come out the lone survivor.

If something bad happens, Kyle is ready, and this is exactly how he runs Hayman Capital Management. Bass might have come from relative obscurity, but he is now projecting raw power, something to which his numerous appearances in global media since his famous subprime trade would attest. After making a ton of money on the subprime trade, he more recently has moved his sights to Japan, which he says is an economic disaster. He isn't going in guns blazing on this one, however. Instead, he is structuring his bets against the Japanese bond market to minimize the costs of waiting for the big payday, which he concedes could take a while.

We conducted this interview at Hayman Capital Management's Dallas offices, where Bass is building a budding hedge fund empire. Bass is a big thinker hailing from a land of big thoughts and big dreams. The world he paints is a precarious one – but one would be foolish not to listen to what he has to say.

How did you wind up running your own hedge fund here in Dallas?

After undergrad, I took a sell side job at Prudential in their training program, but after about 18 months, I quickly figured out that retail was not where I wanted to be. I called up the guy that ran Bear Stearns' office in Dallas, which at the time was the most entrepreneurial firm. If someone wasn't covered anywhere in the world at Bear Stearns, you could cover them – there were no geographical limitations. They took me on right away, and I started working with event-driven funds on investment strategy.

You could focus on equities, fixed income, anything?

Anything. I invested in a lot of merger arbitrage, special situations, spin-offs like Palm/3Com. In 1998, I invested in some of the restructurings of the home health companies like Genesis Health Ventures. I could invest anywhere in the capital structure – it was true special situations research, which we then brought out to funds.

In 2001, I met the guys who ran Legg Mason. They didn't have a presence in Texas, so I signed a five-year deal to start their institutional business in Texas. I told them that in five years and one day, I would be launching my own firm. I had spent my whole career with hedge funds – I had no idea how long-only accounts worked, and at Legg Mason, I was covering long-only mutual funds, in addition to my entire book of business from Bear Stearns.

Legg and Citi did their fateful asset swap in 2005, which enabled me to leave a bit early due to a change of control provision in my contract. I launched Hayman Capital Management in December 2005.

What did you learn from the long-only community?

There's a lot of turnover, a lot of youth, and no special sauce to it.

Did you learn a lot from the hedge funds that you covered as clients?

Absolutely. Early on I was fortunate to have clients like Dan Loeb, Alan Fournier, Jody Lanasa, and Rehan Jaffer. I also worked with a bunch of guys who were young and very new to the business. When I launched my own business, I had $33 million in AUM - $5 million of that was mine, and the balance came from people to whom I had added value to over the years. I have a lot of other investment managers who are invested with me – we tend to talk a lot about markets and strategy. It's not that dissimilar to the conversation you're having for this book. Also, as you know, I have my conference, which assembles these managers to have discussions about the global economy.

How old were you when you launched your fund?

Good Lord! I was … 33? No, sorry – 35.

At the time there was $1.5 to $2 trillion in hedge funds, and here you are in Dallas launching with $33 million – what made you think that you could make it as a hedge fund manager?

I had met the Dallas hedge fund community and thought I understood the differences in strategies and approaches. I had always thought that I needed to have a certain net worth to be able to live – not comfortably, but to survive for the rest of my life if I didn't work. So, I basically took half of that number and invested it in my hedge fund. I had some physical assets and a little money in the bank – but the bottom line was that it had to work. To go from an employee to entrepreneur, you go from making six or seven figure paychecks to paying out six or seven figures for the first year or two. It's a massive swing in lifestyle and net worth. I operated out of this fear of failure, which still drives me today. It had to work and so far, (knock on wood) it has.

Your timing was quite good launching just before the real estate bubble burst. Did you put all your risk on right away?

Yes. In the first two months, by about April, we were roughly 60% net long equities, which was about 80% long and 20% short. Then in June and July, I started putting on the subprime mortgage shorts. By August, I had these on at roughly three times the notional value of the fund, but at a negative carry of about 340 basis points per annum.

How did you source the idea for the subprime trade, and what gave you the conviction to put it on in that size?

Everyone knew there was a housing bubble – everyone but Trust Company of the West. I still have a report put out by TCW in 2006 stating that there is no housing bubble! If you remember, that was the golden age for private equity. All of the term loan B's were LIBOR plus 250 – anyone could get one of these loans – money was essentially free. I was really worried about taking short positions in equities and then having the stock get bought. I was trying to find asymmetries in the space and found one while on a call with my friend, Alan Fournier, who runs Pennant. Alan and I were looking at the Rust Belt because the Rust Belt had negative jobs growth and net emigration. You had already seen home prices decline there, especially in the industrial centers that were exporting jobs to Asia. We had a phone call with one of the heads of the mortgage business at the Royal Bank of Scotland, and we were trying to isolate mortgage securitizations that had a high concentration in the Rust Belt. We found one that might have been 7 or 8% of the pool. The guy was walking us through the math saying, "Look, if half of these loans in the region go bad, it's going to be 3 or 4% of the pool. If you bet against the bottom 3% of the pool, which is trading at par, that slice can be wiped out." I hung up that call with Alan and said, "If I understand this correctly, this is exactly where we need to be."

I went and bought Fabozzi's book on CDOs because I didn't understand the synthetic side of things. I actually read it twice, called Alan back and confirmed, "This is exactly where we need to be and by the way, no one's modeling home price declines." We went and visited all the desks and came to the conclusion that CDO managers were completely wrong in their assumptions (inputs) even though most CDO managers had terabytes of data and incredibly complex models.

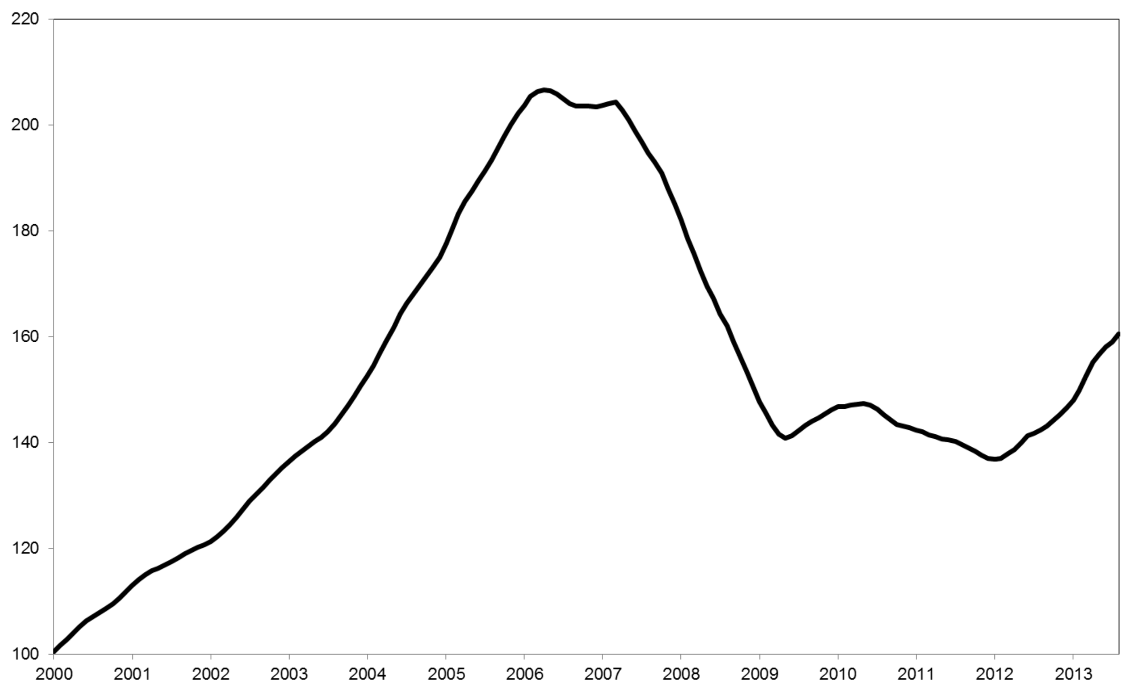
When I launched my subprime-only fund, I named the GP of the fund AF GP, after Alan, because we worked very well together researching different situations in the past and that phone call with RBS was when the light bulb went on for me. It helped me to understand what the structure looked like. Then I just dove in and figured out the whole synthetic space.

When did you find out that there were other people doing the trade?

In September 2006, when I was launching my subprime fund. I was so fearful because whole loan pricing was starting to come down, going from 104.5 to 102.5. The best whole loan originators could originate loans at 102. If whole loan pricing was coming out on top of the origination price, the game was over.

If you remember, the remit data comes out on the 23rd day of every month, and this data was already getting worse. When you looked at the Case-Shiller data, the peak in pricing was 2Q06 for the all-housing index. At the time, we had modeled that if home prices just flattened out – if they didn't grow 6 to 8% in a year as everyone assumed – the cumulative losses to these pools would be almost 9%. It would wipe out the triple-B minuses, the triple-B's, and even some of the rest of the pool.

Case Shiller Composite-20 Home Price Index (2000 - Present)
The peak in pricing was 2Q 2006



SOURCE: Bloomberg L.P.

So you were launching and worried that this big trade was going to run away from you?

We launched on September 16 or 17. People asked why we didn't wait until October 1 – but I couldn't wait for another remit to come out. I couldn't wait for whole loan prices to drop any further. I was so fearful that we weren't going to get our positions on in time because everything we were looking at was telling us that the move was happening.

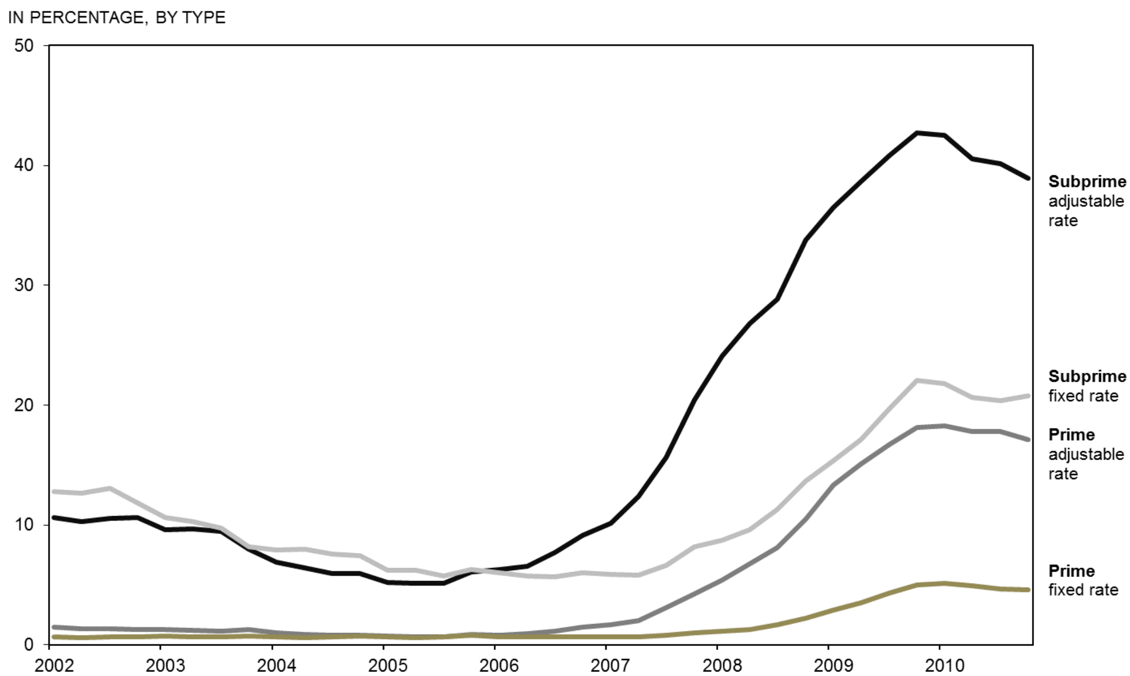
So you got your fund live and got fully invested on day one?

Yes. All of it.

When did you start hearing of others involved in the trade?

When we were raising money, I hit the country club circuit in Texas. I didn't want to go to the institutional circuit in New York for obvious reasons. Someone I met had just been at something that Paulson was doing and they told me that he was also in the trade. I had known John [Paulson] since 1995, so I called him and he said, "I hear you guys are launching a subprime-only fund." I said, "We've been marketing one now for a little over a month." He said, "It sounds like we're both in the right spot."

Mortgage Delinquencies by Loan Type (2002 - 2010)
Serious delinquencies started earlier and were substantially higher among subprime adjustable-rate loans, compared with other loan types



NOTE: Serious delinquencies include mortgages 90 days or more past due and those in foreclosure.
SOURCE: Mortgage Bankers Association National Deliquency Survey

So you got that first big trade right in 2006-07, and you're off to a great start. Tell me about 2008.

2008 was tough. Even knowing exactly how bad some of the banks' balance sheets were and how levered they were, you were juggling this ball between logic and politics, which were two competing forces at the time. If you recall, in September 2008, we had Lehman and the short sale ban. If I ask someone who runs a long/short equity fund, who is 20% long and 20% short, if they're levered, the most likely answer would be no. In reality, if you're short anything you're levered, because if it "Volkswagens" you, you're going to lose all your money.

The day the short ban was instituted in 2008, many financial sector shorts, for example, opened up over 100% that day – risk management was literally out the window. You could not risk manage your portfolio. Even if you were, say, 40% long and 40% short, if your shorts all opened up 100%, you lost 40% because your longs were likely not in the financial space. We made a little bit of money in 2008, but it was so tumultuous and difficult. Even if you got things right, the volatility on the portfolio and on each individual investment was very difficult to manage.

Volkswagened!

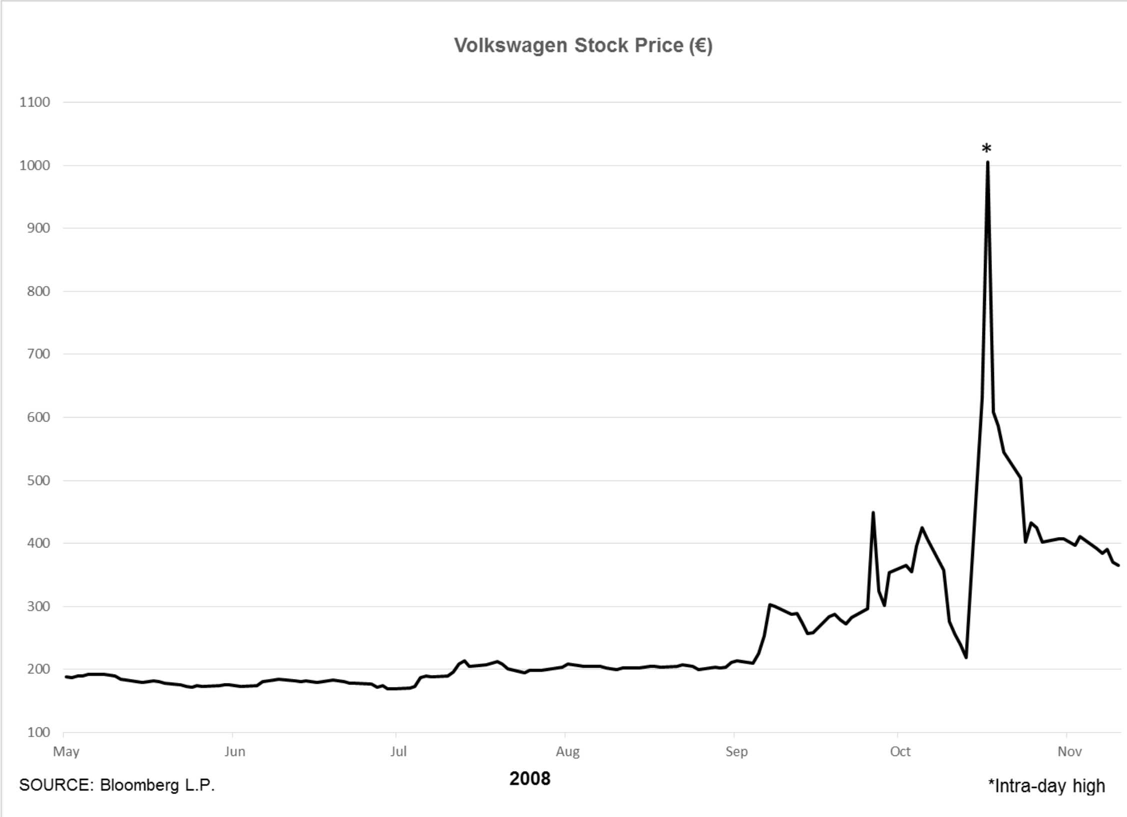
For about three years (up to October 2008), Porsche had been steadily increasing its stake in Volkswagen, a much larger but less profitable carmaker. The two German companies share some production. The consistent purchase of shares, however, had bid up the price of Volkswagen on the market, causing hedge funds to take note and start building short positions. Some hedge funds shorted Volkswagen outright, and some created an arbitrage type of structure whereby they shorted Volkswagen and simultaneously bought Porsche shares (betting the two would converge).

At the time, there were suspicions that Porsche itself was also playing with options on Volkswagen stock. For someone with deep enough pockets (read: Porsche), bidding up Volkswagen shares even more would create a short squeeze, yet Porsche vehemently denied such allegations.

Later in October 2008, Porsche declared that it owned 43% of Volkswagen's stock outright and had derivative contracts on nearly 32% more, tying up much of the tradable float. Fearful hedge funds who were still short the shares rushed to cover their positions, and VW shares spiked from around 200 euros to over 1000 euros, briefly making VW the world's most valuable company.

Some estimate that Porsche made paper gains of 30-40 billion euros on its transactions.

SOURCE: Norris, Floyd. "Porsche reinvents the short squeeze." *The New York Times,* October 30, 2008.



What happened in 2009?

In 2009, we had our only losing year since launch, because we went one-sided, by being short European sovereigns and European banks when the IMF "found" a trillion dollars of new commitments.

I met with Harvard Professor Ken Rogoff in February 2009, when we were following the risk moving from private balance sheets to public balance sheets. As you know, we were one of the first funds to do this public balance sheet work. In 3Q08 I was trying to get my arms around on-balance sheet debt relative to the size of a country's banking system. I ignored contingent liabilities and the much larger liabilities that would show up in the future, and instead just focused on the on-balance sheet debt and the enormity of the banking system's assets. It took us a few months to aggregate that data (which, to the best of our knowledge, didn't exist anywhere inside the Wall Street firms) – no one had any idea what the numbers looked like at that point in time.

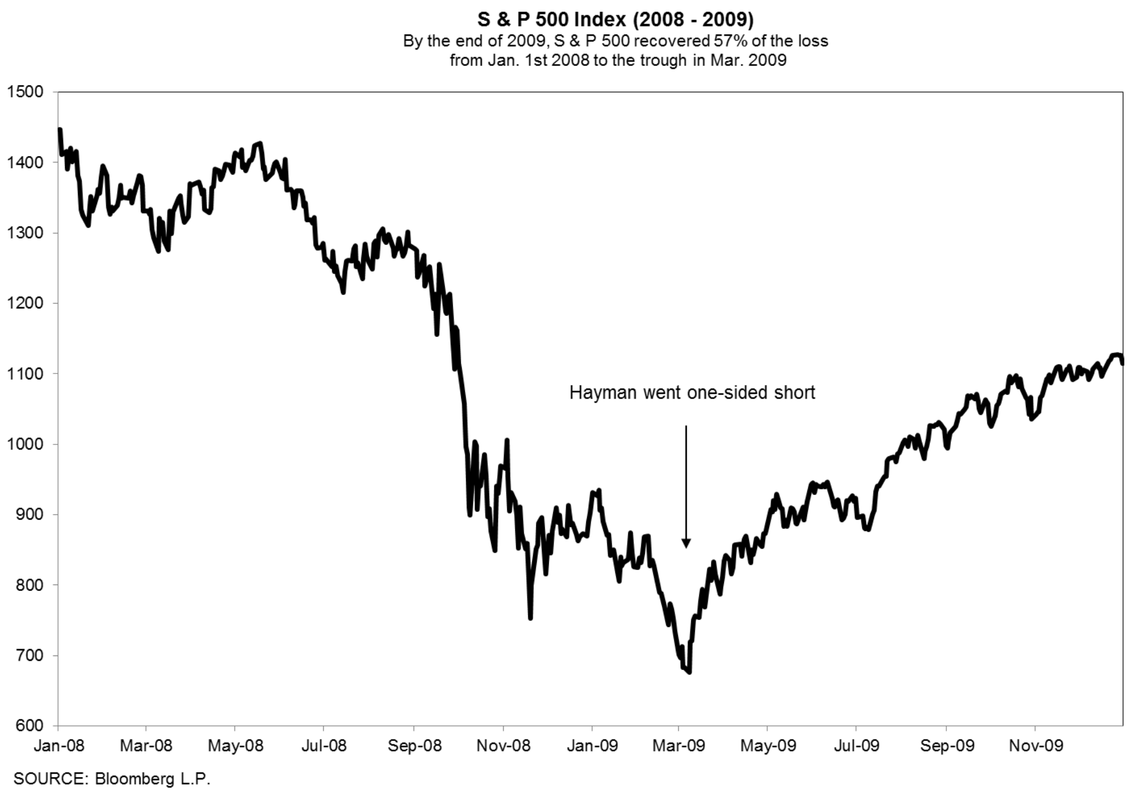
I just wanted to get my arms around the size of the problem. I had read all of Rogoff's white papers; this was before he wrote ***the*** book*. He was really the father of sovereign balance sheet analysis, so I went through his white papers and met with him in February 2009. When I shared my own work with him, he was shocked. Even he didn't realize how big the countries' banking systems were. I left that meeting frightened – if Rogoff didn't understand the implications, then Bernanke and Trichet certainly didn't understand them either.

Next I did a one-on-one meeting with Barney Frank. If you recall, February 2009 was a time in which the US was contemplating giving the IMF another $100 billion. The two largest debtor nations in the world – the US and Japan – were the two largest contributors to the IMF. And the IMF is a kind of amorphous, global, optical backstop. It's not structured to make even a medium-sized loan in a medium-sized country. It was set up by Keynes and White to be an optical backstop so smaller countries could restructure and the IMF could help them out from a balance of payments perspective.

Anyway, I asked Barney Frank where he was going to get the $100 billion to give the IMF, and his response was; "Kyle, we both know that it's not real money, it's just a journal entry." I then angrily said, "If it's just a journal entry, then you need to give them $3 trillion, because that's how big the problem is." He said he couldn't give them $3 trillion, but he could do $100 billion, so I left there feeling apoplectic about the situation. No one had any idea how large this problem was.

I had always run a fairly balanced book in the past but in February 2009 I realized that no one had any idea of the gravity of the situation. The money being thrown at the problem just simply wasn't enough. I had a two-year lock up on my fund but these assets could be four- or five-year workouts. So we took the long side of our book and sold it, at the wrong time. The one time I abandoned a balanced book it caught us and we lost money in 2009. I really learned a big lesson from that. Had we just kept the balance – the longs that we sold – we would have made money. Even though the shorts would have been painful, we would have made a lot of money on our long positions.

* *This Time Is Different: Eight Centuries of Financial Folly* – Carmen M. Reinhart, Kenneth Rogoff; Princetown University Press, September 2009



How has your process evolved?

First off, we operate out of a fear of losing. We institutionalize a lot of processes, especially risk management, and the risk function is framed by how much we can lose. Second, we try to keep a very healthy balance between both longs and shorts, both in credit and equity, and we are constantly evaluating correlations across asset classes. We have position-level and fund-level risk limits in place as well as concentration limits to various themes and/or strategies. Having a hard-and-fast, institutionalized risk management culture has really played in our favor.

Earlier, you began to discuss your experience with the long-only community. If we take your friends at UTIMCO, Texas Teachers, or some of the large family offices here in Texas, should they be managing money the same way that you manage money?

We have about $2 billion right now, and we're still deemed to be pretty small. Texas Teachers has about $120 billion and UTIMCO has almost $30 billion. It is very difficult to move that kind of money around the way we move it. In fact, we're going to soft close soon because I don't want to dilute our returns.

If I were allocating to a hedge fund, I would want someone that has a great, institutionalized risk management process, but I'd also want someone who has a view. I meet too many people who don't have views, but they have really tight stops and rigorous risk management. They risk-manage themselves out of ever making money. So we're very cognizant of the fact that we need to be opinionated, but thoughtful about how we manage the risk.

For example, I have had dogmatic views on Japan since mid-2010, and yet we haven't lost much money in Japan. Sure, we paid out some premium on the optionality. But we've been very negative on the Japanese yen from 93 all the way to 75 and all the way back up to 93, and yet we've avoided significant amounts of pain. Although our views are dogmatic, we build positions with asymmetry through optionality, so that even if we're wrong, we have a defined downside. When you look at the evolution of our firm, there's not only risk management at the position level and portfolio level, but there's also risk management in how we construct the portfolio, and having positions with that kind of asymmetry is very important.

If you were the CIO of a public pension fund, how would you run that portfolio?

By mandate, some public pension funds can only have 5% invested in alternatives. These parameters hamstring institutions like these. Let's do a simple mathematical exercise. Historically, pensions have 60/40 allocations between fixed income and equity. In the past, the Fed funds rate was 5.5% or higher, and the institutional return bogey is 7 or 8%. You're generating about 600 basis points from the fixed income portfolio, across government credit, corporate credit, and distressed. You only have to generate the other 200 basis points from your equity book. Now, however, because you're generating less than 200 basis points from the fixed income book, you have to somehow generate 600 basis points from your equity book. It's just not going to happen. It hasn't happened in the last 30 years. So how do you manage that? The only way is to lower the return target.

What about the promised liabilities in the pension system for example?

That's an unsolvable problem, in my opinion. But you have to start moving there. You might start with increased contributions, but this hamstrings budgets. These are some of the unforeseen consequences of zero rates.

In terms of the public sector balance sheets, do you take into account the contingent liabilities? Pension plans are back-stopped by taxpayers, after all.

When you take that into account, you add another $1-1.4 trillion.

What have you seen from your own underlying investor base that you think is good practice?

We hear from about 80% of our investor base at some point during the year, then catch the remaining 20% at our annual dinner. Right now, I don't have any investors whom I don't like, which is a nice position to be in. In the beginning, I had to take anyone that would write us a check.

I would say that the investors who utilize us well are two of the biggest institutions in the US. But although their investments with us represent a sizeable portion of our assets, for them we remain a small investment.

They are really interested in some of the more dogmatic views that we have. They want to know how to capitalize on them, and especially about the timing. We talk fairly frequently, about twice a quarter. Whenever anything material pops up, they want to hear our views about it. I like having these conversations due to the feedback I get from them. These investors will tell me how the Street and other investors are positioned because they know so much better than I do, and in many cases the individuals have been around significantly longer than I have. You can assemble a great symbiosis with certain like-minded large investors.

Apart from your main fund, you also have some opportunistic funds or SPVs. Are those all investor driven?

The Japan-only fund was investor driven, but subprime, for example, was driven by me. In the past we had a few asset management firms that hired us to run their mortgage books. One of these mandates was for $5 billion in the subprime trade, though we only got $2.7 billion of that actually deployed before the synthetic bid disappeared.

The Japan vehicle was driven by reverse inquiry. We were asked to do a hedge overlay for an investor's entire portfolio.

If that trade is working and they want to capitalize on it, can they?

The beauty of specialized vehicles can be exemplified in the subprime vehicle. Once that fund was up 200-300%, we started getting phone calls asking us to close the vehicle. We were becoming an oversized position, because their other investments were losing money. It was an interesting problem to have, whereby the more money we made, the more pressure we got to close it. I had originally set it up so that we could lose 11% of the fund's assets per year for three years, or I could make 10 times the capital. So in year one it was a 10-to-1 bet, in year two a 5-to-1 bet, and in year three, a 3-to-1 bet, if it took three years.

But in Japan, you can individualize it?

In Japan, I give the investor the steering wheel. If you are a pension or an institution with position limits, we believe the convexity of the Japanese position could be well over 200- or 300-to-one, so depending upon when and if we're right, that position could become a very large position very quickly. It's so much better to hand the investor the wheel, or to put them next to me in the front seat to help me drive.

What is the thesis in Japan and how did you structure it?

We don't discuss exact details how we structure it. We have a multi-faceted bet on in both the currency and rates. It's all paid-for optionality, but the thesis is very simple. You're going to see significant Japanese yen depreciation, and we don't believe the conventional wisdom of the central bankers and/or academics who say that when a heavily indebted nation enters a bond crisis, one of two options exists: default or inflation. Conventional wisdom views these options as mutually exclusive. I believe that central bankers have the privileged right and authority to decide which road to go down. If they engage in severe currency depreciation, they will lose control of rates, so it's a binary outcome that implicates both the rates and the currency. I don't believe it's a spread-widening outcome.

Based upon that ideology, we have spent years thinking about how to optimize convexity. Let's assume you're a pension fund. Maybe you agree with my research but don't want to pay fees. Maybe you want to go out there and do it on your own. First of all, our structure is proprietary and maximizes the outcome of what we believe to be a binary situation. It will be difficult to get close to the convexity that we're proposing. As a pension, how many ISDAs can you obtain? Two or three? We have ISDAs with just about every major dealer. We go out and canvass the dealer community virtually every night. Because we have a constant program and need to maintain a certain portfolio duration, we are constantly adjusting the positions. Last night, for example, we needed to purchase some optionality and the spread in pricing between certain dealers was between 10 basis points and 33 basis points (a whopping dispersion of results). If you only had two or three ISDAs maybe you paid 20 basis points while we paid 10 basis points. Why not pay our fees and have Hayman manage all of this for you? If we're right about the binary nature of this situation, the returns will be enormous and we will most likely perform in the top few percent of all funds.

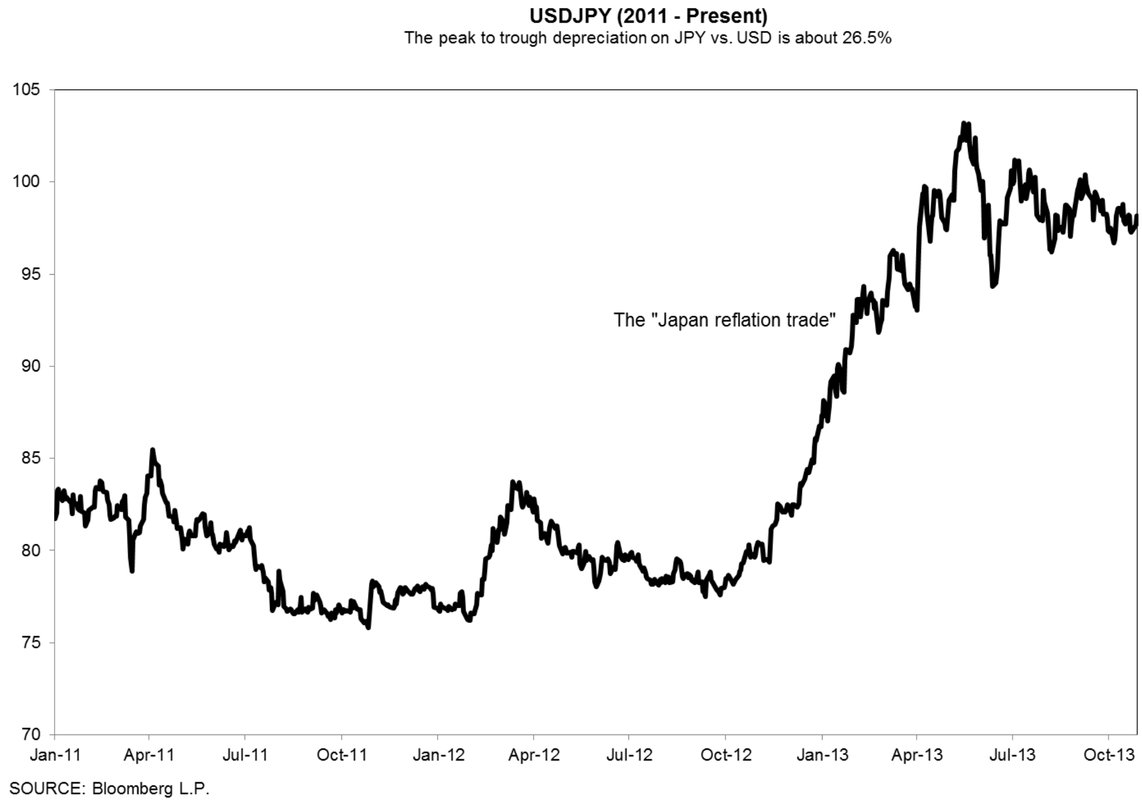
We're not the smartest guys in the world, we're just trying to optimize one position. We're not going to take any mark-to-market gains – it's basically private equity economics on a realized scenario.

You're on the tape saying that dollar/yen is going to 200.

If I'm right, it will go much further than that. I don't think it will hit 500, but in crises, currencies swing too far. They can start discounting 15% or 20% rates out ad infinitum because they are in a full bond crisis. But once they flush the debt and have a reset, you're not going to have 20% rates ad infinitum. We've committed more capital to the currency market, but all of the convexity is in the bond market.

Recently we've seen the yen move your way and everyone is getting excited about "The Japan Trade" – is this the big move you've been looking for?

No, this is just the beginning. It's not the real move. The real move happens when it runs away from the authorities and they lose control.



At what point do you go the other way and buy Japan?

When the yen is 350 and they've wiped out their debts.

You made a name for yourself shorting these subprime debts and now you're buying them. Do you know anyone else that's flipped and gone the other way?

I don't know. I'm not sure if Paulson bought them or not. We were looking at the acuity of the situation in the European banking sector. There is approximately $1 trillion face value of non-agency mortgages. If you break that down, jumbo mortgages are about $440 billion, and then there was Alt-A and then subprime. There was about $250 billion of subprime.

We thought that there was roughly $80 billion of subprime in the European banks. When we were buying it at the end of 2011, we were buying it from European banks. Remember, this was pre-LTRO and pre-OMT. As soon as the LTRO was announced in February 2012, we grossed the position up as fast as we could. We were waiting for the supply to come because technicals showed a big supply overhang and that's why the market dropped almost 20% at the end of 2011. But fundamentally things were only getting better.

Prior to the LTRO announcement, the European banks were selling their subprime portfolios, but once it was announced, European banks dialed this back by roughly 90%. If you had a junk-rated or non-investment grade-rated US structured product, you had to post 100% capital at par as regulatory banking capital. As a result, it was more capital efficient for European banks to take a hit by selling their subprime positions than to hold onto the paper.

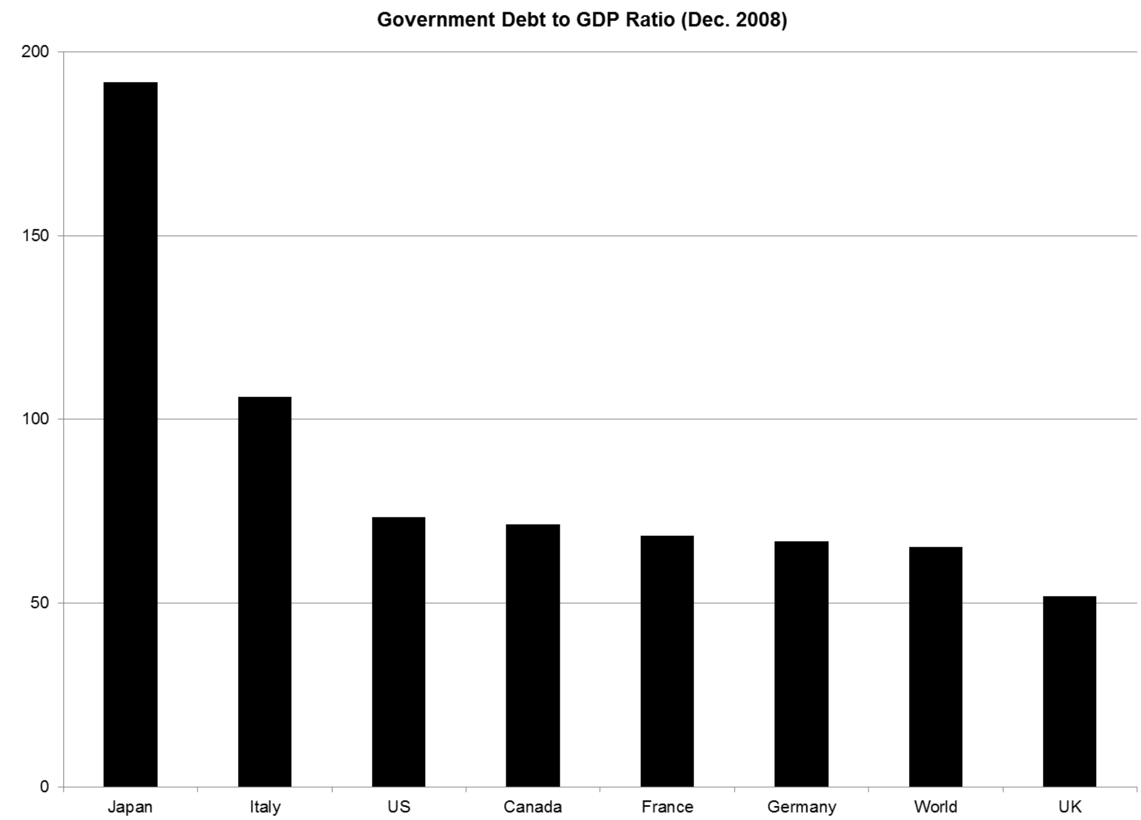
What is your view on mortgages now?

We know the mortgage space as well as anyone, but it requires analyzing thousands of securitizations and 20,000-plus line items in the non-agency market, like we did at the end of 2011. Running our models, three- to four-year effective durations and you were still getting yields of US Treasuries plus 900 to 1000 basis points. In our opinion, these were bulletproof bonds. You could have put together a draconian scenario under which home prices drop another 10%, after an already 36% drop, and loss severities went up to where you're only recovering 15 to 19 cents on the dollar for first lien loans. Even under this severe scenario, you would still not take principal hits on the bonds that we were buying. This was the best risk/reward position in the marketplace at the time.

One thing that happened post-2008 is that suddenly everyone started looking for 100-to-one bets, launching tail funds and buying out-of-the-money S+P puts, which skewed volatility curves and made it more difficult to find these asymmetric bets. But you still seem to find these opportunities. Is that because you spend more time looking for the big asymmetric bets?

We found the Japan situation by canvassing the world, looking at every individual country. Each country has many different inputs. We first try to paint the world with a broad brush, but then we get out the fine-tooth comb and analyze each country's current account, capital account, balance of trade, etc. We basically try to look at everything that impacts a country's debt burden, including their banking system.

Every report and analysis that we looked at was excluding Japan, because Japan blows up every bell curve that exists. So I started to look more deeply at Japan, specifically what had been holding it together, and it just seemed like we are approaching a critical time. We didn't set out looking for another asymmetric bet.



You can be dogmatic. You can have a huge position, and you can think very carefully and still not constantly have big tail positions on. Let me put it into context. I own rates optionality in Japan that notionally is roughly 40 times the value of the deployed capital and it's marked at only 60 basis points.

There are times to have tail positions on, and times not to have that much capital dedicated to them. But when you look at the way the world is today, you have to have them on, because the central banks have created Potemkin villages – they've solved nothing. They've assuaged concerns about debt sustainability in the near term, but they've changed nothing from a fiscal perspective. So nothing has changed, except the level of interest rates in the marketplace and the way that investors somehow feel better about the situation. We're going to see some really big volatility events in the next five years.

I understand that you were the first person to buy CDS on Switzerland. Can you talk about the Swiss trade?

It was an ill-fated trade. When you carved up the world, the level of on-balance sheet debts relative to both GDP and central government tax revenue was many multiples in Switzerland – it was anomalous. The Swiss banking business has been around 800-900 years and they never had a problem with their banking sector. And yet Switzerland screened similar to or even worse than Iceland or Ireland. Switzerland was actually third on the chart, behind Iceland and Ireland, respectively. And Iceland and Ireland were the first two dominoes to fall. Still, when I asked one of the sell side firms if they ever had anyone trading Swiss CDS, they said no. So when I asked where it should trade if they did trade it, they said, "I don't know, 20 basis points." I told them to let me know if they ever wanted to trade some.

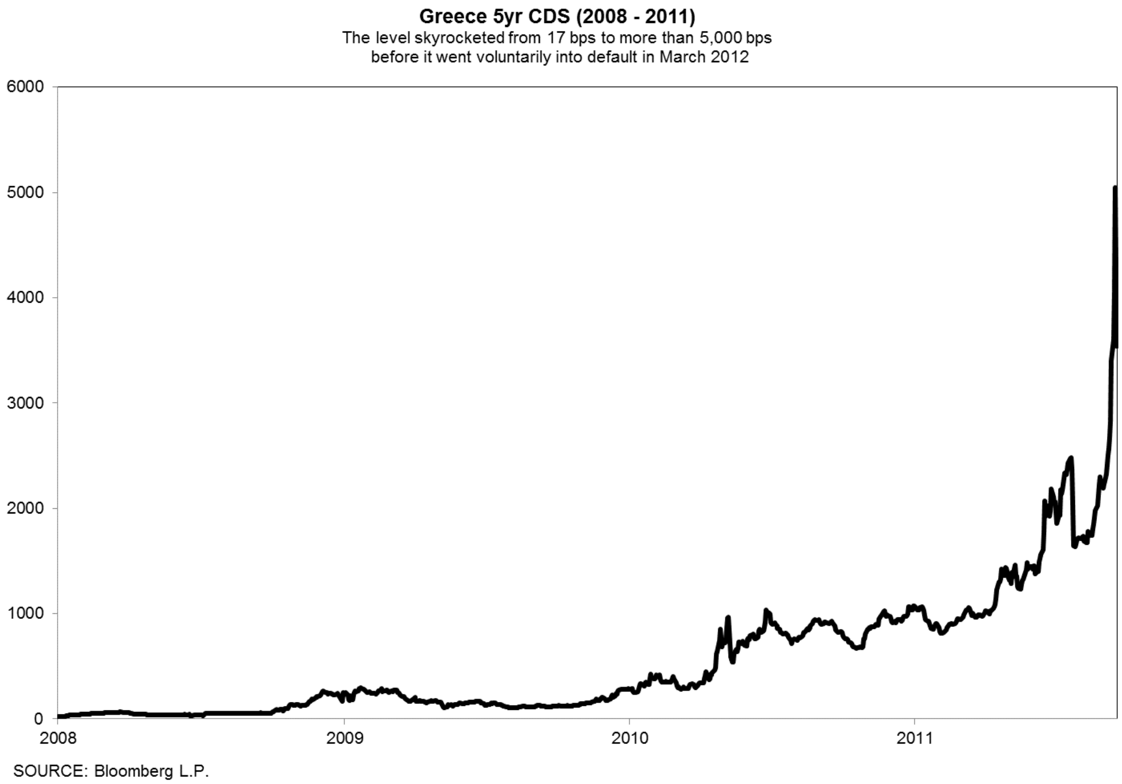
Switzerland couldn't handle the on-balance sheet problems of their banking sector, which was basically comprised of just UBS and Credit Suisse. So we were essentially saying that UBS and Credit Suisse would single-handedly bring down the Swiss banking sector if Switzerland as a country had to take on those liabilities.

The jurisdiction of those assets, however, even though they resided inside Swiss institutions, became an interesting distinction. The majority of UBS assets were held in Europe and the US through wholly owned subsidiaries, not in Switzerland. At the time, the US tax authorities were really pressing UBS. The head of the Swiss National Bank Hildebrand did a masterful job because he refused to turn over everything in the face of US pressure, citing Swiss banking laws. The US authorities threatened to turn off UBS's license in the US, and Hildebrand essentially played chicken with them, and played it masterfully.

Our initial broad-brush analysis showed the assets at UBS and Credit Suisse alone to be so large and their balance sheets so toxic that it was just going to crush the little country of Switzerland. What we miscalculated at the time was the jurisdictional or geographical relevance of those assets. Switzerland would have been off the hook had they just handed the assets over to the Europeans and Americans.

Tell me about the recent Greek bond trade where I read in the press that you had a 650-to-1 structure?

We first bought Greek CDS at 11 basis points in 2008. We didn't touch the bonds, just the CDS. At that time, it was just Mark Hart at Corriente and I involved in Greek bond CDS.



What out-of-the-money stuff is preoccupying you right now?

Japan is our single focus because they have $14 trillion dollars worth of debt, which is about the same as the US, except they have a little more than a third of our population. We are about to see what a heavily indebted Western society looks like when it implodes or explodes. The seminal event in the world in the next couple of years will be Japan. Right now, there are some macro funds playing for a weakening of the yen and things like this. But people don't realize the enormity of the situation in Japan.

Do you travel to Japan a lot?

I have spent a few weeks total in Japan. I have read numerous books on their culture as well as on their past financial problems. I have visited the cultural capital of Japan in Kyoto as well as Osaka and Tokyo. I have met with current government officials as well as prior officials. I have met with banks, insurance companies, and pension funds in Japan and have a good understanding of the situation.

Let's play out your Japan scenario. If the yen goes to 350 and Japanese government bond yields go to 20% and they can no longer finance themselves such that it becomes a financial disaster, what are the implications for the rest of the world?

Well, policymakers have been changing the rules, which is challenging for macro hedge funds. But that's the beauty of this situation.

What if they decide to just knock a few zeros off the debt?

In the end, they may be forced to do so.

What if they bought the whole debt stock at 1% yield?

That's the St. Louis Fed's school of thought, which contends that countries that have their own central banks can print their own currency and will never fall. For the world's sake, I wish that were true. For the last 2000 years, it hasn't been true, and I don't believe it to be true. If it is true, I'll lose 150 basis points a year and move on. Our core portfolio will be fine. Still, if it were true, then why even have fiscal policy? We don't need a fiscal policy if that's the case – we could just spend the money however we want. Policymakers don't believe there are consequences to their actions, but the consequences will come. Economic gravity will actually set in.

But you don't suffer the consequences if you are out of office. That's the next person's problem.

The point is that no one will make those difficult decisions unless they're forced to make them. The politics of all these situations tell me how this is going to play out, and that's through massive central bank balance sheet expansion and capital controls.

The Fed recently wrote a paper that actually endorsed capital controls if done concurrently with other nations. It's hard for me to fathom that capital controls can ever be a great idea, but this is what you're going to see.

We are in a period that will be characterized by enormous cross-border capital flows. How will it play out? Let's assume that I'm right about Japan. What happens then? Nominal interest rates in the US and Germany go negative. The Pavlovian response is to fly to perceived safety; this is why we're not betting against US rates. In fact, we're receiving rates in Europe and Australia right now because some sort of stagflation will play out first, before you start to see the real problems in Japan. If you look at history and try to understand what has created despotic rulers and wiped out populations financially in the past, and what happens next, the logical conclusion is war.

Who is the war going to be between?

I'm not exactly sure, but it seems to me that the aggressor in Asia is China and they don't get along with Japan.

Post-World War II, Japan has been constitutionally limited, such that they cannot declare war. But current Prime Minister Abe is talking about rewriting the constitution so that they can actually declare war again. That's not stabilizing for the region. Nationalism is rearing its head as we speak.

A third of the population in Japan is over the age of 60, and a quarter is over the age of 65. To put this into context, in the broader developed world only about 8% of the population is over 65. At a point when these people need the money the most, they could lose 30-40% of their savings, maybe more in terms of purchasing power. The social repercussions bother us more than the financial repercussions because the social fabric of Japan will either be stretched or most likely torn, and we don't know what's going to happen next.

What happens to the enormous cross-border capital flows during a Japan crisis – Japanese money specifically?

A lot of it is invested domestically, but a lot also internationally. Some pundits say that their net international investment position is so large that the repatriation of that capital in a crisis will be a natural counterbalancing effect to a weakening yen. I disagree. If there is a crisis in Japan, money will flow the other way – they will not repatriate capital into a crisis. When you read what Professor Rogoff has said about prior sovereign defaults, one of the key preconditions is capital mobility. And capital has never been more mobile than it is right now.

Is the whole system sustainable? When you play this scenario out and think through alternate outcomes, do you find one that works?

The system is sustainable. The payment systems will continue to function, because you have to maintain the structural integrity of the banking system when you're running a sovereign nation. This absolutely has to be maintained at all costs. That means payment systems will work and things will settle. When Lehman went down, not one position had any trouble settling – every single derivative trade closed perfectly. Even the Japanese banking system will continue to have a payment system that's functioning. Of course, the value of what they're paying you might be worth a lot less than you think, but you'll get paid. So the system will continue to function if and when these things metastasize, but the value of what you're being paid will be suspect at best.

Is the biggest bubble right now the value of Japanese assets?

It's mostly Japanese yen purchasing power.

Where else do you see things out of balance that worry you?

There is 50% youth unemployment in Spain, 37% youth unemployment in Italy. Italy has the second worst demographics in the world behind Japan, with 120-130% on-balance sheet debts. Italy is a problem.

What are you doing in Europe right now?

Not much. What am I supposed to do there? They keep changing the rules, and the asymmetries are gone. Europe is just a problem, no matter how you look at it. Europe hasn't recapitalized their banking system because they don't have the money to do so. Period.

At what point do you get involved in Europe again?

You will see restructurings in Europe. Greece has to wipe out its official sector debt again. I think Italy and Spain go and France is the proverbial bug in search of the windshield. France is in real trouble when the others go. I won't get involved in Europe until I see a flush out, and if I miss opportunities, that's perfectly fine with me.

What about China?

I don't know what to own in China. We have no positions there.

And inflation? Everyone seems worried about inflation globally.

Yes and it is going to be the ugly kind, which is cost-push, not demand-pull. It could happen soon. You have a heavily leveraged financial system. In the US, you have about $1 trillion of equity in the banking system, and about $16 trillion of on-balance sheet assets, so you're levered roughly 16-to-one. In reality, it is likely more than this.

Throughout the crisis, we've calculated that about $882 billion of preferred equity and equity have been pumped into the system. The US essentially re-equitized its banking system, and Europe hasn't re-equitized anything. Yet, Europe has three times the assets that we have, so their leverage is almost 3.4 times more than the US. Europe hasn't re-equitized anything because they don't have any money.

When you look at what's going on from an inflation perspective, central banks have printed about $10 trillion dollars since the beginning of the crisis. The first $4-5 trillion went into re-equitizing heavily leveraged structures and bringing down rates. The second $4-5 trillion is making its way into the monetary base, and even though the multiplier is not working, at some point this is going to ignite and set cost pressures off. Again, it won't be demand-pull, which is technically a good kind of inflation. Rather, it would result from too much money in the system.

Are you seeing this show up anywhere right now?

Sure, even here in the US you're seeing it. But look at the CPI index for the troubled nations in Europe; they're exceeding expectations by 30-40%. In the US, if you look at CPI, the one great thing that's happening is that we have become the Saudi Arabia of natural gas. The US is starting to become more energy independent through new technology. So it's helping the US, but we think that the rest of the world is going to see cost pressures. It will show up in food in the early stages. Global QE is filtering its way into asset prices. Those closest to the proverbial spigot are enjoying the printing the most with most in the middle and lower class not feeling the love at all. All you have to do is look at the gap between median income and mean income growing ever wider. This means the rich are getting richer while the rest stay stagnant or even decline.

When you talk to pensions, endowments, and family offices, many of them say their biggest concern is inflation and hyperinflation. But how does that play out? How would you position for that?

You want to own productive hard assets, whether it's oil wells, gas wells, or apartments. Operating real businesses, like Nestlé, are also interesting. These investors are already doing the right things to some extent. This is where I believe that the endowment model will actually work pretty well. I just don't think they're going to hit their bogies.

One of the key issues facing both the endowment and pension landscape is the compensation structure. Pensions often have a liability rate of, say, 8% nominal, whereas some endowments have a real return objective of, say, 5% real. The investment staff is paid on how they do relative to the policy portfolio, but there isn't true congruency between the stated return objective – nominal or real – and the compensation structure in relation to the policy portfolio. That's where there's some friction.

They are incented to make decisions that they otherwise wouldn't make. For example, if they think they should be underweight equities this year, and all of a sudden in January equities are up 6%, they will underperform in month one. How do they respond? They will likely plow into equities to try to stop the tracking error. But that is not something that you would do with your own money. The incentive structures are not congruent with the policy objectives.

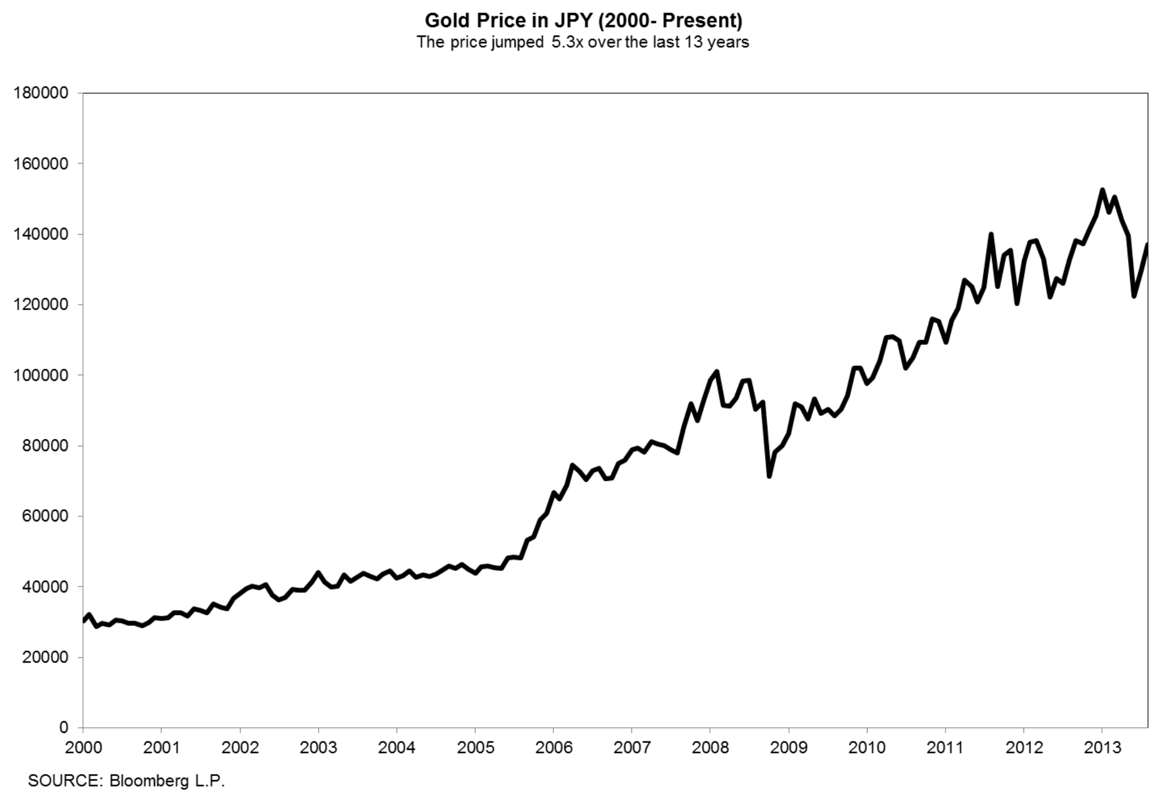
Besides Japan, which is a big one, there has to be something you are mulling over on the back burner, something that bothers you other than Europe.

There are going to be consequences to central bank balance sheet expansion all over the world. Look at currency cross rates. If all central banks are expanding at the same rate, the cross rates aren't moving, but your purchasing power, in terms of goods and services in the country where you live, is diminishing. You're not focused on real returns, you're preoccupied with the cross rates. It's a beggar-thy-neighbor policy, but everyone is beggaring thy neighbor.

I really worry about the true cost of goods and services, but people are preoccupied by the dollar/euro exchange rate to gauge the relative strength of the European economy. You see this preconditioned response and even macro players say things like, "Oh, buy the Nikkei at week end." They're picking up a dime in front of a bulldozer. Japanese industry has been hollowed out. The exchange rate may stop the decline for a certain period of time but it's a secular decline. The people that own Japanese equities right now are tourists. But this creates opportunities in the marketplace.

I suspect that I already know the answer to this next question based on our discussion, but if you could put on only one trade for the next 10 years, what would it be? 100% of your money, and you cannot risk manage the trade or check on it.

I actually wouldn't do the Japanese convexity trade, despite what you probably think. Actually, the answer to this one is easy – I would buy gold in yen.



What was the worst trade of your career?

The second company I ever sold short was a disaster. The first one was actually a great trade. It was an East German shipbuilder that was being heavily subsidized by the government when the Berlin Wall came down. The executives were not applying the subsidies to the shipyards. We shorted the stock around 100 Deutsche marks and it never saw an uptick – it went from 100 to 80 to 60 to 40 to 20 to zero, where they were literally chaining the gates after that.

The second short was a technology company. The COO had just quit under suspicious circumstances and in doing our homework on the capital structure we figured it could be a zero.

Right after we got short this stock, an active and influential newsletter at the time came out and said they thought it was the stock of the century. It doubled on me so fast that it carried me out. All the money I had saved up until that time was literally gone.

I did an enormous amount of work on the balance sheet, met with some of the players, thought I understood what was going wrong, had almost all of the data, and in the end, was even right. But I just couldn't withstand the move.

It was such a beautiful learning experience because I came from no money. I was so broke in college. I came from a middle class family, and by that point I had made a few hundred thousand dollars and saved it, and it was gone. I was apoplectic.

When I think back now, thankfully it happened to me then – it only cost me a couple hundred thousand bucks, and it was the most important lesson in short selling that anyone could ever learn. It taught me the humility and the respect that you must have when you're on the short side of anything. It wound up being one of the best things that ever happened to me.

What do you do differently today with short sales?

We do a lot differently. We do short individual equities from time to time, but we short with respect, experience, and proper sizing and stop-loss levels.

Would you say that your style is more akin to global micro than global macro?

No, I would say that my style is very event-driven, but the macro has become the event right now. People tend to define us as global macro but if you look at where we've made money over the last seven years, the majority has been made in the core book, except in 2007, when we made a lot of money in the tail book. We got involved in Europe because we followed the transition from the private balance sheet to the public balance sheet, where the public balance sheet became the event. Today, the public balance sheet event is in Japan.

If you take out the anomalous position of being short mortgages, our seven-year returns would still be pretty good. This is how we make money. The core event-driven book makes the money while occasionally the tail book kicks in and generates huge returns. It might only pay once every 10 years, but it will pay a lot.

When you compare us to our peers – our peers being some of the others that got the subprime trade right – we stand out because we are far through our high water mark. We're very fortunate because we've been very thoughtful in the risk management and portfolio construction side.

What did you want to be when you grew up? Who was your hero?

I've always admired George Soros throughout his lifetime. I've read everything he's ever written and going into this business, I would say that he was the person whom I admired the most. By now, I have gotten to meet so many great minds in this business, and I admire a lot of them. I want to be known as a great full-cycle investment manager, a prudent fiduciary of people's capital, and be a great friend to my friends, and a great father to my kids. I also want to be able to have some real fun.

I'm enjoying it now. We've had a very difficult 90-day period in our firm and in our personal lives, after losing two people who were very close to us, taken very prematurely in their lives. Their passing has forced time for reflection and forces one to think about what really matters in life and what really matters in the world. I try to stay grounded as much as I can and being in Texas allows me to stay grounded.

What do you do to unplug from markets?

I spear fish.

In lakes?

No, in the Bahamas. Just with spears – it's very primitive. It's my Zen. Just freediving, holding my breath – it's one of those things where you're challenging yourself, trying to get to know yourself a little better, trying to manage the risk of doing what you're doing, and getting the right team to be down there with you. Once a year, I take my whole investment team for a week. It's a great bonding experience. It's similar to surfing where it's just you and the ocean; if you don't have respect for it, it's going to teach you how to respect it. It's a great way to unplug.

Anything else you want to add? Any thoughts or lessons learned?

Never set yourself up for the knockout punch.

About the Book

This is the first chapter to be released from Steven Drobny's upcoming book *The New House of Money*. The remaining chapters will be released serially over the course of the next year and will be available for download at www.drobnycapital.com. An introduction to the book is also available online now. *The New House of Money* follows Steven's two previous critically acclaimed books (*Inside the House of Money* and *The Invisible Hands*) which provide thought provoking and candid views into the global macro investment community. The book, to be compiled and released in hardcover in late 2014, will reveal the insights of a select group of global macro hedge fund managers, some of whom are well known and others who are—as of yet – undiscovered.

Steven Drobny is the founder of Drobny Global Asset Management, a full-service asset management, investment advisory, and consulting firm focused on global macro and commodity hedge fund strategies. The firm helps pensions, endowments, family offices, asset managers and other institutional investors run better businesses and build more effective investment portfolios through thoughtful and strategic use of external allocations to global macro and commodity hedge fund managers. For more information about Steven or Drobny Global Asset Management, please visit www.drobnycapital.com.