

# The End

by Michael Lewis

**Portfolio Magazine - December 2008 Issue\***

\*Portfolio Magazine ceased publication in the Spring of 2009



Photoillustration by: Ji Lee

***The era that defined Wall Street is finally, officially over. Michael Lewis, who chronicled its excess in *Liar's Poker*, returns to his old haunt to figure out what went wrong.***

To this day, the willingness of a Wall Street investment bank to pay me hundreds of thousands of dollars to dispense investment advice to grownups remains a mystery to me. I was 24 years old, with no experience of, or particular interest in, guessing which stocks and bonds would rise and which would fall. The essential function of Wall Street is to allocate capital—to decide who should get it

and who should not. Believe me when I tell you that I hadn't the first clue.

I'd never taken an accounting course, never run a business, never even had savings of my own to manage. I stumbled into a job at Salomon Brothers in 1985 and stumbled out much richer three years later, and even though I wrote a book about the experience, the whole thing still strikes me as preposterous—which is one of the reasons the money was so easy to walk away from. I figured the situation was unsustainable. Sooner rather than later, someone was going to identify me, along with a lot of people more or less like me, as a fraud. Sooner rather than later, there would come a Great Reckoning when Wall Street would wake up and hundreds if not thousands of young people like me, who had no business making huge bets with other people's money, would be expelled from finance.

When I sat down to write my account of the experience in 1989—*Liar's Poker*, it was called—it was in the spirit of a young man who thought he was getting out while the getting was good. I was merely scribbling down a message on my way out and stuffing it into a bottle for those who would pass through these parts in the far distant future.

Unless some insider got all of this down on paper, I figured, no future human would believe that it happened.

I thought I was writing a period piece about the 1980s in America. Not for a moment did I suspect that the financial 1980s would last two full decades longer or that the difference in degree between Wall Street and ordinary life would swell into a difference in kind. I expected readers of the future to be outraged that back in 1986, the C.E.O. of Salomon Brothers, John Gutfreund, was paid \$3.1 million; I expected them to gape in horror when I reported that one of our traders, Howie Rubin, had moved to Merrill Lynch, where he lost \$250 million; I assumed they'd be shocked to learn that a Wall Street C.E.O. had only the vaguest idea of the risks his traders were running. What I didn't expect was that any future reader would look on my experience and say, "How quaint."

I had no great agenda, apart from telling what I took to be a remarkable tale, but if you got a few drinks in me and then asked what effect I thought my book would have on the world, I might have said something like, "I hope that college students trying to figure out what to do with their lives will read it and decide that it's silly to phony it up and abandon their passions to become financiers." I hoped that some bright kid at, say, Ohio State University who really wanted to be an oceanographer would read my book, spurn the offer from Morgan Stanley, and set out to sea.

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

In the two decades since then, I had been waiting for the end of Wall Street. The outrageous bonuses, the slender returns to shareholders, the never-ending scandals, the bursting of the internet bubble, the crisis following the collapse of Long-Term Capital Management: Over and over again, the big Wall Street investment banks would be, in some narrow way, discredited. Yet they just kept on growing, along with the sums of money that they doled out to 26-year-olds to perform tasks of no obvious social utility. The rebellion by American youth against the money culture never happened. Why bother to overturn your parents' world when you can buy it, slice it up into tranches, and sell off the pieces?

At some point, I gave up waiting for the end. There was no scandal or reversal, I assumed, that could sink the system. The crash did more than wipe out money. It also reordered the power on Wall Street. Most economists predict a recovery late next year. Don't bet on it.

Then came Meredith Whitney with news. Whitney was an obscure analyst of financial firms for Oppenheimer Securities who, on October 31, 2007, ceased to be obscure. On that day, she predicted that Citigroup had so mismanaged its affairs that it would need to slash its dividend or go bust. It's never entirely clear on any given day what causes what in the stock market, but it was pretty obvious that on October 31, Meredith Whitney caused the market in financial stocks to crash. By the end of the trading day, a woman whom basically no one had ever heard of had shaved \$369 billion off the value of financial firms in the market. Four days later, Citigroup's C.E.O., Chuck Prince, resigned. In January, Citigroup slashed its dividend.

From that moment, Whitney became E.F. Hutton: When she spoke, people listened. Her message was clear. If you want to know what these Wall Street firms are really worth, take a hard look at the crappy assets they bought with huge sums of borrowed money, and imagine what they'd fetch in a fire sale. The vast assemblages of highly paid people inside the firms were essentially worth nothing. For better than a year now, Whitney has responded to the claims by bankers and brokers that they had put their problems behind them with this write-down or that capital raise with a claim of her own: You're wrong. You're still not facing up to how badly you have mismanaged your business.

Rivals accused Whitney of being overrated; bloggers accused her of being lucky. What she was, mainly, was right. But it's true that she was, in part, guessing. There was no way she could have known what was going to happen to these Wall Street firms. The C.E.O.'s themselves didn't know.

Now, obviously, Meredith Whitney didn't sink Wall Street. She just expressed most clearly and loudly a view that was, in retrospect, far more seditious to the financial order than, say, Eliot Spitzer's campaign against Wall Street corruption. If mere scandal could have destroyed the big Wall Street investment banks, they'd have vanished long ago. This woman wasn't saying that Wall Street bankers were corrupt. She was saying they were stupid. These people whose job it was to allocate capital apparently didn't even know how to manage their own.

At some point, I could no longer contain myself: I called Whitney. This was back in March, when Wall Street's fate still hung in the balance. I thought, If she's right, then this really could be the end of Wall Street as we've known it. I was curious to see if she made sense but also to know where this young woman who was crashing the stock market with her every utterance had come from.

It turned out that she made a great deal of sense and that she'd arrived on Wall Street in 1993, from the Brown University history department. "I got to New York, and I didn't even know research existed," she says. She'd wound up at Oppenheimer and had the most incredible piece of luck: to be trained by a man who helped her establish not merely a career but a worldview. His name, she says, was Steve Eisman.

Eisman had moved on, but they kept in touch. "After I made the Citi call," she says, "one of the best things that happened was when Steve called and told me how proud he was of me."

Having never heard of Eisman, I didn't think anything of this. But a few months later, I called Whitney again and asked

her, as I was asking others, whom she knew who had anticipated the cataclysm and set themselves up to make a fortune from it. There's a long list of people who now say they saw it coming all along but a far shorter one of people who actually did. Of those, even fewer had the nerve to bet on their vision. It's not easy to stand apart from mass hysteria—to believe that most of what's in the financial news is wrong or distorted, to believe that most important financial people are either lying or deluded—without actually being insane. A handful of people had been inside the black box, understood how it worked, and bet on it blowing up. Whitney rattled off a list with a half-dozen names on it. At the top was Steve Eisman.

Steve Eisman entered finance about the time I exited it. He'd grown up in New York City and gone to a Jewish day school, the University of Pennsylvania, and Harvard Law School. In 1991, he was a 30-year-old corporate lawyer. "I hated it," he says. "I hated being a lawyer. My parents worked as brokers at Oppenheimer. They managed to finagle me a job. It's not pretty, but that's what happened."

He was hired as a junior equity analyst, a helpmate who didn't actually offer his opinions. That changed in December 1991, less than a year into his new job, when a subprime mortgage lender called Ames Financial went public and no one at Oppenheimer particularly cared to express an opinion about it. One of Oppenheimer's investment bankers stomped around the research department looking for anyone who knew anything about the mortgage business. Recalls Eisman: "I'm a junior analyst and just trying to figure out which end is up, but I told him that as a lawyer I'd worked on a deal for the Money Store." He was promptly appointed the lead analyst for Ames Financial. "What I didn't tell him was that my job had been to proofread the documents and that I hadn't understood a word of the fucking things."

Ames Financial belonged to a category of firms known as nonbank financial institutions. The category didn't include J.P. Morgan, but it did encompass many little-known companies that one way or another were involved in the early-1990s boom in subprime mortgage lending—the lower class of American finance.

The second company for which Eisman was given sole responsibility was Lomas Financial, which had just emerged from bankruptcy. "I put a sell rating on the thing because it was a piece of shit," Eisman says. "I didn't know that you weren't supposed to put a sell rating on companies. I thought there were three boxes—buy, hold, sell—and you could pick the one you thought you should." He was pressured generally to be a bit more upbeat, but upbeat wasn't Steve Eisman's style. Upbeat and Eisman didn't occupy the same planet. A hedge fund manager who counts Eisman as a friend set out to explain him to me but quit a minute into it. After describing how Eisman exposed various important people as either liars or idiots, the hedge fund manager started to laugh. "He's sort of a prick in a way, but he's smart and honest and fearless."

"A lot of people don't get Steve," Whitney says. "But the people who get him love him." Eisman stuck to his sell rating on Lomas Financial, even after the company announced that investors needn't worry about its financial condition, as it had hedged its market risk. "The single greatest line I ever wrote as an analyst," says Eisman, "was after Lomas said they were hedged." He recited the line from memory: "'The Lomas Financial Corp. is a perfectly hedged financial institution: It loses money in every conceivable interest-rate environment.' I enjoyed writing that sentence more than any sentence I ever wrote." A few months after he'd delivered that line in his report, Lomas Financial returned to bankruptcy.

Eisman wasn't, in short, an analyst with a sunny disposition who expected the best of his fellow financial man and the companies he created. "You have to understand," Eisman says in his defense, "I did subprime first. I lived with the worst first. These guys lied to infinity. What I learned from that experience was that Wall Street didn't give a shit what it sold."

Harboring suspicions about people's morals and telling investors that companies don't deserve their capital wasn't, in the 1990s or at any other time, the fast track to success on Wall Street. Eisman quit Oppenheimer in 2001 to work as an analyst at a hedge fund, but what he really wanted to do was run money. FrontPoint Partners, another hedge fund, hired him in 2004 to invest in financial stocks. Eisman's brief was to evaluate Wall Street banks, homebuilders, mortgage originators, and any company (General Electric or General Motors, for instance) with a big financial-services division—anyone who touched American finance. An insurance company backed him with \$50 million, a paltry sum. "Basically, we tried to raise money and didn't really do it," Eisman says.

Instead of money, he attracted people whose worldviews were as shaded as his own—Vincent Daniel, for instance, who became a partner and an analyst in charge of the mortgage sector. Now 36, Daniel grew up a lower-middle-class kid in Queens. One of his first jobs, as a junior accountant at Arthur Andersen, was to audit Salomon Brothers' books. "It was shocking," he says. "No one could explain to me what they were doing." He left accounting in the middle of the internet boom to become a research analyst, looking at companies that made subprime loans. "I was the only guy I knew covering companies that were all going to go bust," he says. "I saw how the sausage was made in the economy, and it was really freaky."

Danny Moses, who became Eisman's head trader, was another who shared his perspective. Raised in Georgia, Moses, the son of a finance professor, was a bit less fatalistic than Daniel or Eisman, but he nevertheless shared a general sense that bad things can and do happen. When a Wall Street firm helped him get into a trade that seemed perfect in every way, he said to the salesman, "I appreciate this, but I just want to know one thing: How are you going to screw me?"

Heh heh heh, c'mon. We'd never do that, the trader started to say, but Moses was politely insistent: We both know that unadulterated good things like this trade don't just happen between little hedge funds and big Wall Street firms. I'll do it, but only after you explain to me how you are going to screw me. And the salesman explained how he was going to screw him. And Moses did the trade.

Both Daniel and Moses enjoyed, immensely, working with Steve Eisman. He put a fine point on the absurdity they saw everywhere around them. "Steve's fun to take to any Wall Street meeting," Daniel says. "Because he'll say 'Explain that to me' 30 different times. Or 'Could you explain that more, in English?' Because once you do that, there's a few things you learn. For a start, you figure out if they even know what they're talking about. And a lot of times, they don't!"

At the end of 2004, Eisman, Moses, and Daniel shared a sense that unhealthy things were going on in the U.S. housing market: Lots of firms were lending money to people who shouldn't have been borrowing it. They thought Alan Greenspan's decision after the internet bust to lower interest rates to 1 percent was a travesty that would lead to some terrible day of reckoning. Neither of these insights was entirely original. Ivy Zelman, at the time the housing-market analyst at Credit Suisse, had seen the bubble forming very early on. There's a simple measure of sanity in housing prices: the ratio of median home price to income. Historically, it runs around 3 to 1; by late 2004, it had risen nationally to 4 to 1. "All these people were saying it was nearly as high in some other countries," Zelman says. "But the problem wasn't just that it was 4 to 1. In Los Angeles, it was 10 to 1, and in Miami, 8.5 to 1. And then you coupled that with the buyers. They weren't real buyers. They were speculators." Zelman alienated clients with her pessimism, but she couldn't pretend everything was good. "It wasn't that hard in hindsight to see it," she says. "It was very hard to know when it would stop." Zelman spoke occasionally with Eisman and always left these conversations feeling better about her views and worse about the world. "You needed the occasional assurance that you weren't nuts," she says. She wasn't nuts. The world was.

By the spring of 2005, FrontPoint was fairly convinced that something was very screwed up not merely in a handful of companies but in the financial underpinnings of the entire U.S. mortgage market. In 2000, there had been \$130 billion in subprime mortgage lending, with \$55 billion of that repackaged as mortgage bonds. But in 2005, there was \$625 billion in subprime mortgage loans, \$507 billion of which found its way into mortgage bonds. Eisman couldn't understand who was making all these loans or why. He had a from-the-ground-up understanding of both the U.S. housing market and Wall Street. But he'd spent his life in the stock market, and it was clear that the stock market was, in this story, largely irrelevant. "What most people don't realize is that the fixed-income world dwarfs the equity world," he says. "The equity world is like a fucking zit compared with the bond market." He shorted companies that originated subprime loans, like New Century and Indy Mac, and companies that built the houses bought with the loans, such as Toll Brothers. Smart as these trades proved to be, they weren't entirely satisfying. These companies paid high dividends, and their shares were often expensive to borrow; selling them short was a costly proposition.

Enter Greg Lippman, a mortgage-bond trader at Deutsche Bank. He arrived at FrontPoint bearing a 66-page presentation that described a better way for the fund to put its view of both Wall Street and the U.S. housing market into action. The smart trade, Lippman argued, was to sell short not New Century's stock but its bonds that were backed by the subprime loans it had made. Eisman hadn't known this was even possible—because until recently, it hadn't been. But Lippman, along with traders at other Wall Street investment banks, had created a way to short the sub-

prime bond market with precision.

Here's where financial technology became suddenly, urgently relevant. The typical mortgage bond was still structured in much the same way it had been when I worked at Salomon Brothers. The loans went into a trust that was designed to pay off its investors not all at once but according to their rankings. The investors in the top tranche, rated AAA, received the first payment from the trust and, because their investment was the least risky, received the lowest interest rate on their money. The investors who held the trusts' BBB tranche got the last payments—and bore the brunt of the first defaults. Because they were taking the most risk, they received the highest return. Eisman wanted to bet that some subprime borrowers would default, causing the trust to suffer losses. The way to express this view was to short the BBB tranche. The trouble was that the BBB tranche was only a tiny slice of the deal.

But the scarcity of truly crappy subprime-mortgage bonds no longer mattered. The big Wall Street firms had just made it possible to short even the tiniest and most obscure subprime-mortgage-backed bond by creating, in effect, a market of side bets. Instead of shorting the actual BBB bond, you could now enter into an agreement for a credit-default swap with Deutsche Bank or Goldman Sachs. It cost money to make this side bet, but nothing like what it cost to short the stocks, and the upside was far greater.

The arrangement bore the same relation to actual finance as fantasy football bears to the N.F.L. Eisman was perplexed in particular about why Wall Street firms would be coming to him and asking him to sell short. "What Lippman did, to his credit, was he came around several times to me and said, 'Short this market,'" Eisman says. "In my entire life, I never saw a sell-side guy come in and say, 'Short my market.'"

And short Eisman did—then he tried to get his mind around what he'd just done so he could do it better. He'd call over to a big firm and ask for a list of mortgage bonds from all over the country. The juiciest shorts—the bonds ultimately backed by the mortgages most likely to default—had several characteristics. They'd be in what Wall Street people were now calling the sand states: Arizona, California, Florida, Nevada. The loans would have been made by one of the more dubious mortgage lenders; Long Beach Financial, wholly owned by Washington Mutual, was a great example. Long Beach Financial was moving money out the door as fast as it could, few questions asked, in loans built to self-destruct. It specialized in asking homeowners with bad credit and no proof of income to put no money down and defer interest payments for as long as possible. In Bakersfield, California, a Mexican strawberry picker with an income of \$14,000 and no English was lent every penny he needed to buy a house for \$720,000.

More generally, the subprime market tapped a tranche of the American public that did not typically have anything to do with Wall Street. Lenders were making loans to people who, based on their credit ratings, were less creditworthy than 71 percent of the population. Eisman knew some of these people. One day, his housekeeper, a South American woman, told him that she was planning to buy a townhouse in Queens. "The price was absurd, and they were giving her a low-down-payment option-ARM," says Eisman, who talked her into taking out a conventional fixed-rate mortgage. Next, the baby nurse he'd hired back in 1997 to take care of his newborn twin daughters phoned him. "She was this lovely woman from Jamaica," he says. "One day she calls me and says she and her sister own five townhouses in Queens. I said, 'How did that happen?'" It happened because after they bought the first one and its value rose, the lenders came and suggested they refinance and take out \$250,000, which they used to buy another one. Then the price of that one rose too, and they repeated the experiment. "By the time they were done," Eisman says, "they owned five of them, the market was falling, and they couldn't make any of the payments."

In retrospect, pretty much all of the riskiest subprime-backed bonds were worth betting against; they would all one day be worth zero. But at the time Eisman began to do it, in the fall of 2006, that wasn't clear. He and his team set out to find the smelliest pile of loans they could so that they could make side bets against them with Goldman Sachs or Deutsche Bank. What they were doing, oddly enough, was the analysis of subprime lending that should have been done before the loans were made: Which poor Americans were likely to jump which way with their finances? How much did home prices need to fall for these loans to blow up? (It turned out they didn't have to fall; they merely needed to stay flat.) The default rate in Georgia was five times higher than that in Florida even though the two states had the same unemployment rate. Why? Indiana had a 25 percent default rate; California's was only 5 percent. Why?

Moses actually flew down to Miami and wandered around neighborhoods built with subprime loans to see how bad things were. "He'd call me and say, 'Oh my God, this is a calamity here,'" recalls Eisman. All that was required for the BBB bonds to go to zero was for the default rate on the underlying loans to reach 14 percent. Eisman thought that, in certain sections of the country, it would go far, far higher.

The funny thing, looking back on it, is how long it took for even someone who predicted the disaster to grasp its root causes. They were learning about this on the fly, shorting the bonds and then trying to figure out what they had done. Eisman knew subprime lenders could be scumbags. What he underestimated was the total unabashed complicity of the upper class of American capitalism. For instance, he knew that the big Wall Street investment banks took huge piles of loans that in and of themselves might be rated BBB, threw them into a trust, carved the trust into tranches, and wound up with 60 percent of the new total being rated AAA.

But he couldn't figure out exactly how the rating agencies justified turning BBB loans into AAA-rated bonds. "I didn't understand how they were turning all this garbage into gold," he says. He brought some of the bond people from Goldman Sachs, Lehman Brothers, and UBS over for a visit. "We always asked the same question," says Eisman. "Where are the rating agencies in all of this? And I'd always get the same reaction. It was a smirk." He called Standard & Poor's and asked what would happen to default rates if real estate prices fell. The man at S&P couldn't say; its model for home prices had no ability to accept a negative number. "They were just assuming home prices would keep going up," Eisman says.

As an investor, Eisman was allowed on the quarterly conference calls held by Moody's but not allowed to ask questions. The people at Moody's were polite about their brush-off, however. The C.E.O. even invited Eisman and his team to his office for a visit in June 2007. By then, Eisman was so certain that the world had been turned upside down that he just assumed this guy must know it too. "But we're sitting there," Daniel recalls, "and he says to us, like he actually means it, 'I truly believe that our rating will prove accurate.' And Steve shoots up in his chair and asks, 'What did you just say?' as if the guy had just uttered the most preposterous statement in the history of finance. He repeated it. And Eisman just laughed at him."

"With all due respect, sir," Daniel told the C.E.O. deferentially as they left the meeting, "you're delusional." This wasn't Fitch or even S&P. This was Moody's, the aristocrats of the rating business, 20 percent owned by Warren Buffett. And the company's C.E.O. was being told he was either a fool or a crook by one Vincent Daniel, from Queens.

A full nine months earlier, Daniel and Moses had flown to Orlando for an industry conference. It had a grand title—the American Securitization Forum—but it was essentially a trade show for the subprime-mortgage business: the people who originated subprime mortgages, the Wall Street firms that packaged and sold subprime mortgages, the fund managers who invested in nothing but subprime-mortgage-backed bonds, the agencies that rated subprime-mortgage bonds, the lawyers who did whatever the lawyers did. Daniel and Moses thought they were paying a courtesy call on a cottage industry, but the cottage had become a castle. "There were like 6,000 people there," Daniel says. "There were so many people being fed by this industry. The entire fixed-income department of each brokerage firm is built on this. Everyone there was the long side of the trade. The wrong side of the trade. And then there was us. That's when the picture really started to become clearer, and we started to get more cynical, if that was possible. We went back home and said to Steve, 'You gotta see this.'"

Eisman, Daniel, and Moses then flew out to Las Vegas for an even bigger subprime conference. By now, Eisman knew everything he needed to know about the quality of the loans being made. He still didn't fully understand how the apparatus worked, but he knew that Wall Street had built a doomsday machine. He was at once opportunistic and outraged.

Their first stop was a speech given by the C.E.O. of Option One, the mortgage originator owned by H&R Block. When the guy got to the part of his speech about Option One's subprime-loan portfolio, he claimed to be expecting a modest default rate of 5 percent. Eisman raised his hand. Moses and Daniel sank into their chairs. "It wasn't a Q&A," says Moses. "The guy was giving a speech. He sees Steve's hand and says, 'Yes?'"

"Would you say that 5 percent is a probability or a possibility?" Eisman asked.

A probability, said the C.E.O., and he continued his speech.

Eisman had his hand up in the air again, waving it around. Oh, no, Moses thought. “The one thing Steve always says,” Daniel explains, “is you must assume they are lying to you. They will always lie to you.” Moses and Daniel both knew what Eisman thought of these subprime lenders but didn’t see the need for him to express it here in this manner. For Eisman wasn’t raising his hand to ask a question. He had his thumb and index finger in a big circle. He was using his fingers to speak on his behalf. Zero! they said.

“Yes?” the C.E.O. said, obviously irritated. “Is that another question?”

“No,” said Eisman. “It’s a zero. There is zero probability that your default rate will be 5 percent.” The losses on subprime loans would be much, much greater. Before the guy could reply, Eisman’s cell phone rang. Instead of shutting it off, Eisman reached into his pocket and answered it. “Excuse me,” he said, standing up. “But I need to take this call.” And with that, he walked out.

Eisman’s willingness to be abrasive in order to get to the heart of the matter was obvious to all; what was harder to see was his credulity: He actually wanted to believe in the system. As quick as he was to cry bullshit when he saw it, he was still shocked by bad behavior. That night in Vegas, he was seated at dinner beside a really nice guy who invested in mortgage C.D.O.’s—collateralized debt obligations. By then, Eisman thought he knew what he needed to know about C.D.O.’s. He didn’t, it turned out.

Later, when I sit down with Eisman, the very first thing he wants to explain is the importance of the mezzanine C.D.O. What you notice first about Eisman is his lips. He holds them pursed, waiting to speak. The second thing you notice is his short, light hair, cropped in a manner that suggests he cut it himself while thinking about something else. “You have to understand this,” he says. “This was the engine of doom.” Then he draws a picture of several towers of debt. The first tower is made of the original subprime loans that had been piled together. At the top of this tower is the AAA tranche, just below it the AA tranche, and so on down to the riskiest, the BBB tranche—the bonds Eisman had shorted. But Wall Street had used these BBB tranches—the worst of the worst—to build yet another tower of bonds: a “particularly egregious” C.D.O. The reason they did this was that the rating agencies, presented with the pile of bonds backed by dubious loans, would pronounce most of them AAA. These bonds could then be sold to investors—pension funds, insurance companies—who were allowed to invest only in highly rated securities. “I cannot fucking believe this is allowed—I must have said that a thousand times in the past two years,” Eisman says.

His dinner companion in Las Vegas ran a fund of about \$15 billion and managed C.D.O.’s backed by the BBB tranche of a mortgage bond, or as Eisman puts it, “the equivalent of three levels of dog shit lower than the original bonds.”

FrontPoint had spent a lot of time digging around in the dog shit and knew that the default rates were already sufficient to wipe out this guy’s entire portfolio. “God, you must be having a hard time,” Eisman told his dinner companion.

“No,” the guy said, “I’ve sold everything out.”

After taking a fee, he passed them on to other investors. His job was to be the C.D.O. “expert,” but he actually didn’t spend any time at all thinking about what was in the C.D.O.’s. “He managed the C.D.O.’s,” says Eisman, “but managed what? I was just appalled. People would pay up to have someone manage their C.D.O.’s—as if this moron was helping you. I thought, You prick, you don’t give a fuck about the investors in this thing.”

Whatever rising anger Eisman felt was offset by the man’s genial disposition. Not only did he not mind that Eisman took a dim view of his C.D.O.’s; he saw it as a basis for friendship. “Then he said something that blew my mind,” Eisman tells me. “He says, ‘I love guys like you who short my market. Without you, I don’t have anything to buy.’”

That’s when Eisman finally got it. Here he’d been making these side bets with Goldman Sachs and Deutsche Bank on the fate of the BBB tranche without fully understanding why those firms were so eager to make the bets. Now he saw. There weren’t enough Americans with shitty credit taking out loans to satisfy investors’ appetite for the end product. The firms used Eisman’s bet to synthesize more of them. Here, then, was the difference between fantasy finance and

fantasy football: When a fantasy player drafts Peyton Manning, he doesn't create a second Peyton Manning to inflate the league's stats. But when Eisman bought a credit-default swap, he enabled Deutsche Bank to create another bond identical in every respect but one to the original. The only difference was that there was no actual homebuyer or borrower. The only assets backing the bonds were the side bets Eisman and others made with firms like Goldman Sachs. Eisman, in effect, was paying to Goldman the interest on a subprime mortgage. In fact, there was no mortgage at all. "They weren't satisfied getting lots of unqualified borrowers to borrow money to buy a house they couldn't afford," Eisman says. "They were creating them out of whole cloth. One hundred times over! That's why the losses are so much greater than the loans. But that's when I realized they needed us to keep the machine running. I was like, This is allowed?"

This particular dinner was hosted by Deutsche Bank, whose head trader, Greg Lippman, was the fellow who had introduced Eisman to the subprime bond market. Eisman went and found Lippman, pointed back to his own dinner companion, and said, "I want to short him." Lippman thought he was joking; he wasn't. "Greg, I want to short his paper," Eisman repeated. "Sight unseen."

Eisman started out running a \$60 million equity fund but was now short around \$600 million of various subprime-related securities. In the spring of 2007, the market strengthened. But, says Eisman, "credit quality always gets better in March and April. And the reason it always gets better in March and April is that people get their tax refunds. You would think people in the securitization world would know this. We just thought that was moronic."

He was already short the stocks of mortgage originators and the homebuilders. Now he took short positions in the rating agencies—"they were making 10 times more rating C.D.O.'s than they were rating G.M. bonds, and it was all going to end"—and, finally, the biggest Wall Street firms because of their exposure to C.D.O.'s. He wasn't allowed to short Morgan Stanley because it owned a stake in his fund. But he shorted UBS, Lehman Brothers, and a few others. Not long after that, FrontPoint had a visit from Sanford C. Bernstein's Brad Hintz, a prominent analyst who covered Wall Street firms. Hintz wanted to know what Eisman was up to. "We just shorted Merrill Lynch," Eisman told him.

"Why?" asked Hintz.

"We have a simple thesis," Eisman explained. "There is going to be a calamity, and whenever there is a calamity, Merrill is there." When it came time to bankrupt Orange County with bad advice, Merrill was there. When the internet went bust, Merrill was there. Way back in the 1980s, when the first bond trader was let off his leash and lost hundreds of millions of dollars, Merrill was there to take the hit. That was Eisman's logic—the logic of Wall Street's pecking order. Goldman Sachs was the big kid who ran the games in this neighborhood. Merrill Lynch was the little fat kid assigned the least pleasant roles, just happy to be a part of things. The game, as Eisman saw it, was Crack the Whip. He assumed Merrill Lynch had taken its assigned place at the end of the chain.

There was only one thing that bothered Eisman, and it continued to trouble him as late as May 2007. "The thing we couldn't figure out is: It's so obvious. Why hasn't everyone else figured out that the machine is done?" Eisman had long subscribed to *Grant's Interest Rate Observer*, a newsletter famous in Wall Street circles and obscure outside them. Jim Grant, its editor, had been prophesying doom ever since the great debt cycle began, in the mid-1980s. In late 2006, he decided to investigate these things called C.D.O.'s. Or rather, he had asked his young assistant, Dan Gertner, a chemical engineer with an M.B.A., to see if he could understand them. Gertner went off with the documents that purported to explain C.D.O.'s to potential investors and for several days sweated and groaned and heaved and suffered. "Then he came back," says Grant, "and said, 'I can't figure this thing out.' And I said, 'I think we have our story.'"

Eisman read Grant's piece as independent confirmation of what he knew in his bones about the C.D.O.'s he had shorted. "When I read it, I thought, Oh my God. This is like owning a gold mine. When I read that, I was the only guy in the equity world who almost had an orgasm."

On July 19, 2007, the same day that Federal Reserve Chairman Ben Bernanke told the U.S. Senate that he anticipated as much as \$100 billion in losses in the subprime-mortgage market, FrontPoint did something unusual: It hosted its own conference call. It had had calls with its tiny population of investors, but this time FrontPoint opened it up. Steve

Eisman had become a poorly kept secret. Five hundred people called in to hear what he had to say, and another 500 logged on afterward to listen to a recording of it. He explained the strange alchemy of the C.D.O. and said that he expected losses of up to \$300 billion from this sliver of the market alone. To evaluate the situation, he urged his audience to “just throw your model in the garbage can. The models are all backward-looking.

The models don't have any idea of what this world has become.... For the first time in their lives, people in the asset-backed-securitization world are actually having to think.” He explained that the rating agencies were morally bankrupt and living in fear of becoming actually bankrupt. “The rating agencies are scared to death,” he said. “They're scared to death about doing nothing because they'll look like fools if they do nothing.”

On September 18, 2008, Danny Moses came to work as usual at 6:30 a.m. Earlier that week, Lehman Brothers had filed for bankruptcy. The day before, the Dow had fallen 449 points to its lowest level in four years. Overnight, European governments announced a ban on short-selling, but that served as faint warning for what happened next.

At the market opening in the U.S., everything—every financial asset—went into free fall. “All hell was breaking loose in a way I had never seen in my career,” Moses says. FrontPoint was net short the market, so this total collapse should have given Moses pleasure. He might have been forgiven if he stood up and cheered. After all, he'd been betting for two years that this sort of thing could happen, and now it was, more dramatically than he had ever imagined. Instead, he felt this terrifying shudder run through him. He had maybe 100 trades on, and he worked hard to keep a handle on them all. “I spent my morning trying to control all this energy and all this information,” he says, “and I lost control. I looked at the screens. I was staring into the abyss. The end. I felt this shooting pain in my head. I don't get headaches. At first, I thought I was having an aneurysm.”

Moses stood up, wobbled, then turned to Daniel and said, “I gotta leave. Get out of here. Now.” Daniel thought about calling an ambulance but instead took Moses out for a walk.

Outside it was gorgeous, the blue sky reaching down through the tall buildings and warming the soul. Eisman was at a Goldman Sachs conference for hedge fund managers, raising capital. Moses and Daniel got him on the phone, and he left the conference and met them on the steps of St. Patrick's Cathedral. “We just sat there,” Moses says. “Watching the people pass.”

This was what they had been waiting for: total collapse. “The investment-banking industry is fucked,” Eisman had told me a few weeks earlier. “These guys are only beginning to understand how fucked they are. It's like being a Scholastic, prior to Newton. Newton comes along, and one morning you wake up: ‘Holy shit, I'm wrong!’ ” Now Lehman Brothers had vanished, Merrill had surrendered, and Goldman Sachs and Morgan Stanley were just a week away from ceasing to be investment banks. The investment banks were not just fucked; they were extinct.

Not so for hedge fund managers who had seen it coming. “As we sat there, we were weirdly calm,” Moses says. “We felt insulated from the whole market reality. It was an out-of-body experience. We just sat and watched the people pass and talked about what might happen next. How many of these people were going to lose their jobs. Who was going to rent these buildings after all the Wall Street firms collapsed.” Eisman was appalled. “Look,” he said. “I'm short. I don't want the country to go into a depression. I just want it to fucking deleverage.” He had tried a thousand times in a thousand ways to explain how screwed up the business was, and no one wanted to hear it. “That Wall Street has gone down because of this is justice,” he says. “They fucked people. They built a castle to rip people off. Not once in all these years have I come across a person inside a big Wall Street firm who was having a crisis of conscience.”

Truth to tell, there wasn't a whole lot of hand-wringing inside FrontPoint either. The only one among them who wrestled a bit with his conscience was Daniel. “Vinny, being from Queens, needs to see the dark side of everything,” Eisman says. To which Daniel replies, “The way we thought about it was, ‘By shorting this market we're creating the liquidity to keep the market going.’”

“It was like feeding the monster,” Eisman says of the market for subprime bonds. “We fed the monster until it blew up.”

About the time they were sitting on the steps of the midtown cathedral, I sat in a booth in a restaurant on the East

Side, waiting for John Gutfreund to arrive for lunch, and wondered, among other things, why any restaurant would seat side by side two men without the slightest interest in touching each other.

There was an umbilical cord running from the belly of the exploded beast back to the financial 1980s. A friend of mine created the first mortgage derivative in 1986, a year after we left the Salomon Brothers trading program. (“The problem isn’t the tools,” he likes to say. “It’s who is using the tools. Derivatives are like guns.”)

When I published my book, the 1980s were supposed to be ending. I received a lot of undeserved credit for my timing. The social disruption caused by the collapse of the savings-and-loan industry and the rise of hostile takeovers and leveraged buyouts had given way to a brief period of recriminations. Just as most students at Ohio State read *Liar’s Poker* as a manual, most TV and radio interviewers regarded me as a whistleblower. (The big exception was Geraldo Rivera. He put me on a show called “People Who Succeed Too Early in Life” along with some child actors who’d gone on to become drug addicts.) Anti-Wall Street feeling ran high—high enough for Rudy Giuliani to float a political career on it—but the result felt more like a witch hunt than an honest reappraisal of the financial order. The public lynchings of Gutfreund and junk-bond king Michael Milken were excuses not to deal with the disturbing forces underpinning their rise. Ditto the cleaning up of Wall Street’s trading culture. The surface rippled, but down below, in the depths, the bonus pool remained undisturbed. Wall Street firms would soon be frowning upon profanity, firing traders for so much as glancing at a stripper, and forcing male employees to treat women almost as equals. Lehman Brothers circa 2008 more closely resembled a normal corporation with solid American values than did any Wall Street firm circa 1985.

The changes were camouflage. They helped distract outsiders from the truly profane event: the growing misalignment of interests between the people who trafficked in financial risk and the wider culture.

I’d not seen Gutfreund since I quit Wall Street. I’d met him, nervously, a couple of times on the trading floor. A few months before I left, my bosses asked me to explain to Gutfreund what at the time seemed like exotic trades in derivatives I’d done with a European hedge fund. I tried. He claimed not to be smart enough to understand any of it, and I assumed that was how a Wall Street C.E.O. showed he was the boss, by rising above the details. There was no reason for him to remember any of these encounters, and he didn’t: When my book came out and became a public-relations nuisance to him, he told reporters we’d never met.

Over the years, I’d heard bits and pieces about Gutfreund. I knew that after he’d been forced to resign from Salomon Brothers he’d fallen on harder times. I heard later that a few years ago he’d sat on a panel about Wall Street at Columbia Business School. When his turn came to speak, he advised students to find something more meaningful to do with their lives. As he began to describe his career, he broke down and wept.

When I emailed him to invite him to lunch, he could not have been more polite or more gracious. That attitude persisted as he was escorted to the table, made chitchat with the owner, and ordered his food. He’d lost a half-step and was more deliberate in his movements, but otherwise he was completely recognizable. The same veneer of denatured courtliness masked the same animal need to see the world as it was, rather than as it should be.

We spent 20 minutes or so determining that our presence at the same lunch table was not going to cause the earth to explode. We discovered we had a mutual acquaintance in New Orleans. We agreed that the Wall Street C.E.O. had no real ability to keep track of the frantic innovation occurring inside his firm. (“I didn’t understand all the product lines, and they don’t either,” he said.) We agreed, further, that the chief of the Wall Street investment bank had little control over his subordinates. (“They’re buttering you up and then doing whatever the fuck they want to do.”) He thought the cause of the financial crisis was “simple. Greed on both sides—greed of investors and the greed of the bankers.” I thought it was more complicated. Greed on Wall Street was a given—almost an obligation. The problem was the system of incentives that channeled the greed.

But I didn’t argue with him. For just as you revert to being about nine years old when you visit your parents, you revert to total subordination when you are in the presence of your former C.E.O. John Gutfreund was still the King of Wall Street, and I was still a geek. He spoke in declarative statements; I spoke in questions.

But as he spoke, my eyes kept drifting to his hands. His alarmingly thick and meaty hands. They weren’t the hands of a soft Wall Street banker but of a boxer. I looked up. The boxer was smiling—though it was less a smile than a placeholder expression. And he was saying, very deliberately, “Your...fucking...book.”

I smiled back, though it wasn’t quite a smile.

“Your fucking book destroyed my career, and it made yours,” he said.

I didn't think of it that way and said so, sort of.

"Why did you ask me to lunch?" he asked, though pleasantly. He was genuinely curious.

You can't really tell someone that you asked him to lunch to let him know that you don't think of him as evil. Nor can you tell him that you asked him to lunch because you thought that you could trace the biggest financial crisis in the history of the world back to a decision he had made. John Gutfreund did violence to the Wall Street social order—and got himself dubbed the King of Wall Street—when he turned Salomon Brothers from a private partnership into Wall Street's first public corporation. He ignored the outrage of Salomon's retired partners. ("I was disgusted by his materialism," William Salomon, the son of the firm's founder, who had made Gutfreund C.E.O. only after he'd promised never to sell the firm, had told me.) He lifted a giant middle finger at the moral disapproval of his fellow Wall Street C.E.O.'s. And he seized the day. He and the other partners not only made a quick killing; they transferred the ultimate financial risk from themselves to their shareholders. It didn't, in the end, make a great deal of sense for the shareholders. (A share of Salomon Brothers purchased when I arrived on the trading floor, in 1986, at a then market price of \$42, would be worth 2.26 shares of Citigroup today—market value: \$27.) But it made fantastic sense for the investment bankers.

From that moment, though, the Wall Street firm became a black box. The shareholders who financed the risks had no real understanding of what the risk takers were doing, and as the risk-taking grew ever more complex, their understanding diminished. The moment Salomon Brothers demonstrated the potential gains to be had by the investment bank as public corporation, the psychological foundations of Wall Street shifted from trust to blind faith.

No investment bank owned by its employees would have levered itself 35 to 1 or bought and held \$50 billion in mezzanine C.D.O.'s. I doubt any partnership would have sought to game the rating agencies or leap into bed with loan sharks or even allow mezzanine C.D.O.'s to be sold to its customers. The hoped-for short-term gain would not have justified the long-term hit.

No partnership, for that matter, would have hired me or anyone remotely like me. Was there ever any correlation between the ability to get in and out of Princeton and a talent for taking financial risk?

Now I asked Gutfreund about his biggest decision. "Yes," he said. "They—the heads of the other Wall Street firms—all said what an awful thing it was to go public and how could you do such a thing. But when the temptation arose, they all gave in to it." He agreed that the main effect of turning a partnership into a corporation was to transfer the financial risk to the shareholders. "When things go wrong, it's their problem," he said—and obviously not theirs alone. When a Wall Street investment bank screwed up badly enough, its risks became the problem of the U.S. government. "It's laissez-faire until you get in deep shit," he said, with a half chuckle. He was out of the game.

It was now all someone else's fault.

He watched me curiously as I scribbled down his words. "What's this for?" he asked.

I told him I thought it might be worth revisiting the world I'd described in *Liar's Poker*, now that it was finally dying. Maybe bring out a 20th-anniversary edition.

"That's nauseating," he said.

Hard as it was for him to enjoy my company, it was harder for me not to enjoy his. He was still tough, as straight and blunt as a butcher. He'd helped create a monster, but he still had in him a lot of the old Wall Street, where people said things like "A man's word is his bond." On that Wall Street, people didn't walk out of their firms and cause trouble for their former bosses by writing books about them. "No," he said, "I think we can agree about this: Your fucking book destroyed my career, and it made yours." With that, the former king of a former Wall Street lifted the plate that held his appetizer and asked sweetly, "Would you like a deviled egg?"

Until that moment, I hadn't paid much attention to what he'd been eating. Now I saw he'd ordered the best thing in the house, this gorgeous frothy confection of an earlier age. Who ever dreamed up the deviled egg? Who knew that a simple egg could be made so complicated and yet so appealing? I reached over and took one. Something for nothing. It never loses its charm.