

Excerpts from Baupost Limited Partnerships 2005 Year-End Letter

January 26, 2006

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Today's Market Environment: The Bad News About Value Investing

Here is the bad news about value investing: value investing itself has never been more popular. Fans of Warren Buffett now fill a sports stadium when they flock to Omaha in May for the Berkshire Hathaway annual meeting. Russell "value" stocks have outperformed Russell "growth" stocks for six consecutive years. Now opportunity is scarce; when we sift through the debt, equity, and real estate markets around the world, we find few bargains. Risks are high, returns low, and markets feel picked over and still expensive. While it receives limited attention, the broadly-based Russell 2000 Index has been making new all-time highs, even as better known indices such as the S&P and Nasdaq remain well below peak levels.

The asset allocation world is an increasingly desperate place. Capital freely sloshes across asset classes to those purporting to have uncovered the tiniest market inefficiency or mispricing. This has the effect of bidding up prices, thereby lowering the expected return and raising the risk on individual securities and classes of securities. Some say this reflects investors' acceptance of a lower risk premium; we would call it overpaying.

These days, nearly anyone can start a fund to exploit every real or imagined mispricing, and huge sums are routinely allocated to the best performers until they resist new capital entirely, or accept it at the price of being forced to change their style beyond what has made them successful to date. Investors routinely bid increasingly risky and obscure assets to lower and lower returns, with consideration of risk at best an afterthought. Hungry analysts with a computer model searching for a deal are an unusually dangerous breed.

More than ever before, past performance is not a reliable predictor of future results. The half-lives of many formerly stable businesses seem to have shrunk, as competitive forces unleashed by new technology and freely flowing capital erode barriers to entry. An increasingly vast amount of venture, private equity and hedge fund capital flows not into secondary market purchases of securities, but directly into businesses, increasing competition beyond anything heretofore experienced. The bottom line for investors is that if more competitive capital markets don't get you, more competitive business conditions may.

How do we respond to such an environment? With difficulty and trepidation, would be the short answer. We are not so brazen as to believe that we can perfectly calibrate valuation; determining risk and return for any investment remains an art, not an exact science. Should we accept a lower return than we used to in order to buy a bankrupt bond, corporate spinoff or half-empty office building? If we don't, we may be forced to sit on a growing pile of cash, perhaps for a very long time, betting that the markets will revert to historical levels of

valuation. If we do, we will be betting that times have changed, that investing to earn a barely adequate return is better than not investing at all.

Rather than ratchet up risk, our approach has been to hold cash in the absence of opportunity, accepting a minor diminution in expected return where, and only where, the historic returns have been particularly outsized for the risk. There was never any logic, for example, behind the consensus industry annual return targets of 20% or more on bankrupt bonds or private investments. At times, an expected 15-18% return is ample, given the quality of the underlying assets, the conservative nature of the assumptions made, and the limited spectrum of things that can go wrong. Other times, even a projected 25-30% return might be inadequate, where the quality of the assets is suspect, the return is earned in a risky and unhedgeable currency, and the downside risk is larger than usual. The quality of management must be factored in. The expected duration of an investment may also play a role; a short-duration investment earning inadequate return is over soon, and one can move on to better opportunity. Long-duration mistakes are the gifts that keep on taking, locking you in to low returns, or significant capital losses if you exit early.

Another significant risk faces value investors. Jeremy Grantham at GMO has convincingly demonstrated that all financial bubbles eventually fully correct, and many overshoot to the downside. With valuations still universally high, once markets start dropping, even cautious investors are exposed to the significant risk of getting in too soon. Also, valuation can sometimes involve a degree of circularity – a closed-end fund or holding company trading at a discount, for example – so lower market prices do not always translate into better bargains. If you were clever enough to be out of the stock market in 1929, you might have congratulated yourself as you were picking up the bargains of 1930 30% lower than the year before. But by 1933, you would nonetheless have lost over 70% of your capital. In short, the declines from 100 to 20 and 70 to 20 feel almost exactly the same in terms of the pain experienced, and the debilitating effect on client morale and investor psychology are identical. If we do invest prematurely, as we inevitably will in the next severe bear market, having the correct mindset will be more important than ever. It will take tremendous resolve in the face of extreme markdowns to hold on or even add to positions rather than capitulate along with everyone else.

The Good News About Value Investing

Not all the news is bad. We live in a world where nearly every professional investor, bull and bear alike, is fully invested, with many more than fully invested through the use of leverage. Most feel enormous pressure to act – in order to justify their management fees and to produce good relative performance. Many have stretched to keep their capital at work. This means that the competition for investments may greatly diminish just when better bargains are at hand.

There is also a limit on the likely population of value investors because value investing involves more patience and discipline than many people can muster. Growth stocks, at least, are interesting; even disciplined value investors are sometimes tempted by the excitement that new technology or a rapidly expanding emerging market seems to promise. Also, many so-called value investors are what we would call value pretenders, “buy-the-dips” specialists who buy what’s down but not necessarily what’s cheap. This trading strategy has worked well for a long time, but will disappoint in the next real bear market.

As we said last year, even with vast amounts of capital and throngs of clever analysts chasing opportunity, the markets remain inefficient. This is not because of a shortage of timely information, a lack of analytical tools, or inadequate capital. Markets are inefficient because of human nature – innate, deep-rooted, permanent. People don’t consciously choose to invest with emotion – they simply can’t help it.

Investors cannot change their stripes and will always exhibit characteristics of greed and fear. They will remain biased toward optimism, interested more in how much they can make rather than how much they might lose. They will be interested in relative, rather than absolute, performance. They will want to get rich quick, lured by short-term trading strategies, hot IPOs, and technical analysis, rather than truly undervalued but long-term opportunities. (This is as true, by the way, for clever hedge funds as it is for unsophisticated individual investors.) Then, when things go awry, investors will again overreact, selling urgently what has caused them pain without regard for value.

Institutional investors continue to experience weighty constraints on good performance, ranging from their own gargantuan size, to short-term performance pressures, to the inability to hold cash. They face restrictions, real or imagined, on investing in financially distressed, litigious or highly complex situations; the prudent man standard can be an albatross. They may have a rigid mandate as to asset classes, geography, and liquidity, and thus be unable to take advantage of some potential opportunities. Value investors can take advantage of these institutional constraints by remaining long term and absolute-performance oriented, by flexibly pursuing opportunity across traditional boundaries, and, in a world where almost no one does it, by holding cash when there is nothing better to do.

Macro Worries

While rising interest rates seem to have cooled the housing market a bit, there is, as of yet, little pain. If conditions continue to deteriorate, as seems likely, there will be significant carnage (and perhaps investment opportunity) as a result of diminished affordability, excess supply, and foolhardy loans made to poor-quality borrowers.

Of greater concern: we increasingly suspect the true rate of inflation to be significantly understated. One factor is the government’s use of “hedonic price adjustments” that attempt to measure the value of “quality improvements” in many goods. In addition, the way the U.S. government measures the cost of many items, such as housing, is based on an odd construct that, not coincidentally, shows the result the government wishes for rather than the one we all can observe in plain sight. Housing costs, in the government’s calculation, are based on

imputed rents, which have not been rising even as housing prices have surged in recent years. When we consider the expenses in peoples' lives, computers and home electronics are surely becoming cheaper, but almost everything else – food, gasoline, heating oil and natural gas, healthcare, tuition, tickets to theatre, concerts and sporting events, and services from haircuts to lawn care to legal advice are soaring. If the markets wake up, interest rates will surge, housing will deteriorate even more rapidly, and equities will face heady competition from government bond yields.

Finally, as Northern Trust's Paul Kasriel recently highlighted in the *New York Times*, household borrowing is out of control, and this debt is clearly propping up the U.S. economy. By way of example, in the third quarter of 2005, households spent a record annual rate of \$531 billion more than their after-tax earnings. Historically, consumers regularly earned more than they spent; the recent binge in borrowing for consumption is truly unprecedented. It has (thus far) resulted in consumer spending at a record high 76% share of GDP.

Consumers are using their increasingly valuable homes as quasi-ATMs, extracting \$280 billion of cash through home equity borrowings in the second quarter of 2005 alone. This is a surprisingly new phenomenon; in the last three decades of the 1900s, there was virtually no net home equity extraction by consumers. While we cannot predict how these excesses will play out, it seems clear that such trends cannot continue indefinitely, and that a restoration of fiscal sanity will bring with it wrenching, largely unexpected, and painful adjustments.

The world could well be setting up for considerable upheaval and with it an avalanche of opportunity. As we have said, nearly every investment professional is fully invested, and many are leveraged. With massive trade imbalances and huge U.S. government budget deficits, tremendous leverage everywhere you look, massive and unanalyzable exposures to untested products like credit derivatives, still low interest rates, rising inflation, a housing bubble that is starting to burst, and record and unprecedentedly low quality junk bond issuance, there appears to be little, if any, margin of safety in the global financial system. The day of financial reckoning for these and other excesses has been repeatedly put off, creating the illusion that risks are low, when in fact they are enormous and rising. High energy prices, ongoing terrorist threats, and nuclear proliferation add to the vulnerabilities. While we won't hesitate to take advantage of investment bargains we uncover at any time, we are preparing our team to be well-positioned for the emergence of an expanded opportunity set.