

Chapter 1

An Unanswered Invitation

Be sure to stop by if you are ever in Omaha and want to talk credit derivatives . . .

—Warren Buffett in a letter
to Janet Tavakoli, June 6, 2005

It was August 1, 2005, and I was rereading a letter in my correspondence file dated June 6, 2005. The letter was from Warren Buffett, the CEO of the gargantuan Berkshire Hathaway conglomerate. I had not yet responded and had no explanation for the delay save for a little awe. For the several years prior, *Fortune* listed Warren Buffett as either the richest or second richest man on the planet. He and Bill Gates annually jostled for the top spot, with the outcome depending on the relative share prices of Berkshire Hathaway and Microsoft.

Several years earlier, I had sent Warren Buffett a copy of my book, *Credit Derivatives & Synthetic Structures*. In his letter Buffett wrote that he had been looking at the book again and had just found a letter I had tucked between the pages, “Please accept my apologies,” he continued, “for not replying to you when I first received it.”¹ He invited me to stop by if I were ever in Omaha. I looked up. After all this time, I could not remember what I had written in that old letter. I did know that I had not expected a response. But certainly now a response was needed from me, a belated one. “Dear Mr. Buffett,” I began.



I am an investor in Berkshire Hathaway “A” shares, but Mr. Buffett would have no way of knowing that since I hold shares in brokerage accounts. Perhaps Mr. Buffett had a bone to pick with me, but I had warned about the risk of credit derivatives and the hidden leverage they created. I was so persistent in exposing the flaws in the financial system that *BusinessWeek* called me the “Cassandra of credit derivatives.”² But most journalists overlooked a much more important derivatives quote in Mr. Buffett’s 2002 shareholder letter. Berkshire Hathaway invests in multinational businesses with a variety of complex operations, and that means that investments have to be hedged or entered into in ways that create tax or accounting advantages. Mr. Buffett had also written: “I sometimes engage in large-scale derivatives transactions.”³ Yet I dithered and had not responded to his letter.

In 1998, Berkshire Hathaway acquired General Reinsurance. Warren Buffett initially called it his “problem child,”⁴ and its General Reinsurance (Gen Re) Securities unit was its problem sibling. Even before the acquisition, both Warren Buffett and Berkshire Hathaway vice-chairman Charlie Munger realized that the value of Gen Re Securities derivatives transactions was overstated and vainly tried to sell it. Some of the contracts were for 20-year maturities, and the operation would take years to wind down. Furthermore, the models valuing the derivatives give poor approximations of the true *mark-to-market* value—the price at which the derivative can be bought and sold in the market—of some of Gen Re Securities’ esoteric derivatives contracts. There was no real market. Instead, the derivatives contracts were priced

or *marked* based on model valuations known as *mark to model*. Buffett wrote that in extreme cases, it was a “mark to myth.”⁵

In his 2002 letter to Berkshire Hathaway shareholders, Buffett wrote that it sometimes seemed “madmen”⁶ imagined new derivatives contracts. His pique was prompted by the multiyear-long hangover of losses from derivatives, chiefly credit derivatives, in the GenRe Securities unit. It showed a loss of \$173 million, partly due to restating faulty, but standard, derivatives accounting from earlier years. The loss inspired Buffett to call derivatives “financial weapons of mass destruction.”⁷ His viral sound bite quickly circled the globe. After reading Buffett’s quote in the financial press, one investment banker joked that my book on credit derivatives is “the manual on how to blow up the world.”

Warren Buffett’s letter to me arrived in June 2005, a hectic month. One of my clients was a law firm representing a large money center bank as plaintiff in a securities fraud case involving another large money center bank. The defendants’ lawyers had hired a former chairman of the U.S. Securities and Exchange Commission (SEC) as their expert witness. Earlier, I had written both my expert opinion report and a report rebutting the former SEC chairman’s point of view. I prepared to give a two-day-long deposition to discuss my opinion in the case in which hundreds of millions of dollars had been lost. The defendants had read my work, knew they faced serious trouble, and subsequently changed their strategy. In fact, they sent their most experienced litigator to depose me.

I put Buffett’s letter in my purse to remind myself to respond to it. The morning of the deposition’s first day, I saw the letter and felt a glow of confidence. I am not a superstitious person, but I couldn’t help thinking of the letter as an auspicious sign. I put it in my pending correspondence file and forgot about it again.

The deposition came and went, and the plaintiff’s lawyers were delighted. “Everyone gets bloody in a battle, but you slaughtered them.” The defendants’ arguments fell apart in the face of the facts, and the case never went to trial. Shortly thereafter, the defendants came to a settlement agreement to the plaintiff’s satisfaction.

At the end of June, I reviewed my correspondence file and read the letter again. Client business would not take me to Omaha, and I was fairly certain Warren Buffett did not need my help.

July 2005 was another busy month: I had focused so much on the securities fraud case that I had a backlog of business, so I took a much-needed week-long vacation to decompress. At the end of July, I reviewed my pending correspondence file, and it contained only one item: the letter.

After rereading the letter on August 1, I wrote a letter in reply and offered three dates, with August 25, five days before Warren Buffett's 75th birthday, being the earliest of the three:

It is my turn to apologize for being so late getting back to you. . . . Business isn't taking me in that direction anytime soon, but I would be happy to fly in for the day—just because I would enjoy doing it . . .

On August 3, I received an e-mail from Warren Buffett through his assistant stating that August 25 would work:

If you can make it for lunch, I would be glad to take you to a place with no décor but good food.

Everyone in the global financial community knew Warren Buffett by reputation, and his name continually popped up in the financial press, but I operated in specialty niches of the industry, and he was just part of the background noise of my world. I hadn't read any of the books about him, and I hadn't read the many articles about Warren Buffett, the man. But I had read many of Berkshire Hathaway's annual reports including Mr. Buffett's shareholder letters, which I enjoyed very much.

Warren Buffett was already a billionaire at age 60. That in itself was an achievement beyond the reach of all but a miniscule percentage of humans, but his future success dwarfed that accomplishment. Due to the benefits of continued compounded growth off of a greater base of wealth, the bulk of Buffett's wealth accumulated after the age when most men retire to spend their money.

Throughout my career, I worked with people who eventually met or did business with Warren Buffett. It was as if we attended the same university and he were a popular senior and I a freshman. I was well respected in my field, and was a self-made woman; but Warren Buffett was a financial legend *superlatively* good at making money for himself and for his shareholders.

In 1987, Warren Buffett and Charlie Munger rode to the rescue of John Gutfreund, the CEO of Salomon Brothers. Their “white knight” investment of \$700 million of Salomon Inc.’s convertible preferred stock enabled Gutfreund to fend off Ronald Perelman’s hostile takeover. Perelman, a famous, colorful cigar-loving corporate raider with a reputation for ruthlessness, had already swallowed up Revlon, Sunbeam, Panasonic and other companies in the 1980s. In contrast, Buffett and Munger were not well known, and their lifestyles didn’t provide salacious material for the media frenzy that surrounded corporate raiders.

Initially, Salomon’s preferred stock was an ideal Berkshire Hathaway investment. Buffett never supplied management; he looked for good honest managers, and he thought he had found one in Gutfreund. Things changed in 1991. Paul Mozer, a trader on the Arbitrage Desk, pleaded guilty to felony charges after a government bond trading scandal. John Meriwether, the head of Salomon’s Arbitrage trading desk, told Gutfreund that Mozer had confessed to him. Their failure to immediately come forward compounded the scandal, and neither of them survived the fallout. Buffett was compelled to protect Berkshire Hathaway’s investment. In the summer of 1991, he became Salomon’s reluctant CEO for 10 months. Mr. Buffett’s leadership and reputation for integrity salvaged Salomon’s business, which rapidly recovered. The convertible bonds outperformed the fixed income securities that Berkshire Hathaway had sold in their place, but by 1995, the option to convert to common shares of Salomon stock was worthless. In 1997, Buffett off loaded the investment on Sandy Weil, and Salomon eventually became a part of Citigroup.

I had joined Salomon Brothers’ summer 1985 training class lampooned by my classmate Michael Lewis in his book, *Liar’s Poker*. Unlike Lewis, I was one of the trainees actually paying attention at the front of the class, but by the time Mr. Buffett served his brief time as CEO, I was no longer working at Salomon Brothers.

After almost 20 years working for Wall Street firms in New York and London, I made my living running a Chicago-based consulting business. My clients consider my expertise the product they consume. I had written books on credit derivatives and complex structured finance products, and financial institutions, hedge funds, and sophisticated investors came to me to identify and solve potential problems.

Although I was an experienced finance professional, I did not focus on value investing. The University of Chicago was steeped in the myth of efficient markets and leaned to theories put forth by eminent economists. Warren Buffett had earned his MBA at Columbia Business School. He became a friend and disciple of Benjamin Graham, and later worked for Graham's hedge fund. I had read *Security Analysis* by Graham and David Dodd in 1985, but I had not actively practiced its principles for my own investment portfolio. Around the same time, I read John Burr Williams' *The Theory of Investment Value*, and the fourth edition of *The Intelligent Investor*. My edition includes an introduction by Warren Buffett with a tribute to the late Benjamin Graham as well as Warren Buffett's 1984 commencement address at Columbia University titled "The Superinvestors of Graham-and-Doddsville." I remembered both the tribute and the address and reread them in preparation for meeting Mr. Buffett. My focus was chiefly on derivatives and complex securities. While I applied many of the principles of value investing to my analysis of complicated financial products, I did not yet focus on it for my own investments or as a way of looking at the global markets as a whole.



Derivatives are financial bets that something will or will not happen. Any financial investment involves a bet, but derivatives are *leveraged bets*. For very little money down—sometimes no money down—you can make gobs of money (or lose gobs of money). The part about losing gobs of money is something most investors try hard not to think about. Sometimes investment banks selling the products help investors achieve this goal by putting the part about gobs of losses in very fine print buried in hundreds of pages of documents.

Leveraged bets are so popular that there is more money at risk in derivatives than in stocks or bonds. The problem with leverage-driven binge banking is that everyone tends to disgorge assets at the same time, depressing market prices. Financial leverage sometimes moves global markets, and if allowed to get out of hand, leverage can theoretically trigger a global market Chernobyl.

Warren Buffett disproved the theory of efficient markets that states that prices reflect all known information. His shareholder letters, readily available through Berkshire Hathaway's Web site, told investors everything they needed to know about mortgage loan fraud, mispriced credit derivatives, and overpriced securitizations, yet this information hid in plain "site."

I knew the financial markets were at great risk—like children playing with matches in a parched forest—but those thoughts were far from my mind on that hot summer morning in 2005 as I boarded the plane for Omaha. I was about to meet a financial legend, the greatest investor who ever lived.

