SETH KLARMAN NOTES FROM 5-17-2010 MEETING

by iluvbabyb

Jason Zweig interviewed Seth Klarman and these are my incomplete notes scribbled
in haste and not direct quotes.

In value investing, you should think about investing Graham & Dodd style. Volati
lity works in your favor in terms of providing mispriced assets. Volatility shou
ldn't be viewed as a problem. You should be seeking to buy bargains, and the bes
t bargains often are found in the "hairiest" situations, such as in distressed s
ecurities or securities in litigation.

The business climate is more volatile today than during Graham's time. What's on
the books today may not be as reliable as during Graham's days. You need to loo
k behind the numbers. There are more fads today in consumer goods i.e. Lady Gaga
sneakers.

Seth Klarman previously worked for Michael Price and Max Heine of Mutual shares.
The lesson he learned from Michael Price was the endless drive to get informati
on by pulling all threads on a business in the efforts to seek value. Seth descr
ibed Max Heine as a very kind person he always had a smile and kind word for every
one in the shop from a junior analyst to the receptionist.

Seth was asked why so many value managers underperformed the market in 2008. He
said over time value investing works and provides outperformance of 1-2% over th
e S&P 500. While this may seem like slender outperformance, it really adds up ov
er time. There will be periods, however, when value investing underperforms. Man
y value investors were looking at the book value of banks and thinking they knew
what was in it. However, instruments rated AAA weren't all the same. During 200
7/2008, investors needed to be more nimble and pull all the threads together on
a business. Banks got cheap and then cheaper. Many equity investors weren't lookin
g at the whole picture they should have been looking at the credit bubble. Many in
vestors also are pressured to be fully invested all the time. However, once the
plug was pulled out of the tub in 2008, it was a long way down. Even for invest
ors that were right, it wasn't easy. Seth went on to discuss Michael Burry's pos
ition as described in "The Big Short." Burry had to defend his short position ag
ainst his own investors.

Seth Klarman's organization, Baupost, is organized to attract great clients, whi
ch is the key to maintaining investment success. His clients have a long-term pe
rspective. They consist of highly knowledgeable families and sophisticated insti
tutions. He described the ideal client as the one who agrees with them when they
think they have had a good year and adds capital at times when Seth calls sayin
g he is seeing good buying opportunities which are usually the times other firms a
re facing redemptions. Seth was thus able to actively buy investments in 2008 wh
en others had to sell. Many money managers had to liquidate positions just based
on the fear or redemptions.
During 2008, Baupost went from zero exposure in distressed debt and mortgage se
curities to having 1/3 of their assets in distressed debt and mortgages, which s
ubsequently grew to half of their total assets by 2009. They always look for mis
priced securities and evaluate the opportunity costs and are prepared to act wh
en opportunities become available.

Klarman quoted Ben Graham:
Those with the enterprise lack the money and those with the money lack the enter
prises to buy stocks when they are cheap.

During the fourth quarter of 2008, it was easy for Klarman to buy securities. He
doesn't look at investments as pieces of paper like Cramer or Kudlow. He knows

he is buying a fractional interest in a business. When you buy distressed bonds
and you expect them to return to close to par, they become more compelling inves
tments as the price goes down. If you have staying power and the conviction of y
our analysis, you won't panic when prices drop.

Baupost always looks for compelling bargains and then stress tests all their ass
umptions, asking things like what happens to the investment if interest rates ri
se from 8% to 9%? They always buy with a margin of safety. One needs to have hum
ility when investing--always worry about that which could go wrong with the inve
stment.

An investor's own confidence and temperament will impact their performances. One
 needs to be a highly disciplined buyer and seller and avoid the round trips. Te
mperament and a disciplined process will lead to successful investing.

Ben Graham said you need both cash and courage when investing. Having only one i
s not enough.

Klarman thinks indexing is a "horrible idea." Most stocks run up prior to being
put into the index, so the index is buying high. Klarman would rather buy stocks
 that are kicked out of the index, since they are likely to be a better value. F
or the average person, indexing may work but the entry point is critical.

Given the stock market rally since last year, Klarman is now worried of zero to
low returns from the stock market for the next decade.

He compared the stock market to a Hostess Twinkie, which has totally artificial
ingredients. Given the financial crisis, the market has been manipulated by the
government with interest rates kept close to zero, TARP, Cash for Clunkers and C
aulkers, the government buying dubious assets, etc. The government wants people
to buy stocks to restore confidence. However, Klarman is worried about what the
markets and the economy would look like if they hadn't been manipulated if the mar
ket wasn't a Twinkie. The bailouts continue with the latest being put into place
 by the European governments. These bailouts probably won't work.

Klarman said he is more worried about the world broadly than at any time in his
career. There is now a new element to the investing game will the dollar be worth
anything if the government intervenes each time to prop things up? There are not
 enough dollars in the world to solve all the problems. He worries about all pap
er money. It is easy to imagine that politicians will find it easier to debase t
he currency with inflation than solve the hard problems. However, they can't jus
t keep kicking the can down the road. There is no free lunch and inflation is no
t zero.

 The trouble is that we didn't get "value" out of this crisis. There has been no
 Depression mentality. We've had "Just a Bad Week" mentality and there is still
speculation going on.

We're at a tipping point with sovereign debt. If investors think the U.S. will p
ay back debt, they won't be worried. However, if they become worried, we could h
ave failed Treasury auctions. The tipping point is invisible. Our Treasury Secre
tary is lulled into thinking we are AAA, but we have an eroding infrastructure a
nd no fiscal responsibility.

How do you go bankrupt? Gradually and then suddenly like Greece.
Commodities are not investments as they don't produce cash flow. They only have
value if you can sell them to a "greater fool." They are only worth what some fu
ture buyer will pay for them. They are a speculation. Gold is somewhat different
 in that it is seen as a store of value. Investors might consider having some ex
posure to gold due to the worry of debasement of currency.

The investing game was checkers, now it is more like three-dimensional chess due to the potential destruction of dollars. Klarman is seeking an inexpensive hedge against dollar destruction as he is trying to protect against catastrophic tail risk. His way to hedge against inflation is through way out of the money puts on bonds. If interest rates go to double-digit ranges, he will make a lot of money. As long as the insurance is cheap enough, he will do it.

Baupost is managing $22 billion and said size is an anchor when it comes to investing. However, when he anticipated buying opportunities in early 2008, he called folks on his waiting list and allowed them to take advantage of the buying opportunities he was seeing so he could put greater capital to work.

He is worried a great deal about a double-dip recession due to debt morphing to sovereign risk. He now has about 30% in cash in his partnership. He will return the cash to clients if the cash increases much more and he doesn't find any buying opportunities. He has no real lock ups in his hedge fund and calibrates his firm size to manage the right amount of the money dependent on market opportunities. His goal is excellence. He doesn't want to take his company public as it would ruin the firm. He wants to retire at the end of his career knowing that he put his clients first, and he doesn't care if he doesn't charge as much as others.

Klarman had a bad visceral reaction to the Goldman hearings. Goldman's hedging should have been celebrated as they were the Wall Street firm least likely to blow up thanks to the hedging. The world is a wild and woolly place. Brokers may have more conflicts of interest, but he knows Wall Street will always try to "rip out our eyeballs" on a trade. He said they go to Wall Street with their eyes wide open. He doesn't know how to police Wall Street better. As market-makers, Wall Street doesn't owe them any fiduciary duty.

Klarman would welcome more regulation if it helps the country. Limits on leverage and more disclosure would be fine. He wishes proprietary trading would go away. He knows firms front run Baupost trades. Bank capital requirements need to be higher. The bank rescue fund, however, has problems. It will penalize successful firms like J.P. Morgan due to their dumber competitors. He agreed with Bill Ackman who thinks if the bank's equity gets wiped out, the subordinated debentures should be converted to equity.

At Baupost, they try to avoid groupthink. They recently had a conference in which they invited a variety of speakers. Most of them described the terrible problems we face; think the ECU will likely break up and that gold should be held. Following the meeting, members of Baupost questioned whether this was groupthink? They are very good at intellectual honesty and learn from their mistakes. There is no yelling at the firm over mistakes. They are aware of their biases in either direction.

Investors need to pick their poison. You either need to protect on the downside, which means you may not be at the party as long. Or you stay at the party and make money, but realize you will have a bad year or so. At Baupost, they prefer to be conservative. Klarman would rather underperform in a big bull market than get clobbered in a bear market.

In hiring folks, they try to find intellectually honest folks by asking them "What is the biggest mistake you ever made." They also ask lots of ethical questions. Everyone they interview is smart, but they are seeking folks with idea fluency and high integrity.

Klarman believes short-sellers do better analysis than long-only investors since they have to due to the upward bias of the stock market over time. The Street is biased on the bullish side. Short sellers are the policeman of the market. It

is not in the country's interest to limit short-sellers. The one exception is on CDS buyers, who want a company to fail rather than recover and shout "Fire in the theatre" to make it happen. However, the burden should be on companies to not get into a position where their access to capital can be roiled by the short-sellers. GE was irresponsible in thinking they could always roll over their debt. However, if short sellers short on fundamentals and are wrong then Klarman welcomes them being stupid. He also said that if a computer wants to sell him a stock for a penny, he also would like that. When asked about how the flash crash hurt people who had in market orders, he thundered back that no one should ever put in a market order.

When asked about his asset allocation strategy, he just smiled since he doesn't have one. He is highly opportunistic and buys what is out of favor. He goes where the trouble is and can't predict where that will be in the future.

He said "we make money when we buy bargains and count the profits later." He currently is buying commercial real estate as the fundamentals are terrible. The government is winking at banks and telling them not to sell the real estate. While he isn't currently making money in real estate, he is putting money to work in real estate. He is making money currently on the distressed debt he purchased two years ago which has nearly doubled in value.
His holding period is maturity for bonds and "forever" for stocks. This doesn't mean that his turnover might be quicker if a bond rises rapidly from depressed prices to close to par.

When asked to describe a value company, he said there is no such thing. Price is the determinant for every investment.

When asked if he was worried about the counterparty risk for his out of the money puts, he said they worry about everything as there is risk in everything they do. However, they try to choose the best counterparties they can and require collateral posting.

When asked how he was confident enough to be fully invested in 2008, he said they over worry. They considered that the market could drop 40% and the economy could fall off the cliff. Even after considering a Depression scenario, they were still able to find things to buy like the bonds of captive auto finance companies, especially when they could pick up Ford bonds at depressed levels. They stress tested the loan portfolio and thought the bonds were worth significantly more than they were trading for as there wasn't the same overbuilding in the auto industry as in the subprime housing market. As a result, there wasn't the same deterioration in the loan portfolio. Klarman saw amazing upside in buying the bonds with Depression-proof downside, so he invested.

Credit risks remain real, however. The credit market rallies are now overblown especially in the junk market. Lessons were not learned even as investors stared into the abyss. Investors are back to drinking the Kool-Aid. There could be another collapse and people are not prepared for it.

Investors should think about disaster scenarios and prepare for them, although the preparation is more art than science. Klarman is trying to protect his client's assets in the even the world gets really bad. When asked if he plans to re-release his book, "Margin of Safety," he said he has no immediate plans to do so although he has thought about doing it with a new introduction and perhaps a companion volume to raise money for charity. He just hasn't had time.

When asked about other book recommendations, he gave the following:
The Intelligent Investor-Ben Graham
You Can Be a Stock Market Genius-Joel Greenblatt
The Conservative Investor-Marty Whitman

Too Big to Fail-Andrew Sorkin
Anything written by Jim Grant, Roger Lowenstein and Michael Lewis
He said folks should never stop reading as history doesn't repeat but it rhymes
, and in finance, progress is cyclical.