Stanley Druckenmiller Lost Tree Club 1-18-15

D = Don; SR = Sam Reeves; KL = Ken Langone;

MS = male speaker

Chapter 1

D: Good evening, ladies and gentlemen, fellow members, and guests. I'm Don [unint.], and Joyce and I are chairing the 2015 version of the forum, and we're so happy to have such a great turnout. We're delighted to have Stan Druckenmiller and his wife, Fiona here this evening. And I'm going to just give you a little bit of oversight of two gentlemen who are great sponsors of the forum, Sam Reeves and Ken Langone. They're co-sponsors of Stanley Druckenmiller, and they've been just terrific through the years.

Let me just tell you a little bit about Sam. Most of you know both of them quite well. They're long-term members of our club, and they're really accomplished so much in their lifetime - lifetimes I should say. Sam, I sort of think of him as the king of cotton. Dunavant Enterprises, Inc., a cotton merchant, probably the largest in the world, Sam is a partner, president, co-chairman. He actually retired from

that in 1995 and then he started Pinnacle Trading International of which he was president and CEO.

His board memberships, I'll just mention a few: two Morgan Stanley Funds; Tiger Management Corp., I understand that he was one of the early investors with Julian Robertson; Pacific Gas and Electric and then other things, a member of the board of trustees of the Fuller Theological Seminary; chairman of the board of the Saint Agnes Medical Center in Fresno, California; received the highest honor from their Chamber of Commerce and just an all-around terrific guy. And the runner-up in the member/member that ended yesterday. How about that? He has time for golf too. Well, he and Betsy support so many charities that if I started to name them, we'd be here for a long time, but everything from hospitals, churches, the University of North Carolina. Just absolutely outstanding.

Now, last week I introduced Ken Langone, and of course he was the sponsor of Dr. John Damry [ph.] - Hamre, excuse me, who is president of CSIS, which is

a Washington think tank, and he really was a spellbinder. He was absolutely terrific. And Ken continues to be a great supporter. I got to just tell you - again, I'm a little bit repetitive because I talked about it. He not only is a good source of great sponsors, but he has spoken himself, and he first told us a story of EDS, Electronic Data Systems, the Ross Perot company, which he was instrumental in bringing public. And then, of course the Home Depot story. He's co-founder with Bernie Marcus and Arthur Blank, and that's just an absolutely phenomenal story.

Ken gives us his overviews on economics and business with CNBC, and he does so many things. He's won so many awards and the charities are again too numerous to mention. He still runs Invamed, an investment banking firm, and he's the prime mover and the inspiration for the NYU Langone Medical Center. He's the driving force, and he's pursuing excellency all the time.

So, you know quite a bit about these two men, but there's one thing you don't know about Ken Langone, and that is that I have the unique situation of having gotten him involved in a real estate investment which he subsequently called the worst bleeping investment I ever made in my life. I figured enough years have gone by where he wouldn't be too troubled by me bringing this up, but in any event, nobody's perfect, right. At this point I want to bring up Sam, Sam Reeves to introduce our guest speaker. [applause]

SR: Thank you, Don, and thank you for yours and Joyce's leadership in the forum. And we've had these wonderful speakers and tonight there's no exception. I think tonight is going to be fascinating and thought-provoking as we hear maybe a different slant on investing. We all have savings. We all want to enhance the value of those savings. Thirty to 35 years ago basically it was just a ratio of stocks versus bonds and that would depend on the stock broker. By 1980 when Stan first started in the business, you had different type of strategies. You had the hedge fund strategies that were just coming

on, you had the LBOs, you had private equity. You had all the different strategies coming on. Then you had Volcker battling against inflation. Won that. Then you had the Reagan supply-side. So, that created tremendous tailwinds for investing. Then you had the technology revolution, you had the frontier markets, your emerging markets, all these things, the currently fluctuation driven by a lot of the central banks being on steroids, if you would.

All of these developments created a chance for massive gains and massive losses. And with increased complexity of all of this we all need help in investing. We need money managers, but I think you need more than that. You need prescient practitioners, and we're going to talk about that a little bit and rightfully so because $1,000 invested 30 years ago in S&P - S&P's compounded about 11, a little over 11.3, something like that. Your $1,000 would be $27,000 before taxes today, 25 up years, 5 down years, which is also important.

Probably the poster child of investors, Warren Buffett in the last 30 years has compounded just under 20 percent. A thousand dollars 30 years ago would be $177,000 today, 24 up years and six down years of which three of the six were more than 20 percent, and that's going to be interesting when we get to that.

The pundit that you see on TV all the time, the egotistical Bill Gross who you would think is the greatest investor there's ever been, he compounded the last 30 years before he got fired at 7.8 percent, and $1,000 would be $10,000. In the process he's made a couple billion dollars.

So, our speaker tonight if he invested $1,000 30 years ago, today it would be $2.6 million before taxes and after taxes, because people say hedge funds don't do a very good job, they're not tax efficient, $300,000 still. Thirty years, no losses. Brian and I were talking last night it's hard to do anything for 30 years and not have one losing year. That's a phenomenal thing.

So, I think there's five takeaways from here. Never underestimate the compounding, the power of it; the damage of down years; the impact of taxes; absolute returns. Again you think of relative, growth is all about relative. It's like me comparing myself to Kenny relative. With Kenny, I'm pretty good at playing golf. But in an absolute basis neither one of us is any good at all. So, there's a lot of difference between absolute and relative. So, I'm more in the absolute returns. And then finally you better choose a money manager that is a prescient practitioner.

There's two other things I'd like to highlight about the speaker this evening is that we know that the public record suggests - and it says here in this - the flyer that we had is right here. It says he was the most charitable man in America in 2009. That's half right. Fiona and Stan as a couple were the most charitable and still are probably one of the most charitable couples in America.

And I want to say something else about Fiona because Fiona, many of you don't know, is one of the great money managers at Dreyfus. I used to read about Fiona before I ever met Fiona. And so she was - and then she became a mom, and there's three daughters. Sarah's here now, who's in - sitting there with her dad - in med school now, NYU. Ken, isn't that true, she's there? And then Hannah is at home where Stan would like to be watching the football game. And then Tess is at Brown, who has her own band and travels around, and she's got all these CDs and everything else.

Then also Fiona then became and really has a lot of insight into neuroscience. She and Stan have founded the institute again at NYU that's won many recognitions, et cetera, the Nobel Peace Prize, [unint.], et cetera, et cetera. Amazing things that are going on there. And then to add to that five, years ago started a jewelry boutique I guess you would call it. FD is the name of it, and today it's one of the leading brand names in the world. So, she has customers in Europe, China, India, United States,

et cetera, et cetera. In fact it might be an interesting for Harvard a case study because I think probably what as I look and think about what Fiona does, you have a lot of inequities and all these things. It may be a wonderful case study. You have international things going on, but that's another subject.

But to go back to their charitable things, what very few people know was during this time he's running these funds, he had a fund that very few people knew about that was called No Margin, and this fund was for not-for-profits. No fees, no anything. It was a pure - all the returns went to the not-for-profits. Over $1 billion in this fund, and all of the hot issues - in those days you remember back, some of us are old enough to remember hot issues, those went in. So, these not-for-profits had tremendous upside potential. And that was when I had my friend Ed Hurley [ph.] set me up as a 501(c)(3) so I could be a charitable donation for Druck.

Finally, I think that when Druck closed his fund in 2010, he during these years had been returning profits each year to the investors, and I've never seen or heard of this before, in the way of dividends. And when he closed out in 2010, none of the investors, the hundred investors, had a net - had all the initial investment back. No one had any capital at risk. Everything had come back plus some, plus when he distributed the $14 billion. So, when he retired, these 99 people, including Kenny and I and a bunch of them, we had to go back to work. He retired; the rest of us go back to work.

But it is a fabulous record that I think that Stan - and it is a delight for me to share some of that with you because it's not a well-known record, but it's an envious record and I think historical. So, Stan, share if you can, how did this happen? How did this happen? And then also what do you see going forward? [applause]

SD: Thank you, Sam. I know there are a lot of people in the audience who would like to know what's going on

in the football game. The Seahawks have taken the lead 22 to 19...

Chapter 2

SD: ...with one minute to play. This is a special moment to me. I've never spoken in front of my own community before, and it's particularly special because I get to share the stage with probably the two most important people in terms of influence in my life outside of my family, Sam Reeves and Ken Langone. It's not really an accurate statement because I actually consider both of them part of my family. So, that's a real thrill for me. Sam, with the over-the-top introduction, of course, which I anticipated because it's Sam Reeves.

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 percent 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 thought that every event in the world affects some security price somewhere I just found incredibly intellectually [unint.] to try and figure out what the next puzzle was and what was going to move what. And the fact that I could bet on that interaction, those who know me, I do like to bet. One of the great things of this business, I get to gamble for a living and channel it through the markets instead of illegal activity. That was just sort of nirvana for me that I could constantly be making these bets, watch the market moving, and get my grades in the newspaper every day.

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 mentor 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 into 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 be 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 excites you. And if you look at what excites you and then you look down the road, your record on those particular transactions is far superior to everything else, but the mistake I'd say 98 percent 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 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, too 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.

But before he left, he taught me two things. A, never, ever invest in the present. It doesn't matter what a company's earning, what they have earned. He taught me that you have to visualize the situation 18 months from now, and whatever that is, that's where the price will be, not where it is today. And too many people tend to look at the present, oh this is a great company, they've done this or this central bank is doing all the right things. But you have to look to the future. If you invest in the present, you're going to get run over.

The other thing he taught me is earnings don't move the overall market; it's the Federal Reserve Board. And whatever I do, focus on the central banks and focus on the movement of liquidity, that most people in the market are looking for earnings and

conventional measures. It's liquidity that moves markets.

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 percent. 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 percent of our money in oil stocks and let's put 30 percent 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 percent. 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 percent. 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 percent 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 percent of the capital and put it into 30-year treasury bonds yielding 14 percent, 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 percent. And more importantly, it sort of shaped my philosophy again of you don't need like 15 stocks or this currency or that. If you see it, you got to

go for it because that's a better bet than 90 percent of the other stuff you would add onto it.

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 percent in the bonds, I probably would have put about 150 percent 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; Soros 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 percent 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 percent of the ideas he were [ph.] 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 percent 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 [unint.] combined, that they would not have another inflationary experience. So, the Bundesbank, which was getting growth from the [unint.] 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...

Chapter 3

SD: ...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 percent 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 percent of our net worth in this trade, not 100 percent. Do you know how often something like this comes around? Like one or 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.

So, that's probably enough old war stories tonight. I love telling old war stories because I like to reminisce when I was a money manager and doing better returns than I have since I retired, but I do think it's important maybe let's try and move me to the present here a little bit. So, I told you that one of the things I learned from Drelles was to focus on central banks. And Sam was kind enough to point out some very good returns we had over the years.

One of the things I would say is about 80 percent 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 percent and the highest was 6 percent. 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 - can we get the charts up please? I'm experiencing a very strong sense of déjà vu. Let's just play the game I played with my analysts back in 2003, 2004 and go through a series of charts. So, this is the United States households' net worth per household. And it's textbook. You see the big drop in the financial crisis. It's textbook when you have consumer balance sheets torn to pieces by a financial crisis to use super loose monetary policy to rebuild those balance sheets, which the Federal Reserve did beautifully.

What's interesting though is if you look forward by 2011, we had already exceeded the '07 levels, which I think a lot of people would agree was already an overheated [ph.] period, and since then we've gone

straight up for two more years, and household net worth is certainly in very, very good shape.

Here's employment. As you can see after another big problem after the financial crisis, the employment market has largely healed, and we're down at 5.6 on the unemployment rate. Here's industrial production. Again, big drop after '07. Look at this thing. It's screaming. Here's retail sales. Again you see the damage, but you see where we are now. You're right on a 60-year uptrend, which is actually very good.

And then I'm sure for those of you who are unfortunate enough to watch CNBC and read other financial statements, you'll know that the fed is absolutely obsessed with Japan. They've been talking about this Japan analogy for 10 or 15 years now or certainly since Bernanke took over. And let me just show you something. This is the core CPI in the U.S. I'm sure you've heard the word "deflation" more than you'd like to hear it in the last three or four years. We've never had deflation. Our CPI has gone up 40 percent over this time with not one period of

deflation. And at the bottom you see Japan, which is down 15 percent. I did think there was a case, a viable case in '09, '10 that we may follow Japan. But you know what, I've thought a lot of things when I'm managing money with great, great conviction, and a lot of times I'm wrong. And when you're betting the ranch and the circumstances change, you have to change, and that's how I've always managed money. But the feds' thesis to me has been proved dead wrong about three or four years ago, which is okay, but there was no pivot.

Here's another one that I like to look at. Has anybody heard on CNBC in the last week comparisons with 1937 and the mistake the Federal Reserve made in 1937 because it is a constant thing they're bringing up? But again, here's the net worth chart I showed in the first slide in dark blue, but look at the light blue line, which is net worth in the 1930s in the U.S. We're not even close to the kind of numbers we had in 1937. And if I showed you all those other four charts, they wouldn't have moved during the four years either.

And finally, one more comparison with Japan. In light blue is average net worth per household in the U.S. In dark blue is Japan. If you took apples to apples the same time period, there's just no comparison.

So, my point is this, if I was giving you a quiz and you looked at these five charts and you hear all this talk about a deflation and depression and how horrible things are, let me just say this, the Federal Reserve was founded in 1913. 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 these numbers 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. This we 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 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 met [ph.] earlier. It's like gees, 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 hard. 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 percent of them are unprofitable when they come. The only other time we've been at 80 percent 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. Kenny, do you want to come up? [applause]

MS: You've never been on the left in your life, Ken.

KL: I am now. [laughter] There's a first time for everything, Stanley. There's one addition I'd make to Sam's introduction, and not only do the Druckenmillers share their treasure with so many charities, but they share their time. Everything they support, they support not only as they say with their checkbook, but with their time and their effort and their great abilities. And for the both of you for all of us here we say thank you. Okay. [applause]

You mentioned in your talk that there are already early signs of excesses due to over-easy [ph.] monetary policy. What are some of the signs you see?

SD: Okay. I mentioned credit. 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 percent 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 percent of that debt was B rated. Today 71 percent 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 less standards. Another way to look...

Chapter 4

SD: ...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 percent of the debt was issued cov-light.

Now that number is over 60 percent. 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 percent debt to GDP to 390 percent 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.

And just one example might be 18 percent of the high-yield debt issued in the last year is energy. And I don't mean to offend any Texans in the room, but if you ever met anybody from Texas, those guys know how to gamble, and if you let them stick a hole in the ground with your money, they're going to do it. 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.

KL: Will this unprecedented global money printing ever stop? And what is your intermediate and long-term view on inflation?

SD: Well, the global money printing is interesting because the United States is the world's central bank. And Japan had this guy named Shirakawa running the central bank, and he didn't believe in this stuff. So, what happened when he didn't print the money but the U.S. was printing the money and we're [inaud.], the Japanese yen started to appreciate and it stayed appreciating, and it basically hollowed out the country. And they were eventually forced, as you know, two years ago into flooding their system with money.

You have a very, very similar situation going on in Europe now. I know Mario Draghi and Angela Merkel don't like QE. They don't like anything about it, but again, the chump - I have this partner. I don't know if he's in the room, Kevin Warsh who's on the Federal Reserve Board. He said Japan used to be the

new chump because they had the overvalued currency. Now it's Europe. So, their currency went from 82 say back in 2000 all the way up to 160, and it was 140 last summer, and they're absolutely getting murdered. And now they're apparently caving in and they're going to print money.

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.

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 America Online 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 percent 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 percent on the year. And the Nasdaq's gone up 400 percent.

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. [unint.] at 104 times earnings. This is nuts. Just kind of as I explained earlier, we're going to step aside, wait for the net 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 percent a day and I'm out. It is driving me nuts. I mean their little account is like up 50 percent 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 - 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: Here's one you may not be able to answer. Why are the regulators so intent on penalizing our best banks?

SD: Because the regulators are appointed by politicians and the banks make a perfect punching bag for what's going on. And I will say this, I think there were very, very bad actors in '06, '07. Let's not kid ourselves in the banking industries.

KL: I agree.

SD: But the point I was making earlier is there was a great enabler, and that was the Federal Reserve...

KL: Yeah.

SD: ...pushing people out the risk curve. And what I just can't understand for the life of me, we've done Dodd-Frank, we got 5,000 people watching Jamie Dimon when he goes to the bathroom. I mean all this stuff

going on to supposedly prevent the next financial crisis. And if you look to me at the real root cause behind the financial crisis, we're doubling down. Our monetary policy is so much more reckless and so much more aggressively pushing the people in this room and everybody else out the risk curve that we're doubling down on the same policy that really put us there and enabled those bad actors [ph.] to do what they do. Now, no matter what you want to say about them, if we had had five or six percent interest rates, it would have never happened because they couldn't have gotten the money to do it.

KL: What's the future of the euro?

SD: The currency or the union?

KL: The currency.

SD: I think the euro needs to continue to go down because eight of those countries have such a cost disadvantage versus Germany right now. It's about 40 percent because they haven't been behaving themselves since the euro was put together that you have severe outright deflation not like pretend deflation like we talk about on the board. It's real deflation. And they've got sclerosis. I can't see Europe surviving

without the euro going down to somewhere in the mid-80s. And if you think that's a ridiculous forecast, when I restarted Duquesne in 2000, the euro was 82. Now, that was extreme. But let me ask you this, think of the Europe and United States back in 2000 and think of them today. Do you think Europe has made incremental gains versus the United States or declines? So, to me it's not unreasonable to see the euro continue to go down.

The other thing I'll say, I do analyze currencies, and it would be almost unprecedented to have a 10-month currency trend. Because all the dislocations happen when your currency is overvalued and it's up long enough, it takes years to unwind those dislocations. And it's hard to argue the euro is not in a trend. It's down from 140 to 117. And using the rule of time, I don't think it's unreasonable to expect it to break 100 sometime in the next year or two.

In terms of the euro region itself, there's still a lot of questions. That was put together for

political reasons really to create political unity. And as most people in this room know, it's doing just the opposite. It's creating political disunity. So, I don't think it's even a given that that thing stays together.

KL: Okay. You put money out with other managers. What qualities and characteristics do you look for in those people that you place money with?

SD: Number one, passion. I mentioned earlier I was passionate about the business. The problem with this business if you're not passionate, it is so invigorating to certain individuals, they're going to work 24/7, and you're competing against them. So, every time you buy something, one of them is selling it. So, if you're with one of the lazy people or one of the people that are just doing it for the money, you're going to get run over by those people.

The other characteristic I like to look for in a money manager is when I look at their record, I immediately go to the bear markets and see how they did. Particularly given sort of the five-year outlook I've given, I want to make sure I've got a

money manager who knows how to make money and manage money in turbulent times, not just in bull markets.

The other thing I look for, Kenny, is open-mindedness and humility. I have never interviewed a money manager who told you he'd never made a mistake, and a lot of them do, who didn't stink. Every great money manager I've ever met, all they want to talk about is their mistakes. There's a great humility there. But and then obviously integrity because passion without integrity leads to jail. So, if you want someone who's absolutely obsessed with the business and obsessed with winning, they're not in it for the money, they're in it for winning, you better have somebody with integrity.

KL: You've expressed concerns about entitlement. What's the solution? You got a loaded crowd here now. Be careful.

SD: That's a rough one. So, if you go back to 1965, the senior poverty rate in this country was 30 percent, and it's 9 percent now. I think everybody can applaud that's a great achievement. The problem is

you go back to 1965, your child poverty was 21 percent, and now it's 25 per...

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SD: ...cent. So, all the gains we've made in terms of poverty the last 40 years have accrued to the elderly. If you look at the average per capita income in this country, we're spending 56 percent of every worker's dollars on the elderly, and we're spending 7 percent on children.

So, how would I solve it? Well, I couldn't because if I wanted to do it, nobody would ever vote me in office. But I would just say that some solutions are a combination of tax reform dealing specifically with the problem because the longer this goes on, the more you're either going to have to raise taxes or cut spending down the road because of compounding. I would freeze - forget COLAs. I would freeze all the entitlement payments right now because they've already taken such a tremendous share away from the rest of our population.

You know, it's funny, if you go back to as late as 1970, entitlements were 28 percent of all federal outlays. Now they're 72 percent. And when you start talking about oh my God, we can't freeze this stuff, why not? You just picked up 50 points of share on everybody. Why not freeze it? And, you know, Ken and I have talked. I mean it's ridiculous that our Social Security is not means tested. It's ridiculous. I mean the fact that he's getting - what is your monthly check?

KL: Twenty-five hundred dollars a month.

SD: It's ridiculous.

KL: And Elaine gets another thousand.

SD: While we have 24 percent of the kids in this country in poverty and probably, you know, the elephant in the room is obviously the health care system. You've got to get the market into the equation so people see the cost and they have to make an economic decision. A lot of this goes into end-of-life payments. You wonder if you had to pay 30 to 40 percent of the bill instead of not even knowing what the bill is, whether different choices would be made.

But you talk about entitlement. The federal debt right now is $17 trillion. The reason it's $17 trillion and not higher is because all those payments that are promised to Kenny, a lot of the people in this room, myself not too far in the future, they're not on the government balance sheet. Any company in America if you owe payments of that certainty, it would be a debt. In the U.S. government accounting it's revenue.

If you present valued what we have promised to seniors in Medicare and Social Security and Medicaid payments, the federal debt right now under gap accounting would be $205 trillion, not 17 because we have a demographic boom, which is the other side of the baby boom. As everybody knows in this room, it's the grey boom. We are creating 11,000 seniors in this country every day. Every day we're creating 11,000 new seniors, and we're only creating about 18 percent of youth employed to support those payments to them. So, we've got a big problem, and it really doesn't start until 2024, 2025, but if you wait 'til 2024, it's too late. It's not unlike climate change.

It's probably not a problem for 30 years, but if you wait 30 years, you can't fix it. So, you got to start now.

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.

SD: Thanks, Ken.

KL: Great, great night. [applause]

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