

A Response to Lowenstein's Searching for Rational Investors In a Perfect Storm

Seth A. Klarman*

Stock market efficiency is an elegant hypothesis that bears quite limited resemblance to the real world. For over half a century, disciples of Benjamin Graham, the intellectual father of value investing,¹ have prospered buying bargains that efficient market theory says should not exist. They take advantage of the short-term, relative performance orientation of other investors. They employ an absolute (not relative) valuation compass, patiently exploiting mispricings while avoiding overpaying for what is popular and trendy. Many are willing to concentrate their exposures, knowing that their few best ideas are better than their hundredth best, and confident in their ability to tell which is which.

Value investors thrive not by incurring high risk (as financial theory would suggest), but by deliberately avoiding or hedging the risks they identify. While efficient market theorists tell you to calculate the beta of a stock to determine its riskiness, most value investors have never calculated a beta. Efficient market theory advocates moving a portfolio of holdings closer to the efficient frontier. Most value investors have no idea what this is or how they might accomplish such a move. This is because financial market theory may be elegant, but it is not particularly useful in formulating a successful investment strategy.

If academics espousing the efficient market theory had no influence, their flawed views would make little difference. But, in fact, their thinking is mainstream and millions of investors make their decisions based on the supposition that owning stocks, regardless of valuation and analysis, is safe and reasonable. Academics train hundreds of thousands of students each year, many of whom go to Wall Street and corporate suites espousing these beliefs. Because so many have been taught that outperforming the market is impossible and that stocks are always fairly and efficiently priced, investors have increasingly adopted strategies that eventually will prove both riskier and far less rewarding than they are currently able to comprehend.

One of the biggest trends in recent years, indexing, emanates directly from a belief in market efficiency. If the markets are efficient, why try to outperform? Paying minimal commissions and minuscule management fees puts investors two steps ahead of everyone

* President of The Baupost Group, LLC, a private money management firm created in 1982 and now managing \$5 billion; author of numerous articles and *Margin of Safety* (1992); MBA, Harvard Business School; BA in economics, Cornell. Mr. Klarman, a very successful value investor utilizing a low risk approach, has collaborated on previous projects with Professor Louis Lowenstein and was asked by Professor Lowenstein to comment on his Article. Any assertions made in this Comment are based upon Mr. Klarman's own knowledge and personal experiences.

1. See *Great Investors: Benjamin Graham*, at http://www.morningstar.com/classroom/print_quiz/0,3270,3264,00.html (last visited Apr. 2, 2005).

else. Reasonable enough if the market is efficient, but what if it is not?

Decades after market efficiency was first hypothesized, there remains little apparent interest among academics in seriously challenging the theory's precepts. Dozens of professional investors, running value-oriented mutual funds and hedge funds, have achieved stellar records of market outperformance, many with considerably less volatility than the market as a whole. It seems obvious that these professional investors should be carefully studied in order to develop a true and complete understanding of how the stock market works. Are they simply lucky? Are they incurring hidden risks that explain their returns? Or are there systemic factors that enable some investors to reliably outperform? Warren Buffett, the second richest man in the country,² is a value investor; he built his net worth gradually over nearly fifty years of successful investing. Moreover, his net worth continues to grow handsomely. Yet his record is explained away by academics as aberrational! Rather than studying Buffett exhaustively to see what lessons could be learned, academics cling desperately to their faulty theories.

It turns out that this inflexibility of thinking is nothing new. I am intrigued by the observations of a brilliant man who probably would have been an exceptional value investor had he not had something more important to do one century ago. This man was Wilbur Wright, whose aeronautical accomplishments are recounted in James Tobin's *To Conquer the Air*.³ Wright contrasted his family's hands-on approach to learning to fly with the more cerebral efforts of Samuel Pierpont Langley, the Secretary of the Smithsonian in that era, who was generally considered the Wright brothers' most formidable domestic competitor in manned flight.⁴ Wright compared man's first steps toward flight with the more ordinary challenge of riding a horse. He declared:

There are two ways of learning how to ride a fractious horse; one is to get on him and learn by actual practice how each motion and trick may be best met; the other is to sit on a fence and watch the beast a while, and then retire to the house and at leisure figure out the best way of overcoming his jumps and kicks. The latter system is the safest; but the former, on the whole, turns out the larger proportion of good riders. It is very much the same in learning to ride a flying machine; if you are looking for perfect safety, you will do well to sit on a fence and watch the birds, but if you really wish to learn, you must mount a machine and become acquainted with its tricks by actual trial.⁵

So, too, for the stock market. It is easy to study stock tables in solitude from the comfort of your office and declare the market efficient. Or you can be a full-time investor for a number of years and, if your eyes are open, learn that it is not. As with the Wrights, the burden of proof is somehow made to fall on the practitioner to demonstrate that he or she has accomplished something the so-called experts said could not be done (and even he may find himself explained away as aberrational). Almost none of the burden seems to fall on the armchair academics, who cling to their theories even in the face of strong evidence that they are wrong.

2. *Warren Buffett and Postcards From the Bubble*, at http://www.forbes.com/2003/03/10/cx_da_0310topnews.html (last visited Apr. 2, 2005).

3. JAMES TOBIN, *TO CONQUER THE AIR* (2003).

4. *Id.*

5. *Id.* at 122.

In his article, Professor Lowenstein apparently calls for an investigation into the success of leading value investors.⁶ On the whole, his article demonstrates that for the five-year period ending December 31, 2003, a group of value mutual funds spectacularly outperformed the market, making the market seem highly inefficient.⁷ Believers in market efficiency will quibble with Lowenstein's analysis. His selection of ten value managers, although picked by someone else, is tainted because they were chosen *ex post*. For any five-year period, there will, of course, be numerous managers who perform better than the market. Lowenstein's point would be considerably more effective if the managers had been picked *ex ante*, and not after, the period under review.

His choice of the 1999-2003 period will also be problematic for some. While the overall market indices such as the S&P 500 Index were essentially flat during that time frame, this was a highly unusual period. From 1999 to early 2000, large capitalization and especially technology stocks performed particularly well. The Internet bubble was near its peak, and old economy stocks—the apparent losers in the New Economy—were under relentless selling pressure. By 2000, these forces started to reverse, with the market selling off sharply from 2000 to 2002 before rallying sharply in 2003. These upheavals played into the hands of value investors, who, by dint of their disciplined philosophy, were virtually required to invest in inexpensive and undervalued Old Economy stocks as they were being dumped in 1999 and early 2000. Most of these stocks fully recovered their losses and reached new highs over the next several years. Few five-year periods were as heaven-made for value investors as 1999-2003.

One could also quibble with Lowenstein's after-the-fact critique of *Fortune's 10 Stocks to Last the Decade*.⁸ Yes, the stocks on the list performed miserably in the years following the article. Yes, most of the value investors Lowenstein surveyed managed to avoid the names on that list.⁹ But again, there are always some articles that look stupid with 20/20 hindsight. There are always lists of stocks that performed horribly in the past that someone owned and others did not.

On the other hand, the very fact that the stock market was roiled first by an Internet bubble and then by its bursting goes against the efficient market hypothesis. As Lowenstein says, no one could reasonably believe the NASDAQ Composite Index was fairly valued both at 5000 in the spring of 2000 and then barely 1100 only two and a half years later. That the market could experience fluctuations of this magnitude is itself, even if only in hindsight, an argument that the stock market is far from efficient.

What about going forward? Will all the money pouring into super-aggressive hedge funds finally make the stock market efficient? With so many hedge funds, so many people diligently looking to identify mispricings, and so much capital desperate to crowd into even marginally mispriced situations, it might seem that market efficiency will soon be at hand. But it is doubtful that the stock market will ever achieve efficiency.

Let me offer a simple thought experiment. Imagine that every adult in America became a securities analyst, full time for many, part-time for the rest. (With close to half the adults in this country already investing in stocks or mutual funds, this may not be

6. Louis Lowenstein, *Searching for Rational Investors In a Perfect Storm*, 30 J. CORP. L. 539 (2005).

7. *Id.* at 542.

8. David Rynecki, *10 Stocks to Last the Decade*, FORTUNE, Aug. 14, 2000, at 114.

9. See Lowenstein, *supra* note 6, at 544.

quite as ludicrous as it sounds.) Every citizen would scour the news for fast-breaking corporate developments. The numerate ones would run spreadsheets and crunch numbers. The less numerate would analyze competitive factors for various businesses, assess managerial competence, and strive to identify the next new thing. Now, for sure, the financial markets would have become efficient. Right? Actually, no. To my way of thinking, the reason that capital markets are, have always been, and will always be inefficient is not because of a shortage of timely information, the lack of analytical tools, or inadequate capital. The Internet will not make the market efficient, even though it makes far more information available at everyone's fingertips, faster than ever before. Markets are inefficient because of human nature—innate, deep-rooted, and permanent. People do not consciously choose to invest according to their emotions—they simply cannot help it.

So if the entire country became security analysts, memorized Ben Graham's *Intelligent Investor*,¹⁰ and regularly attended Warren Buffett's annual shareholder meetings, most people would, nevertheless, find themselves irresistibly drawn to hot initial public offerings, momentum strategies and investment fads. Even if they somehow managed to be long-term value investors with a portion of their capital, people would still find it tempting to day-trade and perform technical analysis of stock charts. People would, in short, still be attracted to short-term, get-rich-quick schemes. People would notice which of their friends and neighbors were becoming rich—and they would quickly find out how. When others did well (if only temporarily), people would find it irksome not to be participating and begin to copy whatever was working *today*. There is no salve for the hungry investor like the immediate positive reinforcement that comes from making money instantaneously.

A country of security analysts would still overreact. They would shun stigmatized companies, those experiencing financial distress, or those experiencing accounting problems. They would still liquidate money-losing positions as they were making new lows. They would avoid less liquid securities, since those are the last to participate in a rally and hard to get out of when things go wrong. In short, a country full of well-trained investors would make the same kind of mistakes that investors have been making forever, and for the same immutable reason—that they cannot help it.

Hedge funds may have more tools at their disposal. They can go long *and* short. They can leverage. They have the resources to hire the cream of every crop. But going long and short involves risks and even the cream of the crop, the best and the brightest, can make mistakes or become impatient. Hedge funds are big business, and every investment business, be it the stodgiest of old line investment firms or the savviest hedge fund, faces pressure, short-term pressure, to perform. That pressure, from within and from without, dictates that investment firms will always be putting capital to work—even when there is little worth doing.

In addition to solid investment performance, many hedge funds strive for low volatility. While low volatility is pleasing to clients, fulfills marketing promises, and satisfies certain kinds of clients who measure risk this way, this emphasis can become an over-emphasis. At its worst, this results in excessive diversification, technically-based and irrational risk reduction techniques such as stop-loss orders, and, because of the

10. BENJAMIN GRAHAM, *THE INTELLIGENT INVESTOR* (1949).

perceived volatility, avoidance of certain fundamentally attractive investments. Hedge funds tend to avoid investments that are hard to explain to clients. Finally, instead of rationally assessing new developments, they are prone to seizing up in the face of adversity—slavishly gyrating to the dictates of Mr. Market instead of soberly profiting from them. In short, market efficiency is a fine academic theory unlikely ever to bear meaningful resemblance to the real world of investing.

In 1984, Warren Buffett penned an essay entitled *The Superinvestors of Graham-and-Doddsville*,¹¹ making the case that numerous disciples of Benjamin Graham's school of value investing were profiting fabulously, yet independently from each other, by following the precepts of a particular investment philosophy. Even then, it was apparent that there was little, if any, academic interest in understanding and analyzing the astonishing market outperformance of the nine value investors that Buffett examined. How fortunate for the latest two decades of value investors that this was so!

The challenge for academics is simple. Select in advance a group of investors to be studied. Verify with a panel of value investing experts that the individuals to be studied are, in fact, value investors (and not simply those who call themselves value investors). Determine in advance a sufficiently long period over which they will be studied (but not so long that most of them will be retired by the end of the period). Perhaps choose a group of "growth stock" investors to also be examined over the same period. Finally, establish criteria in advance for an analysis of risk, illiquidity, and other considerations which academics are prone to using after the fact to explain away any market outperformance. Then, let the investing begin.

11. Warren Buffett, *The Superinvestors of Graham-and-Doddsville*, HERMES, THE COLUMBIA BUSINESS SCHOOL MAGAZINE (Apr. 1984).