Barron's Interviews: "The Value Hunter --- Seth Klarman Searches for Bargains in a Sky-High Market"

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SETH Klarman is a diehard member of that vanishing breed known as value investors. He believes, in the classic definition of value investing, in buying a dollar's worth of assets for 50 cents. Although somewhat tender in years, Seth is wise in the ways of the business world and the financial markets and his investment vehicle, the Baupost Group in Cambridge, Mass., boasts a sterling track record. While he professes to ignore both the economy and the stock market in his hunt for superior returns, he concedes that the abundance -- or absence -- of inviting investments often reflect whether share prices generally are too high. Although he's heavily in cash, as he has been all year, Seth still has a few special situations that he considers attractive buys now. What his thoughts are on the current investment scene and how he approaches prospective commitments are laid out in his clear and cerebral fashion in the Q&A that follows.

BARRON'S: Seth, why don't we start with the usual boiler plate: What attracted you to the investment business?

Klarman: I've always been interested in the market.

Q: The first words out of your infant mouth were: "Buy at the market."

A: I noticed a column of numbers in the papers, and I was always mathematically inclined. So I was interested. I traded my first stock when I was 10.

Q: What was the stock?

A: Johnson & Johnson.

Q: You should have held it.

A: I did pretty well. I bought one share. Completely as a surprise, it split 3-for-1 the next day.

Q: Don't tell us. You had inside information.

A: My first real education in investing came when I took a summer job in my junior year at college with Max Heine and Mike Price at Mutual Shares. They invited me back to join them in January of '79. I worked there about 20 months until I left for business school. Just before graduation, I was offered the opportunity to join with several individuals who had decided to pool their assets and helped to form the Baupost Group to steward those assets. That was 9 1/2 years ago.

Q: Are your partners still around?

A: These people are all still involved. They were never active day to day.

Q: The best kind.

A: They are wonderful partners.

Q: Daily inactives is the way we refer to them.

A: They are on the board of the company. They are partial owners of the company. And each of them has all of his liquid investable assets here, as do all the principals, all the people who run the money.

Q: How much money do you manage?

A: A little bit over $400 million.

Q: And how much did you start with 10 years ago?

A: $27 million.

Q: Do you call yourself a hedge fund?

A: No. We do not. We are compensated somewhat like hedge funds but do not hedge in the sense of always being long and short. We tend to be long investors. We are rarely on the short side.

Q: Is this institutional money you're managing?

A: All individual money.

Q: It's really unusual to have that much individual money -- or, come to think of it, for individuals to have that much money!

A: That's a pleasant problem for them. We set out at the beginning to be somewhat unconventional, with our clients acting as board members and as part owners. The incentive really was to do whatever it took to maximize the return on their money, not necessarily to grow a profitable business. Along the way, some decisions were made, including one to turn down most of the people who tried to become clients. We actually closed for new clients about five years ago. And we have grown from compounding ever since.

Q: So basically, you're saying, a group of people got together, most of whom are not active managers, pooled a certain amount of money, and you're managing it. Is that right?

A: That's right. And over the years we have grown through word of mouth. In the earlier years, we grew beyond the initial three families, for a couple of reasons. One was that they had some friends who liked the idea of what we were trying to do and wanted to come in. They are the kind of people who say yes to friends. And also partly because we didn't want to be overly dependent on any one person for the success of our business going forward.

Q: Seth, is this a royal, editorial -- or what kind of -- "we"?

A: It's "we" the five of us. There were the three families and I had a partner who was a part-time person who focused primarily on administrative matters.

Q: Essentially, you're the portfolio manager.

A: Yes, since we started.

Q: That is a heavy burden.

A: Some days heavier than others.

Q: How have you done?

A: The compound return to investors after our profit-sharing arrangement has been 20%-25% in the limited partnerships.

Q: That is 20% and 25% a year?

A: A year, over the 8 3/4 years the partnerships have been in existence.

Q: That is not bad at all.

A: And the largest one did the best.

Q: You mentioned several partnerships. Are they cloned, are the stocks in the various portfolios the same?

A: Not exactly the same. We started out with three families who wanted to solve all their financial problems, not just . . .

Q: You mean their rent was too high, that sort of thing?

A: Each of these people had gone from being well-to-do, but with illiquid assets, to well-to-do with liquid assets. They sold a TV station, they sold a personal business and so forth. And I think they correctly perceived that they could spend a lot of their time clipping coupons, collecting dividends, making sure that all the numbers were right. And it could become, if not a full-time job, at least one that consumed a substantial amount of their time. And these were the kind of people who didn't want to spend all their time just counting their money and paying attention to such details. So they pooled it to form Baupost.

Q: And how did you . . .

A: One of the things that they also wanted to do was to have only one person, one entity, worrying about their money. So, when one of them said: "I really like to play it very cautious with this part of my money," another one said, "Couldn't I take some chances with this part of my money?" We realized we couldn't do all that with one vehicle. We wanted to do partnerships. We don't think managing individual accounts is very smart in terms of the amount of time it takes to allocate. And some of the things that we do are quite illiquid, and you couldn't really allocate fairly when it doesn't trade every day. So, we formed a couple of different partnerships with somewhat different objectives. But there is one investment philosophy: value investing. The partnerships particularly differ in terms of the illiquidity that they will bear or in terms of the concentration, how diversified they will be.

Q: How have you done during stressful periods? Let's say 1987?

A: I would argue a little bit about the definition of stressful periods. Because I will tell you I get more stressed when the market is running up than when it is running down.

Q: But, let's take the conventional view of stress, when stocks decline and you are not short.

A: We have historically done very well in down markets. Our general predisposition is that we ought to run our money as if it is our own. And in fact it is our own. As I said, each of the people that work here has his money invested, as well. So we tend to only make investments when we think there is a compelling opportunity being presented. And often we will hold a third or half in cash or even more, awaiting such opportunities. As a result, while we do not do any allocation based on our view of the macro economy or top-down view of the market, by looking bottom-up for opportunities and failing to find them, that tends to self-regulate.

Q: In what way, precisely?

A: When the market gets expensive, we tend to find fewer things. In 1987, we were between 40% and 50% in cash going into the Crash on Oct. 19. That put us in the pleasant position of not getting too clobbered. Much of what we owned at the time was not in market-sensitive securities, either. If I remember correctly . . .

Q: Not market-sensitive securities? They don't trade?

A: Not that they don't trade. For instance, one of our largest positions was in the senior bonds of Texaco in bankruptcy. And they certainly dropped. They didn't drop as much as the market. And they quickly worked out and bounced back. We had a few other positions that were similarly cash-rich, or something like that. Where the short-term hit was not too bad, and they quickly bounced back. So, we actually recovered all of our losses from October '87 by year-end, give or take a fraction of a percent.

Q: Have you had a down year?

A: No.

Q: From what you just said, we assume you are not cash-averse at all.

A: No, we will certainly at any point let it go as high as 100%. At the moment, we are definitely not cash-averse. We are approximately half cash right now.

Q: Looking at today's market, we guess the other half of you can enjoy it.

A: This will be a unique interview because neither the person asking the questions nor the person answering them knows anything about what is going on. We are blessed with a client base that is not short-term-oriented. I don't think any money manager knows how deep the reservoir of client goodwill is.

Q: A lot of them found out last year.

A: Yes. We have not gotten the kinds of calls that people might when there has been a defacto run on the market. Our clients, many of them, are individual businesspeople and have made their own money. They call up and encourage us to maintain the kind of conservative posture that we have. And, in fact, they often say: "Let me know if you ever decide to change because we want out if you do." So we are very lucky that when we feel that there is nothing to do, the clients are supportive of that.

Q: Certainly sounds like a friendly group, anyway. Typically loyalty stops at the color green. Can we take it you stopped accepting new money because you think there is only a certain amount of money you can efficiently manage?

A: That is a fair way to put it. There are dis-economies of scale in terms of the returns that can be earned on managed money. That probably kicks in a lot smaller than we are. It probably kicks in at $50 million or $100 million. But over the realm of all possible sizes, you just don't want to get beyond a certain level, particularly when you have an eclectic strategy like ours. There is only so much that you can buy that fits our kind of criteria. And we are comfortable at our current size.

Q: So this is pretty much a matter of feel?

A: That's right. I think we also want to stay small because it is frankly more fun. We enjoy the camaraderie of being a small firm with everybody doing work, and everybody understanding pretty much where we are going. The last thing I want to be is manager of a staff of a dozen analysts and portfolio managers. I wouldn't like that at all.

Q: You talk about value investing. Which can mean almost anything. And what it has meant in recent years for most people is a lack of return. How do you define value investing?

A: I was waiting for you to ask.

Q: This is known as a soft, hanging-curve-ball question.

A: Atlanta could have used one Sunday night. We define value investing as buying dollars for 50 cents, somewhat like Mike Price's definition.

Q: Or everybody else's.

A: That is a favorite phrase. We certainly don't stick to it rigidly. We will buy dollars for 40 cents, or dollars for 60 cents when they are attractive dollars to buy. I think that we implement it a fair bit differently than many value investors or many so-called value investors who frankly I'm not sure are buying good value at all. Value to some extent is in the eye of the beholder. It is very hard to pin down what the value of a future set of cash flows from a business, be it cable TV or biotechnology, is going to be. Some are easier to predict than others. But it is very hard to predict what those future cash flows are going to be. And it is very hard to ascertain the correct discount rate to bring them back to the present with.

Q: Fine, but tell us not how difficult it is to define, but what you consider value.

A: When we look at value, we tend to look at it on a very conservative basis -- not making optimistic forecasts many years into the future, not assuming growth, not assuming favorable cost savings, not assuming anything like that. Rather looking at what is there right now, looking backwards and saying, Is that the kind of thing the company has been able to do repeatedly? Or is this a uniquely good year, and is it unlikely to be repeated? We tend to look at hard assets as much as possible.

Q: Like . . .

A: For instance, cash is something we understand. When a company has cash on the books, or marketable securities on the books, we think we understand that. And the more you get into businesses that depend on things going right in the future, the harder we find it to understand it. So we tend to buy asset-rich businesses, very predictable businesses. But perhaps most important, we are not just focusing on equities. We focus on any security of a company that is mispriced. We can even find some companies where one security, like the equity, is overvalued, but where another security, like the debt, might be undervalued. We have flexibility in our partnership agreement to do pretty much anything we like. Right now, and for the better part of the last two years, much of our investment has been in the senior securities of overleveraged companies.

Q: Junk bonds?

A: Well, junk bonds, or in most cases, fallen-angel bonds. And in some cases, bank debt.

Q: There was a time, not very long ago, when everyone was a value investor.

A: In the mid-to-late 'Eighties, you had this explosion or proliferation of investors in what I would call private market value, which is a very dangerous term. They don't call themselves value investors. But I think there was both a self-fulfilling prophecy going on and a circularity to it. If some body did a takeover, they said that is the private market value; it didn't matter if that person knew what they were doing or not. It didn't matter if they were using a lot of leverage that might become unavailable some day -- like now. So the private market values that people were touting and using and were in fact projecting forward, such that Company X has a private market value of $50 today, $60 next year, and $100 in three years, were just ludicrous. In my view, predicting future private market value is like predicting future Dow Jones levels: It simply doesn't make any sense at

Q: Many of the people who did this, in fact, had absolutely no idea of what a business is. Period. They talked about private market value, meaning essentially what a businessman would pay for something. It was a Wall Street concept. It had nothing to do with a real, live business, whether private or public.

A: The ultimate irony is that private market value, being defined as what businesspeople would pay, was, in fact, a moot point. There were no businesspeople doing deals because the Wall Street leverage artists had prices way above what prudent businesspeople would pay. We always attempted to define private market value as what we would pay to own a business. It has rarely, if ever, been the level that transactions actually took place at. We could never see ourselves paying that kind of price. Owning a business is not purely a positive, not always great shakes. You are illiquid, you are locked in. Sometimes owning a few shares of stock is vastly superior.

Q: If that period, as you suggest, really was not a value-investing era, you really shouldn't knock it -- it created opportunities for you.

A: What creates opportunities is an interesting question. Often we do best in turbulent times, especially if we are fortunate enough to be holding cash going in. If you think of the stock market as a cauldron of mine strone soup that occasionally somebody sticks a ladle in and stirs up, it takes a while before all the vegetables float back to the level that they were at before.

Q: We just lost our lunch. But go ahead.

A: Sorry. Depends on what you ate, I guess.

Q: Minestrone soup, of course.

A: When it gets shaken up, mispricings tend to occur much more than when the market has been at the same level for a long time.

Q: Aren't there are a lot of people now doing things that somehow impinge on what you are doing?

A: If you are asking, "Is there more competition in many of the areas that we are looking at?" that is absolutely true. The good news is that first of all, we are flexible enough to not be committed in any single area. Take, for example, distressed securities. In 1985, as far as we can remember there was only one firm doing research in dis tress. That was R.D. Smith. In 1991, we check our faxes and our research reports, and we count 44 firms doing work in that area.

Q: Something like short selling in 1990.

A: Maybe close. So there is no question that there's now a crowd. The research coverage and Wall Street's attention to it have increased probably more than the considerable prolifera tion of opportunities in that area. So we have more competition. But we have flexibility, we also have patience. These people have special-purpose funds to do whatever it is they are doing, to do distressed securities, to do LBOs, whatever their funds are looking for. And when opportu nities cease to exist, they will probably distribute the funds and go out of business. Already, we see many of the arbitrageurs from the 'Eighties disappear and go into new lines of business like distressed securities. As you mentioned, short sellers have started to disappear.

Q: How do you get your ideas?

A: We originate, I would guess, half or so internally. That would mean reading the newspapers, looking at periodicals, looking at Barron's, for instance.

Q: Flattery will get you every thing. Does it help on that score that you have businessmen as partners? Do they suggest things because of their knowledge of their particular businesses?

A: We have had some suggestions from clients. But I don't believe that any have translated into actual investments. I would describe it this way: When you have been doing this for a while, you start to become more proficient about where to look, which rocks to look under. The rocks we look under tend to have a few things in common.

Q: We're afraid to ask, but go ahead.

A: One thing we want to look for is perhaps a market inefficiency or imperfection. And often these are caused by what we would call institutional constraints. The institutions, first of all, because of their tremendous size, and second of all, because many have gotten away from fundamental investing, tend to be prolific creators of opportuni ties. An example of this would be when a large company spins off a much smaller subsidiary and distributes the stock free to shareholders. The institutions tend to be natural sellers of the spinoffs.

Q: Why is that?

A: Either they would have to buy an enormous amount to justify a large position, or they sell. And they sell regardless of fundamentals, regardless of the price compared to the value. So we tend to look at spinoffs as one category. That would be a type of rock that we look under. So when in the newspaper it mentions that such and such a company is considering a spinoff, we will follow the progress of that and look at the registration statement when it becomes available for a possible investment. There are, of course, now people who follow spinoffs, including an analyst at one major firm. So even in that area there might be fewer opportunities than before. Although every so often one slips through the cracks, or one is written up but ignored by most of Wall Street. We do find some opportunities even in overpopulated areas.

Q: How about another type of rock?

A: Another type of rock we would look under would be when securities get downgraded from investment grade to below investment grade, i.e., distressed. In particular, many funds that own these are not permitted to own other than investment-grade securities. So when the downgrade happens, they have to sell, they have no choice, given the rules that they operate under. That may create a short-term supply/demand imbalance. Another opportunity created by selling that is not dictated by fundamentals.

Q: We guess we have a reasonable working knowledge of how you work and reason. So why don't we switch to the way you view the economy and the market?

A: One thing I want to emphasize is that, like any human being, we can discuss our view of the economy and the market. Fortunately for our clients, we don't tend to operate based on the view. Our investment strategy is to invest bottom up, one stock at a time, based on price compared to value. And while we may have a macro view that things aren't very good right now -- which in fact we feel very strongly -- we will put money to work regardless of that macro view if we find bargains. So tomorrow, if we found half a dozen bargains, we would invest all our cash.

Q: Duly noted. So tell us, how do you view the economy and the market?

A: Our particular view of the economy comes from talking to companies. We don't talk to all the companies that we have an interest in. But we talk to many companies. We also talk to a lot of businesspeople, including our clients. We talk to other investors. And our view is that the economy is awful. We also have a large number of anecdotal observations from being in many areas and talking to people in those areas. The Wall Street consensus right now seems to be, first of all, that the problems are all well-known and therefore need not be worried about. That just because there is a decade of oversupply of real estate, just because most of the banks and insurance companies are broke, we don't need to worry about that because it is already well-known and therefore, since the market is efficient, it must be reflected in securities prices.

Q: And what say you to that? As if we didn't know.

A: We believe it is well-known. But we don't believe it is reflected in prices at all. Or in people's actions. In effect, we think we have a market of fully invested bears. Everybody can talk about the problems, but very few investors act on them. That has a lot to do with both the trend towards indexing and, more broadly, the tendency of institutional investors to have to more or less mimic each other.

Q: You feel that the market really is responding here less to economic prospects than to certain investment imperatives?

A: I would say that is our strong belief. I think we have seen a sea change in terms of the way debt is used and accepted in this country. That from World War II to the early 'Eighties, the ratio of debt to GNP was approximately 140%. And over the last five or six years, it has shot up to approximately 190%. That, as Jim Grant will repeatedly tell you, had the effect of not only boosting prices of securities and assets where they could be bought on leverage, but also has had the effect of stimulating consumption in the economy, demand in the economy. If we are to return to more historic levels of debt . . .

Q: A very grim prospect.

A: It is very hard to know how we can get from 190% of GNP back to traditional levels without a severe effect, much worse than anything that we have felt so far in terms of deflation, of declining demand in the economy. We are worried that what we have had up to now is only the tip of the iceberg. That it is only the beginning of the decline that we need to live through in order to get our house back in order. I think we have rarely had a situation where things are as bad as they are and the major institutions that could do something about it, like the U.S. government, like the large investing institutions, like the large insurance companies and banks -- so few of them are in a position to help things along.

Q: None of which has bothered the stock market.

A: The perverse thing is that the market insists on hanging around 3000 and trending higher. This has had a very funny effect. You have seen a large number of overleveraged companies bailed out by a rising stock market, Stone Container, Marriott and many others. The question I would throw at you is: How do you think people would be feeling if instead of the market being 3000, the economy was exactly as it is today, but the market were 1500 or 1200? My guess is that people would be screaming for the government to do something. That, in fact, things would be perceived as bordering on a depression.

Q: In other words, it's a most fortunate, or fortuitous, circumstance that the market's run wild in spite of the economy -- or the economy would be suffering even more.

A: I would say that it is a happy coincidence, that we would all be in much tougher shape in terms of being citizens in this country trying to get by if the market hadn't cooperated. But our view is that it is not a market of fundamentals, but rather a market of institutional pressures, a market of indexing, where the money has been available to go into stocks, and therefore has done so. But, in fact, it is not a market in which intelligent fundamental analysis ascertained that stocks are attractive. Our view would strongly be that, on average, the returns from owning stocks are going to be very dismal over the next five or 10 years.

Q: So, what we have had is not at all a precursor of what we are going to get.

A: That would be our guess, although it is very hard to separate our macro-economic view from wishful thinking, because we would love for the market to go down so we can take advantage of lower prices. Right on page 150 of the current issue of Barron's you find that the Dow Jones trailing P/E is now 29.1 times earnings. The dividend yield is 3%, and the market to book is 225%. Those are not the kinds of numbers that seem to me to be a launching pad for a new bull market. Nor the type of numbers that you would usually see when you are in the middle of a biting recession. Even if you looked at the more broad S&P 500, the P/E is approximately 20 and the dividend yield is about the same, the price to book is actually worse -- 245%. So we cannot be optimistic about the returns from putting money into the stock market in general here.

Q: Well, it's true that this market appears without any visible support from fundamentals.

A: While we don't appear to have the amount of portfolio insurance-type activity we had in '87, I think the market is just as vulnerable to a sudden correction, and a very sharp sudden correction. For one thing, as I said, I think we have a market of fully invested bears. The institutional investors, being short-term and relative-performance oriented, are trying to all beat each other every three months, and hence will react to which ever direction the market is going in. As long as the market is generally flat to rising, they will stay in the market. But if they perceive that the market is going down -- in other words, if the market starts to go down -- they may all decide to get out at once, none of them wanting to be in longer than anybody else. We have put on a few circuit breakers, but they don't address the fundamental problem of professional investors who feel compelled to stay in and hold overvalued securities.

Q: To extend that a bit, the thing you mentioned before, the trend to indexing, which has been so powerful a stimulant on the way up, could be precisely the opposite -- or even magnify the trend -- on the way down.

A: There is no question that indexing exacerbated the market movement upward. If we have a bad year or two it is easy to envision that institutions that had money in indexing might pull it out en masse, exacerbating the decline. The other thing I want to make clear is that when we think the market is overval ued we don't believe it is 5% or 10% or 15% overvalued. What concerns us is when we look at most securities, we wouldn't buy them if they dropped by a quar ter or a third. We think these are substantially overvalued securi ties, or at least are valued a quarter or a third above where they become interesting buys. When people say I want the market to go down so it will create opportunities for me, it sounds like the purpose of market declines is simply to create opportunities for people with cash. We don't believe that. The ironic thing is that the market could decline in our view 750 or even 1,000 points, and might still not be at bargain levels.

Q: The last three major declines -- '87, '89, and '90 -- have been followed by new highs. And so the prevailing attitude is that every drop is an opportunity to buy.

A: I think investors always learn the lessons of the recent past. And that is the lesson. The lesson is that any crash, any decline for any reason, whether it is a war or whether it is a 500-point one-day drop, or whether it is the blowup of a major take over, whatever it might be, is, in fact, a buying opportunity. People are conditioned to buy on any decline, on any bad news. We think that that is the kind of thing that it might take a while for people to be weaned away from by the punishment of having the market not rebound. But to us that helps to explain why, when things are as bad in the economy as we perceive it, the market hangs in there. This may take longer to correct.

Q: The triumph of faith or delusion over reality. Seth, despite the big wad of cash in your portfolio, you're up this year, aren't you?

A: Our funds' return to investors through September is approximately 14%-19%.

Q: And that is with how much cash?

A: It has actually been over 50% until very recently. It has probably averaged between 40% and 50% for the year. We were fortunate to be well-positioned at the beginning of the year with a few major positions in distressed securities that worked out quite well.

Q: What was the lowest cash position you have had in the eight-plus years you have been doing this?

A: We came very close to being fully invested shortly after the '87 Crash.

Q: A great time to be fully invested.

A: We talked a little bit before about value investing in the 'Eighties. I think value investors have had both a significant tail wind and a significant head wind into which they have operated. The tail wind has been all the takeover activity and restructuring activity. In much of the 'Eighties, if you found a stock that was a true bargain, you didn't have very long to buy it before somebody came along and made a takeover offer, or the company went private, or they did something that made the stock go up. That helped value investors for the first half through the mid-to-late 'Eighties. The head wind, though, has been that anybody who has acted with a significant degree of conservatism has been penalized for that. For most of the decade, with the exception of one week in 1987, an investor who stayed fully invested and made somewhat optimistic assessments of things did better than an investor who held a lot of cash or that sold short. At some point caution may actually start to earn a return again. Meaning that the market may come down and vindicate those people.

Q: But what a long time coming! Why don't you tell us some of the situations you like here?

A: Our favorite holdings are Treasury bills -- November, December, January and February. We continue to look closely in the distressed area. We have two major positions in that area I can talk about. There is one I cannot talk about because we are restricted on a creditors' committee. Of the two I can talk about, one is the Federated Department Stores bankruptcy, where we were fortunate enough to be buying senior debt shortly after they filed for bankruptcy 1 3/4 years ago.

Q: Had you some stirrings of anticipation that you would be doing this as you watched Federated flounder and then finally founder?

A: It is funny. We had really strong stirrings. It would be in September '89. Early in September, there was news that Federated was in a lot of trouble. They were going to miss a payment of some sort. We actually came into the office en masse over the weekend and decided that there would be a huge sell-off of their bonds and many other people's junk bonds the next week. And we did a lot of work identifying a list of targets whose capital structure was such that we would be comfortable. So we created a list of potential targets. And we came in the next Monday -- and nothing happened.

Q: You mean the securities you had targeted didn't take gas?

A: Federated and Allied Stores paper sold off a little bit. But really there was none of the carnage in the market that we had anticipated. And it was really only months and months later, beginning right at the end of the year and then into 1990 that the sell-off in junk began. So we were in effect early. But we didn't put much money to work early. Then the Federated bonds fell out of bed after they filed for bankruptcy. And, actually, they sank even lower toward the end of last year. We were fortunate enough to buy a quite decent position in the senior bonds.

Q: You're talking about which senior bonds?

A: These are the bonds, the pre-merger debt, that ranked equal with the bank debt. And at one point they traded down to below 40 cents on the dollar. Which was a level where with $2.4 billion of such claims outstanding, one could have owned all of the senior claims, which in effect controlled the company, for approximately or a bit less than $1 billion. At that point, Federated had $500 million on their books in cash. And they had a substantial operating business with five major chains, and were still in the black, ignoring interest expense. And with significant positive cash flow. So, we felt that we were getting in at bargain-basement levels, and the rebound in the distressed market, and the rebound in Federated results early this year, vindicated our assessment.

Q: The company is still in bankruptcy?

A: They are still in bankruptcy. We expect that they will emerge as early as January or February of next year, if things remain on target. And they will emerge as a profitable company going forward, having repaid the senior debt, depending on how you look at it, at par or perhaps a little bit more.

Q: You will get 100 cents on the dollar?

A: They are saying that you are really getting par plus accrued interest. The reality is that you are getting that much in nominal amount, but the actual workout amount will be a bit less than that.

Q: Where are the bonds now?

A: The bonds now are trading in the mid-to-high 70s.

Q: Do you consider them still an attractive buy?

A: Well, the workout involves getting approximately 45 cents of one senior bond issue and 30 cents of another senior bond. So in effect, if those bonds trade at par -- and we don't think they will trade quite at par -- you would get all your money out in new debt, and then receive a significant amount of common stock of the new Federated. Which at their valuation would be worth another 40-odd cents on the dollar, at our valuation perhaps half that, but still the workout would be substantially more than where the bonds are trading. We think it is a fairly low-risk opportunity. Although, given our views on the economy, it is possible that the results will be worse than planned, and that the stock won't trade as well as people think. Fortunately, we have a quite low-cost basis and are able to see what happens without a lot of risk from here.

Q: Interesting. What else?

A: Another of our favorite ideas -- although it has run up a little bit, it is actually still a reasonable purchase -- is some of the debt of Columbia Gas System.

Q: Another bankrupt.

A: Columbia filed for bankruptcy, I believe, right at the end of July, when they ran into trouble with some gas-purchase contracts that were way above market; they had entered into agreements to buy gas as high as $5 or more per thousand cubic feet and gas was limping along at $1.20 or so. They attempted to negotiate with some of the major suppliers to reduce the price and to give them some new securities. And those kinds of discussions never go very well, particularly when you aren't offering people 100 cents on the dollar, as they were not. And therefore they ended up in bankruptcy. To us this is perhaps most reminiscent of the Texaco situation. There is a major liability whose magnitude has been estimated, but is not completely certain. The value of the assets of the company appears to easily cover all the liabilities, including pre-existing liabilities and the gas-contract liability. One indication of this is that the stock still trades at approximately $18 a share, with 50 million shares out. So even though it is in bankruptcy, there is $900 million equity value to this company. We think the stock market isn't completely crazy, but we would not recommend the stock.

But that price, while the company's in bankruptcy, indicates that there is probably enough value here to pay all the debt, plus accrued interest. If the company turns out to be solvent, and we believe that will be the case, the bonds will receive par plus accrued.

Q: Where are the bonds now?

A: They vary from, give or take, the high 70s up to 90, depending on their coupon and stated maturity.

Q: Which particular issue do you like?

A: One bond that we are holding is the 9s of August '93 that were last seen in the very high 80s. The opportunity there is that we expect the company to emerge from bankruptcy by the maturity date. Perhaps it will take a bit longer than that. But in any case, it would appear likely that the company will simply pay off par plus accrued at that date, and you won't have to guess the value of paper that you might receive; you will be out. They will, in effect, reinstate you and then pay you off at maturity.

Q: Have you figured out what return that would provide from present levels?

A: I haven't run that exact number up to date. And because of its near maturity, you would want to. But the last time I looked at that bond, it was yielding 18% annually and 28% in a one-year bankruptcy. There are other, more illiquid bonds that yielded anywhere from the low 20s to as high as 40%, depending on what assumption you made about what you received. For instance, do you get reinstated and still own a 20-year bond with a nineish-type coupon? Or do you perhaps get new paper that will trade at par? And how fast do you get it? Does it take one year, does it take two years, does it take three years? But with a particularly good workout, some of the longer-dated paper might be even better, especially if interest rates stay low, and the company emerges and is in good shape, as we believe it will be.

Q: What did happen to Texaco's senior securities in and then out of bankruptcy?

A: Texaco was enormously successful, and maybe that is what reminds us of this with wishful thinking. But in the case of Texaco, the bonds traded after the Crash as low as 90, even though they already owed you a full year of coupon. These being Eurobonds, they pay only once a year. And you were able to buy a bond with a claim of, I believe, around 115 for 90. They were accruing at approximately 12%. And in less than one year, they came out of bankruptcy, the bonds actually went to a premium above par, and paid you all accrued interest. So 90 went to 130 in less than a year. That was vastly successful.

Q: And you think Columbia Gas could prove similarly successful?

A: One thing that is interesting about Columbia is that, when I say a return of 18%, this is not as high a hurdle rate that many professional distressed securities players demand. And, therefore, they wouldn't get involved with this. In our view, this is a situation where you are senior not only to the equity, but also to other debt. It is almost inconceivable that you are not fully covered at the price you paid. So when we can put money to work with almost no downside and earn 18% or even more, depending on how long the situation takes to resolve itself, in an environment of 5% and 6% Treasury bills, we actually feel very comfortable.

Q: Do you have still another possible buy here?

A: A classic Graham and Dodd situation. This goes all the way back to the Graham's original conception of networking capital. In fact, he recommended you buy stocks below two-thirds of net working capital. Last fall, we identified a stock that traded at 8% of book value, one-fifth of net working capital per share, had virtually no debt, and positive cash flow. The name of this company is Esco Electronics. ESE. It trades on the NYSE.

Q: Was that a spinoff?

A: Esco was a spinoff from Emerson Electric.

Q: Huge capitalization, even when it was selling for 4 or 5.

A: Actually, not a huge capitalization. A huge business. This is the other thing that is amazing. Here is a business with $500-plus million of sales. It has 6,000 employees who work in over three million square feet of space -- it's hard for me to even imagine how much that is. And yet the total market cap last fall was only about $35 million. And even today it is only around $70 million.

Q: Where is the stock today?

A: The stock is approximately 6 1/2 this morning.

Q: So it really hasn't done all that much.

A: It rallied to 8 7/8 right at the end of the year. And then it has fallen back.

Q: What does Esco do?

A: They are in a variety of businesses. They are a defense company. Their biggest area is defense electronics. They also have some more mundane metal-bending businesses. They have a fair degree of technology -- radar, electronic warfare, anti-submarine. We are not experts in the defense business -- far from it. But when we look at this company, a good part of their business comes from the Hazeltine acquisition. In fact, the company's goodwill also comes from that acquisition. They bought Hazeltine about four years ago for, give or take, $180 million. That is alone $15 per Esco share. So if everything else they have is worthless and Hazeltine is worth 40% of what they paid for it, that explains Esco's stock price right here.

Q: Why did Emerson spin them off?

A: Emerson has a record of earnings growth quarter by quarter for many, many years. They tried to sell Esco. They didn't get any good bids. Or they didn't get what they were looking for. The company had a very high book value, the tangible book value is $26 a share, or about $290 million. The total book value was around $480 million. Emerson would have had to take a loss on the sale, which we think would have interrupted their quarterly earnings comparisons. And they also did not get any attractive bids. So, they took the easy route and just made it disappear.

Q: The entire thing was spun off?

A: They spun off 100%. It was 1-for-20. It was a very small fraction of a share you would have received per Emerson share.

Q: And what kind of balance sheet does Esco have?

A: The best thing of all is that the company was spun off with virtually no debt. I think that, at the time of the spinoff, it had $25 or so million of debt. And their debt is down to $18 million total, including short-term and long-term. And they have $42 million of cash on the books. So in fact, this company has almost $4 a share of cash, or $2.25 a share net of debt.

Q: What kind of earnings do they have?

A: Earnings are tough for this company. They just took a write-off. Maybe we should step back a little bit. At the time of the spinoff, the stated book was over $40 a share. Tangible of $26. They generate approximately $22 million of cash flow just from depreciation and amortization. And they are reinvesting all that in the business. They reported approximate break-even earnings for the quarter before the spinoff. And that appeared to be the kind of level that they were at for a while.

Q: Why?

A: What happened to this company is two things. One is that they have heavy goodwill amortization charges from the Hazeltine acquisition that cost them, give or take, 50 cents a share annually. So if that good will disappeared, they would be reporting earnings of 50 cents. There is a second charge that is also nonrecurring after 1995. When Emerson spun this off they stuck in a $7.4 million-a-year charge for five years. That is called a guaranty fee, which has to do with Emerson guarantying Esco's performance on contracts that existed at the time of the spinoff. Beginning in 1996, that goes away, and that would be another approximately 50 cents increment improving Esco's earnings. They may at some point prepay that if they can work out a fair discount rate with Emerson. And that would obviously be positive for the public perception of the company.

Q: Okay, you mentioned two things.

A: The other problem that Esco had is that they had entered into some fixed-cost development contracts. In fact, way too many of them. And they were having trouble completing these as projected. So they were running into some losses from these contracts. They were also tying up an enormous amount of working capital on these contracts. Esco's high book-value number is partly explained by this excess working-capital tied up into these contracts. If their working capital shrank in line with competitors', based on sales, they would free up, give or take, $6 a share of cash. That process has actually begun. What is going on now is Esco took a write-off in the last quarter, the quarter ended September, of something a bit north of $60 million. The reason for that primarily is the write-off of future losses from these six cost-development contracts. At the same time as they did that, they managed to report vastly higher cash, both from freeing up working capital on those contracts and from settling one disputed contract situation with the U.S. government.

Q: So, what happens to the bottom line?

A: Right at this moment, earnings are not terribly important for this company. We don't expect it, but it is possible they would have additional contract issues, maybe another write-off for some accounting issues. There is one issue related to income-tax accounting. And it would be possible that there would be another $2-a-share loss or so. Actually, I think it might just float through the equity rather than hitting profits, and book value could shrink by an additional $2 a share. After the write-off, this company is still looking at tangible book value of $17-$18 a share. Net working capital is still in the teens. We are not sure whether it is $12 or $14 -- but it is still up there. And the stock languishes at 6 1/2 .

Q: Somehow, we still are waiting for the happy ending to this story.

A: Our assessment is that, over time, the company will continue to free up working capital from these fixed-cost contracts; as they achieve a certain percent of completion, the government then pays them based on pro gress. We would expect that to generate several dollars a share of additional cash over the next several years. They are also gen erating cash from the noncash charge of goodwill.

Q: And earnings?

A: They will start to generate earnings once they are able to take care of the guaranty-fee obligation to Emerson and perhaps prepay that. And our assessment would be that they will be able to redeploy the cash either into more profitable lines of business, into more profitable defense businesses (including international -- which they are looking at, expanding in) and perhaps a share buyback. One interesting thing -- we don't expect this to happen -- but at the current share price of 6 1/2, and given the company's $42 million of cash, they could buy back approximately 60% of the capitalization at today's level, and not have to borrow a nickel to do it.

Q: You're starting to persuade us.

A: There has also been insider buying, which is one of the things we look for. The chairman seems like an excellent manager and we appreciate the job he is doing. We think he is doing all the right things, looking at cash flow, and not worrying about earnings comparisons at this point. And certainly not trying to grow the business. He is trying to do the right things for shareholders. He put some money into the stock both at $3 or $4 and then again at $6 or $7. So, he has put his money where his mouth is. Although we would like him to buy some more.

Q: We suppose you've had this experience before, of buying a stock and seeing it languish.

A: I think every stock we ever bought has done that. We are familiar with that feeling.

Q: It is an extremely intriguing company. It just wore some people out. People who bought it early.

A: That is understandable. Of course, the thing we like about it is we don't know how high it can go. We imagine that if it came into favor the stock could double or triple or more. The key thing for us is we don't think there is a lot of downside. Given the tangible assets, given the cash, given the cash flow, we would be very surprised to lose money over a meaningful time frame here.

Q: Let's get your final pick.

A: The last one is something we have been in for a while and have been frankly disappointed in. We think it is now cheaper than it has ever been since we held it. And the name is Safeguard Scientifics.

Q: Does this mean you have a loss in it?

A: We are approximately break-even. We made our first purchase higher.

Q: More than just opportunity cost?

A: Maybe a small real loss. But it has been a frustrating one. It has also changed its character over time. Because when we first bought Safeguard, the attraction was that it had a large stake in Novell, the local area network company. At the time, you could buy Safeguard and, in effect, get the Novell that they owned for your purchase price and the rest of Safeguard for free. The question was what was the rest of it worth. The rest of it consisted of shares of several other public companies that they had investments in, and a large portfolio of private venture-capital-type situations. The company has sold off much of the Novell and has reinvested it in many of these other smaller businesses. Right now, if you come to it fresh, it looks quite different than it did when we first started. Their Novell position is down to only about $20 million. There are 5.1 million shares of Safeguard outstanding.

Q: Novell has been a spectacular stock.

A: Yes. In fact, I've often joked that it's partially my fault that Safeguard doesn't have more of it still. I have always encouraged this company to sell off the Novell and buy back stock. Novell looked awfully high -- and I have been wrong for three or four years. And the chairman has been right. I owe him on that one. I think, some what regrettably for all of us, they put money into some things that haven't worked out. But recently, they have changed their strategy. They are focusing more on a handful of companies with particular promise. They have gotten out of several of their mistakes. They also had to operate it on a leverage basis, which we didn't believe made much sense, and the company has come around to our way of thinking, particularly with bank debt getting tighter. And they paid off about $30 million of bank debt with some of the proceeds from Novell. They also had to pay taxes on the sale.

Q: So Safeguard now is more wholesome financially. But what about its portfolio, if that's the word?

A: They own approximately 70% of CompuCom, a computer reseller. And the value per Safeguard share of their CompuCom of about 2 3/4 just about explains the entire market capitalization of Safeguard. That is worth about $55 million at current market, and Safeguard's market cap is about $62 million. So just the CompuCom and the Novell alone are worth, at market prices, $15. And the stock is trading at $12.

Q: We assume that isn't the extent of their holdings.

A: In addition to that, they have a number of other businesses, all doing better than they have done over the past several years. They have an interest in something called Coherent, which has recently come into the black; they own 100% of the business. They own a metal-finishing operation that makes about $2.5 million pre-tax. About four or five other meaningful companies -- something called Tangram, which is in the software business. It lets PC users interact with mainframes. Premier, which is just turning into the black; they own almost all of that. Sanchez, which is banking-related software. They also own some warrants in QVC, the home-shopping company, which are worth at market price about $8 million. And several other situations.

Q: Pretty much of a grab bag. How do you define what the company is and what it is supposed to be?

A: One of the things is, to be candid, I don't understand the technology of all their businesses. The company, as I think of it, although not as the IRS thinks of it (because they would become an investment company), is somewhat of a closedend fund trading at a substantial discount.

Q: And investing in what?

A: Investing in information technology. You would be right to say, "Seth, with your view of the market and economy, how could you possibly buy a smorgasbord of technology companies, with the stock market placing a value on businesses like that way above anything you as a value investor would buy?" And I would say, you are absolutely right. But on the other hand, for a portfolio that is 55% or 60% cash and very unexposed to any sort of growth-type businesses, here is the way to buy a smorgasbord of technology companies for less than nothing, just by being exposed to two companies with large market capitalizations -- Novell and CompuCom. They also have some exciting things going on. This company is on the verge of launching a fund that they are going to manage that will invest in various technology things. And they will receive management fees for running that.

Q: This will be a venture fund.

A: A venture fund. I guess the other important thing to say is there has been insider buying here. The chairman, Warren Musser, has bought stock within the past several months. The company also has a history of doing things for shareholders. The insiders are large shareholders. They are the largest group of shareholders, in fact. The company did buy back stock after the 1987 Crash. They have done spinoffs. And they have done rights offerings where they offer their own shareholders an interest in some of their underlying companies at a bargain purchase level. The last particularly successful rights offering was, in fact, in Novell, where Safeguard holders could buy Novell at a couple of dollars a share, and they would have made 50 or 100 times their money or more, by participating. So this is a company attuned to the idea that shareholders should do well if the company does well. And they have managed over time to deliver that value to shareholders. Here is a way to play both their potential upside and their accumulated wisdom in this venture-capital area. And, best of all, pay next to nothing or really pay a negative price, since just two of their investments explain their entire market capitalization.

Q: Why do we have the idea you kind of like the stock? Seth, thanks very much.