Klarman, Seth A. – Margin of Safety

Harper Business, 1991, [Equity Investing] Grade ★★★★★

Everybody knows about Warren Buffett, and Buffett is undoubtedly the most successful value investor of the last 50 years. However, Seth Klarman at Baupost is probably the most prominent value investor of the last 25 years. Baupost was set up in 1982 and has since averaged returns of 20 per cent per year. In this book from 1991 Klarman shares his views on the nature of the equity market, his investment philosophy and the process he employs.

To be able to construct a profitable investment strategy you need to have a substantiated theory of how the market works, what mistakes investors in general do and how you can earn money form the incorrect prices this creates. This is also how Margin of Safety starts. The first of three parts in the book is termed Where Most Investors Stumble. Klarman describes issues like how emotions cloud judgement and focus on returns instead of risk management. He is especially critical of institutions who - due to a relative based investment approach, self-imposed restrictions, specialization into niches, bureaucratic set ups and fear of losing clients - become a combination of closet-indexers and short term focused speculators.

The next two parts of the book describes Klarman's investment philosophy and his process. Value investors are often divided into either the Ben Graham type buying bargains or the Warren Buffett type seeking franchises. Klarman doesn't fit nicely on this scale. The foundation he's building on is clearly Graham – this is how he thinks of Mr Market and of how to use volatility to your advantage, of how to seek deep discounts to always have a margin of safety and finally of that you have to stay within you circle of competence to be able to estimate an intrinsic value and hence know the margin of safety.

In addition to this Klarman adds a few ingredients. One is bottom up allocation. If there are no investments that match Baupost's criteria as a bargain the fund will simply hold money in cash. In this way the valuation of individual securities govern the asset allocation. The other is versatility. Baupost hasn't got sector analyst's, they have organized around "opportunities" and these could show up in several asset classes. Even though equites is the bulk of Baupost investments they will invest in basically anything where they spot selling that isn't governed by the value of the investment. Special situations and distressed debt have been huge contributors to the success of Baupost. Finally I would point to risk aversion. The focus is very much on "winning by not losing". While risk management is nothing new for value investors there is just a more intense scrutiny of all kinds of risk at Baupost than at most other firms. Even the concept of "triggers" is framed, not as something increasing returns as they shorten the time until re-pricing of a bargain, but as a risk minimizer as they shorten the time during which something can happen to the operations of the company that erodes the value.

Margin of Safety is unfortunately out of print and sells at outlandish prices on the second hand market. If you can get your hand on a copy you will find an easy to read text full of wisdom. The third part of the book is slightly denser than the prior two with chapters on thrift conversions, distressed securities etc. The book shows a maturity that you would rather expect of an author in the later part of his career, not one just a few years into it. I don't want to picture any similarities but Klarman's writing is deeply engraved in how I think of investment strategy today.

The flexibility to seek value where it can be found and the willingness to hold cash if there are no bargains around are key lessons for all of us in uncertain times. Read, reflect and read it again.

Mats Larsson, December 22, 2011