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- Disclosure
  Important Notice
- Subscribe
  RSS feed
- Search the archives...

Mar 24, 2010

Learning from Michael Burry

If you have ever wanted to learn about Michael Burry, read this post. It is long, but if you feel like skipping what I think, just read the content in the block-quotes, those come straight from Michael Burry of Scion Capital.

Michael Burry of Scion Capital

> "you're a doctor, ipso facto a lousy investor."

That was one of the first messages Michael Burry received when he started his value investing thread on Silicon Investor, back in 1996. Now however, Burry is a pretty well-regarded investor, having made it big with inventing the credit default swap trade as a means of profiting from the financial crisis and being prominently featured in The Greatest Trade Ever by George Zuckerman and The Big Short by Michael Lewis.

What I wanted to find out is how Burry went from being a medical resident to being regarded as one of the greatest investors in recent history. Burry's story is pretty inspirational to investment bloggers — he started out in relative obscurity, posting his ideas on message boards and eventually his own site, until he built a strong institutional following. Eventually, his amateur analyst work attracted the likes of Joel Greenblatt's Gotham Capital and White Mountains Insurance Group (NYSE:WTM). With their money, he started Scion Capital and built a market beating track record. In recent years, Burry unwound his fund in favor of managing his own money.

We are lucky in a way that the internet archives of Burry's posts are still readily available. These archives let us see how Burry invested and the evolution in his process from about 1996 to 2000. I am sure that his approach changed while he was running Scion as well, but I still think the information here is really insightful to young investors.

1. I've read way too much

The first thing that strikes you about Burry is the fact that at the time of his initial post, he has read a lot:

> Ok, how about a value investing thread?
>
> What we are looking for are value plays. Obscene value plays.
> In the Graham tradition.
>
> This week's Barron's lists a tech stock named Premenos, which
> trades at 9 and has 5 1/2 bucks in cash. The business is
> valued at 3 1/2, and it has a lot of potential. Interesting.
>
> We want to stay away from the obscenely high PE's and look
> at net working capital models, etc. Schooling in the art

of fundamental analysis is also appropriate here.

Good luck to all. Hope this thread survives.

Mike

(Silicon Investor)

Look at the type of value investing that Burry is referring to. Remember, most people mistakenly believe value investing is just copying whatever Warren Buffett does, but value investing is actually more diverse than that. The Graham tradition refers to Benjamin Graham, Buffett's teacher, and indicates a more quantitative approach to investing. Graham targeted net-nets, stocks trading at 2/3 their net current asset value. He sought hard assets and did not mind investing in terrible businesses as long as the liquidation value was in tact and protected.

Burry later notes that he is an MD, not an MBA. He picked up most of his knowledge by reading. I believe that if you want to be successful in investing, it is important to be willing to learn and explore new concepts on your own.

This must have been especially true for Burry because when he started posting he was just an outsider. He was no Wall Street analyst and lacked the same resources as many institutional investors. But, Burry made up for his lack of professional knowledge with his drive and determination to learn. Here are some of the books he recommended:

Re: books

To get started, I'd suggest the following four books:

The Intelligent Investor by Graham
Common Stocks and Uncommon Profits by Fisher
Why Stocks Go Up and Down By Pike
Buffettology by Buffett and Clark

If you read these books thoroughly and in that order and never touch another book, you'll have all you need to know. Another book you might want to consider is Value Investing Made Easy by Janet Lowe – a quick read. I have a fairly extensive listing of books on my site, with my reviews of them, and links to purchase them at amazon.

http://www.sealpoint.com/

My problem is I've read way too much. One book stated, "If you're not a voracious reader, you'll probably never be a great investor." But sometimes I wish I had a more focused knowledge base so that my investment strategy wouldn't get all cluttered up.

Re: Security Analysis you can get a lot of the same info in a more accessible format elsewhere, but everyone says that Buffett's favorite version is the 1951 edition. Yes there are differences, and the current version has a lot of non-Graham like stuff in it.

Good Investing,Mike

(Silicon Investor)

From the period of 1996 to 2000, Burry wrote 3,304 posts or about 2.3 posts per day. He didn't let the criticism of more experienced investors get to him, on occasion he was lambasted for being a doctor or not a financial professional. But he kept posting anyway. Many of these posts give us a glimpse of his thought process and the kinds of questions he asked. We can see that he mostly used the site as a sounding board to gauge investment ideas and learn from more experienced investors. His constant asking of questions and stock analysis posts are demonstrative of his intellectual curiosity and how he tried to continuously improve his own abilities as an analyst.

2. There's a way to win at everything. It just has to be found.

If you go back and read Michael Burry's posting history, you will see that his investment style was influenced by Graham and Buffett but also had a number of unique qualities. Note his use of technical analysis:

As I've brought up on this thread before, I was a growth/technical analysis investor for quite a while. I studied TA pretty extensively. Hence, when I felt the market getting toppy last December and became a student of value investing, I found it hard to leave TA completely behind. Mainly I use it only to avoid falling knives and to find buy points at very solid support. I try not to use it to sell stocks
because my horizon remains long-term. With the market this toppy though, I find it hard to ignore when TA says sell after a fast rise. It's the old take the money and run. It has helped me tremendously, and I have been hurt when I ignore it completely. The four companies I hold now I'm not even charting, though I would do so if one or more gains 40-50% in a few weeks, as WHX has done.

Mike

(Silicon Investor)

Most value investors I think would cringe at the very thought of using TA, but Burry found a way to incorporate it into his approach. Part of this has to do with the fact that he actually starting his trading not in stocks, but in coffee futures:

Jim, I guess I still watch the charts a bit. After all, I cut my teeth trading coffee futures. About 8 trading days ago it broke a significant downtrend on decent volume when it moved to the high 40s. At the point, I wished I had bought more in the low 40s. Today it just popped its 200 day, after trending along it for a few days after trendline breakout. This all occurred in a setting in which the years-long

> stock chart tested a years-long uptrend and the support held. Maybe TA is only useful because others use it. I don't know. But it's interesting to watch, and I believe in it to the degree it reflects crowd psychology. Despite SLOT's volatility, I'd be surprised if it goes back to sub-50 now.
>
> And yes, I'm waiting for the 80′s at least before I sell, no matter what the chart does. It's as sure a bet as Apple at 34, Oracle at 23, American Power at 27 (presplit)…
>
> Mike

(Silicon Investor)

Was Burry a futures trading guru? Not quite:

> Re: coffee futures, let's just say I got out with the shirt still on my back.
>
> Mike

(Silicon Investor)

> Off-topic
>
> In futures, I learned a lot about TA. The frustrating thing was it worked. You could actually predict the moves. But slippage ate away everything. I was up big at times, never down big. I left with 98% of my original capital as soon as I realized I would have to quit my day job to do it right. The friend that got me into it did quit his day job and is doing ok. There's a way to win at everything. It just has to be found.
>
> Mike

(Silicon Investor)

We know that right off the bat, Burry had read a number of value investing texts. However, he chose to incorporate things he had picked up previously with his new, value oriented approach. I think that his willingness to create his own systems and methods for investing highlight his ability as an investor. He wasn't just a mindless drone that would follow whatever he read in books.

Take this rule about new lows, it shows that Burry was able to think critically enough to come up with his own investment rules:

> As you know, I have a simple philosophy: sell on new lows.
> There are two reasons for this:
> 1) Many people do this. It's a self-fulfilling prophecy. I try to do it quicker.
> 2) If I know something is a fundamental value and it breaks to new lows, the selling is irrational by definition and I don't want to be in the way of irrational selling. Better to wait for the buyers to show where they are willing to step up and give support.
>
> I suffered for several years trying to be stubborn in the face of irrational selling and all it got me was a lot of 50% haircuts on stocks that had already been too cheap. One of the biggest lessons I've learned was that PE 8 stocks can become PE 4 stocks and stay that way for a long time. AT&T's long-distance business is getting close to trading for 1X EBITDA, yet everyone looks at it like this big albatross around T's neck. Maybe in the future I'll get the long-distance biz for free. All we need is another $15 billion in lost market cap.
>
> That said, I love your rhetorical questions. Why do you think AT&T is getting hit?
>
> Mike

(Silicon Investor)

To me, that is an important aspect of learning investing. Most people will read a book about Warren Buffett and begin to think that there is only one way to really do investing. That kid of thinking really limits you. And Burry brings this up in the context of the tech bubble:

> OK, here's where I go and offend a lot of people. Religion? Style? What's the difference? I'm sitting here fully expecting AMZN to go to 10. Don't expect incredulity from me just because I haven't seen it happen before. At some point, I did give up on my tech ban. Reason being that they are businesses like any other, and I couldn't justify not valuing them. It's fashionable for value investors to steer clear, certainly because of Buffett's influence. But it is possible to invest intelligently there, IMO. I can't just stick my head in the sand and say Microsoft didn't make a lot of really intelligent investors very wealthy. Ratios bite. That's gotta be lesson number 1 in tech value investing. I learned it with one stock – Creative Labs. Applying a little bit of Buffett to tech isn't heresy or impossible, IMO…
>
> Mike

(Silicon Investor)

Burry's willingness to analyze tech companies is more evidence of his propensity to think independently. He makes a great point, totally ignoring tech on the basis of Buffett saying "tech is too hard" is probably a bit of an over generalization. If you look at some of his other posts, he gives some insights into how he evaluates tech stocks:

> I just go for what has value. To me, ignoring tech doesn't make sense. I've done well with Apple, Oracle, American Power this year. IMO, applying traditional value criteria to tech is deadly, because there is usually a reason it looks like a value, and it is too technical to understand.

> So in tech I look for:
>
> 1) Big, Buffett-like established companies with tremendous cash-generating ability that are out of favor despite a franchise on something
> 2) Small techs trading at about cash with no debt. They usually do well in my experience.
>
> In tech, good management is rare and when it is present limits become merely a figment. But for an outsider to somehow judge this before the Street does – I don't know that it is possible.

(Silicon Investor)

To Burry, you don't need to ignore all of tech. Actually, when you look at established tech businesses, they are really some of the best. They tend to have clean balance sheets and are usually almost debt free, making the capital structure very straight forward. For a new investor, a mature tech company is probably easier to analyze than a bank.

Burry breaks tech into two piles. The Buffett businesses are ones that have wide moats and earn a lot — think Microsoft or Ebay (which Scion Capital has owned). The Graham businesses are likely small cap / micro cap stocks that the market has forgotten about, you will often see some of these tech companies on the net-net list (Adaptech comes to mind).

Here is how he described Apple:

> I like AAPL because it IMO is now a bona fide value stock on an enterprise value/ratio basis, and is generating tons of cash. I see loads of opportunity, an extremely strong balance sheet, and little downside. And I see a huge contrarian play because a generation of security analysts have been trained to think that whatever is wrong with this world, AAPL is a part of it.
>
> What the price will do in the next 12 months, I don't know. Whether day traders will ever mature, I don't know. Whether value will even become more important over the next year, I don't know. I just see an absolute value in AAPL at recent prices.
>
> I do feel the greatest margin of safety was back at 34 when no one ever thought it would move, but that there remains a margin of safety for longer-term holders.

(Silicon Investor)

If you were willing to overcome your biases against tech stocks, you would have seen a no-brainer value investment with Apple. Around the time of Burry's post, Apple had about $4.5B in cash and marketable securities, with only $300M in debt. If you had taken Apple's market cap, added the debt, and backed out cash, you would have ended up with the operating business being valued at only 10% of sales. That is absurdly low. The thing is, I am sure many investors missed this because they chose to ignore all tech stocks.

In The Big Short, by Michael Lewis, Burry argues in favor of creating your own investment style:

> Burry did not think investing could be reduced to a formula or learned from any one role model. The more he studied Buffett, the less he thought Buffett could be copied; indeed, the lesson of Buffett was: To succeed in a spectacular fashion you had to be spectacularly unusual. "If you are going to be a great investor, you have to fit the style to who you are," Burry said. "At one point I recognized that Warren Buffett, though he had every advantage in learning from Ben Graham, did not copy Ben Graham, but rather set out on his own path, and ran money his way, by his rules… I Also immediately internalized the idea that no such school could teach someone how to be a great investor. If it were true, it'd be the most popular school in the world, with an impossibly high tuition. So it must not be true."

The Big Short (Michael Lewis)

Basically, Burry did not reject Buffett, but he understood the limitations that came with Buffett's teachings. He didn't have Buffett's resources or talent for influencing management teams. As a smaller investor, he realized that he had to create his own approach so that he could invest effectively.

3. What everybody else was doing was insane

> "The late nineties almost forced me to identify myself as a value investor, because I thought what everybody else was doing was insane."

Michael Burry (The Big Short)

I am a huge believer in having investors study historical financial crises and panics since markets naturally have a tendency to become bubbles. Investors who have never really experienced a bubble will usually relax their investment standards after having a string of homeruns. This almost always leads to disaster, which we saw it in the most recent crisis. Many fund managers lamented that they had strayed a little too far from their core competencies and their investments suffered.

I was really curious about why Burry decided to do the credit default swap trade while so many other investors had missed it. Part of the reason Burry was able to see the mortgage bubble may have been a result of having honed his investment abilities during the dot com bubble. If you look through his posts, he knew the markets were being irrational:

> A very, very close friend of mine whom I work with and talk with 6 hours a day has in the last 3 weeks quintupled his net worth on a single stock. Today he crossed $500,000. He's not an insider at a company or anything. He's just a resident phsyician who's buying what everyone else is buying, and he's telling me the same thing: fundamentals don't matter anymore; who wants to talk about fundamentals?
>
> Paul, if doctors make lousy investors, what does it tell you when doctors are making excellent investors – in droves?

> Mike

([Silicon Investor])

Here is an interest exchange that Burry had with Reginald Middleton, who at the time was selling financial models that projected Microsoft to be worth north of $500 per share:

> Reginald,
>
> You appear to be arguing that junk bonds and technology equity investments have more value because they have been yielding higher returns over the last 7-10 years, thus counterbalancing the risk to a sufficient degree to call these value plays. This is the logic of a growth investor. What if you buy junk bonds just before the next crisis? Or if you buy A junk bond and the company deteriorates or is cannibalized by the people that sold it to you? You'll be sitting on a big fat capital loss. This risk is high, hence the name.
>
> How about the Nifty Fifty and the 72-74 crash? Good companies that didn't see a return to their previous levels for over 10 years. In the inflationary environment of the mid 70′s to early 80′s this was devastating for holders of these growth stocks (which had been deemed "safe" due to their previous returns during the 60′s bull and size/history).
>
> This is why we use AAA corporate bonds and gov't securities as benchmarks for a safe return. Hold until maturity and you are guaranteed (as best as can be expected — if you don't trust the gov't, check out AAA bonds oneself) at least a modicrum of insurance against inflation. I am not arguing that your model doesn't do this implicitly.
>
> In sum, if you buy at the top, where's the value? This is what Margin of Safety is meant to address, and why many people distinguish value investing from growth investing.
>
> Mike

([Silicon Investor])

Finally, there is this:

> Jim, I overheard two conversations today. Both were about investing – one involved the med center librarian, the other a janitor. Moreover, the friend I describe with the half-mill is not the first overnight success story. As I might've mentioned before, my two best friends and my younger brother's two best friends all became multimillionaires this year. But you know, even though I'm here in Silly Valley, I'm on the fringe – that same guy who made half a mill went on a date with an HP IS employee who said it'd take 2 mill to buy her house. When informed of his goal of 3-5 million in a few years, she scoffed and said "That should last 2-3 years." Then she asked what doctors are making in the Valley. He said "$100 to $120k." She actually sniffed.
>
> Jim, I'm reversing my position on your QQQ short, although I'm not yet doing it myself. Never, ever have I heard stock discussion permeate the medical center like this. This is new to me in the last few weeks.
>
> Mike

([Silicon Investor])

Unlike most people at the time, Burry realized that he was living in a bubble. It didn't make sense. Hearing about janitors, librarians, and co-workers, making such outsized returns with little actual investment analysis must have been jarring. The thing is, Burry not only realized that there was a tech bubble, but he sought to profit from it.

Shorting is a somewhat debated topic among value investors. They often complain that shorting saddles investors with potentially unlimited losses and runs counter to the fact that stock markets generally rise. I thought examining Burry's perspectives on short selling would be insightful:

> I've brought this up before, but since there's a new group hanging around,
>
> Does anyone have any rules for shorting based on a value basis?
>
> I'm currently short KO on a value basis and am looking to short G next. (My AXP and WFC shorts are not value-based).
>
> Mike

http://siliconinvestor.advfn.com/readmsg.aspx?msgid=1213782

Even though his shorts were more based in TA, Burry gradually refined his approach to incorporate more fundamental analysis:

> I mentioned that I pick stocks to short based on valuation, not ratios (I ask you to find the correct free cash flow — I bet most people don't kow they're working with negative net working capital, either).
>
> But I ENTER based on technical analysis. KO could go up or down. The odds are down, technically, but that's what buy stops are for. This isn't a long term short by any means. Research on shorts show that profitable shorts make money with small gains, not by waiting for businesses to bankrupt. The small gains are usually there for the picking. Another indicator — if it's mentioned in Barron's as a buy three different times — set me onto Wells Fargo.
>
> What's there to understand about Coke? The business is a KISS model. This gets to my value/short strategy. When people start claiming a business deserves a special valuation above all reasonable

> fundamental analysis (because of the "franchise", because there's so little institutional ownership for a big cap growth stock, because Buffett's in it, because global expansion will provide endless opportunity, because ROE is so damned high, because it's nearly a monopoly, because Buffett's in it…), that's a short, IMO.
>
> I just read a bunch of Graham, and he doesn't deal with shorts (I assume it would be "speculation"), but EMT isn't all that its panned to be either, IMO.
>
> Just trying to think independently,
> Mike

(Silicon Investor)

With further refinement, Burry started to create screens to pick up possible shorts. Here is one:

> A study came out on shorting late last year. It basically said ignore the momentum plays because they move irrationally and fast. Look for companies with immense debt, crummy balance sheets and declining sales. And then hold for a while. This is just so against my nature, if not all human nature.
>
> I screened for negative sales growth plus LT Debt>>equity, and PSR>20. The screen works, in a sense — you get all kinds of companies trading for less than a buck, and a lot of low cap oil&gas explorers. Nothing marginable, so hence they are not shortable. If you leave out the balance sheet problems you get a bunch of development stage cos, esp. biotech. But it seems to be on the right track. I'll keep trying.
>
> As long as you put tight stops on the shorts, there's no unlimited risk. Problem is, how much do you believe the stock will go down? I'm only aiming for 10% in a bull market (which usually happens either quickly or not at all given my technical entry) so I need tight stops. Got stopped out of all mine today except IBM. This is why I'm looking for a value-based alternative.
>
> Good investing,
> Mike

(Silicon Investor)

Even though he was trying, he could not totally come up with a pure value approach to shorting. In this post, Burry describes how his process is still driven by TA, but that he is closer to figuring out a value based strategy:

> Re: stops and shorting
>
> Effectively, you need to use technical analysis. My shorts, though fewer in number by far, have been more successful than my longs — what that says about me I don't know. Alternatively, you could just use percentages, but to me that's a shot in the dark. Or if you know the company intimately, you could just waitbecause you know it's going down.
>
> Using TA, you can find, say, when a company is bumping up agains some significant overhead resistance, hitting a trend channel boundary, or hitting a Fibonacci number on a retracement during a downtrend. There are lots of other examples. Then, you just set a mental stop to get out if the scenario doesn't play out technically. My futures experience led me to study TA intensely. I can't help but use it for position entry in stocks.
>
> To answer someone's question, shorts do not free up cash. They are always borrowed (you are shorting stock that your brokerage borrowed for you from another investors margin account), and hence in your margin account. But it's not like you can keep 100% shorts and then still have 100% cash to play with.
>
> BUT this is TA. Stops are not a part of value investing as I understand it. Hence my search for a value-based strategy.
>
> Shorts take a lot of maintenance as I practice it.
>
> I may have found something, and am currently researching it.
>
> Mike

(Silicon Investor)

This is where Burry's past experience with trading futures was probably helpful. By using frequent stops, he limited the possibility of unlimited losses from a short position. Since he is incorporating shorts into his portfolio, Burry allowed himself to actually profit from the fallout of the bubble popping. Most other investors, who chose not to short, were left putting more and more of their portfolio into cash. Cash is not necessarily bad, while it does not earn returns or compound, in the short term it doesn't decline.

One of the books that Burry recommends for learning short selling is The Art of Short Selling by Kathryn F. Staley. Here is what he had to say:

> For the last week I've been carrying "The Art of Short Selling" around with me just about everywhere. Every time I get a break, I just open to a chapter. Doesn't matter if I've already read it. I just read it again.
>
> If there's one thing that keeps hitting me in the head about that book and its cases is that there's a lot of time to short and still come out ahead. The problem with net stocks is that they appear as if they require constant capital infusions, which makes them good shorts. But they're getting these infusions at will. That makes now now a good time. When the capital spicket is turned off, the stocks will react downward, but won't fully account for how bad the news is then. They'll be terminally wounded but the price won't reflect it. That's

> when IMO you'll be able to grab a lot of the net stocks on their way to zero. But before that, a lot of smaller companies will pitch themselves to larger companies. So the wild card is that they get taken over by a bigger, stupider, more capital-rich, company, a la Yahoo of GeoCities, which stands out as the single most characteristic action of this era. The AofSS describes this risk as the thing that keeps ss's sweaty-palmed and awake at night. I think for good reason.
>
> For my next, more certain short, I'm taking a long, measured look at Pre-Paid Legal (PPL). I posted why over on that thread. I think I finally understand that one.
>
> Mike

(Silicon Investor)

Increasingly, we see Burry progressing towards shorting on the basis of fundamental analysis:

> Shorting stocks where I can see the bad news confirmed in the numbers. Amazon.com (short at 82 5/8 again today) is pursuing some creative financing to get the cash to keep going. Selling euro-dominated bonds follows an Australian issue follows equity-linked debt follows who knows what.
>
> Exodus (short at 129) is in a capital-intensive business with high start-up costs and business inputs that have short half-lives. The barriers to entry are minimal in the long run. Exodus' major shareholders have sold big-time. The company should be raising its needed additional capital by selling inflated shares but instead is borrowing $1billion plus at 10%+ rates. Intel is one of the many targeting this same market.
>
> Pre-Paid Legal (short at 24 3/4) I've gone through before (I shorted it from $37ish down to 24ish last year). Cash flow continues to lag far behind reported net income, membership retention stinks, and the CEO is engaging in borderline stock promotion while he steadily sells. Many in the investor community misunderstand this stock.

(Silicon Investor)

You can see the improvement and progression in his process. You will note that the analysis is more sophisticated here. It is much more value based, akin to an approach that you might see touted by a guy like Jim Chanos or other noted short sellers. With Amazon, Burry found the overall business model to be a bit suspect and disliked the complex financing. Exodus was a weak business that required large amounts of capital investments and financing that could only be raised at 10%+. Conversely, he was able to see larger businesses like Intel pose as competitive threats with the benefit of a cheaper cost of capital. Pre-Paid Legal, which astoundingly still exists today, is often a favorite among shorts. The mis-match between cash flow and net income is found in a lot of fraud businesses and is one of the indicators for trouble that you will find in forensic accounting books.

I talked about Burry's willingness to modify Graham's teachings to fit his own style and the time period. I think that shorting is simply an extension of that. In one instance, after being criticized by another investor, Burry outlines his philosophy on shorts:

> Craig,
>
> I wouldn't go far as to say shorts are not part of a value investing strategy. To each his own, but one might argue that with bonds providing a weak counterweight to stocks over the last few decades, hedging with shorts might be something Graham would have considered by now had he been alive. He definitely was into market timing, and it wouldn't surprise me to learn that he felt that shorts had a place in a rich market as a hedge against a majority long equity position. And re: Paul's remark about hedging and shorts never coming up, I submit that Graham's Bonds/Equity 25/50/25 theory was meant to be the equivalent of a mild hedge strategy. As for me, I've come out ahead on my shorts over the years, but I much favor longs, and in a fairly priced or evem overpriced market will still overwhelming favor longs…
>
> Good investing and keep contributing,
> Mike

(Silicon Investor)

Later, he cites the Rediscovered Benjamin Graham book's material in order to argue that going long value stocks may not be enough if we are faced with a downturn:

> *"I'd like to think that if I own real absolute value stocks it won't matter if the big indexes drop 50%. But that might be wishful thinking. "*
>
> Jim, in that Rediscovered book, Graham makes it quite clear that value stocks will be punished every bit as much and probably more in a market downturn, according to his research. He of course advocates raising cash or adjusting to bonds if one thinks the market is too high. In another area, though, he talks of the tremendous values that can be found even in a high-priced market. I find this book fascinating — lots of stuff I hadn't read before.
>
> Mike

(Silicon Investor)

Eventually, Burry was able to incorporate short selling as just another weapon in his arsenal for value investing. Later, you can really see how improved his level of analysis has become. Take this post on WorldCom:

> To answer whether this is a good business (and not just apparently cheap based on traditional superficial measures) I coincidentally just

> did a new return on capital calc on WCOM today, based on its latest results. Largely, I go by Stern and Stewart's version when doing this. In terms of earning cost of capital, Worldcom is doing a poor job.
>
> In fact, it is not earning its cost of capital. After accounting for past pooling acquisitions, and breaking down Worldcom's cash flows, I figure the company is going to earn, optimistically, $8 billion in cash earnings on invested cash thus far somewhat above $90 billion. Even looking ahead and taking analysts estimates into consideration, I'm seeing at best a 10% return here and hence WCOM is not earning whatever its cost of capital may be – I'm estimating at least 12%.
>
> Right now, it trades above its capital even though it is not earning the cost of its capital. Not good. This may change as WCOM finds a way to leverage its investment into further profits down the road. The latest quarterly report provides a hint of this. But it has said it will have massive capital expenditures in the future – and current cash levels imply additional borrowings to do it. All this will dilute returns further.
>
> I think with T and WCOM, we'd have to find a way to analyze the current levels of investment and somehow come to a conclusion that future earnings will grow quite significantly off this base alone. One wonders what degree of empire building is going on – what is motivating management? Right now, T seems to have the greatest potential because of its cable assets, but it is potential. Management has to execute. Plans to spin off or merge with BT tell me that management is responding to the wrong inputs right now. Ebbers' Sprint plan told me he is responding to the wrong inputs as well…
>
> Following up on my examination of Worldcom, I concluded that Worldcom would have to start showing it didn't need more acquisitions. Its acquisitions to date seem to have been borne of empire-building rather than shareholder reward. And the market is knocking it down drastically on news of its latest acquisition. Certainly it appears that the "story" phase for the stock is over, and the proving time has begun. But Worldcom is still trying to finish the story. **I'm still staying away.**
>
> Good investing,
> Mike

Part I (Silicon Investor)
Part II (Silicon Investor)

As many of you already know, WorldCom had engaged in massive accounting fraud. Some of this was covered up through their clever use of accounting with acquisitions. Each deal boosted their reported earnings whereas it was obvious to Burry that they weren't even out earning their cost of capital. Being able to pick up on small details like this must have been helpful later on when he had to analyze complex subprime-mortgage backed securities.

4. The Big Short

Burry was relentless about seeking out value. That meant buying undervalued tech stocks and shorting the ones that had shoddy fundamentals and were irrationally bid up. To me, when we read about Michael Burry netting huge from credit default swaps against mortgages, we are just seeing an extension of his process.

Value purists may disagree with using credit default swaps because they are derivatives, but Burry's wasn't a purist. He isn't the first value investor to get attracted by insurance. Warren Buffett has had a long history of involvement in the reinsurance business. For Buffett, insurance is all about taking premiums for well priced policies and investing them in the market to compound returns. For Burry, it was more of the opposite. He was being presented with premiums that were so low, relative to the huge payoff, that the CDSs were actually undervalued and worth investing in. His CDS positions may have costed 5% annually but had the potential to deliver 100:1 payouts.

What is funny is that in his SI posts, you could see that Burry was already suspicious about the possibility of a housing bubble back in 1999 with a post about Washington Mutual:

> …with equity/assets of under 5%, WM is not in the strongest shape should its fundamentals deteriorate, i.e. real estate deflate. Out here in Silicon Valley, everyday life feels like a bubble. People can hardly comprehend when I tell them about 90-92 and the foreclosures – not when 2br/1b's are going for 5-600k. I just can't help but think that it will get even uglier before it gets better.
>
> Mike

(Silicon Investor)

Burry constantly frets about the potential downside and isn't deluded into thinking that markets will remain stable. In his posts he brings up cases where investors are afflicted by delusional euphoria. The Nifty-Fifty days, the early 90′s real estate foreclosures, investor behavior during the tech bubble, the ever appreciating home prices in California; he comes off as almost always vigilant against the the possibility of another disastrous bubble around the corner.

In the Michael Lewis article, Betting on the Blind Side, Lewis describes how Burry learned about mortgage bonds:

> In early 2004 a 32-year-old stock-market investor and hedge-fund manager, Michael Burry, immersed himself for the first time in the bond market. He learned all he could about how money got borrowed and lent in America. He didn't talk to anyone about what became his new obsession; he just sat alone in his office, in San Jose, California, and read books and articles and financial filings. He wanted to know, especially, how subprime-mortgage bonds worked.

Betting on the Blind Side (Vanity Fair)

Going back to Burry's past, we know he had a penchant for self-teaching. The way he learned about subprime-mortgage bonds was probably similar to how he learned about investing. Simply by self teaching. My guess is that most investors did not bother wading through subprime mortgage bond prospectuses. At most, they may have double checked the rating on the bond by calling up the people at Moody's or S&P. For Burry though, we know that when he learned something, he sought complete understanding:

> The problem is, I don't believe anything unless I understand it inside out. And even once I understand something, it is not uncommon that I disagree with accepted view (even if it's a Nobel laureate). So I struggle pretty mightily with my own perceptions and definitions every once in a while. That's where I am now.
>
> Mike

(Silicon Investor)

That drive to figure out the ins and outs of every subject must have contributed to the fact that he was willing to sit down and understand all the granular details of a subprime mortgage bond. I doubt listening to a ratings agency or the common market sentiment was enough. He had to personally understand everything. And that singular focus led him to see that subprime mortgage bonds were really a sham:

> But as early as 2004, if you looked at the numbers, you could clearly see the decline in lending standards. In Burry's view, standards had not just fallen but hit bottom. The bottom even had a name: the interest-only negative-amortizing adjustable-rate subprime mortgage. You, the homebuyer, actually were given the option of paying nothing at all, and rolling whatever interest you owed the bank into a higher principal balance. It wasn't hard to see what sort of person might like to have such a loan: one with no income. What Burry couldn't understand was why a person who lent money would want to extend such a loan. "What you want to watch are the lenders, not the borrowers," he said. "The borrowers will always be willing to take a great deal for themselves. It's up to the lenders to show restraint, and when they lose it, watch out." By 2003 he knew that the borrowers had already lost it. By early 2005 he saw that lenders had, too…
>
> In his quarterly letters he coined a phrase to describe what he thought was happening: "the extension of credit by instrument." That is, a lot of people couldn't actually afford to pay their mortgages the old-fashioned way, and so the lenders were dreaming up new financial instruments to justify handing them new money. "It was a clear sign that lenders had lost it, constantly degrading their own standards to grow loan volumes," Burry said. He could see why they were doing this: they didn't keep the loans but sold them to Goldman Sachs and Morgan Stanley and Wells Fargo and the rest, which packaged them into bonds and sold them off. The end buyers of subprime-mortgage bonds, he assumed, were just "dumb money." He'd study up on them, too, but later.

Betting on the Blind Side (Vanity Fair)

My guess is that most of Wall Street did not bother to wade through the hundreds of pages that comprised a subprime MBS. Unlike Burry, who sat in an office and learned these bond deals by himself, most of Wall Street likely deferred their judgement to the ratings agencies or sell side contacts. Ultimately, those groups lacked any substantial knowledge about these securities, their models were flawed which made their opinions flawed. So when investor groups came to them to get their opinions, they were almost always given the wrong answer.

Going through all of Burry's posts, you will see that he was constantly analyzing stocks. To the point where he was at least posting a few ideas every week, in addition to his day job. To me, that is the definition of deliberate practice for an investor. You really have to get into the habit of frequently analyzing and valuing companies. In one post, Burry mentions that he has built a watch list of over 80 companies that he would be ready to pounce on if they ever hit his target price. That level of work, with a tendency to think independently, should help improve anyone's investing.

This quote by Michael Burry in The Big Short says it best:

> I have always believed that a single talented analyst, working very hard, can cover an amazing amount of investment landscape, and this belief remains unchallenged in my mind.

Category: Global Macro, Learning From, Michael Burry, Short Selling, Superinvestors, Value Investing

Comments for this thread are now closed. ×

44 Comments **Street Capitalist** samuallau

Recommend 13 Share Sort by Best

Johny S • 6 years ago

If you care about improving your returns as an investor, you are better focussing your time. IMO, you are far better off reading some annual reports or industry publication than reading about past achievements of "great" investors. I remember Burry from Sealpoint and valuestocks days - actually have a few posts that I printed at the time - but don't see the point in sharing. I used to read all the books every one reads now - Lynch, Train, Stark, Klarman...etc. But, you only really learn/improve by doing and thinking for yourself. And that doesn't include all the folk who coattail/blog about it. There is a big difference between blogs of endless Buffett & Co. quotes and quality blogs like brontecapital. Bring on the hate. Johny

10 • Share ›

Tariq Mod → Johny S • 6 years ago

Johny, I think one of the points, that I hopefully stressed enough was that Burry was constantly analyzing stocks which is exactly the advice you are prescribing - to read annual reports and do real analyst work.

Share ›

Johny S → Tariq • 6 years ago

Yep, totally agree. I actually rate your blog - but hopefully you know what I meant (I'm sure my post sounded too harsh - it wasn't meant to). There just seem to be so many blogs out there that lack any substance other than "insert name of great investor" has bought this, without any indepth analysis. I guess that why I remember Burry - he was generous enough to share his good ideas. And, it worked out for him. God, I never would share my ideas - especially if illiquid - good ones are rare and take so much work. happy investing. Johny

Share ›

Marcus Toy • 6 years ago

Hi Tariq,

This is an amazing post. Great work!
Thanks for going through thousands of Burry's posts and making this great summary.
Hope to read more from you!

Marcus.

2 • Share ›

AK • 5 years ago

Thank you Tariq, great article.

1 • Share ›

Mickey A • 6 years ago

Just wanted to show my appreciation for a compelling article. You obviously spent alot of time and effort researching and putting it together in a cohesive way. An outstanding insight to an outstanding mind.

1 • Share ›

DonnaRae • 6 years ago

How do I find out if Michael Burry has started a New fund and how do you invest in it?

1 • Share ›

Eclecticvalue → DonnaRae • 6 years ago

Unfortunately, he closed his fund and is now investing for himself with his own money. Doesn't want outside investors anymore.

3 • Share ›

Shangrila78 • 6 years ago

Great thread/post! Much appreciated!

1 • Share ›

Charles Logan • 6 years ago

Congratulations for this article. I read "The Big Short" a couple of weeks ago and I wanted to know more about Michael Burry. In fact I was gonna read all his posts in the Value Investing thread he created. You have made a great job describing the evolution of MB's investment decission-making process. Thank you very much for this insighful article. This is just what I was looking for.

Greetings from Spain.

1 • Share ›

Pete • 6 years ago

I got a kick out of seeing Mike's mention of WHX, because I put forward the idea on the Value Investing thread. When we bought it, the stock sold for just a little more than the value of its cash. I got the idea from a writer on thestreet.com, which was in its infancy at the time.

1 • Share ›

Tariq Mod → Pete • 6 years ago

ahh yes, I have that post in my archives:

"The STREET" website < http://www.thestreet.com > just posted an article on WHX, the parent company of Wheeling-Pittsburg Steel.
Current stock price of 8 5/8 for a company with @$16/shr in cash and a book value of >$30 rates WHX "a steal" to some.

Why so cheap? Company in middle of a strike; primary bone of contention is the pension plan. I am taking a look.

--

Funnily enough, I briefly owned WHX a few years ago.

1 • Share ›

bubbles • 6 years ago

Looking to learn a little more about technical analysis. Any recommended readings?

1 • Share ›

Tariq Mod → bubbles • 6 years ago

I haven't personally read too much about TA. But I know people who enjoyed Jack Schwager's Getting Started in Technical Analysis book and John J. Murphy's Technical Analysis in Financial Markets.

Maybe you could flip through them at your book store or library and see if they are good. Both seem to get pretty solid reviews on Amazon.

1 • Share ›

bubbles → Tariq • 6 years ago

Great. I'll take a look at them.

Thanks.

• Share ›

Arthur O'Keefe • 6 years ago

Great summary. Thanks for go through all this work analyzing and posting.

1 • Share ›

Mgenx • 6 years ago

I've read through the early Burry posts and even in '96 and '97 he seemed pretty savvy with respect to financial accounting and research. His gee, aw shucks, I know nothing seems to be a ruse if you ask me - I'm sure he was planning on managing a hedge fund all along, even in the earliest days.

• Share ›

Ijmia • 6 years ago

Great job Tariq, thanks for sharing with us. A few years ago I got a prospect from Scion Capital . I had no clue who Mike Burry was and saw he was a medical doctor.He was raising money for a new venture. I thought this must be the top in hedge fund Business when a medical doctor is investing in stocks,so I threw the prospect in the garbage and ran.

• Share ›

joe327 • 6 years ago

I really enjoyed this post. Thanks

• Share ›

Johny S • 6 years ago

by the way, at the risk of undermining previous comment, you can find his MSN Money articles on way back machine - you have to search though!

• Share ›

Ankit Gupta • 6 years ago

Tariq - keep up the good work man, this was simply one of the best finance related topics that I've read yet.

• Share ›

Todd Metheny • 6 years ago

Excellent post. Fascinating. I just received my copy of The Big Short and look forward to reading it. Burry seems to be all the things you need to be - independent, a voracious learner, skeptical of groupthink, etc. Quite a combination for an investor.

• Share ›

E3 • 6 years ago

Great summary and obviously a lot of hard work. It is really appreciated.

• Share ›

Leila • 6 years ago
Thank you for this Tariq!
Share ›

nickswenson • 6 years ago
This is a very informative pice, thank you.
Michael lewis mentions that Burry wrote a series of summaries and notes on a list of best books on investing. do you know where this material might be found?
Nick Swenson
Share ›

Tariq Mod → nickswenson • 6 years ago
Nick

I believe he had those reviews on his old website, which is not available anymore.
But by combing through his posts, those are the ones I saw him frequently suggest, he seemed to really like the Pike book.

Sorry I can't be of more help

Share ›

nickswenson → Tariq • 6 years ago
Tariq,

This is quite helpful. I had never heard of the Pike book.

Thanks again,

Nick
Share ›

Chris Tillman → Tariq • 6 years ago
Most websites which are gone now, can be found at www.archive.org assuming you know what the site address was.
Share ›

Tariq Mod → Chris Tillman • 6 years ago
Right, but unfortunately both of them, sealpoint and valuestocks are blocked from archive.org
Share ›

financelover • 6 years ago
Thank you very much for taking the time. Very interesting summary indeed.
Share ›

wsmmd1 • 6 years ago
Excellent summary
Thanks for taking the time to put it together
Share ›

sami • 6 years ago
great post thanks for taking the time to do it
Share ›

stockmanmarc • 6 years ago
Thanks for posting Tariq, enjoyed the read. I originally read the Mike Lewis article on Vanity Fair, thought it was very interesting. Your added commentary was a bonus... I did read it :-). Once again nice work.
Share ›

Tim • 6 years ago
Great post and thanks for taking the time to research it all.

Lots of good ideas to implement.

Share ›

Gregory P • 6 years ago
I am wondering if the "Reginald Middleton" is not the same as the "Reggie Middleton" from the BoomBustBlog ?
• Share ›

Tariq Mod → Gregory P • 6 years ago
I am pretty sure they are the same person.
• Share ›

Gregory P → Tariq • 6 years ago
Interesting how he has changed over the years. From idiot growth investor to deep fundamental value investor.
• Share ›

Daniel Splittgerber • 6 years ago
This is a really interesting post - thanks for putting it all together!
• Share ›

marketfolly • 6 years ago
Damn Tariq, how long did it take you to go through all those SI posts?! Nice compilation
• Share ›

Tariq Mod → marketfolly • 6 years ago
haha! there is a reason I had not posted for more than a week.
• Share ›

Jason • 6 years ago
Nice work Tariq. Thanks for the write-up.
• Share ›

CoryJ • 6 years ago
Great writeup. I started going through his posts on SI, but didn't take nearly the time you did to get the salient points.
• Share ›

fruffing • 6 years ago
Superb precis of a career arc worthy of admiration. When I think of the pap we were being fed at Merrill during these times (retail-friendly CDOs anyone?), excepting Dave Rosenberg, I'm amazed I got out with my soul...
Thanks for the post!
• Share ›

Kartik Rao → fruffing • 6 years ago
Awesome work Tariq. You're compilation is truly remarkable and much appreciated. Greetings from India. Kartik Rao
• Share ›

About Me

My name is Tariq Ali, I run Street Capitalist. I recently graduated from the University of Texas at Austin. There, I stumbled onto value investing via the school library. I read everything I could and now I'm here, writing out my thoughts and investment ideas.

I have a lot of heroes when it comes to investing, it seems like every investor has some kind of niche. Some, whose books and writings have had the biggest impact on me are: Warren Buffett, Benjamin Graham, Joel Greenblatt, Seth Klarman, and George Soros.

Have any questions? Want to stay in touch?
Feel free to e-mail me at TariqTX@gmail.com

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