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Seth Klarman

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by Roger Thompson

Klarman

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While other money managers scrambled to survive the financial market meltdown, value investor extraordinaire Seth Klarman (MBA '82), president of The Baupost Group in Boston, cautiously pursued buying opportunities. After sitting patiently on the sidelines with a mountain of cash — 40 to 50 percent of Baupost's $14 billion–plus in assets — for several years, the firm's recent investments have cut its cash stash in half. Distress selling, it seems, breeds the kind of bargains Klarman lives for.

Fresh out of HBS, Klarman didn't hesitate when Adjunct Professor Bill Poorvu recruited him to help manage a $27 million pool of capital in the newly formed Baupost. While the starting salary was an underwhelming $35K, it turned out to be the opportunity of a lifetime. In 26 years, Baupost has racked up an enviable 20 percent annual compound rate of return, earning Klarman entry into the Alpha magazine Hedge Fund Hall of Fame. The firm has grown from 3 to 100 employees.

A consummate team player, Klarman rarely uses his private office, choosing instead to sit at the trading desk where he works closely with analysts on investment decisions. But work isn't all-consuming. He makes time for family and outside pursuits. As his three children grew, he coached his daughters' soccer teams and attended his son's recitals. And he is deeply committed to a number of philanthropic causes. Klarman recently took time to discuss investing, the credit crisis, and his approach to philanthropy.

When you started with Baupost at age 25, did you already consider yourself a value investor?

Yes. After my junior year in college and right after graduating, I worked for Mutual Shares Corporation, which was run by a wonderful gentleman named Max Heine. I learned a huge amount about value investing. It turns out that value investing is something that is in your blood. There are people who just don't have the patience and discipline to do it, and there are people who do. So it leads me to think it's genetic.

Did you ever waver in your investment style?

Never once.

What gave you the resolve to say no to all the other investment approaches?

There are several answers. First, value investing is intellectually elegant. You're basically buying bargains. It also appeals because all the studies demonstrate that it works. People who chase growth, who chase highfliers, inevitably lose because they paid a premium price. They lose to the people who have more patience and more discipline. Third, it's easy to talk in the abstract, but in real life you see situations that are just plain mispriced, where an ignored, neglected, or abhorred company may be just as attractive as others in the same industry. In time, the discount will be corrected, and you will have the wind at your back as a holder of the stock.

Do you set an annual return target?

We think it's madness to target a return. Return lies in some relationship to risk, albeit there are moments when it's out of whack, when you can make a high return with very limited risk. My view is that you can target risk versus return. So you can say, I'll take the very safe 6 percent, I'll take the somewhat risky 12, or I'll take the enormously risky 20, knowing that 20 might actually be minus 20 by the time the actual results are known. We just don't think targeting a return is smart.

You are lead editor of the new edition of *Security Analysis*, the bible of value investing by Benjamin Graham and David Dodd, first published in 1934. Is their advice still relevant 75 years later?

At no time since 1934 has it been so relevant given the financial turmoil and distress in the world and the possibility that we could be reliving some sort of serious economic downturn. What's wonderful about Graham and Dodd is that their advice is timeless. And it is not just about investing; it's also about thinking about investing. It basically teaches you the questions that you should ask, and it makes endless references to the foibles of human nature in the markets.

Given the recent credit market meltdown, have we made much progress in figuring out how to avoid the pitfalls pointed out by Graham and Dodd?

No. What happens is that people always want to believe that this time is different, that there's something new under the sun, and that through their own ingenuity they can wish away risk. The idea that risk premiums would go to zero, that we're somehow overcoming human nature, is absurd. The whole reason that our capitalist system works the way it does is because there are cycles, and the cycles self-correct. With too much excess, eventually you get a downturn.

So the explosion in securitized assets was a ticking time bomb?

It's not amazing that securitized products were created. There are huge financial incentives for the people involved. What's amazing is that anybody actually bought them. That's because they're created with a one-dimensional idea of what the economy and the world are going to do. If you have nothing but good times, then securitization makes tremendous sense. But securitization, for all of the commingling and diversification it gives you, also gives you a lack of transparency. So if you have an environment like the one we have now, the assets that have been securitized actually make you worse off than if they were just held as whole loans.

The unanswered question is how did the smartest people in the world who run the major Wall Street firms not understand that these products were toxic and end up getting caught with them on their books?

As Fed chairman, did Alan Greenspan have a hand in creating the current credit market crisis?

Until recently, Greenspan seemed unaware of his role in influencing markets. As Fed chairman, when he advised people not very many years ago to take out variable rate mortgages, he aided and abetted the housing market excesses. When he said there was irrational exuberance in the market [in 1996], he was basically right. But then he didn't act even though he had plenty of levers he could have pulled that didn't have to do with changing interest rates. He could have raised margin requirements, for example. But instead, he came up with the ridiculously lame idea that bubbles need to be allowed to run and that the Fed can clean up the mess afterward, which only had the effect of inflating subsequent bubbles, most notably the housing bubble that came as a result of the easy money. So he's just been unaware of the impact of his encouragement, and his inaction got us into the terrible mess we're in today. It's not all his fault, but I hold him largely responsible for it.

How have Ben Bernanke and Henry Paulson (MBA '70) done in managing the financial crisis?

They have been dealt an unimaginably bad hand. If any of us were in their shoes, we would be doing similar things, although it is reasonable to assume that part of the problem we are facing today is a result of previous government actions, and today's government actions will give rise to future problems as well.

The lesson should be that we need to get to a point where we don't need to intervene in the future, because we realize that intervention also delivers incredibly dangerous messages and creates a giant moral hazard. Bernanke and Paulson have to realize that if we're going to intervene when things are bad, we're also going to intervene when things are good and take away the punch bowl before the party gets too far along. One-sided intervention is even more dangerous. It will create an ever bigger bunch of excesses that will require an even bigger bailout next time.

Was the $700 billion federal rescue package, sold as a plan to buy toxic mortgage-backed securities from banks, the right way to go?

Defining the problem you are trying to solve is critical in knowing whether this plan will solve it. The bailout does almost nothing to solve the specific problem of declining housing prices. If the government really wants to tackle that problem, making capital available so that banks can make safe loans is crucial. Injecting $250 billion into the nation's banks is a big step in that direction.

How do you approach philanthropy?

I'm a big believer in giving back. We all have an obligation to leave things better than where we found them.

I have more than I'll ever need, and more than my family will ever need. I'm only working now for philanthropy. So everything I do is about giving back. In fact, one of the things we did at Baupost when we recently took on some additional clients was to accept only educational endowments and foundations. We figured we would further benefit the world by helping these organizations rather than individuals. That decision was very important for me and for all the firm's partners.

Also, given the extremely difficult financial environment we are in, I expect charities will be greatly affected. That's why it's incumbent on those who can to step up and help fill the void.