A Lesson in Judging Risk From Seth Klarman

> "A margin of safety is achieved when securities are purchased at prices sufficiently below underlying value to allow for human error, bad luck, or extreme volatility in a complex, unpredictable and rapidly changing world." – Seth Klarman

I had the pleasure of listening to legendary hedge fund manager Seth Klarman speak at a conference a few years ago.

It was the fall of 2009, about a year after the economy nearly imploded from the bursting of the debt bubble.

Investors were still licking their wounds.

Klarman shared some of his tales from investing during the eye of the storm in the fall of 2008. This was right after Lehman Brothers had declared for bankruptcy. At that point everyone was looking around for the next domino to fall. AIG was the logical choice.

Klarman discussed an investment in the bonds of a company that was somehow affiliated with AIG. He didn't get into the specifics of the business. The company's bonds were trading for 20-30 cents on the dollar.

Even though this company was basically a third party, investors didn't wanted anything to do with credit investments that were in any way involved with a company like AIG that could go under any day.

These bonds were trading at a discount of 70-80%, but they were actually scheduled to pay back investors at par value (100 cents on the dollar) just one week later.

This is what they call throwing the baby out with the bath water.

Klarman said that he and his team did their due diligence and determined that the company had more than enough cash on hand to pay back their bondholders.

The fund ended up making the investment and got paid back the following week at par value.

Klarman said it was by far the highest single IRR (internal rate of return) he has received on any investment in his career by a wide margin. I can imagine a return in the range of 230-400% in a single week looks pretty good on an annualized basis.

The lesson here is not simply that Klarman is an unbelievable value investor (although he is). The

lesson is that risk comes in various forms and doesn’t mean the same thing to everyone in the market.

For individual securities, price is the ultimate determination of risk and your end results. If you buy a stock at a price that's too high, the quality of the underlying business likely won’t matter. On the other hand, even low quality businesses can make for solid investments at the right price.

The Klarman investment is an extreme example, but could have been any number of low quality businesses that came with headline risk at the time.

Around the time I listened to Klarman speak, stocks had rallied something like 50% off of the lows seen in March of 2009. Even with this snapback rally, investors were still nervous with the financial crisis looming large in everyone’s rearview mirror.

I remember reading research report after research report about the fact that it was a ‘junk stock rally’ and the stocks leading the market higher were all of the overleveraged low quality companies. The thesis was that the rally was unsustainable because of this.

It’s easy to see in hindsight that this idea was off the mark, but this again speaks to the fact that price is really all that matters in stocks. The reason those junk stocks were leading the charge higher is because they were also the same stocks that completely collapsed in price on the way down.

At the right price level, any stock can become a good investment opportunity. If there is no one left to sell, then it doesn’t take much to reverse course.

This reminds me of the concept of first and second level thinking from Howard Marks. Marks uses this line of thinking to show how great investors operate:

First level thinking says, 'It’s a good company; let’s buy the stock.' Second level thinking says, 'It’s a good company, but everyone thinks it’s a great company, and it’s not. So the stock’s overrated and overpriced; let’s sell.'

First-level thinking says, ‘The outlook calls for low growth and rising inflation. Let’s dump our stocks.’ Second-level thinking says, ‘The outlook stinks, but everyone else is selling in a panic. Buy!’

First-level thinking says, ‘I think the company’s earnings will fall; sell.’ Second-level thinking says, ‘I think the company’s earnings will fall less than people expect, and the pleasant surprise will lift the stock; buy.’

Determining risk is not always as obvious as you may think.

Source:
The Most Important Thing

Now for my favorite reads from this week:

- Top ten rules of forecasting (**Turnkey Analyst**)
- A historical look at the crash and recovery through the humble eyes of Barry Ritholtz (**Big Picture**)
- There’s nothing wrong with 401(k)s, except the players involved (**Washington Post**)
- What should investor's expect? (**Crossing Wall Street**)
- "Expectations aren't everything, they're the only thing" (**The Irrelevant Investor**)
- There are no perfect investment books, portfolios or investors (**Rick Ferri**)
- Turney Duff on regrets, mistakes and what really matters in life (**CNBC**)
- Howard Lindzon: "The markets are always open, but they work just as well without you" (**Howard Lindzon**)
- There’s always a tug of war between fear and greed in the mind of most investors. Lately, greed is gaining (**St. Louis Post Dispatch**)
- The bull market from '09 only looks easy with a severe case of hindsight bias (**Reformed Broker**)
- How to manipulate people into saying ‘Yes’ (**NPR**)

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