Institutional Investor's alpha

Greg Lippmann's LibreMax Moves Beyond Mortgages

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The former Deutsche bank trader, who shot to fame with his portrayal in The Big Short, has built his firm to exploit the entire structured-credit universe.

LibreMax Capital founder Greg Lippman

Back in 2010, when Greg Lippmann launched his hedge fund firm, New York-based LibreMax Capital, curious investors lined up to get a look at the guy renowned for his prescient oversize bet against subprime residential mortgage securities before the collapse. Popular author Michael Lewis made Lippmann famous by depicting him in The Big Short as a somewhat smarmy and full-of-himself Wall Street bond trader with foresight and a nose for profit. The subprime short made a $2 billion killing for Lippmann's bosses at Deutsche Bank and earned him a hefty bonus. What hedge fund investors found at LibreMax, however, was a man who appears only marginally like the character in the Lewis book. In person Lippmann is an intensely serious investment manager with little use for social niceties (his directness can come across as abrupt), and he retains a consuming obsession with the obscure

intricacies of structured credit. In short order, investors began showering Lippmann with money to invest through his new hedge fund at a time when many other start-ups were starved for new capital. He launched with $400 million and quickly passed $1 billion. Today, LibreMax manages $2.8 billion and continues to attract new investment dollars.

"To go from zero to nearly $3 billion in this market is nothing to scoff at," says one fund-of-funds manager who is familiar with LibreMax and Lippmann. "He has had a great launch."

Now his challenge is to prove that he is more than just a souped-up trader in subprime bonds — that he can manage a large hedge fund and consistently find opportunity beyond the mortgage bond market over an extended period of time and in different market situations. Although Lippmann hasn't discovered another bonanza like the subprime short, his initial results are promising: He has been churning out a steady stream of profitable bets without straying from his specialty of structured credit.

The firm's flagship fund, LibreMax Partners, produced an annualized return of 12.2 percent (exactly the return Lippmann says he aims for) from its inception in 2010 through the end of October, with a Sharpe ratio of 2.65. The fund returned 20.4 percent in 2012 and was up an additional 11.02 percent through October of this year. By comparison, the HFRI fixed income asset-backed hedge fund index was up 7.61 percent this year through October.

Though he initially put about two thirds of his LibreMax capital into subprime at an opportune moment, Lippmann has since branched out to invest in a number of other structured-credit products. Lately, his investment mix is about 30 percent subprime, an equal amount in commercial-mortgage-backed securities (CMBSs), about 19 percent in consumer asset-backed securities (ABSs) and the rest spread among other nonagency mortgage bonds, collateralized loan obligations (CLOs) and collateralized debt obligations (CDOs).

LibreMax finds and executes its deals using the research-driven system Lippmann has installed at the firm; this reflects his dedication to data mining and analysis as the source of trading ideas — a process he developed at Deutsche Bank.

"There is a lack of price transparency in the mortgage market and for securitized products broadly," Lippmann says. "So research is critical to suss out which securities we should study further. We have a quantitative model for every asset class we invest in. We use the models to slice and dice loans. Then we compare the valuations ourselves."

The LibreMax investment team consists of specialists in each product the firm targets. The various product leaders strive to keep up with what is for sale at any given moment in each area. Things that look interesting — say, bonds trading at a discount inside a structured security — are screened and

evaluated using the firm's custom-designed computer models, which are fueled with voluminous third-party data on things like loan defaults, prepayments and borrower profiles. By the time a trade is made, LibreMax has worked up both a history of the bond and the underlying loans and borrowers as well as predictive models on how they may behave in the future.

LibreMax is not alone in using sophisticated models to evaluate trading opportunities. The trick is figuring out which trading opportunities to pursue and how aggressively to go after them. That's where the human element comes into play, and where Lippmann's instincts are key.

Each week LibreMax holds an investment committee meeting that includes the heads of each product group, Lippmann and other top executives. Ideas are tossed out and debated. Lippmann has the final say on which ones to pursue. What comes out of those meetings often is an original approach to an investment, such as a trade last year involving student loans — a now-hot area that LibreMax got to before it became fashionable.

Discovering opportunities that others may miss or fail to capitalize on and figuring out how to exploit them — and overcome any resistance — is a Lippmann hallmark. At Deutsche Bank he had to push his famed subprime short through an organization heavily involved in the other side of the trade.

"I think being able to identify that trade was a contrarian call," says Thomas Williams of Pine Grove Asset Management, a Summit, New Jersey-based fund-of-funds firm that has placed money with LibreMax. "Going against the grain in that climate tells you something. It was probably not wildly popular. If at first he can't get in the door, he crawls in the window."

But that contrarian streak had a downside when LibreMax was getting off the ground. Would-be investors wanted to see if Lippmann lived up to his reputation for being personally difficult and confrontational, and whether those traits might pose a problem for a hedge fund manager.

The hard edge that Lippmann presents to the world was certainly in evidence in The Big Short. In one scene an unnamed co-worker of Lippmann's at Deutsche Bank describes him as "the asshole known as Greg Lippmann," adding that Lippmann "took everything too far." Lippmann says the portrait of him in the book is clearly a caricature, which he doesn't spend time worrying about.

Those who know Lippmann note that although he can be overly direct and challenging, his manner reflects intellectual rigor and curiosity more than mean-spiritedness. He is invariably described as "quirky," someone who lacks the moderating filter most people use in casual conversation.

"He is very serious about everything he does," says Paul Yablon, a senior portfolio manager at Moore Capital Management who is a friend and professional colleague of Lippmann's as well as an investor in

LibreMax. "He is not your typical company man at all, not a politician. He sticks to the facts and lets the facts speak for themselves in a reasonably unbiased, objective fashion. He is a guy who has an enormous amount of intellectual energy."

In person, Lippmann comes across as more bland than brash. As one investor in LibreMax notes, if Lippmann were really as cocky and abrasive as he has been portrayed, his direct co-workers at Deutsche Bank would have been glad to be rid of him. Instead, they followed him to his new firm and have not left, making up the key management team at LibreMax.

"Leadership is the ability to make talented people want to work with you," says a senior banker who has known and worked with Lippmann. "Greg has that. You can see it in the people who elected to join him, who left secure and successful jobs."

One of those people is Fred Brettschneider, co-founder and president of LibreMax, and the second-largest shareholder behind Lippmann. Brettschneider was previously Deutsche Bank's head of global markets for the Americas, a division that had about 2,000 people, including Lippmann. In effect, Brettschneider left a job where he was over Lippmann to join LibreMax and work under him. Before moving to Deutsche Bank in 2000, Brettschneider and Lippmann both worked at Credit Suisse. A Canadian, Brettschneider holds a bachelor's degree from the University of Toronto, an MBA from York University and a master's in economics from the London School of Economics and Political Science.

Another Deutsche Bank employee who opted to go with Lippmann is Eugene Xu, a co-founder of LibreMax and head of investing technology. Xu oversaw quantitative modeling on Lippmann's team at Deutsche; he's a mathematics whiz who grew up in China and holds undergraduate and master's degrees in math from Fudan University in Shanghai and a Ph.D. from the University of California, Los Angeles. Before Deutsche Bank he did mortgage-backed-securities research and analysis for Smith Barney, Chase Securities and Credit Suisse.

Jordan Milman, head of trading at Deutsche, also made the move, as the fourth and final LibreMax co-founder. He previously ran subprime and nonagency residential-mortage-backed-securities trading under Lippmann at Deutsche Bank, which he joined in 2000 out of college. Like Lippmann, Milman holds a bachelor's degree in economics from the University of Pennsylvania. (The name LibreMax is taken from the first letters of the last names of the firm's four founders.)

Brettschneider proved to be a key member of the new firm. His broad experience managing a large division within a big bank complemented the trading smarts of Lippmann. Brian Walsh, co-founder of Saguenay Strathmore Capital, a fund-of-funds firm based in Purchase, New York, says he was initially wary of the firm because of what he'd read about Lippmann in the Lewis book. But he agreed to take a meeting, partly as a courtesy to Brettschneider, a fellow Canadian. Walsh walked away from the

meeting so impressed with Brettschneider and LibreMax that he changed his mind. He has been happily invested ever since.

FOR LIPPMAN, 44, understanding and trading mortgage-backed securities and other structured products has been his life's work, starting with his first job out of college.

He grew up in Westchester County, New York. His father owned and managed real estate. Lippmann was captain of the rugby team at Penn, and after his graduation in 1991, he found himself back home, trying desperately to land a job. He put out feelers in real estate and finance, but the job market was tight for people who only had undergraduate degrees. When he finally got an offer from Credit Suisse, he jumped, as much to get out of his parents' house as for the quality of the position. As it turned out, his first job would launch him into his specialty.

Data tracking and modeling of mortgage-backed securities was not yet very sophisticated, and investment houses had to devise their own methods of collecting and analyzing data. Lippmann's job as an analyst was menial: to manually update the in-house database with information on mortgage loans. From there he moved on to a similar data-support role for traders, writing simple computer code that would provide information, such as amortization data, on loans. The job required reading mortgage and bond legal documents about such details as prepayments and defaults, then turning that information into computer code so it could be easily accessed by traders.

When he started, Lippmann knew almost nothing about computers or mortgage-backed securities. Over the next 18 months, he learned a little more about computers and a lot more about MBSs. He not only studied the documents, he watched the traders as well.

"I was becoming an expert on understanding how the structure works," Lippmann recalls. "I was gaining an understanding of the issues surrounding the quality of loans. And I was gaining an understanding of trading and markets. What is the relative value between two bonds? How do deals work? What makes one deal better or worse than another deal?"

Always a feisty competitor, Lippmann wanted to know how his productivity compared with that of other coders in his group. He found a way to look up how many coding requests had been completed by each member of his group. Lippmann says he completed more than the other five members of the group combined.

"My long-term goal was not to remain in that group," he says. "I had the foresight to see that trading was a more interesting job, with fewer hours and more pay. My goal every day was to have someone say, ‘This guy is smart and works really hard.' "

It happened just as he'd hoped. He was promoted to a junior trading slot in mortgage bonds, where he immediately discovered his calling. Within a year he was given a small amount of capital to manage.

Lippmann was struck by how many of those he encountered suffered from analysis paralysis: an inability to know when to stop analyzing and execute the trade. He is seemingly immune to that malady. He digests information quickly, sizes up the odds and acts. He firmly believes that what allows him to trade successfully is a sense of when and where to strike. This is informed by analysis but ultimately requires intuition and nerve. "I don't believe you can teach intuition or common sense," he says. "It is just a feel for when you should be aggressive. It came easy to me."

As Lippmann continued to trade and gain experience, he developed a knack for spotting overlooked anomalies and opportunities in the MBS space. And he wasn't afraid to move against the conventional wisdom in structuring his trades if he was convinced he was right and the rest of the world was wrong.

One such case involved mortgage bonds he bought in 1997. At the time, rating agencies had slightly altered the criteria for mortgage bonds: Bonds issued in 1997 that got a rating of triple-B or better would likely have been ranked much lower under the earlier standards; conversely, older bonds that carried low ratings might have had underlying characteristics that would have earned them higher ratings under the 1997 standards. But no one bothered to go back and have those older-vintage bonds rerated or repackaged under the new standards.

What brought this into focus for Lippmann was a batch of mortgage bonds issued in 1993 that were rated B and trading at a deep discount to par (100), in the low 60s. When he examined the underlying characteristics of those bonds, he determined that their quality was as good as that of similar bonds issued in 1997 under the new standards. Instead of carrying a B rating, the new bonds came in between triple-B and A. But no one was willing to reexamine those 1993-vintage bonds, so they languished under a lower rating.

Lippmann thought to himself, "What if I bought a whole bunch of those 1993 bonds, repackaged them into a new mortgage-backed security and then asked Moody's to rate the new security? Wouldn't Moody's have to rate under the new guidelines, which would yield a much higher rating and thus a much greater value?"

He began buying those 1993-vintage bonds, which holders were happy to sell. Once he had amassed a pool of the bonds, he repackaged them and paid Moody's Investors Service a rating fee to reexamine them. The agency came back with the conclusion Lippmann hoped for: His new package of old bonds was an A-rated security.

With that new rating Lippmann was able to resell bonds he bought in the 60s for prices in the 80s. Ultimately, investors who purchased those bonds from Lippmann saw them rise in value to par. The deal took Lippmann more than half a year of work — an eternity in the bond-trading world at the time, when banks sought to quickly turn over bonds rather than hold them for a scheme like the one he had proposed. Lippmann not only had to execute the deal adroitly but also push it through Credit Suisse's in-house bureaucracy, which resisted the idea.

That pattern — of making contrary bets, using unorthodox methods and overcoming bureaucratic opposition — would pop up again in a few years in Lippmann's most famous trade, the subprime short at Deutsche Bank, which he joined in 2000.

By 2005, with the MBS market running full-throttle, some Wall Street wags began to question the underlying assumptions about the housing market and the strength of mortgage-backed securities, particularly those that were subprime. Lippmann was one of the earliest members of that camp. He put Xu to work running scenarios through his models. What emerged was a stark portrait of subprime securities. The analysis showed that home mortgage borrowers were so tied to rapidly escalating prices and the ability to refinance or flip homes that housing values didn't need to fall to disrupt the mortgage market but simply to stop rising as quickly; that change would be enough to push borrowers into default in droves. In short, it wouldn't take much for the subprime market to collapse.

Lippmann began betting against subprime in 2005 by buying insurance on those bonds with cheap credit default swaps and amassing a position so large that when the market did collapse, in 2007, he earned his giant payoff. He was still in his 30s and had suddenly become a legend on Wall Street, his reputation soon to be immortalized in The Big Short. He had a catchphrase attributed to him in the book — "I'm short your house!" — printed on T-shirts that he handed out.

He stayed with Deutsche Bank through the economic downturn but began looking for an opportunity to set out on his own. By 2010 subprime bonds were recovering and Lippmann saw a chance to cash in by going long the very bonds he had shorted. He also figured it could be the catalyst he needed to launch his hedge fund.

"I felt that those assets had collapsed to a level that they were attractive as an intermediate play," Lippmann says. "I felt it was the time to launch a fund when you had the wind at your back. And the notoriety I had gotten would make it somewhat easier to garner interest."

Brettschneider says he and Lippmann were determined to build a fund worthy of institutional investment. This meant starting out not just with trading capability but also with risk and back-office functions that would impress pension funds and foundations. "When we launched, we had 15 people, which was more than typical for a launch of our size," Brettschneider says. "We thought if we had a

robust infrastructure it would attract capital, and that's how it's worked out. We feel like we have always been a step ahead in terms of infrastructure and risk management." LibreMax currently has a staff of about 35 operating out of its Midtown Manhattan office.

The first big break came quickly, shortly after the October 2010 launch. As a result of new post-economic-collapse banking rules that raised bank reserve capital levels and added restrictions on proprietary trading, banks began liquidating large pools of securities. In December 2010 one of the banks — LibreMax won't say which one — decided to unload a stash of nonagency subprime and Alt-A mortgage-backed securities. The Lippmann team dove in, using Xu's models to run background checks on key aspects of the underlying loans, such as default and prepayment rates.

"We had all hands on deck," Milman says. "We were able to run our analysis and to realize that the value was there faster than anyone else. So we were able to act quickly."

LibreMax made an offer to buy the package while competitors were still analyzing it. The offer was quickly accepted. LibreMax bought securities at 20 to 30 cents on the dollar and promptly resold the first batch at about 33 cents, earning about $3 million. It resold much of the rest over the next few months at between 40 and 50 cents.

From there the firm moved into the other structured products that are now part of its mix. One recent example is the student loan trade from last year. LibreMax began focusing on an overlooked asset-backed security built of student loans whose bonds were selling at a discount — as little as 50 cents on the dollar for subordinate bonds. In its analysis LibreMax determined that the underlying loans were of good enough quality that they were worth more as a whole loan pool than the individual pieces in the structure.

The question was how to extract that extra value. The intriguing thing about this particular security was that it was relatively small, with fewer tranches than most other structured securities. Lippmann and his team decided it might be possible to buy up every existing bond in the package at a reasonable price. Then, as the sole owner of the security, LibreMax could collapse the entire structure and free up the loans, which could be sold for repackaging as a new structured product or to a loan servicer.

LibreMax started quietly buying the bonds in March 2012 and ultimately spent about $180 million to acquire all of them. Lippmann and his team then unwound the security and sold the entire pool of loans that November to a loan servicing company for $195 million, earning a profit of about $15 million. LibreMax used leverage to juice returns, so it only invested about $50 million of its own money and borrowed the rest. The net return for LibreMax: about 30 percent.

Although Lippmann has moved beyond mortgages, as the student loan trade shows, he has no intention of venturing outside structured credit.

"We are very focused on having no style drift," he says. "You won't find us in unsecured credit, corporate credit, equities. In 2011 a lot of funds got involved in agency mortgages. We are not experts in agency mortgages, so we did not get involved in agency mortgages."

Where you will find Lippmann for the foreseeable future is parked at a workstation on the trading floor of his firm, peering into one or more of the multiple screens facing him as he prowls the structured-credit universe in search of hidden opportunities. Lippmann says that what sets him apart is not just the research and analysis that his team produces, which underlie his trades, but also his ability to spot opportunities that others overlook. He says, "I try to focus on things others don't see."

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