Mr. Seth Klarman

Presentation at the Ben Graham Centre for Value Investing, Richard Ivey School of Business

Presentation Notes by Loh Wei
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Prof George Athanassakos arranged for an amazing speaker for our Value Investing class today. We had a video conference with Seth Klarman. Klarman wrote the now out of print 'Margin of Safety' which is sold on ebay and amazon for over 1400 USD. He shared with us his insights on investors' psychology, his investing process, and some amazing opportunities that are available in the market.

Seth Klarman is the President of Baupost Group and has been running the investment house for more than 20 years. His annualized return over that period has been over 20%. Over the last few years, having astutely side-stepped land mines with an ample cash position allowed the firm to thrive in this volatile market.

The **3 underlying pillars** to his investment approach:

1. Focus on risk

Be a big fan of worrying. Risk is NOT BETA. Risk is the probability and size of losing under different scenarios. It is most important not to be obsessed about single point estimate, but to focus on range of outcome.

2. The world is orientated to relative performance

Mutual funds are largely asset gatherers, as they earn management fee as a percentage of underlying asset. They are not incentivized for outperformance. Mutual funds are hugely penalized when they underperform due to client defection. This has encouraged many actively managed funds to be 'closet index fund'. Being mediocre is perfectly fine in the mutual fund world.

To gain an edge, we should focus on absolute return. Thus we would rank not losing money as more important than out performing the index. Losing 18% when the world is losing 20% is just insane.

3. Bottom up orientation

Very few people have shown that they are able to predict the macro economy. And even if they predict accurately, the asset class and security chosen may not work out as well as they macro prediction.

We could gain an edge by focusing on bottom up approach to investing. We need to analyze the individual company and security thoroughly and work out all the possible outcomes for that individual security under different stress test scenarios.

Identify an edge

Klarman told us to focus and identify an edge. Every investor needs to think about this, but few of us do. One of Baupost's edge is that it has a long term orientated investment policy backed by long term money. Many good funds couldn't invest right now as they are afraid that they'll have to sell more stocks to meet redemptions demands. Having committed long term capital is crucial to long term investment success.

Another edge Baupost has is that it loves messy situations. A favorite asset class right now is distressed debt that has been recently downgraded. Many pension funds and bond funds invest in high credit rating bond because they want safety, that their fund mandates it. When a downgrade occurs (i.e., 'safety' condition removed), many such investors are forced to sell. Good investors love to buy when the other party is in a panic selling mode.

Know who you are buying from

Think twice about buying when you know that the seller is a good investor who has done due diligence; or the other party is an insider. You don't want to be the patsy.

Other Mispriced Situation

A stock that is knocked out of S&P index would have huge selling pressure. About 10% of all S&P stocks are owned by index fund. Being removed from the index would mean that many index funds would be forced to sell, causing the stock to be mispriced.

Corporate Spinoff – It is often the unloved child that is being spun off. Normally it has low ROA, litigation, or weak management. Owners of the parent company stock don't want to own the ugly child. Having many motivated sellers provides some mispricing opportunity.

Car loans provided some interesting investment opportunity; many originators are keen to sell these off, but the traditional securitization market has dried up. When analyzing car loans, a good question to ask when assessing the safety of the security could be “if historical loss rate quadruple, can we still be safe?”. Or when analyzing housing related securities, ask if “housing prices in the area goes back to 1979 level, can we still be safe?”.

Some things are easier to forecast in this current environment; earnings from gaming houses in Las Vegas is down 20%, but it is very hard to guess what next year earnings will be. However, the sale of Kleenex is unlikely to decline by 20% over the next year as people are still going to buy Kleenex.

For beginners – there are some close end funds trading way below NAV. If you think there is sufficient MOS, this could be a beautiful opportunities.

Margin of Safety

Only buy when an appropriate Margin of Safety could be established. The alternative or default position would be cash. Klarman’s fund entered 2008 with over 35% in cash, but its cash position is now in the low 20s. However, he sold some assets to maintain a high cash position as he said this is a period of time where you don’t want to be caught without cash. It is interesting to note that Buffett sold some Johnson and Johnson shares after his buying spree late last year to maintain high cash position.

Investments should be simple and straight forward without need for over optimistic projections. A biotech companies that his fund owns has a royalty streams of over 30% IRR. The current price is lower than the present value of this highly predictable stream of royalty. There is no need for great things to happen to the company for the investment to provide adequate return, and there is no place for optimism in valuation.

He currently price in several years of GDP decline into every scenario analysis and would only buy if he’s comfortable with that.

Risk

Perform intensive sensitivity analysis on every security that you purchase. For instance, when Klarman stress tests mortgage backed securities (where there are some interesting mispricing going on), he factors housing prices changes, default rate changes, and repayment of loan rate changes. If at a depression level scenario the security still presents good value, then it is a clear buying opportunity.

Academics think that more risk (volatility or beta) more return. But value investors know that the less the risk, defined as Probability of loss multiplied by magnitude of loss, and the greater the margin of safety, the greater return.

On a macro level, in 2006 when financial institutions grew to 40% of S&P, Klarman was worried because it showed that the growing economy is driven by growing leverage. Over the last 2 years, many traditional value investors got killed as they were not quick enough to re-calibrate their understanding of book value. He also noticed that for most investor, once you lose 30% - 50% of capital, your thinking gets fuzzy.

Valuation

Make use of multiple scenarios and valuation methods to value a security. Examples of valuation technique used are liquidation value, replacement cost, book value, PV of cashflow, earnings and cashflow multiples, breakup value, private market take over value (not levered), LBO or MBO.

If the current price is in the middle of your multiple case analysis, then there is sufficient Margin of Safety.

If everyone in the market looks at a business and values it a certain way, e.g. as a LBO target, it is often beneficial to look at it another way – e.g. at liquidation value. This provides both margin of safety and a more dynamic approach to valuation.

Optimism

It is unreasonable to think that the world is simply not going to wake up tomorrow. Klarman has not seen so many opportunities to invest in since the day he graduated. The period with the highest return going forward would be the worst period of return looking backward.