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Extra11/20/2009 8:25 PM ET

8 lessons from a \$20 billion trade

In the greatest trade ever, a New York hedge fund manager scored big betting on the housing collapse. Even average investors can learn from his tactics.

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By Gregory Zuckerman, The Wall Street Journal

Even as the financial system collapsed last year and millions of investors lost billions of dollars, one unlikely investor was racking up historic profits: John

Paulson, a hedge fund manager in New York.

His company made \$20 billion between 2007 and early 2009 by betting against the housing market and big financial companies. Paulson's personal cut would amount to nearly \$4 billion, or more than \$10 million a day. That was more than the 2007 earnings of J.K. Rowling, Oprah Winfrey and Tiger Woods combined.

How did he do it? Believing that a collapse in the housing market was coming, Paulson spent more than \$1 billion in 2006 to buy insurance on what he then saw as risky mortgage investments. When the housing market cracked and the mortgages

tumbled, the value of Paulson's insurance soared. One of his funds rose more than 500% that year.

Then in 2008, he shorted financial shares, or wagered that they would fall in price, profiting again when those companies collapsed.

Find on Bing: How does a hedge fund work?

Are there any investing skills that average investors can learn from his success? Yes. There are no guarantees, of course, but the success of Paulson and

a few other underdog investors lends encouragement to individuals trying to compete with Wall Street's pros.

Here are eight investing lessons of Paulson's \$20 billion gamble, the greatest trade in financial history:

1. Don't rely on the experts

Many investors lost big in 2007 and 2008 as housing crumbled and the stock market tumbled. But no one lost more than commercial and investment banks caught

with toxic mortgage-related securities. Those bankers were the same ones who had

created the bad investments, and Wall Street's top analysts had vouched for their safety, even as Paulson and other investors bet against the investments.

Lesson: When Wall Street is wheeling out its latest can't-miss product, be skeptical.

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2. Bubble trouble

Some academics argue that financial markets have become more efficient. But a rash of financial bubbles in recent years, including those in housing, energy,

technology and Asian currencies, suggests that markets are becoming harder to navigate and are more prone to overshooting.

Today, investors of all sizes read the same articles, watch the same business television programs and chase the same hot tips. They invariably head for the exits at the same time.

Lesson: Have an exit strategy -- and cash to cushion any tumble.

3. Focus on debt markets

Most investors track the ups and downs of the stock market but have only a vague

sense of moves in debt markets. That's a mistake.

Early signs of trouble were seen in sophisticated markets that don't get much limelight, like the subprime-mortgage bond market. Those problems eventually felled the housing and stock markets -- and the overall economy -- like a set of

falling dominoes that Paulson and his team correctly had anticipated.

Lesson: Debt markets can do a better job of predicting problems than stock markets.

4. Master new investments

Paulson scored huge profits by buying credit default swaps, derivative investments that serve as insurance on debt. When risky mortgage bonds tumbled in value, Paulson's insurance soared. But many experts were flummoxed by CDS contracts or shied away from educating themselves about those relatively new investments.

Paulson and his team had no experience with CDS contracts, but they put the time into learning about them.

Lesson: Educate yourself about the range of exchange-traded funds being introduced, some of which can play a valuable role in a portfolio.

Video: Are hedge funds coming back?

5. Insurance pays

A number of investors worried about a bursting of the housing market, but few did much about it, even though insurance, such as CDS contracts, at the time were selling dirt-cheap. Out-of-the-money put contracts -- options that pay off only if the market tumbles -- also were trading at reasonable levels. As cheap as this insurance was, many pros ignored it.

Lesson: Don't underestimate the value of a safety net, such as put options.

6. Experience counts

Some of the biggest winners in the meltdown were middle-aged investors dismissed by some observers as past their prime. But they had experienced previous market downturns, while some of the bankers and analysts caught flat-footed had known only good times.

Lesson: A historical perspective can be a valuable tool.

7. Don't fall in love with an investment

In early 2009, Paulson became more bullish about the banks and financial companies that he had wagered against in 2008, after determining that the companies had improved their balance sheets. The moves resulted in profits this year.

Lesson: Even the greatest trade doesn't last forever.

8. Luck helps

In early 2006, Paulson determined that housing was in trouble and set out to profit from the impending fall. But some housing experts had already determined that real estate was overpriced. Others had wagered against housing but could no

longer stomach their losses. Just months after Paulson placed his historic trade, U.S. housing prices began to fall.

Lesson: Don't risk too much in any one trade, even one that seems like a sure thing.

This article was adapted from "The Greatest Trade Ever: The Behind-the-Scenes Story of How John Paulson Defied Wall Street and Made Financial History" by

Gregory Zuckerman.

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wordfrominside#1

Saturday, November 21, 2009 1:10:00 PM

All this article proves is that you need tons other people's money to invest with and the deep pockets to survive the gambler's hole to make big money. Most of the instruments mentioned in this article cannot be entered into without 7 figure minimum investments and operate on long timelines. Nothing that anyone but the truly wealthy can use.

Woohooo! Well, there is an idea that has never been floated.

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dial 911#2

Sunday, November 22, 2009 10:40:04 AM

It may well be Paulson and Paulson are not related but I bet one was passing information to the other.

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bugudan#3

Monday, November 23, 2009 4:40:34 AM

Investment banking careers have perennial appeal, even with current economic conditions. And for the talented, there will always be opportunities, especially

given the role investment banks play in mergers and other company restructuring activities.

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malesui#4

Monday, November 23, 2009 4:44:43 AM

When considering an investment purchase you should also source the best investment loan structure for you.

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mrsortafixit#5

Monday, November 23, 2009 7:07:32 AM

Heck yes!!!! Its great to invest other peoples money....The "little Guy" can still make it on the street if he/she can get a good sandwich board and tin cup....

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Polarknight#6

Monday, November 23, 2009 11:54:34 AM

I agree with the first comment, that only those with the capital can take full advantage of the system. It is very difficult for the average investor to put up

the kind of capital required without using the traditional tools available to them ie Mutual Funds and ETF's. Even then the returns will be minimalistic at best. If you want to gamble away at it look into Options and Margins, but beware, as that is like putting the lit match in charge of the dynamite stack. It can turn sour in an instant on you. For those of us who choose to do the slow

drive to recovery, it hasn't been too bad of a year, but in order to take full advantage, you will have to get your foot in the door of the investment trading market and learn the system. All they do is invest your money and pull a percentage anyways.

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zhaocaigoug#7

Monday, November 23, 2009 12:06:40 PM

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given the role investment banks play in mergers and other company restructuring activities.

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