Permanently "Risk-Off"

Legendary investor Seth Klarman in these excerpts from his latest annual letter takes a less-than-sanguine view of the global macroeconomic environment, praises "anti-fragility," describes the high bar to be cleared before he makes an investment, and reflects on lessons learned in the 30 years since The Baupost Group was founded.

Market Forces at Bay

The success of an investment firm is necessarily dependent on the actions of others. The collective behavior of the entire community of investors determines market prices, and price fluctuations, in turn, drive investment opportunity. In other words, determined effort, deep analysis, strong processes, and good judgment are necessary but not sufficient for investment success. When buyers are numerous and sellers scarce, opportunity is bound to be limited. But when sellers are plentiful and highly motivated while potential buyers are reticent, great investment opportunities tend to surface.

The actions of two powerful figures, Ben Bernanke and Mario Draghi, impacted us and other investors profoundly last year. Throughout 2012, the Federal Reserve chairman and his counterpart at the European Central Bank (ECB) were maestros whose monetary symphonies beguiled most investors. Their seductive melodies, consisting of the same flat notes of lenient policy actions and endlessly offbeat repetitions, had the effect of intensifying competition for investments by luring many investors into paying up for risky assets while dampening any urgency sellers may have had. Bernanke's plan for quantitative easing (QE3), announced in September 2012, involved the Fed's purchase of $40 billion of agency mortgage-backed securities (MBS) a month. Then, only three months later, he effectively doubled down with a plan to augment the MBS activity with monthly buybacks of $45 billion of long-term U.S. Treasury securities. Bernanke's ongoing financial experiment (now in its fifth year and counting) is a real-world test of his Ph.D. thesis on the proper response to a looming depression. In reaction to his efforts, investors belted out a resounding chorus of "risk on" for much of the year.

While economic conditions in the U.S. have moderated from crisis levels, Eurozone economies continue to struggle. Greece remains mired in economic depression; its GDP today is 19% below its level of four years earlier. Reported Spanish unemployment hit 25% recently, the highest since 1976. Mario Draghi's mid-year announcement to undertake Outright Monetary Transactions (OMTs), in which the ECB buys back shorter-term maturities – between one and three years – of peripheral European countries' sovereign debt, calmed markets while provoking risk taking. Spain, Italy, and other countries have temporarily benefited from issuing debt at interest rates well below what the market would have otherwise demanded, while European banks purchase debt of their own sovereigns through collateralized borrowings in a new form of carry trade. Meanwhile, according to the International Monetary Fund (IMF), the underlying sovereign debt-to-GDP ratios of Portugal, Ireland, and Spain all continue to grow. According to the IMF, Germany and France – Europe's core – now have debt-to-GDP ratios of 83% and 90%, respectively, a level considered dangerous for any country's long-term fiscal soundness. The sovereign debt crisis and Eurozone fiscal imbalances remain grievous threats to the global economy, with Draghi effectively declaring a three-year truce between debtors and creditors at great expense to the healthier European economies. His actions are keeping market forces temporarily at bay, but when they re-emerge another day of reckoning will be at hand.

THE RISK OF "RISK ON":

When market forces reassert themselves, those who grabbed for return and bore excessive risk will encounter substantial declines.

Thanks to Bernanke's and Draghi's interventionist policies – and the markets' belief that they will continue indefinitely – interest rates have plummeted. In the U.S., the ten-year Treasury bond yield bottomed at 1.43%, while the yield on thirty-year Treasuries hit an astonishingly low 2.46%. Triple-A-rated Microsoft recently issued five-year paper at less than one percent, while the five-year Treasury bond yielded as little as 0.56%. Similarly in Europe, rates in most countries fell significantly while bond prices surged. Vanishing interest rates have combined with the pressures wrought by short-term, relative investment performance measurement to drive investors into riskier investments (i.e., "risk on"). Desperate for yield, investors poured money into high-yield bond funds; 2012 inflows into such funds more than doubled the previous yearly high set four years ago. As a result, junk-bond investors have posted huge gains as yields plummeted to all-time record lows in late 2012 and again in early 2013. Similarly, yields on commercial mortgage-backed securities hit their lowest level since the inception of the Barclays Capital U.S. CMBS Investment Grade Index in 1997, while leveraged loan issuance hit a five-year high. As perceived risk dropped and bond yields plummeted, most global equity markets surged in 2012 in an equally frenetic reach for return. Both the Russell Midcap Index and the Russell 2000 Index of small-cap stocks hit an all-time high just yesterday. When today's aggressive policies finally end and market forces reassert themselves, those who grabbed desperately for return and bore excessive risk to do so will encounter substantial market value declines.

Ticking Time Bomb

Turning our attention homeward, our nation's ever-mounting burden of on- and off-balance-sheet liabilities is a ticking time bomb. The U.S. now owes $16.4 trillion to creditors, up from $10.6 trillion only four years ago, an increase of over $50,000 per household over those four years. Assuming a continuation of current tax and spending policies, public debt, only 38% of GDP in 1965, is projected by the Congressional Budget Office to hit an ominous 90% of GDP within ten years and by JPMorgan to hit an absurd 247% of GDP within thirty years. The government is on the hook for about another $55 trillion, in addition to public and intragovernmental debt, to meet other federal commitments and unfunded entitlement programs such as Social Security and Medicare. The cost of such entitlement programs, well under one-third of the federal government's total outlays in 1960, amounted to two-thirds of federal spending by 2010. "On its current path," commentator Fareed Zakaria recently warned in *Foreign Affairs*, "the U.S. federal government is turning into, in the journalist Ezra Klein's memorable image, an insurance company with an army."[1]

In 2011, the federal government took in approximately $2.3 trillion of revenue and spent roughly $3.6 trillion, running up a deficit of over 8% of GDP. Even the most aggressive remedies balanced between revenue increases and spending cuts, such as those proposed by the Simpson-Bowles deficit-reduction plan, are unlikely to halve the deficit over the next decade and the national debt would continue to mount. These deficits mean that we are spending borrowed money to fund current "priorities," while leaving future generations on the hook for the debt we incur. Indeed, the U.S. government currently spends four dollars on citizens over age 65 for every dollar it spends on those under 18.[2] Fewer and fewer Americans pay federal income taxes (though most, of course, still pay FICA withholding, local sales, and real estate taxes), while increasing numbers receive payments from the government. Tackling the federal deficit would weaken an already soft economy, while failing to act would push us closer to unsustainable debt levels. To meet the annual cost of all its unfunded obligations, the U.S. government would, by some estimates, need to take in an additional $7 trillion a year. Yet all federal taxable income – individual plus corporate, in its peak year of 2006 – totaled only about $6.7 trillion, meaning that these entitlements are completely unaffordable and can never be paid.

RAMIFICATIONS OF DEBT:

It's like driving with a faulty navigation system along a steep mountain road at night while wearing a blindfold.

The fiscal cliff deal to raise tax rates for the wealthy may matter symbolically, but the recently voted increases only scratch the surface of the deficit problem. Meanwhile, the absence of any agreement on spending cuts augurs ominously for the future. The sooner we acknowledge the full reality of our predicament and amend benefits and eligibility for these programs, the better the chance of limiting the uncertainty and potential social upheaval when the promised benefits fail to appear.

Worse still, today's debt-service costs are artificially low because interest rates have been pushed down by QE, masking the mounting danger. One prominent economist bizarrely argues (twice weekly) that today's deficits pose no danger because interest rates remain historically low, as if QE were not artificially driving down rates and as if markets are not both fickle and often wrong. Government debt maturities, which, in a rational world, should have been extended during a time of low rates, have, in fact, been shortened. Total interest expense on the federal debt is roughly unchanged from 2007 levels, even though the debt is about 80% greater. The shorter debt duration also means that the U.S. government must tap the capital markets to the tune of about $4 trillion annually, including amounts needed to fund the deficit and refinance debt maturities. It is dangerous to need constant access to the capital markets for such staggering amounts of financing. An unknowable tipping point looms over the horizon. When we reach it, outsiders and U.S. citizens alike will become suspicious of our creditworthiness, causing interest rates to rise and the dollar to plummet. Holders of greenbacks will rush to spend their money while it still has some value, causing the prices of goods and stores of value (like gold) to surge. No one knows precisely how much debt is too much, or at what moment the tipping point will be reached. It's like driving a car with a faulty navigation system along a steep mountain road at night while wearing a blindfold. Sooner or later, you're going to plummet over the edge. By the time we reach that point, it will likely be too late. Astonishingly, we seem to lack the political will to act in advance, dooming us to the vicissitudes of volatile markets and the unpredictable hand of fate.

As we enter 2013, our nation is on a dangerously flawed trajectory of unprecedented money printing, unchecked government spending, massive federal deficits, government subsidies, artificially low interest rates, and speculative behavior. According to the Pew Research Center for the People and the Press, close to 50% of Americans aged 18 to 29 view capitalism negatively. We aren't teaching young people about the virtues of the free-market system, though they do seem aware of its inevitable shortcomings. Meanwhile, even though we are all in this together, the government continues to ask nothing difficult from the majority of its citizens. We talk of everyone paying his or her fair share, but no one discusses the obligation we as citizens have in a democracy to do our fair share. Instead, we are encouraged to follow the feckless path of living beyond our means, making life more comfortable in the near term while the nation's crumbling infrastructure, faltering education system, and declining international competitiveness put us further and further behind – all

the while piling up a crushing debt burden for future generations.

As investors have become accustomed to sputtering economies and massive government intervention, episodic "risk-on" and "risk-off" behaviors drive the capital markets. Unexpected bad news means risk off. A stopgap solution to the crisis *du jour* is offered – i.e., a bailout, a rescue, a Band-Aid deal, QE(n) – and risk-on resumes. We have been on a roller-coaster ride for the last four years and counting, with no meaningful recovery, no feasible solutions, and ineffectual leadership. Investors conditioned to the short-term trading mentality are increasingly ill prepared for policy changes. What will happen when the Fed declares, as it someday must, that the era of low interest rates is at an end? What if governments holding trillions of dollars of sovereign debt and other securities stop buying and begin to sell? Or if another serious crisis – economic, political, international – materializes and governments have insufficient ammunition to intervene? The content, though not the timing, of the next chapter in market history is quite predictable. Few will say they saw it coming, though, in fact, everyone could have seen it if they had only chosen to look.

Antifragile

One of the investment challenges arising from the current environment is that while the U.S. stock market may appear to be quite volatile, posting as much as one- and even two-percent swings on some days, overall market volatility has been low to average over recent months and years. In mid-January, the VIX Volatility Index hit a five-year low. This dampened volatility, accompanied by higher securities prices, is a challenge for Baupost. Big market swings can benefit us. Extremely high prices, for example, are useful for taking profits. Were the markets to rise dramatically from today's levels, we would undoubtedly take advantage by selling into strength. Conversely, if the markets were to drop significantly, we would redeploy cash on hand to thoughtfully scoop up the bargains uncovered by the receding tide. Unfortunately, the Federal Reserve's relentless interventions and manipulations (the "Bernanke put") have truncated market declines, leaving relatively little worth acquiring – at least for now.

Nassim Taleb, author of the new book, *Antifragile*, praises volatility and criticizes those who would artificially damp it at great unseen cost. He is concerned about the rigidities inherent in our system. Taleb writes: "Stifling natural fluctuations masks real problems, causing the explosions to be both delayed and more intense when they do take place. As with the flammable material accumulating on the forest floor in the absence of forest fires, problems hide in the absence of stressors, and the resulting cumulative harm can take on tragic proportions. And yet our economic policy makers have often aimed for maximum stability, even for eradicating the business cycle…. [In contrast,] Mervyn King, Governor of the Bank of England, has advocated the idea that central banks should intervene only when an economy is truly sick and should otherwise defer action."[3]

ON "ANTI-FRAGILITY":

This is exactly what we strive to do: Embrace elements that benefit from volatility, variability, stress and disorder.

Accepting that we cannot predict the future – i.e., that there will always be unexpected and highly consequential events – is the first step in becoming less fragile and more adaptable. People should be highly skeptical of anyone's, including their own, ability to predict the future, and instead pursue strategies that can survive whatever may occur. Taleb advises us to be "anti-fragile" – i.e., to embrace those elements that benefit from volatility, variability, stress and disorder. This is exactly what we strive to do at Baupost, and Taleb has coined a name for it. The world will always deliver surprises coming from left field, things that have never happened before or, at least, that no one can remember having happened. As Nobel Laureate Daniel Kahneman notes, people tend to underestimate the odds of extreme events that haven't occurred recently. It's a tendency known as availability bias. This tendency is crucial to effectively position ourselves to survive and even thrive regardless of an uncertain future. How do we do that? By eschewing portfolio leverage, keeping ample cash balances ready for rapid deployment, pursuing a mostly generalist and flexible approach while avoiding narrow silos, seeking bargain-priced investments where possible adverse developments are already priced in, holding numerous investments with uncorrelated catalysts to drive outcomes irrespective of market levels, maintaining prudent diversification, demanding high intellectual honesty while consistently striving to improve, and having clients whose long-term orientation matches our own.

High Bar

We clear a high bar before making an investment, and we resist the many pressures that other investors surely feel to lower that bar. The prospective return must always be generous relative to the risk incurred. For riskier investments, the upside potential must be many multiples of any potential loss. We believe there is room for a few of these potential five and ten baggers in a diversified, low-risk portfolio. A bargain price is necessary but not sufficient for making an investment, because sometimes securities that seem superficially inexpensive really aren't. "Value traps" are cheap for a reason – perhaps an inept and entrenched management, a poor history of capital allocation, or assets whose value is in inexorable decline. A catalyst for the realization of underlying value is something we seek, but we will also make investments without a catalyst when the price is sufficiently compelling. It is easy to find middling opportunities but rare to find exceptional ones. We conduct an expansive search for opportunity across industries, asset classes, and geographies, and when we find compelling bar-

gains we drill deep to verify the validity of our assumptions. Only then do we buy. As for what we own, we continually assess and reassess to incorporate new fundamental information about an investment in the context of market price fluctuations. When bargains are lacking, we are comfortable holding cash. This approach has been rewarding – as one would hope with a philosophy that is painstaking, extremely disciplined, and highly opportunistic.

Fundamental Lessons

We opened our investment partnerships for business in early 1983, a fledgling firm with an investment philosophy adopted straight from Graham and Dodd. We've refined that approach a bit over the years, pursuing some new asset classes (commercial real estate) and covering some new geographies (we've become more global), but we have stuck to the bedrock principles of value investing and are far better off for it. We seek absolute returns, not relative ones, and resist being benchmarked against market indices for that reason. We have always had a traditional, seat-of-the-pants view of risk, and we steer clear of the foolhardy academic definition of risk as volatility, recognizing, instead, that volatility is a welcome creator of opportunity. We've maintained a commonsensical, albeit increasingly unconventional, approach to investing in that we strive to maintain a long-term perspective in a world of short-term actors, and we patiently hold cash in the absence of compelling opportunity, refusing to pull the trigger until the target is clear and compelling. Oddly, few others seem willing or able to follow suit. We put our money where our mouths are, always aligning interests as much as possible by investing the vast majority of our personal net worths in our partnerships directly alongside client capital.

We pursue opportunity largely off the beaten path, sifting through the debris of financial wreckage, out-of-favor securities and asset classes in which there is limited competition. We specialize in the highly complex while mostly avoiding plain vanilla, which is typically more fully priced. We happily incur illiquidity but only when we get paid well for it, which is usually when others rapidly seek liquidity and rush to sell.

ON STRATEGY:

We sift through the debris of financial wreckage, out-of-favor securities and asset classes with little competition.

We make no heroic assumptions in our analysis, hoping, instead, that by compounding multiple conservative assumptions, we will create such a substantial margin of safety that a lot can go wrong without impairing our capital much or even at all. We never invest just to invest and don't bet blindly on mean reversion or on historical relationships holding up. Our settings are permanently turned to "risk off."

For thirty years, we've been more focused on risk than on return, which perhaps counterintuitively has actually served us well in achieving strong returns with very limited likelihood of permanent capital impairment. We've suffered market-value declines in only two years out of thirty. We always work hard, really hard, to find compelling opportunity. But we are cognizant of the risk in trying overly hard to make money, because in investing one can definitely try too hard, which usually involves overpaying, excessive risk tolerance, and an increasingly compressed time horizon that often leads to lower rather than higher returns. Pressuring yourself or your team for results is, more often than not, counterproductive. Rather, we strive to avoid loss, which actually works as intended. In 2012, as in every year prior, we incurred only very limited risk, assiduously searched for opportunity and found some, and achieved many successes with relatively few mistakes, while earning decent risk-adjusted returns.

Some twenty-one years ago, *Margin of Safety* was published, which spelled out why financial markets weren't, and never would be, efficiently priced and what we intended to do about it. I endeavored to make the book timeless – more about how to think about investing than about what one should buy or sell at any given moment. Some of the categories of opportunity I wrote about hardly exist today (e.g., thrift conversions), while others that have emerged in recent years couldn't have been specifically contemplated two decades earlier (e.g., distressed structured products). But while the categories and the specific opportunities may have changed, the fundamental lessons remain. VII

Footnotes: *(1) Fareed Zakaria, "Can America Be Fixed?" Foreign Affairs, January/February 2013; (2) Fareed Zakaria, "Can America Be Fixed?" Foreign Affairs, January/February 2013; (3) Nassim Nicholas Taleb, "Learning to Love Volatility," The Wall Street Journal, November 16, 2012.*