

Notes To The Book “Margin Of Safety”
Author: Seth Klarman
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According to www.wikipedia.com "Margin of Safety – Risk-Averse Value Investing Strategies for the Thoughtful Investor" is a name of a book written by [Seth A. Klarman](#), a successful value investor and President of the [Baupost Group](#), an investment firm in Boston. This book is no longer published and sometimes can be found on [eBay](#) for more than \$1000 (some consider it a collectible item).

These notes are hardly all encompassing. These are notes I would find helpful for me, as a money manager. I do not mention Klarman’s important premise of looking at investments as “fractional ownerships.” I don’t mention things like that in these notes, as I am already tuned into those concepts, and do not need a reminder. Hence a reader of these notes, should read the book on their own, and get their own information from it. I found this book at several libraries. One awesome library I went to was the New York Public Library for Science, Business and Industry.

<http://www.nypl.org/research/sibl/index.html>

Throughout this paper you will see items in “quote marks.” The quotes exclusively represent direct quotes of Seth Klarman, from the book.

As I read this book, and through completion, I felt fortunate that I have been following most of his philosophies for many years. I am not comparing myself to Klarman, not at all. How could I ever compare myself to the greats of Klarman, Buffett, Whitman et al? What I did experience via this reading was a confirmation of my style and discipline. This book really put together and confirmed to me, so many of the philosophies and methods which I have been using for many years. These notes are a means for me to

look back, and feel my roots every so often. At times in these notes, I have added sections which I have found appropriate in my workings.

Introduction

“This book alone will not turn anyone into a successful value investor. Value investing requires a great deal of hard work, unusually strict discipline and a long-term investment horizon.”

“This book is a blueprint that, if carefully followed, offers a good possibility of investment successes with limited risk.”

Understand why things work. Memorizing formulas give the appearance of competence. Klarman describes the book as one about “thinking about investing.”

I interpret much of the introduction of the book, as to not actively buy and sell investments, but to demonstrate an “ability to make long-term investment decisions based on business fundamentals.” As I completed the book, I realize that Klarman does not embrace the long term approach in the same fashion I do. Yet, the key is to always determine if value still exists. Value is factored in with tax costs and other costs.

Fight the crowd. I think what Klarman is saying is that it is warm and fuzzy in the middle of crowds. You do not need to be warm and fuzzy with investing.

Stay unemotional in business and investing!

Study the behavior of investors and speculators. Their actions “often inadvertently result in the creation of opportunities for value investors.”

“The most beneficial time to be a value investor is when the market is falling.” “Value investors invest with a margin of safety that protects from large losses in declining markets.” I have only begun the book, but am

curious as to how any value investor could have stayed out of the way of 1973 –1974 bear market. Some would argue that Buffett exited the business during this period. Yet, it is my understanding, and I could be wrong, that Berkshire shares took a big drop in that period. Also, Buffett referred his investors who were leaving the partnership to Sequoia Fund. Sequoia Fund is a long term value investment mutual fund. They also had a horrendous time during the 1973 –1974 massacre.

“Mark Twain said that there are two times in a man’s life when he should not speculate: when he can’t afford it and when he can.”

“Investors in a stock expect to profit in at least one of three possible ways:

- a. From free cash flow generated by the underlying business, which will eventually be reflected in a higher share price or distributed as dividends.
- b. From an increase in the multiple that investors are willing to pay for the underlying business as reflected in a higher share price.
- c. Or by narrowing of the gap between share price and underlying business value.”

“Speculators are obsessed with predicting – guessing the direction of prices.”

“Value investors pay attention to financial reality in making their investment decisions.”

He discusses what could happen if investors lost favor with liquid treasuries, and if indeed they became illiquid. All investors could run for the door at once.

“Investing is serious business, not entertainment.”

Understand the difference between an investment and a collectible. An investment is one, which will eventually be able to produce cash flow.

“Successful investors tend to be unemotional, allowing the greed of others to play into their hands. By having confidence in their own analysis and

judgment, they respond to market forces not with blind emotion but with calculated reason.”

He discusses Mr. Market. He mentions when a price of a stock declines with no apparent reason, most investors become concerned. They worry that there is information out there, which they are not privy to. Heck, I am going through this now with a position that is thinly traded, and sometimes I think I am the only purchaser out there. He describes how the investor begins to second-guess him or herself. He mentions it is easy to panic and just sell. He goes onto to write, “Yet, if the security were truly a bargain when it was purchased, the rationale course of action would be to take advantage of this even better bargain and buy more.”

Don’t confuse the company’s performance in the stock market with the real performance of the underlying business.

“Think for yourself and don’t let the market direct you.”

“Security prices sometimes fluctuate, not based on any apparent changes in reality, but on changes in investor perception.” This could be helpful in my research of the 1973 – 1974 period. As I study that era, it looks as though price earnings ratios contracted for no real apparent reason. Many think that the price of oil and interest rates sky rocketed, but according to my research, that was not until later in the decade.

He discusses the good and bad of Wall Street. He identifies how Wall Street is slanted towards the bullish side. The reason being that bullishness generates fees via offerings, 401k’s, floating of debt, etc. etc. One of the sections is titled, “Financial Market Innovations Are Good for Wall Street But Bad for Clients.” As I read this, I was wondering if the “pay option mortgages,” which are being offered by many lenders, are one of these products. These negative amortization and adjustable mortgages have been around for 25 years. Yet, they have not proliferated the marketplace in the past as much as they have the last several years. Lenders such as Countrywide, GoldenWest Financial and First Federal Financial have been using these riskier mortgages as a typical type of loan in 2005 and 2006. “Investors must recognize that the early success of an innovation is not a reliable indicator of its ultimate merit.” “Although the benefits are apparent from the start, it takes longer for the problems to surface.” “What appears

to be new and improved today may prove to be flawed or even fallacious tomorrow.”

“The eventual market saturation of Wall Street fads coincides with a cooling of investor enthusiasm. When a particular sector is in vogue, success is a self-fulfilling prophecy. As buyers bid up prices, they help to justify their original enthusiasm. When prices peak and start to decline, however, the downward movement can also become self-fulfilling. Not only do buyers stop buying, they actually become sellers, aggravating the oversupply problem that marks the peak of every fad.”

He later writes about investment fads. “All market fads come to an end.” He clarifies, “It is only fair to note that it is not easy to distinguish an investment fad from a real business trend.”

"You probably would not choose to dine at a restaurant whose chef always ate elsewhere. You should be no more satisfied with a money manager who does not eat his or her own cooking." Just to reiterate, I do eat my own cooking, and I don't "dine out" when it comes to investing.

“An investor’s time is required both to monitor the current holdings and to investigate potential new investments. Since most money managers are always looking for additional assets to manage, however, they spend considerable time meeting with prospective clients in addition to handholding current clientele. It is ironic that all clients, Present and potential, would probably be financially better off if none of them spent time with money managers, but a free-rider problem exists in that each client feels justified in requesting periodic meetings. No single meeting places an intolerable burden on a money manager’s time; cumulatively, however, the hours diverted to marketing can take a toll on investment results.”

“The largest thrift owners of junk bonds – Columbia Savings and Loan, CenTrust Savings, Imperial Savings and Loan, Lincoln Savings and Loan and Far West Financial, were either insolvent or on the brink of insolvency by the end of 1990. Most of these institutions had grown rapidly through brokered deposits for the sole purpose of investing the proceeds in junk bonds and other risky assets.”

I personally suspect that the same will be said of the aggressive mortgage lenders of 2005 – 2006. I have looked back at my files of 1st quarter 1980 Value Line for a few of these companies mentioned above. Here are some notes on one of the companies I found.

Far West Financial: Rated C++ for financial strength. In 1979 it was selling for 50% of book value. “The yield-cost spread is under pressure.” “Lending is likely to decline sharply in 1980.” “Far West’s earnings are likely to sink 30 – 35% in 1980. Reasons: The deteriorating margin between yield on earning assets and the cost of money, less loan fee income...” Keep in mind that the stock price rose around 400% from 1974 – 1979. From 1968 – 1972 the P/E ratio was in a range from 11 – 17. From 1973 through 1979 the P/E ratio was in a range from 3.3 – 8.1. It would be interesting for me to look at the 1990 – 1992 Value Lines of the same companies.

A Value Investment Philosophy:

“One of the recurrent themes of this book is that the future is unpredictable.” “The river may overflow its banks only once or twice in a century, but you still buy flood insurance.” “Investors must be prepared for any eventuality.” He describes that an investor looking for a specific return over time, does not make that goal achievable. “Targeting investment returns leads investors to focus on potential upside rather on downside risk.” “Rather than targeting a desired rate of return, even an eminently reasonable one, investors should target risk.”

Value Investing: The Importance of a Margin of Safety”

“Value investing is the discipline of buying securities at a significant discount from their current underlying values and holding them until more of their value is realized. The element of the bargain is the key to the process.”

“The greatest challenge for value investors is maintaining the required discipline. Being a value investor usually means standing apart from the crowd, challenging conventional wisdom, and opposing the prevailing investment winds. It can be a lonely undertaking. A value investor may experience poor, even horrendous, performance compared with that of other investors or the market as a whole during prolonged periods of market overvaluation.”

“Value investors are students of the game; they learn from every pitch, those at which they swing and those they let pass by. They are not influenced by the way others are performing; they are motivated only by their own results. He discusses that value investors have “infinite patience.”

He discusses that value investors will not invest in companies that they don't understand. He discusses how value investors typically will not own technology companies for this reason. Warren Buffett has stated this as the reason as to why he does not own any technology companies. As a side note, I do believe that at some point, Berkshire will take a sizable position in Microsoft (\$24.31 5/1/06). Klarman mentions that many also shun commercial banks and property and casualty companies. The reasons being that they have unanalyzable assets. Keep in mind that Berkshire Hathaway (Warren Buffett is the majority shareholder) is basically in the property and casualty business.

“For a value investor a pitch must not only be in the strike zone, it must be in his “sweet spot.”” “Above all, investors must always avoid swinging at bad pitches.”

He goes onto discuss that determining value is not a science. A competent investor cannot have all the facts, know all the answers or all the questions, and most investments are dependent on outcomes that cannot be foreseen.

“Value investing can work very well in an inflationary environment.” I wonder if the inverse is true? Are we in a soon to be deflationary environment for real estate? I think so. Sure enough he discusses deflationary environments. He explains how deflation is “a dagger to the heart of value investing.” He explains that it is hardly fun for any type of investor. He explains that value investors should worry about declining business values. Yet, here is what he said value investors should do in this environment.”

- a. “Investors can not predict when business values will rise or fall, valuation should always be performed conservatively, giving considerable weight to worst-case liquidation value and other methods.”
- b. Investors fearing deflation could demand a greater discount than usual. “Probably let more pitches go by.”

- c. Deflation should give greater importance to the investment time frame.

“A margin of safety is achieved when securities are purchased at prices sufficiently below underlying value to allow for human error, bad luck, or extreme volatility in a complex, unpredictable and rapidly changing world.”

“The problem with intangible assets, I believe, is that they hold little or no margin of safety.” He describes how tangible assets might have alternate uses, hence providing a margin of safety. He does explain how Buffett recognizes the value of intangibles.

“Investors should pay attention not only to whether but also to why current holdings are undervalued.” He explains to remember the reason you bought the investment, and if that no longer holds true, then sell the investment. He tells the reader to look for catalysts, which might assist in adding value. He looks for companies with good management and insider ownership (“personal financial stake in the business.”)

“Diversify your holdings and hedge when it is financially attractive to do so.”

He explains that adversity and uncertainty create opportunity.

“A market downturn is the true test of an investment philosophy.”

“Value investing is, in effect, predicated on the proposition the efficient-market (EMT) hypothesis is frequently wrong.” He explains that market pricing is more efficient with larger capitalization companies.

“Beware of Value Pretenders”

This means, watch out for the misuse of value investing. He explains that these pretenders came about via the successes of Michael Price, Buffett, Max Heine and the Sequoia Fund. He labels these people as value chameleons, and states that they are failing to achieve a margin of safety for their clients. He claims these investors suffered substantial losses in 1990. I find this section difficult. For one, the book was published in 1991,

certainly not a long enough time to comment on investments of 1990. Also, he doesn't mention the broad based declines of 1973 – 1974

“Value investing is simple to understand but difficult to implement.” “The hard part is discipline, patience and judgment.” Wait for the fat pitch.

“At the Root of a Value Investment Philosophy”

Value investors look for absolute performance, not relative performance. They look more long term. They are willing to hold cash reserves when no bargains are available. Value investors focus on risk as well as returns. He discusses that the greater the risk, does not necessarily mean the greater the return. He feels that risk erodes returns because of losses. Price creates return, not risk.

He defines risk as, “ both the probability and the potential of loss.” An investor can counteract risk by diversification, hedging (when appropriate) and invest with a margin of safety.

He eloquently discusses the following, “The trick of successful investors is to sell when they want to, not when they have to. Investors who may need to sell should not own marketable securities other than U.S. Treasury Bills.”

Warning, warning , warning. Eye opener next. “The most important determinant of whether investors will incur opportunity cost is whether or not part of their portfolios are held in cash.” “Maintaining moderate cash balances or owning securities that periodically throw off appreciable cash is likely to reduce the number of foregone opportunities.”

“The primary goal of value investors is to avoid losing money.” He describes the 3 elements of a value-investment strategy.

- a. A bottoms up approach, searching via fundamental analysis.
- b. Absolute performance strategy.
- c. Pay attention to risk.

“The Art of Business Valuation”

He explains that NPV and IRR are great tools for summarizing data. He explains they can be misleading unless the flows are contractually determined, and when all payments are received when due. He talks about the adage, “garbage in, garbage out.” As a side note, [Milford Blonsky, CPA](#) during the 1970’s through the mid 1990’s, taught me that with frequency.

Klarman believes that investments have a range of values, and not a precise value.

He discusses 3 tools of business valuation”

- a. Net Present Value (NPV) analysis. “NPV is the discounted value of all future cash flows that the business is expected to generate. He describes the importance of avoiding market comparables, for obvious reasons. Use this method when earnings are reasonably predictable and a discount rate can be chosen. This is often a guessing game. Things can go wrong, things change. Even management can’t predict changes. “An irresolvable contradiction exists: to perform present value analysis, you must predict the future, yet the future is reliably predictable.” He explains that this should be dealt with using “conservatism.”

He discusses choosing a discount rate. He states, “A discount rate is, in effect, the rate of interest that would make man investor indifferent between present and future dollars.” He mentions that there is no single correct discount rate and there is no precise way to choose one. He explains that some investors use a generic round number, like 10%. He claims it is an easy round number, but not necessarily the best choice. He emphasizes to be conservative when choosing the discount rate. The less the risk of the investment, the less the time frame, the less the discount rate should be. He explains, “Depending on the timing and magnitude of the cash flows, even modest differences in the discount rate can have a considerable impact on the present-value calculation.” Of course discount rates are changed by changing interest rates. He discusses how investing when interest rates are unusually low, could cause inflated share prices, and that one must be careful in making long term investments.

Klarman discusses using various DCF and NPV scenarios. He also emphasizes one should discount earnings or cash flows as opposed to dividends, since not all companies pay dividends. Of course, one wants to understand the quality of the earnings and their reoccurring nature.

- b. Analyze liquidation value. You need to understand what would be an orderly liquidation versus fire sale liquidation. Klarman quotes Graham's "net net working capital." Net working capital = Current Assets – Current Liabilities. Net Net working capital = Net Working Capital – all long-term liabilities. Keep in mind that operating losses deplete working capital. Klarman reminds us to look at off balance sheet liabilities, such as under-funded pension plans.

- c. Estimate the price of the company, or its subsidiaries considered separately, as it would trade on the stock market. This method is less reliable than the other 2 and should be used as a yardstick. Private Market Value (PMV) does give an analyzer some rules of thumb. When using PMV one needs to understand the garbage in, garbage out concept, as well as the use of relevant and conservative assumptions. One has to be wary of certain periods of excesses when using this method. Look at historic multiples. I am reminded of some recent research I have been working on in regards to 1973 – 1974. Utility companies were selling for over 18X earnings, when they typically sold for much lower multiples. I believe this was the case in 1929 as well. Klarman mentioned television companies, which historically sold for 10X pre-tax cash flow, but in the late 80's were selling for 13 to 15X pre-tax cash flow. "Investors relying on conservative historical standards of valuation in determining PMV will benefit from a true margin of safety, while others' margin of safety blows with the financial winds." He suggests when you use PMV to determine what you would pay for the business, not what others would pay to own them. "At most, PMV should be used as one of several inputs in the valuation process and not the exclusive final arbiter of value."

I think that Klarman mentions that all tools should be used, and not to give too great a value to any one tool or procedure of valuation. NPV has the greatest weight in typical situations. Yet an analyst has to know when to apply each tool, and when a specific tool might not be relevant. He

mentions that a conglomerate when being valued might have a variety of methods for the different business components. He suggests, “Err on the side of conservatism.”

Klarman quotes Soros from “The Alchemy of Finance.” “Fundamental analysis seeks to establish how underlying values are reflected in stock prices, whereas the theory of reflexivity shows how stock prices can influence underlying values. (Pg. 51 1987 ed)”

Klarman mentions that the theory of reflexivity makes the point that a stock price can significantly influence the value of a business. Klarman states, “Investors must not lose sight of this possibility.” I am reminded of Enron when reading this. Their business fell apart because they no longer were able to use their stock price as currency. Soon covenants were violated because of falling stock prices. Mix that difficult ingredient with fraud, and you have a fine recipe for disaster. How many companies today are reliant on continual liquidity from the equity or bond markets?

He discussed a valuation from 1991 of Esco. He indicated that the “working capital / Sales ratio” was worthwhile to look at. He included a discount rate of 12% for first 5 years of valuation, followed by 15%. He mentioned that these higher rates indicated “uncertainty” in themselves. He stressed that investors should consider other valuation scenarios and not just NPV. This was all outlined above, but it was cool to see in a real time approach. He discussed that PMV was not useful, as there were no comparables. He indicated that a spin-off approach was helpful, as Esco previously purchased a competitor (Hazeltine). He mentioned that the Hazeltine acquisition, although much smaller than Esco, showed Esco to be severely undervalued. He indicated that liquidation value would not be useful, because defense companies could not be easily liquidated. He did look at a gradual liquidation, as ongoing contracts could be run to completion. He did use Stock market valuation as a guide. He noticed that the company was selling for a small fraction of tangible assets. He called this a very low level, considering positive cash flow and a viable company. He couldn’t identify the exact worth of Esco, but he could identify that it was selling for well below intrinsic value. He looked at all worst-case scenarios, and still couldn’t pierce the current market price. He claimed the price was based on “disaster.” He also noticed insider purchasing in the open market.

Klarman discussed that **management could manipulate earnings**, and that one had to be wary of using earnings in valuation. He mentioned that managements are well aware that investors price companies based on growth rates. He hinted that one needs to look at quality of earnings, and the need to interpret cash costs versus non-cash costs. Basically, indicating a normalization of earnings process. "...It is important to remember that the numbers are not an end in themselves. Rather they are a means to understanding what is really happening in a company."

He discusses that book value is not very useful as a valuation yardstick. Book Value provides limited information (like earnings) to investors. It should only be considered as one component of thorough analysis.

"The Challenge of Finding Attractive Investments"

If you see a company selling for what you consider to be a very inexpensive price, ask yourself, "What is wrong with this company?" This reminds me of Charles Munger, who advises investors to "invert, always invert." Klarman mentions, "A bargain should be inspected and re-inspected for possible flaws." He indicates possible flaws might be the existence of contingent liabilities or maybe the introduction of a superior product by a competitor. Interestingly enough, in the late 90's, we noticed that Lucent products were being replaced by those of the competition. We can't blame the entire loss of wealth on Lucent inferiority at the time, as the entire sector followed Lucent's wipeout at a later date. There were both industry and company specific issues that were haunting Lucent at the time.

Klarman advises to look for industry constraints in creating investment opportunities. He cited that institutions frowned upon arbitrage plays, and that certain companies within an industry were punished without merit. He mentions that many institutions cannot hold low-priced securities, and that in itself can create opportunity. He also cites year-end tax selling, which creates opportunities for value investors.

"Value investing by its very nature is contrarian." He explains how value investors are typically initially wrong, since they go against the crowd, and the crowd is the one pushing up the stock price. He discusses how the value investor for a period of time (and sometimes a long time at that) will likely suffer "paper losses." He hinted that contrarian positions could work well in

over-valued situations, where the crowd has bid up prices. Profits can be claimed from short positions.

He claims that no matter how extensive your research, no matter how diligent and smart you are, the diligence has shortcomings. For one, “some information is always elusive,” hence you need to live with incomplete information. Knowing all the facts does not always lead to profit. He cites the “80/20 rule.” This means that the first 80% of the research is gathered in the first 20% of the time spent finding that research. He discusses that business information is not always made available, and it is also “perishable.” “High uncertainty is frequently accompanied by low prices. By the time uncertainty is resolved, prices are likely to have risen.” He hints that you can make decisions quicker, without all of the information, and take advantage of the time others are looking and delving into the same information. This extra time can cause the late and thorough investor to lose their margin of safety.

Klarman discusses to watch what the insiders are doing. “The motivation of company management can be a very important force in determining the outcome of an investment.” He concludes the chapter with this quote: “Investment research is the process of reducing large piles of information to manageable ones, distilling the investment wheat from the chaff. There is, needless to say, a lot of chaff and very little wheat. The research process itself, like the factory of a manufacturing company, produces no profits. The profits materialize later, often much later, when the undervaluation identified during the research process is first translated into portfolio decisions and then eventually recognized by the market.” He goes on to discuss that the research today, will provide the fruits of tomorrow. He explains that an investment program will not succeed if “high quality research is not performed on a continuing basis.”

Klarman discussed investing in complex securities. His theme being, if the security is hard to understand and time consuming, many of the analysts and institutions will shy away from it. He identifies this as “fertile ground” for research.

[Spin-offs](#)

The goal of a spin-off, according to Klarman is for the former parent company to create greater value as a whole by spinning off businesses that

aren't necessarily in their strategic plans. Klarman finds opportunity because of the complexity (see above) and the time lag of data flow. I don't know in 2006 if this is still the case, but Klarman mentions there is a 2 to 3 month lag of data flow to the computer databases. I have owned several spin-offs and have ultimately sold them, as they were too small for the pie, or just not followed by my research. As I think back, I think quite a few of these spin-offs did fairly well. One example would be Freescale. As I look at the Freescale chart, it looks like it went from around 18 two years ago, to around 33 today. Ahh, this topic alone, enabled the book to provide potential value to my future net worth.

Bankrupt Companies

Look for Net Operating Losses as a potential benefit. He describes the beauty of investing in bankrupt companies is the complexity of the analysis. This complexity, as described often in his book, leads to potential opportunity, as many investors shy away from the complex analysis. Pending a bankruptcy, costs get leaner and more focused, cash builds up and compounds with interest. This cash buildup can simplify the process of reorganization, because all agree on the value of cash.

Michael Price and his 3 stages of Bankruptcy:

- a. Immediately after bankruptcy. This is the most uncertain stage, but also one of the greatest opportunities. Liabilities are not evident, there is turmoil, financial statements are late or unavailable and the underlying business may not have stabilized. The debtor's securities are also in disarray. This is accompanied by forced selling at any price.
- b. The second stage is the negotiation of a reorganization plan. Klarman mentions that by this time, many analysts have pored over the financials and the company. Much more is known about the debtor, uncertainty is not as acute, but certainly still exists. Prices will reflect this available information.
- c. The third stage is the finalization of the reorganization and the debtor's emergence from bankruptcy. He claims this stage takes 3 months to a year. Klarman mentions that this last stage most closely resembles a risk-arbitrage investment.

“When properly implemented, troubled-company investing may entail less risk than traditional investing, yet offer significantly higher returns. When badly done, the results of investing can be disastrous...” He emphasizes that the market is illiquid and traders take advantage of unsophisticated investors. “Caution is the order of the day for the ordinary investor.”

Klarman mentions to use the same investment valuation techniques you would use for a solvent company. He suggests that the analyst look to see if the companies are intentionally “uglifying” their financial statements. He cites the example of expensing rather than capitalizing certain expenses. The analyst needs to look at off-balance sheet arrangements. He cites examples as real estate and over-funded pension plans.

Klarman discusses the investor should typically shy away from investing in common stock of bankrupt companies. He mentions there is an occasional home run, but he states, “as a rule investors should avoid the common stock of bankrupt entities at virtually any price; the risks are great and the returns are very uncertain.” He discusses one ploy of buying the bonds and shorting the stock. He used an example of Bank Of New England (BNE). He mentioned that BNE bonds were selling at 10 from 70, whereas the stock still carried a large market capitalization.

He concludes the bankruptcy section by stressing that this type of investing is sophisticated and highly specialized. The competition in finding these securities is savvy, experienced and hard-nosed. When this area becomes popular, be extra careful, as most of the money made is based on the uneconomic behavior of investors.

Portfolio Management and Trading

“All investors must come to terms with the relentless continuity of the investment process.”

He mentions the need for liquidity in investments. A portfolio manager can buy a stock and subsequently find out he or she made an error, or that a competitor has a stronger product. With that said, the portfolio manager can typically sell that situation. If the investment was in an annuity or limited partnership, the liquidity is pierced and the change of strategy cannot be

economically deployed. “When investors do not demand compensation for bearing illiquidity, they almost always come to regret it.”

He discusses that liquidity is not of great importance in managing a long-term oriented portfolio. Most portfolios should contain a balance of liquidity, which can quickly be turned into cash. Unexpected liquidity needs do occur. The longer the duration of illiquidity, should demand a greater form of compensation for the liquidity sacrifice. The cost of illiquidity should be very high. “Liquidity can be illusory.” Watch out for situations that are liquid one day, and illiquid the next. He claims this can happen in market panics.

“Investing is in some ways an endless process of managing liquidity.”

When a portfolio is in cash only, the risk of loss is non-existent. The same goes for the lack of gain when fully invested in cash. Klarman mentions, “The tension between earning a high return, on the one hand, and avoiding risk, on the other, can run high. This is a difficult task.

“Portfolio management requires paying attention to the portfolio as a whole, taking into account diversification, possible hedging strategies, and the management of portfolio cash flow.” He discusses that portfolio management is a further means of risk reduction for investors.

He suggests that, as few as ten to fifteen different holdings should be suffice for diversification. He does mention, “My view is that an investor is better off knowing a lot about a few investments than knowing only a little about each of a great many holdings.” He mentions that diversification is “potentially a Trojan horse.” “Diversification, after all, is not how many different things you own, but how different the things you do own are in the risks they entail.”

In regards to trading Klarman stated, “The single most crucial factor in trading is the developing the appropriate reaction to price fluctuations. Investors must learn to resist fear, the tendency to panic, when prices are falling, and greed, the tendency to become overly enthusiastic when prices are rising.

“Leverage is neither necessary nor appropriate for most investors.”

How do you evaluate a money manager?

- a. “Personal interviews are absolutely essential.”
- b. “Do they eat their own cooking?” He feels this is the most important question of an advisor. When an advisor does not invest in his or her own preaching, Klarman refers to it as “eating out.” You want the advisor to act in a “parallel” fashion to his or her clients.
- c. “Are all clients treated equally?”
- d. Examine the investor’s track record during different periods of varying amounts of assets managed. How has the advisor performed as his or her assets have grown? If assets are shrinking, try to examine the reason.
- e. Examine the investment philosophy. Does the advisor worry about absolute returns, about what can go wrong, or is the advisor worried about relative performance?
- f. Does advisor have constraining rules? Examples of this could be the requirement to always be fully invested.
- g. Thoroughly analyze the past investment performance. How long a track record is there? Was it achieved in one or more market cycles?
- h. How did the clients do in falling markets?
- i. Have the returns been steady over time, or have they been volatile?
- j. Was the track record from a steady pace, or just a couple of successes?
- k. Is the manager still using the same philosophy that he or she has always used?

- l. Has the manager produced good long-term results despite having excess cash and cash equivalents in the portfolio allocation? This could indicate a low risk approach.
- m. Were the investments in the underlying portfolio themselves particularly risky, such as shares of highly leveraged companies? Conversely, did the portfolio manager reduce risk via hedging, diversification and senior securities?
- n. Make sure you are personally compatible with the advisor. Make sure you are comfortable with the investment approach.
- o. After you hire the manager, monitor them on an ongoing basis. The issues that were addressed prior to hiring should be used after hiring.

He finishes the book with these words. “I recommend that you adopt a value-investment philosophy and either find an investment professional with a record of value-investment success or commit the requisite time and attention to investing on your own.”

Respectfully submitted,

Ronald R. Redfield CPA, PFS

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