

INVESTING IN A DEFLATIONARY ENVIRONMENT

Reference: Interview with Seth Klarman <http://streetcapitalist.com/2008/12/05/seth-klarman-investing-against-deflation/>

In a deflationary environment, assets tend to decline in value.

Buying a dollar at 50 cents may not be a bargain if the asset value is dropping.

Historically, investors have found attractive opportunities in companies with substantial 'hidden assets', such as an overfunded pension, real estate carried on the balance sheet below market value, or a profitable finance subsidiary that could be sold at significant gain. Amidst a broad-based decline in business and asset values, however, some hidden assets become less valuable and in case may become hidden liabilities. A decline in the stock market will reduce the value of pension fund assets; previously overfunded plans may become underfunded. Real estate, carried on companies' balance sheets at a historical cost, may no longer be undervalued. Overlooked subsidiaries that were once hidden jewels may lose their luster.

Value investors need to be cautious and not forget the fact that underlying values can indeed decline.

There are three possible ways to invest if we think that the business value may decline:

Since investors cannot predict when values will rise or fall, valuation should always be performed conservatively, giving considerable weight to worst-case liquidation value as well as to other methods.

Investors fearing deflation could ***demand a greater than usual discount between price and underlying value*** in order to make new investments or hold current positions. This means that investors should let pitches that they would normally select go by.

The prospect of asset deflation ***places a heightened importance on the time frame of investments and on the presence of a catalyst for the realization of underlying value***. In a deflationary environment, if you cannot tell whether or not you will realize underlying value, you may not want to get involved at all. If underlying value is realized in the near-term directly for the benefit of shareholders, however, the longer-term forces that could cause it to diminish become moot.

We should ***increase the margin of safety*** in investments we make. We must also ***stick to areas we are more certain about. Concentrate on areas where the asset values are easier to determine.***

One interesting possibility: there are areas with greater certainty of modeling or immediate catalysts that have been sold off in company with the broader market, presenting an arbitrage of the margin of safety.