

The Value of Not Being Sure

In these excerpts from his latest annual letter, Seth Klarman describes the biggest challenge in investing today, how he's responding to the market's turmoil and why he considers fear of the unknown such a great motivator.

Editors' Note: *With the possible exception of Warren Buffett, no investor plying the trade today commands more respect than Baupost Group's Seth Klarman. Since founding his investment partnership in 1983, Klarman has not only produced peerless returns, but he has also from time to time offered wise and timeless commentary on markets and the craft of investing. With his permission, we reproduce here various excerpts from his latest annual letter, published late last month.*

Erratic Mr. Market

It is easy for the volatility of one's thinking to match the volatility of prevailing conditions. Time horizons have shortened even more than usual, to the point where the market's 4:00 p.m. close seems to many like a long-term commitment. To maintain a truly long-term view, investors must be willing to experience significant short-term losses; without the possibility of near-term pain, there can be no long-term gain. The ability to remain an investor (and not become a day-trader or a bystander) confers an almost unprecedented advantage in this environment. The investor's problem is that this perspective will seem a curse rather than a blessing until the selloff ends and some semblance of stability is restored.

The greatest challenge of investing in this environment is neither the punishing price declines nor the extraordinary volatility. Rather, it is the sharply declining economy, which makes analysis of company fundamentals extremely difficult. When securities decline, it is crucial to distinguish, as possible causes, legitimate reaction to fundamental developments from extreme overreaction. At Baupost, we are always on the lookout for such overreactions, whether due to the disappointing earnings of a failed growth stock, a ratings downgrade of a bond, the deletion of a stock from an index or its delisting from an exchange, or the forced

sale resulting from a margin call. Usually, fearful overreaction equals opportunity.

In today's market, however, where almost everything is down sharply, distinguishing legitimate reaction from emotional overreaction is much more difficult. This is because there is a vicious circle in effect (the reverse of the taken-for-granted virtuous circle that buoyed the markets and economy in good times). This vicious circle results from the feedback effects on the economy of lower securities and home prices and a severe credit contraction, and, in turn, effects of a plunging economy on credit availability and securities and home prices.

With residential and commercial real estate prices collapsing and global stock markets down 40%, 50%, and more this year alone, tremendous damage has been done to individual and institutional wealth. Suddenly, new corporate, university, and hospital facilities are on hold, and big ticket items like automobiles, consumer electronics, and luxury goods are going unsold. The worsening economy and rising unemployment portend a possibly protracted period of falling sales volumes, with industry overcapacity leading to pricing pressures, and thus sharply lower earnings and cash flows. Consumer spending declines could be more secular than cyclical; consumption patterns may have changed in semi-permanent ways. Some of the lost demand simply may not come back. Municipal governments face a severe crunch as tax receipts fall while entitlement spending rises. Ultimately, this vicious cycle will be broken and neither securities prices nor the economy will go to zero, just as they did not go to infinity when the virtuous cycle was in place. But throughout 2008, prudent investors sifting through the rubble for opportunity were repeatedly surprised by the magnitude of the selling pressure, and, in many cases, by the extent to which the deterioration in business fundamentals

has come to justify the lower market prices. Many forced sellers, through their early exits, inadvertently achieved better outcomes than the value-oriented bargain hunters who bought from them.

Warren Buffett has said – and others have endlessly repeated – that you can't tell who is swimming naked until after the tide goes out. This turns out to be only partially true. The tide has receded, and most portfolios are down. But not all declines are equal. Some investors have lost money and locked in those losses by going to cash. Some have made investments in failed or failing banks, brokers, and homebuilders, or toxic subprime mortgage securities; these losses are largely permanent and irreversible. But the investment baby has been thrown out with the bathwater, and some who invested wisely aren't naked, it just seems that way. Buying early on the way down looks a great deal like being wrong, but it isn't. It turns out you won't be able to accurately tell who's been swimming naked until after the tide comes back in.

As Benjamin Graham and David Dodd taught us, financial markets are manic and best thought of as an erratic counterparty with whom to transact, rather than as an arbiter of the accuracy of one's investment judgments. There are days when the market will overpay for what you own, and other days when it will offer you securities at a great discount from underlying value. If you look to "Mr. Market" for advice, or if you imbue him with wisdom, you are destined to fail. But if you look to Mr. Market for opportunity, if you attempt to take advantage of the emotional extremes, then you are very likely to succeed over time. If you see stocks as blips on a ticker tape, you will be led astray. But if you regard stocks as fractional interests in businesses, you will maintain proper perspective. This necessary clarity of thought is particularly important in times of extreme market fluctuations.

Age-Old Showdown

There have been days recently where fear has completely dominated greed. While business fundamentals remain awful, the moment will arrive when some of the cash on the sidelines will creep back into the markets, rejecting infinitesimal yields and seeking better returns. The contrast between the exceptionally attractive yield and low purchase price for “risky” corporate debt or mortgage securities, and the extremely low yields and very full price for “safe” U.S. Government bonds, is yet another demonstration of Mr. Market’s manic behavior. When economic recovery is anticipated, when investors decide to take a bit more risk, “safe” government bonds will fall significantly in price and frightened investors who overpaid for safety will be tallying their losses. As 2009 gets under way, we expect a steady diet of bear market rallies and financial market volatility, as economic woes and continued deleveraging vie with government intervention and bargain-hunting in a continuation of the age-old showdown between greed and fear.

Timing the Market

Baupost built numerous new positions as the markets fell in 2008. While it is always tempting to try to time the market and wait for the bottom to be reached (as if it would be obvious when it arrived), such a strategy has proven over the years to be deeply flawed. Historically, little volume transacts at the bottom or on the way back up and competition from other buyers will be much greater when the markets settle down and the economy begins to recover. Moreover, the price recovery from a bottom can be very swift. Therefore, an investor should put money to work amidst the throes of a bear market, appreciating that things will likely get worse before they get better.

Process, Not Outcome

Especially in today’s difficult environment, money managers must keep firmly in mind that the only things they really can control are their investment philosophy, investment process, and the nature of

their client base. Controlling your process is absolutely crucial to long-term investment success in any market environment. James Montier, Société Générale’s market strategist, recently pointed out that when athletes were asked what went through their minds just before competing in the Beijing Olympics, the consistent response was a focus on process, not outcome. The same ought to be true for investors.

It is so easy for one’s investment process to break down. When an investment manager focuses on what a client will think rather than what they themselves think, the process is bad. When an investment manager worries about their firm’s viability, about possible redemptions, about avoiding loss to the exclusion of finding legitimate opportunities, the process fails. When the manager’s time horizon becomes overly short-term, the process is compromised. When tempers flare, recriminations abound, and second guessing proliferates, the process cannot work properly. When investment managers worry about maximizing the value of their firm – or, if publicly traded, its share price – rather than the long-term best interest of clients, the process is corrupted. Investing is hard enough. Success virtually requires that a process be in place that enables intellectual honesty, rigor, creativity, and integrity.

In Defense of Uncertainty

Successful investing requires resolve. When taking a contrary approach, one has to be able to stand one’s ground, be unwavering when others vacillate, and take advantage of others’ fear and panic to pick up bargains. But successful investing also requires flexibility and open-mindedness. Investments are typically a buy at one price, a hold at a higher price, and a sale at a still higher price. You can never be sure if the economy will grow or shrink, whether the markets will rise or sink, or whether a particular investment will meet your expectations. Amidst such uncertainty, people who are too resolute are hell-bent on destruction. Successful investors must temper the arrogance of taking a stand with a large dose of humility, accepting that despite

their efforts and care, they may in fact be wrong.

Robert Rubin once observed that some people are more certain of everything than he is of anything. We feel the same way. One can see the investment universe as full of certainties, or one can see it as replete with probabilities. Those who reflect and hesitate make far less in a bull market, but those who never question themselves get obliterated when the bear market comes. In investing, certainty can be a serious problem, because it causes one not to reassess flawed conclusions. Nobody can know all the facts. Instead, one must rely on shreds of evidence, kernels of truth, and what one suspects to be true but cannot prove. One must also balance one’s own perception of the truth with one’s best assessment of what others believe. In investing, other people’s perception of reality influences price more than any underlying truth; your own assessment, even if correct, is valueless if it is already reflected in the market price.

It is much harder psychologically to be unsure than to be sure; certainty builds confidence, and confidence reinforces certainty. Yet being overly certain in an uncertain, protean, and ultimately unknowable world is hazardous for investors. To be sure, uncertainty breeds doubt, which can be paralyzing. But uncertainty also motivates diligence, as one pursues the unattainable goal of eliminating all doubt. Unlike premature or false certainty, which induces flawed analysis and failed judgments, a healthy uncertainty drives the quest for justifiable conviction.

Always remembering that we might be wrong, we must contemplate alternatives, concoct hedges, and search vigilantly for validation of our assessments. We always sell when a security’s price begins to reflect full value, because we are never sure that our thesis will be precisely correct. While we typically concentrate our investments in the most compelling situations measured by reward compared to risk, we know that we can never be fully certain, so we diversify. And, in the end, our uncertainty prods us to work harder and to be endlessly vigilant. **VI**