Why analysts should not be investors, Andy Zaky edition

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By Felix Salmon

Back in October [1], Andy Zaky put out his sixth "buy" recommendation on Apple stock. The first five — in July 2006, November 2008, August 2010, June 2011, and May 2012 — all did spectacularly well, and all hit his price target within the time span he specified. Zaky was a first-rate Apple analyst, quoted by me [2] and many, many others; as Philip Elmer-DeWitt [3] says, he had "a series of spot-on predictions", of everything from Apple's earnings, to its iPhone sales, to — of course, its stock-price movements.

Smart and accurate Apple analysts are in high demand, and Zaky, quite sensibly, decided to monetize his gift. In June 2011 he put his blog [4] behind a paywall, charging first $49 per month and then, in June 2012, $200 per month. With 700 subscribers, that meant a six-figure income *per month*, just by selling access to his detailed Apple analysis and trading recommendations.

Unlike most analysts, however, Zaky soon discovered* that his subscribers actually followed his recommendations — to the letter, in many cases. They weren't using his analysis to inform their own decisions, they were outsourcing all of their decision-making to Zaky, simply placing the trades themselves. And so Zaky made a fateful decision: in that case, he might as well start his own hedge fund.

Bullish Cross Asset Management was launched in late 2011, and by November 2012 some 28 investors had invested a total [5] of $10,607,815 with Zaky. And had lost it all. For Zaky, it turns out, was a truly dreadful fund manager: the kind of guy who not only put all his eggs in one basket, but the kind of guy who would also desperately double down upon incurring trading losses. With that kind of a trading strategy, even someone who's right 85% of the time is going to blow up pretty quickly.

Zaky of course feels bad about this, and says he wants to make his partners whole, and "make things right". But that would involve investing money, and investing money is clearly something Zaky is incredibly bad at. It's easy and facile to sneer at analysts, saying that if they were actually any good at their jobs, they'd be making ten or a hundred times as much money by actually investing, instead of just putting out recommendations. But the fact is that analysis and investing are two very different skillsets, and while Zaky was very good at the former, he was very bad at the latter.

There's no particular shame in that; sometimes you only learn your limitations by trying and failing. But the most astonishing part of the Andy Zaky story is not that he set up a tiny hedge fund which failed. Rather, it's the lemming-like way in which the subscribers to his newsletter lost a mind-boggling sum of money — quite possibly well over $1 billion [6].

Elmer-DeWitt has heard from 36 former subscribers to Zaky's newsletter; between them, they lost a whopping $92.5 million. Just one of them claims to have lost $50 million, or five times the total assets of Zaky's hedge fund. If you ignore that one outlier, the rest of the subscribers have still lost an average of $1.2 million apiece — vastly more than the $380,000 or so invested by the average partner in Zaky's hedge fund. And if you include the $50 million outlier, then the average loss rises to $2.6 million. Multiply either number by 700 subscribers, and it's easy to see how total losses could reach the billion-dollar mark.

Reading Elmer-DeWitt's original story [3], it's clear that many of those investors were incredibly unsophisticated. And probably their self-reported loss estimates should be taken with a pinch of salt: they're probably calculating their losses from their mark-to-market high point, rather than from the amount of cash they invested into trading Zaky's recommendations. Still, this story is clear proof, in case any were needed, that you don't need to qualify as a sophisticated or wealthy investor in order to engage in ridiculously risky trading strategies.

The Zaky story is depressing for another reason, too. The subtitle of his blog is "The Power of Compounded Returns in Holistic Quantitative Modeling" — it looks impressive, but it's ultimately meaningless, and it naturally appeals to the ignorant. It can't have taken Zaky very long to work out, on a subconscious if not a conscious level, that the best way to develop a reputation, and to build up his subscriber base, was to be as aggressive as possible in his calls, and to try to maximize both returns and risk. No one was going to pay him $2,400 a year to outperform Apple stock a little bit: these people were greedy, and wanted to shoot the moon. As such, they only have themselves, rather than Zaky, to blame for their losses. In fact, by creating a strong incentive for Zaky to ramp up the risk quotient in his calls, they probably helped turn a first-rate analyst into a busted investor: Zaky's behavior, in some sense, was his subscribers' fault.

Zaky, it's clear, had much more value to the world of investing when he *didn't* have skin in the game than when he did. That might be hard for a former trader like Nassim Taleb [7] to understand, but the fact is that investing creates all manner of psychological feedback loops, which have to be managed with discipline. If you can't manage those feedback loops, you'll blow up — but at the same time, absent those feedback loops, you can still be a very perspicacious analyst.

Why did people take money they couldn't afford to lose, and invest it in high-risk options strategies playing a single stock? Why did one person invest *50 million dollars* in such strategies? And why did any of them trust a kid with no investing track record? It seems incomprehensible to me. But as Larry Summers famously said, "there are idiots. Look around." You think a billion dollars is a lot to lose on Apple stock? Well, Macau's casinos took in $3.4 billion [8] of gambling revenues just last *month*. There will always be gamblers, and gamblers will always lose money. But it's easy to see why Apple's executives have historically paid as little attention as possible to the antics of the stock market.

****Update***: Mick Weinstein [9] points me to an unbelievably hubristic Zaky post [10] from October 2011, which helps explain why people were following him so slavishly. There's a whole section called "Bullish Cross Model Portfolios: The Importance of following our Models to the Letter":

"We've repeatedly mentioned over and over again that closely following the various Apple-based model portfolios to the letter is very key. That when we make a decision with regards to these portfolios, that decision is very carefully calculated and delicately executed to contemplate nearly every scenario that the market can throw at us. If you decide to deviate from the model, you're likely to run into problems…

I could put out 10,000 pages of material and that wouldn't even come close to scratching the surface of what goes into my decision making process. There is no way for me to practically reduce all of my knowledge, experience or reasoning abilities to the written word…

It is completely unreasonable to expect me to reduce every single thought or reason behind every decision we make to the written word. No one could do that… There is so much in terms of experience that there is simply no practical way I can teach people everything.

The equity markets is very much as complicated as the human body and it would be like asking a physician to teach you to practice medicine in a few months. When we make a decision, we try to do the best we can to give the core reasons behind that decision. But you should understand right now that (1) there's very little that is lost on me, (2) there's very little that you've thought of that isn't already on my mind."

For 95% of people, this kind of thing is a huge red flag, saying "stay well away from this guy". But for the other 1%, it's weirdly comforting.

[1] October: **http://tech.fortune.cnn.com/2012/10/10/andy-zaky-makes-the-case-for-buying-apple-now/**

[2] me: **http://blogs.reuters.com/felix-salmon/2011/11/28/chart-of-the-day-apple-valuation-edition/**

[3] Philip Elmer-DeWitt: **http://tech.fortune.cnn.com/2013/03/04/apple-zaky-bullish-cross/**

[4] blog: **http://bullishcross.com/**

[5] total: **http://www.sec.gov/Archives/edgar/data/1533896/000153389612000002/xslFormDX01/primary_doc.xml**

[6] over $1 billion: **http://tech.fortune.cnn.com/2013/03/06/apple-zaky-bullish-cross-2/**

[7] Nassim Taleb: **http://nassimtaleb.org/category/skin-in-the-game/**

[8] $3.4 billion: **http://www.scmp.com/business/companies/article/1166178/macau-gambling-revenue-115pc-february**

[9] Mick Weinstein: **https://twitter.com/mickwe/status/309622344924680192**

[10] unbelievably hubristic Zaky post: **http://bullishcross.com/2011/10/the-apple-game-plan-for-october/**

How an Internet-trained Apple analyst lost tens of millions of other peoples' money

By Philip Elmer-DeWitt

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In the late 1990s, an ad agency creative director I'll call Joe Smith to protect his privacy bought several hundred shares of Apple (AAPL) at $60 apiece. Last fall, at age 42, he found himself out of work and increasingly dependent on the value of those shares to make ends meet.

Following the lead of a 33-year-old investment advisor named Andy Zaky who had written that Apple was going to $750 by January and to $1,000 within a year, Smith converted most of his Apple common stock -- more than he should have -- into high-risk Apple call options. When those options expired in the third week of January with Apple trading below $500, they were worth exactly zero. Smith had lost roughly $400,000 and all his Apple shares.

A lot of people lost a lot of money when Apple went into the extended downward slide that just entered its sixth month. And there were plenty of other experts saying all along that the stock was undervalued and ready to bounce. But Smith's story -- and the story of hundreds of other investors who were following Andy Zaky's so-called Apple model portfolio last fall -- hold a special poignancy for me. Not only did these people get some spectacularly bad advice, but they got it from someone whom I helped make famous.

I'd been writing about Zaky since the fall of 2008. I'd covered his earnings predictions, his buy and sell calls, his critiques of competing fund managers. I'd eaten dinner with him, toured him around my Brooklyn neighborhood, introduced him to my wife.

So I feel a personal and professional obligation to find out what went wrong.

First, some background.

Andy Zaky was born in 1979 and raised in Southern California. He graduated from UCLA in 2003 and UCLA Law School in 2008. His bio on Seeking Alpha, where he's published more than 90 articles over the past five years, describes him as having 10 years of investment experience, although he has no formal training in financial management or technical analysis.

He says he learned everything he knows about trading stocks on the Internet, where he developed a knack for anticipating when a stock was over- or undersold based on a variety of technical indicators, including the Chaikin Oscillator and the RSI (relative strength index).

He first came to my attention in September 2008 with an e-mail that began "Please check your facts." I had written iPod nano when I meant iPod shuffle, and thanked him for catching the error. A month later he showed up in the first of my quarterly "Earnings Smackdowns," which pit professional Wall Street analysts against amateur Apple investors. He was tied for top honors that quarter, having forecast Apple's earnings for Q4 2008 to within a penny.

It was the first of what was to be a series of spot-on predictions -- of Apple's quarterly earnings, of its iPhone unit sales, of the high and low points in Apple's wildly variable stock chart. On May 17, 2012, for example, two days before the stock jumped $30 and began its four-month run to over $700, he issued a public call to buy Apple at $533.52 a share -- advice that was rebroadcast by Daring Fireball's John Gruber to tens of thousands of readers. "This is only the fifth time Zaky has issued a buy on Apple," Gruber wrote. "He's four-for-four."

By then, Zaky had become something of a celebrity. At an Apple Investor Summit held at the Los Angeles Convention Center last March -- a gathering that drew such headliners as Apple co-founder Steve Wozniak, Steve Jobs biographer Walter Isaacson, CNBC's Jim Goldman, Fox Business' Cody Willard, Asymco's Horace Dediu and Fortune's Adam ("Inside Apple") Lashinsky -- Zaky was mobbed by admirers from the moment he identified himself at the back of the room.

Zaky was working hard that spring. He had taken his free newsletter, Bullish Cross, behind a paywall in June 2011, charging subscribers $49 a month for his daily live market analysis, annotated charts and weekly summaries -- pieces that were sometimes 3,000 or 4,000 words long.

"There's a solid easy 500% gain to be had in Apple with an imbalanced low level of risk involved," he wrote, with typical bravado, at the launch of Bullish Cross Pro. "There is such a low risk profile in this trade, that I'm actually pretty shocked that not a whole lot has actually been written about it."

As Apple's share price climbed and Zaky's fame spread, investors clamored to get in. In June 2012 he opened his newsletter up to a flood of new subscribers, charging the members of this group $200 a month. At its peak, Bullish Cross Pro had 700 subscribers and a lively bulletin board where Zaky would often field more than 500 comments and questions a day.

Meanwhile, he was onto something even bigger. In late 2011 he'd launched Bullish Cross Capital L.P. -- basically an Apple-only hedge fund -- with a handful of subscribers. By the spring of 2012, the fund's investor rolls had grown six fold. In a Form D filed in November 2012, Zaky reported to the Securities and Exchange Commission that Bullish Cross Asset Management (BCRAM) had attracted 28 limited partners with an average investment of $378,000. The minimum investment, which started at $250,000, had grown to $500,000 by March 2012.

It was in the hedge fund that the first signs of trouble appeared. An investor who spoke off the record because he is bound by a nondisclosure agreement, describes how the fund missed both of Apple's big 2012 rallies -- in April when it hit $644 and in September when it hit $705. Zaky lost nearly nearly 50% of the fund's capital in one month (March) by buying bearish put spreads just before the stock rose 10%. The fund also managed to get crushed when the stock went down. In May, when the stock fell nearly 100 points, Zaky had bet heavily on bullish calls spreads.
"It iis amazing how poorly positioned the fund was," this investor writes. "He based his trades too much on how Apple traded in the past and completely discounted any black swan scenarios. He didn't follow any of his own previous advice about how to properly position yourself -- not over-allocating on single trades and having proper upside and downside hedging."
Bt the fall of 2012, Zaky was desperate to recoup the fund's losses. He bet what was left of its capital on more call spreads, gambling that the stock would rally at $630 and hit $700 by January.
When Apple fell to $505 in late November, he sent his investors what must have been one of the most painful letters of his life:

"Dear Limited Partner," it begins. "It is with extraordinary regret that I must inform you that during this very dramatic period, the fund has sustained very heavy and largely irreversible losses... At this point, it makes very little sense for anyone to make a redemption given that the fund's liabilities are greater than the fund's capital balance."

Zaky had taken under management more than $10.6 million of other people's money and lost it all.
But those lost millions -- suffered largely by well-to-do investors who knew the risks they were taking -- pale next to the damage done to the 700 subscribers at Bullish Cross Pro. Many of these investors have since fled the site and joined a Google group called bc-subs (for "Bullish Cross subscribers"), where they commiserate about their lost retirement funds, their ruined marriages, their thoughts of suicide. Many lost hundreds of thousands of dollars. Some lost millions.
"A significant number of the people who lost money following Zaky's trades were people who were not sophisticated enough to understand the instruments in which they were investing," says one member who asked not to be identified. "Early on, Zaky had made recommendations about not putting more than a certain percentage of one's capital into following his Apple positions, but most people ignored that."

"I fell in love with this punk kid," recalls a 40-year-old freelancer who converted shares she had purchased at $90 into the call spreads Zaky was recommending. "He was cool. He wasn't bullshitting. He made sense."
But things got out of hand in October, when Zaky became convinced that Apple was set to rally. "At some point he lost it. When he said hold on to our spreads, I was losing $25,000 a day. I froze. I couldn't sleep."

"I can distinctly remember his urging members to deploy 'any spare cash' they had into the $655-$705 call spread," recalls another former Bullish Cross member.
"It all seems a bit, well, a bit crazy in retrospect," says Joe Smith, the ad guy who converted his $60 Apple shares into options that expired worthless. "He had this way of very agresively stating his position. But when the share price really started dipping in October and November, his comments started sounding more emotional and bombastic."

Smith recalls Zaky doing things a professional money manager would never do: Picking a public fight with a prominent Apple bear (Seabreeze Partners' Doug Kass). Urging members to write to Apple Investor Relations. Talking about a meeting with Apple chief designer Jony Ive that never panned out.
Most tellingly, when subscribers started asking whether they shouldn't be buying some downside protection, hedging their bets in case Apple kept falling, he grew increasing angry and defensive. "By the time I got there he wasn't talking about risk management," says Smith. "He was talking about going all in."

When Zaky finally advised his readers to bail out of their call spreads, it was too late.
Although there is plenty of anger in the Google group -- talk of a lawsuit and what might happen if they ran into Zaky in a dark alley -- many members recognize that they share some of the blame for putting more money than they could afford to lose into high-risk investment vehicles. Besides, no one forced them to follow the advice, as one member put it, of some punk on the Internet they'd never met.

Others, however, seem to be mostly interested in finding another investment guru who will promise, as Zaky did, easy gains with low risk. One complaint often heard in the group is that Zaky never took responsibility for what happened or apologized for the losses that were suffered. But I know Andy well enough to know that he's shattered by the experience. You can hear it in his letter to BCRAM's investors:

"As a first generation Coptic-American, I was raised with very deep seeded (sic) traditional notions of honor and responsibility. For this reason, I will spend every living breath I have to work with an effort to make our partners whole again...

"I am deeply sorry that I failed you. I brought dishonor to myself and my family, and all I can do at this point is work hard to try and make things right."

On Bullish Cross Pro, Zaky has moved away from covering Apple and concentrated on trading the SPY, which tracks the S&P 500 and requires less faith in fundamentals. For the few members that remain, he has recommended several recovery plans, some of which involved investing in January 2014 Apple options that have already lost most of their value.

Zaky declined to be interviewed for this article beyond a brief e-mailed comment:

"The bottom line is we didn't expect Apple to crash 40% of its value inside of a few months and trade at a 10 P/E ratio given its cash flows. We were on the bull side of the Apple case and it didn't work. I wish I could give you more, but then it would just look like a complicated set of excuses. And what's the point."

Zaky did post a 19,000-word "Apple postmortem" on Bullish Cross explaining what, as he sees it, went wrong. One member of the Google group summarized it in a haiku:

Technicals failed
Fundamentals also
No one did better