

Baupost's Seth Klarman on Risk and "Productive Worrying"

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A Paucity of Worry

Investment success is often made out to be exclusively about return. Investment performance is typically measured, whether by the media or the masses, solely by the magnitude of that single number. One reason is that return is readily quantifiable, while risk cannot be easily measured. While for any investment we know *a priori* that prospective return must be weighed carefully against risk, *a posteriori* we can usually only measure the outcome, and therefore the return earned. Although we can observe what happened, we are unable to accurately measure how much risk was incurred. When people do try to measure investment risk, they typically assess the historic volatility of an investment compared to that of the overall market (known as beta), which derives from capital asset pricing theory. We consider the concept of beta to be irrelevant, both because volatility is not the same thing as risk and because one cannot reliably project past share price patterns into the future. (It is, of course, fortunate for us that others remain so misguided.) We continue to adhere to a common-sense view of risk—how much we can lose and the probability of losing it. While this perspective may seem oversimplistic or even hopelessly outdated, we believe it provides a vital clarity about the true risks in investing.

When Baupost considers risk, we evaluate both company specific risks, such as an earnings shortfall or increased competition, and market risks, such as those caused by geopolitical upheaval, an unexpected recession, or a currency crisis. When conditions are generally benign, with markets perhaps even shrugging off bad news, investors tend to forget just how much they can lose and are lulled into sleeping well when they should be tossing and turning. While the recent absence of calamity is not necessarily a sign of impending disaster, neither is it a reason to project only blue skies ahead. After all, financial disasters, like natural disasters, can strike without warning.

Most professional investors face significant pressure to generate return in the near-term. They believe their clients demand it. Their internal incentives encourage it. Their psyches need it. Few investors are comfortable taking a truly long-term point of view, no matter how compelling the opportunity, because their results are measured in the very short-run. While others attempt to win every lap around the track, it is crucial to remember that to succeed at investing, you have to be around at the finish. What matters is not who performs best during sequential short-term intervals, but the attainment of a successful long-

term, risk-adjusted, cumulative result. Oddly, risk moves to the forefront of investor consciousness only when things are already going badly. Losing money is perhaps the only thing that makes most investors worry about losing money. With so much pressure for competitive short-term performance, worrying about what can go wrong may seem like a luxury. Ironically, when almost no one is focused on the downside, even a minor increase in investor perception of risk can trigger dramatic market declines.

While we believe it is crucial to worry about what can go wrong, unproductive worrying will not and cannot make a difference. Worrying that your favorite team will lose is obviously unproductive. Worrying that you might have an ulcer could even prove counterproductive. Productive worrying, on the other hand, enables you to identify action that reduces or eliminates the source of concern, often at little or no cost. Concerned that it might rain? Pack a raincoat and umbrella. Worried you will be late? Leave earlier than originally planned.

Successful investing goes hand in hand with productive worrying. Worried that a stock you hold might fall sharply? Reduce your holdings or buy some puts. Concerned that interest rates may rise or the dollar fall? Establish an appropriate hedge. Worried that the stock you bought on a tip might be a bad idea? Sell it and move on. Worry enough during the day and you can, in fact, sleep justifiably well at night.

All of us are subject to biases that can impair our objectivity in investment decision-making. Striving to overcome these biases is crucial for long-term investment success. Have we been too optimistic in our assumptions? Have we blindly ignored new information because we are clinging too tightly to our original thesis? Have we held onto an investment because it keeps going up, irrationally ignoring that it has become overvalued? Without a healthy dose of reflective worry, we are unlikely even to identify our lapses in judgment, let alone correct them. In other words, only by actively, productively, relentlessly worrying about what can go wrong can we maximize the odds that things will go right, by doing everything within our control to perfect our decision-making. You rarely, if ever, make money from worrying; it does not typically enhance return. But by avoiding loss, you are able to hang on to what you have accumulated, which is a cornerstone of successful investing.