# THE SAGES

## WARREN BUFFETT, GEORGE SOROS, PAUL VOLCKER, AND THE MAELSTROM OF MARKETS

CHARLES R. MORRIS

AUTHOR OF THE *NEW YORK TIMES* BESTSELLER *THE TRILLION DOLLAR MELTDOWN*

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THE VIOLENT FINANCIAL DISRUPTIONS of the past several years have toppled nearly all of the lords of Wall Street, the global financial regulators, and the economic gurus. While true believers of free-market fundamentalism oversaw the great asset bubble of 1995–2005, there were voices that warned of economic collapse. Among them, three men have stood out as beacons of sound judgment and wisdom: Warren Buffett, George Soros, and Paul Volcker. Though their experiences and styles vary—Buffett is the canny stock market investor; Soros is the reader of shifting global tides in trade and currencies; and Volcker is the regulator and governor, sheriff and clean-up crew—they have very much in common.

All three men have more than fifty years of deep involvement in markets. All are skeptical of Wall Street frenzies. All have a profound mistrust of nostrums and academic certitudes. They have seen too many cycles of herd-driven, emotion-riding booms and busts for their views to remain hostage to the sweeping and simplistic assumptions of "efficient-markets" models.

The careers of these three men are, to a large degree, stories of success in volatile times. With the benefit of his own deep understanding of markets and finance, bestselling author Charles R. Morris brilliantly analyzes their records. In eminently readable prose, he distills their distinctive strategies, their wisdom, and their experience—and argues for the importance of humility and common sense in navigating the current global economic crisis.

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Charles R. Morris

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# INTRODUCTION

America and the world are trapped in the deepest, longest recession in postwar history. That by itself is good reason to reflect on the careers of Warren Buffet, George Soros, and Paul Volcker. Buffett and Soros are among history's most successful investors, with a record of making money in good times and bad. Volcker is a regulator, one of the greatest of American civil servants, whose entire career has been defined by crises. And all three saw this one coming long ago.

That last fact is worth dwelling on. The *Wall Street Journal* ranked the nation's leading economic forecasters on the accuracy of their 2008 economic forecasts, using two key data points: 2007–2008 fourth-quarter to fourth-quarter real GDP growth, and 2008's ending unemployment rate.[1] There are fifty-one economists in the sample. The actual fourth-quarter to fourth-quarter real GDP change was -0.8 percent. Only Goldman Sachs's Jan Hatzius, who forecasted -0.4 percent—which, given the margin of error in the data, counts as a direct hit—had the right sign of the change. All the others expected positive real growth, with a mean estimate of 2 percent, and the top estimate a giddy 5 percent. On unemployment, all of the forecasters expected a much better outcome than the actual 6.9 percent. The closest any of them came to the real number was 6.2 percent, while the mean forecast was a rosy 5.2 percent, and the cheeriest, 4.3 percent.



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Of the 102 separate forecasts, then, for both unemployment and GDP, 101 of them are wrong *in the same direction*. Note that the forecasts were made in late 2007 or early 2008, when the credit crunch had been dominating headlines for months, and the government was taking extraordinary measures to blunt its effects. And these are not casual forecasts. Every economist represents a major bank or forecasting service that competes for customers in part by the excellence of its research and the accuracy of its forecasts, and all have made large investments in forecasting models and economic data bases. But as a group, they didn't understand what was going on, or have even an inkling of its global effects.

These three greybeards, however—Volcker is eighty-one; Buffett and Soros are both seventy-eight—did understand, and said so. Soros started warning about the gathering "superbubble" in the late 1990s. Buffett was sounding the alarm about the excesses of financial engineering just a few years later. Volcker's worries are long-standing, but he did not publicize them while his successor as Federal Reserve chairman, Alan Greenspan, was still in office.

On the surface, they are very different men. Buffett and Soros have almost diametrically opposed investment styles. Buffett is the classic hyperanalytic value-seeker. He does deep research, buys relatively infrequently, and typically holds his positions for many years. Soros is the global predator, with feline sensitivity to quivers of disharmony in the economic flux. He moves in and out of positions quickly and omnivorously—commodities, currencies, stocks, bonds, wherever there is opportunity.

Volcker has never been a professional investor, but he deserves primary credit for the signal macroeconomic achievement of the past thirty years—slaying the inflation monster that was engulfing

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the American economy at the end of the 1970s. The stable global economic growth of the 1980s and 1990s was grounded on Volcker's conquest of inflation.

But their commonalities transcend the obvious differences. All three embody what the Romans called "virtue"—steadfastness, consistency, devotion to principle. J. P. Morgan called it "character." Principled consistency is not the same as blind adherence to dogma; it implies, rather, weighing and judgment and common sense. For Buffett and Soros, it is evidenced by their disciplined approaches to investing, their readiness to admit mistakes, their imperviousness to febrile enthusiasms. For Volcker, it is the granitic integrity that has made him the first person to call when authorities need an unflinching view on a possible scandal.

Both Buffett's and Volcker's prestige is such that their mere appearance on a platform with then president-elect Barack Obama, presenting his economic recovery plans, caused a jaded world to breathe a sigh of relief. Soros was also an early Obama supporter and behind-the-scenes adviser.

During their active careers, all three have seen the United States twice reign as global hyperpower, and twice fall from grace amid international overreaching and economic mismanagement.

The Great Inflation of 1965–1980 ended the era of America's near-total dominance of the post–World War II world. For the first time since the nineteenth century, America became a debtor nation, facing sharp competitive pressure from a revitalized Japan and Germany.

Volcker's victory over inflation vaulted America back into something like its old dominance, riding the crest of a broadly gauged transformation in business and communications technology, until

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the implosion of the great asset bubble of 1995–2005. The vast wealth transfers to China, India, and the resurgent petro-states during the bubble years have left the country wallowing in the deepest debt pit in history.

Significantly, each crisis followed a decade of near-unanimity among professionals on policy rules for managing the national economy. The "Keynesian consensus" was the unassailable doctrine in the run-up to the Great Inflation, much as the theories of the Chicago School "New Classicals" pumped up the great asset bubble.

Living through such violent reversals—and in Buffett's and Soros's case, profiting mightily from them—reinforced all three's deep skepticism of nostrums and academic certitudes. They are respectful of markets, but they know markets can take a long time to get things right. Disparate as Buffett's and Soros's investment styles appear, their core assumption is that markets are frequently wrong. Buffett buys, or invests in, valuable companies, and has almost no interest in the fluctuations of their stock prices. Soros sniffs out incipient bubbles and rides them, confident he can get out before they pop. Volcker, of course, has spent much of his life dealing with the aftermath of markets gone wrong—the breakdown of the gold standard, runaway inflation, the petrodollar bust, S&Ls, and now, as an Obama adviser, the great asset implosion.

In particular, they understand that financial markets relate to the idealized "Market" of theory as the shadows in Plato's cave do to reality. Financial markets are dominated by people investing other people's money, often in contexts where destructive behavior generates great fortunes.

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Consider the ironies of the current economic cycle. Finance gurus, led by Alan Greenspan, convinced of the universal correctness of market outcomes, presided over a virtual withdrawal of financial regulatory oversight. Now, hardly a decade later, the entire banking sector is on its way to being nationalized, along with insurance companies, automobile companies, and possibly much more. CEOs are beating a path to Washington to plead for money and favor. Government economic power is steadily increasing, even as its debt spirals up and the dollar quivers on the edge of the abyss.

For true believers in free-market ideology, it is the worst of all possible worlds—and they brought it on themselves. Greenspan practically wept at the congressional hearing when he conceded that he had never imagined that market professionals could be so reckless and so wrong. And as the *Journal*'s forecasting tabulations suggest, as late as last year, mainstream economists still did not understand what was going on.

That recent history is the best reason for studying Buffett, Soros, and Volcker. The great inflationary episode of the 1970s exposed the deficiencies of a too-eager espousal of Keynesianism. The current crisis is a painful lesson in the dangers of a blind adherence to market dogmatism. The real world of markets and governments is one where fallible humans act on dimly perceived trends—or, in Soros's words, in a state of "radical uncertainty"—and frequently get it disastrously wrong. The careers of these three are stories of success under conditions of uncertainty.

This book comprises three extended biographical essays, one on each of the main protagonists, plus a concluding essay pulling

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together their histories and insights in light of the current crisis. The biographical essays make no pretense to full-blown biography; rather, they are offered as compact narratives of the "Sages'" careers as market players and influencers, with enough personal information to identify the predispositions they brought to those roles.

I got to know both Soros and Volcker during previous writing projects, and they were fully cooperative with this one. I caught Buffett at a time when he had declared a temporary interview blackout, but there is a vast amount of material—both by and about him—which was more than enough for my purposes. What I most enjoyed from an extended period learning about the three Sages and delving into their histories was that it confirmed that even today, in an age ruled by dogmatisms as rigid as those of medieval Spain, common sense, good judgment, mature experience, and humility in the face of what one does not know is still a path to great success.

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# SOROS

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George Soros, by any measure, is one of the half dozen or so of the world's most successful investors. For the thirty years from 1969 through 2000, when he retired from active fund management, Soros's Quantum Fund returned investors an average of 31 percent a year. Ten thousand dollars invested with Soros in 1969 would have ballooned to $43 million by 2000, a good three decades' work by any standard.

Soros is one of the diaspora of brilliant Hungarian Jews that has enriched the West since the rise of Nazism and Soviet Communism. His company includes the great mathematician and computer pioneer John von Neumann; the atomic scientists Edward Teller and Leo Szilard; cultural figures like the novelist Arthur Koestler (*Darkness at Noon*) and the film director Michael Curtiz (*Casablanca*); and Soros's younger contemporary, former Intel CEO Andrew Grove.

Born in Budapest in 1930, Soros grew up in a cultured but not wealthy family. His father, Tivadar, was an attorney who, as an Austro-Hungarian officer in World War II, was captured by the Russians and endured a long stint in a POW camp before engineering a group escape and a circuitous flight back to Hungary. Although he lacked ambition and was a bit of an operator, Tivadar was greatly admired by young George. His skills in flimflam, indeed, may have been ideal for surviving the Nazi occupation. Some 400,000 Jews were "deported" from Hungary by the Nazis, but Tivadar brought his family—his wife, Elizabeth, and his two sons, George and Paul—safely through the war by dint of bribes,



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false identities, and multiple hiding places. For fourteen-year-old George, the experience was thrilling—like *Raiders of the Lost Ark*, he later recalled. Conceivably, his youthful experience running risks in the face of a menace like the Nazis contributed to his legendary cool in financial dealings.[1]

During the unsettled interregnum between the Nazi withdrawal and the Soviet takeover of Hungary, George at seventeen decided to take his chances in London. His father covered his travel, and he had an additional small sum from a relative. He supported himself with odd jobs—swimming pool attendant, waiter, painter, even farmhand—while reading voraciously and waiting for admission to the London School of Economics. His reading interests centered on philosophy and about 1951, he discovered, and was deeply impressed by, Karl Popper's *The Open Society and Its Enemies*. Soros later befriended Popper and has regarded him as his philosophical lodestone ever since.

Popper was primarily a philosopher of science, analyzing issues like the meaning and truth of statements of physics. His *Open Society*, published in 1945, was a devastating critique of the methods of social sciences, with a special focus on how social science had been dragooned into the service of totalitarianism. Popper's special *bêtes noires* were Plato, Hegel, and Marx, all of whom imagined some form of inexorably unfolding historical progression toward (or in Plato's case, back to) an ideal society. In Popper's view, such constructs were not only nonsensical, but stifled free inquiry and fostered tyranny. The proposed antidote was his famous requirement of falsifiability as a test of meaningfulness. Since the sweeping claims of philosophy, religion, or politics were generally unfalsifiable, he contended, they lacked meaningful content.

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Popper believed that while there was such a thing as objective "truth," human knowledge was always provisional. No matter how useful or long-standing, any falsifiable belief was always at the mercy of some new critical experiment. The best that humans could hope for was to advance the state of knowledge by the conscious, critical application of scientific method, producing ever-revised approximations to the truth.[2]

Surprisingly, given his taste for philosophy, and his intelligence and wide reading, Soros was only an indifferent student, and by his own report was poor at math. Although he had hoped to become a philosophy teacher, his grades were too low to land a teaching assistantship. After graduation, Soros finally caught on as a trainee at a London securities firm in 1953 and became an arbitrage trader—exploiting temporary price misalignments among similar securities. In 1956, frustrated at the stodginess of London's "City" firms, he emigrated to New York.

His timing was perfect. Europe was in full recovery mode, the original six-nation Common Market was moving from dream to reality, and big companies, especially in Germany, were rapidly making up commercial ground lost during the war. Although only in his late twenties, Soros was a natural cosmopolite, multilingual, and with a much better grasp of European investment opportunities than most American brokers. By 1967, he was research director of a substantial firm with a big international trading book and increasingly thinking of managing portfolios. His firm encouraged him, and, after a trial with a model portfolio, he created the Eagle Fund, a mutual fund, with $3 million of initial capital. It was very successful, and in 1969, the firm created the Double Eagle Fund with $4 million in capital. This was a hedge fund, with few of the

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limitations that constrained mutual fund managers, and Soros was on his way.

Despite his burgeoning financial career, Soros never relinquished his dream of succeeding as a philosopher. As it turned out, for the next quarter century, finance and economics were dominated by ruling ideologies that looked to Soros much like the political paradigms that Popper had attacked in *Open Society*. With a native skepticism sharpened by his Popperist intellectual apparatus, Soros evolved an investment strategy akin to that of an atheist coolly fleecing the natives in a land of religious idiots.

## THE SHIFTING RELIGIONS OF ECONOMICS

The Kennedy administration marked the first broad ascension of academic economists to dominant influence in economic policy making. (The great influence of John Maynard Keynes in establishing the postwar monetary settlements was something of a special case.) At least a half-dozen star economists, all "neo-Keynesians," four of them from Harvard, had prominent seats in Kennedy's policy discussions.* The key campaign promise was to "get the country moving again," or to accelerate economic growth. Kennedy's own grasp of economics was fragile, so he looked to the economists to make it happen.

* The most influential were: Walter Heller from the University of Minnesota, James Tobin from Yale, and Kermit Gordon from Harvard, all of whom sat on the Council of Economic Advisers (Heller was chair); the remaining three also came from Harvard: David Bell, budget director; Seymour Harris, special adviser to the Treasury; and John Kenneth Galbraith, ambassador to India and all-around gadfly.

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The experiment seemed to be an amazing success. *Time* magazine picked Keynes for its 1965 "Man of the Year" cover, and its lead story hailed the "new economics." Kennedy's economists, it gushed, "skillfully applied Keynes's ideas—together with a number of their own invention—to lift the nation through the fifth, and best, consecutive year of the most sizable, prolonged, and widely distributed prosperity in history."[3] It was an illusion, of course, as was demonstrated by the precipitate unraveling of the neo-Keynesian consensus during the inflationary debacle of the 1970s.

The intellectual vacuum left by the fall of Keynesianism was immediately filled by the monetarist free-market liberalism taught by Milton Friedman and his intellectual heirs at the University of Chicago. The interventionist bias of the Keynesians, they argued, merely interfered with the natural tendency of markets to reach optimum outcomes on their own. Their prescription was to reduce or eliminate market regulation and taxes on capital, restrict the size of government, and confine its financial role to providing steady, formula-based monetary growth.

Much as in 1965, the advent of the new orthodoxy coincided with a sharp economic revival—the 1980s Reagan recovery—which the monetarists took as full confirmation of their theories. But dreams of a new golden age of markets dissolved in the worldwide credit crunch of the 2000s. Free-market ideology, it turns out, was just cover for the extraction of great fortunes by an avaricious new class of financial operators running Ponzi games in housing and other highly leveraged debt. The wreckage of institutions and assets will take years to repair.

At bottom, the difference between neo-Keynesians and the monetarists is small. They are both built on highly mathematized

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