Seth Klarman is More Worried than at Any Time in his Career

By Robert Huebscher
May 25, 2010

The concern that the dollars he earns for his clients will lose their purchasing power is always on hedge fund manager Seth Klarman's mind. The possibility that the government will continue to print money to solve our economic problems has left him more worried than at any time in his career.

"There are not enough dollars in the world to do that, unless we greatly debase them," he said.

Klarman has enjoyed one of the most illustrious careers in the investment industry. As founder and president of the Boston-based Baupost Group, he has compiled a track record of 20% annual returns over the last 28 years. Most remarkably, in only one year has he lost money.

He spoke at last week's CFA Institute annual conference, where he participated in an hour-long question-and-answer session with author and *Wall Street Journal* columnist Jason Zweig.

This article is longer than usual, since we are providing comprehensive coverage of Klarman's remarks, from start to finish, on topics including how Baupost is organized, market valuation levels, the investment industry and how he is protecting his clients against a potential decline in the value of the dollar.

Hostess Twinkies

"A Hostess Twinkie is something that has made many childhoods slightly happier with totally artificial ingredients," Klarman said.

That metaphor explains the prevailing environment in the US over the last year, he said, when virtually every market condition was maintained by the government, which kept interest rates at zero, bought up mortgage-backed securities, and installed far-reaching lending programs.

"We don't know the full extent to which we were manipulated," he said. "The government wanted people to buy equities, to invest so that the market would go higher, to build the wealth effect so that people would feel better, and to restore a degree of optimism so that the economy might recover."

He is still worried about what would happen to the economy and the market if those artificial ingredients are removed and “we realize it was in effect a Twinkie.”

That high degree of government involvement continues, he said, with the “gargantuan” European bailout program, which he said is not likely to work and merely “kicks the can down the road,” serving as the latest example. “It is one more manipulation tempting people to own things.”

“It’s almost like the government was in the business of giving people bad advice. ‘We’re going to hold rates at zero, so please buy stocks or junk bonds that will yield at least five or six percent so you might make something.’ In effect, it is forcing unsophisticated investors to speculate wildly on things that are fully too overvalued,” he said.

Sophisticated investors are similarly tempted, he said, mostly because they are engaged in a short-term performance race.

The new element in the game

Government involvement is why Klarman is more fearful now than at any previous point in his career. He said he always thought, until recently, that he could do well by having a good process and a clever approach, and his wits would enable him to find good bargains.

Now, however, he said a new question affects his outlook: will the dollar be worth anything?

His clients are US-based investors, his results are measured in dollars, and he hedges his positions back to dollars. While he conceded that this crisis might not be different from other crises – and we might successfully recover from it – he is worried that the solution to every problem is to push the problem further down the road.

Politicians find it easier to “create inflation” than to tackle the serious problems, he said. He cited newly elected Massachusetts senator Scott Brown as someone with the right attitude and the ability to communicate clearly, and he said we need more politicians like Brown to address those problems.

Klarman said most Americans understand that there is no “free lunch” and that and we cannot indefinitely forestall problems such as budget deficits, but he is unsure whether the current crisis will force us to act in the right manner.

“We didn’t get the value we should have from this crisis,” he said, contrasting the recent woes with the Great Depression, which spurred one or two whole generations to change their values – Americans in the decades after the Depression believed in saving and not borrowing to the point of overextending themselves. Though the Depression itself was terrible, Klarman said, “it was a great thing to have a Depression mentality.”

Instead, we've had a "really bad couple of weeks" mentality, he said, and that's not enough to help us avoid future bubbles.

US debt worries

Klarman warned that sovereign debt crises, such as the US may potentially face, are characterized by what Malcolm Gladwell describes as "tipping points," and that history is not a perfect guide.   Everything may seem fine with countries with overextended debt, until one day it's no longer fine and a crisis unfolds.

Journalist Jim Grant has described debt has "money of the mind," and Klarman said that description applies to sovereign debt too. "If we think the US will pay us back and not suffer from inflation, investors will line up to buy its debt," he said. Otherwise, we will have failed auctions and higher interest rates.

Through his public remarks, Treasury secretary Tim Geithner seems to have been lulled into thinking that there is nothing we can do that will cause us to not be AAA, Klarman said. "That kind of thinking virtually guarantees we will not be AAA."

Protecting against inflation and a decline in the dollar

Given Klarman's concerns about the fragility of the dollar, a key question was how Baupost is defending against the possibility of inflation or a weakened currency.

He protects his portfolio against "tail risk" – unlikely but possibly catastrophic events, such as much higher inflation. He does not use TIPS for this purpose; he believes the government understates inflation because it has an incentive to do so.

Klarman said it is more likely that bond market vigilantes will react to inflation risk before it shows up in government-reported data. He has bought out-of-the-money put options on bonds. If rates go up by as much as 5% or even 7%, he will not profit. But if rates rise by 20% or 30%, then he could make 50- to 100-times his investment. He said the odds of such a scenario were unlikely in the short term and more likely five years out – but not a 50/50 probability.

He compared such protection, which is available at a reasonably low cost, to buying homeowners insurance.

Tail risk protection is "very much art and not science," he said, and advised investors to contemplate many scenarios with and without the dollar as the reserve currency. Gold is not necessarily the answer, he said, because it could go "berserk" on the upside or could go down from its current record high. Nonetheless, he said gold has a role in a portfolio because "it has the age-old aspect of being seen as a store of value."

The purpose of owning gold is not to make money, he said. "If the world gets really bad, we want to protect as much of clients' purchasing power as possible, or offset a decline in market value of their assets." He said his goal is to avoid "being down 30% and being paralyzed."

Clearly, his downside protection strategy involves many more elements than those he discussed, and he said he did not want to reveal those details for fear that those in attendance would "frankly, overpay for derivatives." He stressed that he does not have a fundamental view that he knows what will happen with regard to tail risks, and he recommended seeking inexpensive hedges.

Klarman derided commodities in general, singling out fine arts and collectibles. He said that anything that does not generate intrinsic cash flow is therefore based on the belief that it can be sold to a greater fool. As such, he said, buying commodities is speculating and not investing.

Among commodities, only gold and land have value as investments in Klarman's eyes. Land is hard to evaluate, though, because it has the potential to generate cash flow only at some point in the future.

Index funds and stocks for the long run

Klarman has been critical of index funds in the past, and he reiterated his concerns last week. He considers these funds to be a "horrendous idea," because stocks trade up when they are included in the index, and buyers (including index funds) overpay for them. He prefers to buy stocks when they trade down because they are taken out of an index, at which time they possess the classic characteristics of a value stock.

The average investor who can't afford the time to analyze investment opportunities "does not have a lot of good choices," he said. The preaching of "stocks for the long run" does a "tremendous disservice," he said, because "you have to make sure you are around for the long run." Individual investors may not have a sufficiently long time horizon or may be forced to sell at precisely the wrong time, when market conditions are depressed, because of liquidity needs.

The "entry point" is really what matters, he said, which explains why we have had 10-12 years of zero returns, referring to those who bought US equities at high valuations a decade ago. He is worried about similar returns for the next decade, too, given the recent market run-up.

"Saving transactions costs and management fees doesn't mean it will produce good results," he said.

There are times when other assets classes are far more attractive, he said. A year ago, on a risk-adjusted basis, debt was much more attractive than equity. You may have done better in equities, but that doesn't mean debt was less attractive.

Goldman and regulation

Klarman was more forgiving than most of Goldman Sachs. He recognizes that Wall Street does not exist for his or anyone else's benefit. It is there to make its institutions money, just as it has always been. He credited sell-side firms that work with Baupost, and he said that many have become more acutely aware, over the last 15 years, of the types of clients he represents.

"I know Wall Street will always try to rip our eyeballs out," he said, but he is not sure on which trade that might happen.   He deals with brokers with "open eyes" and avoids taking unnecessary risks, and he considers this the only way to effectively police their actions. Those firms have a responsibility not to lie, but he does not expect them to act as a fiduciary in a trading relationship.

"The perception that they are evil is misguided," he said.

He would welcome requirements about disclosure, limits on leverage, and the elimination of proprietary trading desks, which he said create a conflict of interest. Elimination of those desks, he admitted, would also eliminate some of the competition his firm faces.

A systemic risk regulator would be ineffective, he said, because human nature makes people feel too good when things are going well and the market is going up. It is unlikely that "just the right skeptic" could be found for that position, or that such a person would be able to defend an unpopular position before Congress. "Regulating risk in that way is impossible," he asserted.

The proposed bank rescue fund is also misguided, because it penalizes the successful and more competent banks by requiring them to fund the bailout or dissolution of their less competent competitors. A better solution, which he credited to Bill Atwood, executive director of the Illinois State Board of Investment, would be to wipe out the equity of failed institutions and convert their subordinated debt to equity. That would have been much more effective in rescuing AIG, he said.

Short sellers do not pose a threat to the markets, Klarman said. To the contrary, he credited them for being "market policemen."   His experience is that short sellers do far better analysis on their ideas than long buyers, because the market is biased upwards.

If short selling were banned, we would have a market that "levitates" more than the current one, he said, and that would not be in the country's best interests. There would be more scams and more potential for the little guy to suffer painful losses.

One exception, which he said amounts to yelling "'fire!' in the theater," occurs when investors short companies that need regular access to the market. He cited General Electric as an example, explaining that GE made a terrible mistake by assuming it could roll-over its commercial paper as the financial crisis unfolded.

"The acts of selling short and voting for overvaluation are more patriotic than those on CNBC, whose message is to constantly rally the market," he said.

In regard to the May 6 "flash crash," he made one comment that seemed to startle many in the audience. He was asked about investors who put in market orders and found that they had sold shares at prices near zero. "Nobody should put in a market order," he said. "It doesn't make sense. You are not the seller at the market, because the market can change rapidly. Why would you do that?"

No funds-of-funds

Having great clients is one of the keys to investment success, Klarman said. The bulk of his clients are highly knowledgeable families and sophisticated institutions. During 2008, most sophisticated institutions had problems but understood the underlying dynamics of the crisis and the opportunities it presented for value-minded investors. Most individuals, by contrast, were left "staring into the abyss," he said.

Two characteristics define what he considers an ideal client. First, when his firm has what he considers a great year, his clients should agree. It would be a "terrible mismatch," he said, if he achieved what he considered excellent results but his clients were unsatisfied. Second, when he calls clients to say there are unprecedented opportunities, he would like to know that they will at least consider adding capital and not redeeming.

"Most of the time they add and not subtract," he said, which allowed him to be an active buyer in 2008, a year when other managers were forced to sell many of their best ideas.

"We need to have clients that would love that phone call," he said.

Funds-of-funds do not meet Klarman's criteria for acceptable clients. They can't take a long-term horizon, he said, because they are not in control of their own fate. They don't know their clients, who might be individual investors who become scared at a market downturn and make redemptions at the wrong time, even if the manager is doing a great job.

Investing for the long term

Investing with that long-term focus is necessary, according to Klarman, and the results of most money managers suffer because they are engaged in a constant race to demonstrate short-term performance. He spoke about this issue broadly in a talk he gave last year, and he touched on it again last week.

In early 2009, he increased his position in residential mortgages from zero to nearly 50%, something he was able to do thanks to the long-term nature of his investing philosophy and his unconventional organizational structure.

Most firms have analysts assigned to specific industries – such as pharmaceuticals, oil and gas, and finance. Instead, Baupost is organized by investment theme, with teams that, for example, focus on distressed debt, post-bankrupt securities and spinoffs. This allows them to avoid wasting time following quarterly earnings announcements from companies that they are unlikely to invest in. They can be nimble and focus instead on where excess leverage is being liquated and where there is misguided selling or redemptions.

That made it easy for Klarman to buy in the fourth quarter of 2008 and the first quarter of 2009. The critical thing, he said, is to understand that securities are not pieces of paper that trade in “blips up or down” as reflected on the CNBC ticker and described by personalities such as Jim Cramer and Larry Kudlow. “This is not investing,” he said.

If you are afraid that a bond you bought at 60 might go to 50 or even 40, then you will be nervous to buy more. “But if you know it is covered in an extreme likelihood to 80 or to par or even above par, then you are likely to buy more of it,” he said. He anticipates holding every investment a “really long time and potentially forever,” he said. “Otherwise, it is speculating and not investing.”

“If you lose sight of that and can’t hold it for the full holding period – to maturity or in a bankruptcy beyond maturity – then you have to worry about where it will trade, what your clients will think, what your team will think, and ultimately what you will think,” he said. “But if you have the staying power and have the conviction of your analysis – that your analysis wasn’t optimistic or flighty or based on a snapshot of an economy that would not tolerate any stress – then you will not panic when it goes down.”

Only by stress-testing all his investment ideas, subjecting them to scenarios that include economic, interest rate and other kinds of risk, does Klarman gain a high degree of conviction that those ideas will succeed with the necessary margin of safety.

Courage versus arrogance

While that analysis engenders the courage to invest, Klarman draws a careful line between courage and arrogance.

When investors believe or claim that they know more than the market, or when they simply buy when everyone is selling or sell when everyone is buying, that is arrogance. Attitude must be tempered with humility, Klarman said. “We know we could be wrong, that things could change, that this is hard not easy, and that we have lots of smart competitors.”

This mindset reminds him to be underexposed and prepared for when things go badly, and to not be fully invested if there are insufficient opportunities.

“We are aware of our biases – which are to be worried and pessimistic about how things will go – and aware of the risks” they create, he said. “Investors need to pick their poison. Is it is to make more money when times are good and have a really ugly year every so often, or protect on the downside but not be at the party as long when things are good?”

“We have picked our poison and would rather underperform in a huge bull market,” he said.

“Being conservative all the time, by being both a highly disciplined buyer and seller, gets you in the right frame of mind,” he said. “It enables you to be around for the long term.”

The pressure to be fully invested was the undoing of many managers during the financial crisis. “In some sense when the markets are fairly ebullient, you hold least-objectionable securities rather than true signs of value,” he said. “The inability to hold cash and the pressure to hold something meant that when the plug was pulled out of the tub, it was a long way down.”

Even in the bleakest of times, Klarman said, there will be attractive investment ideas. In 2008, faced with the prospect of an economic depression, he said one place to hide was in the bonds of the captive auto finance companies, some of which were selling for 40 cents on the dollar. At the time, Klarman believed Ford Motor Credit was the best positioned of the “big three” auto companies. He said that if their loan losses grew eight-fold (which translated to 40% of their whole loan portfolio getting wiped out), those bonds would still be worth 60, and with four-fold growth they would be worth par. It was a “depression-proof” idea, he said, with limited downside. Others were extrapolating from the sub-prime crisis and housing to the automotive sector and implying the same rate of losses, which depressed the price of those bonds. But his analysis did not show that there was equivalent overbuilding in automobiles as there was in housing, nor was there the same deterioration in credit standards.

Ideational fluency

A key to identifying such opportunities is having a team that shares a similar investment philosophy and an organizational culture that allows them to think and analyze problems in a critical and objective framework. Klarman discussed the interviewing process Baupost uses to select new hires and how it avoids “groupthink.”

Hiring for intellectual honesty is a first step toward overcoming groupthink. Klarman looks for people who can admit their mistakes, something he said he can learn through the interviewing processes.

He also holds people accountable for their mistakes on a day-to-day basis, he said, but there is “no yelling” in his office. He recognizes that mistakes are never the analyst’s fault, since each analyst works with a partner and all decisions ultimately go through Klarman himself. “If the analyst is wrong, then we are all wrong,” he said.

In the interview process, he drills a lot on past experiences – asking, for example, what a candidate considers to have been their biggest mistake. He looks for an honest answer – one that does not include trivialities. He asks a lot of ethical questions to see if candidates “think morally.” He said he doesn’t necessarily care if they identify the proper approach to a moral dilemma, as long as they can identify the critical issues.

Klarman considers his interview process unusual, since he is driving for different things than most firms. Every candidate he sees is smart and can do the job, he said, but he is looking for exceptional people who can fit into the Baupost organization. “We look for it all – ethics, intelligence, and the proven ability to work hard,” he said.

Finally, he cited ideational fluency as a key trait in successful candidates. He looks for “idea people,” who can take the germ of an idea and identify 10 or 15 new possible directions and “threads on which to pull.” He does not want those who are surprised by such questions and are unsure where to go.

Klarman’s only goal

The number one thing on Klarman’s mind is the size of his firm and its assets under management. He said he always thought size was a negative, because it forces him to look at larger opportunities, be less nimble, and unable to “move the needle” with otherwise attractive but smaller investment ideas.

As he entered the chaotic period of 2008, he anticipated for first time in eight years that additional capital might be useful. He went to his wait list, recognizing that the opportunities he would see would be plentiful, large, lumpy, and unpredictably arriving.

That proved to be correct. He said he got a lot of calls from people trying to move merchandise, some of which was in liquid securities.

Nonetheless, he is totally prepared to return capital, both psychologically and logistically. He has 30% of his firm’s $22 billion in cash. He said investors are not subject to any real lockups after the end of this year. If valuations got materially higher, he would return capital.

Calibrating his firm's size to manage the right amount of money – which is not necessarily the amount he currently manages – has been a key to Baupost's success. Klarman said that decision is "absolutely market dependent," since he will only invest when he sees the right value-minded opportunities.

"My only goal is excellence," he said. "I don't care if we manage $5, $20 or $25 billion. It doesn't matter. We would never go public or sell out, either of which would ruin us."

"If we can go to bed at night each day, and retire at the end of a long career, and feel like we've done right by our clients, put them first, haven't gouged or proliferated products, or charged as much as we could, I'm going to feel great, even if I made a small fraction of what I could have. "

Earning fees is not what his work is all about, Klarman said. "This is about the sacred trust of managing clients' money."