

3 Key Takeaways from Seth Klarman's 2013 Letter

[% oldschoolvalue.com/blog/investing-perspective/klarman-2013-letter/](http://oldschoolvalue.com/blog/investing-perspective/klarman-2013-letter/)

Seth Klarman of [Baupost](#) is clearly skeptical of two big themes today. (Check out notes from his 2013 annual letter [here](#) and [here](#).)

1. The bull market in the U.S.
2. The opportunity mindset in Europe.

Remember that his approach and views are freakishly spot on.

Two obvious ones include avoiding the Internet bubble in 1999 and the 2008 crisis.

Klarman isn't just a smooth talker though. He walks the walk.

During the "lost decade", Baupost obliterated the averages, returning 14.8% and 15.9% for the 5 and 10-year periods ending December 31st versus -2.2% and -1.4%, respectively, for the S&P. – Outstanding Investor Digest

While everyone was freaking out during the 2008 crisis, this is what Klarman did.

During the crisis in 2008, Baupost lost "between 7% and the low teens." Still though, he certainly outperformed the market indices and much of his investment management brethren in a time of panic. – [MarketFolly](#)

When Klarman talks, you should listen.

So based on the latest annual letter, here are 3 key takeaways you should know and the implications involved.

Key Takeaway #1

"If you're more focused on downside than upside, if you're more interested in return of capital than return on capital, if you have any sense of market history, then there's more than enough to be concerned about"

Brilliant.

This is related to what Bruce Greenwald means when talking about [earnings power value](#).

If a business is unable to generate more cash than what it needs to operate (or reproduction cost), then it's just earning enough cash to sustain itself.

This is a tricky comparison.

According to simple metrics, such as return ON capital, the company may be making a killing. But this

difference is going to make many investors pour money into overvalued assets and taking on unnecessary risks.

Key Takeaway #2

“Fiscal stimulus, in the form of sizable deficits, has propped up the consumer, thereby inflating corporate revenues and earnings. But what is the right multiple to play on juiced corporate earnings?”

Warren Buffett said that “probably the best single measure of where valuations stand at any given moment” is the Wilshire Total Market Capitalization divided by the US GDP.

As of March 12th, the total market cap highlights a significant overvaluation at about 117.2% of the last reported GDP.

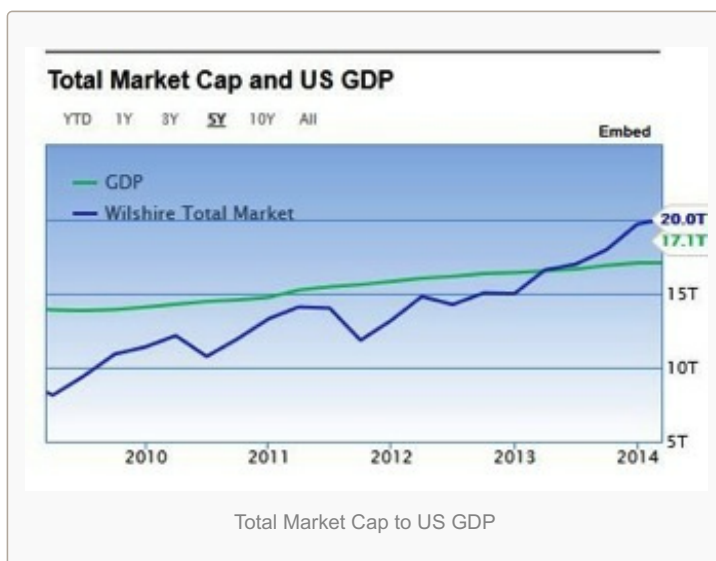
This implies a 1.6% return a year going forward.

Another frequently used tool is the [Shiller P/E](#).

Right now, the Shiller PE reflects a value that is 54.5% higher than the historical mean, also implying a return of 1% for next year.

So what is the right multiple to play on juiced corporate earnings?

The question that Seth Klarman poses is one to reflect upon. As investors look at all the profits taken in recent years, their mouths could be watering. Is the expensive price justified to enter now at the market?



Key Takeaway #3

“On almost any metric, the U.S. equity market is historically quite expensive. A skeptic would have to be blind not to see bubbles inflating in junk bond issuance, credit quality, and yields, not to mention the nosebleed stock market valuations of fashionable companies like Netflix, Inc. and Tesla Motors Inc.”

Look at the yield spreads between high yield bonds and the Treasury spot curve at the moment.

We’re really close to historical low digits, and the spread is 7.25%.

Without question, QE has initiated a search for yield that impacted nearly every market available to investors.

Now look at what this environment is doing to the valuation of actual companies.

Klarman called out two specific companies and grouped them as “nosebleed stock market valuations”

1. Netflix (NFLX)
2. Tesla (TSLA)

Check out the valuation numbers for NFLX and TSLA which is only going to exemplify Klarman’s example. I’ll come up with a raw estimate of its intrinsic value. Numbers are from the [OSV Stock Analyzer Software](#).

The numbers I'm about to show you are raw numbers without adjustments for predicting "future" growth. Even slight adjustments don't help these two companies to justify their current price.

Netflix (NFLX) Intrinsic Value and Valuation Ratios

Tesla (TSLA)

Intrinsic Value and Valuation Ratios

Now check out Tesla.

The Trend is Your Friend Until it Isn't

Check the numbers above again. Klarman isn't exaggerating.

The old adage "the trend is your friend until it isn't", is closer than any given point in the past 5 years.

As a value investor, take the market's optimism with a grain of salt. Use common sense, patience and diligence to protect your capital while achieving satisfactory returns.

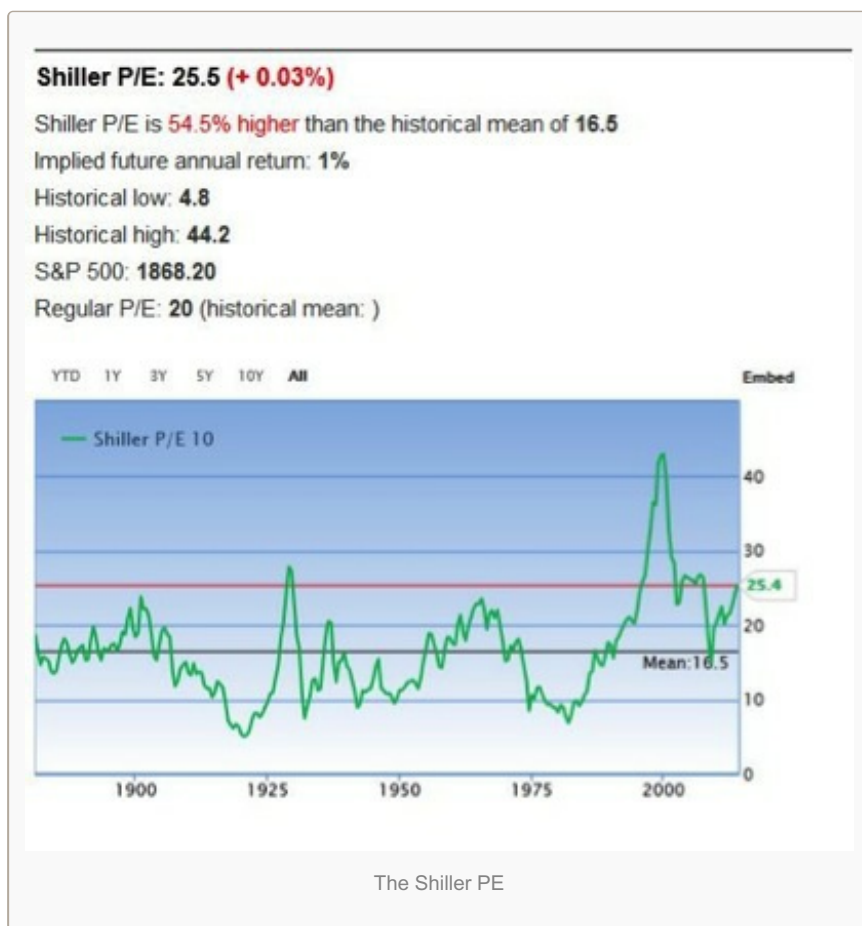
Not the other way around.

Howard Marks wrote in one of his [memos](#);

We must strive to understand the implications of what's going on around us.

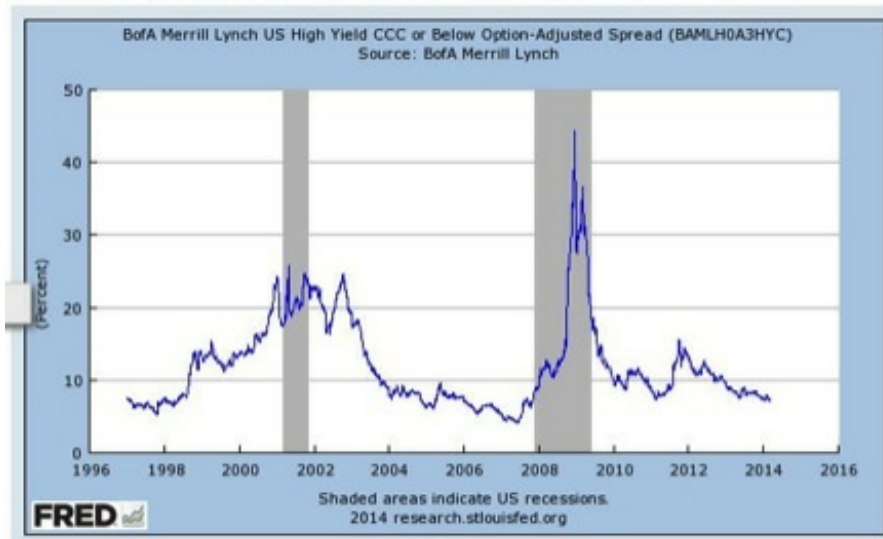
When others are recklessly confident and buying aggressively, we should be highly cautious; when others are frightened into action or panic selling, we should become aggressive.

What about you? Where are we at now?



BofA Merrill Lynch US High Yield CCC or Below Option-Adjusted Spread (BAMLH0A3HYC)

2014-03-11: **7.25** Percent Last 5 Observations
Daily, Close, Not Seasonally Adjusted, Updated: 2014-03-12 7:51 AM CDT



Valuation

| | | |
|--|----|---------|
| Current Price | \$ | 405.99 |
| NCAV | \$ | (17.06) |
| Total Net Reprod. Cost | \$ | 37.82 |
| Earnings Power Value (EPV) | \$ | 77.20 |
| Discounted Cash Flow (DCF) | \$ | 12.06 |
| EBIT Multiple Valuation | \$ | 76.58 |
| Katsenelson Absolute PE | \$ | 423.86 |
| Ben Graham Formula | \$ | 106.75 |

Margin of Safety

| | |
|--|---------|
| | -100.0% |
| | -100.0% |
| | -100.0% |
| | -100.0% |
| | -100.0% |
| | 4.2% |
| | -100.0% |

NFLX Intrinsic Value Ranges

| Netfix, Inc. (NFLX) 3/21/2014 | | %old school value | | | | | | | |
|---|--|-------------------|--------|--------|---------|----------|----------|--------------|--------|
| Enter Ticker Refresh | | 2010 | 2011 | 2012 | 2013 | TTM | Min | Median | Max |
| P/E | | 60.53 | 20.75 | 329.62 | 179.54 | 219.48 | 20.75 | 34.92 | 329.62 |
| P/E (cash adjusted) | | 58.35 | 17.22 | 286.00 | 168.86 | 208.80 | 17.22 | 26.76 | 286.00 |
| EV/EBITDA | | 15.46 | 3.53 | 2.91 | 7.89 | 9.70 | 2.91 | 6.06 | 15.46 |
| EV/EBIT | | 33.49 | 11.31 | 101.17 | 97.30 | 117.98 | 11.31 | 24.84 | 163.31 |
| P/S | | 4.50 | 1.46 | 1.57 | 4.61 | 5.64 | 1.41 | 1.72 | 5.64 |
| P/BV | | 33.56 | 7.30 | 7.59 | 15.13 | 18.50 | 3.95 | 7.30 | 33.56 |
| P/Tang BV | | 90.49 | -11.61 | -7.43 | -26.64 | -32.57 | -32.57 | 5.54 | 90.49 |
| P/CF | | 20.77 | 5.52 | 5.46 | 11.86 | 14.50 | 1.31 | 6.77 | 20.77 |
| P/FCF | | 82.05 | 25.65 | -84.42 | -907.47 | -1109.24 | -1109.24 | 25.65 | 91.48 |
| FCF/S | | 5.5% | 5.7% | -1.9% | -0.5% | -0.5% | -1.9% | 5.1% | 20.5% |
| FCF Yield | | 1.2% | 3.9% | -1.2% | -0.1% | -0.1% | -1.2% | 2.8% | 14.6% |
| Magic Formula Earnings Yield | | 3.0% | 8.8% | 1.0% | 1.0% | 0.8% | 0.6% | 4.0% | 8.8% |
| ROE | | 55.4% | 35.2% | 2.3% | 8.4% | 8.4% | 2.3% | 15.6% | 58.2% |
| ROA | | 16.4% | 7.4% | 0.4% | 2.1% | 2.1% | 0.4% | 8.6% | 17.0% |
| ROIC | | 71.0% | 22.8% | 1.8% | 6.4% | 6.5% | -123.8% | 71.0% | ##### |
| CROIC | | 48.8% | 17.5% | -4.3% | -1.1% | -1.1% | -167.6% | 48.8% | ##### |
| GPA (Gross Profitability to Assets) | | 82.0% | 37.9% | 24.8% | 23.9% | 23.9% | 23.9% | 60.7% | 86.9% |
| Book to Market | | 3.0% | 13.7% | 13.2% | 6.6% | 5.4% | 3.0% | 13.7% | 25.3% |

Dashboard Statements Statements% Ratios Quality Inventory Charts Competitors DCF Valuation Graham Value

NFLX Overvalued Valuation Ratios | Click to Enlarge

Valuation

| | | |
|--|----|---------|
| Current Price | \$ | 228.89 |
| NCAV | \$ | (3.93) |
| Total Net Reprod. Cost | \$ | 15.04 |
| Earnings Power Value (EPV) | \$ | (14.00) |
| Discounted Cash Flow (DCF) | \$ | 4.16 |
| EBIT Multiple Valuation | \$ | 18.34 |
| Katsenelson Absolute PE | | #DIV/0! |
| Ben Graham Formula | \$ | 45.62 |

Margin of Safety

| | |
|--|---------|
| | -100.0% |
| | -100.0% |
| | -100.0% |
| | -100.0% |
| | -100.0% |
| | 0.0% |
| | -100.0% |

TSLA Intrinsic Value – Overvalued

| Tesla Motors, Inc. (TSLA) 3/21/2014 | | %old school val | | | | |
|---|--|-----------------|---------|---------|----------|----------|
| Enter Ticker Refresh | | 2010 | 2011 | 2012 | 2013 | TTM |
| P/E | | -9.28 | -10.62 | -9.32 | -235.12 | -369.39 |
| P/E (cash adjusted) | | -8.64 | -9.52 | -8.81 | -223.69 | -358.31 |
| EV/EBITDA | | -10.32 | -11.52 | -10.83 | 318.17 | 518.29 |
| EV/EBIT | | -9.18 | -10.64 | -10.00 | -445.89 | -726.73 |
| P/S | | 12.27 | 13.23 | 8.94 | 8.64 | 14.00 |
| P/BV | | 6.92 | 12.06 | 29.61 | 26.09 | 42.27 |
| P/Tang BV | | 6.92 | 12.06 | 29.61 | 26.09 | 42.27 |
| P/CF | | -14.90 | -53.56 | -29.24 | 52.78 | 85.53 |
| P/FCF | | -8.52 | -8.65 | -7.31 | -2793.27 | -4526.03 |
| FCF/S | | -143.9% | -152.9% | -122.3% | -0.3% | -0.3% |
| FCF Yield | | -11.7% | -11.6% | -13.7% | 0.0% | 0.0% |
| Magic Formula Earnings Yield | | -10.9% | -9.4% | -10.0% | -0.2% | -0.1% |
| ROE | | -74.5% | -113.6% | -317.7% | -11.1% | -11.1% |
| ROA | | -40.0% | -35.7% | -35.6% | -3.1% | -3.1% |
| ROIC | | -76.3% | -105.2% | -102.2% | -4.5% | -4.4% |
| CROIC | | -83.6% | -129.1% | -130.4% | -0.7% | -0.7% |
| GPA (Gross Profitability to Assets) | | 8.0% | 8.6% | 2.7% | 18.9% | 18.9% |
| Book to Market | | 14.5% | 8.3% | 3.4% | 3.8% | 2.4% |

Dashboard Statements Statements% Ratios Quality Inventory Charts Competitors

How much "future" growth are you really paying for? | Click to Enlarge