

# Game Theory

*Peter Thiel bases his hedge fund's strategems on some dark predictions*

BY ERIC J. SAVITZ

**P**ETER THIEL SITS IN HIS office on the 43rd floor of the Bank of America building, with its stunning view of downtown San Francisco, dressed in white, explaining how the financial markets are going to be shaken by severe post-bubble aftershocks. Thiel, the intellectually intense proprietor of **Clarium Capital Management**, a \$260 million hedge fund, is detailing how the dollar's decline has barely begun and why deflation seems inevitable. And he's explaining all this while wearing this ill-fitting white outfit, like he's about to climb into his Mr. Softee truck to sell ice cream. He looks kind of silly, really. And this is largely my fault, at least indirectly, since the white outfit is the brainstorm of the photographer for this story. (You can see the results on the section's cover.)

But Thiel isn't silly. Quite the contrary: He's got gravitas and complex, well-conceived ideas about the world and the financial markets, which he puts to use in his stunningly successful hedge fund—which is up 125% from its inception in October 2002 through the end of January. He's a serious cookie, and always has been. As an undergraduate philosophy major at Stanford—where he also went to law school—he was a nationally ranked chess player. (He reports in a confessional tone that he “still plays more chess than is healthy for me.”) Given his dark views on the financial markets, you'd expect him to be wearing all black.

Only 36 years old, Thiel has packed a lot into his relatively short career. After law school, he moved to New York, and became a corporate-securities lawyer. He later switched to Wall Street, where he traded derivatives at Credit Suisse. He is also an avowed libertarian, and has been for years. In 1987, as a Stanford undergrad, he co-founded a conservative-libertarian newspaper called the *Stanford Review*, which continues to publish. In 1995, his work at the *Review* led him to co-write a book called *The Diversity Myth*, an attack on multiculturalism at Stanford. Thiel even showed up on one online list of possible 2004 Libertarian Party presidential candidates. (While flattered, he notes that he can't run, since he was born in Germany.)

There is one other thing you need to know about



*For Peter Thiel, the next move for the economy could be a deflationary swoon with a devastating impact on employment. That's led him to make some highly contrary investment bets.*

Thiel: He's a dot-com millionaire. In 1996, after leaving Credit Suisse, he moved back to California and set up a small fund called Thiel Capital, starting with \$1 million in friends-and-family money. Among other things, it invested in a start-up company working on encryption technology that evolved into PayPal, the online-payment company. In 1998, the company made Thiel its CEO. Over the next four years, PayPal turned into a huge success. In March 2000, days before the Nasdaq began to crumble, it raised \$100 million in venture capital. PayPal went public with a \$1 billion market capitalization in February 2002, and five months later was acquired for \$1.5 billion by eBay. For his approximate 4% stake in PayPal, he got about \$60 million in eBay shares.

That gave Thiel the grubstake to get back in the investment business. Initially, he considered starting both a hedge fund and a venture fund—and, in fact, he has \$70

million of his own money invested in start-ups. After some analysis, he decided the risks of starting a big venture fund were too high.

“The whole venture industry is facing low returns for many years to come,” he says. “There's an \$80 billion overhang in the venture business,” he contends. “At a reasonable pace, the industry could invest \$5 billion to \$10 billion a year. Realistically, they will invest it faster, and end up with low, if not negative, returns. It's the worst time ever to be a venture capitalist. But it's a great time to be an entrepreneur—it's a seller's market to a degree that's never been seen before.”

That said, Thiel has made significant bets on a number of start-ups, using his own capital. The list includes Friendster, an online networking and dating site that subsequently received venture funding from Kleiner Perkins and Sequoia Capital, and American Thunder, a magazine for NASCAR fans.

Thiel thinks the hedge-fund arena is getting overpopulated as well. “There are an awful lot of funds pursuing disturbingly similar strategies,” he says. He avoids the crowds by making some highly contrary bets. “We aren't living in ordinary times. We went through the largest financial bubble in the history of the world, which created an incredibly distorted context on many levels. Our mission is to make sense of the crazy world...and to understand where there are great opportunities for

returns. Not many people are asking the big questions.”

Which questions? “Questions about what globalization means for the U.S. and other developed countries,” he says. “Questions about what sectors of the economy were massively underinvested-in over the past 20 years. The world is much different than in the 20th century. There is a single worldwide economy, but more than 250 countries, far more than in 1945. The trend is toward unity on an economic level, more fragmentation on a political level. The central question is the role of the U.S. in that world.”

The fund manager foresees wrenching change in real estate and financial services. “Real estate is considerably more expensive than it was four years ago,” he says, owing to an explosion in consumer leverage. “People are borrowing more, and saving less. The savings rate is barely above zero percent. What makes that not just extreme, but insane, is that we're talking about 40-some-

thing and 50-something baby boomers who should be saving like crazy for retirement, because government won't be able to take care of them, since Social Security will be broke. People are spending as though they will get a heart attack and die on the day they turn 65. People will reach 65 with a big house and no savings and have to work until they're 85."

Thiel argues the popping of the equity bubble should have been followed by deleveraging of the economy. But that didn't happen, thanks to plunging interest rates. "Under normal circumstances, the bubble collapse would have led to a depression," he says. "Unemployment would have gone up like crazy, it would have been a real economic disaster in the short term. But instead, Fannie Mae and others were encouraged to lend more money than ever. People are pretending the situation in the U.S. is totally normal, when you can buy a house with 3% down, or borrow 125% of the equity in your house, or buy pets on the installment plan."

Thiel thinks the real-estate market is cooling down: "Prices are going up more slowly than before. It's taking longer to sell houses. Insiders at big property developers are selling shares like crazy. The game is nearly over." What that will eventually mean, Thiel maintains, is deflation. He thinks we are headed for a period like 1990s Japan, with annual deflation of 1% to 2%. "Nobody thinks this is in the cards," he says. "Everyone is asking when the Fed will have to start raising rates. But the real question is: When does the Fed throw in the towel and cut rates all the way to zero? They have one more point to go."

Such a deflationary environment would "be catastrophic on the employment side," he says. "Construction, housing, the service sector...all of that will come under enormous pressure. And it isn't just about people losing jobs. It becomes a negative lottery. When too many people lose jobs, everyone else becomes anxious."

With that as the backdrop, Thiel's hedge fund is betting on four themes. The first is deflation. "In trading, people always over-emphasize the immediately previous analogous event," he says. "In this case, people look to the early 'Nineties recession. In 1994, there was a painful bond-market sell-off, the worst since 1926. That's what everyone is remembering. But the reality is, we weren't nearly as leveraged then as we are now. And when you're that leveraged, even a small increase in rates would derail things. The Fed understands history a lot better than people in the private sector. This is our single biggest bet right now." In short, Thiel thinks rates will go even lower, so he's loaded up on 10-year Treasury bonds.

His second big bet is on the dollar's continued slide, which he believes has another 50% to go. "During the bubble, enormous capital inflows into the U.S. created a superstrong dollar, which is why [former U.S. Treasury Secretary Robert]

Rubin could have a strong-dollar policy under Clinton," he says. Thiel says one reason the buck hasn't already fallen more is the political incentive for a strong dollar in the export-oriented Asian economies. "China's government is happy to spend \$100 billion or \$150 billion a year buying dollars to keep the buck artificially strong," he says. "It's a way of ensuring domestic tranquility. But the situation isn't sustainable in the long run." Thiel has been long a basket of currencies against the dollar, including the New Zealand and Australian dollars, the Japanese yen and the Brazilian real.

A third theme: an energy shortage. "The world is running out of cheap oil," he says. "And a lot of what we do have is concentrated in unstable countries in the Middle East. Oil and natural gas and some other commodities are systematically undervalued." Crude, he says, is "easily underpriced by a factor of two," and should be at \$50 to \$60 a barrel. He suggests investors look for oil-exploration firms with high production costs, which have weighed on the stocks: "Think of them as options on much more expensive oil," he says.

Thiel says he's been looking at Canadian oil-sands companies—he won't be specific—and some Russian oil plays. He's also high on **ExxonMobil**, "the most profitable company in the world on a current-dollar basis."

Finally, Thiel is making a bearish bet on stocks. He figures the market is stuck in a wide range—1100 to 2200 on the Nasdaq, 6000 to 12,000 on the Dow Industrials. With stocks near the top of those ranges, he advises against being long equities. Thiel is particularly bearish on the prospects for financial stocks, prompting bearish bets on the Standard & Poor's 500 and on the German DAX, both indexes rich with financials.

"One of the distorted perspectives people have in the financial industry is that they don't believe there is anything unusual about a financial industry as big as the one we have," he says. "In a normal

#### The DJ HEDGE-FUND BENCHMARKS appear on page F11.

economy, finance is derivative. At this point, it's almost central."

Like energy stocks in the 1980s and technology stocks in the bubble, he adds, financial equities have become a disturbingly large part of the major stock indexes. Depending on how you count quasifinancial companies like **General Motors**, which gets most of its profit from financing, the sector makes up about a quarter of the S&P 500's value, he figures. "That, says Thiel, hitching up his oversized white pants, "is way too much."

Nope, despite appearances, he's no Mr. Softie. ■

## HEDGE FUND PERFORMANCE

This table gives performance data for hedge funds managing at least \$20 million in assets. The returns are net of fees. The funds are listed alphabetically.

Source: CISDM 212-213-6202

	YTD % Return	12-Month % Return	3 Year % Return	Assets 1/30/04 (\$ Million)	Type
Absolute Return Europe Fund (Euro)	0.45	18.14	na	124.95	Global Est
Accessturkey	-1.45	63.61	78.47	20.60	Global Emer
ACM High Grade Strategy	0.43	4.47	24.16	491.03	Mkt Neutral
ACM Market Neutral Research Fund	0.94	-1.89	11.66	84.65	Mkt Neutral
Advantage Partners	0.23	1.67	4.28	22.70	Mkt Neutral
Aetos Corp (A)	0.67	2.98	0.55	144.90	Event-Driv
Aggressive Appreciation 100 Fund	2.14	63.43	-8.21	23.90	Sector
Aggressive Appreciation 100 Strategy	1.90	52.97	-18.50	29.23	Sector
AIG DKR Soundshore Investors	0.46	3.69	29.53	339.20	Mkt Neutral
AJR International (A)	0.62	20.29	51.27	314.20	Global Est
Akanthos Arbitrage Fund	2.10	12.21	na	394.00	Mkt Neutral
Alexandra Global Master Fund	2.20	24.41	84.03	1531.00	Mkt Neutral
Alphabridge Fixed Income Fund	1.03	9.50	28.75	51.00	Mkt Neutral
Alphaquest Composite Fund	-5.75	27.09	na	92.00	GI Macro
Alternative Asset Strategies	0.33	20.14	37.57	253.80	Event-Driv
American Durham	2.52	26.89	50.72	170.00	Event-Driv
Andromeda Global Credit Fund	0.51	18.22	47.05	67.50	Event-Driv
Antares European Fund Ltd (Euro)	7.27	41.94	9.21	83.71	Global Est
Anvers Healthcare Investors	0.46	24.13	26.13	58.96	Sector
Anvil Fund	1.24	4.91	12.89	158.00	Mkt Neutral
Anvil Partners	1.17	4.74	12.50	27.00	Mkt Neutral
Apogee Fund	2.24	49.73	8.95	87.00	Global Est
Aquila Intl Fund (A)	1.09	23.20	-20.93	56.30	Global Intl
Arbaway Investments Intl	-0.03	1.57	na	39.00	Event-Driv
Arcas Intl Fund (Covered Interests)	-2.26	-30.24	6.73	36.00	Short-Sales
Arcus Japan Long/Short Fund (Yen)	3.90	44.59	125.60	44.10	Global Est
Arcus Zensen Fund (B)	2.32	28.66	na	268.00	Global Est
Argent Classic Conv Arb (A)	2.46	28.52	93.94	47.92	Mkt Neutral
Argent Classic Conv Arb (B)	3.76	52.11	207.83	90.16	Mkt Neutral
Argent Classic Conv Arb (Bermuda) (A)	1.98	25.49	94.49	391.48	Mkt Neutral
Argent Classic Conv Arb (Bermuda) (B)	3.08	45.95	215.65	204.25	Mkt Neutral
Argent Classic Conv Arb (Bermuda) (C)	0.57	7.31	26.53	171.90	Mkt Neutral
Argent Classic Conv Arb (C)	1.00	12.50	40.13	77.45	Mkt Neutral
Argo Fund	1.89	26.19	104.99	195.00	Global Emer
Aria Partners	3.13	14.88	25.66	30.00	Event-Driv
Armor Capital Partners	0.21	3.46	15.90	26.90	Global Est
Artemis European Hedge Fund	0.20	3.89	na	26.00	Global Est
Artemis Intl	1.72	13.57	11.20	136.70	Global Est
Artemis Partners	1.72	13.66	11.46	40.65	Global Est
Artemis Partners II	1.63	13.44	10.69	35.77	Global Est
Artis Technology Partners	1.49	15.11	na	28.90	Sector
Artis Technology Partners Ltd	1.56	13.98	na	379.90	Sector
Artis Technology Qualified Partners	1.53	14.89	na	191.80	Sector
ASA Tax Advantage Relative Value	0.76	13.74	na	133.40	Mkt Neutral
ASA Taxable Relative Value Fund	0.90	na	na	34.70	Mkt Neutral
Ash Master Fund II	2.75	na	na	35.00	Global Est
Ash Offshore Fund	2.75	na	na	25.00	Global Est
Ashmore Asian Recovery Fund	3.37	22.51	38.75	259.60	Global Emer
Ashmore Emerg Markets Liquid Invest	2.43	35.94	76.33	1734.00	Global Emer
Ashmore Local Currency Debt Port	1.44	16.47	56.58	250.23	Global Emer
Ashmore Russian Debt Portfolio	1.77	20.36	177.27	68.00	Global Emer
Aspect European Equity Fund	4.45	3.02	30.67	95.00	Global Est
Aspect Japanese Equity Fund	-0.20	-3.35	na	20.00	Global Est
Aspect Master Fund	2.42	17.80	na	123.00	GI Macro
Avery Intl	0.91	5.26	9.65	121.00	Event-Driv
Avery Partners	1.16	5.70	10.48	231.90	Event-Driv
Baker Street Capital Partners	0.58	8.27	32.60	23.48	Mkt Neutral
Balboa Fund	4.70	18.92	22.51	60.50	Mkt Neutral
Balboa Fund Ltd	4.30	17.52	20.29	51.00	Mkt Neutral
Barep Convertible Arbitrage (Euro)	0.56	-4.08	na	245.92	Mkt Neutral
Barep Long Short Equity (Euro)	0.55	5.33	na	59.62	Mkt Neutral
Basis Pac-Rim Opport. (Professional Class)	0.39	5.72	na	206.68	Global Emer
Basswood Financial Partners	1.10	18.68	36.45	267.00	Sector
Basswood Opportunity Partners	1.78	22.85	31.61	153.00	Sector
Bay Harbour 90-1	3.65	34.68	9.40	141.70	Event-Driv
Bay Harbour Partners	3.03	34.30	13.24	158.80	Event-Driv
Bay II Resource Partners	-1.90	15.81	na	77.00	Global Est
Bay Resource Partners	-2.40	13.89	48.31	214.00	Global Est
Bay Resource Partners Offshore Fund	-1.20	19.94	57.90	198.00	Short-Sales
Bayou Funds	1.05	15.44	35.34	306.70	Mkt Neutral
Bedford Falls Investors	1.75	21.55	12.57	119.77	Event-Driv
Black Diamond	0.77	8.59	16.74	426.90	Mkt Neutral
Black Diamond Energy	0.01	6.56	18.67	51.70	Mkt Neutral
Black Diamond Energy Partners	0.02	6.64	19.27	58.10	Mkt Neutral
Black Diamond Partners	0.78	8.73	17.44	321.60	Mkt Neutral
Black Diamond Relative Value	0.59	6.30	21.65	77.90	Mkt Neutral
Boyer Allan Japan Fund (A)	-0.54	14.28	34.14	360.20	Global Est
Boyer Allan Pacific Fund	3.16	63.90	65.42	577.90	Global Intl
Boyer Allan Pacific Partners	3.16	63.90	67.93	20.50	Global Intl
BPI Global Equity Hedge Fund (A)	0.13	13.59	na	239.60	Global Est
Braddock Partners	4.24	59.34	82.66	90.00	Global Est
Bric 6	4.69	153.53	na	32.10	Global Est
Bricoleur Enhanced	1.87	41.25	56.36	102.00	Global Est
Bricoleur Enhanced Offshore	0.98	39.31	na	87.80	Global Est
Bricoleur Offshore	0.90	20.46	28.27	247.00	Global Est
Bricoleur Partners	1.05	18.33	24.43	175.00	Global Est
Bricoleur Partners II	1.07	18.24	23.81	204.00	Global Est
C&O Investment Partnership	1.22	-17.04	-7.63	76.85	Short-Sales
Caduceus Capital	4.62	52.94	14.53	69.00	Sector
Caduceus Capital Ltd	4.70	52.80	15.55	198.00	Sector
Cambrian Fund (A)	0.52	34.74	66.87	335.00	Global Est
Cambrian Partners	0.54	35.13	68.37	130.80	Global Est
Camelot Capital Mgt	1.87	20.64	39.44	22.30	Global Est
Canyon Capital Arbitrage Cayman (B)	1.32	6.69	43.75	201.00	Mkt Neutral
Canyon Capital Arbitrage Fund	1.71	8.01	45.95	71.00	Mkt Neutral
Canyon Value Realization Cayman (A)	1.96	20.26	41.35	1400.00	Event-Driv
Canyon Value Realization Cayman (B)	1.93	19.74	39.63	820.00	Event-Driv
Canyon Value Realization Fund	2.37	23.42	44.16	869.00	Event-Driv
Caspian Capital Partners	1.40	14.32	41.38	384.00	Event-Driv
Catalyst Associates	3.61	31.51	65.49	33.75	Global Est
Catalyst Fund	3.53	27.56	11.53	33.50	Event-Driv
CDC European Events (Euro)	5.00	na	na	58.75	Event-Driv
Cedar Street Offshore Fund	2.33	21.83	na	31.69	Global Est
Chatham Asset High Yield Offshore	1.49	na	na	303.00	Event-Driv
Chatham Asset Partners High Yield	1.49	na	na	142.70	Event-Driv
Circle T Intl	4.46	22.17	1.90	110.00	Global Est
Circle T Market-Neutral Fund	1.34	11.98	na	23.20	Mkt Neutral
Circle T Partners	5.29	23.49	2.15	126.00	Global Est
Circle T2 Partners	3.06	12.54	24.24	37.19	Global Est
Clarion Offshore Fund	1.99	34.26	8.44	56.21	Mkt Neutral
Clarion Partners	1.61	33.44	8.01	56.35	Mkt Neutral
Clarium Capital	5.30	63.79	na	180.00	GI Macro
Clipper Fund I	0.74	9.88	48.03	50.71	GI Macro
Clipper Intl	0.74	9.85	48.01	36.31	GI Macro
Coast Arbitrage Fund II	1.29	10.97	25.61	120.01	Mkt Neutral

### FOCUS ON: Clarium Capital

Investment Style: Global Macro Fund.

Specialty: None; invests in bonds, currencies, equities, index, commodities.

Web Address: <http://www.clariumcapital.com>

#### INVESTMENT THEME

Deflation is coming.

The dollar will drop dramatically.

Crude-oil prices will rise sharply.

Stocks are near the top of a wide range; financials are particularly vulnerable.

#### HOW TO PLAY IT

Buy 10-year U.S. Treasuries.

Go long a basket of foreign currencies—including those of Australia, New Zealand, Japan and Brazil—against the dollar.

Invest in ExxonMobil, Canadian oil-sands firms, Russian oil outfits.

Short stock indexes heavy with financial stocks, including the S&P 500 and the German DAX.