WSJ.com THE WALL STREET JOURNAL. ONLINE

January 15, 2008

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Trader Made Billions on Subprime

John Paulson Bet Big on Drop in Housing Values; Greenspan Gets a New Gig, Soros Does Lunch

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January 15, 2008; Page A1

On Wall Street, the losers in the collapse of the housing market are legion. The biggest winner looks to be John Paulson, a little-known hedge fund manager who smelled trouble two years ago.

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Funds he runs were up $15 billion in 2007 on a spectacularly successful bet against the housing market. Mr. Paulson has reaped an estimated $3 billion to $4 billion for himself -- believed to be the largest one-year payday in Wall Street history.

Now, in another twist in financial history, Mr. Paulson is retaining as an adviser a man some blame for helping feed the housing-market bubble by keeping interest rates so low: former Federal Reserve Chairman Alan Greenspan. (See article[3].)

On the way to his big score, Mr. Paulson did battle with a Wall Street firm he accused of trying to manipulate the market. He faced skepticism from other big investors. At the same time, fearing imitators, he used software that blocked fund investors from forwarding his emails.

One thing he didn't count on: A friend in whom he had confided tried the strategy on his own -- racking up huge gains himself, and straining their friendship. (See article[4].)

Like many legendary market killings, from Warren Buffett's takeovers of small companies in the '70s to Wilbur Ross's steelmaker consolidation earlier this decade, Mr. Paulson's sprang from defying conventional wisdom. In early 2006, the wisdom was that while loose lending standards might be of some concern, deep trouble in the housing and mortgage markets was unlikely. A lot of big Wall Street players were in this camp, as seen by the giant mortgage-market losses they're disclosing.

"Most people told us house prices never go down on a national level, and that there had never been a default of an investment-grade-rated mortgage bond," Mr. Paulson says. "Mortgage experts were too caught up" in the housing boom.

In several interviews, Mr. Paulson made his first comments on how he made his historic coup. Merely holding a different opinion from the blundering herd wasn't enough to produce huge profits. He also had to think up a technical way to bet against the housing and mortgage markets, given that, as he notes, "you can't short houses."

Also key: Mr. Paulson didn't turn bearish too early. Some close students of the housing market did just that, investing for a downturn years ago -- only to suffer such painful losses waiting for a collapse that they finally unwound their bearish bets. Mr. Paulson, whose investment specialty lay elsewhere, turned his attention to the housing market more recently, and got bearish at just about the right time.

Word of his success got around in the world of hedge funds -- investment partnerships for institutions and rich individuals. George Soros invited Mr. Paulson to lunch, asking for details of how he laid his bets, with instruments that didn't exist a few years ago. Mr. Soros is famous for another big score, a 1992 bet against the British pound that earned $1 billion for his Quantum hedge fund. He declined to comment.

Mr. Paulson, who grew up in New York's Queens borough, began his career working for another legendary investor, Leon Levy of Odyssey Partners. Now 51 years old, Mr. Paulson benefited from an earlier housing slump 15 years ago, buying a New York apartment and a large home in the Hamptons on Long Island, both in foreclosure sales.

After Odyssey, Mr. Paulson -- no relation to the Treasury secretary -- became a mergers-and-acquisitions investment banker at Bear Stearns Cos. Next he was a mergers arbitrager at Gruss & Co., often betting on bonds to fall in value.

In 1994 he started his own hedge fund, focusing on M&A. Starting with $2 million, he built it to $500 million by 2002 through a combination of its returns and new money from investors. After the post-tech-bubble economic slump, he bought up debt of struggling companies, and profited as the economy recovered. His funds, run out of Manhattan offices decorated with Alexander Calder sculptures, did well but not spectacularly.

Auto Suppliers

By 2005, Mr. Paulson, known as J.P., worried that U.S. economic strength would flag. He began selling short the bonds of companies such as auto suppliers, that is, betting on them to fall in value. Instead, they kept rising, even bonds of companies in bankruptcy proceedings.

"This is crazy," Mr. Paulson recalls telling an analyst at his firm. He urged his traders to find a way to protect his investments and profit if problems developed in the overall economy. The question he posed to them: "Where is the bubble we can short?"

They found it in housing. Upbeat mortgage specialists kept repeating that home prices never fall on a national basis or that the Fed could save the market by slashing interest rates.

One Wall Street specialty during the boom was repackaging mortgage securities into instruments called collateralized debt obligations, or CDOs, then selling slices of these with varying levels of risk.

For buyers of the slices who wanted to insure against the debt going bad, Wall Street offered another instrument, called credit-default swaps.

Naturally, the riskier the debt that such a swap "insured," the more the swap would cost. And this price would go up if default risk appeared to be increasing. This meant an investor of a bearish bent could buy the swaps as a way to bet on bad news happening.

During the boom, however, many were so blind to housing risk that this "default insurance" was priced very cheaply. Analyzing reams of data late at night in his office, Mr. Paulson became convinced investors were far underestimating the risk in the mortgage market. In betting on it to crumble, "I've never been involved in a trade that had such unlimited upside with a very limited downside," he says.

Paulo Pelligrini, a portfolio manager at Paulson & Co., began to implement complex debt trades that would pay off if mortgages lost value. One trade was to short risky CDO slices.

Another was to buy the credit-default swaps that complacent investors seemed to be pricing too low.

"We've got to take as much advantage of this as we can," Mr. Paulson recalls telling a colleague around the middle of 2005, when optimism about the housing market was at its peak.

His bets at first were losers. But lenders were getting less and less rigorous about making sure borrowers could pay their mortgages. Mr. Paulson's research told him home prices were flattening. Suspecting that rating agencies were too generous in assessing complex securities built out of mortgages, he had his team begin tracking tens of thousands of mortgages. They concluded it was getting harder for lenders to collect.

His confidence rose in January 2006. Ameriquest Mortgage Co., then the largest maker of "subprime" loans to buyers with spotty credit, settled a probe of improper lending practices by agreeing to a $325 million payment. The deal convinced Mr. Paulson that aggressive lending was widespread.

He decided to launch a hedge fund solely to bet against risky mortgages. Skeptical investors told him that others with more experience in the field remained upbeat and that he was straying from his area of expertise. Mr. Paulson raised about $150 million for the new fund, largely from European investors. It opened in mid-2006 with Mr. Pelligrini as co-manager.

Adding to the Bet

Housing remained strong, and the fund lost money. A concerned friend called, asking Mr. Paulson if he was going to cut his losses. No, "I'm adding" to the bet, he responded, according to the

investor. He told his wife "it's just a matter of waiting," and eased his stress with five-mile runs in Central Park.

"Someone from more of a trading background would have blown the trade out and cut his losses," says Peter Soros, a George Soros relative who invests in the Paulson funds. But "if anything, the losses made him more determined."

Investors had recently gained a new way to bet for or against subprime mortgages. It was the ABX, an index that reflects the value of a basket of subprime mortgages made over six months. An index of those made in the first half of 2006 appeared in July 2006. The Paulson funds sold it short.

The index weakened in the second half. By year end, the new Paulson Credit Opportunities Fund was up about 20%. Mr. Paulson started a second such fund.

On Feb. 7, 2007, a trader ran into his office with a press release: New Century Financial Corp., another big subprime lender, projected a quarterly loss and was restating prior results.

Once-complacent investors now began to worry. The ABX, which had begun with a value of 100 in July 2006, fell into the 60s. The new Paulson funds rose more than 60% in February alone.

But as his gains piled up, Mr. Paulson fretted that his trades might yet go bad. Based on accounts of barroom talk and other chatter by a Bear Stearns trader, he became convinced that Bear Stearns and some other firms planned to try to prop the market for mortgage-backed securities by buying individual mortgages.

Adding to his suspicions, he heard that Bear Stearns had asked an industry group to codify the right of an underwriter to modify or buy out a faltering pool of loans on which a mortgage security was based. Mr. Paulson claimed this would "give cover to market manipulation." He hired former Securities and Exchange Commission Chairman Harvey Pitt to spread the word about this alleged threat.

In the end, Bear Stearns withdrew the proposal. It was merely about clarifying "our right to continue to service loans -- whether that be modifying loans when people can't pay their mortgage or buying out loans when rep and warranty issues are involved in the underwriting process," says a Bear Stearns spokesman.

Events at Bear Stearns soon added to the worries: Two Bear Stearns hedge funds that invested in subprime mortgages collapsed in mid-2007. Suddenly, investors began to shun such mortgages.

As Mr. Paulson's funds racked up huge gains, some of his investors began telling others about the funds' tactics. Mr. Paulson was furious, worried that others would steal his thunder. He began using technology that prevented clients from forwarding his emails.

In the fall, the ABX subprime-mortgage index crashed into the 20s. The funds' bet against it paid off richly.

Credit-default swaps that the funds owned soared, as investors' perception of risk neared panic levels and they clamored for this insurance.

And the debt slices the funds had bet would lose value, indeed fell -- to nearly worthless.

Debt Protection

One concern was that even if Mr. Paulson bet right, he would find it hard to cash out his bets because many were in markets with limited trading. This hasn't been a problem, however, thanks to the wrong bet of some big banks and Wall Street firms. To hedge their holdings of mortgage securities, they've scrambled to buy debt protection, which sometimes means buying what Mr. Paulson already held.

The upshot: The older Paulson credit funds rose 590% last year and the newer one 350%.

Mr. Paulson has tried to keep a low profile, saying he's reluctant to celebrate while housing causes others pain. He has told friends he'll increase his charitable giving. In October, he gave $15 million to the Center for Responsible Lending to fund legal assistance to families facing foreclosure. The center lobbies for a law that would let bankruptcy judges restructure some mortgages.

Helping Homeowners

"While we never made a subprime loan and are not predatory lenders, we think a lot of homeowners have been victimized," Mr. Paulson says. "Bankruptcy is the best way to keep homeowners in the home without costing the government any money."

The bill, besides helping borrowers, could help the Paulson funds' bearish mortgage bets. If the result was that judges lowered monthly payments on some mortgages, their market value could fall. Mr. Paulson says it's far from certain his funds would benefit. The center says that none of the $15 million will be used to lobby.

Mr. Paulson, who was already worth over $100 million before his windfall, isn't changing his routine much. He still gets to his Manhattan office early -- wearing a dark suit and a tie, unlike many hedge-fund operators -- and leaves around 6 p.m. for the short commute to his East Side townhouse.

One thing is different: It's easy to attract investors now. The firm began 2007 managing $7 billion. Investors have poured in $6 billion more in just the past year. That plus the 2007 investment gains have boosted the total his fund firm manages to $28 billion, making it one of the world's largest.

Mr. Paulson has taken profits on some, but not most, of his bets. He remains a bear on housing, predicting it will take years for home prices to recover. He's also betting against other parts of the economy, such as credit-card and auto loans. He tells investors "it's still not too late" to bet on economic troubles.

At the same time, he's looking to the next turn in the cycle. In a recent investor presentation, he said his firm would at some point "start preparing" for opportunities in troubled debt.

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