Seth Klarman
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Back to Hall of Fame main page | Kenneth Griffin | David Swensen

Seth Klarman is nobody's idea of a fast-buck, quick-change investor. Since helping to found Boston-based Baupost Group in 1982 with $27 million pooled from four families, he has emulated prototypical value-investment role models like Warren Buffett and the late Benjamin Graham. He buys underpriced equities and securities of bankrupt or distressed companies and usually steers clear of leverage and shorting, though last year he made very profitable investments in credit protection and recorded his best-ever annual return (52 percent). Klarman credits his "very strong team" and stresses that he doesn't even consider himself a hedge fund manager in the traditional sense (though he accepts only legally qualified investors and charges a 20 percent performance fee). Yet his nearly 20 percent annualized returns rival those of larger peers who take more risks. A professorial 51-year-old who manages $12 billion today, Klarman has an economics degree from Cornell University and an MBA from Harvard Business School but traces much of his success to two Wall Street mentors, Max Heine and Michael Price.

How did you decide value investing was for you?

I was fortunate enough when I was a junior in college — and then when I graduated from college — to work for Max Heine and Michael Price at Mutual Shares [a mutual fund founded in 1949]. Their value philosophy is very similar to the value philosophy we follow at Baupost. So I learned the business from two of the best, which was better than anything you could ever get from a textbook or a classroom. Warren Buffett once wrote that the concept of value investing is like an inoculation- — it either takes or it doesn't — and when you explain to somebody what it is and how it works and why it works and show them the returns, either they get it or they don't. Ultimately, it needs to fit your character. If you have a need for action, if you want to be involved in the new and exciting technological breakthroughs of our time, that's great, but you're not a value investor and you shouldn't be one. If you are predisposed to be patient and disciplined, and you psychologically like the idea of buying bargains, then you're likely to be good at it.

What traits in Heine and Price influenced you?

Max Heine was great at not looking at what something was called, what its label was. He looked at what it actually was. For example, back in the late '70s, Mutual Shares was buying the bonds of bankrupt railroads, and I think a lot of people would have said, "They're bankrupt," and "Who needs railroads?" Max and one of his partners knew how many miles of track the railroad had, what the scrap steel on the track could have been sold for and which railroads might have wanted pieces of those networks. They also knew what the real estate rights above the terminals were worth.

Michael Price was fabulous at pulling threads. He would notice something, and then he would get curious and ask questions. And one thing would lead to another thing, and that would lead to another thing. I remember a chart that Michael made of interlocking ownership of mining companies that was an extension of a thought where one good idea led to another and had the potential to lead to many more if the threads kept being pulled. That was a great lesson — to never be satisfied. Always be curious.

Value is your mantra.

We don't even think of ourselves as a hedge fund. We see ourselves as basically long-only investors. Unlike hedge funds, we don't leverage the portfolio — never a nickel of portfolio leverage. We have a minimal amount of shorts, currently less than 1 percent of the total assets. We're not the stereotypical hedge fund in terms of an idea a minute. We're very bottom up, not top down. We don't come into the office with a view that interest rates, the dollar or the economy are going to do this or that. We come in with a view that this particular asset or security is trading for less than it's worth and we want to buy it. We have a different approach than a lot of, quote, "hedge funds."

What were some of your best value investments?

Distressed-debt investments where we owned the senior debt. That is a favorable place for a value investor. You have a margin of safety since, as things go bad, people who are junior to you are the ones who lose value before you do. Second, the bankruptcy process itself is a catalyst. A cheap stock can stay cheap forever, but if you own a bankrupt bond, the process of emerging from bankruptcy and distributing new securities offers a practical catalyst to realize the value. Back in 2001, 2002, we successfully invested in the debt of funeral home companies like Service Corp. International and Stewart Enterprises. We were investors in Xerox Credit Corp. debt.

Biggest mistakes?

There are too many examples that we could say, "Ah, that was right in our sweet spot, and we should have had it." All investors need to learn how to be at peace with their decisions. We as a firm are always going to buy too soon and sell too soon. And I'm very at peace with that. If we wait for the absolute bottom, we won't buy very much. And when everybody's selling, there tends to be tremendous dislocation in the markets.

What's the secret to success?

Every manager should be able to answer the question, "What's your edge?" This isn't the 1950s, when all you had to do was buy a corner lot and build a small drugstore and it gradually became incredibly valuable land or you owned a skyscraper or you built a small shopping center and it became the big regional mall. The market's very competitive; there are a lot of smart, talented people, a lot of money chasing opportunity. If you don't have an edge and can't articulate it, you probably aren't going to outperform.

Why do some hedge fund managers fail?

Their clients are pressuring them for short-term results, or they think their clients want short-term results. That's probably the biggest problem for professional money managers. It makes it very, very hard for an investor to hold a stock that's going down, to take a contrary viewpoint. I also think leverage is a great risk. If you look at hedge fund failures, virtually all of them were on the back of excess leverage.

Are you worried about the hedge fund industry becoming too crowded?

If you took some of the people in your [Hall of Fame] group and compare what they do with what we do, there would be no overlap of positions. Probably ever. So are there too many? No. It's not competition for us, but yes, more and more money has gone into the kinds of strategies many hedge funds follow. On the other hand, there are also some bad hedge funds — overleveraged hedge funds — and those are the causes of tremendous selling opportunities. When they get in trouble, they may be forced to sell at bargain prices.

Is it getting more difficult to find value?

Sure, but I can't worry too much about things I can't control. If suddenly tomorrow I got the conviction that all securities were efficiently priced, that nothing was dropping to levels where I cared about it, I would be happy to close up shop. But human nature makes it hard for the markets to be efficient. As recently as earlier this year, there were days when it felt to a lot of people like the world was ending,

that we were staring into some kind of abyss of financial distress, and a lot of buyers weren't buying. Those were interesting days. We were looking for bargains, and the Fed massively intervened, and people decided it was safe to invest again, and the markets worked out. So the question is not, Are people smart, are people sophisticated, do they have clever ways of looking at things, are they looking in the right areas? The question is, Are there periods when none of that matters because their human natures get the best of them?

What's your opinion on hedge funds going public?

It's a terrible mistake. One of the worst days for the hedge fund industry was the day the first one became public. As an investor, you do best when you think about what's in your client's interest, which is managing a reasonable amount of money that will earn a good return with limited risk. When you go public, you change that risk-return equation and start thinking about how much money you can make. It becomes a business where the client relationships don't have to be longer than the next quarter and the talent can leave and the clients can leave.

Name one of the most pressing issues the world faces today.

It would be great if we got a long-term energy policy in this country, because if we could put a floor under the price of oil, we could enable alternatives to spring up. We can't risk oil going back to $40, and we're just so shortsighted and stupid about that. We could have a global war over energy if we're not careful.

What's your philosophy when it comes to philanthropy?

I'm not a big fan of giving to endowments, because people in endowment situations tend to give away the minimum. I believe problems are compounding faster than the money, so spending more money sooner rather than later is more likely
to address a problem. I'm interested in situations where you get a sizable bang for the buck, where it's proven that intervention is effective and where even a relatively small amount of money or a relatively targeted amount of money can change the game.

— Interview by Stephen Taub

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