

# 'It Was Fun While It Lasted'

A Quarter-Century of Short Ideas In Grant's Interest-Rate  
Observer; Where We Go From Here

James Chanos  
Kynikos Associates

Grant's Fall Investment Conference  
October 21, 2008  
The Plaza Hotel

## 'Another Voice in the Choir,' Singing a Different Tune

- **Grant's Interest Rate Observer debuts**, November 7, 1983. *Another voice in the choir.*
  - “In a more perfect world, this magazine would not have been born.”
- **Born at the Right Time:** Grant's introduction coincided with the birth of a 25-year explosion in credit.
- **Voice of reason and contrarian wisdom.**
- **Broken Clock?** No, just ahead of Wall Street's time.



# Jim Grant: The 'Anti-Junk' Warrior

- **Grant's Declares Itself 'Anti-Junk.'**
  - *September 1984.* 'The world is 'long on debt and very short on equity,' and 'if there is a slump in the offing, credit-quality concerns will tighten, and junk will suffer.'
  - *April 22, 1985.* [Jim Chanos] pointed out "junk companies earn less than the marginal cost of their capital, which he said, is an unstable state of affairs."
  - *March 25, 1985.* "...we will remain bearish on bonds."
- **Early But Right on the Perils of Junk.**
  - Grant's railed against the excesses of the junk bond market.
  - The first nine months of 1989 saw \$4 billion in junk bond defaults and moratoriums. Taxpayers wound up holding the bag



# Drexel & the Daisy Chain

- **Grant's Exposes Drexel's 'Illness.'**
  - December 8, 1989; *'The Wicked Witch Is Ill.'* "In palmier days, [Drexel] was able to shift around bonds among its satellites, but that time is past, and the names of some of Drexel's best customers turn up nowadays on the stock-market new low-lists."
- **The Wicked Witch Is Dead.**
  - 1989: junk bond market crashes.
  - 1990. Drexel's commercial paper rating slashed by agencies.
  - February 1990: Drexel declares bankruptcy.



# Integrated Resources: Down with Drexel

- **Grant's Warns Early and Often on Integrated Resources.**
  - *August 13, 1984.* 'The company reminds [Chanos] of Baldwin-United, low on cash flow and high on empty earnings.'
  - *May 1985.* Grant's states Integrated and Executive Life, both clients of Drexel, entered into a dodgy trade of Integrated preferred. "Before the paper was shuffled, there was a \$10 million hole to account for. Somehow, after the rearranging, no loss was visible."
  - *June 1989.* Integrated defaulted on \$1 billion of bonds.
  - *February 1990.* Integrated declared bankruptcy alongside Drexel.



## Artifice of the Deal: Commercial Real Estate Goes Bust

- **Grant's Takes on Trump and the Bubble.**
  - *June 8, 1990.* '[Trump] bought the best and didn't scruple to pay top dollar for it. Why should he have? Banks were eager to accommodate him, and the world was full of optimists even greater than he.'
  - *July 20, 1990.* 'Stocks might be back up, but Hamptons real estate is way down. The classified real-estate advertisements of *The East Hampton Star* are now written in the universal bear-market style.'
  - *September 14, 1990.* "The bottom of the real-estate barrel has not yet been scraped or even, perhaps, plumbed."



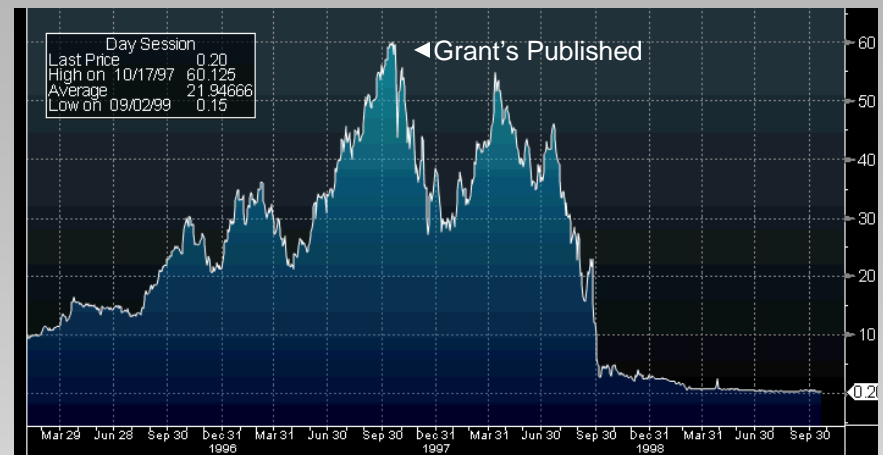
# Boston Chicken Gets Roasted From Day One

- **Fowl Odor at Boston Chicken.**
  - *December 3, 1993.* During its IPO road show, 'Boston Chicken declined to answer questions about same-store sales, deeming them 'not meaningful.
  - *December 3, 1993.* 'When financial historians look back on 1993, one question will be uppermost in their minds: Who were these guys?'
  - *December 1996.* More criticism as stock peaked.
  - *October 1998.* Boston Chicken declared bankruptcy.



# FirstPlus: Subprime Collapse, 1990s Edition

- **FirstPlus Gets Caught 'Slumming'.**
  - *October 1997 Grant's Conference.* "Unlike most companies that 'earn' \$86 million over the span of nine months, FirstPlus consumed a whopping \$994 million. Not by coincidence, the sum it raised through financing was an even more whopping \$1,024 million."
  - *October 1997.* "The people without whom a certain percentage of the B and C [subprime mortgage] industry could not exist, it seems to us, are the accountants."
  - *March 1999.* FirstPlus declared bankruptcy.





# From Russia, Thailand and Greenwich With Love

- **Early Bear on Thailand and Russia.**

- *April 25, 1997.* ‘From India to Thailand to South Korea, growing and profitable companies are capitalized as if they were neither. The underlying reason for these bear markets is that emerging markets do not emerge each and every day of the year. Periodically, they submerge.’
- *July 18, 1997.* ‘[Russia] is no longer a buy and is probably a sale. This is a new idea from *Grant’s*, which has been bullish on Russia since we first got acquainted with the general partners of the Firebird Fund in the spring of 1994.’

- **Requiem for LTCM.**

- *November 6, 1998.* “When Buffet proposed to buy LTCM for \$250 million (in addition to putting up \$3.75 billion of new capital), were his motives offensive or defensive? Was he trying to turn an opportunistic profit?”



“Dad, how much money does the IMF have?”



“By the way, what’s the market doing?”

# Dot-Com: 'It's a Bubble'

- **Grant's Cries 'Bubble' in '98.**
  - *May 22, 1998.* "The US bull market is a bubble' amid 'the violation of every conventional valuation measure' and 'the popular acceptance of the nutty idea that a two-for-one stock split is fundamentally bullish."
  - *December 17, 1999.* The Grant's drumbeat peaks, comparing 1999 and 1929. "Never before have American investors so willingly financed and subsidized loss-making enterprises."
  - *March 2000:* The bubble pops. The Nasdaq Composite falls 78% by October 2002 – 38% below Grant's May 1998 bubble call.



# Tech Wreck: A Small Sample of Stock Busts

- **Priceline** (May 1999): 'PCLN trades at 865.4 times annualized first-quarter gross profit. Sabre, at the same multiple, would need command a market cap of \$2 trillion. You'd need a stepladder.'
  - **Outcome:** PCLN fell 99% over 18 months.
- **Nextel** (August 2000): 'Nextel's five million or so customers foot up to a lifetime value of \$18.25 billion, or just 44% of the current (and shrunken) \$40.9 billion stock-market cap. Plainly, the bulls anticipate growth.'
  - **Outcome:** the stock fell 95% over two years.
- **Cisco** (September 2000): P/E 'has climbed to about 160 from 40' in 1996, 'whereas ROE has fallen to about 10% from 32%. Plainly, the stock market has found something to hang its hat on.'
  - **Outcome:** CSCO fell 86% by Oct. 2002

## Priceline.com



# Accounting for Tots: Tyco Toys With Earnings

- **Grant's Sounds Alarm on Tyco.**
  - *December 3, 1999.* "If a management tries to smooth a naturally jagged pattern of earnings, the underlying problems of the business itself are likely to be obscured—until the day they can't be any longer."
  - *1999-2002.* Grant's repeatedly countered bullish sell-side defenders of Tyco such as BofA analyst James Samuels.
  - *July 2002.* Stock had fallen 79% from first Grant's article, with TYC on its way to a \$9 billion loss in 2002 and criminal prosecution of top management.



Meanwhile, at the Shadow Dow Jones committee meeting...



'I'll second that.  
GE's out, Tyco's in.'

# Enron: The Crooked E Crumbles

- **Chanos 'Asks Why?'**
  - *May 2001 Conference.* Chanos tells audience members Enron is a 'poor performing hedge fund at five times book value'
  - With Enron's stock traded at 40x forward earnings, most sell-side analysts rated Enron a 'buy.'
  - *November 2001,* Grant's called Enron 'a former hedge fund at 0.7 times pro forma book value.'
  - *December 2001.* Enron declared bankruptcy



*"You mean that Daddy liked Enron just because everyone else did?"*

# Fannie, Freddie: Houses that Could Not Stand

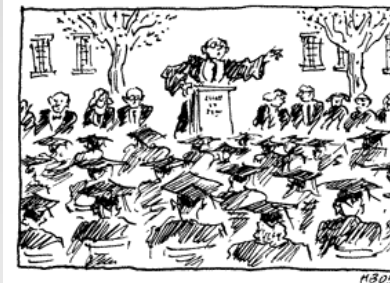
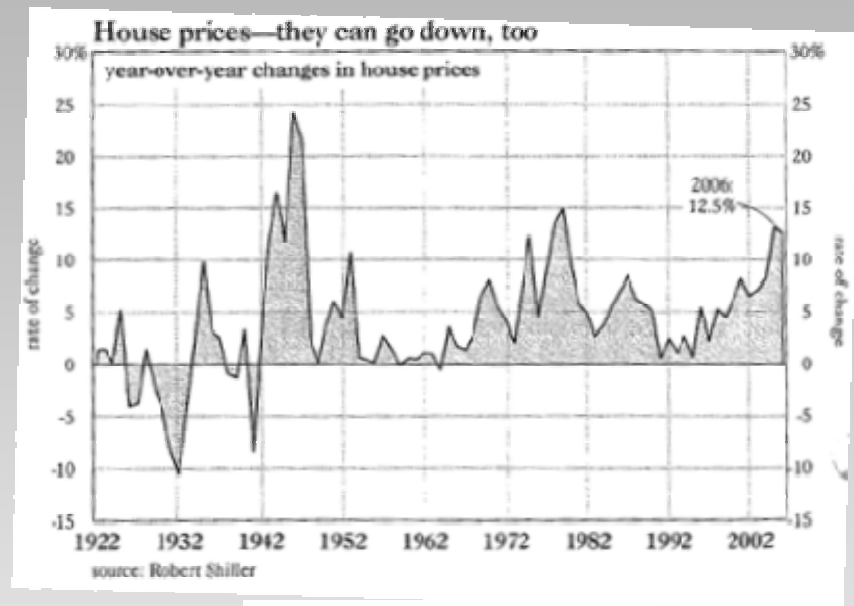
- **GSEs: 84 Critical Mentions.**
  - *2000-2008.* Grant's wrote dozens of critical articles on excessive risk at GSEs.
  - *October 13, 2000.* "Credit risk will become 'a real issue' for Fannie before the cycle is through."
  - *October 7, 2005.* Fannie isn't capitalized to absorb outside losses. ... If 100 basis points of impairment were acknowledged, book value would take a \$4.5 billion hit.'
  - *September 7, 2008.* Fannie and Freddie were taken into conservatorship by the FHFA



# Houses of Cards: Calling the Top at the Top

- **The Housing Bubble Set to Burst.**
  - *August 2006.* “Many contend that a sustained pullback in house prices is unthinkable. But the unthinkable’ – a 52% surge in home prices from 1997-2005 – ‘has already happened.”
  - *August 2006.* Grant’s offered a mix of three triggers: ‘wild and woolly mortgage finance; the propensity of market-determined prices to revert to the mean;’ and real-estate markets moving from beneficiaries of economic growth to the drivers.
  - *October 2008:* The Case-Shiller home price index is off 25% from its peak.

From Grant’s August 2006



*“And I urge you,  
America’s future leaders  
—buy a condo.”*

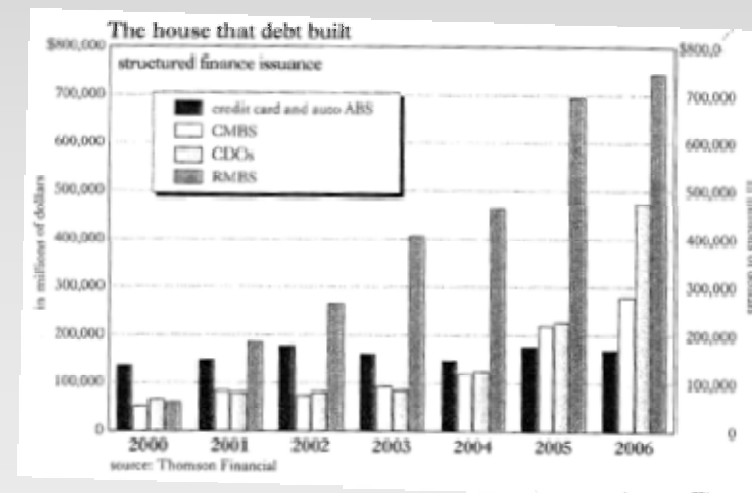
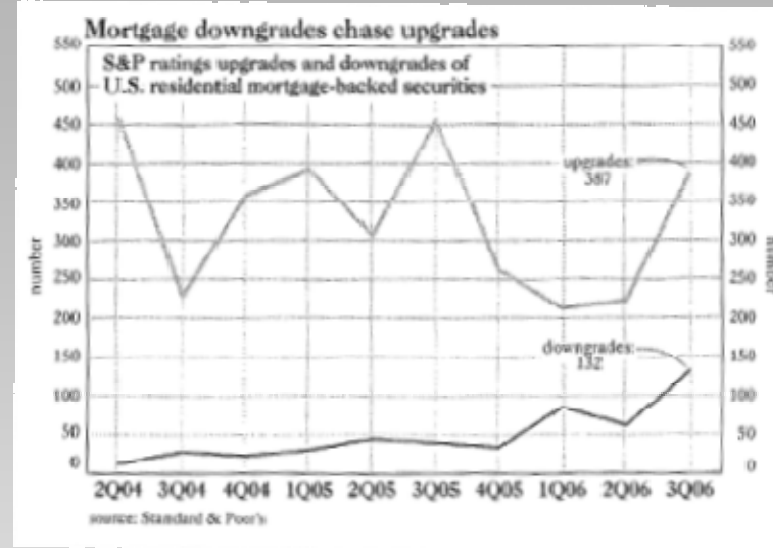
# In the Alphabet Soup: CDOs and Other Toxic Debt

- **Structured Products: Financial Alchemy.**

- *December 2006:* Noting the more than \$1 trillion in subprime mortgage originations since 2002, sliced into stacks of debt, Grant's warned that even 'the penthouse tranches are not intrinsically creditworthy.' 'When spreads eventually do fly open, the world will know about it.'

- **ABCs of Credit Contagion.**

- *February 2007.* "Credit is cyclical. It flows and it ebbs. It has been flowing since 2002, to the point today of nearly overflowing its banks (and hedge funds). A future cyclical contraction is a certainty ... the down cycle may have already begun."
  - *February 2007.* Grant's raises concern about rating agencies' complicity, and toxic nature of ABS, MBS, CDOs and other structured products..
  - *Fall 2008.* Grant's predicted credit plague comes to fruition, results in near-death experience.

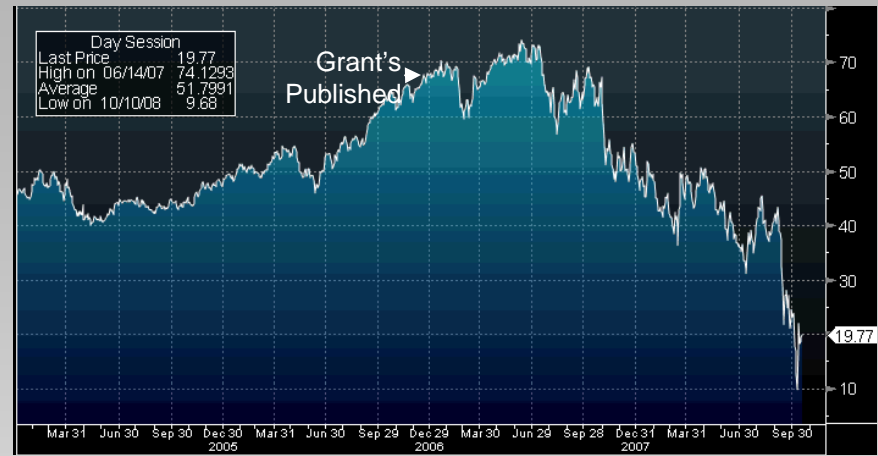




# Banking on Disaster: Morgan Stanley and the Brokers

## Broker-Dealers: The Real Systemic Risk

- *October 2006; Over the cliff with Morgan Stanley.*
  - Morgan Stanley is the owner of a '\$1 trillion balance sheet,' and now 'deploys more assets than the house of Ben S. Bernanke.'
  - Grant's questions Moody's view that 'the risk management at securities firms actually works pretty well.'
  - Grant's, in the minority view, says, 'it's a great time to buy some disaster protection—puts or, for the institutionally equipped, CDS, on Morgan Stanley.'
  - **Outcome:** Morgan Stanley shares fall 85% from publication to October 10, 2008.



*"I understand we own \$1 billion of CDOs.  
Question: What's a CDO?"*

## Where Do We Go From Here?



HB08

*“Well, Dumpling, I think  
you were bearish enough.”*

# Field of Dreams-Styled Capital Allocation

'Build It and Hope They Will Come'

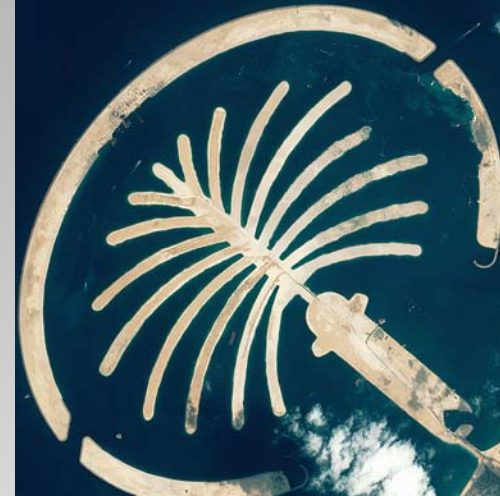
**Global infrastructure boom fueled by plentiful, cheap credit.**

- **Dubai: Building a City in the Desert.**

- By 2006, 30,000 cranes, or 24% of the world's total, in Dubai.
- World's tallest building almost complete ... bigger one planned.
- Man-made island, indoor slopes in the desert defy laws of nature and logic.
- In the business of building Dubai.

- **China: Planned Economic Promised Land**

- Building the future now? Industry and construction comprised 48% of GDP.
- Rebuilding previous poor construction does not equal economic growth.
- 'Miracle' wanes: factories close down, costs uncompetitive, civil unrest.



# Welcome to the Real World

## Paper World Weighs on Real World

- **Credit ‘crunches’ real assets.**
  - Paper world of Wall Street in tatters
  - Next big leg down is real world assets.
- **Excessive credit fueled ‘commodities super-cycle.’**
  - Easy credit led to parabolic commodity price movements.
  - Food, energy and materials rose to unsustainable levels.
  - Credit contagion exposes ‘commodities super-cycle’ and ‘emerging markets decoupling’ as myths; BRIC economies wane.



# Short Opportunities in the Real World

- **Infrastructure Boom/Bust**
  - Owners: Macquarie, Abertis, etc.
  - Contractors: KBR, Shaw Group, etc.
- **Infrastructure Arms Merchants**
  - Materials: Lafarge, ArcelorMittal, etc.
  - Transport: Shipping, rails, etc.
- **Commodities Super-Cycle?**
  - Food: Bunge, Weir Group.
  - Alternative Energy: solar, wind, etc.

