When Markets Melt Down, These Traders Cash In

Mark Spitznagel and Nassim Nicholas Taleb profit from global chaos. They expect a lot of chaos ahead.

By Scott Patterson

As investors fretted about the possibility that the White House and Republican lawmakers would fail to raise the debt ceiling, one $20 billion firm wasn't concerned about the potential stock-market mayhem.

That's because Miami-based Universa Investments reaps huge rewards in market crashes. It made billions in 2008 when the market collapsed during the global financial crisis, as well as in the 2020 crash sparked by the Covid-19 pandemic.

Universa's founder, veteran trader Mark Spitznagel, sees another catastrophe looming. At a conference in late May, he said decades of low interest rates and other factors were leading to what he called a "mega-tinderbox time-bomb" in the financial system, repeating a warning he'd written about in January. "We should expect some kind of inferno," he said. That doesn't mean he thinks stocks are poised for a crash now; indeed in the short term he believes the market could be in for a strong rally.

Universa is a pioneer of a small but growing coterie of hedge funds that bet on "black swans": those unforeseen catastrophic events made famous by Universa adviser Nassim Nicholas Taleb in his 2007 bestseller, "The Black Swan." Taleb and Spitznagel have been partners for decades, having launched the first black-swan fund, called Empirica, in 1999.

> Market crashes. Pandemics. Terrorist attacks. Riots. Megafires. Superstorms.

Trading on market chaos is Taleb and Spitznagel's bread and butter. Taleb made a fortune in the Black Monday collapse of 1987. Both made money in the 1990s during market upheavals such as the 1997 Asian financial crisis. Empirica cleaned up in the early 2000s by betting against stocks when the dot-com bubble collapsed.

At the time of its founding, Empirica was highly unusual. Its strategy consisted of making large, consistent bets on major market collapses. At Empirica, investors who put a small percentage of their cash in the fund could be protected when the black swan swooped down.

The strategy worked like this: Every day, Empirica would buy so-called put options that pay off when stocks decline. The bets weren't on small declines—they were on huge crashes. Normally, the options expired worthless and Empirica took a small loss. But when the market did crash, the options became wildly valuable, providing massive gains while other investors' portfolios went up in smoke.

Mark Spitznagel
- **Hobby:** bow hunting
- **Outside activity:** raising goats
- **Favorite sport:** hockey
- **On his desk:** bust of economist Ludwig von Mises

Nassim Nicholas Taleb
- **Favorite exercises:** bicycling and hiking
- **Birthplace:** Lebanon
- **Pastime:** flaneuring
- **Favorite food:** squid-ink pasta

The birth of their strategy, for both Taleb and Spitznagel, occurred in the 1980s. For Spitznagel, it emerged from the hard-charging trading pits in Chicago. For Taleb, it started with one of the biggest market blowups of modern times.

Why'd they blow up?

Taleb sat perched on the edge of his chair at a row of desks, eyes red and wide. He was on the trading floor of the giant investment bank First Boston at Park Avenue Plaza, a stone's throw from St. Patrick's Cathedral in Midtown Manhattan. Pandemonium had broken out all around him. Digits were moving rapidly on his computer screen in ways he'd never seen before. It was Oct. 19, 1987. Black Monday.

The stock market was crashing.

He had no idea why. No one did. Markets were going wild around the world for no apparent reason. The 27-year-old trader stayed focused on his positions. They weren't in stocks. They were dollar-denominated deposits outside the U.S., known as Eurodollars. Rather, they were options on Eurodollars. For months he'd been building up a huge position in bargain-basement Eurodollar options that would, in theory, benefit from a big swing in volatility. Stocks had been ripping higher for years. Despite a few ominous wobbles in previous weeks, the bull market seemed unstoppable. Few expected that would change anytime soon—making Taleb's bets dirt cheap. No one else wanted them.

In the middle of the day, a trader, pale white and clearly suffering, approached him. "Don't they know that six sigma events only happen once in a lifetime?" he said in an eerily quiet voice. (A six sigma event is roughly two in a billion in a normal distribution; in reality they are far more common in the financial world, which doesn't obey the laws of a normal distribution.)

"The market doesn't know," Taleb replied. Some people stood shellshocked in the middle of the trading room, quietly crying. Jimmy Powers, Taleb's boss, kept begging the prices on his screen to stop moving.

At the end of trading, Taleb left the office and began to walk, dazed, to his Upper East Side apartment. On the way, he ran into a colleague and began chatting about the day's insane events. A woman walked up to them looking terrified. "Do the two of you know what's going on?" she asked. Her eyes spoke of pure panic.

Back in his apartment, he started phoning colleagues to see how they were doing. A cousin called and said the police were outside his building at 72nd Street and First Avenue. Someone had jumped to their death from an upper-floor apartment. "It hit close to home," Taleb said later.

While other traders had suffered enormous pain that day, Taleb's portfolio had fared relatively well. But it wasn't career-making. That changed the following day, when Alan Greenspan, chairman of the Federal Reserve, injected vast amounts of cash into the financial system. Taleb's positions in Eurodollars shot to the moon. Contracts he'd bought for a few pennies were selling for $3, $4, $5, according to Taleb. At the desk, he felt he was losing his mind as he watched his positions soar. He knew what was happening should not be happening. "Sell for $3.50!" he screamed over the phone to his floor broker in the pit. A minute later, the broker called back. "Sold for $4.50!" "Sell for $5!" "Sold for $5.50!"

Statistically, the move was virtually unquantifiable, one that shouldn't have occurred in the history of the universe, or 10 universes—in a normal world. As Taleb was learning, in finance things were often far from normal, and those who assumed they were normal would get them wrong again and again.

It was a lesson Taleb would never forget. He felt vindicated. His strategy of wagering on rare events, derided by other traders who racked up gains day after day, had worked like a miracle. At the time, it wasn't so much the result that mattered as the revelation that the methods and models those traders used were deeply flawed. It was mostly gut instinct and Taleb's deeply ingrained contrarian nature. But his experience planted the idea. If all these guys are so smart, why'd they blow up?

And why didn't I?

One day's profit: $1 billion

Over the next decade, Taleb refined his market-crash trading strategy, making windfalls during other cataclysmic events such as the 1998 collapse of the massive hedge fund Long-Term Capital Management. Spitznagel, who'd gotten his start trading in the late 1980s on the floor of the Chicago Board of Trade, was discovering similar strategies.

The two met in 1999 at New York University, where Taleb taught and Spitznagel was a newly enrolled student in the school's elite master's program for mathematical finance. After realizing they shared a similar approach to trading, they teamed up to launch Empirica that same year.

Taleb closed Empirica in 2004. Three years later, as the global financial crisis began to erupt, Spitznagel launched Universa.

Universa cleaned up in 2008, when markets around the world imploded, making the fund some $1 billion in profits. In the following years, Universa would continue to profit when the market imploded, including a $1 billion gain in a single day in May 2010 when the Dow Jones Industrial Average fell more than 1,000 points in a matter of minutes, the so-called Flash Crash.

But nothing compared with 2008—until the Covid-19 pandemic hit in early 2020.

Gray swans, dragon kings

Market crashes. Pandemics. Terrorist attacks. Riots. Megafires. Superstorms. Extreme, destructive, often deadly events seem to be happening across the planet with greater frequency—and greater harm. They happen suddenly and strike widely.

A chillingly perverse result of their increasing frequency is that such events are becoming more predictable in certain ways. They aren't black swans that sweep in out of the blue. They're what Taleb calls gray swans—devastating events that are all too foreseeable. The coast-smashing hurricanes that occur with numbing regularity. The West Coast wildfires that appear on cable news in the summers like a reliable seasonal effect—akin in their cyclical nature to autumnal foliage or winter snowstorms.

Taleb has argued that our increasingly unstable world is the paradoxical result of humankind's efforts to control it with technology, quantitative models, and ubiquitous just-in-time optimization, resulting in an ever-more-complex, human-built, fragile society susceptible to shocks. Extreme events "are necessarily increasing as a result of complexity, interdependence between parts, globalization and the beastly thing called 'efficiency' that makes people now sail too close to the wind," he wrote in his 2012 book "Antifragile."

Financial markets, and the economies that depend on them, have become increasingly complex, unstable, and prone to crashes. In the early 2000s, economists such as Ben Bernanke, who would later become chairman of the Federal Reserve, claimed that the global economy had entered a so-called Great Moderation. The steady hand of economic technicians, the spread of derivatives and other products of Wall Street's financial engineers, known as quants, and low inflation meant the world was set to enjoy untold prosperity, the gift of not-too-hot-not-too-cold, centrally managed perpetual growth. Then came 2008, when the collapse of the U.S. subprime mortgage market ignited a global economic panic attack. The loss of hundreds of billions of dollars in mortgages spread like a contagion through derivatives markets, leading to trillions in losses.

This powder-keg market was an ideal fit for Universa.

We're pirates, not the navy!

Working from his home in Northport Point, Mich., in March 2020, Spitznagel had been preparing for such moments since he was a 16-year-old staring in awe at the pandemonium of a Chicago trading pit in the 1980s. He was born to be a trader. As pandemonium broke out across world markets when Covid-19 spread across the globe, he was perfectly calm.

What seemed to be lining up in March 2020 for markets and the global economy was the ultimate black swan—worse than anything the world had seen since the Great Depression of the 1930s. National economies ground to a halt as workers and families huddled in their homes. Millions of Americans suddenly found themselves out of work. By mid-March, the value of everything from stocks to bonds to commodities was in complete free fall.

As Spitznagel tracked the market's unraveling in Michigan—and as lockdowns and school closures swept across the country—Universa traders working from the firm's headquarters in Miami stayed up through the night one Sunday, managing the firm's positions. Turmoil rippled from Hong Kong to Europe to the U.S. Around 5 a.m. on Monday the 16th, a few senior traders arrived at the firm's office. Universa's team of 16 programmers and traders—Ph.D.s, computer nerds, mathematicians—were exhausted. After working through the day's chaotic opening, Spitznagel hopped on a private plane and departed from a grass airstrip. By the afternoon, he'd taken up his usual spot at a desk beside a floor-to-ceiling window. "Remember, we're pirates! Not the navy!" he'd exclaim from time to time, adapting a famous line from Steve Jobs.

The following week, as head-snapping volatility crushed the market, the small band of Universa traders would get little sleep, many napping just a few hours at a time on office couches or in their home offices before getting up, gulping down coffee, and quietly racking up a fortune. Spitznagel and his team saw their investments go vertical, like a rocket. By the end of March, Universa's Black Swan Protection Protocol Fund had clocked an astonishing three-month gain of more than 4,000%. Such gains have helped Universa post a 15-year average annual return on capital of over 100%, according to audited results.

Now in 2023, as Congress resolves the debt-ceiling standoff, investors have skirted what some warned would be financial armageddon. That doesn't mean Spitznagel is giving up his expectations that the system remains a tinderbox waiting to explode—he just doesn't know when the bomb will go off.

Adapted from "Chaos Kings: How Wall Street Traders Make Billions in the New Age of Crisis" by The Wall Street Journal's Scott Patterson, to be published on June 6 by Scribner.

The growing frequency of hurricanes and other natural disasters could make black-swan strategies all the more lucrative.

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