Seth Klarman: Investors Downplaying Risk "Never Turns Out Well"

John Mauldin | March 12, 2014

Today's Outside the Box is unusual in that it isn't an original document but rather a summary of a client letter from one of the greatest investors of our generation, Seth Klarman, who is also one of the more reclusive – he rarely speaks in public or grants interviews. He is known for his very deep value investing style and willingness to pursue value where others get very nervous.

This last year he returned $4 billion cash to his clients (from a fund in the $30 billion range). Not difficult for a hedge fund, you may say, but this is what a good value investor does when there aren't many opportunities. He won't have any trouble raising cash if he decides he wants more at some point, as his fund is easily in the top-performing bracket by almost any measure. Some refer to him as the Warren Buffett of his generation.

I think the author of the piece you're about to peruse, Mark Melin, did a pretty good job of giving us the highlights and a little color from what is really a thought-provoking letter from Seth Klarman.

Tonight I find myself in Houston, where I flew down for a meeting. I am always exploring ways to serve you better and help you protect yourselves from the consequences of the Code Red policies of central banks and governments. This is not a short-term problem; it will be with us for some time. More to come as we work through a hundred logistical issues.

The last few issues of Thoughts from the Frontline have sparked the most comments and letters of any column ever, including healthcare. It seems income inequality is a very sensitive subject, and I have heard from you, both pro and con. Some remarks have been merely dismissive but most have been quite thoughtful. And I was pointed to LOTS more research that I now have to cover for this week's letter.

One thing I can count on is that readers will let me know when I miss something. I mentioned in passing at the end of last week's letter that I had dinner with Senator Rand Paul in DC last week and that our conversation was conducted under Chatham House rules. As it turns out that is not quite the case. I actually had a very polite letter from DeAnne Julius, a former chairman of Chatham House (and a former member and founder of the Monetary Policy Committee of the Bank of England, CIA analyst, World Bank economist, etc. – one very busy lady!). She wrote:

> Not to be pedantic, but there is only ONE rule. More importantly, that rule is that participants are free to use the ideas and information they gain from the discussion but NOT to identify any of the speakers or participants. In other words, the rule is nearly the opposite of what you say below. If the content of the discussion is not to be revealed, then the discussion is "off the record" rather than "under the Chatham House rule."

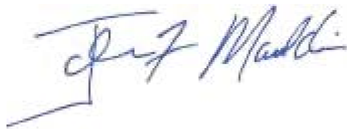
Sigh. I knew that. David Kotok gives us a lecture on the Chatham House rule every summer at the beginning of our Maine "Shadow Fed" meetings. At the end of my letters, when I write my personal notes, I sometimes write "on the fly" and don't stop and think about what I am saying. And when I blow it, I hear from very nice people who politely correct me.

DeAnne did offer to arrange for me to come to Chatham House and conduct a discussion group, after which I presume I could actually state correctly that I was in a meeting held under the Chatham House rule. I may take her up on that.

It is time to hit the send button. I am making preparations to leave for Argentina and South Africa next week and be out for 25 days. But I will be in contact and writing and reading away. And I will have a new wifi-enabled Moto X phone that in theory will enable me to make and receive calls from even the remote Andes essentially for free. The whole thing is remarkably cheap and is a shift in the cost paradigm for cellular. And the phone looks to be cool, although I have to learn to speak something called Android as opposed to iPhone. I am told that it is easier to learn than Spanish, so maybe this old dog can figure it out.

Have a great week and enjoy the spring weather, whenever it gets to you. It is perfect in Dallas and Houston.

Your always looking for value analyst,



John Mauldin, Editor
Outside the Box

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By Mark Melin, March 04, 2014, 2:00 pm

ValueWalk.com

Major hedge fund trader says the QE stimulus bubble will burst... at some point

In his letter to investors, Seth Klarman noted that "most" investors are downplaying risk and this "never turns out well," noting that most people are not prepared for anything bad to happen. "No one can know what the future holds, but any year in which the S&P 500 jumps 32% and the NASDAQ Composite 40% while corporate earnings barely increase should be cause for concern, not further exuberance," Seth Klarman's investor letter said. "It might not look like it now, but markets don't exist simply to enrich people."

Noting that stock markets have risk and are not guaranteed investments may seem like an obvious notation, but against today's backdrop of never before witnessed manipulated markets Seth Klarman sagely notes "Someday, financial markets will again decline. Someday, rising stock and bond markets will no longer be government policy. Someday, QE will end and money won't be free. Someday, corporate failure will be permitted. Someday, the economy will turn down again, and someday, somewhere, somehow, investors will lose money and once again come to favor capital preservation over speculation. Someday, interest rates will be higher, bond prices lower, and the prospective return from owning fixed-income instruments will again be roughly commensurate with the risk."

When will this happen? "Maybe not today or tomorrow, but someday," he writes, then starts to consider what a collapse might look like. "When the markets reverse, everything investors thought they knew will be turned upside down and inside out. 'Buy the dips' will be replaced with 'what was I thinking?' Just when investors become convinced that it can't get any worse, it will. They will be painfully reminded of why it's always a good time to be risk-averse, and that the pain of investment loss is considerably more unpleasant than the pleasure from any gain. They will be reminded that it's easier to buy than to sell, and that in bear markets, all to many investments turn into roach motels: 'You can get in but you can't get out.' Correlations of otherwise uncorrelated investments will temporarily be extremely high. Investors in bear markets are always tested and retested. Anyone who is poorly positioned and ill-prepared will find there's a long way to fall. Few, if any, will escape unscathed."

Seth Klarman's focus on Fed

Seth Klarman then once again turned his sharp rhetorical knife to the academics that run the US Federal Reserve who seem to think that controlling free markets is a matter of communications policy.

"The Fed, in its ongoing attempt to tamp down market volatility as much as possible decided in 2013 that its real problem was communication," Seth Klarman dryly wrote. "If only it could find a way to communicate to the financial markets the clarity and predictability of policy actions, it could be even more effective in its machinations. No longer would markets react abruptly to Fed pronouncements. Investors and markets would be tamed." The Fed has been harshly criticized by professional traders for its lack of understanding of real world market mechanics.

This lack of understanding is a concern given that the Fed is taking the economy into uncharted territory with unprecedented stimulus. "As experienced traders who watch the markets and the Fed with considerable skepticism (and occasional amusement), we can assure you that the Fed's itinerary is bound to be exceptional, each stop more exciting than the one before," Seth Klarman wrote, sounding a common theme among professional market watchers. "Weather can suddenly turn foul, the navigation faulty, and the deckhands hard to understand. In short, the Fed captain and crew are proficient in theory but lack real world experience. This is an adventure into unexplored terrain, to parts unknown; the Fed has no map, because no one has ever been here before. Most such journeys end badly."

While the mainstream media is loaded with flattering articles of the Fed's brilliance in quantitative easing and its stimulus program, the real beneficiaries of such a policy are the largest banks. Here Seth Klarman notes they have placed the economy at great risk without achieving much reward. "Before 2009, the Fed had never bought a single mortgage bond in its nearly 100-year history," Seth Klarman writes of the key component of the Fed's policy that took risky assets off the bank's balance sheets. "By 2013, the Fed was by far the largest holder of those bonds, holding over $4 trillion and counting. For that hefty sum, GDP was apparently raised as little as 25 basis points in the aggregate. In other words, the policy has been a near-total failure. Bernanke is left arguing that some action was better than none. QE in effect, had become Wall Street's new 'too big to fail' policy."

Seth Klarman: What do economists know?

There has been considerable discussion that the academic side of the economics profession has little clue how markets really work. Economic academics, who now make up the majority of the Fed governors, often look at the world from the standpoint of a game of chess, where one can explore different options and there is now a "right" or "wrong" approach to market manipulation.

"The 2013 Nobel Memorial Prize in economics was shared by three academics: two were proponents of the efficient market hypothesis and the third was a behavioral economist, who believes in market inefficiency," Seth Klarman wrote. "We suppose that could be considered a hedged position for the awards committee, one that would never occur in the hard sciences such as physics and chemistry, where a prize shared among three with divergent views would be an embarrassing mistake or a bad joke. While a Nobel Prize might well be the culmination of a life's work, shouldn't the work accurately describe the real world?"

Another interesting insight on the topic was to come from David Rosenberg, Chief Economist and Strategist at GluskinSheff, who recently wondered "[A]m I the only one to find some humour, if not irony, in the fact that the three U.S. economists who won the Nobel Prize for Economics did so because they 'laid the foundation for the current understanding of asset prices' at the same time that

these asset prices are being determined less today by market-determined forces but rather by the distorting effects of the unprecedented central bank manipulation?"

Seth Klarman: Fed Created Truman Show Style Faux Economy

Baupost Group, among the largest hedge funds in the world, returned $4 billion in assets to clients at the end of 2013 because it didn't want to grow too quickly and dilute performance. Klarman's fund, which in 2013 had a high of 50% of his portfolio in cash, up from 36% in 2012, posted 2013 returns in the mid-teens consistent with the fund's nearly 22-year track record.

Seth Klarman on Baupost's returns

Saying the fund "drew a line in the sand" when it decided to return roughly $4 billion to clients at year end, Seth Klarman reflected on the decision, saying he wanted to control the fund's head count, noting "we could not allow the firm to grow without limit. We are wise enough to know a good thing when we see it, and cautious enough to want to cherish, protect and nurture it so that we might maintain its essential qualities for a very long time." A 50% cash position for a hedge fund might be construed as an indication the fund has grown to the point it was having difficulty allocating all the capital in appropriate trades.

He noted the 2013 performance occurred "despite the drag of large, zero-yielding cash balances throughout the year." Klarman, author of Margin of Safety: Risk-Averse Value Investing Strategies for the Thoughtful Investor, said the performance resulted from "considerable progress in event-driven and private situations, and at least some uplift from the strong equity rally. Distressed debt, public equities, structured products, and real estate led the gains." Tail risk hedges, the only material area of loss in the portfolio, cost approximately 0.2% as the fund reduced exposure to distressed debt, structured products, and private investments while public equity exposure increased modestly.

Market bifurcation {the basis for being bullish on equities}

In 2013 Seth Klarman noted the market bifurcation, which he describes as "a momentum environment of market haves (which we avoid spending time on) and have-nots (which receive our undivided attention) – coupled with our energetic sourcing efforts and valued long-term relationships," and he expressed optimism for the fund in 2014 amidst what might be a stock market subject to individual interpretation. "In the face of mixed economic data and at a critical inflection point in Federal Reserve policy, the stock market, heading into 2014, resembles a Rorschach test," he wrote. "What investors see in the inkblots says considerably more about them than it does about the market."

Seth Klarman noted that those “born bullish,” those who “never met a stock market they didn’t like” and those with “a consistently short memory,” might look to the positives and ignore the negatives. “Price-earnings ratios, while elevated, are not in the stratosphere,” he wrote, stating the bull case. “Deficits are shrinking at the federal and state levels. The consumer balance sheet is on the mend. U.S. housing is recovering, and in some markets, prices have surpassed the prior peak. The nation is on the road to energy independence. With bonds yielding so little, equities appear to be the only game in town. The Fed will continue to hold interest rates extremely low, leaving investors no choice but to buy stocks it doesn’t matter that the S&P has almost tripled from its spring 2009 lows, or that the Fed has begun to taper purchases and interest rates have spiked. Indeed, the stock rally on December’s taper announcement is, for this contingent, confirmation of the strength of this bull market. The picture is unmistakably favorable. QE has worked. If the economy or markets should backslide, the Fed undoubtedly stands ready to once again ride to the rescue. The Bernanke/Yellen put is intact. For now, there are no bubbles, either in sight or over the horizon.

Seth Klarman’s market analysis

Like many of the best market analysts, Seth Klarman looks at both sides of the issue, the bull and bear case, in depth. “If you’re more focused on downside than upside, if you’re more interested in return of capital than return on capital, if you have any sense of market history, then there’s more than enough to be concerned about,” he wrote. Citing a policy of near-zero short-term interest rates that continues to distort reality and will have long term consequences, he ominously noted “we can draw no legitimate conclusions about the Fed’s ability to end QE without severe consequences,” a thought pervasive among many top fund managers. “Fiscal stimulus, in the form of sizable deficits, has propped up the consumer, thereby inflating corporate revenues and earnings. But what is the right multiple to pay on juiced corporate earnings?”

As he outlined the bear case, he started to divulge his own analysis that “on almost any metric, the U.S. equity market is historically quite expensive. A skeptic would have to be blind not to see bubbles inflating in junk bond issuance, credit quality, and yields, not to mention the nosebleed stock market valuations of fashionable companies like Netflix, Inc. and Tesla Motors Inc.

As it turns out he was just warming up. “There is a growing gap between the financial markets and the real economy,” Seth Klarman wrote, noting that even as the Fed promised that interest rates would stay low, they did get out of control to some degree across the yield curve in 2013. “Medium and longterm bond funds got hammered in 2013. Meanwhile, corporate earnings sputtered to a mid-single digit gain last year even as stocks drove relentlessly higher, without even a 10% correction in the last two and a half years,” a concern among many professional traders.

When it comes to stock market speculation and jumping on the bull market happy talk, Seth Klarman notes it's never hard to build a "coalition of willing" who are willing to climb on the bandwagon. "A flash mob of day traders, momentum investors, and the usual hot money crowd drove one of the best years in decades for U.S., Japanese, and European equities," he wrote. "Even with the ranks of the unemployed and underemployed still bloated and the economy barely improved from a year ago, the S&P 500 , Dow Jones Industrial Average 2 Minute, and Russell 2000 regularly posted new record highs."

Seth Klarman noted that whether you see today's investment glass as half full or half empty depends on your age and personality type, as well as your "lifetime" of experiences. "Our assessment is that the Fed's continuing stimulus and suppression of volatility has triggered a resurgence of speculative froth," while citing numerous examples of overvalued internet stocks that defied value investing logic.

"In an ominous sign, a recent survey of U.S. investment newsletters by Investors Intelligence found the lowest proportion of bears since the ill-fated year of 1987," he wrote. "A paucity of bears is one of the most reliable reverse indicators of market psychology. In the financial world, things are hunky dory; in the real world, not so much. Is the feel-good upward march of people's 401(k)s, mutual fund balances, CNBC hype, and hedge fund bonuses eroding the objectivity of their assessments of the real world? We can say with some conviction that it almost always does. Frankly, wouldn't it be easier if the Fed would just announce the proper level for the S&P, and spare us all the policy announcements and market gyrations?" he said in a somewhat hilarious moment that bears a degree of truth.

Seth Klarman on Europe

Seth Klarman still isn't much of a bull in Europe, as we noted in a previous ValueWalk. "Europe isn't fixed either, but you wouldn't be able to tell that from investor sentiment," he noted. "One sell-side analyst recently declared that 'the recovery is here,' a sharp reversal from his view in July 2012 that Greece had a 90% chance of leaving the Euro by the end of 2013. Greek government bond prices have nearly quintupled in price from the mid-2012 lows. Yet, despite six years of painful structural adjustments, Greece's government debt-to-GDP ratio currently stands at 157%, up from 105% in 2008," he said, noting a growing concern among fund managers regarding the government debt crisis getting out of hand.

Seth Klarman noted that Germany's own government debt-to-GDP ratio stands at 81%, up from 65% in 2008, and said "That doesn't look fixed to us." The EU credit rating was recently reduced by S&P, he noted, while European unemployment remains stubbornly above 12%. "Not fixed," he said. "Various other risks lurk on the periphery: bank deposits remain frozen in Cyprus, Catalonia seems to be forging ahead with an independence referendum in 2014, and social unrest continues to escalate in Ukraine and Turkey. And all this in a region that remains saddled with deep structural

imbalances. As Angela Merkel recently noted, Europe has 7% of the world's population, 25% of its output, and 50% of its social spending." While he notes the problems in Europe, Seth Klarman did not rule out that opportunity might be found in the region.

Seth Klarman on Bitcoin

Seth Klarman also weighed in on Bitcoin, noting that "Only in a bull market could an online 'currency' dubbed bitcoin surge 100-fold in one year, as it did in 2013. Now most sell-side firms are rushing to provide research on this latest fad," he also noted that while "bitcoin funds" are being formed, the fund is "happy to let pass us by, the thinking behind cryptocurrencies may contain a kernel of rationality. If paper currencies – dollars and yen – can be printed in essentially unlimited volumes, and just as with all currencies are only worth what recipients on any given day will exchange in goods or services, then what makes them any better than the "crypto" kind of money?"

Comparing the economy and the Federal Reserve's management of it to the movie The Truman Show, where the lead character lived in a false, highly-orchestrated environment, Seth Klarman notes with insight, "Every Truman under Bernanke's dome knows the environment is phony. But the zeitgeist is so damn pleasant, the days so resplendent, the mood so euphoric, the returns so irresistible, that no one wants it to end, and no one wants to exit the dome until they're sure everyone else won't stay on forever." Then he quotes Jim Grant who recently noted on CNBC, the problem is that "the Fed can change how things look, it cannot change what things are."

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