Remarks by James S. Chanos
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[Ed. Note: James S. Chanos of Kynikos Associates is arguably the most famous living focused short seller. Though short sellers are often vilified and at times hated, a review of his thoughts and insights on the Enron debacle reveal him to be an intelligent investor - someone to whom it is worth paying attention. Short selling is an arcane craft and takes a unique mindset that few on Wall Street possess.

In his comments below, Jim Chanos discusses how he was early in spotting the problems at Enron. As you will see from his comments, a careful analysis of a weak company's business and financial statements often portends early signs of trouble (smoke) in advance of the actual blowup (fire), and even as others are rushing into the market fray (crowded theater? ☺) an intelligent investor often has the tools to take a pass or even profit from the folly of others. Moreover, Mr. Chanos' thoughtful concluding observations about potential reforms and his warnings on the ways of Wall Street are also worth reading and re-reading. We hope you enjoy his comments.]

Introduction

Good afternoon. My name is James Chanos. I would like to take this opportunity to offer my perspective on the tragic Enron story.

I am the President of Kynikos Associates, a New York private investment management company that I founded in 1985. Kynikos Associates specializes in short-selling, an investment technique that profits in finding fundamentally overvalued securities that are poised to fall in price. Kynikos Associates employs seven investment professionals and is considered the largest organization of its type in the world, managing over $1 billion.

Prior to founding Kynikos Associates, I was a securities analyst at Deutsche Bank Capital and Gilford Securities. My first job on Wall Street was as an analyst at the investment banking firm of Blyth Eastman Paine Webber, a position I took in 1980 upon graduating from Yale University with a B.A. in Economics and Political Science. Neither I nor any of our professionals is an attorney or a certified public accountant, and none of us has had any direct dealings with Enron, its employees or accountants.

About Kynikos Associates

On behalf of our clients, Kynikos Associates manages a portfolio of securities we consider to be overvalued. The portfolio is designed to profit if the securities it holds fall in value. Kynikos Associates selects portfolio securities by conducting a rigorous financial analysis and focusing on securities issued by companies that appear to have (1) materially overstated earnings (Enron), (2) been victims of a flawed business plan (most internet companies), or (3) been engaged in outright fraud. In choosing securities for its portfolios, Kynikos Associates also relies on the many years of experience that I and my team have accumulated in the equity markets.

Enron Hits Our Radar Screen

My involvement with Enron began normally enough. In October of 2000, a friend asked me if I had seen an interesting article in The Texas Wall Street Journal (a regional edition) about accounting practices at large energy trading firms. The article, written by Jonathan Weil, pointed out that many of these firms, including Enron, employed the so-called "gain-on-sale" accounting method for their long-term energy trades. Basically, "gain-on-sale" accounting allows a company to estimate the future profitability of a trade made today, and book a profit today based on the present value of those estimated future profits.

Our interest in Enron and the other energy trading companies was piqued because our experience with companies that have used this accounting method has been that management's temptation to be overly aggressive in making assumptions about the future was too great for them to ignore. In effect, "earnings" could be created out of thin air if management was willing to "push the envelope" by using highly favorable assumptions. However, if these future assumptions did not come to pass, previously booked "earnings" would have to be adjusted downward. If this happened, as it often did, companies addicted to the crack cocaine of "gain-on-sale" accounting would simply do new and bigger deals (with a larger immediate "earnings" impact) to offset those downward revisions. Once a company got on such an accounting treadmill, it was hard for it to get o

First Signs of Trouble

The first Enron document my firm analyzed was its 1999 Form 10-K filing, which it had filed with the U.S. Securities and Exchange Commission. What immediately struck us was that despite using the "gain-on-sale" model, Enron's return on capital, a widely used measure of profitability, was a paltry 7% before taxes. That is, for every dollar in outside capital that Enron employed, it earned about seven cents. This is important for two reasons; first, we viewed Enron as a trading company that was akin to an "energy hedge fund." For this type of firm a 7% return on capital seemed abysmally low, particularly given its market dominance and accounting methods. Second, it was our view that Enron's cost of capital was likely in excess of 7% and probably closer to 9%, which meant, from an economic cost point-of-view, that Enron wasn't really earning any money at all, despite reporting "profits" to its shareholders. This mismatch of Enron's cost of capital and its return on investment became the cornerstone for our bearish view on Enron and we began shorting Enron common stock in November of 2000.

We were also troubled by Enron’s cryptic disclosure regarding various "related party transactions" described in its 1999 Form 10-K as well as the quarterly Form 10-Qs it filed with the SEC in 2000 for its March, June and September quarters. We read the footnotes in Enron’s financial statements about these transactions over and over again but could not decipher what impact they had on Enron’s overall financial condition. It did seem strange to us, however, that Enron had organized these entities for the apparent purpose of trading with their parent company, and that they were run by an Enron executive. Another disturbing factor in our review of Enron’s situation was what we perceived to be the large amount of insider selling of Enron stock by Enron’s senior executives. While not damning by itself, such selling in conjunction with our other financial concerns added to our conviction.

Finally, we were puzzled by Enron’s and its supporters boasts in late 2000 regarding the company’s initiatives in the telecommunications field, particularly in the trading of broadband capacity. Enron waxed eloquent about a huge, untapped market in such capacity and told analysts that the present value of Enron’s opportunity in that market could be $20 to $30 per share of Enron stock. These statements were troubling to us because our portfolio already contained a number of short ideas in the telecommunications and broadband area based on the snowballing glut of capacity that was developing in that industry. By late 2000, the stocks of companies in this industry had fallen precipitously, yet Enron and its executives seemed oblivious to this! Despite the obvious bear market in telecommunications capacity, Enron still saw a bull market in terms of its own valuation of the same business — an ominous portent.

The Ways of Wall Street

In January 2001, we began contacting a number of analysts at various Wall Street firms with whom we did business and invited them to our offices to discuss Enron. Over the next few months a number of them accepted our invitation and met with us to discuss Enron and its valuation. We were struck by how many of them conceded that there was no way to analyze Enron, but that investing in Enron was instead a "trust me" story. One analyst, while admitting that Enron was a "black box" regarding profits, said that, as long as Enron delivered, who was he to argue! It was clear to us that most of these analysts were hopelessly conflicted over the investment banking and advisory fees that Enron was paying to their firms. We took their "buy" recommendations, both current and future, with a very large grain of salt!

Something else that caught our attention was a story that ran in The New York Times about Enron in early February of 2001. In light of the California energy crisis, Enron was invoking a little-noticed clause in its contract with its California retail customers. This clause allowed Enron to directly match its retail buyers of power in California with the power providers with whom Enron had contracted on its customers’ behalf. Most of these power providers were in bankruptcy. In effect, Enron was telling a number of very prominent California companies and institutions "This is now your problem, not ours." This was done despite the fact that Enron was paid by its customers a middleman fee precisely so that Enron would accept what is called counter-party risk — something Enron now backed out of doing. As a result, Enron’s credibility in the entire energy retail business began to crumble simply because the company refused to recognize sure losses in California. One of my analysts said at the time, "Gee, it’s as if Enron can never admit to a losing trade!" Future revelations would prove that remark prophetic.

It was also in February 2001 that I presented Enron as an investment idea at our firm's annual "Bears In Hibernation" conference. As I recounted Enron's story to the conference participants, most of them agreed that the fact pattern and numbers presented were very troubling. Most also agreed that Enron's stock price left no room for error. Following our conference, the short position in Enron (reported monthly) began to move higher.

More Signs of Trouble at Enron

In the spring of 2001, we heard reports, confirmed by Enron, that a number of senior executives were departing from the company. Further, the insider selling of Enron stock continued unabated. Finally, our analysis of Enron's 2000 Form 10-K and March 2001 Form 10-Q filings continued to show low returns on capital as well as a number of one-time gains that boosted Enron's earnings. These filings also reflected Enron's continuing participation in various "related party transactions" that we found difficult to understand despite the more detailed disclosure Enron had provided. These observations strengthened our conviction that the market was mispricing Enron's stock.

In the summer of 2001, energy and power prices, specifically natural gas and electricity, began to drop. Rumors surfaced routinely that Enron had been caught "long" the power market and that it was moving aggressively to reverse its exposure. It is an axiom in securities trading that, no matter how well "hedged" a firm claims to be, trading operations always seem to do better in bull markets and to struggle in bear markets. We believed that the power market had entered a bear phase at just the wrong moment for Enron.

Also in the summer of 2001, stories circulated in the marketplace about Enron's affiliated partnerships and how Enron's stock price itself was important to Enron's financial well-being. In effect, traders were saying that Enron's dropping stock price could create a cash-flow squeeze at the company because of certain provisions in agreements that it had entered into with its affiliated partnerships. These stories gained some credibility as Enron disclosed more information about these partnerships in its June 2001 Form 10-Q, which it filed in August of 2001.

To us, however, the most important story in August 2001 was the abrupt resignation of Enron's CEO, Jeff Skilling, for "personal reasons." In our experience, there is no louder alarm bell in a controversial company than the unexplained, sudden departure of a chief executive officer no matter what "official" reason is given. Because we viewed Skilling as the architect of the present Enron, his abrupt departure was the most ominous development yet. Kynikos Associates increased its portfolio's short position in Enron shares following this disclosure.

The events affecting Enron that occurred in the fall of 2001, particularly after October 16th, have been recounted seemingly everywhere in the financial press. Kynikos Associates cannot add much to that discussion, but I have tried to provide an overview of what our firm thought were significant developments and revelations during the preceding twelve months.

Some Observations, Recommendations, and Lessons to be learned Post-Enron

I would like to share a few observations about what happened:

First and foremost, no one should depend on Wall Street to identify and extricate investors from disastrous financial situations. There are too many conflicts of interest, all of them usually disclosed, but pervasive and important nevertheless. In addition, outside auditors are archeologists, not detectives. I can't think of one major financial fraud in the United States in the last ten years that was uncovered by a major brokerage house analyst or an outside accounting firm. Almost every such fraud ultimately was unmasked by short sellers and/or financial journalists.

In addition, a company's adherence to GAAP (generally accepted accounting principles), does not mean that the company's earnings and financial position are not overstated. GAAP allows too much leeway in the use of estimates, forecasts and other inherently unknowable things to portray current results. In the hands of dishonest management (a rapidly growing subset in my opinion), GAAP can mislead far more than they inform! Further, I believe that certain aspects of GAAP, particularly accounting for stock options in the United States, are basically a fraud themselves. Such obvious accounting scams should be ended immediately without any interference by third parties.

While no fan of the plaintiffs bar, I also must point out that the so called "Safe Harbor" Act of 1995 has probably harmed more investors than any other piece of recent legislation. That statute, in my opinion, has emboldened dishonest managements to lie with impunity, by relieving them of concern that those to whom they lie will have legal recourse. The statute also seems to have shielded underwriters and accountants from the consequences of lax performance of their "watchdog" duties. Surely, some tightening of this legislation must be possible, while retaining the worthy objective of preventing obviously frivolous lawsuits.

Our current system of self-monitored disclosure is first-rate, in my opinion, with one important exception. In this day and age of EDGAR, the internet and real-time disclosure, our system for disclosing insider stock purchases and sales remains antiquated. Insiders buying or selling shares should disclose such transactions immediately. And esoteric collars, loan/stock repurchase deals, etc., that are in the "gray area" of insider disclosure should be treated for what they are — another way to either buy or sell shares. The structure of an insider transaction should never hinder its immediate disclosure!

Finally, I want to remind you that, despite two hundred years of "bad press" on Wall Street, it was those "un-American, unpatriotic" short sellers that did so much to uncover the disaster at Enron and at other infamous financial disasters during the past decade (Sunbeam, Boston Chicken, etc.). While short sellers probably will never be popular on Wall Street, they often are the ones wearing the white hats when it comes to looking for and identifying the bad guys!

Interesting Quote: "*If something can't go on forever, it won't!*" – Herb Stein

[Ed. Note: Subsequent to our original creation of this transcript, we had a chance to hear Mr. Chanos speak on two additional occasions in 2005 (more recently at Whitney Tilson and John Schwartz's excellent inaugural Value Investing Congress in New York City where he emphasized that secular technology-driven forces are disrupting traditional media business models and creating compelling shorting opportunities today).

Mr. Chanos would probably agree that in the market place of ideas and an open society vocal minority voices with the courage to challenge the conventional wisdom (at least as regards to particular securities in the financial market place of ideas) play a critical role. In this respect, shorts can be seen as just another set of investors offering alternate hypothesis that can be tested in the market place (ultimately to be proven either right or wrong). Of course, as George Soros would point out, this market process may not tend towards an ideal equilibrium but is better understood as dialectical or historical process. One that is both dynamically unstable and reflexive/recursive. These properties can lead to greater volatility in the short-term and may be the price that society must accept for the other benefits of an open (vote with your wallet) debate between shorts and longs.

The image of a vigorous debate, however, fails to explain why some companies get so aggressive and vocal in publicly fighting shorts. George Soros's framework sheds light on this conundrum when he observes that short sellers are more than just theorists: as active participants in the market, the acceptance of the short hypothesis could significantly accelerate the realization of the underlying thesis or even become (in the extreme case) a self fulfilling prophecy. Of course some of the particularly virulent/borderline emotional criticism of shorting may be rooted in the same well documented behavioral pitfalls that snare investors in general. The existence of articulate, vocal, and well capitalized short sellers may be perceived as a threat to a human psyche that would rather ignore conflicting data once a pre-existing commitment is made (anchoring), tend towards optimism (over-confidence) and follow the herd (social proof). When shorts profit by holding the market (and individuals in the market) accountable for deviating from sound thinking - their participation is likely to contribute to market efficiency and sanity (at least in the aggregate in the long-run). If so, Mr. Chanos's policy suggestions should receive balanced consideration by policy makers in our polity regarding their potential societal and market impacts.]

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