

CHAPTER 1**J. Kyle Bass***Timing Is Everything*

Of all the legendary men in this book, perhaps the least known is J. Kyle Bass. A hedge fund manager from Dallas, Texas, Kyle is a young, energetic and brilliant man who is not exactly of the Harvard Business School pedigree. Educated at Texas Christian University, the elusive Bass is one to be reckoned with. He is famous for shorting the subprime mortgage crisis that enveloped our country late in the first decade of the 2000s.

But don't be fooled. The man is as shrewd as hedge funders come. Bass saw the crisis coming back in early 2006, when the stock market was peaking and everything was still fine and dandy. Only 36 years old at the time, Bass was one of the youngest managers in the business to spot the crisis coming and to actually place a large bet on it.

THE BACK STORY

Bass started his career as a retail securities broker at Prudential Securities before moving on to Bear Stearns & Co., Inc. and later to Legg Mason, Inc., where he stayed until January 1, 2006. While Bass had plenty of success working for Wall Street firms, in December 2005 he decided it was time to strike out on his own.

Starting your own hedge fund is a daunting task that requires intense preparation. And then there is the capital—who is going to give you capital if no one's heard of you? You are just another face in the crowd.

Bass, not just any regular face in the crowd, was able to raise an adequate amount of money for his new fund, Hayman Capital. The fund would be sufficient, but not overburdened, and Bass got to work researching investments.

It is extremely important to be familiar with the tale of derivatives and subprime, second-lien mortgages that unfolded after Bass set up Hayman Capital, and, to truly understand and appreciate the financial alchemy that is in Bass's story, you need to be well educated. First and foremost in the story of Kyle Bass are subprime mortgages.

A FEW DEFINITIONS

Most people understand what a mortgage is, but what about a subprime mortgage? An easy way to think of it is to break down the word *subprime*. What do you think of when the word *prime* comes to mind? For some, it's steak. So you've got a prime cut of steak, like a filet mignon, or perhaps a not-so-good cut that is *under prime* quality. Devalue it further in the case of subprime, and you get the drift; *sub*, of course, means "under" in Latin. Thus, one takeaway is that a *subprime* mortgage is a mortgage that leaves much to be desired for an investor. And that raises the question, "If you're an astute investor, why not just toss out the crappy mortgages and buy up the good ones?" The answer is easy: the process of turning something into a security known as securitization. Stocks, bonds, and Treasuries are all securities, so why not securitize mortgages? It even makes sense on paper. Mortgages provide a steady flow of monthly payments to the originating lender or bank that can then be used to service debt.

A mortgage-backed security (MBS) is created when a firm (usually an investment bank) packages a pool of mortgages together and creates debt instruments that are backed by the cashflows and collateral of the underlying mortgages. For years it was viewed as a fool-proof investment because it seemed like everybody would win. Mortgage originators would sell a group of mortgages to a securitization firm (usually an investment bank) or, in the case of larger financial institutions that originated mortgages, they would handle the securitization process themselves. This process

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allowed originators to clear the loan portfolios off their balance sheets and free up capacity to originate more loans and make more fees. A genius idea, really. But why stop there when having a stroke of genius?

Initially, people securitized mostly prime mortgages. As the demand for MBS increased, the market soon realized it could securitize and sell lower-credit quality mortgages. It accomplished this by offering multiple classes of debt backed by the loans. The classes or “tranches” would vary in interest rate and payment terms, with more senior tranches generally being repaid first and as a result yielding a lower interest rate. To best explain the idea of tranches, think of an Olympic medal ceremony. There are three winners (who we’ll compare to the investors in our mortgage scenario), and they are delineated into gold, silver, and bronze medalists. The gold medalist is at the top of the podium and a safe bet due to his consistent performance. The gold medalist represents the top tranche, and as you could imagine, it doesn’t provide a staggering rate of return. The top tranche is the first to receive cash from the mortgage pool (and importantly the last to absorb losses). In our example, an investor may get close to a 4 percent return by investing in the top (gold) tranche—little return for little risk.

Then there is the silver medalist, who may have had a few bad runs in the course of an Olympic career, but generally is a decent and respectable contestant to put a wager on. The silver medalist is like the second tranche of MBSs. They have a little more risk, but also a little more return for the risk. The second tranche will return close to, say, 6 percent. This tranche is slightly more risky because it will experience losses from the mortgage pool before the gold does.

And finally, we have the bronze medalist. Bronze is the bottom tier. While few people bet on bronze, if bronze pulls out a win the payout would be significant. The bronze medalist represents the riskiest portion of the securitization because its tranche is the first to absorb any losses from the underlying mortgages and the last to be repaid from the cashflows. However, if a sufficient number of homeowners pay off their mortgage or do not default until the later stages of the payments, the bronze tranche would be repaid. In this example, the bronze tranche would earn 8 percent because of the additional risk.

In summary, the first tranche is nearly risk-free and thus has a very small rate of return. The second tranche is a little more risky but pays out a little more than the first. And bronze is the riskiest tranche of them all but, should it work out, pays out very nicely.

BASS ASKS WHY

With that brief MBS 101 lesson behind us, we head back to 2006, when J. Kyle Bass started Hayman Capital. At the time, home ownership in the United States was near an all-time high and home prices were continuing to climb. Bass noticed, however, that average income in the United States was not keeping pace. He sat there wondering how exactly this was happening. If home prices were climbing but average income was not increasing at the same rate, how were home buyers able to obtain mortgages to purchase homes and continue to drive prices up? He decided to investigate the mortgage originators (the lenders) who were getting people with no credit or bad credit—and in some cases no jobs—into homes.

A lot of politicians in the United States have always pushed the belief that home ownership is a good thing and that everyone should have access to the ability to own a home. It's part of the American dream, for sure. But it doesn't always work out that way or, at least, it shouldn't. Should a 20-year-old making \$2,470 a month with three jobs be allowed to get a \$183,000 mortgage backed by the Federal Housing Administration with just 3.5 percent down? History has already been the judge on this one, and the answer is a resounding "no." For those of you without a house, 3.5 percent of a \$183,000 mortgage equates to about \$6500—a ridiculously small amount for a down payment.

And this is just one example, mind you. In simple terms, all over America, predatory lenders were out searching for people sign up for mortgages—in some cases by any means necessary—so they could collect the *fees* while passing on the actual *risk* to a bank or investment firm. In addition, once secured, the mortgages would then be sold to securitization firms that had little incentive to scrutinize the original borrowers. So, what started out as a genius idea turned out to be a no-holds-barred game of deceit because of a number of complicated factors.

And what deceit it was! Some lenders would approve potential homeowners with just a name, Social Security number, and any kind of identification. A typical conversation could be imagined to have gone along these lines:

Lender: "All right, Mr. Johnson, so we're going to give you a \$250,000 adjustable-rate 30-year mortgage. How's that sound to you?"

Borrower: "Fantastic! I've always wanted to live in my own home and stop renting. But there is a problem..."

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Lender: “And what’s that?”

Borrower: “Well, I don’t have a job right now and I also have six credit cards. Oh, and I work two jobs and have a car loan that’s outstanding, too.”

Lender: “No problem! Let’s just make it up as we go along. Sound good to you? I really want to get you into this house. Think about how much easier your life will be when you’re a homeowner!”

Borrower: “Yeah! Okay. Sure! Let’s do it!”

Lender: “Great! I’m going to take 20 minutes and go grab some lunch. When I get back I want to see some details on a job, your annual income, and your list of debts on this paper, if you get my drift.”

Sounds unimaginable, right? But if you think I’m being a bit too absurd, think again. As part of his investment research, Bass hired private detectives, who uncovered interactions similar to the conversation just described. In an interview I conducted in March 2010, Bass told me that the loan originators he found in 2005 and 2006 were the absolute lowest of the low. They, and the organizations they worked for, preyed upon the public interest in home ownership and tried to exonerate themselves from the ethical challenges of such work by employing the underbelly of the earth: drug dealers, convicted felons, and any other similar type of creature that came along. Not just the “regular Joes” but the “really bad guys.”

For a number of reasons, almost no one could see this web of lies, money, and mortgages destroying the country one loan at a time, but one of the few exceptions was Kyle Bass. He simply looked at the data from his research and said to himself: “Something doesn’t make sense here.” Of course, this behavior was atypical at the time, but Bass is a man with a voice and mind-set different from the status quo. He once convinced JP Morgan to help him finance a portion of his house in Japanese yen on the bet that it would ultimately be cheaper than the U.S. dollar.

Kyle Bass has always made the case that companies, no matter how big or small, should be subject to the concept of fiscal Darwinism: The weak perish while the strong survive. Should American International Group, better known as AIG, have been allowed to fail and the taxpayer spared billions? In his mind, the answer was “absolutely.”

Politicians were oblivious to what was going on. Anyone with a basic understanding of economic theory knows that a country cannot continue to print money as it wishes while racking up gigantic deficits. Throughout the period of subprime lending, home prices continued to soar to new highs

as Americans' incomes failed to keep pace. Without both factors working together, the spread between the two became wider and more dangerous. And that is exactly what Bass saw happening when he took a deeper look into the activity in the market. He recognized that this country was giving everyone and their uncle an opportunity to own a home despite the fact that home ownership was well beyond their means. Maybe it was proof that, as Jeff Kreisler said in his book *Get Rich Cheating*, "The American dream is just that: a dream."

LEARNING FROM THE PAST

Undoubtedly, the worst part of the financial crisis of the late 2000s is the fact that we actually had an opportunity to learn from our past mistakes. In 1998, the year when John Meriwether was blowing up his hedge fund, Long-Term Capital Management, another crisis was unfolding. Bass described this in great detail during our interview:

I don't know if you remember, but back in 1998, there was a sub-crisis. 1998 was a time in which there were companies that were high loan-to-value (LTV) second-lien lenders.

Okay, so what these guys would do was, they would make these high LTV loans like 125 percent at loan-to-value loans and they would be second liens. So think about your priority in that position: You're never going to collect if anything ever goes wrong. So they were hiring PhDs and trying to figure out what the incidents of default on these second-liens were going to be. And the bottom line was, again, there were convicted felons making these mortgage loans. And at the time, there were many Wall Street firms that just didn't care, packaging these things up and securitizing them. This is back in '98, so '96, '97, '98 second liens. So that market blew up in 1998.

All those companies went bankrupt except for...one which was acquired by another firm. And it almost brought down the other firm. It eventually was spun out in bankruptcy to a private equity firm.

Think of 1998 as a test run for the housing crisis of the late 2000s. Adding further fuel to the fire, a lot of the people who ran these firms went and started subprime mortgage origination shops in 1999 and 2000! It was a time when subprime mortgages were the last thing on regulators' minds.

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The American people hadn't even heard the term because in 1999 and 2000, the tech boom and dot-com IPO era was making millionaires overnight at an astounding rate. America was in good times and letting the good times roll.

In addition, the people running these firms were not just middle-level managers with their own greedy agendas. They were also CEOs, CFOs, and principal partners who all ran the companies right into the ground and then started right back up again in another venue. It was a vicious cycle.

Shady lending will continue to be the de facto way of lending to the nation's poor and less fortunate until a proper set of regulations and conditions are put into place. The fact that convicted felons have the ability to offer someone a home loan and approve or deny it seems unethical at the least. And the corruption does not stop there. In the early 2000s, if you thought a homebuilder has built too many homes, you were essentially laughed off. Money flowed freely, thanks to the Federal Reserve, and as a result, private-equity deals were happening left and right. If you bet against a homebuilder by going short, the next day you'd discover the firm had gone private and was now safe from your speculation. It was all rigged: Enron, home prices, the U.S. monetary system, and of course, the façade of regulation. In 2006 and 2007, Bass geared up to make one of the biggest bets of all time: shorting the subprime housing market.

SHORTING SUBPRIME LOANS

To *go short* is to bet that prices will fall and, in terms of the housing market, fall they did. In late 2006, as new home loans began to seize up and credit tightened, prices inflated. Through the use of derivatives, Bass and his newly created Subprime Credit Strategies Fund reaped the benefits of this crisis by investing in derivatives that enabled them to profit if the housing market tanked.

Bass explained in detail how he couldn't wait to launch his fund:

I literally couldn't wait one more day. I was so afraid that this [situation] was going to crack before I got the money raised. And remittance data comes out on the 25th day of every month and I couldn't wait for one more bit of data to come out. So I was fearful that we had spent all this time doing work, in-depth research, and modeling mortgages and, when I was meeting with investors, I'd say, 'We need to raise this right now.'

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THE GREATEST TRADES OF ALL TIME

If you saw it coming, you'd want to prepare yourself to go short immediately, too. Bass elaborated:

In July of 2006, you had, on average, about two million homes in inventory for the last five or six years in available-for-sale inventory. And what you saw was that inventory, by the end of '06, had moved up in six months' time to four million homes. So what you saw was prices leveling out, you saw inventory massively building, and then you saw at the very end of 2006, the whole loan pricing starting to come down. So we launched [the Subprime Credit Strategies Fund] in the middle of September of 2006.

It should be made clear that derivatives are not evil. They are not the devil incarnate unleashed into the hands of greedy young traders. Derivatives are a perfectly legitimate tool for hedging and protecting yourself from bets made in markets. After all, the word *derivatives* is just a fancy way of saying that an instrument or contract derives its value from the value of some other instrument or contract. Futures are a type of derivative. A farmer may sell a futures contract to smooth his cash flow and lock in a certain value for his crop. Is that so wrong? Similarly, a bank may use derivatives to hedge against its outstanding loans in case they default or get a ratings downgrade and lose part or all of their value.

Now that you can appreciate the value of derivatives, no matter your opinion, you can see that Bass speculated that the housing market was about to crumble.

THE BEST POSITION

In February 2007, Bass began to orchestrate one of the greatest trades of all time. We already know Bass had researched his investment thesis and uncovered the shadier practices of certain mortgage originators. These originators secured customers for the banks and were paid handsomely in fees for performing the mundane task. It didn't matter that the customers could afford only the first few years of interest-only payments on a home loan. As long as the originator booked it and got the fee, the repercussions of what could (and in this case, what did) happen later were moot.

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Bass reminded us that mortgages are more than just numbers for accountants and actuaries to crunch. They also contain a qualitative aspect:

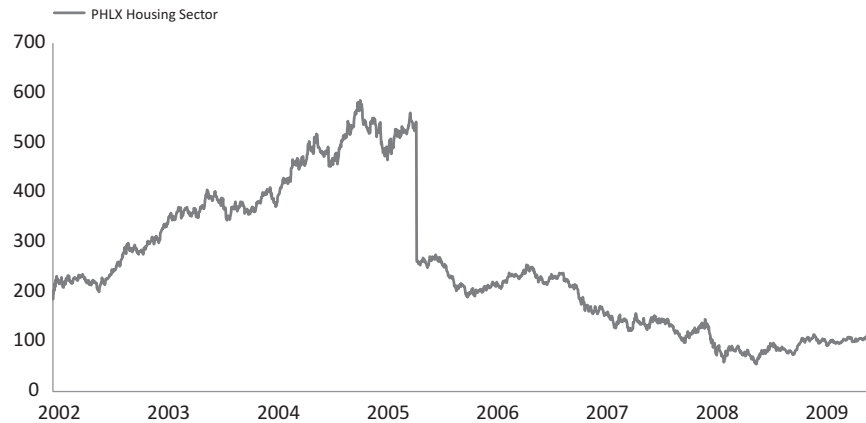
What you had to figure out was there's the quantitative aspect of things and there's the qualitative aspect of things. And the quantitative aspect, everybody had. Everybody had [all the] terabytes of mortgage data, modeling software that they could buy.

But the qualitative aspect was kind of: who were the originators that had literally no standards at all? . . . So what we did was, we went out and we found the bad guys.

Bass found plenty of bad guys. He investigated the lifestyles and backgrounds of these mortgage originators and their companies. Who were they? What was their incentive to offer someone making \$30,000 a year a \$500,000 loan? Clearly something was amiss, and Bass was able to exploit the small window of opportunity where the economy and housing market began to turn just a tad sour. Originally, he claims, he wanted to find out if the originators were "fine, upstanding members of the community just trying to earn a buck" or whether they were "guys that had big drug problems that were financing themselves and their crazy lifestyles with mortgage origination."

If you think about it, the point Bass makes is scary. Twenty years ago, when credit wasn't flowing like a broken faucet in the United States, someone looking for a loan would have to go to the bank and speak with a man in a suit and show the proper backup in order to justify the loan. It was a trusted process, and there was plenty of due diligence on both sides of the transaction. Flash forward to 2006, and there you are telling an ex-convict how much you want a loan and you have no way to back it up. Salary, debt-to-income ratios, and other important factors of a loan were simply tossed out the proverbial window and made up on the spot in order to satisfy the banks. These loan originators collected their fee and then repeated the process with more and more customers until satisfied with their income.

Bass saw hints of the coming mess as early as 1998. Looking back, it seems like the warning signs were everywhere and becoming more frequent, popping up every week practically as 2007 neared. In that year, toxic loans were still being made, but not at the pace of previous months and years. By the time the market and the U.S. government began to realize that something was up, it was too late; Bass had already gone short and was entering a position that would ultimately become one of the best of his life.

**FIGURE 1.1** The Subprime Crisis

Data source: Historical data from Yahoo! Finance

The housing crisis is ultimately a complicated web that's hard to untangle but Figure 1.1 shows just how complex the system really was.

As Bass's investors began to see profits, like anyone making a decent rate of return, some investors became inclined to redeem and book their profits up to that point. Bass says during that time, he insisted that investors leave their money in the fund so it could truly grow. His point: If you double your money, that's fantastic. But what if you could earn a lot more on the investment? That's what Bass really had in mind. Investors would inquire about redeeming and Bass would retort, "Are you kidding me?" The move he was making was an opportunity of unprecedented scale. In the months leading up to the crisis, an investor could throw a dart at a stock and watch it go up with the rest of the stock market as the Dow hit new highs and continued to climb without care. But when things turned sour with housing and credit, it was Bass's investors who began making the big bucks.

In February 2007, the Subprime Credit Strategies Fund was kicking into high gear. By July 2007, the fund was up over 100 percent. That's 100 percent return on investment in six months! Any investor would be smiling ear-to-ear if after hearing that within such a short period their investments had doubled. One million dollars turned into \$2 million, \$10 million into \$20 million, \$100 million into \$200 million. And Hayman Capital was one of the hottest (albeit relatively unknown) hedge funds on the block.

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It should be made clear that the counterparties to the investments made by Bass were large securities dealers, not homeowners who were losing their houses. Bass's investments were in derivatives that got their value from the default rates of the lower-rated mortgage securitization tranches. The American people and investors of the world suffered due to the lack of governmental oversight of the mortgage industry at many fundamental levels. A jaw-dropping example of this is found in a book by Henry Paulson, a former Goldman Sachs CEO and former secretary of the Treasury, *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System*. It is a tale of how even our own secretary of the Treasury did not have a clue about what was going on until it was too late.

Indeed, quite scary.

THE EFFECTS OF ABUSE

The housing crisis turned into the credit crisis, which turned into the financial crisis. In a little under four years, home values plummeted like a rock off a cliff. One could argue, though, that it was simply the market correcting itself after years of abuse. While this may be true, it doesn't negate the fact that millions of Americans lost the shirts off their backs and got stuck in homes with mortgages costing way more than they were worth. In many cases, these were people who had reasonable credit histories and had been making their mortgage payments each month—they weren't even a part of that risky third tranche.

Because of this domino effect, job by job, bank by bank, loan by loan, things began to crumble. First Bear Stearns stood on the brink of collapse; it was ultimately bailed out for \$10 a share by JP Morgan. Then came the highly leveraged Lehman Brothers and Merrill Lynch, which were sold off to Barclays and Bank of America, respectively. Countrywide. AIG. General Motors. When would it stop? The United States and its financial industry came to a screeching halt.

In 2006, Bass started shorting subprime housing lenders and subprime mortgage insurance providers, and he shorted them hard. And just as his gamble began to really pay off, our nation saw economic collapse of unprecedented proportions. Ten percent unemployment may not sound like a large number, but when you realize that means that almost 1 in 10 Americans is without a job, it is humbling. To get an idea of how unemployment looked up until 2008, see Figure 1.2.

**FIGURE 1.2** Unemployment Rate

Most of those out of work will file for unemployment benefits, and this contributes to rising governmental costs and adds strain to our national deficit. Add that stress to the burden of the home the unemployed have been paying on for 10 years with an adjustable-rate mortgage, which will soon balloon to a payment they cannot afford (never mind the foreshadowed mortgage payment increase; they are unable to make the current mortgage payments) and expand it by millions of people, and you start to see the magnitude of the situation. The bank that lent the homeowner the money will foreclose on the house, contributing to its balance sheet losses. And even worse, the housing market has collapsed, and the house is now worth substantially less than its purchase price. The restaurant down the street where the homebuyer ate twice a week is now seeing him twice a month, and it continues to lose money. The restaurant cannot afford to pay all its employees, so it lays off a few of them. The vicious cycle repeats itself in additional venues until divine intervention by either God or the Federal Reserve arrives.

To underscore the impact of the recent financial crisis, see Table 1.1, which presents data from the St. Louis Federal Reserve.

At the start of 2005, unemployment was at a respectable 5.3 percent. In 2006 it fell to 4.6 percent, where it stayed until 2008, when the crisis really kicked into high gear. It then shot up to where it stands at the writing of this book: 9.7 percent, which is a little lower than the 10.1 percent unemployment rate of October 2009. Will the economy improve? Perhaps. The last time we had double-digit unemployment was in 1983.

TABLE 1.1 St. Louis Federal Reserve Data, 2005–2010

Year	Month	Unemployment Rate
2005	January	5.3%
2005	June	5.0%
2006	January	4.7%
2006	June	4.6%
2007	January	4.6%
2007	June	4.6%
2008	January	5.0%
2008	June	5.5%
2009	January	7.7%
2009	June	9.5%
2010	January	9.7%

If you take a cue from Bass and stress the importance of numbers, you can look at any presentation of mortgage data for the past decade and the number of loans in delinquency or default and correlate the data with Table 1.1. You will notice the pattern of worsening home sales and rising unemployment. The same can be said for retail sales, consumer confidence, and many other economic measures.

WHO WAS WATCHING?

Where were the governmental regulators when we needed them most? Well, aside from dealing with Enron and WorldCom in the early 2000s, regulators were relatively inept in their ability to spot the potential crisis. After all, the only reason that companies like Enron and Lehman Brothers were in the news is that a dreadful lack of regulation had failed to catch the misdeeds of these companies. And when it's too late and the shareholders have been wiped out, that's when it becomes important to the Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA). It happened about the same time as people started to see the scandals on the five o'clock news.

Kyle Bass went around talking to people throughout the financial community in 2010 in an attempt to explain just how serious the situation had become. He posed an incredible question: "What business do you know that is a trillion-dollar business that directly touches a consumer that's unregulated? Save for mortgage origination, there isn't one." He drove home

the point that could have very well prevented the previous three years of recession, poverty, and job loss:

We need to regulate mortgage origination. Period. At both the bank and non-bank, at state and federal [levels]. I don't care where the regulation is but it needs to be firm. Right? They need to set firm debt-to-total-income ratios, just coverage ratios saying, "This is what you can do and you can't do anything else." It just makes sense.

During our interview, Bass became more intense and showed a true passion for wanting to stop the nonsense in the housing market. For sure, he could wait for another crisis to come along, go short, make more money, and be on his way. But I believe that's not how Bass sees himself overall. Yes, an extraordinary opportunity brought him a boatload of money, but unlike other investors, Bass would like to also see a change come out of it: an end to the predatory lending of the past decade and a clear direction on where this country is headed in terms of regulation and finance.

One issue for Bass is that even if regulators imposed strict lending standards and prevented people who can't afford a home from getting into homes, a sizable portion of the United States' population would suddenly find themselves segregated. It is why we have Freddie Mac and Fannie Mae, why the Federal Reserve keeps a close watch on the economy, and why the Federal Housing Authority exists. Bass explained that if we simply did away with all the bureaucracy and put in place set-in-stone laws and regulation, it would cut out a sizable portion of existing mortgages and future lending prospects. This type of restriction would cause major consequences. In a more regulated market, banks couldn't lend to as many people and couldn't take in as much money as they'd like. Thus, non-home loans from banks would begin to become scarce. Fannie and Freddie would have no way of buying home loans because there simply wouldn't be enough to guarantee. Asset-backed securities tied to home loans would shrivel up, soon followed by auto loan-backed securities, credit card-backed securities, and so on, up until there was simply a minimal amount of credit flowing. The securitization business would soon grind to a halt. This is all, of course, somewhat of a worst-case scenario, but we need to keep it in the back of our minds. Remember: Everything in an economy is ultimately systemic.

Further, our government is part of the problem, not a solution, and it is a matter of fiscal responsibility, not politics. Taking a cold, hard look at government-sponsored entities Fannie Mae and

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Freddie Mac, Bass discussed how we're just postponing a long overdue problem with these bailed out GSEs:

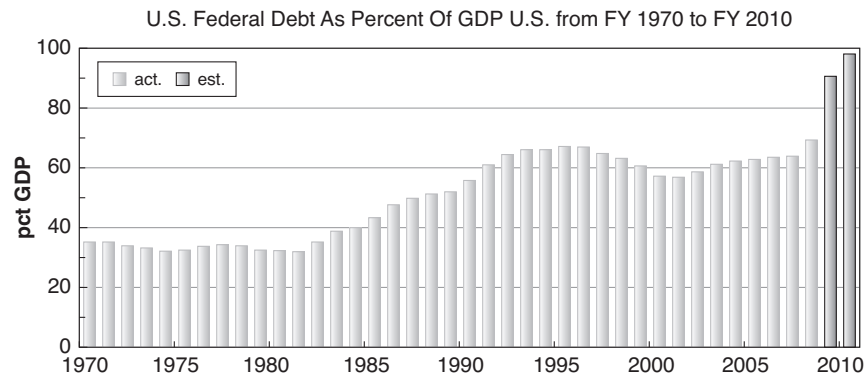
Well, you look at Fannie and Freddie, right? [The U.S. government has] already given them \$181 billion, and it is not in the Obama budget by the way, and if you look at the 2010 budget or the 2009 budget, that \$180 billion is in never-never land. It's not in the budget. Fannie and Freddie are going to cost taxpayers over \$400 billion when it's all said and done.

Think about what Bass is saying: \$400 billion. The savings and loan crisis at the end of the 1980s cost the taxpayers \$120 billion. We've given \$181 billion to Fannie and Freddie alone. Even if you adjust for today's dollars, our GDP was half of what it was back in, say, 1988. So even if you double that number to \$240 billion, just Fannie and Freddie alone are going to lose \$400 billion. And we've already written down about \$900 billion for the banks. It's almost incomprehensible. But people seem impervious to it. They say, "Oh yeah, what's a billion trillion dollars? It doesn't matter. I don't even know what numbers that large mean." But it's very relevant especially when thinking in terms of size. And the Fed's answer has been to keep printing money. Ben Bernanke, later chairman of the Federal Reserve, said in 2006, "I wouldn't worry, I have a printing press!" And he's using it.

Hank Paulson, former Goldman Sachs CEO and secretary of the Treasury under President George W. Bush, agrees. In his book, *On the Brink*, Paulson details how he believed a sweeping overhaul of Fannie and Freddie were needed in order to prevent them from imploding under their own weight. Paulson tried to get Congress to see the problem, but it ultimately was a lost cause. It was also a shame, considering that the foresight of Paulson and others like Bass had could have prevented our deficit from taking on another couple of hundred billion dollars from bailouts. And really, the deficit is the key. Figure 1.3 showcases the U.S. deficit as a percentage of GDP from 1970 through 2010.

After 2005, when the financial system began to collapse, the cost of these bailouts skyrocketed the deficit to unprecedented levels. It was double or triple that of some years past. It is funny to think that as little as 10 years ago our deficit was a surplus.

Now that our debts have climbed above 10 percent of our GDP, printing more money will only delay the inevitable. At the time of this writing, Fannie and Freddie equity was trading at around \$1.10 and \$1.35 a share, respectively. These are penny stocks that would no doubt be delisted from

**FIGURE 1.3** U.S. Debt

an exchange if it weren't for their government bailout and conservatorship. Bass spoke in our interview of how this situation mirrors that of United Airlines in 2002:

Nobody knows where Fannie and Freddie will be 5 to 10 years down the line. I don't know. You've got to handicap the politics of Fannie and Freddie because the financial aspects of Fannie and Freddie should be in receivership. It's now in conservatorship, which is never-never land—it's the Twilight Zone. And still, it's theoretically public that the taxpayers are losing up to \$400 billion and there's still public equity that trades, which should be wiped out.

Think about this: United Airlines was in bankruptcy for a number of years. There was a point where they were about to emerge from bankruptcy and then the equity was wiped out and the subordinated debt was only worth 18 cents. Essentially, the stock was worthless, but it was trading hundreds of millions of shares and it went from \$1 to \$3 because the general public was watching CNBC and heard United was about to emerge from bankruptcy. The public then bought the prebankrupt, preconditioned equity and lost all their money. It just goes to show you that people have no idea what they're doing.

It is when people do not understand what they are doing that other people profit from it most. As the housing market, government-sponsored enterprises, and economy all took a turn for the worse in late 2006, people like Kyle Bass made the most of the situation and profited handsomely. While some may decry the practice of a fund turning a healthy profit in a

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time when the macroeconomic picture of things is headed downward, one must remember that there is always a way to turn tragedy into money.

RE-CREATING BASS'S TRADING STRATEGIES

The thing about Kyle Bass that makes his trade difficult to replicate by the retail investor is one big concern: capital. Bass had plenty of capital and is an accredited investor who is capable of buying complex instruments. But the main themes we can learn from behind his trade involved two things: the housing crisis and mortgage originators.

A way you could short the housing market involves futures contracts based on specific real estate markets offered by CME Group. These contracts are based on the Case-Shiller Home Price Index, the de facto standard for a gauge of America's housing situation.

Table 1.2 shows contracts offered by CME Group. For instance, say you thought Chicago's housing market was going to be in shambles between now and May 2011. You could sell the May 2011 Chicago S&P/Case-Shiller Home Price Index contract and hope that the underlying index for that contract falls in value. You would then buy it back at a lower price and profit.

If you're not acclimated to futures trading or you don't have the capital for that sort of trade, another way to play the housing market would be to short homebuilders. This can be done via an exchange-traded fund (ETF) offered by State Street Global Advisors (the Homebuilders SPDR ETF), trading under the ticker XHB. Simply short the ETF and, should the price drop, buy it back and profit.

In Figure 1.4, you can see the five-year performance of XHB. Clearly, this ETF took a huge hit during the recent financial/housing crisis.

While this may not reap you the sort of returns that Kyle Bass and his investors saw, it's a solid, easy way to play the same sort of trade.

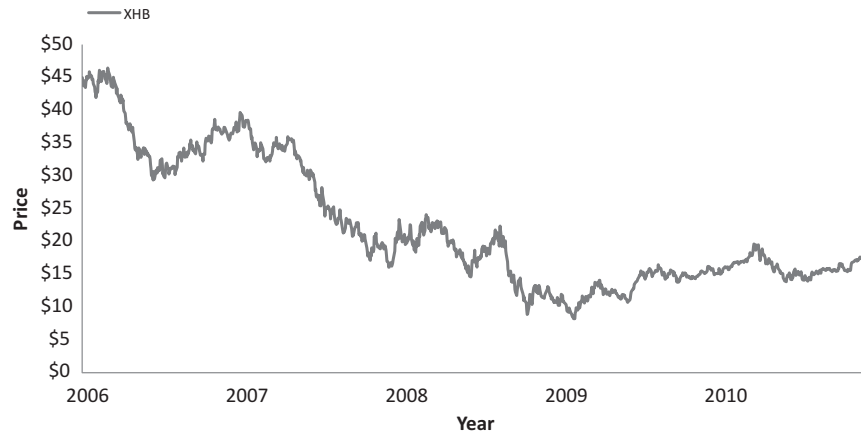
BASS'S TOP TRAITS

Kyle Bass is one of the greats. Few people saw the subprime housing crisis coming from so far, and he performed his fiduciary duty to his clients to the fullest effect, netting them returns in triple digits. The housing market may very well never return to the levels seen in the past unless we experience an

TABLE 1.2 Real Estate Calendar

Comm Code	Exch	Month Code	Contract Name	Product Type	Last Trade Date	Settle Date
BOSG11	CME	201102	February 2011 Boston S&P/Case-Shiller Home Price Index	FUT	02/18/2011	02/22/2011
BOSK11	CME	201105	May 2011 Boston S&P/Case-Shiller Home Price Index	FUT	05/27/2011	05/31/2011
CHIG11	CME	201102	February 2011 Chicago S&P/Case-Shiller Home Price Index	FUT	02/18/2011	02/22/2011
CHIK11	CME	201105	May 2011 Chicago S&P/Case-Shiller Home Price Index	FUT	05/27/2011	05/31/2011
DENG11	CME	201102	February 2011 Denver S&P/Case-Shiller Home Price Index	FUT	02/18/2011	02/22/2011
DENK11	CME	201105	May 2011 Denver S&P/Case-Shiller Home Price Index	FUT	05/27/2011	05/31/2011
CUSG11	CME	201102	February 2011 Housing Composite Index	FUT	02/18/2011	02/22/2011
CUSK11	CME	201105	May 2011 Housing Composite Index	FUT	05/27/2011	05/31/2011
LAVG11	CME	201102	February 2011 Las Vegas S&P/Case-Shiller Home Price Index	FUT	02/18/2011	02/22/2011
LAVK11	CME	201105	May 2011 Las Vegas S&P/Case-Shiller Home Price Index	FUT	05/27/2011	05/31/2011
LAXG11	CME	201102	February 2011 Los Angeles S&P/Case-Shiller Home Price Index	FUT	02/18/2011	02/22/2011
LAXK11	CME	201105	May 2011 Los Angeles S&P/Case-Shiller Home Price Index	FUT	05/27/2011	05/31/2011
MIAG11	CME	201102	February 2011 Miami S&P/Case-Shiller Home Price Index	FUT	02/18/2011	02/22/2011
MIAK11	CME	201105	May 2011 Miami S&P/Case-Shiller Home Price Index	FUT	05/27/2011	05/31/2011
NYMG11	CME	201102	February 2011 New York Commuter S&P/Case-Shiller Home Price Index	FUT	02/18/2011	02/22/2011
NYMK11	CME	201105	May 2011 New York Commuter S&P/Case-Shiller Home Price Index	FUT	05/27/2011	05/31/2011
SDGG11	CME	201102	February 2011 San Diego S&P/Case-Shiller Home Price Index	FUT	02/18/2011	02/22/2011
SDGK11	CME	201105	May 2011 San Diego S&P/Case-Shiller Home Price Index	FUT	05/27/2011	05/31/2011
SFRG11	CME	201102	February 2011 San Francisco S&P/Case-Shiller Home Price Index	FUT	02/18/2011	02/22/2011
SFRK11	CME	201105	May 2011 San Francisco S&P/Case-Shiller Home Price Index	FUT	05/27/2011	05/31/2011
WDCG11	CME	201102	February 2011 Washington D.C. S&P/Case-Shiller Home Price Index	FUT	02/18/2011	02/22/2011
WDCK11	CME	201105	May 2011 Washington D.C. S&P/Case-Shiller Home Price Index	FUT	05/27/2011	05/31/2011

Data source: CME Group, www.cmegroup.com

**FIGURE 1.4** XHB Chart

Data source: Historical data from Yahoo! Finance

inflationary economic period of accelerated proportions. If that happens, you can bet Bass will be going over the charts again.

Bass's trading style exemplifies talent that is rare. Here are a couple of reasons why he profited so magnificently from his greatest trade:

1. **Foresight:** Kyle Bass is a thinker. When the numbers don't add up, he really thinks about the situation and constantly asks why. He also has history on his side. Bass is incredibly knowledgeable on everything related to economics, finance, and everything in between. He predicted the housing crisis because he didn't like what he saw going on with mortgage originators and related issues after doing research.
2. **Persistence:** Bass wouldn't budge when investors came knocking at his door. When the going got tough, he knew he was right and didn't move. He stayed cool and assured everyone that they would make money if they held on a little longer.

■ ■ ■

Bass will undoubtedly become one of the most successful investors ever due to his clear thinking during the unique time that was the 2000s, and it will be interesting to see what his next big payoff is. Again, players like Bass are few and far between. When they become known for their trades, pay close attention and listen to what those trades are saying.

In the next chapter, you will learn about one of the best short sellers.

