Why One Legendary Investor Is More Worried Than Ever

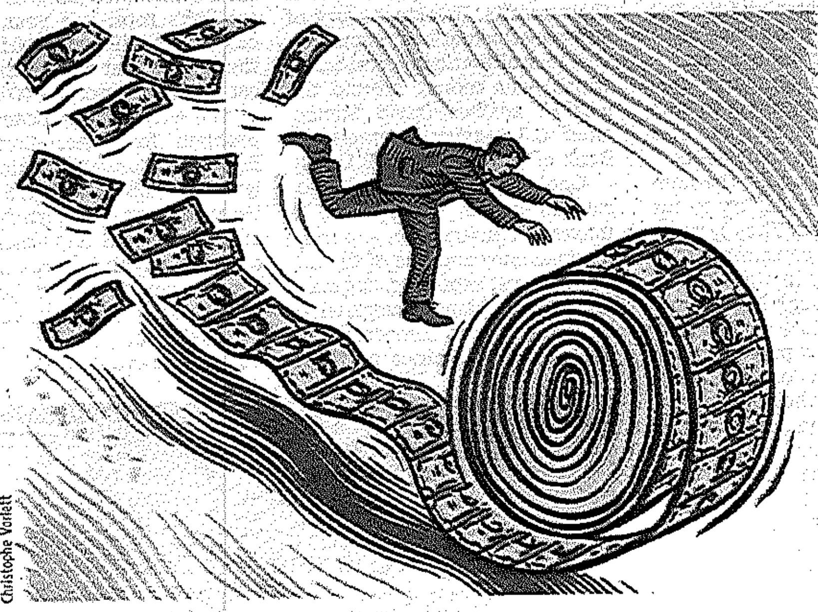
BY JASON ZWEIG

Seth Klarman is worth listening to, especially when markets go mad.

Mr. Klarman is president of the **Baupost Group,** an investment firm in Boston that manages $22 billion. His three private partnerships have returned an annual average of around 19% since inception in 1983—and nearly 17% annually over the past decade, as stocks went nowhere.

To measure Mr. Klarman's importance as an investor, you need only see the value his rivals place upon his words. You could have earned at least a 20% average annual return since 1991—better than twice the performance of the market—merely by buying and holding Mr. Klarman's book, "Margin of Safety": Published that year at a cover price of $25, hard copies now fetch up to $2,400.

But the professorial Mr. Klarman speaks in public about as often as the Himalayan yeti. He made an exception last Tuesday, when I interviewed him in front of a standing-room-only crowd of 1,600 financial analysts at the CFA Institute annual meeting in Boston. He then made another exception, speaking with me over the phone later to clarify points that he feared had been misconstrued.



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Mr. Klarman specializes in buying securities that nauseate other investors. As the credit crisis exploded, he put more than a third of his assets into high-yield bonds and mortgage-related securities. I asked him what he had meant, in a recent letter to his clients, when he compared the financial markets to a Hostess Twinkie. "There is no nutritional value," he said. "There is nothing natural in the markets. Everything is being manipulated by the government." He added, "I'm skeptical that the European bailout will work."

Some members of the audience gasped audibly when Mr. Klarman said, "The government is now in the business of giving bad advice." Later, he got more specific: "By holding interest rates at zero, the government is basically tricking the population into going long on just about every kind of security except cash, at the price of almost certainly not getting an adequate return for the risks they are running. People can't stand earning 0% on their money, so the government is forcing everyone in the investing public to speculate."

"We didn't get the value out of this crisis that we should have," Mr. Klarman told the audience. "For our parents or grandparents, it was awful to have had a Great Depression. But it was in some ways helpful to carry a Depression mentality throughout their later lives, because it meant they were thrifty with their money and prudent in their investment decisions." He added: "All we got out of this crisis was a Really Bad Couple of Weeks mentality."

You could have heard a pin drop as Mr. Klarman proclaimed, "I am more worried about the world, more broadly, than I ever have been in my career." That's because you can make good investing decisions and still end up with bad results if you reap your profits in currencies that do not hold their purchasing power, he explained.

"Will money be worth anything," asked Mr. Klarman, "if governments keep intervening anytime there's a crisis to prop things up?"

To protect against that "tail risk," said Mr. Klarman, Baupost is buying "way out-of-the-money puts on bonds"—options that have no value unless Treasury bonds plummet. "It's cheap disaster insurance for five years out," he said.

Later, I asked Mr. Klarman what would suggest for smaller investors who share his worries.

"All the obvious hedges"—commodities and foreign currencies, fo example—"are already extremely e pensive," he warned.

Especially gold. "Near its all-tim high, it's a very hard moment to re ommend gold," said Mr. Klarman.

Mr. Klarman pointed out that his own ideas "on bottom-up opportun ties in undervalued securities are more likely to be accurate than my top-down views on what's going to happen in the world at large." In other words, while you might want insure against a disaster scenario, you shouldn't bet the ranch on it.

And, said Mr. Klarman, one of th best ways to protect against a decline in purchasing power is to buy whatever is "out of favor, loathed a despised." So forget about gold or other trendy hedges. Instead, wait patiently for markets—European stocks, perhaps—to get so cheap th they turn most investors' stomachs Then you can pounce.

As Mr. Klarman put it, "Sometimes, when you can't figure out a good defense, the best thing to do to go on offense."

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