

## May 15, 2015

**Just between us billionaires...** It's not often you get a chance to hear one billionaire interview another. However, in January, that's exactly what transpired at the Lost Tree Club in North Palm Beach, Florida, when Home Depot co-founder Ken Langone interviewed Stan Druckenmiller before a live audience.

Although he's not a household name to most US investors, Mr. Druckenmiller served as yet another billionaire's investment chief during the glory years of George Soros' legendary Quantum Fund. You may have heard of the Soros/Druckenmiller attack on Great Britain's currency in 1992. That coup bestowed upon them the reputation of having "broken the pound" and ensured their status among the pantheon of investment demi-gods.

In his interview with Ken Langone, the basis of this month's *Guest EVA*, Mr. Druckenmiller describes this epic transaction, one that earned Mr. Soros even more billions and elevated Stan himself to the ten-figure net worth level. You'll soon read that the main lesson he learned from George Soros was to make large capital commitments when convinced he had found an unusually attractive investment, such as shorting the pound. To qualify for that status, it needed to have an asymmetrical risk/reward characteristic—relatively minor downside with huge upside if you were right. Basically, Sorors taught him that when you come across such an extraordinary opportunity, you ignore the old Wall Street adage that bulls and bears both can make money, but pigs get slaughtered.

Perhaps the most fascinating story he tells, though, is the time he was very wrong. It was the late 1990s and tech stocks were doing their infamous moon-shot. His initial reaction was to short them, as he felt they were trading at astronomical and unsustainable prices. How he came to reverse that stance and to do so with a massive bet—this time ignoring the asymmetrical criteria—is a captivating tale of human fallibility. It's a classic case study of what Evergreen calls *The Tyranny of the Temporary*, a syndrome that can afflict even the most talented investors. (The parallel with today may be those professionals who know this era of grotesque central bank asset price inflation will end in mass destruction, but are convinced they can exit pre-deluge.)

In the wake of his dot.com bomb, Stan parted ways with Soros and started his own fund. By the middle of the last decade, he began to suspect there was another chance to make a huge wager, this time with the proper risk/reward trade-off. Stan realized the Fed had allowed the housing bubble to inflate to monstrous proportions and it was certain to implode. He was a bit early, so his returns in 2006 were sub-par, but once the Ponzi scheme known as sub-prime mortgages began to unravel, he was on his way to another multi-billion dollar payday.

Although these days Stan's getting, as he says, a "strong sense of déjà vu," he's not sure the latest bubbles created by another instance of misguided Fed policies are heading for pin pricks anytime soon. But he's clearly on guard for some very well-articulated reasons that I'd strongly suggest you read and reflect upon—before you hear that loud popping sound!

(I have condensed the following transcript to about half of its original length but if you'd like to read it in its entirety please [click here](#).)

## **LOST TREE CLUB**

Stanley Druckenmiller

Stan Druckenmiller (SD): I thought I would spend a moment just reflecting on why I believe my record was what it was, and maybe you can draw something from that. But the first thing I'd say very clearly, I'm no genius. I was not in the top 10% of my high school class. My SATs were so mediocre I went to Bowdoin because it was the only good school that didn't require SATs, and it turned out to be a very fortunate event for me.

But I'd list a number of reasons why I think I had the record I did because maybe you can draw on it in some of your own investing or also maybe in picking a money manager. Number one, I had an incredible passion, and still do, for the business.

The second thing I would say is I had two great mentors. One I stumbled upon and one I sought out. And I see some young people in the audience and probably some grandparents who have some influence on some young people in the audience, and I would just say this. If you're early on in your career and they give you a choice between a great mentor or higher pay, take the mentor every time. It's not even close. And don't even think about leaving that mento until your learning curve peaks. There's just nothing to me so invaluable in my business, but in many businesses, as great mentors. And a lot of kids are just too short-sighted in terms of going for the short-term money instead of preparing themselves for the longer term.

The third thing I'd say is I developed partly through dumb luck—I'll get to that—a very unique risk management system. The first thing I heard when I got in the business, not from my mentor, was bulls make money, bears make money, and pigs get slaughtered. I'm here to tell you I was a pig. And I strongly believe the only way to make long-term returns in our business that are superior is by being a pig. I think diversification and all the stuff they're teaching at business school today is probably the most misguided concept everywhere.

And if you look at all the great investors that are as different as Warren Buffett, Carl Icahn, Ken Langone, they tend to make very, very concentrated bets. They see something, they bet it, and they bet the ranch on it. And that's kind of the way my philosophy evolved, which was if you see—only maybe one or two times a year do you see something that really, really excited you. And if you look at what excited you and then you look down the road, your record on those particular transactions is far superior to everything else, but the mistakes I'd say 98% of money managers and individuals make is they feel like they got to be playing in a bunch of stuff. And if you really see it, put all your eggs in one basket and then watch the basket very carefully.

Now, I told you it was kind of dumb luck how I fell into this. Ken Langone knows my first mentor—Speros Drelles—very well. He's not a well-known guy, but he was absolutely brilliant, and I

would say a bit of a maverick. He was at Pittsburgh National bank. I started there when I was 23 years old. I was in a research department. There were eight of us. I was the only one without an MBA, and I was the only one under 32 years of age. I was 23 years old.

After about a year and a half—I was a banking and a chemical analyst—this guy calls me into his office and announces he's going to make me the director of research, and these other eight guys and my 52-year-old boss are going to report to me. So, I started to think I'm pretty good stuff here. But he instantly said, "Now, do you know why I'm doing this?" I said no. He says, "because for the same reason they send 18-year-olds to war. You're too dumb, young, and too inexperienced not to know to charge. We around here have been in a bear market since 1968." This was 1978. "I think a big secular bull market's coming. We've all got scars. We're not going to be able to pull the trigger. So, I need a young, inexperienced guy. But I think you've got the magic to go in there and lead the charge." So, I told you he was a maverick, and as you can already see, he's a little bit eccentric. After he put me in there, he was gone in three months. I'll get to that in a minute...

Now, I told you he left three months later, and here's where the dumb luck came in in terms of my investment philosophy. So, right after he leaves, the Shah of Iran goes under. So, oil looks like it's going to go up 300%. I'm 26—25, excuse me. I don't have any experience. I don't know anything about portfolio managers. So, I go well, this is easy. Let's put 70% of our money in oil stocks and let's put 30% in defense stocks and let's sell all our bonds. So, and I would have agreed with him if I had some experience and I was a little more experienced, but the portfolio managers that were competing with me for the top job, they, of course, thought it was crazy. I would have thought it was crazy too if I'd have had any experience, but the list I proposed went up 100%. The S&P was flat. And then at 26 years old they made me chief investment officer of the whole place. So, the reason I say there was a lot of luck involved is because as Drelles predicted, it was my youth and it was my inexperience, and I was ready to charge.

So, the next thing that happened when I started at Duquesne, Ronald Reagan had become President, and we had a radical man named Paul Volcker running the Federal Reserve. And inflation was 12%. The whole world thought it was going to go through the roof, and Paul Volcker had other ideas. And he had raised interest rates to 18% on the short end, and I could see that there is no way this man was going to let inflation go. So, I had just started at Duquesne. I had a small amount of new capital. I took 50% of the capital and put it into 30—year treasury bonds yielding 14%, and I owned nothing else. Sort of like the oil and defense story, but now we're on a different gig. And sure enough, the bonds went up despite a bear market in equities. Right out of the chute I was able to be up 40%.

So, after that happened, my second mentor was George Soros, and unlike Speros Drelles, I imagine most of you have heard of George Soros. And had I known George Soros when I made the bond bet, I probably would have made a lot more money because I wouldn't have put 50% in the bonds, I probably would have put about 150% in the bonds. So, how did I meet George Soros? By the early to mid-'80s commodities were having dramatic moves. Currencies were having big moves, bonds were having big moves, and I was developing a philosophy that if I can look at all these different buckets

and I'm going to make concentrated bets, I'd rather have a menu of assets to choose from to make my big bets and particularly since a lot of these assets go up when equities go down, and that's how it was moving.

And then I read *The Alchemy of Finance* because I'd heard about this guy, Soros. And when I read *The Alchemy of Finance*, I understood very quickly that he was already employing an advanced version of the philosophy I was developing in my fund. So, when I went over to work for George, my idea was I was going to get my PhD in macro portfolio manager and then leave in a couple years or get fired like the nine predecessors had. But it's funny because I went over there, I thought what I would learn would be like what makes the yen goes up, what makes the deutsche mark move, what makes this, and to my really big surprise, I was as proficient as he was, maybe more so, in predicting trends.

That's not what I learned from George Soros, but I learned something incredibly valuable, and that is when you see it, to bet big. So what I had told you was already evolving, he totally cemented. I know we got a bunch of golfers in the room. For those who follow baseball, I had a higher batting average; Sores had a much bigger slugging percentage. When I took over Quantum, I was running Quantum and Duquesne. He was running his personal account, which was about the size of an institution back then, by the way, and he was focusing 90% of his time on philanthropy and not really working day to day. In fact a lot of the time he wasn't even around.

And I'd say 90% of the ideas he was using came from me, and it was very insightful and I'm a competitive person, frankly embarrassing, that in his personal account working about 10 % of the time he continued to beat Duquesne and Quantum while I was managing the money. And again it's because he was taking my ideas and he just had more guts. He was betting more money with my ideas than I was.

Probably nothing explains our relationship and what I've learned from him more than the British pound. So, in 1992 in August of that year my housing analyst in Britain called me up and basically said that Britain looked like they were going into a recession because the interest rate increases they were experiencing were causing a downturn in housing. At the same time, if you remember, Germany, the wall had fallen in '89 and they had reunited with East Germany, and because they'd had this disastrous experience with inflation back in the '20s, they were obsessed when the deutsche mark and the East German currency combined, that they would not have another inflationary experience. So, the Bundesbank, which was getting growth from the reunification and had a history of worrying about inflation, was raising rates like crazy. That all sounds normal except the deutsche mark and the British pound were linked. And you cannot have two currencies where one economic outlook is going like this way and the other outlook is going that way. So, in August of '92 there was \$7 billion in Quantum.

I put a billion and a half, short the British pound based on the thesis I just gave you. So, fast-forward September, next month. I wake up one morning and the head of the Bundesbank, Helmut Schlesinger, has given an editorial in the Financial Times, and I'll skip all the flowers. It basically said the British pound is crap and we don't want to be united with this currency. So, I thought well, this is my

opportunity. So, I decided I'm going to bet like Soros bets on the British pound against the deutsche mark.

It just so happens he's in the office. He's usually in Eastern Europe at this time doing his thing. So, I go in at 4:00 and I said, "George, I'm going to sell \$5.5 billion worth of British pounds tonight and buy deutsche marks. Here's why I'm doing it, that means we'll have 100% of the fund in this one trade." And as I'm talking, he starts wincing like what is wrong with this kid, and I think he's about to blow away my thesis and he says, "That is the most ridiculous use of money management I ever heard. What you described is an incredible one-way bet. We should have 200% of our net worth in this trade, not 100%. Do you know how often something like this comes around? Like once every 20 years. What is wrong with you?" So, we started shorting the British pound that night. We didn't get the whole \$15 billion on, but we got enough that I'm sure some people in the room have read about it in the financial press.

One of the things I would say is about 80% of the big, big money we made was in bear markets and equities because crazy things were going on in response to what I would call central bank mistakes during that 30-year period. And probably in my mind the poster child for a central bank mistake was actually the U.S. Federal Reserve in 2003 and 2004. I recall very vividly at the end of the fourth quarter of 2003 calling my staff in because interest rates, Fed Funds were one percent. The nominal growth in the U.S. that quarter had been nine percent. All our economic charts were going through the roof, and not only did they have rates at one percent; they had this considerable period—sound familiar?—language that they were going to be there for a considerable time period.

So, I said I want you guys to try and block out where Fed Funds are and just consider this economic data and let's play a game. We've all come down from Mars. Where do you think Fed Funds would be if you just saw this data and didn't know where they were? And I'd say of the seven people the lowest guess was 3% and the highest was 6%. So, we had great conviction that the Federal Reserve was making a mistake with way too loose monetary policy. We didn't know how it was going to manifest itself, but we were on alert that this is going to end very badly.

Sure enough, about a year and a half later an analyst from Bear Stearns came in and showed me some subprime situation, the whole housing thing, and we were able to figure out by mid-'05 that this thing was going to end in a spectacular housing bust, which had been engineered - or not engineered but engendered by the Federal Reserve's too-loose monetary policy and end in a deflationary event. And we were lucky enough that it turned out to be correct. My returns weren't very good in '06 because I was a little early, but '07 and '08 were—they were a lot of fun.

So, that's why if you look at today—I'm experiencing a very strong sense of *deja vu*. This is the first time in 102 years, A, the central bank bought bonds and, B, that we've had zero interest rates and we've had them for five or six years. So, do you think this is the worst economic period looking at recent economic data we've been in in the last 102 years? To me it's incredible.

Now, the Fed will say well, you know, if we didn't have rates down here and we didn't increase our

balance sheet, the economy probably wouldn't have done as well as it's done in the last year or two.

You know what, I think that's fair, it probably wouldn't have. It also wouldn't have done as well as it did in 2004 and 2005. But you can't measure what's happening just in the present in the near term. You got to look at the long term.

And to me, it's quite clear that it was the Federal Reserve policy. I don't know whether you remember. They kept coming up with this term back at the time, they wanted an insurance policy. We've got to ensure this economic recovery keeps going. The only thing they ensured in my mind was the financial crisis. So, to me you're getting the same language again out of policymakers. On a risk-reward basis why not let this thing run a little hot? You know, we got to ensure that it gets out. But the problem with this is when you have zero money for so long, the marginal benefits you get through consumption greatly diminish, but there's one thing that doesn't diminish, which is unintended consequences.

People like me, others, when they get zero money—and I know a lot of people in this room are probably experiencing this, you are forced into other assets and risk assets and behavior that you really don't want to do, and it's not those concentrated bet kind of stuff I mentioned earlier. It's like geez, these zero rates are killing me. I got to do this. And the problem is the longer rates stay at zero and the longer assets respond to that, the more egregious behavior comes up.

Now, people will say well the PE is not that high. Where's the beef? Again, I feel more like it was in '04 where every bone in my body said this is a bad risk/reward, but I can't figure out how it's going to end. I just know it's going to end badly, and a year and a half later we figure out it was housing and subprime. I feel the same way now. There are early signs. If you look at IPOs, 80% of them are unprofitable when they come. The only other time we've been at 80% or higher was 1999.

The other thing I would look at is credit. There are some really weird things going on in the credit market that maybe Kenny and I can talk about later.

But there are already early signs starting to emerge. And to me if I had a message out here, I know you're frustrated about zero rates, I know that it's so tempting to go ahead and make investments and it looks good for today, but when this thing ends, because we've had speculation, we've had money building up for four to six years in terms of a risk pattern, I think it could end very badly.

I mentioned credit. Let's talk about that for a minute. In 2006 and 2007, which I think most of us would agree was not a down period in terms of speculation, corporations issued \$700 billion in debt over that two-year period. In 2013 and 2014 they've already issued \$1.1 trillion in debt, 50% more than they did in the '06/'07 period over the same time period. But more disturbing to me if you look at the debt that is being issued, Kenny, back in '06/'07, 28% of that debt was B rated. Today 71% of the debt that's been issued in the last two years is B rated. So, not only have we issued a lot more debt, we're doing so at much lower standards. Another way to look at that is if those in the audience who know what covenant-light loans are, which is loans without a lot of stuff tied around you, back in '06/'07 less than 20% of the debt was issued cov-light.

Now that number is over 60%. So, that's one sign. The other sign I would say is in corporate behavior, just behavior itself. So, let's look at the current earnings of corporate America. Last year they earned \$1.1 trillion; \$1.4 trillion in depreciation. Now, that's about \$2.5 trillion in operating cash flow. They spent \$1.7 trillion on business and capital equipment and another \$700 billion on dividends. So, virtually all of their operating cash flow has gone to business spending and dividends, which is okay. I'm onboard with that.

But then they increase their debt 600 billion. How did that happen if they didn't have negative cash flow? Because they went out and bought \$567 billion worth of stock back with debt, by issuing debt. So, what's happening is their book value is staying virtually the same, but their debt is going like this. From 1987 when Greenspan took over for Volcker, our economy went from 150% debt to GDP to 390% as we had these easy money policies moving people more and more out the risk curve. Interestingly, in the financial crisis that went down from about 390% to 365%. But now because of corporate behavior, government behavior, and everything else, those ratios are starting to go back up again.

Look, if you think we can have zero interest rates forever, maybe it won't matter, but in my view one of two things is going to happen with all that debt. A, if interest rates go up, they're screwed and, B, if the economy is as bad as all the bears say it is, which I don't believe, some industries will get into trouble where they can't even cover the debt at this level.

So, I don't exactly know what's going to happen. I don't know when it's going to happen. I just have the same horrific sense I had back in '04. And by the way, it lasted another two years. So, you don't need to run out and sell whatever tonight.

I don't know when it's going to stop. And on inflation this could end up being inflationary. It could also end up being deflationary because if you print money and save banks, the yield curve goes negative and they can't earn any money or let's say the price of oil goes to \$30, you could get a deflationary event. If you had asked me this question in late '03, I'd have said well, this probably ends with inflation, but by the time we needed to, we figured out no, this is going to end in deflation. So, the fed keeps talking about deflation, but there is nothing more deflationary than creating a phony asset bubble, having a bunch of investors plow into it and then having it pop. That is deflationary.

Ken Langone (KL):

You mentioned some of your biggest winners in your career. What is the biggest mistake you made and what did you learn from it?

SD:

Well, I made a lot of mistakes, but I made one real doozy. So, this is kind of a funny story, at least it is 15 years later because the pain has subsided a little. But, in 1999 after Yahoo and AOL had already gone up like tenfold, I got the bright idea at Soros to short internet stocks. And I put \$200 million in them in about February and by mid-march the \$200 million short I had lost \$600 million on, gotten completely beat up and was down like 15% on the year. And I was very proud of the fact that I never

had a down year, and I thought well, I'm finished.

So, the next thing that happens is I can't remember whether I went to Silicon Valley or I talked to some 22-year-old with Asperger's. But whoever it was, they convinced me about this new tech boom that was going to take place. So I went and hired a couple of gun slingers because we only knew about IBM and Hewlett-Packard. I needed Veritas and Verisign. I wanted the six. So, we hired this guy and we end up on the year—we had been down 15% and we ended up like 35% on the year. And the Nasdaq's gone up 400%.

So, I'll never forget it. January of 2000 I go into Soros's office and I say I'm selling all the tech stocks, selling everything. This is crazy. All this stuff at 104 times earnings. This is nuts. Just kind of as I explained earlier, we're going to step aside, wait for the next fat pitch. I didn't fire the two gun slingers. They didn't have enough money to really hurt the fund, but they started making 3% a day and I'm out. It is driving me nuts. I mean their little account is like up 50% on the year. I think Quantum was up seven. It's just sitting there.

So like around March I could feel it coming. I just—I had to play. I couldn't help myself. And three times during the same week I pick up a phone, but I think don't do it. Don't do it. Anyway, I pick up the phone finally. I think I missed the top by an hour. I bought \$6 billion worth of tech stocks, and in six weeks I had left Soros and I had lost \$3 billion in that one play. You asked me what I learned. I didn't learn anything. I already knew that I wasn't supposed to do that. I was just an emotional basket case and couldn't help myself. So, maybe I learned not to do it again, but I already knew that.

KL:

This is my question, is there any way possible you think that we could have a soft landing from all the excesses we've had in the last 10 or 15 years?

SD:

Anything's possible. I sure hope so. And I haven't committed. I'm not net short equities. I mean the stock market right now as a percentage of GDP is higher than—with the exception of nine months from '99 to—it's the highest it's been in the last hundred years of any other period except for those nine months. But you know what, when you look at the monetary policy we're running, it should be—it should be about where it is. This is crazy stuff we're doing. So, I would say you have to be on alert to that ending badly. Is it for sure going to end badly? Not necessarily. I don't quite know how we get out of this, but it's possible.

KL:

Okay. Stanley, fabulous. Thank you so much.