Financial Analysts Journal
Volume 66 • Number 5
©2010 CFA Institute

PERSPECTIVES

Opportunities for Patient Investors

Seth A. Klarman and Jason Zweig

At the CFA Institute 2010 Annual Conference in Boston (held 16–19 May), Jason Zweig sat down with legendary investor Seth Klarman to gain insights into Mr. Klarman's successful approach to investing.

Zweig: The first question I would like to ask you, Seth, concerns your work at Baupost. How have you followed Graham and Dodd, and how have you deviated from Graham and Dodd?

Klarman: In the spirit of Graham and Dodd, our firm began with an orientation toward value investing. When I think of Graham and Dodd, however, it's not just in terms of investing but also in terms of thinking about investing. In my mind, their work helps create a template for how to approach markets, how to think about volatility in markets as being in your favor rather than as a problem, and how to think about bargains and where they come from. It is easy to be persuaded that buying bargains is better than buying overpriced instruments.

The work of Graham and Dodd has really helped us think about the sourcing of opportunity as a major part of what we do—identifying where we are likely to find bargains. Time is scarce. We can't look at everything.

Where we may have deviated a bit from Graham and Dodd is, first of all, investing in the instruments that didn't exist when Graham and Dodd were publishing their work. Today, some of the biggest bargains are in the hairiest, strangest situations, such as financial distress and litigation, and so we drive our approach that way, into areas that Graham and Dodd probably couldn't have imagined.

The world is different now than it was in the era of Graham and Dodd. In their time, business was probably less competitive. Consultants and "experts" weren't driving all businesses to focus on their business models and to maximize performance. The business climate is more volatile now. The chance that you buy very cheap and that it will revert to the mean, as Graham and Dodd might have expected, is probably lower today than in the past.

Also, the financial books of a company may not be as reliable as they once were. Don't trust the numbers. Always look behind them. Graham and Dodd provide a template for investing, but not exactly a detailed road map.

Zweig: Seth, you started your career at Mutual Shares, working for Max Heine and alongside Mike Price. Can you give us a couple of lessons you learned from those gentlemen?

Klarman: What I learned from Mike—and I worked most closely with him—was the importance of an endless drive to get information and seek value. I remember a specific instance when he found a mining stock that was inexpensive. He literally drew a detailed map—like an organization chart—of interlocking ownership and affiliates, many of which were also publicly traded. So, identifying one stock led him to a dozen other potential investments. To tirelessly pull threads is the lesson that I learned from Mike Price.

With Max Heine, I learned a bit of a different lesson. Max was a great analyst and a brilliant investor—and he was a very kind man. I was most taken with how he treated people. Whether you were the youngest analyst at the firm, as I was, or the receptionist or the head of settlements, he always had a smile and a kind word. He treated people as though they were really important, because to him they were.

Zweig: One of the striking lessons that came out of the global financial crisis of 2008 and 2009 is the way traditional value investors got slaughtered. What went wrong, and why did so many smart people get caught by surprise?

Klarman: Historically, there have been many periods in which value investing has underperformed. Value investing works over a long period of time, outperforming the market by 1 or 2 percent a year, on average—a slender margin in a year, but not slender over the course of time, given the power of compounding. Therefore, it is not surprising that value could underperform in 2008 and 2009.

Seth A. Klarman is president of The Baupost Group, LLC, Boston. Jason Zweig is a columnist for the Wall Street Journal, *New York City.*

I would make two points. First, pre-2008, nearly all stocks had come to be valued, in a sense, on an invisible template of an LBO model. LBOs were so easy to do. Stocks were never allowed to get really cheap, because people would bid them up, thinking they could always sell them for 20 percent higher. It was, of course, not realistic that every business would find itself in an LBO situation, but nobody really thought much about that.

Certainly, many of the companies had some element of value to them, such as consumer brands or stable businesses, attributes that value investors might be attracted to. But when the model blew up and LBOs couldn't be effected, the invisible template no longer made sense and stocks fell to their own level.

Second, because of the way the world had changed, it was no longer sufficient to assume that a bank's return on book value would always be 12 or 15 percent a year. The reality was that instruments that were rated triple-A weren't all the same. Watching home-building stocks may not have been the best clue to what was going on in the mortgage and housing markets.

Equity-minded investors probably needed to be more agile in 2007 and 2008 than they had ever needed to be before. An investor needed to put the pieces together, to recognize that a deteriorating subprime market could lead to problems in the rest of the housing market and, in turn, could blow up many financial institutions. If an investor was unable to anticipate that chain of events, then bank stocks looked cheap and got cheaper and earnings power was moot once the capital base was destroyed. That's really what primarily drove the disaster.

Zweig: With hindsight, it strikes me that a problem many traditional value investors had was that they didn't have enough on their dashboard. They were accustomed to bubbles forming in the equity market, but the credit bubble was in the periphery. Equity investors didn't take the credit bubble seriously enough, because it wasn't in their central field of vision.

Klarman: Another issue that affected all investors, not just value investors, was the pressure to be fully invested at all times.

When the markets are fairly ebullient, investors tend to hold the least objectionable securities rather than the truly significant bargains. But the inability to hold cash and the pressure to be fully invested at all times meant that when the plug was pulled out of the tub, all boats dropped as the water rushed down the drain.

Zweig: A chilling moment in Michael Lewis's wonderful book *The Big Short* is when Michael Burry, a very talented hedge fund manager in California, finds himself, in 2007, in the desperate situation of having to defend his short positions in leveraged mortgage securities against his own investors, who are just besieging him, screaming at him, why are you doing this? At the very moment when his temperament is telling him that he *should* be doubting his own judgment, his clients are compelling him to explain to them why he has no doubts about his judgment.

How have you organized Baupost to discourage your clients from putting you in a similar position?

Klarman: We have great clients. 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.

We have emphasized establishing a client base of highly knowledgeable families and sophisticated institutions, and even during 2008, we could see that most of our institutional clients—although some of them had problems—understood what was going on.

Zweig: If you were to give one piece of advice on how to raise the quality of one's client base, what would it be?

Klarman: 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.

At the worst possible moment, when your fund is down because cheap things have gotten cheaper, you need to have capital, to have clients who will actually love the phone call and—most of the time, if not all the time—add, rather than subtract, capital. Having clients with that attitude allowed us to actively buy securities through the fall of 2008, when other money managers had redemptions and, in a sense, were forced not only to *not* buy but also to sell their favorite ideas when they knew they should be adding to them.

Not only are actual redemptions a problem, but also the fear of redemptions, because the money manager's behavior is the same in both situations. When managers are afraid of redemptions, they get liquid. We all saw how many managers went from leveraged long in 2007 to huge net cash in 2008, when the right thing to do in terms of value would have been to do the opposite.

Zweig: There is an interesting tension in the way Baupost operates. You are organized for the long term, you invest for the long term, and yet you have demonstrated that you can be extremely opportunistic in the short term. For example, in 2008, you took distressed debt and residential mortgage-backed securities from basically zero to more than a third of the fund in a matter of months. How do you take a firm that thinks long term yet get everyone to turn on a dime and jump on something when it's cheap?

Klarman: Actually, we increased the position to about half of the fund by early 2009. There is no single answer. First, I have incredible partners. We share common aspirations for the business and a common investment approach. And we are not conventionally organized. We don't have a pharmaceutical analyst, an oil and gas analyst, a financials analyst. Instead, we are organized by opportunity. We have analysts whose focus is on spinoffs or distressed debt or post-bankrupt equities.

Not only do we not miss too many opportunities, but we also do not waste a lot of time keeping up with the latest quarterly earnings of companies that we are very unlikely to ever invest in. Instead, we spend a lot of our time focusing on where the misguided selling is, where the redemptions are happening, where the overleverage is being liquidated—and so we are able to see a flow of instruments and securities that are more likely to be mispriced, and that lets us be nimble. It is fairly easy to say, "Well, this is much better than what we own. Let's move from this direction to that direction"—and we are doing that all the time.

Zweig: In a *Forbes* article in the summer of 1932, Benjamin Graham wrote, "Those with enterprise haven't the money, and those with money haven't the enterprise, to buy stocks when they are cheap."[1] Could you talk a little bit about courage? You make it sound easy. You have great clients and great partners. Was it easy to step up and buy in the fourth quarter of 2008 and the first quarter of 2009?

Klarman: You may be skeptical of my answer, but, yes, it was easy. It is critical for an investor to understand that securities aren't what most people think they are. They aren't pieces of paper that trade, blips on a screen up and down, ticker tapes that you follow on CNBC.

Investing is buying a fractional interest in a business and buying debt claims on a business. If you are afraid that a bond you bought at 60 might go to 50 or even 40, you may find it difficult to buy more; but if you know that the bond is covered, with extremely high likelihood, between 80 and par or even above par, the bond becomes more and more compelling as its price falls.

But you do have to worry about how a bond will trade and what your clients will think if you don't have enough staying power to hold to maturity or even beyond maturity in the case of a bankruptcy. But if you have the conviction of your analysis—are sure that your analysis wasn't optimistic or flighty or based on a snapshot of an economic environment that cannot tolerate any stress—then you will not panic if the bond's price starts to drop.

Our approach has always been to find compelling bargains. We are never fully invested if there is nothing great to do. We test all our assumptions with sensitivity analysis. Through stress testing, we gain a high degree of conviction that we are right. We are prepared for things to go slightly wrong because we adhere to a margin-of-safety principle that gives us the necessary courage to go against the tide.

Yet, we don't actually think of it as courage, but more as arrogance. 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 last point I would make is that your psychology as an investor is always important. If you lose your confidence, if you've made too many mistakes, if you are down too much, it becomes very easy to say, "I can't stand being down more than this." Unless you have a bet-the-business mentality, you would worry about your business, about client redemptions, and about your own net worth in the business.

So, by being conservative all the time—by being both a highly disciplined buyer to ensure that you hold bargains and a highly disciplined seller to ensure that you don't continue to own things at full price—you will be in the right frame of mind. Avoiding round trips and short-term devastation enables you to be around for the long term.

Zweig: I once paraphrased Graham's wonderful sentence as, An investor needs only two things: cash and courage. Having only one of them is not enough. And you are saying that courage is not just a matter of temperament but also a function of process.

Klarman: Absolutely.

Zweig: You were quite critical of indexing in *Margin of Safety: Risk-Averse Value Investing Strategies for the Thoughtful Investor*,[2] which you wrote many years ago. Have you changed that view?

Klarman: I still think indexing is a horrendous idea for a number of reasons. That said, the average person who spends a very small amount of time on investing doesn't have a lot of good choices out there.

A tremendous disservice is perpetrated by the idea that stocks are for the long run, because you have to make sure you are around for the long run, that when you have unexpected pain, as many people did in 2008, you don't get out and you actually are a buyer. The prevailing view has been that the market will earn a high rate of return if the holding period is long enough, but entry point is what really matters.

Stocks trade up when they are put in an index. So, index buyers are overpaying just because a stock is included in an index. I am much more inclined to buy a stock that has been kicked out of an index because then it may have value characteristics—it has underperformed. A stock is kicked out of an index because its market cap has shrunk below the top 500 or the top 1,000.

We all know that the evidence shows that when you enter at a low price, you will have good returns, and when you enter at a high valuation, you will have poor returns. That is why we have had 10–12 years of zero returns in the market. And given the recent run-up, I am worried that we will have another 10 years of, if not zero, at least very low returns from today's valuations.

The mentality of "I'll save transaction costs and management fees by indexing" ignores the fact that the underlying still needs to produce for you. Indexing usually refers to equities, but the attractive asset class a year ago, on a risk-adjusted basis, was clearly debt, not equity.

Zweig: In one of your recent letters, you discussed what you called the "Hostess Twinkie market." First, can you explain what a Hostess Twinkie is? Second, can you explain what you meant when you compared markets to a Hostess Twinkie?

Klarman: A Hostess Twinkie is a confection that has made many childhoods slightly happier, but it is composed of totally artificial ingredients. My context, of about 6–12 months ago, was that virtually everything was being manipulated by the government. Nothing was natural in the markets. Interest rates were held at zero, the government was buying all kinds of securities—notably, mortgage securities—and who knows what else has ended up on the Fed's balance sheet.

We have had lending programs—Troubled Asset Relief Program (TARP), Cash for Clunkers, and even Cash for Caulkers. We just don't know the full extent to which investors have been manipulated. But certainly, the government wants people to buy equities, to invest so that the market will move higher, creating a wealth effect or at least eliminating the negative wealth effect in order to make people feel better about their situation, to restore a degree of optimism so that the economy might recover.

I am worried to this day about what would happen to the markets, to the economy if, in the midst of all these manipulations, we realized that they are, in fact, a Twinkie. I think the answer is that no one knows, including those in Washington. Will the economy continue to recover and grow at a healthy rate or will we sink into a double-dip recession? As we can all see, the high degree of government involvement continues.

The European bailout is gargantuan. I doubt it will work because it kicks the can further down the road and is yet one more manipulation that encourages people to own securities. It is almost as if our government is in the business of giving people bad advice: "We are going to hold rates at zero. Please buy stocks or junk bonds that will yield [an inadequate] 5 or 6 percent." In effect, it forces unsophisticated investors to speculate wildly on securities that are too overvalued.

Zweig: It also forces sophisticated investors to do the same.

Klarman: For a different reason, but absolutely.

Zweig: Because the money is free.

Klarman: And because they are in a short-term-performance game where they have to keep up.

Zweig: Are you concerned about the longer-term consequences of the Fed and the Treasury having essentially turned the whole planet into a "carry trade at zero cost"?

Klarman: I am more worried about the world, more broadly, than I have ever been in my career.

Zweig: Why?

Klarman: Until recently, I thought it was enough to have a good process at our firm, a clever approach, and that by our wits we would find sufficient bargains. I worry now that a new element has been introduced into the game, which is, in effect, Will the dollars we make be worth anything? And if we can print money in unlimited amounts, will the government intervene whenever it deems it necessary to save the financial system, to prop up the economy? There are not enough dollars in the world to do that unless we greatly debase them. It's not clear that any currency is actually all that trustworthy, and so I worry about all paper money.

We judge ourselves in dollars. Our clients are all effectively in the United States. We don't have an offshore fund, and so we hedge everything back to dollars. Perhaps today is no different from other crises. Nevertheless, over time, politicians find it easier to create inflation and debase currency than to tackle hard problems, and so I worry about the dollar.

We haven't tackled a single hard problem. There is no evidence that we will, and in some sense, every can is being kicked further down the road. So, I am very concerned about that.

I would love to see some sign of energy in Washington that would suggest somebody is willing—even if it means not being re-elected—to take a tough stand and try to tackle some of these serious problems, but I don't see it.

Zweig: Do you think we will eventually tackle these problems?

Klarman: People think of me as a pessimist, but I am actually an optimist. When somebody like Senator Scott Brown of Massachusetts comes along and says, "I am just going to speak plain English. I am going to tell what I see is the truth," that has appeal, especially in difficult moments when no one else is saying that. I am optimistic that more politicians will come along who realize that such a stance is actually a path to electoral victory.

Large parts of the country understand that there is no free lunch, that we have been lied to, that all kinds of numbers are distorted and manipulated, that inflation is not really zero percent, and that every adjustment the government makes to any reported data is to make the numbers more favorable to its agenda.

I am hopeful that people will understand that we can't all just exist on handouts and no taxes, and that we will begin to move in the right direction. But I am not sure whether this crisis is bad enough to force us.

I am also troubled that we didn't get the value out of this crisis that we should have. The Great Depression led us to a generation—or even two generations—of changed behavior. I grew up hearing about how our grandparents had a "depression mentality." It's awful to have a depression, but it's a great thing to have a depression mentality because it means that we are not speculating, we are not living beyond our means, we don't quit our job to take a big risk because we know we might not get another job. There is something stable about a country, a society built on those values.

In some sense, from the recent crisis we have developed a "really bad couple of weeks" mentality, and that's not enough to tide us through, teach us to avoid future bubbles, and ensure a strong recovery.

Zweig: Seth, the simplest way to look at what has happened in the world over the past three years is that the leverage that was taken on by the household, corporate, and financial sectors has been assumed by governments around the world, with the United States in the lead. How is this going to play out, and is there an investment angle on it?

Klarman: I am a bottom-up value investor, and so my partners and I are not experts on top-down investing. But broadly speaking, with sovereign debt, in a Malcolm Gladwell kind of sense, we are talking about tipping points—we don't know how much debt is too much.

History, of course, is not a perfect guide, and sentiment plays a crucial role. In the 1990s, Jim Grant wrote a book about credit called *Money of the Mind*.[3] I think sovereign debt is "money of the mind." For example, if we believe that the United States will repay its debt and inflation will not be a big problem, people will line up to buy U.S. debt. But if we become worried that the U.S. dollar will be debased, inflation will be high, or the United States might default—although default isn't realistic because the government can just print more dollars—we will then have the risk of failed auctions and much higher interest rates.

A tipping point is invisible, as we just saw in Greece. In most situations, everything appears fine until it's not fine, until, for example, no one shows up at a Treasury auction. In the meantime, we can be lulled into thinking all is well, that the United States will always be rated triple-A. Treasury Secretary Timothy Geithner speaks as if—at least in his public statements—he has been lulled into thinking that the United States will always be triple-A. That kind of thinking guarantees that someday the United States will no longer be triple-A. A sovereign deserves to be rated triple-A only if it has valuable assets, a good education system, a great infrastructure, and the rule of law, all of which are called into question by an eroding infrastructure, a government that changes the law or violates it whenever there is a crisis, and a legislature that shows no fiscal responsibility. There is an old saying, "How did you go bankrupt?" And the answer is, "Gradually, and then suddenly." The impending fiscal crisis in the United States will make its appearance in the same way.

Zweig: In your book, *Margin of Safety*, you said as a general rule that commodities, with the possible exception of gold, are not investments because they don't produce cash flow. Do you regard commodities as investments in today's market?

Klarman: No, I don't. In the book, I was mostly singling out fine-arts partnerships and rare stamps—addressing the commodities that were trendy then. Buying anything that is a collectible, has no cash flow, and is based only on a future sale to a greater fool, if you will—even if that purchaser is not a fool—is speculating. The "investment" might work—owing to a limited supply of Monets, for example—but a commodity doesn't have the same characteristics as a security, characteristics that allow for analysis. Other than a recent sale or appreciation due to inflation, analyzing the current or future worth of a commodity is nearly impossible.

The line I draw in the sand is that if an asset has cash flow or the likelihood of cash flow in the near term and is not purely dependent on what a future buyer might pay, then it's an investment. If an asset's value is totally dependent on the amount a future buyer might pay, then its purchase is speculation.

The hardest commodity-like asset to categorize is land, an asset that is valuable to a future buyer because it will deliver cash flow, not because it will be sold to a future speculator.

Gold is unique because it has the age-old aspect of being viewed as a store of value. Nevertheless, it's still a commodity and has no tangible value, and so I would say that gold is a speculation. But because of my fear about the potential debasing of paper money and about paper money not being a store of value, I want some exposure to gold.

Zweig: Benjamin Graham drew a sharp and classic distinction between investment and speculation. I believe his exact words were, "An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."

But Graham sometimes speculated over the course of his career. So, maybe regarding commodities as speculative doesn't preclude you from owning them, right?

Klarman: I would say that a commodity's speculative nature is not what precludes investment. When Graham was talking about safety of principal, he was not referring to currency. He wasn't really considering that the currency might be destroyed, but we know that can happen, and has happened, many times in the 20th century.

The investing game has historically been closer to checkers, but now it is more like chess—almost in three dimensions. The possibility that the dollars you make could be worth much less in the future leads an investor to think, How can I protect myself? Should I be shorting the dollar against another currency, and if so, which one?

Zweig: Right. And can you give us an indication of how you are applying that principle to your portfolio?

Klarman: We try to protect against tail risk: the risk of unlikely but possible events that could be catastrophic. Such an event would lead to much higher inflation. There are ways to hedge against inflation, including specific bets on the reported inflation rate. What we don't like about those hedges is that the government is the party that determines the official rate of inflation.

And it seems to me that we have much higher inflation today—and have had for most of the last 20 years—than the government admits to. We believe it is likely that the bond market vigilantes will call the government on inflation before the actual inflation shows up in the government's accounting. Therefore, we have bought way-out-of-the-money puts on bonds as a hedge against much higher interest rates. If rates reach 5–7 percent, we won't make anything on the hedge. But if rates go to double digits, we can make anywhere from 10 to 20 times over money, and if rates go to 20 or 30 percent, we can make 50 or 100 times our outlay. The puts are one kind of disaster insurance.

I think the odds are low that such high inflation will happen in the near future, but looking ahead five years, it becomes more likely, although certainly not a 50/50 chance. With a very limited initial outlay, I think a hedge like ours is a reasonable protection.

Zweig: So, it's cheap insurance.

Klarman: Yes, it's cheap insurance in the same sense that if you have a $400,000 home and homeowner's insurance costs $2,500 a year, you'll buy the insurance. But if homeowner's insurance costs $150,000 a year, you'll say, "I am going to be more careful with matches."

Zweig: If clients should give you more money when things are undervalued, do you give it back when markets are overvalued?

Klarman: Great question. That is probably number one in my mind most of the time—how to think about firm size and assets under management.

Throughout my entire career, I have always thought size was a negative. Large size means small ideas can't move the needle as much. You may be less nimble because you have larger positions. Today, we have $22 billion in assets under management, but 20 years ago we were at $200 million.

As we entered the chaotic period of 2008, we anticipated that things would start to get pretty wild. And so, around February 2008, for the first time in eight years, we went to our wait list because we recognized that the opportunities were likely to be both plentiful and large—and lumpy and arriving unpredictably.

We believed that having more money under management might let us take advantage of opportunities that otherwise we would have had to pass on because we didn't have enough buying power—and that proved to be right.

We certainly didn't foresee the events of September 2008, but we were ready for them. We got a lot of interesting phone calls from people who needed to move merchandise in a hurry—some of it highly illiquid, and most of it, in one way or another, fairly illiquid. So, to have a greater amount of capital available proved to be a good move. If we had waited until the crisis hit to raise cash, we would probably have been much less successful in doing so.

Today, we are trying to walk a tightrope. Even as we are trying to build our firm to manage the capital we have, we are also—psychologically and in other ways—readying ourselves to return it.

One of the nice things about our investment approach is that we always have cash available to take advantage of bargains—we now have about 30 percent cash across our partnerships—and so if clients ever feel uncomfortable with our approach, they can just take their cash back.

We have a lockup on a portion of our capital that is running off at the end of 2010. After that, we have lengthy notice periods but no real lockup. Thus, clients can have their cash back if and when they'd like it. In addition, we are discussing whether we should return cash. If our cash position rose materially higher than it is today, we would send some cash back—and we've told our clients this. Our clients appear not to like to hear that and would thus far like us to keep it. But I think returning cash is probably one of the keys to our future success in that it lets us calibrate our firm size so that we are managing the right amount of money, which isn't necessarily the current amount of money.

Zweig: How do you decide whether you have the right amount of assets under management?

Klarman: Our capacity level is absolutely market dependent. We don't want to be a distressed-debt firm that suddenly buys bonds at par. We want to buy bargains, and our only goal as a firm is excellence. I really don't care if our firm has $5 billion or $25 billion in assets. And I don't care to ever go public, to sell out, which would, I think, ruin our firm.

If my partners and I can go to bed every night and retire at the end of a long career feeling that we have done right by our clients, that we have put them first, that we have always thought about their interests before our own, that we haven't gouged them and haven't proliferated products, I am going to feel great, even if I have made a small fraction of what I could have made, because that's not, in my mind, what any of this is about. What my partners and I do every day is about the sacred trust of managing clients' money, not about how we can make more for ourselves.

Zweig: Seth, that's a great segue into the next question. Please discuss the change in the moral fabric and ethics of Wall Street since the time of Graham and Dodd.

Klarman: Wall Street exists to make money, and I don't think it has ever been otherwise. The perception of Wall Street as a horribly evil place is, from my perspective, misguided.

With new-fangled securities and with proprietary trading, there may be more inherent conflicts of interest today than in the era of Graham and Dodd. For instance, our firm is in contact with maybe 10–15 different desks at each of the major firms. How each of the firms manages potential conflicts of interest is open to question.

I know that Wall Street is always trying to rip our eyeballs out, but I never know on which trade. Anybody who thinks they can do business with Wall Street without their eyes being wide open—without caveat emptor applying—is taking unnecessary risks. Wall Street certainly has a responsibility not to lie, but they owe us no fiduciary responsibility on a trade. They are a counterparty or a market maker connecting us with a seller.

The idea of a Wall Street broker betting against a customer on a transaction is a little bit different, but even there, it is highly complicated. The situation could be that the customer wants to buy a mortgage security, whereas the firm that sells it wants to hedge its exposure, which should not be a concern. In my opinion, we should celebrate Goldman Sachs for not blowing up, rather than wishing they had blown up like their peers months earlier by not hedging.

The ethical issue is tough. I regard as highly ethical virtually every buy-side manager I know. I would put my money with them and trust them to deal with my affairs in my absence. I would also give those on the sell side fairly high marks in terms of personal integrity and character and in realizing that life isn't just about making every last nickel, but with the understanding that some people will take advantage in the short run to get a bonus or to look good in front of their boss.

Zweig: Are there any particular reforms you would like to see or not see coming out of Washington?

Klarman: We don't engage in any activities that would be regulated away or would likely be affected by new regulation. We don't borrow money. We don't use margin. Any requirements regarding disclosure or limits of leverage would be fine with us.

I would love for proprietary trading to go away, however, so that we have fewer competitors. I believe that proprietary trading creates a conflict for brokerage firms that can't give us the best service if their desks are aware of our orders and are front-running them, which we think happens—but again, we don't blame them because we know it goes on.

Systemic risk regulators will not be effective because the pressure on them will be so great. People like it when stock prices are up, when the economy is strong. It's human nature. A systemic risk regulator will have to pull away the punch bowl when the party has barely started and likely would be called before Congress to explain why. Regulating risk in that way is almost impossible.

Bank capital requirements should be higher. The potentially growing bank rescue fund also has its problems. In effect, we are saying to Jamie Dimon, "When your less successful, less capable competitors screw up, it's your problem. Friends don't let friends drive drunk. So, Jamie, you are really running Bank of America and Citigroup and all the other banks." That's craziness. It's not fair. In no other business would we penalize the successful firm for not instructing its less astute competitors on how to run their businesses better. But I don't really know how to fix that.

Broadly speaking, there are ways to prevent a financial crisis. If we could make it so that the equity is wiped out of failing financial firms and the subordinated debt converts automatically to equity, we wouldn't need government capital injections. We've seen a lot of firms get bailed out unnecessarily, such as the AIG holding company's creditors, who are getting par as debt matures for no reason that I can fathom. We could have rescued the subsidiary without rescuing the parent.

Zweig: At Baupost, how do you avoid groupthink?

Klarman: That's a fabulous question. At our recent investment team retreat, virtually every speaker—many of the leading thinkers in the markets and in business—was of the opinion that terrible problems await in terms of paper money and that gold is an asset investors should seriously consider. Also, the prevailing opinion was that the European Monetary Union is likely to break up. All of our partners instinctively said, "Wow! That's groupthink. We better be really careful before assuming that because everyone thinks that, it is definitely going to happen."

I think we are very good at intellectual honesty. We actually hire for intellectual honesty. In an interview, we work hard to see whether people can admit mistakes. We hold our people accountable to that standard. Everybody is going to make mistakes, but we like to know that people will accept that they have made them, figure out what they have learned from them, and move on.

We are aware of our biases, which are probably to be worried and to be pessimistic about the markets and the economy, but they help us in being thorough so we can be right. We are aware of the risks of being unduly biased in either direction. Investors need to pick their poison: Either make more money when times are good and have a really ugly year every so often, or protect on the downside and don't be at the party so long when things are good.

At Baupost, we are all clearly in the same camp. We have all our own money invested in the firm, and so we are very conservative. We have picked our poison. We would rather underperform in a huge bull market than get clobbered in a really bad bear market.

Zweig: How do you hire for intellectual honesty? How do you screen for that? How do you find it?

Klarman: We dwell a lot on past experiences. We ask people, What is the biggest mistake you've ever made? It's a very open-ended question because it's not solely an investment question, although prospective hires often answer as if it were.

We ask a lot of ethics-related questions to gauge their response to morally ambiguous situations. We care that they can identify a tough call and a conflict of interest.

We also look for *ideational fluency*, which essentially means that someone is an idea person. In response to an issue, do they immediately have 10 or 15 different ideas about how they would want to analyze it—threads they would want to pull á la

Michael Price—or are they surprised by the question? We don't want them to be sitting at their desks not knowing how to pursue the next opportunity when it comes along. We throw out a lot of different things in interviews, but we are looking for people who have it all: ethics, smarts, work ethic, intellectual honesty, and high integrity.

Zweig: Does short selling by hedge funds amount to the biggest market manipulation out there?

Klarman: I would be surprised to find out that that is true.

We don't sell short at Baupost, but my experience is that short sellers do far better analysis than long buyers because they have to. The market is biased upward over time—as the saying goes, stocks are for the long run. And just by the nature of what they do, the street is biased toward the bullish side, and so there is more low-hanging fruit on the short side.

Short sellers are the market's police officers. If short selling were to go away, the market would levitate even more than it currently does. In my opinion, it would not be in the country's best interest to have short selling prohibited. There would be more scams, more potential for the little guy to rack up painful losses because securities would be allowed to rise unchecked. The act of selling something short, of voting that it's overvalued, is a positive for the system.

The one exception is when short sellers, in effect, yell "Fire!" in a crowded theater in an attempt to create fear or spread malicious rumors.

A potential market manipulation is the purchase of credit default swaps by those who want companies to file for bankruptcy rather than recover. That activity has a problematic aspect to it.

Zweig: Can you think of any possible mechanism that would limit the kind of short selling that feeds on self-fulfilling rumor while permitting more "fundamental" short selling?

Klarman: I really don't have a problem with most rumors. It's yelling "Fire!" in the theater and causing problems for a company that needs to roll its debt that I am worried about. But I would also say there should be some burden on companies that continue to be dependent on rolling over debt regardless of the market environment.

For example, what General Electric did going into the financial crisis was irresponsible. GE assumed that the markets would be the same as they had been for decades and that it could always roll commercial paper—and when it couldn't, the government rescued it. In my view, GE had a responsibility to extend the maturity on its debt so as not to be dependent on access to the capital markets at all times.

If short sellers are wrong on fundamentals—if they want to short a stock at 10 that I know is worth 20 and they want to drive it to 8 and 6—I am going to buy and they are eventually going to be wiped out.

I don't understand the worry about computers selling stocks at a penny, other than it creates a false sense of calm in investors' minds that the markets won't be volatile, which would be a false sense of well-being because markets are, and should sometimes be, volatile. If someone wants to sell me a stock worth 50 bucks for a penny, it doesn't bother me at all. I don't think it should bother any of us.

Zweig: What about the problem of individual investors who had market orders in and just got crushed?

Klarman: Nobody should ever put in a market order. It doesn't make sense because the market can change rapidly.

Zweig: What are your top investment asset classes for the next decade?

Klarman: My answer is that we are highly opportunistic, and I will be buying what other people are selling, what is out of favor, what is loathed and despised, where there is financial distress, litigation—basically, where there is trouble. That is how we direct our search. We don't have a crystal ball, and so we don't know what those asset classes will be.

Zweig: All right. The next question is the sister of the last question. I can't resist asking it because I know it will drive you crazy. The question is, how are you making money?

Klarman: 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.

Right now, we are buying, or trying to buy, private commercial real estate because the stresses in that market are creating bargains. The private market in commercial real estate, especially the private market for anything less than center city Class A office or malls, has terrible fundamentals, and the likelihood that they will get better soon is not good. Yet the government has propped the market up with TARP money and Public-Private Investment Program money and also, essentially, by winking at the banks. I think the Federal Deposit Insurance Corporation has told banks, "Don't be in a hurry to sell your commercial real estate. We will bear with you." Servicers of commercial real estate securities and mortgage securities have also been slow to sell and eager to restructure.

In contrast to the private markets, the public market in real estate has rallied enormously. Many REITs are yielding 5 or 6 percent, which reflects vastly higher prices and less attractive yields than the private market offers.

Nevertheless, we are not making any money in real estate right now. We are putting money to work in private commercial real estate when we can, very selectively, because those investments will yield a good return over time, unlike the public part of real estate that is quite unattractive.

We are making money on the distressed debt we bought two years ago, which has gone from 40 or 50 or 60 to 90 or par, and on other similar securities that have been grinding along, throwing off cash, mostly rising in price or going through a process that will ultimately deliver a profit to us.

Zweig: How does Baupost define a value company, and what is your average holding period?

Klarman: 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. Again, if you don't do that, you are speculating and not investing. We may, however, turn over positions more often.

If we buy a bond at 50 and think it's worth par in three years but it goes to 90 the year we bought it, we will sell it because the upside/downside has totally changed. The remaining return is not attractive compared with the risk of continuing to hold.

In our view, there is no such thing as a value company. Price is the essential determinant in every investment equation. At some price, every company is a buy; at some price, every company is a hold; and at a still higher price, every company is a sell. We do not really recognize the concept of a value company.

Zweig: Regarding the way-out-of-the-money puts on bonds that you mentioned earlier, are you concerned about counterparty risk down the road?

Klarman: Yes. We worry about counterparty risk in everything we do, including the puts. We diversify counterparties. We try to choose only the best-run, most solvent, best-capitalized counterparties. As often as possible, we make sure that they post collateral; so, if the trade goes our way, we have valid collateral that we can collect if they have trouble.

Even if we run into trouble with counterparties, it doesn't mean we will lose all our money. It may be that we would collect, down the road, 50 cents instead of a dollar, but that still might be better than not having the protection.

Some investors missed some very important hedges over the last few years because they were unduly worried about their counterparties, which isn't to say we shouldn't have that concern. We very much do, but we live in a world where you have to make tough decisions. Sometimes, we choose a good enough counterparty over doing nothing.

Zweig: You spoke of deploying capital and being fully invested in 2008 and 2009. Can you give an example of a situation that justified deploying your capital in the midst of a decline of that magnitude?

Klarman: We began by asking, Is there anything we can buy and still be fine in the midst of a depression? Our answer was yes—the bonds of the captive auto finance companies, which were trading as low as 40 cents on the dollar. Ford Motor Credit was particularly attractive because Ford seemed to be the best positioned of the Big Three, the most likely to survive.

If Ford's loan losses went from the existing run rate to eight times the run rate, 40 percent of the company's entire loan portfolio would be totally wiped out. But the bonds we were interested in, which we could buy at 40 cents on the dollar, would still be worth 60 cents on the dollar. That, to me, is a depression-proof investment.

Auto loans did not show the same signs of overreaching by lenders as did subprime and other housing loans, yet many people were extrapolating the problems associated with housing to autos. As we saw it, the same deterioration in credit standards, broadly speaking, that plagued subprime housing loans was not apparent in the loan portfolios of the Big Three auto companies.

In addition, current erosion was not a problem. Although housing delinquencies and defaults went through the roof in late 2006 and 2007, nothing similar occurred in auto loans. And into 2008, no major uptick in delinquencies and defaults materialized. Even assuming a much worse default rate than we were seeing at the time, Ford bonds had an amazing upside under almost any scenario—if default rates only quadrupled (rather than octupled, as we assumed) to 20 percent, the bonds were worth par—and thus appeared to have a depression-proof downside. We all agreed to make those investments.

Zweig: Is there any situation like that out there today?

Klarman: No. The rally may very well be overblown. It's certainly overblown on the credit side because risks remain real in the world, yet bonds are starting to be priced for close to perfection, especially in the junk-bond market, where pay-in-kind (PIK) bonds and dividend recap bonds are appearing once again.

Essentially, the problem is that government intervention interfered with the lessons investors needed to learn. Those who stared into the metaphorical abyss are right back at it, with the possible exception of college endowments, for whom the pain has been long lasting because of their spend rate. Almost everybody else is drinking the Kool-Aid again, and it is very troubling. We could have another serious collapse, and people would again not be prepared for it.

Zweig: How are you protecting your clients against unanticipated inflation and a decline in the dollar?

Klarman: Our goal is not necessarily to make money so much as to do everything we can to protect client purchasing power and to offset, as much as possible, a large decline in market value in the event of another severe global financial crisis. We not only care about the intrinsic underlying value of our clients' investments, but we also want to avoid the psychological problem of being down 30 or 40 percent and then being paralyzed.

At this juncture, there are just too many scenarios to enumerate. We have thought about scenarios in which the dollar remains the reserve currency and those in which it doesn't; those in which gold goes berserk on the upside and those in which it stays flat and then falls, because gold is currently at a record high. All scenarios are worth contemplating. This type of analysis is really very much art and not science.

Zweig: Can you recommend a few books other than those by Graham and Dodd that our audience might enjoy?

Klarman: Certainly. First, however, let me say that Graham's *The Intelligent Investor*,[4] which you recently revised, is probably more accessible than Graham and Dodd's *Security Analysis*,[5] although the nifty thing about the sixth edition of *Security Analysis* is the updated comments.

Joel Greenblatt's *You Can Be a Stock Market Genius*[6] is tactical and includes some very specific and interesting strategies, and *The Aggressive Conservative Investor*,[7] by Marty Whitman and Martin Shubik, is also very interesting.

Anything Jim Grant writes is wonderful. Even if he's not always right on his predictions, he is among the best thinkers and financial historians. Michael Lewis has never written a bad book. *Moneyball*[8] is about value investing. Looking back 20 years from now, *The Big Short*[9] may be the definitive book about this era. It is about a microcosm, but the microcosm explains everything. Andrew Ross Sorkin's *Too Big to Fail*[10] is fabulous, as is Roger Lowenstein's *The End of Wall Street*.[11] In fact, all of Roger Lowenstein's books are excellent, and so we should read everything Roger has written.

Never stop reading. History doesn't repeat, but it does rhyme. Jim Grant has a wonderful expression: In science, progress is cumulative, and in finance, progress is cyclical. Fads will come and go, and people will think we are on to a new thing in finance or investing; but the reality is that it is probably not really new, and if we have seen the movie or read the book, maybe we know how it turns out.

Zweig: By the way, I would recommend a few more books that I have no financial interest in. One is called *How to Lie with Statistics*,[12] by Darrell Huff. It was first published in 1954 and has never gone out of print. You could read it on a single subway or bus ride. It's a terrific book.

I would also recommend any book by Richard Feynman, the Nobel Prize–winning physicist, because I think if you pick up any of his books, you will learn more about how to think in the time it takes you to read that book than you could learn in just about any other way.

Seth, unfortunately, we are out of time, and I am the most disappointed person in the room.

Thank you.

This article qualifies for 0.5 CE credit.

Notes

1. Benjamin Graham, "Are Corporations Milking Their Owners?" *Forbes* (1 June 1932).
2. Seth A. Klarman, *Margin of Safety: Risk-Averse Value Investing Strategies for the Thoughtful Investor* (New York: HarperCollins, 1991).
3. James Grant, *Money of the Mind: Borrowing and Lending in America from the Civil War to Michael Milken* (New York: Farrar Straus Giroux, 1992).
4. Benjamin Graham, *The Intelligent Investor*, edited by Jason Zweig (New York: HarperCollins, 2003).
5. Benjamin Graham and David L. Dodd, *Security Analysis*, 6th ed. (New York: McGraw-Hill, 2009).
6. Joel Greenblatt, *You Can Be a Stock Market Genius* (New York: Simon & Schuster, 1997).
7. Martin J. Whitman and Martin Shubik, *The Aggressive Conservative Investor* (Hoboken, NJ: John Wiley & Sons, 2006).
8. Michael Lewis, *Moneyball: The Art of Winning an Unfair Game* (New York: W.W. Norton, 2003).
9. Michael Lewis, *The Big Short: Inside the Doomsday Machine* (New York: W.W. Norton, 2010).
10. Andrew Ross Sorkin, *Too Big to Fail* (New York: Viking, 2009).
11. Roger Lowenstein, *The End of Wall Street* (New York: Penguin, 2010).
12. Darrell Huff, *How to Lie with Statistics* (New York: W.W. Norton, 1993).