Outstanding Investor Digest

PERSPECTIVES AND ACTIVITIES OF THE NATION'S MOST SUCCESSFUL MONEY MANAGERS.

THE FOLLOWING WAS EXCERPTED
FROM OUR 8-PAGE FEATURE WITH:
BAUPOST GROUP

Investors featured in this Edition:

Other Investors in this Edition:

Companies & Investments in this Edition:

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BAUPOST GROUP'S SETH KLARMAN
"IT'S A GREAT TIME TO BE A VALUE INVESTOR.
THE COMPETITION SEEMS TO HAVE GONE AWAY."

Re-reading Seth Klarman's annual letter from a year ago, it's remarkable just how many of his warnings turned out to be tomorrow's headlines. Among those warnings were that the subprime mortgage debacle and housing contraction were likely to be "the first failure in a broader reckoning," that increased risk aversion would lead to tighter lending

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FAIRHOLME FUND'S
BRUCE BERKOWITZ & CHARLIE FERNANDEZ
"I THINK ALMOST OUR ENTIRE PORTFOLIO
IS SELLING AT A BACK-UP-THE-TRUCK PRICE."

Bruce Berkowitz knocked the cover off the ball for his clients return-wise while he was with Lehman Brothers — and then proceeded to do the same within the pages of *OID* in his early '90s features. So it was no surprise to us at all when he picked up right where he left off after founding Fairholme Capital in 1997. For example, since its inception on 12/29/99, his Fairholme Fund shareholders have enjoyed compound returns an incredible 13.5% per year better than

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GRANTHAM, MAYO, VAN OTTERLOO'S
JEREMY GRANTHAM
"THIS CRASH SHOULD HAVE SURPRISED NO ONE.
GREAT CRASHES *ALWAYS* FOLLOW ASSET BUBBLES."

We can think of few observers who provide more insight into the big picture than Jeremy Grantham and his team at Grantham, Mayo, Van Otterloo, and few times where a rigorous assessment of the big picture — in terms of how we got here, how deep the hole is, and what it may take to dig ourselves out — could be more timely and relevant.

So when we heard that Grantham was going to speak

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WINTERGREEN FUND'S
DAVID WINTERS
"I'VE NEVER SEEN SO MANY TRIFECTAS IN MY LIFE —
GOOD BUSINESSES WITH GOOD MGM'T AT LOW PRICES."

David Winters has described his decision to leave his position as chief investment officer at Franklin Mutual Advisers in 2005 and hang out his own shingle as an "epiphany", namely how he wanted to found a firm that emphasized investing, with maximum flexibility, over marketing and asset gathering — a firm where associates, using Buffett's phrase, would want to "tap dance to work".

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BAUPOST GROUP'S
SETH KLARMAN
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standards, higher borrowing costs, less economic activity and lower securities prices — and finally, that, "We will not be certain until much later whether the so-called bargains of January, 2008 were truly undervalued or merely dangerous temptations to value-starved investors." Well, needless to say, that verdict is in.

In addition to being a thoughtful writer and speaker on the subject of value investing, Klarman has an outstanding track record as an investor. Since its February 1, 1983 inception through December 31st, his Baupost Limited Partnership Class A-1 has provided its limited partners an average annual return of 16.5% net of fees and incentives, versus 10.1% for the S&P 500. During the "lost decade", Baupost obliterated the averages, returning 14.8% and 15.9% for the 5 and 10-year periods ending December 31st versus -2.2% and -1.4%, respectively, for the S&P.

It's our pleasure to bring you the following excerpts from Klarman's comments and his answers to the questions which followed at the Heilbrunn Center for Graham & Dodd Investing's 18th Annual Graham & Dodd Breakfast, and at a symposium entitled "Celebrating 75 Years of *Security Analysis*" both of which were held on October 2nd in Manhattan. We hope that you find them as timeless, and timely, as we do.

IN A MARKET LIKE WE'VE BEEN EXPERIENCING, MOST INVESTORS LOSE THEIR RUDDERS.

Sometimes, being too early *is* the same as being wrong....

Seth Klarman: For years, when someone asked me what my biggest fear was as an investor in managing my portfolio, my answer was that it was buying too soon on the way down from often very overvalued levels. I knew a market collapse was possible. And sometimes, I imagined that I was back in 1930 after the market had peaked the year before, and then dropped 30%. Surely, there would've been some tempting bargains then. And just as surely, you'd have been crushed by the market's subsequent plunge over the next three years — down to below 20% of 1929 levels.

A fall from 70 to 20, and from 100 to 20, would feel almost exactly the same by the time you hit 20. Sometimes being too early becomes indistinguishable from being wrong.

After a 30% drop, who knows how much further it might go?

Klarman: Of course, getting in too soon as the market falls involves great risk for all investors, including value investors. Certainly, when a few securities start to get cheap even as the bull market continues, a value-starved investor will step up and buy them. Soon enough, many of these prove to be no bargain at all, as the flaws that caused them to be rejected by the bulls become more glaringly apparent when the world gets worse.

After a stock market has dropped 30%, there's no way to tell how much further it might have to go. It'd be silly to expect every bear market to turn into the Great Depression. But it would be equally wrong to expect that a fall from overvalued to more fairly valued couldn't badly overshoot on the downside.

We're bombarded by apparent opportunity....

Klarman: So when individual stocks reach levels where they are truly undervalued, what are value investors supposed to do other than to buy them? Anything else is market timing. Investors live in real time — not in several year intervals, but in months, days, hours and even minutes. Because we cannot know the future — and cannot see in the middle of the cycle its end, and not even necessarily its beginning — we will be bombarded by apparent opportunity as the market descends. We will see tempting bargains and value imposters, false rallies and legitimate recoveries, smart bottom fishers and mindless buy-the-dippers — and we will never know until after the fact how low things might go.

We can become macro forecasters, predicting 10 of the next two recessions, or we can ignore the macro economy, buying bargains that cease to look cheap as the economy deteriorates and credit contracts and the tide goes out on all marketable securities.

In a market like this, most investors lose their rudders....

Klarman: When a value investor is tempted to become something other than what he or she is, I find it best to recall the wisdom of Graham and Dodd. Graham and Dodd have provided us with a remarkable road map that has been carried on some of the world's most successful investment journeys for 75 years — a road map that allows us to navigate through difficult, even uncharted, territory and come out ahead.

In a market like we've been experiencing, most investors lose their rudders. They become incapacitated, unable to navigate amidst extreme turmoil, declining corporate results, and a litany of economic woes and mounting losses. They become unwilling to part with their cash — afraid of possible redemptions, and afraid of adding to their losses.

Investors today, who are tempted to pull out of the market and wait for some kind of "all clear" signal before recommitting, would be well advised to remember the counsel of Graham and Dodd who wrote in 1934: "While we were writing, we had to combat a widespread conviction that financial debacle was to be the permanent order." If they could say that then, I must restate it now.

Value investors have a multifaceted and adaptable tool kit.

Klarman: Value investors who are able to maintain their focus and resist the pressures inherent in the investment business to pursue short-term results have a multifaceted and adaptable tool kit that should allow them to prosper even in difficult times. First, by maintaining their discipline and by remaining patient in good times and bad, value investors own bargains — securities trading at a discount to underlying value which confer a margin of safety. This doesn't mean those holdings can't or won't drop in price; it means that when they decline, they'll be an even better bargain to which you are likely to seek to add.

In difficult times, value investors certainly benefit from their relentlessly-kept discipline by having avoided highly-leveraged stocks, troubled financials, perpetually marginal businesses, and risky junk bonds. When the

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market drops, holders of such speculations quickly regret their choices.

Warren Buffett's advice is wiser than ever today....

Klarman: Most value investors paint from a broad palette — taking advantage of the best bargains across a variety of industries, countries, and for some, even securities types. They don't fall in love with companies or their managements. They favor what is undervalued and shun what is overvalued. As rigorous assessors of value, they can readily decide which of their holdings, and indeed, which securities in the marketplace, offer the most inexpensive valuation and the best reward to risk and readjust their portfolios to reflect these updated assessments.

Warren Buffett has often cautioned that we should hold investments where it wouldn't matter if the financial markets were closed for the next five years. Today, when market closure is at least an imaginable possibility, this advice is wiser than ever. Amidst turmoil, when nearly everyone's time frame has been compressed to taking it one day at a time, value investors should remain focused on the long run, picking up the bargains — bargains with little downside and plenty of upside — that will work out over a several-year period.

ONLY BY STANDING AGAINST THE PREVAILING WINDS CAN AN INVESTOR HOPE TO PROSPER OVER TIME.

Graham and Dodd remain our North Star to navigate by....

Klarman: Graham and Dodd have given us some 800 pages of reasons to be rigorous in our investing. Their diligence motivates us — demanding that no stone be left unturned in the quest for information, and no question unasked or unanswered in the desire to identify and mitigate risk. They are like silent sentinels, watching from the past to see if we have understood their lessons and successfully implemented them, as the road we must travel continues to twist and turn. We navigate as best we can — and they remain our North Star.

Value investing is at its core the marriage of a contrarian streak and a calculator. The strategy of buying what's in favor is a fool's errand, ensuring long-term underperformance. Only by standing against the prevailing winds — selectively, but resolutely — can an investor prosper over time. But for awhile, a value investor typically underperforms.

You can only control your process and approach....

Klarman: Value investors have a perspective that allows them not to *suffer* these interim losses, but to relish or at least appreciate them — because interim price

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declines allow an investor to average down, to buy more at an even better price, which results in much greater profits over time than if prices had not declined at all.

It is critical that you remind your clients, your investment team, and, as often as necessary, yourself, that you can only control your process and approach — that you cannot forecast the vagaries of the market, which in any case are an opportunity and not a problem for value investors. And then you should invest, comfortable that you're doing the right thing, indifferent if you lose your short-term oriented clients — who will never understand what you do, or how they are their own worst enemies — and confident that when the dust settles and the crisis passes, your steadfastness and discipline will have added more value than any other approach.

And the pressure builds to change during poor performance.

Klarman: This point about controlling your process is absolutely crucial. James Montier, SocGen's market strategist, pointed out in a recent piece that when athletes were asked what went through their minds just before competing in the Beijing Olympics, the response again and again was that the competitor was focused on the process, not on the outcome. The way to maximize outcome is to concentrate on the process.

Montier points out that psychologists have long been aware of a phenomenon known as "outcome bias". This is the tendency to judge a decision differently based on its outcome. For example, if a doctor performs an operation and a patient survives, the decision is rated as significantly better than if the same operation fails and the patient dies. According to Montier, during periods of poor performance, the pressure builds to change your process. But so long as the process is sound, this would be *exactly* the wrong thing to do.

It is crucial to have, and maintain, a sound process....

Klarman: It's so *easy* for one's investment process to break down — and process is everything in investment firms. And today, many firms have a broken process. When investors worry about what a client will think rather than what they themselves think, the process is bad. When an investor is worried about their firm's viability, about constant redemptions, about avoiding loss to the exclusion of finding a legitimate opportunity, the process will fail. When one's time orientation becomes absurdly short-term, the process is compromised. When tempers flare, when recriminations abound, when second-guessing proliferates, the process cannot work properly. When investors worry about the good of the firm or its publicly-traded share price rather than the long-term best interest of the clients, the process is corrupted.

When the process is broken, you can't invest well. It's hard enough to invest well when the process is *good*. So it's crucial to have a sound process that will enable you to perform this difficult task with intellectual honesty, rigor, creativity and integrity.

Graham and Dodd teach us how to *think* about investing.

Klarman: Today, as we honor the legacy of Graham and Dodd, it is important to remember that value investing is not a perfect science. Rather it is an art, with an ongoing need for judgement, refinement, patience and

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reflection. It requires endless curiosity, the relentless pursuit of additional information, the raising of questions, and the search for answers. It necessitates dealing with imperfect information — knowing you will never know everything and that that must not prevent you from acting. It requires a precarious balance between conviction, steadfastness in the face of adversity, and doubt — keeping in mind the possibility that you could be wrong.

Ultimately, Graham and Dodd teach us not only about investing, but also *thinking* about investing. At the core of its wisdom are not mechanical rules to be blindly adhered to, but a way of thinking that allows us never to be blinded by rapidly changing facts or conditions. Mechanical rules are dangerous — requiring the world to be more constant and predictable and analyzable than it can be. In this sense, Graham and Dodd's principles are perhaps best utilized as a screen — a sieve to sort through the mass of securities to find those of greatest interest, with rigorous analysis and keen judgement then used to make the final investment decision.

TODAY, WHEN MANY PEOPLE *HAVE* TO SELL,
IT'S A GREAT TIME TO BE A VALUE INVESTOR.

A frenetic and crazy market is an opportunity....

Attendee: How do you see the current investment scene?

Klarman: One of the things characterizing today's markets is the presence of large numbers of urgent sellers — people who are scared, getting margin calls, being liquidated, or who are otherwise being forced to transact.... And one of the things I'm always amazed to see is otherwise-smart people writing in their client letters: "The markets have become so frenetic and crazy that I'm going to the sidelines."

That "frenetic and crazy" is an opportunity. If you want to manage your portfolio to never have a down month, then perhaps T-bills are the only alternative — but they also *were* the only alternative for the last several decades as well.

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What better opportunity to take advantage of dislocation than a market where people are periodically — meaning, every few minutes — getting margin calls, losing their taste for a particular security, overreacting to news, and overreacting to false news. It's a remarkable time.

But you have to be careful that the patsy is not you....

Klarman: So my experience — and experience is usually a good thing, but occasionally it can lure you into being too early or doing the wrong things — is that when people start to give something away at a ridiculous price because they *have* to, not because they want to, that's a good time to buy.

Warren Buffett has often referred to the idea of being in a poker game — and when you look to the left and to the right and you can't figure out who the patsy is, it's you. And in the financial markets, I've always been — and I think all investors should be — worried about that: that there are so many smart people out there, that this room is filled with plenty of capable competitors, and that the markets are thus also filled with them. Corporate insiders are able to transact in the markets enough of the time so that there's a lot of information out there.

In most environments, you have to play against really smart competitors. In today's environment, many of the buy side competitors are standing back or even becoming sellers — and many, many more sellers exist than usual. And these are not sellers who carefully analyze a bond that suddenly was downgraded, or a stock that suddenly plunged by missing earnings by a penny — they're people who *have* to get out and who haven't done their analysis. So it's a great time to be a value investor....

Ironically, when you don't allow failure, you get more of it.

Klarman: It seems to me that the reason people panic out of their minds these days at a relatively moderate market drop — or, God forbid, the word "recession" — is because the government has, in one way or another, encouraged us to do that. At various difficult times — like '87 or possibly '98 — the Fed, under irresponsible leadership for so many years, has jumped in to bail out real and imagined problems and restore investors' confidence, effectively giving them the well-named "Greenspan put". And we're now asking the government to save us from what wouldn't, perhaps, have been necessary if they had not saved us so many times already when the problem was not that large.

So I just think it's incredibly important to note that when you don't allow failure, you get more failure. When you take away the price of personal risk in your decisions, you get much more risk taking. So we are harvesting what we've sown. And while I understand the argument for government intervention at this point, I think it's incredibly important that the government learn how to intervene on both sides. If we're going to prop things up when they're down, we perhaps also ought to take away the punch bowl much earlier, so we wouldn't be in this mess....

TO SOME EXTENT, WE WERE PREPARED THIS TIME —
BUT YOU CAN NEVER BE PREPARED ENOUGH.

Once in a while, structural imbalances *really* matter....

Klarman: Jim Grant called liquidity and credit,

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"Money of the mind." It's there — and then it's not there. It's amorphous. You can't see it. It's not real. And in a way, to me, anybody that ever says, "How can the market go down — there's a wall of liquidity?" or, "There are structural imbalances"... As long as I've been alive, there have been structural imbalances. And most of the time, they don't matter; but once in a while, they *really* matter.

That's what's hard — if you run your portfolio to do fine in an up market, you will have exposures that you wish you didn't have in a worse market.

Do you overpay for insurance — or do you go uninsured?

Klarman: In terms of our firm, I tried so hard to learn the lessons of 1998 in particular, which were: Don't be unprepared for something out of the blue that's really bad.

To some extent, we were prepared this time. However, you can never be prepared enough. We had a lot of macro protection in terms of credit default protection on bonds where we were just betting that credit spreads would widen. That's been incredibly helpful. But we've gotten really tired of buying market puts, or anything like that, because they inevitably are expensive and expire worthless.

So as an investor, you have terrible trade-offs. Do you overpay for insurance — or do you go uninsured? That's just one of those dilemmas for which there are really no perfect answers.

You must anticipate things that have never happened.

Klarman: When Warren Buffett put out his job description for who would replace him some day, he said that one of the criteria he was looking for was somebody who could deal with and even anticipate things that had never happened before. Well, that was prophetic — and incredibly important for investors.

All of us — every day, every week, every month — have to deal with things we've never seen before. In every previous downturn in my investment career, some things would be getting killed while a lot of things would be recovering. In this environment, it's been straight down for everything. We've had almost no respite. So the idea that you can recycle money from one holding that has recovered into another one — that has just not happened.

So you need to be prepared for that. But anybody who says that they see five-standard-deviation events occurring every couple of years is obviously not thinking correctly about probabilities. So things happen — and you need to be ready.

FOR THOSE WITH BUYING POWER AND EXPERTISE,
IT'S A GOOD TIME TO BE IN DISTRESSED DEBT.

There's much financial distress — and there will be more

Attendee: There are a lot of distressed private equity funds out there now. What's your view on those?

Klarman: I think that it's clear that debt of all types is a subset of what value investors look at.... This is a time when there's obviously a great deal of financial distress — and there will be more. One of the odd things about this moment is that the distress is very concentrated. In the financial sector, there is *enormous*, unprecedented distress. In industrials, there is only starting to be distress. In commercial real estate, the market is completely frozen — there will be massive dislocation, and a lot of projects will fail. But the sellers are not urgent because they can only apparently focus on one thing at a time, and are focusing on residential real estate problems — or because they haven't been forced to the table yet.

I'd definitely be putting money into the distressed area now.

Klarman: So I believe it is an attractive time to be in distressed debt. One of the regrettable things for many practitioners is that, as we all know, sometimes it's hard to sit idly on your hands waiting for opportunity. The last distressed debt cycle was 2002, which recovered handsomely into '03 and '04, at which point there was virtually nothing to buy — almost no defaults in the last four or five years, and very little in the way of interesting opportunity.

And unfortunately, sometimes when you give people money, they find things to do with it. So a lot of the distressed funds of that vintage put money into initiating loans at par that may or may not be well covered — especially today — but that used up buying power that might otherwise be used to take advantage of opportunity. So if I were allocating fresh money today — if I were an endowment — I would definitely be putting money into the distressed area.

It's not clear how to think about investing in private equity.

Klarman: Private equity is different. Obviously, private equity has huge issues in terms of anything they bought. They have huge issues in terms of business performance and in terms of how they will get out — because they paid multiples that aren't obtainable today, and that are unlikely to be obtainable any time soon. And they have huge issues when their debt comes due and huge issues in valuing their assets.

Some private equity firms are also strong in distressed debt. But many of them are really LBO practitioners and don't really know much at all about distressed debt. And we have seen some of them misstep in a variety of names where there was great public information about problems at companies.... Yet they stepped into some of those positions that were foolhardy....

So it's not clear how to think about investing in private equity. If you want exposure to distressed debt, it might be wise to leave it to distressed debt practitioners.

THE TIME TO BUY BARGAINS
IS WHEN YOU FIND THEM.

I just think that you buy one security at a time....

Moderator: Typically, you don't do timing from a value pers… you talk about dis… the financial … e a lot of shoes tha… omy.... Do you think at these levels, distressed debt is really a bargain — or is there a lot more pain to go?

THE PRECEDING WAS EXCERPTED FROM OUR 8-PAGE FEATURE

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JEAN-MARIE EVEILLARD, FIRST EAGLE GLOBAL FUND

"Our attitude towards current circumstances is that there are two major positives vis-a-vis investing in equities. The first positive is the fact that equity markets — not just in the U.S. but throughout the world — have declined by 50%-60%, which is quite a bit. And the second, more important, factor — although it's a matter of judgement, and I may be wrong — is that the authorities are engaged in a major, continuing effort to get out of the hole.... And I think that the authorities will eventually be successful in engineering some recovery, with some inflation — as long as a weaker dollar and/or higher long-term interest rates do not complicate matters. Whether that recovery, if it does occur, will be sustained over three to five years, though, is questionable: If too much debt is the problem, is adding debt on debt the cure?

"For as long as we're in the crisis, I expect companies with very strong positions in their market — *and* a very strong balance sheet — to gain additional competitive advantage vis-a-vis their weaker rivals. For the past few years, up until the credit cycle turned, Wall Street was advising American companies to 'optimize their balance sheet' — which was code, of course, for adding debt to increase return on equity, and buy back stock with borrowed money — which is a horror. I expect plenty of 'optimized balance sheets' to get American companies into trouble over the next year or two.

"We see investment opportunities in particular in Japan — where there are small, Benjamin Graham-type stocks and world-class industrials as well as attractive pharmaceutical businesses. Anybody who bicycles knows that your good bicycles tend to have parts manufactured by Shimano — which is a genuine Japanese multinational. They dominate — with 80% of the market for good-quality bicycle parts. In Europe, there are a few here and there — some blue chips such as Air Liquide (the equivalent of Air Liquide in the American stock market is Praxair, which supplies industrial gases) and Sodexo, a catering business with a very important business in the U.S. They're catering to the Marine Corps, among other things.

"Historically, we've done relatively little in emerging markets. My successor (and I fully agree with him) intends to spend a lot more time on emerging equity markets over the next five to ten years — particularly in Asia outside Japan — because that's where the future is. If you just look at the consumer sector, then you could say at one end of the spectrum, you have the American and British consumer who are genuinely tapped out, and where even the mindset of the consumer may be changing — where they'll have to spend the next three to five years rebuilding their balance sheet. For instance, in retailing, as a result of a 25-year credit boom, the U.S. is an over-stored country. Therefore, I wouldn't touch the stock of an average — or, even worse, weak — retailer at *any* price with a 10-foot pole. I say that in part because from here on in, retailers who are successful will be successful at the expense of *other* retailers since the pie is no longer growing.

"In the middle, you have developed countries such as Japan and Germany where, sometimes for cultural reasons, the consumer is still saving and is not tapped out. There is the potential in those countries — it may not be realized, mind you, and it's nowhere near the potential that exists in Asia — for the consumer to spend more. At the other extreme, you have the consumer in Asia outside Japan with very little leverage. There are plenty of consumers in Asia with no credit cards. Some apartments and houses are bought with cash. And of course, beyond the current cyclical problem, the ranks of the middle class will expand by tens of millions every year in India and China and a few other countries in Asia outside Japan."

Speech at the 92nd Street Y — March 10, 2009

JEREMY GRANTHAM, GRANTHAM, MAYO & VAN OTTERLOO

"It was psychologically painful in 1999 to give up making money on the way up and expose yourself to the career risk that comes with looking like an old fuddy duddy. Similarly, today, it is painful and risky to one's career to part with your increasingly beloved cash — particularly since cash has been so hard to raise in this market of unprecedented illiquidity. As this crisis climaxes, formerly reasonable people will start to predict the end of the world, armed with plenty of terrifying and accurate data that will serve to reinforce the wisdom of caution. Every decline will enhance the beauty of cash until, as some of us experienced in 1974, 'terminal paralysis' will set in. Those who were overinvested will be catatonic and just sit and pray. Those few who look brilliant, oozing cash, will not want to easily give up their brilliance. So almost everyone is watching and waiting with their inertia beginning to set like concrete.

"Typically, those with a lot of cash will miss a very large chunk of the market recovery.... In June 1933, long before all the banks had failed or unemployment had peaked, the S&P rallied 105% in six months. Similarly, in 1974, it rallied 148% in five months in the UK! How would you have felt then with your large and much beloved cash reserves?

"Finally, be aware that the market does not turn when market participants begin to see light at the end of the tunnel. It turns when all looks black, but just a subtle shade less black than the day before."

GMO Article, *Reinvesting When Terrified* — March 4, 2009

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