Seth Klarman: Why Most Investment Managers Have It Backwards

By Robert Huebscher
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For value investors, last fall's crisis provided an unprecedented opportunity. Down markets are a great time to buy securities, as Graham and Dodd said in *Securities Analysis,* since the average investor can usually only get them "at prices that the future may cause him to regret."

For Seth Klarman, founder and president of the Boston-based Baupost Group, last fall was a period that offered many of those opportunities. He delivered the keynote lecture at the annual meeting of the Boston Security Analysts Society last week. Klarman also was the lead editor of and authored the preface to the sixth edition of Graham and Dodd's *Securities Analysis*, published in 2008.

In that speech, Klarman praised his team for remaining clear-headed amid exceptional market volatility and positioning the firm's portfolio to deliver superior long-term performance for its investors.

Unfortunately, Klarman said, clear, long-term goals are not the norm throughout the industry. Before detailing the most attractive opportunities created by the crisis, Klarman first addressed a fundamental conflict within the investment management industry that he said is at odds with investor objectives.

Investment managers, such as pensions and endowments, exist in perpetuity and should be focused on long-term wealth creation. Yet performance is almost universally evaluated using short-term results – managers are compared using quarterly, monthly, or even daily returns, creating extreme short-term pressures. "Managers who do well in the short term are rewarded with more assets," he said. "Those who do not do well in the short term often don't survive to see the long term."

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"Money managers know the Sword of Damocles is poised to fall on them next," he added, which forces them to sacrifice long-term wealth creation to pursue short-term gains.

Klarman strives to avoid such counterproductive incentives, mostly by investing for clients – like endowments – with a long-term focus, and avoiding others – like funds-of-fund and unsophisticated investors – whose goals may be at odds with his own.

If the technology existed to permit real-time performance measurement of his portfolios, Klarman said, he wouldn't want it, since it would run completely contrary to his long-term focus.

After all, the result is behavior that makes little sense. Investment managers can usually be found "scurrying around" to achieve superior daily or weekly performance, even though their proper goal is to realize substantial gains farther down the road.

By contrast, managers with a long-term focus gained extraordinary advantages in the current crisis. Klarman described a situation that illustrated the disparity between managers who are able to focus on long-term objectives and those who must engage in short-term performance races: His firm had the opportunity to bid on a publicly traded debt instrument. Another bidder was willing to pay significantly more than his initial bid, but Klarman still determined that he would earn a 25% return, even at the higher price.

Klarman said every client should want their manager to make such an investment. But most with a nearsighted focus would be extremely reluctant to pull the trigger, particularly because the bonds in question lack liquidity and are unlikely to be marked up to the level where this trade would take place.

Having a long-term focus requires keeping the emotions of fear and greed in check. For most of the last 12 months, fear dominated greed, causing investors to flee to cash, despite its negative yields. Those investors, along with many who suffered losses on Treasury bonds bought at depressed yields, also paid dearly in opportunity cost – their inability to buy securities at depressed valuation. "Managers who were too fully exposed were unable to appreciate the opportunities," Klarman said.

Frightened clients made things worse for managers, who are unfortunately guided by what clients think – or what they are afraid clients are thinking.

All managers made some mistakes and likely posted losses. Shrewd investors, who picked up bargains, looked like "risk takers." Klarman even admitted to some mistakes of his own – he stretched his criteria to buy some marginally cheap stocks, for instance, and one of his private investments went bad.

But Klarman does see a sliver lining: He believes the current crisis may embolden more managers to stand apart from the crowd – and perhaps even charge fairer fees.

Among those who will have the opportunity to stand out are managers with broader mandates, who are particularly well positioned to serve clients' needs, Klarman said.

Narrowly focused managers, such as junk bond managers, he said, are often forced to be 100% invested, regardless of the risk/return profile of their investable universe. Such constraints eliminate the potential for contrarian thinking, which is critical to the success of value investors like Klarman.

The current rally

Klarman called the market rally that began in March “increasingly speculative” and driven by investors who “looked for and saw green shoots – or thought they did.” He questioned whether we can know if things are “stabilizing or pausing before they get worse.”

Recently, Klarman has spent a lot of time thinking about what a bear market rally would look like. He concluded that it would closely resemble the current rally – a bold move, fueled by speculation based on green shoots or similar wishful thinking, led by more speculative securities.

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The rally has led some investors – who six months ago would have “cut a deal with the devil to stabilize their portfolios” – to resume speculating on shares that have risen two- or three-fold in the current rally.

“The pressure not to lose has been replaced by the pressure not to miss out,” he said, and that fear leads to speculation, not investing. Indeed, such speculation combines the two motivations that are anathema to rational, long-term investors like Klarman: “The fear of missing out on a rally is greed, not fear,” he said.

Klarman did not offer any forecasts for the economy or the market. Such forecasting would belie his investment style, which focuses on individual security valuation and purchasing undervalued assets, not on betting that the economy or the market is headed in a particular direction.

“Value investors don’t know what will come next,” he said. “They must focus on the issue of price versus value and owning things because they are cheap.” The problem, he noted, is that undervalued stocks can remain cheap for a long time.

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Inflation, however, is one outcome that Klarman clearly fears, and he has taken out “massive” portfolio protection through interest rate caps and swaptions, he said. He prefers these two hedging techniques because he pays a one-time premium and can tailor them to the maturities he wants to protect. If rates do go up, he can take the protection off.

Klarman does not like TIPS because he doesn't trust the government's calculations of the inflation index, and he isn't inclined to make a meaningful bet on his portfolio with gold at current price levels because of the high opportunity cost.

Klarman said to ignore the noise and the "idiots on cable TV" and instead to form an opinion and act on it, divorcing one's decisions from short-term price movements. Investing requires the right temperament and the right business model – one that focuses on long-term value creation.

Positioning his portfolio

Since the onset of the crisis, Klarman has moved portions of his portfolio into deeply discounted senior corporate and securitized mortgage debt, which he said offer very attractive returns relative to their risk.

Investors "overreacted" and sold off these securities, he said. Valuations were further depressed by legal uncertainties – in some cases, companies must go through bankruptcy before investors will earn satisfactory returns. The analytical complexity of evaluating securitized assets, each of which has unique characteristics, also contributed to their being underpriced.

The "contractual repayment of principal is the catalyst for achieving value," Klarman said. For corporate bonds, bankruptcy is an acceptable outcome, since senior securities will be first in line to receive payment. For securitized loans, a par recovery may be doubtful, but that also limits the universe of potential buyers, depressing prices to more attractive levels.

In some cases, the securities he bought declined in value, which he used as an opportunity to increase his holdings.

Klarman sees fewer opportunities today – a "sudden dearth" that "makes us more than a little bit miserable," he said. But he recognizes that "money is made when the crop is planted, not when it is harvested," acknowledging that he expects a strong payoff from the repositioning of his portfolio last fall.

Klarman is intent on optimizing the duration of his portfolio, a concern he says is often overlooked by investors. Investments become more compelling as the duration lengthens, but last fall he viewed long-duration securities as too risky. He believed medium-duration debt offered the best risk-adjusted returns, since the yield curve was flat or inverted for the types of investments he was making.

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The big questions

Investors face serious questions, the least of which may be whether the recent green shoots that have cropped up are for real. Klarman said investors must determine the right multiple to pay for companies that benefit from government backing and when government intervention will end.

Markets will pay a price for government actions, but he is not sure whether that price will be inflation, a loss of faith in the dollar, or both.

Another dilemma is whether Americans would be willing to accept the pain of slower growth, if that turns out to be the only way out of the crisis.

The biggest question in Klarman's mind concerns moral hazard, and whether the government has created "the mother of all moral hazards" by instilling a belief in investors' minds that all crises can and will be solved by government actions. Such a belief, he fears, would skew every investment decision toward unnecessary risk taking.

In the Dr. Seuss book, *The Cat in the Hat Comes Back,* a house-crashing cat leaves a pink stain around the bathtub after helping himself to some cake. All attempts to clean the stain fail, as the mess is spread elsewhere – to a dress, a wall, a pair of shoes, and eventually to an entire yard-covering spot.

Klarman fears government actions to deal with the financial crisis are merely repositioning — and expanding — the stain. "Our over-leveraged, over-consuming population has been living beyond its means," he said, surviving by borrowing from foreigners. Many individuals and governments are effectively insolvent, and we are tackling the problem with more debt while keeping incompetent lenders in business.

Klarman did not say whether he believes the government's actions will work, or whether they will be forever shifting the location of the stain.

Seuss' tale, incidentally, ends as Little Cat Z takes off his hat and unleashes a "Voom" – perhaps a precursor to the TARP program – which magically cleans up the yard and restores order in the home.