I have found other peoples notes from events such as the Berkshire Hathaway Annual Meeting and the Value Investing Congress very useful and wanted to share something of my own. I took these notes by hand and tried transcribing my scribbles. I do not believe I have made any mistakes, but if I did, I apologize in advance.

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Full Disclosure: I get a commission on anything purchased from the links to Amazon.com

**Seth Klarman Discussion with Jason Zweig of The Wall St. Journal**
**At the CFA Institute Annual Conference, 5/18/2010**

**JZ:** How have you followed Graham and Dodd, and how have you deviated?
**SK:** Graham and Dodd is really a way to think about investing, think about bargains and where they come from. Our search process is definitely based on G&D. We deviate by investing in instruments that didn't exist then, and the business is more competitive than it was then. Also, what is on the books is not as reliable, we don't trust the numbers, we look behind them.

**JZ:** What lessons did you learn from Mutual Shares working with Mike Price and Max Heine?
**SK:** From Mike Price, endless desire to get into and seek out value. Mike once found a mining stock he thought was undervalued and drew up a map of interlocking ownership structures and found about 10 securities he could buy that owned part of this company. From Max Heine: While he was a great analyst, he was a better man. He was very kind to everyone, from the receptionist on up, I learned how to treat people well.

**JZ:** What went wrong in 2008, and how did so many Value Investors get hammered?
**SK:** Value investing doesn't work all the time, you need to expect periods of underperformance. In the Pre 08 period, the world was valued on an invisible LBO Model. Stocks were not allowed to get cheap because of an underlying expected LBO bid. But when the model got fragmented, the template no longer made sense. So in order to do well, equity minded investors needed to be more agile in 07/08 and have an opinion on subprime mortgages and the ripple effect. Bank stocks looked cheap unless you thought their capital would be destroyed. Also the modern day pressure to be fully invested and on short term performance didn't help.

**JZ:** In Michael Lewis's book The Big Short, Mike Burry finds himself in the situation in 2007 of defending himself to his investors at the precise moment that he's doubting himself. How is Baupost organized to avoid this?
**SK:** Having great clients is the key to investment success. We have emphasized very sophisticated families and Institutions as our clients, who had the ability to see through the financial crisis as opposed to many individuals who felt as if they were staring into the abyss.

**JZ:** Any advice on how to raise the quality of your clients?
**SK:** Avoid Fund of Funds since you don't see the actual client, they are at the mercy of their clients and don't have staying power. Our ideal client has two characteristics: 1.) If we feel we have had a good year, they agree, regardless of relative performance and 2.) when we call, asking them to consider adding new capital, they a.) appreciate the call and b.) add new capital. It's not only actual withdrawals that matter but the fear of redemptions as well.

**JZ:** Baupost is organized for the long term, but can be opportunistic in the short term, such as in 2008 when Mortgage Backed Securities went from 0% to 30% of the fund…
**SK:** And got as high as 50% in early 2009. I have incredible partners, with common investment approaches. We have a non conventional approach to organizing our analysts. We don't have Pharma or Oil/Gas analysts, but they're organized by opportunity: Spinoffs, Bankruptcy, Legal, etc. They don't waste their time keeping up on latest quarterly earnings from companies we will never invest in, but spend their time looking for irrational sellers.

**JZ:** In 1932, Benjamin Graham wrote in Forbes, "Those with the enterprise lack the money and those with the money lack the enterprise to buy stocks when they are cheap." How did you have the courage, was it easy to step up and buy in the fall of 2008?
**SK:** "Yes, it was easy." The critical thing to understand is that securities are not pieces of paper that fluctuate in price tick by tick like Cramer says on TV, instead they are in fact claims on earnings or assets of businesses. If you are afraid a security will go lower then you worry about what clients, or partners, will think. If you have conviction in your analysis, you will hold and buy more. So what do we do to give us conviction? 1.) Find compelling bargains, not slight bargains. 2.) Test everything with sensitivity analyses. 3.) Prepare to be wrong. It's not courage, it's Arrogance, when you buy something, you're saying you're smarter than everyone else. We realize we have lots of smart competition and temper our arrogance with humility to realize that many things could go wrong. Our own confidence matters, and we're highly disciplined buyers and sellers to avoid round trips and take advantage of short term sell offs.

**JZ:** So Investors need cash and courage…
**SK:** Courage is a function of process.

**JZ:** In Margin of Safety, you were critical of Indexing, is that still the case?
**SK:** There is no perfect answer. Yes, I still believe indexing is a horrible idea. Stocks trade up when they're added to the index so the index investor is paying up. I'm more likely to buy the companies kicked out of the index. For the average person, however, they don't do enough research to own individual stocks. The idea of owning stocks for the long run is a disservice to investors, because many are not there for the long run. Many got out in 2008 when they should have been buying, because the entry point matters most. Transaction costs and Taxes don't matter if the market goes nowhere. I'm very worried about another 10 years of zero or low returns since the market has run up so fast.

**JZ:** In the past you have referred to a "Hostess Twinkie Market", can you explain what you mean?
**SK:** Hostess Twinkies make childhood happier with totally artificial ingredients. The market has been made happier by government manipulation. 0% interest rates, Mortgage Lending Programs, Cash for Clunkers, Cash for Caulkers, Tarp, etc. We don't know how much it went up because of these, but the Government wanted people to buy equities to enact the wealth effect. I'm worried to this day if all the manipulation wasn't happening what would happen. We can't know, no one can. And it's continuing with the European bailouts. It's as if the Government is in business to give bad financial advice and force unsophisticated (and sophisticated) investors to speculate. In the short term performance game, everyone needs to keep up.

**JZ:** How worried are you that we're in a giant world wide carry trade that will end badly?
**SK:** I'm more worried about the world then at any point in my career.

**JZ:** Why?
**SK:** The new element is will the US Dollars we make be worth anything? There's not enough money in the world for all the bailouts unless it is debased. It's easier to debase than take hard problems, easier to kick it down the road. I want to see someone that is willing to lose a re-election in Washington to tackle the hard problems.

**JZ:** What is the chance of that? How much above zero?
**SK:** I'm an optimist. Scott Brown has appeal. More politicians will come along who see tackling the hard problems as a way to get elected. Lots of people in the country realize there is no free lunch. Every adjusted economic number is in the government's favor. I'm troubled that the country didn't get value out of the crisis like we did in the 30s. Depressions aren't good but the depression mentality is good. We developed a "bad couple of weeks" mentality.

**JZ:** Are you concerned about government debt?
**SK:** I'm not an expert and don't have much to add. Think of it from a Gladwell Tipping Point perspective. I'm not sure how much debt is too much. Sovereign debt is "money of the mind" (James Grant Reference) and the tipping point is invisible, all is fine until it is not fine. It will be fine until bidders don't show up at the Auction. The Treasury Secretary has been lulled into thinking the US will always be AAA Rated. That type of thinking ensures we won't always be AAA Rated. A Sovereign debt crisis will be "gradual until sudden."

**JZ:** In Margin of Safety, you said commodities were not investments since they do not produce cash flows, one possible exception being gold. Do you still feel this way?
**SK:** I haven't changed my mind, but that statement was in reference to rare stamps, or fine art, etc. Valuing collectibles based on a future sale to a greater fool is speculating. There is no way to analyze what it will be worth in the future. Land is complicated because it will be valuable to future buyers and it can have cash flows. Gold has been thought of as a store of value but it is just a commodity and therefore it is a speculation. I own gold because I want exposure to a devaluation of all paper monies.

**JZ:** Graham stated that an investment is anything you analyze, has safety of principle and an adequate return, and all else is speculation. But he speculated…
**SK:** Graham wasn't thinking about currency devaluation. If you want to short the dollar, you need to short it against something, what is that something? No other currency makes sense. Gold is an expensive hedge to protect against severe erosion in purchasing power, but it's something we feel is worth it. We are looking to protect tail risks that could be catastrophic, one of which is hyperinflation. We don't like TIPS since the government keeps the inflation data. It's more likely the Bond Market would call the government on inflation before it shows up in government data. So what we did is buy way out of the money puts on bonds. We lose 100% if rates go to 5% or 6%. However, if rates get to double digits, we'll make 10, 15, 20 times our money. If they get to 20-30%, we'll make 50-100x. And there's way less than a 50/50 chance this would happen in 5 years or less. But we view it as very cheap insurance and it's worth risking our capital to buy that insurance.

**Questions from the audience, as filtered by Jason Zweig:**
**JZ:** Do you give money back when the market is overvalued?
**SK:** The number one thing on my mind at most times. I've said for years size is negative for performance. I said that at $200m in AUM and now at $22B I still think so. However, in Feb 2008 we went to our wait list for the first time in 8 years to raise more capital as we thought opportunities would be plentiful, large, lumpy, and unpredictable. I thought being larger was better at that time. And it was. We got a lot of calls from distressed sellers and couldn't have acted on them without the additional capital. I am prepared to return capital but am worried about a double dip. We're at 30% cash now and I would not raise more cash without returning some to investors.

**JZ:** Sounds like the size of your firm is market dependent?
**SK:** Our firm's only goal is Excellence. I have no plans to sell out, or to go public, as that would hurt the firm. I feel great knowing I made a fraction of what I could. The key is doing right by clients, not making more money for myself or partners.

**JZ:** Any comment on what appears to be a change in morals among execs?
**SK:** Regarding the Goldman Sachs hearings, I know the world is wild, that Wall St. exists to make money, not to benefit Baupost. I know that Wall St. will always try to take our money, I go in with open eyes, you need to think "Caveat Emptor" when dealing with Wall St. I don't know how to police it, they don't owe us a fiduciary responsibility when we trade, they're either a counterparty or a market maker. We should celebrate GS that they didn't go bankrupt and were hedging, we shouldn't wish they'd gone bankrupt sooner.

**JZ:** What reforms would you welcome?
**SK:** We'd welcome more registration if it helps the country, it would not affect us on a disclosure level. As a competitor, I'd like Prop Trading to go away, and I do think there is a conflict there. A single regulator won't work, regulating risk won't work (people like risk in an up market, but don't like it in a down market). I think required bank capital ratios should be raised. The Bank Bailout fund is ridiculous as it penalizes those firms that didn't need bailouts (why is Jamie Dimon/JPM paying for BAC/C bailouts?). Bill Ackman was the first I heard to suggest that in a bailout all equity should be made worthless and subordinate debt should be automatically converted to new equity, which makes sense to me, as we'd avoid the unnecessary bailouts such as all the AIG holders/creditors.

**JZ:** How do you avoid group think?
**SK:** We recently had an investment team retreat with leading thinkers. They all said there was a terrible problem with paper money, we should consider gold, the EU would break up. Our partner's immediate thought was that gold was a group thought and we should be cautious holding it. So we focus on intellectual honesty and try to learn from mistakes, accept them, and move on. We spend a lot of time on this in our hiring process. When there's a mistake, there is no yelling, it's never the analyst's fault (unless it's a dumb formula error, etc), everything is reviewed by senior people and we're wrong together. We're aware of our biases and the risk of being biased. As an investor you need to decide if you'd rather make more money in up years and have a few bad years, or protect your downside, and we've obviously chosen the latter. We'd rather underperform a huge bull market then get clobbered in a bear.

**JZ:** Everyone says it's never the analyst's fault, but often they don't stick to this when something goes wrong. How do you screen for Intellectual Honesty in your hiring process?
**SK:** We ask about their biggest mistake, which doesn't have to be investing related. But if you say your biggest mistake is wearing mis-matched socks one day, then that's likely not being intellectually honest. We ask ethical questions, ask them how they'd respond in morally ambiguous situations, we want to see that they realize conflicts can exist. We want people who fit in. One key thing is idea fluency, if I present a thesis I want people to immediately come up with 10 places to look to exploit it, I don't want them sitting at their desk thinking, "hmm, where should I look?"

**JZ:** Is Short Selling market manipulation?
**SK:** I'm surprised by that question. We don't short unless it's a stub we're trying to isolate. But I believe that Short Sellers do better analysis than buyers. The world is biased against them, they're the market policemen, it's not in the country's best interest for short sellers to go away. Short Sellers are more patriotic than the CNBC Perma Bulls. There is one exception, and that's yelling "fire" when companies need access to capital to roll their debt. If they buy Credit Default Swaps and want a default to happen, that's troublesome. But some of this fault lies on CFO's who assumed that markets would always be accessible. GE was irresponsible heading into the crisis, they should have extended maturities. Short Sellers need to be right more than buyers. If a computer wants to sell stocks short at $0.01, let them do it.

**JZ:** What about the individual investors whose sell orders went off at $0.01?
**SK:** Never use market orders. You're not a seller at the market, the market changes too fast.

**JZ:** What are the top asset classes for the next decade?
**SK:** Ask Jeremy Grantham! We're opportunistic, we'll buy what's out of favor, what's in financial distress, in litigation, in trouble, whatever.

**JZ:** Tell us how you make money?
**SK:** <silence, laugh> we make money when we buy, not when something goes up in value. We're trying to buy commercial real estate right now, but there is a problem. There are 2 markets in Commercial Real Estate. The private market, for not Class A stuff, is propped up by the government with TARP and PPIP. The FDIC told banks with a wink to not be in a hurry to sell, so no one is selling. The public market through REITs trade as low as a 5% yield which is much, much less attractive and not worth owning.

**JZ:** Can you define a Value Stock and what is your average holding period?
**SK:** As for a Holding Period, we buy expecting to hold a bond to maturity and a stock forever. Now we may turn over quicker if there's rapid appreciation and the return from the current price doesn't seem to compensate for the risks anymore. There's no such thing as a Value Company. Price is all that matters. At some price, an asset is a buy, at another it's a hold, and at another it's a sell.

**JZ:** With regard to your OTM puts, how do you think about counterparty risk?
**SK:** We worry about it in everything we do. We diversity amongst many counter parties, try to go with the best run / most solvent companies. We force them to post collateral. But sometimes we realize that a 50% haircut to what we are owed, instead of colleting 100%, can still be a good investment. We choose "good enough" over "not do".

**JZ:** What metrics did you look at that told you the time was right to deploy capital?
**SK:** With most stocks down 40%, it wasn't economically too different form a depression. We assumed a depression was going to happen, and looked for what would still work out. One example was captive auto finance companies whose bonds were trading at $0.40. We specifically liked Ford Motor Credit since they seemed to be the best run. And we said, ok, you have 5% of loans defaulting. What happens if this doubles, or quadruples, or goes up 8x? We decided that at a 20% default rate the bonds would be worth par, and at 40% default, they'd be worth $0.60. So we thought we were pretty safe buying since we didn't think defaults would go anywhere near that high. In 07/08 there wasn't an erosion in auto loans, people just expected there to be one. Autos didn't have over building and multiple investment cars like homes had. So we looked for depression protection.

**JZ:** What about today?
**SK:** It's an indiscriminate rally that's over blown, at least on credit, specifically Junk Bonds. There are now PIK and Dividend Recapture bonds. The market is not prepared for another potential serious collapse.

**JZ:** How do you protect your clients against inflation/falling US Dollar?
**SK:** I mentioned the OTM puts on bonds, I don't feel comfortable mentioning anything else and having 1600 people call up their brokers and over pay for protection. But you need to think about and consider gold going down, the US Dollar not being the reserve currency (or continuing to be the reserve currency). It's more art than science, and what we're doing could very well have a negative NPV, but we think it's a good idea to try to protect client purchasing power if the world gets really bad.

**JZ:** When will we see a re-issue of Margin of Safety?
**SK:** I have no immediate plans, but I do want to bring it back with either a companion manual or fresh introduction. I have no time to write it, however, so it's not coming anytime soon. It's not intentionally out of print, it happened accidentally. I'd like to raise money for charity somehow when I do bring it back.

**JZ:** Any Book Recommendations (besides Margin of Safety and Security Analysis, of course)?
**SK:** Read as much as you can about the markets, economy, and financial history. Never stop reading. Specific book recommendations include The Intelligent Investor, Greenblatt's You Can Be A Stock Market Genius, Whitman's Aggressive Conservative Investor, Anything from Jim Grant (he's a great thinker, even if his predictions may not turn out right), Roger Lowenstein has not written a bad book, anything from him. Also Michael Lewis, who also hasn't written a bad book either, but specifically MoneyBall which will go down as a definitive book on investing. Also Too Big to Fail is good.
**JZ:** I'll add How to Lie with Statistics.