



The Consummate Contrarian, What Michael Burry Can Teach Us about Following the Pack

Michael Burry, who accurately predicted the housing calamity long before anyone else, offers insight into the behavior of crowds, and those that move against them.

Michael Burry's article in *Vanity Fair*, is a short tease for his new book, *The Big Short*, which exposes how Burry accurately predicted the housing debacle far in advance of the actual crisis. The *Vanity Fair* article reveals how Burry single-handedly outmaneuvered Wall Street's elite, and how this success has not ingratiated him to those he took to task.

Burry, a Stanford educated physician, is undoubtedly very smart, but this is not why Burry was able to see what others could not. It is Burry's questioning, contrarian nature that led him to perform substantial due-diligence into an assumption that others had taken for granted: that housing was on an epic, sustained run that would never cease.

Burry's story is a tale of two unique, if interrelated, phases. The first phase involved Burry's tenacious slog through a thicket of documents, prospectuses and textbooks, looking for clues to the impending disaster and performing bank credit analysis on the home loans that he was analyzing, the same analysis that should have been performed by the issuing banks, but wasn't. The second phase, convincing Wall Street to create financial products so that he could short the market, was pure genius.

Michael Burry's analysis of the housing market and his conclusions are due primarily to his dogged due-diligence, pure and simple. This effort was nothing short of herculean in scope but otherwise unremarkable and tedious, and was the product of Burry's tireless review of thousands of documents. Once completed, though, this due-diligence provided Burry the platform for the unshakeable faith in his ability to detect patterns and draw conclusions from within the housing bubble, and ignore the conventional and usually mistaken wisdom of crowds.

What did Michael Burry see in the housing crisis and what patterns and conclusions did he reach?

1. Burry began learning about the bond market early in his career, learning all he could about credit and how America borrowed money.
2. He then began learning about subprime-mortgages and reading mortgage bond prospectuses. He learned that the mortgage bonds were backed by subprime mortgage loans for which underwriting standards had virtually collapsed. Subprime loans had been issued in

a nearly infinite pastel of variations, most having as their common theme placing people into homes that they likely could not afford.

3. Burry then concluded that lending standards were virtually nonexistent, and that the subprime loans backing the bonds would eventually begin defaulting in massive quantities. Loan volume was inversely correlated with loan standards: as lending standards went down, loan volume substantially increased.

4. Degradation of lending standards occurred primarily because the banks no longer kept the loans on their balance sheet, but sold them off to be packaged into the bonds.

For all his genius, Burry's conclusions regarding the housing market were unspectacular, largely predictable, and the product of study and due-diligence. Surely, anyone with even a modicum of common sense and intelligence could have replicated this analysis. But no one did.

Burry's true genius, though, was in fashioning a methodology, an instrument really, through which he could short these housing bonds directly, without having to short the peripheral stocks involved in the housing industry, such as homebuilding companies or materials suppliers. Initially, he began buying credit-default swaps, a form of insurance that would pay in the event of default, on companies he thought might falter in a protracted real-estate downturn. This, though, was dangerous, as there was no guarantee that the companies would actually default or go bankrupt.

The most direct way of shorting housing and the bonds that affected them was to purchase credit default swaps on the subprime bonds themselves. Credit default swaps on subprime bonds, though, did not exist in 2004. Eventually, Burry persuaded Deutsche Bank and Goldman Sachs to sell him the credit default swaps he so badly wanted. The rest of the story played out exactly as he had anticipated: the housing market collapsed and so did the subprime bonds associated with it. This is how Michael Burry turned due-diligence into hedge fund success.

None of this, though, would have happened without Burry's insatiable appetite to digest, read and synthesize information, his ability to analyze and relate seemingly mundane bits of information into a weave. What personality characteristics did Burry possess that might influence or otherwise enhance these abilities?

1. An obsession with fairness.
2. An obsession with topics that interested him.
3. The ability to work, focus and concentrate.
4. A drive to be productive.
5. The ability to recognize and make sense of complex patterns.
6. An innate sense of the correctness of his convictions, while completely opposed to prevailing wisdom.

The first five of these personality characteristics are shared by tens of thousands of smart, capable individuals throughout the world. The last one, though, is tenaciously difficult to acquire or possess: the ability to stand against others and dare to be right.

Why did Burry possess this ability and why did he alone stand and fight against overwhelming conventional wisdom? Because Burry alone had done the due-diligence required to prevail, and he alone understood the coming debacle. Where others guessed, he knew, where others vacillated or wavered, he stood firm. All because of the grinding, dirty slog through a seemingly impenetrable forest of documents.

The lesson drawn is not Burry's genius in creating a unique financial product with which to short Wall Street. This is hedge fund politics at its best. The lesson for the rest of us lies in understanding the degree to which simple, predictable, and thorough due diligence under-pinned his entire effort, which in turn provided Burry the unshakeable belief in his early convictions that the entire housing market would soon collapse. This in the face of the greatest asset-price inflation ever witnessed, which made housing contrarians like Burry extremely unpopular and subjects of ridicule.

Michael Burry did not guess or speculate with disproportionate amounts of his hedge fund's investment. No, Michael Burry understood his subject-matter so well that he was sure that he bet correctly. Not even his own investors believed he was right, and many sought to withdraw from the hedge fund.

Of course, Burry was right, as he asserted in a recent New York Times editorial, but no one really acknowledged this, not now, not then. Burry became this debacle's Cassandra, cursed by the knowledge of imminent collapse but reviled for being right. Still, I would rather be right.