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Alphachatterbox – Jim Chanos and the art of short-selling

[Cardiff Garcia] Hey everyone, welcome to Alphachatterbox, the long form business economics and tech podcast of the Financial Times. I'm Cardiff Garcia, and I'm here to introduce today's guest host, Matt Klein, my colleague on Alphaville. Matt, how are you?

[Matt Klein] Good. How are you?

[Cardiff Garcia] Okay. This is very exciting. Why don't you start by telling our listeners who you spoke to.

[Matt Klein] I spoke to a guy named Jim Chanos. He's the founder of Kynikos Associates, and probably the most famous fundamental short seller operating today. He's probably best known for having bet against Enron and calling it correctly as a fraud back in 99, before it bust.

More recently he's made some very correct calls on companies such as Valeant [the pharmaceutical manufacturer]. He bet against home builders and banks in anticipation of the financial crisis, and a whole lot of other interesting smaller companies you may not have heard of.

[Cardiff Garcia] Short selling is one of those topics where every once in a while I think of how little I know about it. Right, I mean I understand the basic mechanics. You borrow a stock hoping that it will go down, or betting that it will go down, and then later on you give it back to whoever you borrowed it from and you profit on the decline in the stock.

There's actually so much about it that's a little bit murky, I think even to people who are steeped in other parts of finance. How do they hedge? How much of your portfolio you should allocate to it. Things like that. Did you cover that? And what are some other topics that you got into with Jim?

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[Matt Klein] Yes, we definitely talked about the mechanics, or what he called the "back office section" of the conversation, but I think it's definitely interesting stuff that often gets glossed over when people ask "what do these people do?" It's relevant, and has implications for people who invest in these strategies.

We also talked about his research process and how the team works and comes up with ideas. It's pretty amazing the range of industry sectors and geographies that they cover. There's a big world out there, a lot of potentially bad companies to find, so we talked about how they cover that. We looked a bit at some particularly notable past successes, some mistakes that he's made. And some opportunities that he missed out on purpose for various reasons.

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[Cardiff Garcia] Fascinating. Well, I think our listeners are going to really like this. It's a big name in this space, and he has lots of interesting things to say. Here it is: Matt interviewing Jim Chanos.

[Music plays]

[Matt Klein] Thanks for coming. I want to start with how you got into the business that you are in, which is that you bet against companies. Within finance it's an incredibly niche business. My colleague, Dan McCrum, wrote last summer that within the Hedge Fund Research database of about 9,000 funds, there are only 17 that are short-biased. Two of those are yours, I think. How did you find yourself in this particular slice of the finance industry?

[Jim Chanos] Well, thanks for having me Matt. It was inadvertent. I started out first very briefly in investment banking and then research, first for a small brokerage firm and then for a larger one. And the first idea I wrote about in 1982 as a sell side analyst turned out to be a massive fraud.

And after that idea ran its course, the hedge fund clients of the small brokerage fund I worked for sort of pestered my boss to ask what else I didn't like. And so for a few years on the sell side I thought I could carve out a niche looking for fundamentally overvalued institutionally ideas. But it's a tough… If you think it's tough to do it in a hedge fund form, it's even tougher to do it on the sell side. Just for all the biases you might imagine.

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And so in 1985, when I found myself on the front page of the *Wall Street Journal* on this article about an "evil cabal" of hedge fund managers and short sellers who were dragging all these poor companies down…

It was sort of funny, of the ten companies mentioned, I think nine went bankrupt or were indicted for fraud or their CEOs were investigated for fraud. And my employers at the time suggested I might want to look for work elsewhere when my contract was up. So luckily for me I had some people interested in backing me, and so Kynikos Associates was started in October of 85. So we just had our 30th anniversary.

[Matt Klein] Congratulations. One of the things that seems particularly challenging about short selling, and you mentioned this just now, is that there are a lot of institutional biases against short-selling. The entire sell side industry, much of the financial media, a lot of politicians, they think if things are going up that it's good. Your 401K is richer. There's a lot of psychological pressure. You don't want to be against the crowd.

How do you, as an investor, deal with that and be able to on the one hand stick with the position when you think it's correct, and also not be so bull headed about it that you ignore the conventional wisdom when it's actually right?

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[Jim Chanos] Well first of all, to get to the preface of your question – "up is good and down is bad" – of course while on the surface that seems right we always forget that having Grandma Klein pay too much for stocks can be bad. Short-selling is an important check on the marketplace. And in fact Bill Sharpe in his Nobel Prize acceptance speech pointed out that frictionless short-selling is essential for the efficient market hypothesis and the capitalised pricing model. And so it is an essential part of the marketplace, but the trickier part of course is doing it right and doing it well, and that is much, much tougher.

And generally speaking we assume that securities prices over time, in the United States anyway, will generally drift up. That's the safe bet. But that's not what you get paid for in my business. And so what I've always said in terms of the business proposition of a fundamental short seller, and it's paradoxical, but here we go, being short with a good short seller who's producing nominally minor positive returns in a bull market enables you to be more long.

And that's really the essence of what we're doing. So for example, if I make you a few percent a year being short, in effect I'm an insurance policy. I'm protecting your downside and I'm paying you a small amount in dividends. But think about it. You could then go twice long the market, be short my portfolio, and have 2X the market plus a few percent, minus your cost of the additional carry.

And that's the proposition, and that's why short selling alpha is so prized in the marketplace when you can find it, because it enables you to be more long. And when I tell people that they scratch their head. Here you have a noted bear saying that: My proposition to you is that I'm going to let you be more long.

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[Matt Klein] Is that something that in general your clients think about? They invest in you being aware that that's the value of a short portfolio and they effectively over-invest in their other equities?

[Jim Chanos] Exactly. We really won't accept and don't want to accept any money we know is consciously coming to us because they think the market's going down. You can get that protection elsewhere. They're investing with us because we're a construct for their portfolio, and we're enabling them to hedge out either their excess long exposure or to let them be more long than they otherwise would be comfortable in being. And that's really what it is at the end of the day. As I keep saying to people: I'm in the insurance business.

[Matt Klein] So how do you manage your own wealth? It seems like, based on this logic, you would not be putting all of your own money in Kynikos directly, right?

[Jim Chanos] Well not in our short only. For myself and my partners and our employees, we've encouraged them to be in one of our hedged vehicles, which we have a couple. And it just makes more sense personally. And our clients understand that.

[Matt Klein] Can you speak more on these differences? There are multiple…I believe there are three distinct funds that you operate. What are the differences and how do clients view them?

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[Jim Chanos] I have to be a little careful, because I can't make this a testimonial, as you know. But just broadly speaking the three pools are basically our oldest, our short only book of business, going back to 1985. We then have a long short business, more traditional, where we take our best ideas and look for ways to hedge them, and that's in effect market-neutral, give or take.

And then we have the most controversial thing, which we rolled out to outside investors last year, but we've been running for the last 16 years – actually closer to 20 years. That's our 190/90, meaning we're about 100% net long, but we're 190% long our longs and then 90% short, to basically produce a 100% net long fund. And when that came out, I think it was the *New York Times*, people said: "That's the absolute top of the market." And maybe it will be. Who knows?

[Matt Klein] Speaking of tops and hedging and this balancing, I'm curious how you think about risk management. Risk management is very difficult for investing in general. It seems like it's, at least in the popular perception, even more difficult for someone that is going to be short-focused.

The stereotype is if you put your money in a company hoping it's going to go up, the worst that happens is you lose all the money you put in. If you put your money betting it's going to go down, it could go up, theoretically to infinity. How do you think about this and balance and manage risk?

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[Jim Chanos] Well, I always first of all start by saying I've seen far more stocks go to zero than infinity, and that comment underscores a real problem from a behavioural finance point of view in the way people think about the short side. They tend to think of it far more discretely than they do their portfolio on the long side, and short selling is a portfolio, so for us globally we have 80 names. Domestically we have 50 names. Typically no one position will ever be more than 3% or 4% of the portfolio.

So right then and there, unless you're just going to put your positions on and fall asleep, you have some theoretical ability to prevent the runaway portfolio. Another check of course is that if you go into one of our partnerships, you can only lose what you put in. You're a limited partner, and people kind of forget that. I have the unlimited liability as the general partner.

More practically on a day to day basis, however, in terms of managing a portfolio, the short side has got a lot of asymmetries, and one of the asymmetries of course is that as your position goes for you, it becomes smaller. It's exactly the opposite on the long side, where the long side the more it works your way, the bigger it becomes. I might argue that's not a bad thing. That your risks increase the more something works for you and vice versa. Of course limited by the zero bound.

One other thing I would point out to you is that if you gave me $100 and I just had a one stock portfolio on the short side – if I shorted Enron at $100 and continued to short it on the way down – you could make more than 100% without having to give me any more money, as long as you're willing to add to the position. Because the profits go your way, you then go back to 100% short. So you can make more than 100% on the short position by only putting up $100.

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[Matt Klein] In terms of risk management techniques you mentioned diversification is obviously the main tool in any investor's arsenal. How do you think also about situations where you are conceptually correct but just early? It seems like it happens a lot, especially in some of the companies that you've targeted in the past successfully. It's hard to time the entry point, and how is that something that you as an investor deal with?

[Jim Chanos] Yes. There are two reasons why it seems like you tend to be early on the short side. Number one, a lot of the things that fundamental short sellers like us look for tend to show up well before they hit the earnings report, or the P&L [profit and loss statement]. So it might be problems in the balance sheet or the footnotes that you see or something, some other problem that you see well before management fesses up to it in its earnings releases.

Number two, you have to borrow the shares, and sometimes when it becomes apparent that something may be about to happen, your timing could be much better, but you might not be able to effect the trade. So that is an issue in some cases. Or that the rebate, the amount of interest you earn on the sale process, might be negative and might in fact be a governor on your ability to profit from the trade.

So by the time that it became apparent that Sears Holding, to use an example, was a basket case, the negative rebates were 40, 50, 60%. And so it really wasn't economic for you to bet on that.

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[Matt Klein] In other words the stock would have had to fall by at least 60% for you to break even?

[Jim Chanos] Yes. So again there are lots of asymmetries that a short seller has to deal with, so it tends to make you early. And it's very rare that we've ever timed anything almost perfectly. Our average holding period tends to be about a year.

[Matt Klein] When you think about a trade that was a success, not all the companies you go after necessarily are going to be driven into bankruptcy and the CEOs arrested for fraud. How do you know when it's time to either declare victory and move on or alternatively to say: Maybe we made a mistake on where the stock was going, and get out?

[Jim Chanos] Well in both those instances, I would say that it's a nice problem to have, Matt, but it really depends also on the environment. So two guiding principles there. A stock can be a better short even though it's gone down. It can be a better long even though it's gone up if you have new information. And certainly that was the case in lots of situations in our past like the Enrons of the world.

On the other hand, another contributing factor for your decision making is what else is out there? Are you in an environment where there are lots of great ideas and you're willing to take some money off the table on an idea that's working even though you might think it has further downside, because there's an awful lot of things out there that seem even crazier.

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So it does depend. Again, it's a portfolio approach just like any money management decision, and you're looking at competing ideas for your capital. But really, since we're pure fundamental investors, it depends on the news flow and what we now know that we didn't know weeks or months prior to that. And if we decide that we actually know a lot more, we've gotten a much better glimpse at what's really going on in these companies, then a stock that's already down 20, 30, 40% might still be an opportunity.

[Matt Klein] So I want to take a moment to actually look at a specific example I think might be relevant to this question, which is Herbalife. It's a company that certainly got a lot of attention. It's dropped out of the news recently, but some people, like Bill Ackman, were saying it was a complete scam, other people were saying it was good and were buying it.

You were shorting it at one point and then I saw you said you'd exited the short after Ackman gave his presentation. You said the price was no longer compelling in terms of what the upside return would be for you. Can you walk through a little bit how you did that calculation and came to that decision?

[Matt Klein] Well, so we were short Herbalife, and when Bill put his first report out the stock was down almost 50% in a matter of days. And at that point we just determined the risk reward had changed dramatically. That unless we felt the FTC or someone else was going to immediately move to crimp their business, that two other multi-level marketing ideas that we were also short – which didn't move as much, they were only down a little bit – actually were much better uses of our capital at that point.

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So that's a good example of what we were just talking about a few minutes ago. We covered our Herbalife, not knowing Bill was going to say anything, but suddenly the market was marking that down 50% and we reallocated that capital into two other ideas, one which worked really well and one which didn't work at all. But it just was a real-time good example of the idea the market gave us an opportunity to reallocate that capital into things that we thought were even more expensive. And had the FTC moved, or the government moved quickly to move against Herbalife, we think these other stocks would have dropped just as much, because they were probably just as egregious.

[Matt Klein] You mentioned that you have about 80 positions globally at a time, 50 in the US and I guess 30 internationally. Is that something you have a pretty hard target, or how much flexibility do you give yourself?

[Jim Chanos] We have a lot of flexibility. Globally right now it's 80. We've gotten a little more concentrated as the market's gone up. Some ideas we just love have gotten bigger and we like them. Globally it can be 80 to 100, domestically 40 to 60. Now, since our domestic portfolio is 30 years old, that's been a pretty accurate number and a lot of it's due to the companies I think I can follow.

We have a top heavy research model as well in that all the partners really do a lot of the work themselves on the ideas as well as the investment analysts, and I just think that those are numbers which I feel I can comfortably keep an eye on and know pretty well along with the help of my very able staff. So I think that it would be hard to do more than that.

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[Matt Klein] I think this is a natural transition to ask: how do you come up with ideas? If we think about a lot of people who have opinions about companies doing well or badly, whether it's on the sell side or the buy side, they generally specialise in an industry sector or a geography.

But if we go back and look through your track record, it seems like it's gone through all sorts of countries, all sorts of industry sectors. And you have different reasons for betting against companies. You don't just look for fraud. Sometimes it's companies with dying business models or it's just a fad that's overpriced. What is the method here? How do you source ideas?

[Jim Chanos] We try not to limit ourselves. It's a big world out there, and at any given time certain industries are going to be in and out of favour and regions are going to be in and out of favour, and so by restricting yourself I think you're restricting yourself. I think since we're being asked to really, for our clients, hedge off broad equity exposures, I think it behooves us to look pretty widely.

Now, we weren't looking abroad until 2005, when we opened up our global fund, and we wanted to see whether the research process could work and the shorting process could work. Because prior to that, for the size we were, there were two limiting factors.

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Number one was the disclosure regime for a lot of markets was terrible. Companies did not really tell you a whole lot that you might think they would. And then secondly, the ability to borrow the shares was also problematic. The growth in hedge funds has helped that, paradoxically. And disclosure's gotten a lot better due to IFRS and other reasons.

So we found that as we were constructing and doing research on a global basis that our approach, which was pretty rigorous security analysis, worked just fine. In fact arguably better because what we then found out – one of the good asymmetries – was that generally the sell side analyst community abroad was even less sceptical than ours. And that's saying something. They prized management access more than anything. And so you almost never saw negative comments or negative commentary about companies abroad, whereas occasionally you see it in the States.

So all those things I think set up the idea that we could take what we had been doing for at that point 20 years, and port it over, which we've done for the last ten years, on the global side. But again I think that we look far afield and wherever it will take us. We came across the whole idea of the Chinese credit bubble from doing work just on a specific individual sector, the miners, in 2009. And that's a good example of just looking at an industry on a micro basis and having it lead us down a very interesting winding road. So we don't want to restrict ourselves. Some of our best shorts right now are in pretty esoteric markets.

[Matt Klein] Why don't you walk us through how that China trade developed? I read an article, it was a profile of you from December, 2008 saying that you'd seen that electricity consumption in China was down and GDP growth was still going at like 8%, and you thought: They're making up the numbers. There was a sense of recognition of companies in the past that you've gone up against.

How do you translate that insight into the country as a whole having a debt problem? And then, going from there, how do you get to: these are the actual specific companies I'm going to bet against, and here's how I will put on the trades? Can you walk us through all the steps?

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[Jim Chanos] Yes. That commentary in 08 was just a preview, and we weren't short China at that point. But I was beginning, like a lot of people, just to try to understand this economic model over there and just how dynamic it was. And it wasn't until 2009, the fall of '09, where we really began to try to understand it.

As I mentioned, we were looking at the global mining companies and trying to figure out why it was they were profitable in the teeth of the recession. And it became very apparent to us very quickly. We knew it was because of China, of course. And I'm talking about companies like BHP Billiton and Rio Tinto and Vale. But we didn't have a sense as to magnitude until--

The story is internally now one of our great stories. A real estate analyst was addressing the partners and he said: "Currently there's 5.6 billion square metres of high rises in China under construction. Half residential, half office space." And I thought for a second and I said: "No, you've gotten the American, rest of the world metrics wrong. You must mean 5.6 billion square feet. Because 5.6 billion square metres is roughly 60 billion square feet."

And my analyst looked at me sort of terrified. He was a young analyst at the time. He said: "I know. I double checked. It's 5.6 billion square metres." And I thought for a second and I said: "Well if half of that's office space, that's roughly 30 billion square feet of office space. And that's a five foot by five foot office cubicle for every man, woman and child in China."

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And that's when we all looked at each other and our jaws dropped. Realised, wow, this is a once in a lifetime kind of thing, where this whole country is in effect building itself out in a very short period of time. So then we looked at the capital spending of these miners, and we went back and looked at a time series of those that were around from 1990 on, and once again it was just one of these hit your head kind of moments.

So from 1990 to 2001 the total capex for these companies went from $6 billion a year total to $14 billion a year in 2001, which is a pretty good growth rate. Half of that is the cost of digging the hole and half of that is the Caterpillar and Komatsu tractors and bulldozers, earthmovers.

From 2001 to ultimately the peak in 2012, it went from $14 billion a year to $122 billion a year. So it went from an arithmetic function in the 90s, which was a pretty good growth decade for the globe, to this insane geometric function when China joined the WTO [World Trade Organization] in 2001.

This was back in almost 2010, so we hadn't even hit the peak yet, but we saw how important this giant building boom, this construction site called China, was not only for China and for its economic model, but for Australia and Indonesia and Sub-Saharan Africa and Brazil and Canada – anybody that was selling things into this.

That's when we realised it's not going to be just China. It's going to be lots of different things. And that this is going to play out over a period of time, which it has. And it's not over. This story is far from over – whether it's China itself, or the hard commodity companies, or the countries. This is going to be the driver.

I like to joke there have been two givens in the investment world for the last handful of years: "The central banks have your back, and China's going to stimulate." So the central banks have the investors' backs and China has the global economy's back. China will be the engine of global growth and central banks will make sure nothing goes wrong in the financial markets. Those are two very, very big pillars and they'd better hold up, because everybody believes them.

[Matt Klein] Just to clarify, you came up with this insight stemming from real estate and the miners and then…

[Jim Chanos] Yes, and the magnitude. More or less the magnitude. Having gone through the commercial real estate bubble in the late 80s here. I missed the Japanese one, to my eternal detriment. The residential real estate bubble here in the US in the mid millennium. And so the numbers were striking. We began to look at the size of the banking system relative to the economy. All sort of traditional metrics you would look at.

And anything you looked at was just screaming at you: Credit bubble. And one of the definitions, one of the buckets we've found an awful lot of our ideas have ended in, in the past, has been booms that go bust. And we define that pretty tightly as being credit driven asset inflation where the assets being purchased with borrowed money do not generate enough cash to service the debt incurred. So it really is a leveraged bubble.

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And China fit that description across the board in almost any industry you wanted to look at. And that's why it was so exciting to us, because here you have an economic model that I believe is unsound. It's based on 50% investment. And you have a banking system that is, in my view, insolvent based on any kind of rational look at the value of the debts. And you have a Politburo and group of policy makers who, while they know this, can't let up on the gas pedal, for basically fear of stalling out or losing control of the car, and so they're just going faster and faster round the track. And to me that sounds just an absolute prescription for disaster.

[Matt Klein] So you have this view in your head. You have it relatively early and it's now becoming somewhat more consensus, although I don't think to the extent that you're articulating it. How do you then decide what actual trades to put on, especially given the limits that China has on foreigners actually betting on their own companies?

[Jim Chanos] So the interesting thing is we've never been short any shares inside China, the A-share market. My friend Marc Cohodes has a wonderful term: "It's like pigs on LSD." Because there's no correlation to the economy, and who knows which way the Chinese retail investor's going to go, what side of the bed they're going to wake up on any given week, month or year.

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But you do have the H-share market which is a much more institutional market where the big institutional-sized companies trade. And then you have all these derivatives, which were really at the end of the day the best way to be short, whether it's Macao, whether it was the Australian iron ore industry, or container shipping.

There are a variety of different situations as this has washed through the global economy, and continues to do so. So we have found that those ideas – companies tied to China or companies that sell into China – have been a much better way to play this than actually trying to short A-shares in China itself. So we continue to pursue that strategy.

[Matt Klein] And to be clear, you only focus on stocks of companies. You wouldn't look at things like exchange rates or commodity prices in this case?

[Jim Chanos] No. We have the right to do so, particularly in our hedge fund, but we haven't put the currency trade on or anything like that.

[Matt Klein] Or the price of iron ore?

[Jim Chanos] Well, right now we're long oil in our hedged fund and short selective energy stocks. So we do do that from time to time.

[Matt Klein] Speaking of longs, I'm curious, how does that process work? Is that something that you find to be a different discipline than shorts? There are certainly a lot more long investors, or fundamental long investors than fundamental shorts. How do you go about that process?

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[Jim Chanos] So most hedge fund investors, and a lot of other investors, basically will start by constructing a long portfolio that they like and then often will hedge it passively. Whereas most of our longs are done exactly the opposite way: we start with the short portfolio. That's what we do. In our hedged fund for example, if we can find a great way to hedge out the systematic market risk of an idea, we'll do that. Maybe a pairs trade or an industry ETF.

Otherwise it's basically reasonably passive in terms of indices or whatever. We know what our strength is. It's the short side. It's awfully hard to beat the market, and it's even harder to beat the market on the long side. And everybody's trying to do that. And so we have our little market niche of just a handful of us doing this full time, but on the short side I'm happy to passively hedge most of that risk and try to extract the alpha from the short side, not the long side.

[Matt Klein] Getting back into the general sense of where ideas come from, are there kinds of patterns that you look for? What are the sorts of things, whether it's capital structure of a company or management that sets off alarm bells?

[Jim Chanos] We don't look to fill buckets, but we've tended down through the years to see that a lot of our ideas fit certain broad themes. One I mentioned is the booms that go bust, where you just get these credit-driven asset manias and the asset can't service the debt. Usually that ends in tears.

Another one is technological obsolescence. The internet's been a great wealth creator, but it has destroyed lots of business plans and lots of moats, and we keep our eye out. And that's, for us, an ongoing source of ideas. It's amazing how the analog-to-digital revolution just continues to find new businesses to decimate. And we're mindful of that. It's the Schumpeterian view of capitalism.

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Third, which is a fun one, is consumer fads. I think you mentioned it earlier. And there you see Wall Street over and over and over again just extrapolating out single product companies with hockey stick growth, whether it's George Foreman Grills or Nordic Tracks or Cabbage Patch Dolls or FitBits or whatever it might be. "This time it's different. Everybody's going to have five." And it rarely is.

Another area would be growth by acquisition. We're just drawn like moths to the flame, I guess, to companies in crummy businesses that decide to tell the Street that they're actually growth companies by buying the growth. Typically this leads to the temptation of playing acquisition accounting games in terms of valuing the assets and/or spring-loading by having the target companies hold off business in the interim period between the announcement of the deal and the closing of the deal so they look better once you fold them in. And so we love those kinds of stories, the rollups, or as they've been deemed, the "platform companies".

Then there are just pure outright accounting stories, where we just find a company that's just completely playing legal or illegal accounting games to obscure the reality of what's going on. And then finally, any time we can sell $1 for $2 because the market gives us some silly trade, we'll do that till the cows come home.

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[Matt Klein] One of the things you mentioned earlier is the importance of your colleagues or partners and your staff for generating ideas and doing research and managing risk. Can you give some more sense of what is it everyone does and how you pick them, what the value is to the organisation as a whole?

[Jim Chanos] Our model's a little bit different than a lot of investment management firms I believe, in that one of the things I find interesting about our business is that one of the most essential parts of the process, idea generation, most investment firms hand that responsibility to the youngest, least experienced people on the staff.

The portfolio manager will put pressure on the junior analyst to come up with ideas for him or her to evaluate. And I think that's really, really asking a lot. Particularly on the short side, where you have some of these other barriers like the borrowability and so on and so forth. The rebate structure. And in our view we would rather have the partners head up research and the portfolio managers spend some time on the ideas.

And we have analysts who will say: "I think we ought to be looking at something", but before they do a deep dive, we take a shallow dive and just make sure that this looks interesting from someone who's got a number of years of experience in doing this and can immediately see something doesn't look right.

Valeant is a good example. That's a name we've been short now for a couple of years, and the first time I looked at this company, before we handed it to our very able pharmaceutical analyst, I immediately at a research meeting said: "This looks like Tyco." In terms of not the business itself but the frantic nature of the acquisitions, and a CEO who was just hell-bent on buying companies and making them fit no matter what.

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And again that was a gut check kind of reaction, but it was also pattern recognition, having seen these sorts of things before. And having a person running a company to please Wall Street can really be problematic, and even on the first pass through you would see that with a company like Valeant, and that's why it was so exciting and why I then insisted that we spend a lot of time on it, because it just seemed to… For a couple of us on the team who are a little bit older than the others, we saw parallels to some of the great rollups of the late 90s and early 2000s. So I think that was helpful for us.

[Matt Klein] Speaking of Valeant, there's a couple of interesting things there. It's a pretty strange company. The traditional model of pharmaceuticals is you spend a lot on research and you fund yourself with equity and you have cash because your earnings are going to be lumpy. You have hits and then they die out.

And Valeant is the opposite. They have a ton of debt, they spend nothing on research. Their model is essentially they buy a drug someone else has already invented and they try to raise the price. How they get people to overpay is an interesting question they're now getting in trouble with.

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There's a thing there that's interesting in terms of the personality of the executive there and at another company that you had a lot of interesting experience with, Enron. I'm not going to say that McKinsey is the cause of either one, but it's interesting that these are both veteran McKinsey consultants who were beloved by the industries and respected who then came in to run these companies. Initially were very successful, at least on the surface, became very rich doing it. Is this something that people should – is this an automatic signal for you, when a consultant goes into the chief executive role?

[Jim Chanos] Well I'm always wary of accountants who become CEOs too. That's always a bad sign for me. I don't know about that, but I do know when I see a mindset, and when you see the mindset, the company is a black box and Valeant has had some of that…

Valeant also, one of my partners pointed out that Valeant, in terms of a narrative or a parallel, also resembled Worldcom. Because you had this iconoclastic guy, Bernie Ebbers, and he was apart from his other executives, and again it was this rapid, rapid deal making with questionable numbers and then open feuding with his own executives toward the end of the Worldcom story. So there's a couple of parallels in there.

And then I saw Tyco. So Valeant within confines of a few different opinions at our shop looked like Tyco, Enron and Worldcom. You're probably on the right track if you're a short seller if it reminds you of not only one of those, but three of those.

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And it's interesting because what made the stock attractive to the bulls was its new way of doing business. R&D's terrible. It doesn't yield anything. That was the new mantra. So why do it? Why don't you selectively buy drugs that seem to be overlooked and then run them through this sausage grinder of your reimbursement model and derive all this value that others are just leaving on the table?

And that was my first problem. Because it was just this easy to raise prices 800% and get reimbursed, why wouldn't everybody do that? Why wouldn't the guys who owned the drugs not do that? That's the first thing that I couldn't get an answer on. And we now know why. In Pearson's own words from his January 2013 conference call: "Well, there are ways even if a payer refuses to pay for a script [prescription], there are ways to get paid." I'm paraphrasing, but that was a real warning sign for us that these guys were going to play somewhat fast and loose.

Then he came up with the idea, well I'm going to buy drugs, so that's my R&D in effect. So every other drug company that's spending 16% of sales on R&D or 15% of sales on R&D, Valeant's spending 2% or 3%. And the difference is meaningful, number one. Number two, of course Pearson would have you add back any purchased R&D amortisation that was running through the income statement, because of course drugs don't last forever. They do have lives. And he was buying things sometimes with relatively short lives. And in any case no drug has more than a 20 year patent.

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So if you were rational about this, if he bought $40 billion worth of companies, you might want to set aside $2 billion a year – at least – to replenish that portfolio over time. And that would be the equivalent of your R&D expense. Well, no, he wanted you to add back any amortisation and he called that his proforma cash earnings per share. And Wall Street dutifully pointed out: "Oh, that's great, because it's non-cash."

And we pointed out: "Well, yeah, but take a look at Hewlett-Packard and some of these other companies that have had to buy companies to keep their revenue growth just constant. That's the same as maintenance capex. In the drug business, that's the same as maintenance R&D."

So he got Wall Street for a very short period of time to have its cake and eat it too by how he had them evaluate the company, and now I think people are beginning to see through that, of course. So a lot of these rollups, they truly have to get Wall Street to believe that two plus two equals five, for a short period of time. When in fact the way they do deals, two plus two is often 3.5.

[Matt Klein] The Valeant trade, I'm curious more on the specific timing. Now the share price has gone down tremendously from its peak, but there was a period when it was going up by…

[Jim Chanos] It went up 100% on us.

[Matt Klein] Right. How is that…?

[Jim Chanos] We started in the low 100s and our first blended set of average prices was somewhere around 130. So, yes, it got our attention. It doubled first.

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[Matt Klein] You mentioned the way that Valeant was creating an alternative *pro forma* accounting metric that was popular with Wall Street. One of the things that I've been reading a lot recently is this growing gap between the official…

[Jim Chanos] GAAP [generally accepted accounting principles] and "GAAP", yes.

[Matt Klein] Right, the "GAAP gap". And it seems like it's mostly coming down to treatments of things like one-offs and stock based compensation, which sounds familiar from 15 years ago. Is this something that we should be aware of in general? Are there legitimate reasons why this could be happening?

[Jim Chanos] Well, there are always legitimate reasons why you can break out something on a line out. Doesn't always mean it's legitimate to give the management the benefit of the doubt if common sense belies what they're telling you. So it's a problem.

I teach a course on the history of financial market fraud, and usually trying to ferret out when companies are playing games with their numbers, as many do, takes some digging and some figuring out. What's so amazing about the past five or six years is they lay it all out for you. And then they just tell you: Disregard it.

So whether it's stock based compensation, which of course is compensation…my favourite is the annual restructuring charge. There are companies now that have been charging off charges every single year for nine, ten, 11, 12 years. And sometimes every quarter. And Wall Street dutifully takes that out, to which I keep pointing out: "It's happening five years in a row. Seems like it's recurring to me." But Wall Street gives them the benefit of the doubt for the fact that they break it out on a line item.

And this has been going on for a while now, and the problem with it, Matt, is that now the disparity between the so-called operating EPS [earnings per share] and the GAAP number, I think it's getting close to $30 a share for the S&P [index of large American companies]. I think the trailing 12 months' now are somewhere in the high 80s and I think the operating number is somewhere in the 115, 116.

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And people say: The market's not so expensive. I'm always raising my hand and will say: Depending on what? On the $88 it certainly is expensive. But we're going to disregard that bad stuff. And then of course I love the people that say: "Well, but of course that's energy. Energy's down, you've got to take that out." And I say: "Well, what about when energy goes back up? Are we going to take it out then?"

But again Wall Street is always a glass half full kind of place. But in this case it's been interesting to us just how obvious some of these things are that they want you to disregard. Valeant was a master at that. This *pro forma* cash EPS, which by the way was just multiples of its real cash flow, was just one for the ages.

[Matt Klein] This gets to another topic that you've raised in the past, which is the difference between a rules-based and a principles-based accounting system. And we in the US have a rules-based system, and the downside that you've articulated in the past is if you have rules, then people are going to try to optimise around them and you're going to pay a lot of money to find good accountants and lawyers and bankers. The counterpoint I guess would be: how would you have a standards-based system where you can actually enforce the standards properly? Can you elaborate more of your thinking on this?

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[Jim Chanos] It's not hard if you have people with good standards, which in the financial world is a constant question. My friend Bethany McLean has a term which I've actually turned into one of the models of my fraud class, and she calls it legal fraud, and I think it's as good a definition as any. And she basically points out that companies can actually completely comply with all the rules and regulations to accounting and corporate governance and what have you, and yet still there's an intent to deceive.

Enron was the good example, where really they complied with all the accounting aspects of it. The Enron executives were not prosecuted for accounting fraud. They were prosecuted for lying to investors. And yet I don't think anybody would doubt that there was an intent to deceive.

And this is the real problem. When you have the rules-based system almost by definition you're going to do deals to comply with the rules, but that doesn't mean that the rules reflect the economics of the transactions accurately. And so you have to apply certain amounts of common sense to this. You also have to understand that the system is easily gamed, and I think that's where most investors really have a hard time, because it's very difficult in human nature to sit across the table from someone and realise that they're lying to you. Or they're deceiving you. And often they are, and that's how investors keep getting fooled over and over in these certain situations.

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[Matt Klein] If we were to have a principles-based, standards-based accounting system, how would that look and what would be some of the big differences between that and what we have now?

[Jim Chanos] You already have lots of judgement calls in accounting. GAAP has lots of areas where judgement has to be used on things like depreciable lives and write downs to goodwill. But I think you would have to really, really tighten up the audit committee functions. I think there are lots of things you would need to do structurally to governance. Not just necessarily in the way you're setting up the accounting standard system and the people that do it, but in oversight not only of the accountants but of the audit function separately. And given all of the other corporate governance issues we have, I just don't see that happening any time soon. I think it's a pipe dream.

[Matt Klein] Related to that, one of the things you've said in the past is every company that's ended up going down for fraud had its accounts certified by one of the big four accounting firms.

[Jim Chanos] Yes, usually.

[Matt Klein] This sounds like a pretty big indictment of the profession. Is that an accurate way of interpreting the statement?

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[Jim Chanos] Well one of the questions that I always ask my class in the first or second lecture is I always give them a pop question: Who prepares a company's financial statements? And an awful lot of smart business school students will blurt out: "The auditors."

Of course that's false. The management prepares the financial statements. So the point at which the auditors start their process is not produced by them, it's produced by the corporate management team, and the auditors are reviewing it. And often, unless they know where to look, or something is just glaringly obvious, they can sign off on things they shouldn't sign off all the time.

In addition, when they do raise certain issues, management often has very, very cogent, plausible answers to explain why some account looks off. And it's tough. These auditors do want to do a good job, but they also want to stay employed, they want to keep their business, and so they have to serve a lot of masters, and I think that's difficult. And I don't think it's going to change any time soon, so we do joke when someone says: "Who are their auditors?" I always say: "Who cares?" It just really doesn't matter.

[Matt Klein] It seems like it's interesting that, with the notable exception of Arthur Andersen, there haven't really been major consequences for auditor firms signing off on companies that have turned out to be doing something they shouldn't.

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[Jim Chanos] Well everybody remembers Arthur Andersen, and going after the firm itself and putting the firm out of business, and then it was of course reversed on appeal and the firm was already out of business.

But let's just get back to a broader point of the whole criminal justice system when it comes to finance, where you have this bizarre idea that "we just can't hold individuals responsible for their actions, we have to look at the corporation." So "we have to look at Arthur Andersen, not the Arthur Andersen partners that were signing off on this," and "we have to look at the banks as a whole, not the guys who were running the banks or who were doing the deals."

And so you get this asymmetry where we just decide: "Well, then we're just going to keep fining them, but we're never going to send anyone to jail for crossing the line in any kind of financial crime." And I think that's not a good situation.

[Matt Klein] It would be better, in other words, if more individuals were directly prosecuted?

[Jim Chanos] Absolutely. I think one of the things the Bush administration did well, and generally speaking I don't think he did a lot well, but one of the things they did well was they turned their back on their friends at Enron and others when the various different accounting scandals in 2001 and 2002 and 2003 hit, and they went after them.

They formed a task force and they basically said: "This is wrong and we're going to go after it." Just as Bush's father did in the savings and loan situation. That there are externalities and people do distrust the markets and do distrust free market capitalism when you just let people run roughshod over the rules and enrich themselves at everybody else's expense.

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And we're still fighting that. I think we're still fighting it not only financially but politically in this country. Just this feeling that people got away with murder in 2008 and 2009, and whether it's accurate or not, it was never really tested. With the exception of some small prosecutions, really the view of the Obama administration was to tread lightly and worry about the economic consequences.

In fact, the Justice Department admitted that affected whether or not to bring cases. One of the Justice Department's bedrock principles has been to factor in the economic impact on markets by their prosecutions, but they were supposed to seek justice.

[Matt Klein] It's interesting, if we bring this back to what you were talking about with the intent to deceive and the question of legal fraud. I freely confess to not being a legal expert, but there have been some very well done econometric studies of what was going on with the mortgages put in the various sub-prime securities and systematic "misrepresentation" of what was in them, which someone was clearly aware of… You don't have those kinds of systematic errors, if you will, occur unless someone was being deliberately…

[Jim Chanos] And let me be clear. This is not a screed about going after rich bankers. There was fraud going on by the people taking the mortgages out. The so-called liar loans, and people were lying left, right and centre about their incomes and lack thereof, and I think to be consistent I think there should have been prosecutions throughout that system. There were the mortgage brokers who looked the other way. All the way up, through the risk managers to the people putting the securitisations together.

There's a very popular movie out [*The Big Short*] which walked you through how this all happened. My friend David Faber wrote a great book. It's in my class: *And Then the Roof Caved In*. He took a single mortgage and he walked you through how it got from California to Narvik, Norway. It's fabulous. And just all the stuff that happened to that mortgage.

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And once you looked at it on a granular basis that way, you understood that it was throughout the entire system. The securitisation system, the hot potato just kept moving, and everybody along the way looked the other way or outright told fabrications. And so if we had a serious criminal investigation, I would have pushed for it to go down the chain as well as up the chain. I think that's important.

[Matt Klein] Speaking of mortgage fraud, or "mis-selling", or what have you, you identified that there were excesses in the housing market in 2005 and 2006, were betting against home builders and banks and so forth. Were you ever thinking that you might want to engage in some of the CDS trades that others did in terms of betting on the mortgages, the bonds directly?

[Jim Chanos] We thought about it. And my fear was: I was worried that we wouldn't get paid, and that really was what kept us in the listed stocks and we did just fine there. But I was shown some of those trades and I always said: "Well, what if the worst occurs?" Because if what I'm seeing in the level two and level three securities on these balance sheets comes to pass, in what you hope to achieve by being short some of these things, well the system goes down.

I was short AIG, and covered way too early, but I saw what their role was in this and I think if the federal government had not stepped in to make sure AIG could cover its obligations, the system probably would have imploded. And that was the bet everybody was making, because if AIG couldn't meet those margin calls or whatever, an awful lot of people that were right about the mortgage market would have not gotten paid. That's with hindsight of course.

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So to me it always… I went through [the stock market crash in October] 1987 and I went through the Drexel insolvency in 1990, and I know what the fear of not getting paid is. It's through the clearing. And I was actually far more terrified, I've always said, in the three days in the third week of October 1987 than I was every afraid in 2008. Because in 1987 it was the first time this happened, and I really was concerned the system was going to blow up. Whereas in 2008 it happened in slow motion.

And I think that that was the bet you were making. You had to bet that all the trades cleared right and anybody who thought they were insured, if it turned out they weren't and you were relying on them, you were screwed too. And at the end of the day the government stood behind all that stuff, and so therefore the speculators got paid. I didn't want to make that bet with my clients' money.

[Matt Klein] This brings us back to questions earlier about risk management and how you deal with that. Can you give us some sense of how… If you were worried for example that a given investment bank wouldn't necessarily make good on the CDS promise with you, would you be willing to… Presumably you would also be very sceptical about trading with them at all in terms of borrowing shares from them…

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[Jim Chanos] Well we have a rule. We don't short anybody that we're actually doing business with. That entails pretty big conflicts.

[Matt Klein] But presumably that would also affect… In terms of…

[Jim Chanos] We had money with Bear Sterns, for example, when they got in trouble. And so we couldn't be short anything of Bear Sterns. So that's just one thing I should point out.

[Matt Klein] But it wasn't like you were concerned about their solvency or ability to pay you and would move money away from…

[Jim Chanos] Well, we moved money into government securities, so we were concerned, yes. And I didn't incur any margin debt so that they couldn't rehypothecate securities, which was a big issue that a lot of people don't understand to this day: the role in the crisis and how liquidity came out of the system even though there were these assets there. Hedge funds moved quickly to reduce their margin balances, and if you weren't borrowing money from them, they couldn't take the securities out of your account and go borrow against them and stick Bear Sterns IOUs in your account.

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[Matt Klein] Could you maybe walk through that a little more?

[Jim Chanos] Yes. It's part of the history. Personally I believe that the so-called run on Bear Sterns, which a lot of people think started in March of 2008, I think it started in February of 2008, and I remember that my head of stock loan went to a meeting that Bear Sterns had with its prime broker clients to put them at ease.

My partner came back and he was of course less at ease based on that meeting. And we decided at that point, our securities at Bear Sterns, to as best we could take our cash balances and get them in the form of government securities. And so having gone through this in Drexel in 1990, I knew what to do.

And what a lot of people don't realise is that a form of liquidity for anybody with a big prime brokerage book, which Bear Sterns had, was if you [a hedge fund] have indebtedness, if you've borrowed money from them [the prime broker] in that account, they have the right to rehypothecate the collateral – your securities in your account.

So say you have… This is a simplified manner. There are bells and whistles. But for the purposes of your listeners, say I have one share of IBM, and if I just own the one share of IBM and don't borrow against it, that one share of IBM stays in my account.

If I have a margin account, and I buy one share of IBM and then I use that to borrow another $100 on my IBM, Bear Sterns can take that one share of IBM that's in my account and borrow against it for their own purposes. Pledge it as collateral to another bank and give me a $100 Bear Sterns IOU in my account. Now, I'll still… My equity will go up and down based on the price of IBM, but I won't have a share in there. I'll actually have a Bear Sterns IOU.

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So if the music stops and Bear Sterns files bankruptcy, suddenly as opposed to my share of IBM in my account, I'm an unsecured creditor of Bear Sterns. And that's what the hedge fund and other communities realised belatedly, having not gone through this before. The other dress rehearsal was LTCM in 98. And they began to shrink their balances to ensure that they weren't incurring margin debt, and that was forcing Bear Sterns to return the collateral, and thus…

[Matt Klein] That was the run.

[Jim Chanos] So that exacerbated the run. Now, there were other assets at Bear Sterns that were being pledged in the mortgage-backed area, but in the equity prime broker stuff, that didn't help. Because that was a source of liquidity for them and that was going the other way as well. And so a lot of hedge funds were getting up to speed very quickly on just how exposed they could be to a prime broker if the broker went under, which was adding to the problem.

[Matt Klein] Can you explain how you, on the short side, are exposed to a prime broker? It's not like you own the stock and they're lending it out to someone else. So how does that work?

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[Jim Chanos] Yes, so again when I… In an unmargined situation where I'm not borrowing any money, I'll put up collateral. So simplified example again. You give me $100 to short IBM. I will buy a $100 T-bill [short-term US Treasury debt], and that will be the asset to begin with in the account, and there will be $100 therefore of equity.

I will then take that $100 T-bill and use it as collateral, one to one, to borrow $100 worth of IBM and sell it short. So now in my little imaginary balance sheet, I have two assets. I have a $100 Treasury bill and I have $100 of cash from the sale of the IBM. I now have a liability, which is called short market value, and that's my mark to market on my short IBM position that I owe the broker. And then I also still have $100 in equity, because that hasn't moved yet.

So the dynamics are a little different, because my assets are my Treasury bills and the excess cash. What I don't want is to have that excess cash become a Bear Sterns IOU. So I want to move to have all of my assets in government securities in my clients' names, against that short market liability. Last thing you want to do is have what you think is a cash asset become an unsecured creditor position of an IOU of a broker.

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And so again you make all the efforts you can to safeguard the asset side of your balance sheet if you're a short seller. Liabilities are in the marketplace. And that's a simplified example, but it gets to the point. It's actually much worse if you are a traditional long guy and you're margined. That's actually when you can find yourself far more exposed to a prime broker than you otherwise would think.

[Matt Klein] Just to go back to that example to illustrate…

[Jim Chanos] We're getting a bit "back office" here. I think you're going to lose all your listeners.

[Matt Klein] I don't know, I think, well, maybe this is just me, but this is something that most people don't get a chance to hear about when they get to talk to investors or learn about how short-selling works. Hopefully at least some will be interested at this point in the…

[Jim Chanos] And all the prime broker guys are going to be screaming at me when this runs: "Why did you tell him all this?"

[Matt Klein] In the example you gave, after you've sold the stock short that you borrowed, you have the $100 stock liability and you have the $100 you put up and then $100 of cash. Which means if the stock…

[Jim Chanos] Your assets are cash.

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[Matt Klein] Right. But some of which you had to start with and some you got from selling stock you borrowed. Were the shares to appreciate, then…

[Jim Chanos] Your equity goes down.

[Matt Klein] Right. Your equity goes down and there's some relationship between… Once the stock hits $200 then you have problems? How does that work?

[Jim Chanos] You'll get a margin call before that. The rules are, whatever it is, 30, 40% you'll be asked to put up more cash in the asset side of that balance sheet to shore up your equity. But, yes, unlike most investors it's a little counterintuitive. Most investors, if they own an asset, they're used to the asset value going up and down every night, right? And that's my P&L, my equity. For a short-seller, you have a liability that goes up and down depending on the price. You want the liability to go down. And your assets are fixed, in effect.

And so actually people always say: "Well, short-selling's expensive." And I point out, actually, in a reasonably higher rate environment, short selling throws off tons of cash, because you're earning interest on your T-bill and then typically you split the interest 80/20 with the prime broker on the segregated sale proceeds.

So when interest rates were 6%, my portfolio was earning about ten or 11 on the asset side, minus any dividends I owed on the short. So short selling threw out an awful lot of cash when rates go up. Short sellers are the biggest proponents of higher interest rates on the street. So that's the thing. But people have a hard time understanding that for a short position, your liability goes up and down every night, not your asset.

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[Matt Klein] I want to switch gears a bit. I looked for it, I couldn't find, and please correct me if this is not right, but as far as I can tell there were not big bets, at least public bets that you made, regarding the euro crisis. Which is interesting to me because it seems like there are elements of that that really fit your playbook in terms of the leveraged credit bubble, unproductive assets, housing booms in certain places. Can you walk through how…

[Jim Chanos] Well we were in 2008 and 2009, or 2007 and 2008 I should say. We were short things like Northern Rock and the Irish banks, things like that. But I was a little compromised because I was part of a small number of pro bono groups who were advising people that were… Greek-Americans that were advising the Papandreou administration in Greece in 2010 and 2011.

And I made a pledge: I wouldn't be short any Greek securities, and then I really felt that kind of restricted me elsewhere. And so there was that. And number two, if you recall, almost immediately the Europeans went into a freeze the short selling regime, which we warned them was going to be a mistake, and here's why.

In 2008 when they did that in the US market, I pointed out to the SEC that you're going to have a big problem. Because when you restrict the ability to sell short junior securities in a capital structure, people who otherwise would be willing to stay with more senior instruments, thinking they could hedge them, will not take that risk and will simply not roll more senior securities. And so when you begin short selling bans and restrictions on CDS, and that sort of things, you can only have CDS on something you own. Well if that's the case, just sell the damned bond.

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CDS was designed to hedge in some part non-marketable risks. So say I had a commitment from Bear Sterns Realty to finance a project, and the credit markets are tightening and I'm ready to put my high rise up in 2008. Suddenly Bear Sterns is on the ropes. The only way I can hedge that promise – and that's an asset to me, by the way – is either shorting the stock or in the CDS market. And that's exactly why it was designed. I keep pointing out to people that during the crisis, the biggest short sellers of financial equities and purchases of financial CDS were other financial institutions. It wasn't people like me. They were all hedging off their counterparty risks. See Goldman and AIG.

And so once you begin to fiddle with that, then the unintended consequence of that is you begin to tighten up the liquidity in the credit markets and the money markets, and the capital structures of these institutions, because then nobody's going to take any risks. And I'm just not going to roll the commercial paper. What's in it for me?

If I can't hedge this somehow if I need to, there's no upside for me holding par pieces of paper from a questionable lender. And that's exactly what happened. It made the credit crisis worse. So we had the real time experience of that and Chairman Cox I think later came out and said it [the SEC's short-selling ban] was big mistake, it made things worse not better. And the Europeans went right down the same road.

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And we were asked about it and we said: "Don't do it. It's going to make your situation turn into a banking crisis." That's exactly what it did. And so people think that, well, we're going to stop short selling because it's bad and lower prices are bad. And not understanding that, no, it's a hedging vehicle by and large, and that if you don't let people hedge out in junior securities, your senior securities are going to be at risk. And they keep finding that out the hard way, over and over and over again.

[Matt Klein] What was the advice that you gave to Papandreou when you were there?

[Jim Chanos] He obviously didn't take it. There were a group of us. It was a small handful of us Greek-Americans, and we weren't paid. Lazard was their advisor. And the majority of us actually felt in 2010 when these disclosures were first made and it became apparent just how bad the budget crisis was… I personally felt they should have left the Euro then, because they waited five years for last year's crisis, and it's only gotten much, much worse. The debts have increased and they're no better off than they were then. I had hoped they would take their medicine much earlier on in the process.

They should have never been in the euro, quite frankly, and I think getting out in 2010 would have been far more preferable. But politically it wasn't going to happen, and that became pretty apparent, and when the Samaras government came in they made that clear as well, and we were thanked, but it's just a shame what's happened, because in effect Greece and to a lesser extent Portugal and some of the others have been made examples of.

I keep pointing out: "Look, Italy, Spain and France are just one real bad recession away from where Greece was." And so this is a political issue. It's not a financial issue. And the whole idea of having this trade union and a monetary union, with a kind of fiscal union, where you had this mish-mosh at least until recently of banking regs was just folly. Margaret Thatcher had it right.

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[Matt Klein] Changing gears a bit, what made you decide to go into teaching on the side?

[Jim Chanos] I've been blessed with the opportunity of teaching at my alma mater's business school for the last handful of years, and it's one of the best things I've done. It's just a few weeks out of the year, but I think it's been a lot of fun and I've met a lot of great people.

"History of Financial Market Fraud" is the class, and when Rick Levin brought up the subject of possibly doing something, and I told him what my idea was, he said: "Well, it's how to detect it, right? Not how to commit it?" Rick really was the person behind that.

I think that business school students are taught, correctly so, to emulate success and use the paradigms and cases. But the problem is that as we know almost of all of them, even if they're not short-sellers, are going to be touched by corporate fraud at some point in their life. And you don't want it to devastate your portfolio or your career or your reputation, and there are fairly rigorous systematic models out there that have stood the test of time, as well as some newer ones, on just how some of the great corporate frauds fit over and over again some of the same patterns, boing back to the 1680s and 1690s.

And so it's a fun class to teach, because we're talking about a lot of the rogues and financial scallywags of the last 500 years, 400 years, and it's a lot more fun to teach about Ivar Kreuger and John Law and the Enron guys than doing just another marketing model. That's no knock on my marketing professors but…

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[Matt Klein] Your short selling career has been long, but it doesn't go back to the time of John Law. How did you…?

[Jim Chanos] John Law was great. He's awesome. He's one of… And one of the most polarising figures, by the way, in the history of finance, because there's a revisionist history that what he did was… What he brought forth was basically the first comprehensive fiat currency system in modern times.

And so, you know, he killed a guy and played stock market manipulation and sent retarded people to their deaths in the swamps of Louisiana. These were just small things to pay for the modern fiat currency system that we now all bow down to. I just think he's a fantastic character. But, no, he was a little before my time. Correct.

[Matt Klein] Right. So my question is, I guess, how did you come across this history originally? Obviously I can see it being interesting for someone, given your career path, but not something that necessarily would have come across in your work.

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[Jim Chanos] It's not a course on booms and busts, but we do point out that the fraud cycle tends to follow the financial cycle, typically with a lag. For example, we don't talk about tulip bulbs in Amsterdam in the 17th Century, but the Mississippi scheme and the South Sea bubble which occurred within one year of each other in Paris and London in 1719 and 1720 were indeed frauds. They were based on absolutely giant lies. And both were basically equity for debt schemes.

In the case of John Law, he French government was hopelessly in debt, and in order to get out of it John Law convinced the debt holders to take shares in the Mississippi Company, the Compagnie D'Orient, whose basic charter was to develop Louisiana and the Louisiana territory, and he painted this picture of rivers of gold and fields of diamonds and friendly Indians and just this paradise. And he developed a port on the Mississippi, called it after his benefactor, Le Duc D'Orleans. He named it New Orleans. And they sent the first group of settlers. They paraded them through Paris in a sort of gaudy display of picks and gold picks and shovels, and it was all just a giant stock promotion.

And it didn't start really falling apart until, among other things, the first reports came out after much lag, of people dying and alligators in the swamp and very unfriendly Indians and no rivers of gold and fields of diamonds, but really the malarial swamps of Louisiana. And he was really quite something. As someone pointed out, at his peak he was the Head of the Central Bank, he was the Treasury Minister, and he was nominally the CEO of the largest company with operations everywhere, so he was the equivalent of our Fed Chief, Treasury Chair and CEO of the largest Fortune 500 companies all in one man. It's just unbelievable, the financial power this one individual had in this country at that moment. So he's a great guy to study.

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[Matt Klein] You're talking about the financial cycle and the fraud cycle, and earlier about how you spot companies that are problems with fads and technological obsolescence. It seems like there's now, with the private markets, there are a lot of companies that potentially, if you could short them, you might like to. Speculating idly, if you could pick any one of these, what would you…

[Jim Chanos] Well, shorting public companies is tough enough, but to go speculate on companies I can't even short… I'm not going to fall for that one, Matt. There's clearly a couple of obvious ones that I'm scratching my head about, as other people are, and some business models I've yet to be convinced about. But without really looking at the financials and just based on press hearsay, it's tough to know. As I say, it's tough enough when you actually have financial statements to figure this out, but just based on what people say about certain things, it's tough. So I'll pass on that one.

[Matt Klein] Fair enough. What, in your career, do you think has been the biggest mistake that you've made?

01:18:11

[Jim Chanos] The one we always cite, which was a twofold mistake, and that was the great America Online. We got killed being too early. I know earlier on in this interview you talked about being early, and this was the great example. Now, we also did a decent job though of limiting our losses because of risk parameters. So we kept the position, it was never more than 1% at any given time. So although it went from basically $8 to $80 on us, it didn't put us out of business. It just made numbers look bad for a couple of years. And it was an accounting story. It was basically…

Our view on America Online in the late 1990s was that they were deferring and capitalising the costs of sending those CDs out everywhere, those ubiquitous AOL disks. But the way they were showing their churn was deceptive in our view. And if you analysed it properly and adjusted for the free trials and all the rest of this stuff, you could come to the conclusion that actually toward the end of the 1990s, the marginal customer was not going to be profitable. This is when they were at about 24 million subscribers, or 22 million subscribers.

And it didn't matter. It was wrong place, wrong time, wrong group. It was the internet and it was a massively popular stock. And so we finally… Exhaustion set in in late 1998, early 1999. I forget. And we covered our last share and walked away.

And a year later, Time Warner buys them. Or they merge. In this $160 billion combination. And the second mistake we made was we didn't short Time Warner, which would have been the way to do it, because the story had already begun to play out. The growth had slowed. In fact, Time Warner, I think, bought them when they were 26 million subscribers, and they peaked out at 27 million a year later. They bought them right at the top. And of course realised that the business was uneconomic and people were beginning to ultimately transfer to the regular internet. AOL was the training wheels.

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In the past, when we've had companies bought out by other companies, we have shorted the buyer. It's like: "Boy, really? You kidding me? This is crazy." And we didn't do it with Time Warner. And Time Warner ended up going down to 80%. 84%, something like that. And we compounded our error and our misjudgement and our timing on the way up by missing the easier short on the way down. And nobody was going to buy Time Warner at that point, right? So we didn't have any takeover risk. So it was doubly… Just a double error. So both up and down. That's easily probably number one in our book.

[Matt Klein] I think that's it. Thank you very much for coming.

[Jim Chanos] Great, this was fun. Thank you very much for having me.