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The Collected Wisdom of Seth Klarman

ON VALUE INVESTING

"We define value investing as buying dollars for 50 cents."

"There is nothing esoteric about value investing. It is simply the process of determining the value underlying a security and then buying it at a considerable discount from that value. It is really that simple. The greatest challenge is maintaining the requisite patience and discipline to buy only when prices are attractive and to sell when they are not, avoiding the short-term performance that engulfs most market participants."

"Value investing lies at the intersection of economics and psychology. Economics is important because you need to understand what assets or businesses are worth. Psychology is equally important because price is the critically important component in the investment equation that determines the amount of risk and return available from any investment. Price, of course, is determined in the financial markets, varying with the vicissitudes of supply and demand for a given security."

"I've actually never seen people be successful over a long period of time without being value investors. To me, it's sort of like the $E = MC^2$ of money and investing."

"Few are willing and able to devote sufficient time and effort to become value investors, and only a fraction of those have the proper mind-set to succeed."

"When we look at value, we tend to look at it on a very conservative basis—not making optimistic forecasts many years into the future, not assuming growth, not assuming favorable cost savings, not assuming anything like that. Rather looking at what is there right now, looking backwards and saying, is that the kind of thing the company has been able to do repeatedly? Or is this a uniquely good year, and is it unlikely to be repeated? We tend to look at hard assets as much as possible."

"Unlike speculators, who think of securities as pieces of paper that you trade, value investors evaluate securities as fractional ownership of, or debt claims on, real businesses."

"Value investing requires deep reservoirs of patience and discipline."

"As the father of value investing, Benjamin Graham, advised in 1934, smart investors look to the market not as a guide for what to do, but as a creator of opportunity."

"Value investing is, in effect, predicated on the proposition that the efficient-market hypothesis is frequently wrong."

"As value investors, our business is to buy bargains that financial market theory says do not exist."

"Buying such bargains confers on the investor a margin of safety, room for imprecision, error, bad luck, or the vicissitudes of economic and business forces."

"To value investors, the concept of indexing is at best silly and at worst quite hazardous."

"Price is the ultimate thing that matters, [although we] worry about risks before focusing on returns."

"Every security or asset is a 'buy' at one price, a 'hold' at a higher price and a 'sell' at some still higher price."

"Successful investors tend to be unemotional, allowing the greed and fear of others to play into their hands."

"You have to be able to stand things going bad before they go good."

ON LONG-TERM ORIENTATION

"Beyond [an] investor's speculative impulses, technological innovation over the years has compressed investor time horizons. Technology enables a money manager's performance to be measured not only annually, quarterly, or monthly—but of course daily, hourly and constantly."

"The performance pressures most investors feel drives them into an absurdly short-term orientation."

"We don't try to be anyone's best performing manager in a given year because such an attempt would almost certainly fail. It would distract us from our focus on risk-aversion and the pursuit of excellent long-term results, while shifting our attention toward quick gains, short-term trades and market momentum."

"With the exception of an arbitrage or a necessarily short-term investment, we enter every trade with the idea that we are going to hold to maturity in the case of a bond and for a really long time, potentially forever, in the case of a stock."

"Value investing is a long-term orientated investment approach—never to be confused with short-term speculation—that requires considered patience, discipline and rigor."

"We have no interest in running companies. We think that we do one thing well, and that's enough. We're basically long-term investment artists."

"We are always long-term oriented. We never attempt to gauge near-term market movements; we have no edge there. We strive to make long-term investments that have truly compelling risk-reward characteristics. We are never afraid to stand apart from the crowd. We stick to our game plan, and focus on areas where we are skilled and experienced. We are resolute in resisting the short-term performance pressures and herd behaviors that plague the investment business."

"We've maintained a commonsensical, albeit increasingly unconventional, approach to investing in that we strive to maintain a long-term perspective in a world of short-term actors, and we patiently hold cash in the absence of compelling opportunity, refusing to pull the trigger until the target is clear and compelling."

ON FINDING BARGAINS

"Great investments don't just knock on the door and say 'buy me.'"

"It is easy to find middling opportunities but rare to find exceptional ones."

"When buyers are numerous and sellers scarce, opportunity is bound to be limited. But when sellers are plentiful and highly motivated while potential buyers are reticent, great investment opportunities tend to surface."

"Rather than buy from smart, informed sellers, we want to buy from urgent, distressed or emotional sellers."

"A bargain price is necessary, but not sufficient for making an investment, because sometimes securities that seem superficially inexpensive really aren't."

"Institutional constraints and market inefficiencies are the primary reasons that bargains develop. Investors prefer businesses and securities that are simple over those that are complex. They fancy growth. They enjoy an exciting story. They avoid situations that involve the stigma of financial distress or the taint of litigation. They hate uncertain timing. They prefer liquidity to illiquidity. They prefer the illusion of perfect information that comes with large, successful companies to the limited information from companies embroiled in scandal, fraud, unexpected losses or management turmoil."

"We pursue opportunity largely off the beaten path, sifting through the debris of financial wreckage, out-of-favor securities and asset classes in which there is limited competition. We specialize in the highly complex while mostly avoiding plain vanilla, which is typically more fully priced. We happily incur illiquidity but only when we get paid well for it, which is usually when others rapidly seek liquidity and rush to sell."

"When you have been doing this for a while, you start to become more proficient about where to look, which rocks to look under. The rocks we look under tend to have a few things in common."

"You must buy on the way down. There is far more volume on the way down than on the way back up, and far less competition among buyers. It is almost always better to be too early than too late, but you must be prepared for price markdowns on what you buy."

"Market inefficiencies, like tax selling and window dressing, also create mindless selling, as can the deletion of a stock from an index."

"These causes of mispricing are deep-rooted in human behavior and market structure, unlikely to be extinguished anytime soon."

"Investing is, in many ways, a zero-sum activity in which your returns above market indices are derived from the mistakes, overreactions, or inattention of others as much as from your own clever insights."

"Typically, we make money when we buy things. We count the profits later, but we know we have captured them when we buy the bargain."

ON HAVING AN EDGE

"You cannot have an edge doing what everyone else is doing; to add value you must stand apart from the crowd. And when you do, you benefit from watching the competition at work."

"If you are investing and you don't have an edge you probably shouldn't be [investing]. And so we think about that a lot, that there are a lot of really formidable competitors, a lot of money that's flowed into the hands of very capable value investors, long-term oriented, smart people. There are obviously also people that know a huge amount about industries, industry specialists, corporate executive, former executives, and so it's very competitive out there most of the time. So much of the time we have drifted into less liquid or more obscure parts of the universe."

"We'd rather not try to outsmart somebody, we're not sure we could. We'd rather try to hunt where they're not looking."

"We believe that while investors need to focus great attention on the fundamentals, they must simultaneously answer the question: What's your edge?"

"To succeed in today's overcrowded environment, investors need an edge, an advantage over the competition, to help them allocate their scarce time. Since most everyone has access to complete and accurate databases, powerful computers, and well-trained analytical talent, these resource provide less and less of a competitive edge; they are necessary but not sufficient. You cannot have an edge doing what everyone else is doing; to add value you must stand apart from the crowd. And when you do, you benefit from watching the competition at work."

"In highly competitive financial markets with thousands of very smart, hard-working participants, what will enable you to reliably outperform the field? Your toolkit is critically important: truly long-term capital; a flexible approach that enables you to move opportunistically across a broad array of markets, securities, and asset classes; deep industry knowledge; strong sourcing relationships; and solid grounding in value investing principles."

ON RISK

"Baupost's investment approach is highly risk-averse."

"We continuously worry about what can go wrong with each investment and the portfolio as a whole; avoiding and managing risk is a 24/7/365 obsession for us."

"Our general predisposition is that we ought to run our money as if it is our own."

"The best investors do not target return; they focus first on risk, and only then decide whether the projected return justifies taking each particular risk."

"Right at the core, the mainstream has it backwards. Warren Buffett often quips that the first rule of investing is to not lose money, and the second rule is to not forget the first rule. Yet few investors approach the world with such a strict standard of risk avoidance."

"We try to focus on the downside. We diversify. We try to look into places that other people don't consider."

"We clear a high bar before making an investment, and we resist the many pressures that other investors surely feel to lower that bar. The prospective return must always be generous relative to the risk incurred. For riskier investments, the upside potential must be many multiples of any potential loss."

"Leverage does not have to be dangerous. Non-recourse debt on an asset can serve to make a large purchase more affordable. Taking out a non-recourse loan on an already owned asset can actually reduce risk, since the borrowed funds become yours, while the risk of loss is transferred to the lender."

"There is also a bit of a slippery slope in that if a little leverage is good, why isn't more leverage better? When do you stop?"

"Investors should always keep in mind that the most important metric is not the returns achieved, but the returns weighed against the risks incurred. Ultimately, nothing should be more important to investors than the ability to sleep soundly at night."

"[People] invest without much attention to risk, because risk is unpleasant to contemplate and difficult to measure."

"The latest trade of a security creates a dangerous illusion that its market price approximates its true value. This mirage is especially dangerous during periods of market exuberance. The concept of 'private market value' as an anchor to the proper valuation of a business can also be greatly skewed during ebullient times and should always be considered with a healthy degree of skepticism."

"You rarely, if ever, make money from worrying; it does not typically enhance return. But by avoiding loss, you are able to hang on to what you have accumulated, which is a cornerstone of successful investing."

ON BEHAVIORAL FACTORS

"In investing—as in most things—people like what is popular, trendy, exciting and dislike what is boring, out of favor and stigmatized. They like assets that have been rising and shun those that have been falling."

"Investing, when it looks easiest, is at its hardest."

"The overwhelming majority of people are comfortable with consensus, but successful investors tend to have a contrarian bent."

"Most investors tend to project near-term trends—both favorable and adverse indefinitely into the future."

"Most people lack the courage and stamina to stand apart from the herd and tolerate short-term underperformance in order to reap long-term rewards."

"The daily blips of the market are, in fact, noise—noise that is very difficult for most investors to tune out."

"Investors unfortunately face enormous pressure—both real pressure from their anxious clients and their consultants and imagined pressure emanating from their own adrenaline, ego and fear—to deliver strong near-term results."

"Pressure to keep up with a peer group renders decision making even more difficult."

"Human nature is such that emotion frequently overwhelms reason causing security prices to overshoot in both directions."

"It is psychologically hard to fight the crowd, to take a contrary stance and stick with it."

"Worry[ing] about what can go wrong can lead to protracted periods of underperformance."

"Understanding how our brains work—our limitations, endless mental shortcuts, and deeply ingrained biases—is one of the keys to successful investing. At Baupost, we believe that it is sometimes easier to predict how investors will behave in certain situations than it is to predict a company's bottom line. At times of market extremes, by avoiding emotional overreaction and remaining aware of our biases, it may be possible to know market participants better than they can know themselves."

"In investing, whenever you act, you are effectively saying, 'I know more than the market. I am going to buy when everybody else is selling. I am going to sell when everybody else is buying.' That is arrogant, and we always need to temper it with the humility of knowing we could be wrong—that things can change—and acknowledging that we have a lot of smart competitors. Thus, in worrying about all the things that can go wrong, you can prepare, you can hedge—and you must remember to sell fully priced securities so that you are underexposed when things go badly. All these elements give us the courage to follow our convictions."

"The stock market is the story of cycles and of the human behavior that is responsible for overreactions in both directions."

"Here's how to know if you have the makeup to be an investor. How would you handle the following situation? Let's say you own a Procter & Gamble in your portfolio and the stock price goes down by half. Do you like it better? If it falls in half, do you reinvest dividends? Do you take cash out of savings to buy more? If you have the confidence to do that, then you're an investor. If you don't, you're not an investor, you're a speculator, and you shouldn't be in the stock market in the first place."

ON STRUCTURE & PROCESS

"A truly long-term orientation is not just in your mind, but also in your structure."

"By the time the market drops and bad news is on the front pages, it is usually too late for investors to react. It is crucial to have a strategy in place before problems hit, precisely because no one can accurately predict the future direction of the stock market or economy."

"Having clients with a long-term orientation is crucial. Nothing else is as important to the success of an investment firm."

"Investment success requires standing apart from the frenzy, the short-term, relative performance game played by most investors."

"We put great emphasis on a consistent investment process that demands enormous creativity, energetic sourcing, outside-thebox thinking, intellectual honesty, and vibrant debate."

"We will always try to put the interests of our clients first and will never gouge on fees or wildly proliferate new investment products. We will never permit performance pressures to compromise our approach."

"While investment performance clearly must be measured, it must not be done in a way that skews time horizons and distorts investment judgment."

"I hate turnover; I really value long-tenured people. So I'd rather pay up for people that I might be able to attract to make their entire careers at our firm rather than try to be cheap about it and hire bargains, but ultimately pay the price for that in turnover or other things."

"We think more value is added by being generalists and seeing opportunities from a broader perspective. If you have silos, you're going to own things only within those silos. If you have the broader perspective, you can say, 'I don't even like stocks, I'm working on distressed debt,' or something like that."

"There are huge advantages to not keeping track of each person's individual contribution in terms of letting capital slosh back and forth so that no one person hogs the capital. In terms of senior people bringing younger people into the firm, if you're forced to share too much of the credit, what's your incentive to bring in younger people?"

"The best single decision I have made at Baupost was hiring our CFO 18 years ago. The reason it was a great decision, aside from [him] being a great guy and a great partner, is the fact that he was as good as me, and that let me focus on the parts of the business that I was interested in and that I would be particularly good at."

"I have had friends at other hedge funds say to me, 'You have a better model, but we can't do this with our clients. Our clients just would not understand.' The truth is, some of our clients don't understand, but we've worked really hard over time to explain it and to educate them to our way of thinking."

"People ask me for advice and I say, 'The first and most important thing is make sure that you choose your clients carefully.' Most people would either look at me like I had three heads, like 'You've got to be kidding me,' like, 'That's quaint.'"

"We work in a team environment and [have] a very open seating environment—I have a private office. I'm never in it."

"Having great clients is the real key to investment success. It is probably more important than any other factor in enabling a manager to take a long-term time frame when the world is putting so much pressure on short-term results."

"In our minds, ideal clients have two characteristics. One is that when we think we've had a good year, they will agree. It would be a terrible mismatch for us to think we had done well and for them to think we had done poorly. The other is that when we call to say there is an unprecedented opportunity set, we would like to know that they will at least consider adding capital rather than redeeming."

MISCELLANEOUS

"I traded my first stock when I was 10."

"It is very hard for the government to be countercyclical because all political pressure is against that."

"There comes a responsibility with success, and that is leaving the world better than you found it."

"We've managed to do really well for ourselves by putting clients first, by charging a fair fee, and by focusing on their best interests. I'm proud of the fact that virtually everybody who has been connected with the firm — employees, clients, advisers, business partners — has benefited from that experience."

"An economy built with no margin of safety will eventually implode."

"Everyone can ask questions, but not everyone can identify the right questions to ask."

"I have never calculated the alpha or beta of my firm's investment performance, which is how some people would determine whether or not we have done a good job."

"Today's sound bite culture reinforces the popular impression that investing is easy, not rigorous and painstaking."

"To me, the science of valuing things and of identifying when things sell at a discount is as straightforward as could be. It's almost a commodity these days; when you hire business school kids, they all know how to do that."

"If someone asked me to invest their money with the goal of turning a quick profit over the next six to twelve months, I'd have no idea how."

"Be sure that you are well compensated for illiquidity – especially illiquidity without control – because it can create particularly high opportunity costs."

"Some of our best analysts can get up to speed in a day or two on something they've never heard of before."

"I think some of the best things that any investor today can read are [Buffett's] early partnership letters."

"Every great investor has bad periods. The ones who stick to their approach the most diligently probably have the worst periods because approaches go in and out of favor."

"Never stop reading. History doesn't repeat, but it does rhyme."