AWARD-WINNING *WALL STREET JOURNAL* COLUMNIST

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THE GREATEST TRADE EVER

THE BEHIND-THE-SCENES STORY OF HOW JOHN PAULSON DEFIED WALL STREET AND MADE FINANCIAL HISTORY

The Behind-the-Scenes Story of How John Paulson Defied Wall Street and Made Financial History

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prologue

John Paulson seemed to live an ambitious man's dream. At the age of forty-nine, Paulson managed more than $2 billion for his investors, as well as $100 million of his own wealth. The office of his Midtown Manhattan hedge fund, located in a trendy building on 57th and Madison, was decorated with dozens of Alexander Calder watercolors. Paulson and his wife, Jenny, a pretty brunette, split their time between an upscale town house on New York's fashionable Upper East Side and a multimillion-dollar seaside home in the Hamptons, a playground of the affluent where Paulson was active on the social circuit. Trim and fit, with close-cropped dark hair that was beginning to thin at the top, Paulson didn't enjoy exceptional looks. But his warm brown eyes and impish smile made him seem approachable, even friendly, and Paulson's unlined face suggested someone several years younger.

The window of Paulson's corner office offered a dazzling view of Central Park and the Wollman skating rink. This morning, however, he had little interest in grand views. Paulson sat at his desk staring at an array of numbers flashing on computer screens before him, grimacing.

"This is crazy," he said to Paolo Pellegrini, one of his analysts, as Pellegrini walked into his office.

It was late spring of 2005. The economy was on a roll, housing and financial markets were booming, and the hedge-fund era was in full swing. But Paulson couldn't make much sense of the market. And he wasn't making much money, at least compared with his rivals. He had been eclipsed by a group of much younger hedge-fund managers who had amassed huge fortunes over the last few years—and were spending their winnings in over-the-top ways.

Paulson knew he didn't fit into that world. He was a solid investor, careful and decidedly unspectacular. But such a description was almost an insult in a world where investors chased the hottest hand, and traders could recall the investment returns of their competitors as easily as they could their children's birthdays.

Even Paulson's style of investing, featuring long hours devoted to intensive research, seemed outmoded. The biggest traders employed high-powered computer models to dictate their moves. They accounted for a majority of the activity on the New York Stock Exchange and a growing share of Wall Street's wealth. Other gutsy hedge-fund managers borrowed large sums to make risky investments, or grabbed positions in the shares of public companies and bullied executives to take steps to send their stocks flying. Paulson's tried-and-true methods were viewed as quaint.

It should have been Paulson atop Wall Street, his friends thought. Paulson had grown up in a firmly middle-class neighborhood in Queens, New York. He received early insight into the world of finance from his grandfather, a businessman who lost a fortune in the Great Depression. Paulson graduated atop his class at both New York University and Harvard Business School. He then learned at the knees of some of the market's top investors and bankers, before launching his own hedge fund in 1994. Pensive and deeply intelligent, Paulson's forte was investing in corporate mergers that he viewed as the most likely to be completed, among the safest forms of investing.

When the soft-spoken Paulson met with clients, they sometimes were surprised by his limp handshake and restrained manner. It was unusual in an industry full of bluster. His ability to explain complex trades in straightforward terms left some wondering if his strategies were routine, even simple. Younger hedge-fund traders went tieless and dressed casually, feeling confident in their abilities thanks to their soaring profits and growing stature. Paulson stuck with dark suits and muted ties.

Paulson's lifestyle once had been much flashier. A bachelor well into his forties, Paulson, known as J.P. among friends, was a tireless womanizer who chased the glamour and beauty of young models, like so many others on Wall Street. But unlike his peers, Paulson employed an unusually modest strategy with women, much as he did with stocks. He was kind, charming, witty, and gentlemanly, and as a result, he met with frequent success.

In 2000, though, Paulson grew tired of the chase and, at the age of forty-four, married his assistant, a native of Romania. They had settled into a quiet domestic life. Paulson cut his ties with wilder friends and spent weekends doting on his two young daughters.

By 2005, Paulson had reached his twilight years in accelerated Wall Street–career time. He still was at it, though, still hungry for a big trade that might prove his mettle. It was the fourth year of a spectacular surge in housing prices, the likes of which the nation never had seen. Home owners felt flush, enjoying the soaring values of their homes, and buyers bid up prices to previously unheard-of levels. Real estate was the talk of every cocktail party, soccer match, and family barbecue. Financial behemoths such as Citigroup and AIG, New Century and Bear Stearns, were scoring big profits. The economy was roaring. Everyone seemed to be making money hand over fist. Everyone but John Paulson, that is.

To many, Paulson seemed badly out of touch. Just months earlier, he had been ridiculed at a party in Southampton by a dashing German investor incredulous at both his meager returns and his resistance to housing's allures. Paulson's own friend Jeffrey Greene had amassed a collection of prime Los Angeles real-estate properties valued at more than $500 million, along with a coterie of celebrity friends, including Mike Tyson, Oliver Stone, and Paris Hilton.

But beneath the market's placid surface, the tectonic plates were quietly shifting. A financial earthquake was about to shake the world. Paulson thought he heard far-off rumblings—rumblings that the hedge-fund heroes and frenzied home buyers were ignoring.

Paulson dumped his fund's riskier investments and began laying bets against auto suppliers, financial companies, anything likely to go down in bad times. He also bought investments that served as cheap insurance in case things went wrong. But the economy chugged ever higher, and Paulson & Co. endured one of the most difficult periods in its history.

Even bonds of Delphi, the bankrupt auto supplier that Paulson assumed would tumble, suddenly surged in price, rising 50 percent over several days.

"This [market] is like a casino," he insisted to one trader at his firm, with unusual irritation.

He challenged Pellegrini and his other analysts: "Is there a bubble we can short?"

PAOLO PELLEGRINI felt his own mounting pressures. A year earlier, the tall, stylish analyst, a native of Italy, had called Paulson, looking for a job. Despite his amiable nature and razor-sharp intellect, Pellegrini had been a failure as an investment banker and flamed out at a series of other businesses. He'd been lucky to get a foot in the door at Paulson's hedge fund—there had been an opening because a junior analyst left for business school. Paulson, an old friend, agreed to take him on.

Now, Pellegrini, just a year younger than Paulson, was competing with a group of hungry twenty-year-olds—kids the same age as his own children. His early work for Paulson had been pedestrian, he realized, and Pellegrini felt his short leash at the firm growing tighter. Somehow, Pellegrini had to find a way to keep his job and jump-start his career.

Analyzing reams of housing data into the night, hunched over a desk in his small cubicle, Pellegrini began to discover proof that the real estate market had reached untenable levels. He told Paulson that trouble was imminent.

Reading the evidence, Paulson was immediately convinced Pellegrini was right. The question was, how could they profit from the discovery? Daunting obstacles confronted them. Paulson was no housing expert, and he had never traded real estate investments. Even if he was right, Paulson knew, he could lose his entire investment if he was too early in anticipating the collapse of what he saw as a real estate bubble, or if he didn't implement the trade properly. Any number of legendary investors, from Jesse Livermore in the 1930s to Julian Robertson and George Soros in the 1990s, had failed to successfully navigate financial bubbles, costing them dearly.

Paulson's challenges were even more imposing. It was impossible to directly bet against the price of a home. Just as important, a robust infrastructure had grown to support the real estate market as a network of low-cost lenders, home appraisers, brokers, and bankers worked to keep the money spigot flowing. On a national basis, home prices never had fallen over an extended period. Some rivals already had been burned trying to anticipate an end of housing's bull market.

Moreover, unbeknownst to Paulson, competitors were well ahead of him, threatening any potential windfall Paulson might have hoped to make. In San Jose, California, three thousand miles away, Dr. Michael Burry, a doctor-turned-hedge-fund manager, was busy trying to place his own massive trades to profit from a real-estate collapse. In New York, a brash trader named Greg Lippmann soon would begin to make bearish trades, while teaching hundreds of Paulson's competitors how to wager against housing.

Experts redirected Paulson, pointing out that he had no background in housing or subprime mortgages. But Wall Street had underestimated him. Paulson was no singles hitter, afraid of risk. A part of him had been waiting for the perfect trade, one that would prove him to be one of the greatest investors of all. Anticipating a housing collapse—and all that it meant—was Paulson's chance to hit the ball out of the park and win the acclaim he deserved. It might be his last chance. He just had to find a way to pull off the trade.

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by
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