Reflections

National Bank Financial
280 King Street East, 4th Floor
Toronto, ON, Canada M5A 1K7
t 416 363 3050 – 1 800 665 1757
f 416 368 4330
www.LeckieIntrinsicValue.com

Investing for the future

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Scott Leckie: Seth Klarman at the New York Grant's Conference.

I was inspired a very long time ago by a book called *Margin of Safety* written by Seth Klarman. Seth Klarman is a value investor who works from Boston and is a principal at Baupost Group, a value focused investment firm.

Over the years I have had the opportunity to hear Klarman speak at the New York bi-annual Grant's Conference on several occasions. Years ago we even purchased all of Grant's available copies of Margin of Safety (some 20 copies at $25 each), which we then lent to our investors.

In late March I attended the Grant's Conference again and heard Klarman. He spoke about where we are now and what to do about it, and of the importance of a good process.

In Klarman's view, a view we share, the world changed in 2008. The system appears to be broken. Looking at public finances from an intrinsic value standpoint, there seems to be no margin of safety anymore in the economic affairs of many countries, leaving little about which to be optimistic. Some countries seem headed toward an invisible tipping point the when and how of which nobody can accurately forecast.

The world of investment does not seem to care much. As evidenced by the almost universal focus on short-term performance, it is driven by short-term gratification thanks to both internal and external factors.

Internally, you have a lot of smart, ambitious type-A people managing money and aiming at quick success. Externally, you have consultants who base their recommendations upon reams and reams of data that are collected on ever-shorter time frames. Moreover, because the finance industry makes the great majority of its money on transactions rather than performance, the tendency is encourage transacting - not a recipe for patience and long-term views.

For most professional and private investors, these circumstances makes it difficult to stand away from the crowd and take unpopular stances.

So, what can we do, given a precarious world where rebellions and material disasters seem to strike with regularity?

Well, value investing works. That is, the simple practice of buying securities that trade at a low price relative to their asset value, cash flow and earnings. Many years ago, the value investment firm Tweedy, Browne published a classic study called "What has worked in investing". That piece consolidated 40 different studies showing how a number of methodologies seeking to identify and extract value worked out overtime. They did: not every year and not always by a lot but by a couple of percentage points over the index, which – compounded over a number of years – can make the difference between a good investment experience and a great investment experience. This 60-page study is still available from Tweedy, Browne online at: http://www.tweedy.com/resources/library_docs/papers/WhatHasWorkedInInvesting.pdf .

To further improve your thinking about investing and your chances of success, you can add Benjamin Graham's "Mr. Market" way of looking at market prices, which leads to understanding and viewing market volatility not as risk but as opportunity (see our website http://www.leckieintrinsicvalue.com/what-is-intrinsic-value/what-risk-is-not/).

Within this paradigm (value investing, where the absolute level of prices matters), you will start looking at the inherent volatility of the market through the right lens (as opportunity). And in exploiting your newfound vision, you will naturally identify your own specific edge within that paradigm – your own very personal way to find value, which leverages your skills and affinities.

For example, in both Baupost's and our case we share a long term view regarding price and value. Some securities have short, contractual time frames for value realization, like a take-over arbitrage position or near term option contracts. Others have much longer time frames attached to value realization, like a stake in a developing iron ore mine that will not produce free cash flows for five years (we own such a position).

Our edge also includes a flexibility of approach that allows us to consider many types of opportunities. We nevertheless limit ourselves to only those that we can ***fully understand***.

The Classic Value strategy can choose between debt and equity securities, is not constrained by market capitalization and can hold cash in the absence of opportunity. The Premium Value strategy has greater flexibility, especially the ability to short and arbitrage securities. Baupost, with the large staff necessary to invest much larger assets, draws on a wider range of expertise and for example invests directly in commercial real estate. The point here is that there can be intrinsic value opportunities anywhere; the key is to have the ability to understand and assess them properly.

Klarman reiterated that in his view a top-down allocation of capital does not make sense (when you first judge the economy, then judge which sectors look attractive in light of your economic view, and finally choose securities within those sectors). The accuracy of economic forecasts is extremely poor. Rather, he lets opportunities speak to him. If insurance companies are absolutely cheap, why add a bank to your portfolio when you could add a second or third cheap insurance company?!!

Klarman looks for opportunities especially where he sees demand/supply imbalances. For example, when a stock is kicked out of an index, index funds and some institutional investors might be obligated to sell it, artificially depressing its price; if a bond receives a rating downgrade, certain holders might be obligated to sell it due to rating limitations contained in their investment mandate.

In fact, most value situations are a result of a demand / supply imbalance. When we bought Westaim at 25¢ while the company had net cash holdings of 50¢ per share (March 2009), the shares were available at that price because nobody wanted them. Many previous owners had been burned and wanted the stock out of their portfolios at any price (cosmetics are important in the traditional investment world where portfolios are reported to investors only a few times a year). One man's garbage may be another man's treasure… and our investment doubled in price. Anytime we can buy cash at that kind of discount we are going to be interested in at least investigating the opportunity.

Klarman also talked about how Baupost find opportunities in complex situations in a world that prefers "plain vanilla". We must confess that we too have a preference for simple things, but simple things hiding in plain view. Whereas Klarman manages billions of dollars and must seek out opportunities in highly complex securities, we are of such a size that we can operate around the edges of the market and discover many interesting opportunities without having to seek misunderstood complexity.

Other comments from Klarman about developing an "edge" to add incremental value to the already advantageous pursuit of investing through a value approach included:

- Maintain discipline on targeted purchase and sale prices. This means buying only at a significant discount to intrinsic value – do not chase stock prices. It also means selling your securities as they approach intrinsic value – a number which is always inexact and more of a range than a number with third decimal point precision.
- Maintain a risk-adverse approach, giving equal weight (or more) to how much money you might lose as you give to what return you might achieve. Again, the consideration is about the permanent impairment of capital, not volatility in the price of your securities.
- You need good relationships with those individuals who provide you with prospective investment ideas and industry knowledge be they analysts, brokers, partners, competitors or seasoned business professionals.
- You need to be a good partner treating all of your clients, partners, staff and suppliers with fairness and honesty in order to foster an environment conductive to quality decision making – and quality reviews of past decisions.
- Reasonable but not excessive diversification allows for both a balance between risk reduction (the risk of being wrong) and focusing on the very best ideas that you can know thoroughly.
- Being comfortable holding cash despite its low return allows a value-based manager to wait for

extraordinary opportunities without feeling compelled to be "in the market" for the sake of being fully invested. This is unlike most professional money management where portfolio managers run a great career risk by deviating too far from their benchmark which by definition is "fully invested".

Klarman also talked, like we do, about the importance of having a good process. This includes an atmosphere of intellectual honesty, outside of the box thinking, and the ability to respond to opportunities quickly (i.e. an absence of bureaucracy in the investment process).

Klarman thinks that the values of a firm matter. We do too. It requires a culture of compliance and Klarman himself has two common sense tests:

- The Wall Street Journal Test:
  Would you be happy if what you are doing now is reported tomorrow in the WSJ (for your mother to read)?
- The Football Field Test:
  If you play near the sidelines, you will eventually step out of bounds.

Finally, Klarman said that at its core investing is an arrogant act. You are saying that you know more about the current value of a security than the rest of the market. As such, your arrogance needs to be tempered by humility. You need to be open to new information and the possibility that you might be wrong!

Klarman concluded by saying that some of these ideas are not particularly new. Indeed, they can be seen on display in the way that Warren Buffett has operated for many years.

Why I like being an Intrinsic Value investor.
For those of you who have been curious about my own personal motivation in pursuing value based investing beyond the great psychic satisfaction received from doing well for years – I have written this section.

My true, daily motivator is that I really like the challenge of searching for and finding value. It is like a treasure hunt requiring contrary thinking, patience and discipline. It demands intellectual independence, common sense and a rational process. It leaves you free to read, think, and ponder until you are ready to decide – I am not enslaved to a desk, a screen, a market – the freedom is (almost) complete.

It is certainly not for the money. Once you have secured a certain amount which I describe as "Freedom Money[*]". (I actually called it something a little more colorful, but this has been edited out…), money loses its motivating ability. This was the case for me, and I suspect it is the case for many.

On the other hand, the satisfaction of seeing my discoveries blossom as I expected them to is immense, even more so when I think that the value I was able to add will help some of my investors realize their own dreams. For me, this is priceless. Searching for, finding and realizing value against consensus thinking allows me to do good while triumphing over greed, fear, misplaced popularity contests and stupidity… A very satisfying endeavour, well worth dedicating one's life to it!

Scott Leckie
Scott Leckie Intrinsic Value Management

[*] *"Freedom Money" is the amount of money you require to be able to extricate yourself from a job, a boss, any situation you do not like, and have enough resources left to support yourself and your family's lifestyle without being beholden to anybody. "Freedom Money" is what guarantees your independence.*