Lunch with the FT Life & Arts

Jim Chanos: 'We are in the golden age of fraud'

The short-seller on being a bear in a bull market, betting against Tesla and why he thinks 'trouble's coming'

Harriet Agnew 7 HOURS AGO

Jim Chanos has been cast as the "Darth Vader of Wall Street", the "Catastrophe Capitalist" and the "LeBron James of short selling". The 62-year-old titan of the $3.2tn global hedge fund industry predicted the downfall of US energy giant Enron almost two decades ago, making a fortune in the process. But the course of true riches, it seems, never did run smooth. On the day of our encounter, Tesla, which Chanos has bet against for the past five years, overtakes Toyota as the most valuable carmaker in the world, leaving him nursing heavy losses. But more about that later.

I am ensconced at Oswald's, an elegant London members' club for oenophiles. It's the first time I've set foot in a restaurant in four months. But where more appropriate to interview the short-seller than an antique mirrored dining room in Mayfair, the heart of the European hedge fund industry? It's three days before "Super Saturday", when London's restaurants and bars can reopen. I've been granted an exception and am the sole diner. Social distancing would not be a problem here, however. The round tables are generously spaced apart, designed with discretion in mind.

I am to have early dinner — Chanos is to have lunch. He is in Miami Beach, where he has been stuck since the start of lockdown in early March. For our encounter, he has persuaded Prime 112 steakhouse, his go-to place on Friday nights, to allow him to use its private room. When he comes on screen, his air is more benevolent academic than pantomime villain, dressed in a white open-necked shirt and blazer. Chanos likes to present himself as a "real-time financial detective who is incentivised to root out fraud". Or, more prosaically, a "forensic financial statement junkie".

To critics, short selling represents the scourge of modern capitalism. Whereas so-called value investors such as Warren Buffett try to buy shares in companies that the market is underestimating, short-sellers such as Chanos seek out overvalued companies. They borrow shares and then sell them, hoping to buy them back later for less. In short, "they are profiting when others are losing money", says Chanos — and this makes some people uncomfortable.

Chanos is buoyant. A week earlier, one of his largest short positions — the German payments company Wirecard — filed for bankruptcy, after admitting that €1.9bn of its cash probably did "not exist". This followed a five-year FT investigation into its accounting practices. Chanos's funds made almost $100m from the trade, according to an investor. He laughs: "It's bittersweet, Harriet, because short-sellers put up with weeks and months of misery, and you feel good for hours and days."

Even its detractors acknowledge that short selling, in a normal environment, helps the markets to question conventional wisdom. But a sharper complaint, usually heard from targets, is that short-sellers acting together to sow FUD (fear, uncertainty and doubt) about a company's accounting or financial position can become a self-fulfilling prophecy. In the past, investors such as Chanos have moved markets just by revealing a bet against a particular company.

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Chanos happily concedes that he talks frequently to other short-sellers. He shorted Luckin Coffee, once touted as China's answer to Starbucks, after Carson Block of Muddy Waters encouraged him to look at it. (The company is now being investigated for accounting fraud.) But it's "a myth" that short-sellers act together, he tells me from Prime 112's private room. "If there were conspiracies, we'd be in something much more profitable than short selling."

I mention Canadian insurer Fairfax Financial. It sued a group of hedge funds, including those run by Chanos, Dan Loeb and Steve Cohen, for allegedly driving down its stock under a short selling scheme. "That was the perception, but it wasn't true," says Chanos. "The case was thrown out [in 2018] on jurisdictional grounds. Our allegation was that the company was overstating their earnings, and during the process they restated their earnings."

Chanos's hedge fund manager Kynikos Associates is named after the ancient Greek word for "cynic". His pitch is that he can identify corporate disasters-in-the-making. The New York-based outfit employs 20 people and has $1.5bn in assets under management. Chanos also teaches a course on the history of financial fraud ("how to detect it, not how to commit it", he quips) at Yale University, his alma mater. The syllabus stretches back to the 17th century. Today, he says, "we are in the golden age of fraud".

Chanos describes the current environment as "a really fertile field for people to play fast and loose with the truth, and for corporate wrongdoers to get away with it for a long time". He reels off why: a 10-year bull market driven by central bank intervention; a level of retail participation in the markets reminiscent of the end of the dotcom boom; Trumpian "post-truth in politics, where my facts are your fake news"; and Silicon Valley's "fake it until you make it" culture, which is compounded by Fomo — the fear of missing out. All of this is exacerbated by lax oversight. Financial regulators and law enforcement, he says, "are the financial archaeologists — they will tell you after the company has collapsed what the problem was."

All in all, it's "a heady witch's brew for trouble".

A waiter arrives to take his order. Chanos knows the menu by heart and picks a wedge salad of iceberg lettuce, bacon, tomatoes and Roquefort dressing, followed by a strip steak (medium) with a baked potato. He doesn't normally eat or drink like this at midday but says he will make an exception for Lunch with the FT, and orders a glass of Cabernet Sauvignon.

Prime 112

112 Ocean Drive, Miami Beach, Florida 33139

Wedge salad with bacon, tomatoes and Roquefort dressing **$23**

Strip steak with baked potato **$59 plus $15**

Fried Oreos **$16**

Pellegrino **$9.50**

Glass of Faust Cabernet Sauvignon **$35**

Total (inc tax) **$171.68**

Oswald's

25 Albemarle Street, London W1S 4HU

Cornish oysters served with mignonette

Toro tuna carpaccio with avocado purée

Coconut choc ice

Glass of Krug, 164ème Édition

Glass of Puligny-Montrachet Premier Cru Les Champs Gain 2015

Harriet was a guest of Oswald's

At Oswald's, the general manager Michele greets me with a glass of champagne and explains that the chef will prepare his own selection of dishes for me. I'm out of practice with ordering, so this comes as something of a relief.

Chanos's mission is focused on understanding a company's business model and then ascertaining if its financial statements reflect it. Certain themes crop up time and again in his hunt for short positions: technological obsolescence, consumer fads, single-product companies, growth via acquisitions and accounting games. Notably he looks for "legal fraud" — where companies adhere to the accounting rules and regulations but there's still an "intent to deceive". Enron epitomised this — Chanos identified that it was using aggressive accounting to front-load profits and hide debt in its subsidiaries.

He wasn't the first short-seller to the Wirecard party. Chanos initiated a short in the German payments company last year and increased the position last autumn, when the FT published documents indicating that profits at Wirecard units in Dubai and Dublin were fraudulently inflated and that customers listed in documents provided to auditor EY did not exist.

Wirecard's collapse, when it finally came, was dramatic. But, says Chanos, most fraud is on the edges. And these days, often it is "staring at you right in the face through the use of company-designed metrics" through which they are "gaming the system". He is referring to creative accounting measures used to flatter companies' books, notably office-space provider WeWork's now infamous community-adjusted ebitda. The coronavirus crisis has spawned "ebitdac", or earnings before interest, taxes, depreciation, amortisation — and coronavirus — where companies are adding back profits they say they would have made but for the pandemic.

Regulators, he says, could be much firmer in clamping down on metrics "that just are increasingly unmooring themselves from reality".

Growing up as the son of Greek and Irish immigrants who ran a chain of dry-cleaning shops in Milwaukee, Chanos says he was interested in stock markets at an early age. After Yale, he worked for an investment bank in Chicago and then retail brokerage Gilford Securities, where he began writing research on individual stocks. He had a baptism by fire: "The first major company I looked at and wrote up turned out to be an immense accounting fraud."

Baldwin-United was a piano company that had morphed into a financial supermarket. Chanos's research pointed out inconsistencies with its numbers and recommended that investors sell the stock. It went bankrupt the following year, in 1983, at the time the largest-ever US corporate bankruptcy. Baldwin's collapse piqued the interest of Gilford's hedge fund clients who followed its stock recommendations, notably George Soros and Michael Steinhardt. "What else does the kid not like?" they asked, Chanos recalls.

Soon afterwards, he joined Deutsche Bank in New York. It was a shortlived affair. In September 1985, The Wall Street Journal ran a front-page investigation into the "aggressive methods" of a network of short-sellers that it alleged was driving down the shares of US companies. The then 27-year-old Chanos was portrayed as an *enfant terrible* at the centre of the network. "People think I have two horns and spread syphilis," he quipped in the article. Deutsche fired him and his boss. "The postscript is that nine of the 10 companies mentioned [in the article] either went bankrupt or were prosecuted for fraud," he says.

Chanos's wedge salad and my own starter (a plate of oysters, deliciously juicy, with a glass of crisp white Burgundy) arrive.

It must take a certain personality type to be a perma-bear, I venture.

A long time ago, Chanos believed that going short was just "the mirror image of going long". He has changed his tune on this, however, "because there is a lot of behavioural finance at work in the markets". On Wall Street, he says, "the bull case is everywhere" — optimistic management projections, takeover rumours that boost targets' stock prices, and company earnings estimates revised upwards.

"So I think that it does take a certain peculiar personality — and I'll leave it at that — to say 'OK, here's my facts and here's the conclusions I draw from my facts, and that's why I think there's an opportunity on the short side here.'"

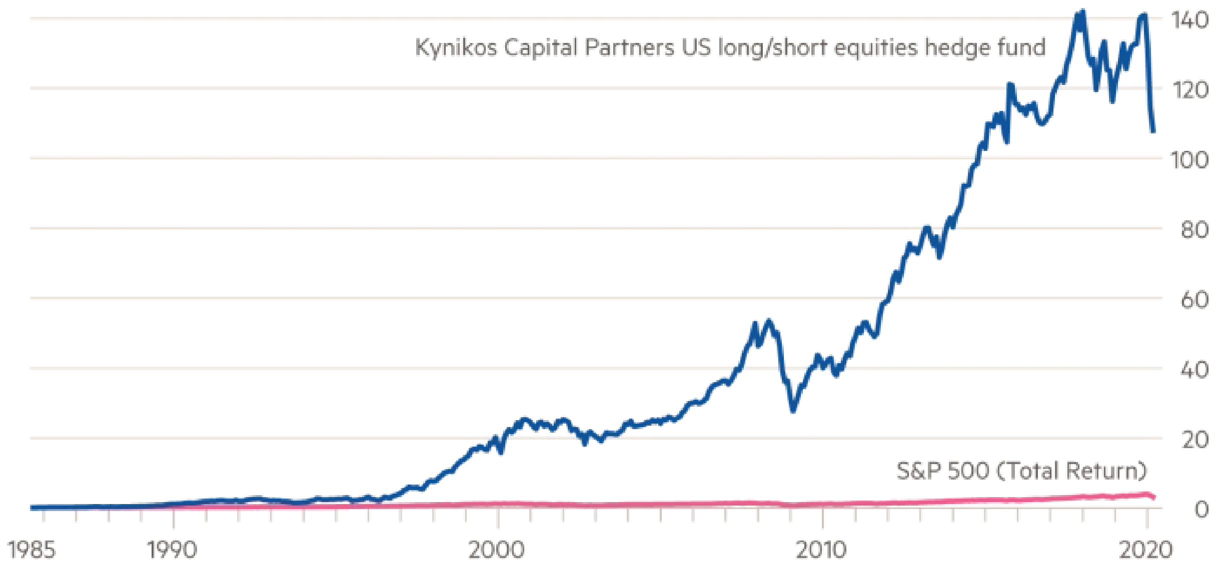
Many can't stomach it. Less than a year after the 1985 launch of Kynikos — amid "the rip-roaring bull market" of the time — Chanos's business partner declared that he wasn't comfortable with the pure short selling side of the business. He said his accountant had advised him to sell back his stake to Chanos for a nominal amount of $1. "And I paid him right there on the spot out of my wallet," says Chanos. "It was the greatest trade I think I ever did," he adds with a chuckle.

Chanos has put the remains of his salad to one side to make way for the steak. I'm delighted by my main course: deep red toro tuna carpaccio, garnished with avocado mousse.

My guest has one of the best track records in the hedge fund industry. The Kynikos Capital Partners fund, a long/short equity strategy, has gained 22 per cent a year on average over the past 35 years — double that of the S&P 500 index. In the same period, against the backdrop of rising equity markets, its US short-only Ursus strategy — named after the Latin for "bear" — has lost 2 per cent a year.

Rise of Kynikos

Rebased, Sep 1985 = 100 (000s)



Sources: Kynikos Associates, Refinitiv
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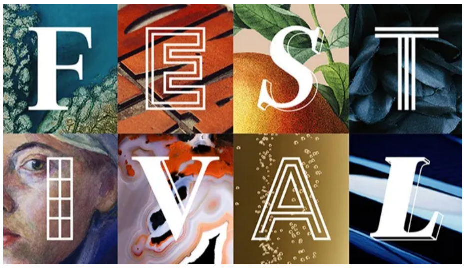
The past decade has been a difficult one for short-sellers in general, as trillions of dollars of central bank stimulus have lifted prices of assets indiscriminately across the board. How do you trade that? "Very carefully and painfully," he says.

Fundraising has been tough. Kynikos's assets peaked at around $7bn after 2008, when short-only Ursus gained 44 per cent, net of fees. They have slumped to $1.5bn since then. This year Chanos sold a minority stake in the management company to boutique investment firm Conlon & Co and the family office of Richard M Daley, former mayor of Chicago.

Prolonged periods of quantitative easing — most recently to ease the economic pain of the coronavirus crisis — is "adding to inequality" by benefiting the people who own financial assets, says Chanos. He believes that the Federal Reserve ought to cut credit card rates for consumers, which are still 15-18 per cent in the US, and sees a potential political backlash against the central banks for their part in how "the rich have gotten much richer and the vast majority of people have not".

FTWeekend Festival



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Political risk is one of the reasons that Chanos is shorting gig economy companies such as ride-hailing apps Uber and Lyft and online food-delivery platforms Grubhub and Just Eat Takeaway. Not only are they losing money, but he believes that there is going to be a greater political focus on low-wage workers, which poses an existential threat to their business models.

Chanos sits on the finance committee of US presidential hopeful Joe Biden, who is supporting a new California law to strengthen legal protections for gig economy workers. A Biden administration raises the prospect of higher taxes. "I think it's fair that rates of taxation on capital probably should go up, relative to rates of taxation on earned income. I know that makes me a communist on Wall Street but I've always felt that."

Chanos declines a second glass of wine, joking that "I don't want to be drunk for this." Defeated by his huge steak and salad, he asks the waiter to put them in a doggy bag. On my encouragement, he decides to be a good sport and orders the "decadent" fried Oreos that the restaurant is famous for. My own dessert is a coconut choc ice.

I return to the subject of Tesla, whose shares have surged around six-fold in the five years since Chanos began shorting the company. What is going on here? "I think Elon Musk has personified the hopes and dreams of this bull market," he says, setting out his bear case against Tesla, which he sees as unprofitable, highly leveraged and facing increasing competition. Tesla "burnishes its results through aggressive accounting", in his view. He also describes it as "a culture of deception" because it is selling self-driving to consumers, which as yet "doesn't exist".

What, I ask, is Chanos's main motivation: to be rich or to be right?

"I want to do this until they pull me out of the seat," he replies. When Wirecard filed for insolvency, there was "an electricity" that ran through Kynikos. "That keeps you going." And so, he says, does his belief that "this market is setting up to be one of the great short opportunities of all time".

"Trouble's coming, I don't know when, but it's coming."

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