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Learn from the Masters: The edge of value investor

If relatively unknown to retail investors, it is because Seth Klarman prefers flying under the radar. But when he does express his views, either publicly or via his newsletters, institutional investors across the globe scramble to heed them.

In the first quarter of this calendar year, he raised concerns about a looming asset price bubble and "nosebleed valuations" in certain stocks. "Any year in which the S&P 500 jumps 32% and the Nasdaq 40% while corporate earnings barely increase should be a cause for concern, not for further exuberance. On almost any metric, the U.S. equity market is historically quite expensive." A few months ago, he commented that "investors have been seduced into feeling good".

In his out-of-print book *Margin of Safety,* that has a cult following and sells for over $1,500 on Amazon.com, he writes about stock prices and reality. The real success of an investment must not be confused with its success in the stock market. A rise in the stock price does not ensure that the underlying business is doing well or that the price increase is justified by a corresponding increase in underlying value. Likewise, a price fall does not necessarily reflect adverse business developments or value deterioration.

Hence his advice: Value in relation to price, not price alone, must determine your investment decisions.

Klarman runs one of the world's largest hedge funds- the Baupost Group, which has racked up 19% annualised gains in three decades (according to ValueWalk). It's not just the performance that makes him exceptional, it's his very approach.

At heart, Klarman is a value stock picker. He pays deep attention to risk, is leery of leverage, and has no qualms about holding huge amounts of his portfolio in cash. At any given time, it will not be unusual to see around 30-50% of his portfolio parked in cash. He believes that value investing is not designed to outperform in a bull market. It is in a bear market that the value investing discipline becomes important and helps you find your bearings when reassuring landmarks are no longer visible. It is joked that he is probably the most patient hedge fund manager in the world and can sit on a fairly static portfolio for months without getting restless.

The ingredient to his success

Klarman is of the view that value investing is simple to understand but difficult to implement. It requires a great deal of hard work, unusually strict discipline, and a lot of patience. He believes very few have the proper mindset to succeed.

Since being a value investor usually means standing apart from the crowd, challenging conventional wisdom, and opposing the prevailing investment winds, it can be a very lonely undertaking. A value investor may experience poor, even horrendous, performance compared with that of other investors or the market as a whole during prolonged periods of market overvaluation.

When securities prices are steadily increasing, a value approach is usually a handicap; out-of-favour securities tend to rise less than the public's favourites.

The most beneficial time to be a value investor is when the market is falling. This is when downside risk matters and when investors who worried only about what could go right suffer the consequences of undue optimism.

Emotional investors and speculators inevitably lose money; but investors who take advantage of the market's periodic irrationality have a good chance of enjoying long-term success.

Klarman adheres to Benjamin Graham's margin-of-safety concept – to invest at a sufficient discount so that even bad luck or the vicissitudes of the business cycle won't derail an investment.

Very simply put, his investing style is "mispricing due to overreaction". He picks up securities that trade at a wide discount to their underlying value, what he calls "the element of a bargain". In other words, it's key to establish a margin of safety that not only enables you to make a sufficient profit, but also gives a wide enough discount from the underlying value. This way, you are able to profit even if your estimate of the underlying value is incorrect. Value investors invest with a margin of safety that protects them from large losses in declining markets.

Herein lies Klarman's secret. He will only make an investment if he is extremely confident that it won't lose much value, even if his initial investment thesis proves to be wrong.

But he also notes that investors can be pressured into investing prematurely; the cheapest security in an overvalued market may still be overvalued. This is where the discipline of a value investor comes in which will enable him to wait for an opportunity to buy, offering a better return for money.

Seth Klarman's advice to investors....

The investing philosophy of Klarman can be drilled down to a few key lessons.

- **Expect the unexpected**

Always be prepared for the unexpected, including sudden, sharp downward swings in markets and the economy. Whatever adverse scenario you can contemplate, reality can be far worse.

- **Uncertainty is not risk**

Risk is not inherent in an investment; it is always relative to the price paid. Uncertainty is not the same as risk. Indeed, when great uncertainty - such as in the fall of 2008 - drives securities prices to especially low levels, they often become less risky investments.

- **Don't get comfortable with excesses**

When excesses such as lax lending standards become widespread and persist for some time, people are lulled into a false sense of security, creating an even more dangerous situation. These excesses will eventually end, triggering a crisis at least in proportion to the degree of the excesses. Correlations between asset classes may be surprisingly high when leverage rapidly unwinds.

- **Understand the different aspects of risk**

Do not accept principal risk while investing short-term cash: the greedy effort to earn a few extra basis points of yield inevitably leads to the incurrence of greater risk, which increases the likelihood of losses and severe illiquidity at precisely the moment when cash is needed to cover expenses, to meet commitments, or to make compelling long-term investments.

- **Have some cash**

Be sure that you are well compensated for illiquidity - especially illiquidity without control - because it can create particularly high opportunity costs.

- **Be wary of leverage**

Beware leverage in all its forms. Borrowers - individual, corporate, or government - should always match fund their liabilities against the duration of their assets. Borrowers must always remember that capital markets can be extremely fickle, and that it is never safe to assume a maturing loan can be rolled over. Even if you are unleveraged, the leverage employed by others can drive dramatic price and valuation swings; sudden unavailability of leverage in the economy may trigger an economic downturn. Financial stocks are particularly risky. Banking, in particular, is a highly leveraged, extremely competitive, and challenging business.

- **Don't forget the human element**

Do not trust financial market risk models. Reality is always too complex to be accurately modeled. Attention to risk must be a 24/7/365 obsession, with people - not computers - assessing and reassessing the risk environment in real time. Despite the predilection of some analysts to model the financial markets using sophisticated mathematics, the markets are governed by behavioural science, not physical science.

Because investing is, in many ways, a zero-sum activity in which your returns above the market indices are derived from the mistakes, overreactions or inattention of others as much as from your own clever insights, there is a second element in designing a sound investment approach: you must consider the competitive landscape and the behavior of other market participants.

When observing your competitors, your focus should be on their approach and process, not their results. Short-term performance envy causes many of the shortcomings that lock most investors into a perpetual cycle of underachievement. You should watch your competitors not out of jealousy, but out of respect, and focus your efforts not on replicating others' portfolios, but on looking for opportunities where they are not.

- **Know when to walk away**

Nowhere does it say that investors should strive to make every last dollar of potential profit; consideration of risk must never take a backseat to return.

- **Don’t be fooled by high stock prices**

The latest trade of a security creates a dangerous illusion that its market price approximates its true value. This mirage is especially dangerous during periods of market exuberance.

- **There is a time to buy**

You must buy on the way down. There is far more volume on the way down than on the way back up, and far less competition among buyers. It is almost always better to be too early than too late, but you must be prepared for price markdowns on what you buy.

Price is perhaps the single most important criterion in sound investment decision making. Every security or asset is a "buy" at one price, a “hold” at a higher price, and a "sell" at some still higher price. Yet most investors prefer what is performing well to what has recently lagged, often regardless of price. They prefer full buildings and trophy properties to fixer-uppers that need to be filled, even though empty or unloved buildings may be the far more compelling, and even safer, investments.

- **Always look for opportunities**

Most investors feel compelled to be fully invested at all times. To require full investment all the time is to remove an important tool from investors' toolkits: the ability to wait patiently for compelling opportunities that may arise in the future. Moreover, an investor who is too worried about missing out on the upside of a potential investment may be exposing himself to substantial downside risk precisely when valuation is extended. A thoughtful investment approach focuses at least as much on risk as on return. But in the moment-by-moment frenzy of the markets, all the pressure is on generating returns, risk be damned.

- **Don’t be comfortable at the wrong time**

Most investors take comfort from calm, steadily rising markets; roiling markets can drive investor panic. But these conventional reactions are inverted. When all feels calm and prices surge, the markets may feel safe; but, in fact, they are dangerous because few investors are focusing on risk. When one feels in the pit of one's stomach the fear that accompanies plunging market prices, risk-taking becomes considerably less risky, because risk is often priced into an asset's lower market valuation.

Investment success requires standing apart from the frenzy – the short-term, relative performance game played by most investors.

How to profit from panic

With these 3 investing lessons, **Warren Buffett** tells us that value investing is all about patience and the courage to tread forward when the market beats a retreat.

The laws of value investing

James Montier is a blue-blooded value investor. Here he shares 5 principles that he follows when scouting for value stocks.

How to be a smart contrarian

According to **Howard Marks**, investing is a popularity contest, and the most dangerous thing is to buy something at the peak of its popularity.

How to be a bargain hunter

Sir John Templeton believed that the time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell.

How to identify undervalued stocks

David Dreman is a contrarian investor who got booted for sticking to his guns. He was eventually vindicated for his stance and had the last laugh.

Betting with deep conviction

When **Sean Riskowitz** is on the hunt for value, he refuses to be constrained by formulae or shackled by traditional value investing rules.

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