Ivey interview with Seth Klarman – Value investing course

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I'm so happy today. We had a video conference with Seth Klarman. I want to be this man in 35 years time. Unassuming and really knows his stuff, and btw…rich too. So glad that Prof George Athanassakos arranged for such an amazing speaker.

Seth Klarman is the President of Baupost Group and has been running the investment house for more than 20 years. His annualized return over that period is over 20%. Over the last few years, astute side-stepping of land mine and holding cash when no margin-of-safety could be established allowed the firm to perform well in this volatile market.

Klarman wrote the now out of print Margin of Safety which is sold on ebay and amazon for over 1400 USD. Pssst….SMU library has a copy, donated by our librarian - Ruth

The **3 underlying pillars** to his investment approach

1. Focus on risk

Be a big fan of worrying. Risk is NOT BETA. Risk is the probability and size of losing under different scenarios. It is most important to not be obsessed about single point estimate, focus on range of outcome.

2. The world is orientated to relative performance

Mutual funds are largely asset gatherer, as they earn management fee from % of underlying asset than by outperformance. Mutual funds are hugely penalized when they underperform as client defect, thus this encouraged many actively managed funds to be closet index fund. Being mediocre is perfectly fine in the mutual fund world.

To gain an edge, we should focus on absolute return. Thus we would rank not losing money as more important than not underperforming index. Losing 18% when the world is losing 20% is just insane.

3. Bottom up orientation

Very very few people has shown that they are able to predict the macro economy. And even if they are accurate, then asset class and security chosen may not work out as well as they macro prediction.

Focus on bottom up approach to investing. Analyze the individual company/security thoroughly and work out all the possible outcome for that individual security under different stress test scenarios.

Identify an edge
Klarman told us to focus and identify an edge. Every investors needs to think about this, but few of us do. One of Baupost's edge is that it has a long term orientated investment policy backed by long term money. Many good funds couldn't invest right now as they are afraid that they'll have to sell more stocks to meet redemptions demands. Having committed long term capital is crucial to long term investment success.

Another edge Baupost has is that it loves messy situation. A favorite asset class right now is distressed debt that has been recently downgraded. Many pension funds and bond funds invest in high credit rating bond because they want safety, and that their fund mandates it. When a downgrade occurs (ie 'safety' condition removed, many such investors are forced to sell. Good investors love to buy when the other party is in panic selling mode.

Know who you are buying from. Think twice about buying when you know that the seller is a good investor who has done due diligence; or the other party is an insider. You don't want to be the pasty :)

Other Mispriced Situation
A stock that is knocked out of S&P index would have huge selling pressure. About 10% of all S&P stocks are owned by index fund. Being kicked out would mean that many funds would be forced to sell.

Corporate Spinoff – It is often the unloved child that is being spun off. Normally it has low ROA, litigation, or weak management. Owners of the parent company stock don't want to own the ugly child, causing huge mispricing opportunity

For beginners – there are some close end fund trading way below NAV. If you think there is sufficient MOS, this could be a beautiful opportunities.

Margin of Safety
Only buy when an appropriate Margin of Safety could be established. Hold cash when you can't find any. Klarman's fund entered 2008 with over 35% in cash, and it is now in the low 20s. However, he sold some assets to maintain a high cash position as he said this is a period of time where you don't want to be caught without cash. (interestingly, Buffett sold some JNJ after his buying spree late last year to maintain high cash position).

One of the biotech company that his fund owns has a royalty streams of over 30% IRR. There is no need for great things to happen, and the price is lower than the value of this highly predictable stream of royalty. There is no place for optimism for valuation.

He currently price in several years of GDP decline into every scenario analysis and would only buy if he's comfortable with that.

Risk
Perform intensive sensitivity analysis on every security that you purchase. For instance,

when he stress test mortgage backed security (where there are some interesting mispricing going on), Factors such as housing prices changes, default rate changes, and repayment of loan rate chages would be fed into the model. And at depression level, would the security still be a good buy? If yes, then BUY!

Academics thinks that more risk (volatility or beta) more return. But Value investor know that the less the risk (P(of loss)xloss) and MOS, the more return.

On a macro level, in 2006 when financial institution grew to 40% of S&P, Klarman got worried because it showed that the growing economy is driven by growing leverage. Over the last 2 years, many traditional value investors got killed as they are not quick enough to re-calibrate their understanding of book value. He also noticed that for most investor, once you lose 30% - 50% of capital, your thinking gets fuzzy.

Further example of modeling financial Armageddon – For instance, when analyzing car loans (many originator are keen to sell this off, but the traditional securitization market has dried up) would the security still be of value if historical loss rate quadruple? Can we still be safe?
Or when analyzing housing related security, if housing prices in the area goes back to 1979 level, can we still be safe?

Some things are easier to forecast in this current environment; earnings from gaming houses in Las Vegas is down 20%, but it is very hard to guess what next year earnings will be. However, the sale of Kleenex is unlikely to decline by 20% over the next year as people are still going to buy Kleenex.

Valuation
Make use of MULTIPLE scenarios and valuation method to value. If the current price is right smack in the middle of your multiple case, you know you don't have a Margin of Safety.

Valuation technique used - liquidation value, replacement cost, book value, PV of cashflow, earnings and cashflow multiples, breakup value, private market take over value (not levered) , LBO or MBO.

If everyone in the market looks at a business and values it a certain way, e.g. as a LBO target, it is often beneficial to look at it another way – e.g. at liquidation value. This provides both margin of safety and a more dynamic approach to valuation.

Optimism

The period with the highest return going forward would be the worst period of return looking backward. He simply don't understand why some people believe that the world is not going to wake up tomorrow. Klarman has not seen so many opportunities to invest in since the day he graduated.