



OAKTREE

H O W A R D ' S M E M O S

The Best of...

Memo to: Oaktree Clients

From: Howard Marks

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Re: The Best of . . .



To celebrate 35 years of my memos, I'm thrilled to release this collection of the ones I think are the best.

These memos fall primarily into two categories. Some set out what I consider the enduring truths of investing – from the need for second-level thinking to the importance of risk control, the inevitability of cycles, and the futility of macro forecasting. Others chronicle the most impactful financial events of the last three decades: the dot-com bubble, the Global Financial Crisis, and the sea change in interest rate policy that took place in 2022.

Writing the memos is an absolute joy for me. They serve as the vehicle through which I share my thinking with the investment community, allow me to connect with Oaktree's clients and employees, and serve as my creative outlet. I plan to keep at it.

October 12, 2025



The Route to Performance

October 12, 1990

The Route to Performance is the first memo I wrote. It articulates what would later become a core part of Oaktree's investment philosophy: that long-term investment success is best achieved through a string of consistently good returns and an absence of poor years, rather than by aiming for brilliant successes, getting there in some years and flopping in others.

First Quarter Performance

April 11, 1991

In the first quarter of 1991, markets swung from extreme pessimism toward more reasonable sentiment, leading to excellent performance for sub-investment grade credit. The pendulum-like fluctuation between optimism and pessimism, fear and greed, and risk tolerance and risk aversion remains one of the most dependable features of the investment world.

How the Game Should Be Played

May 26, 1995

Using sports metaphors to illustrate Oaktree's investment philosophy, I describe how our "game plan" is directed at avoiding strikeouts and achieving a high batting average over time, not at swinging for the fences on every trip to the plate.

bubble.com

January 2, 2000

This was the first of my memos to engender any response from readers! It describes the psychology of market bubbles in the context of a dot-com boom that would shortly become a dot-com bust when equity valuations fueled by excessive belief in the "the new, new thing" fell back to earth.

What's It All About, Alpha?

July 11, 2001

In this memo, I reconcile the investment theory I was taught at the University of Chicago with the reality I encountered in the real world. I provide my take on alpha, beta, risk and return, and, most importantly, market efficiency – and the key implications for investors. If you swallow the efficient market hypothesis, you shouldn't be an active investor. But if you ignore it, you're likely to make critical mistakes.

You Can't Predict. You Can Prepare.

November 20, 2001

This is my first memo focused on the importance of economic and market cycles and the limits on knowledge of the macro future. It outlines a concept that permeates all Oaktree investment activity: we may never know where we're going, but we ought to know where we are, and that knowledge of today's environment should determine our response.



The Realist's Creed

May 31, 2002

This memo serves as an acknowledgement that “I don’t know” is often the only reasonable refrain. It encourages investors to eschew macro forecasts and instead focus their attention on evaluating fundamentals and developing specialized expertise.

Returns and How They Get That Way

November 11, 2002

Here I express my view as to where equity returns come from – either growth in earnings or an upgrading of how investors value those earnings – and my belief that relying on the latter might not work in the long run. I also provide my thoughts on a tougher question; how to judge whether a manager truly possesses skill given the presence of significant randomness in the investment world. You can guess what I look for: a long record of consistent but possibly modest outperformance, rather than occasional flashes of brilliance.

What's Your Game Plan?

September 5, 2003

This was my second memo dedicated to the parallels between investing and sports, employing anecdotes from tennis and baseball and emphasizing Oaktree's motto from the beginning: “if we avoid the losers, the winners will take care of themselves.”

Us and Them

May 7, 2004

This memo highlights the contrast between two styles of investors: the “I know” school – confident, aggressive, and forecast-driven, and the “I don’t know” school – consistent, risk-conscious, and focused on fundamentals. I look closely at personality types, attitudes toward the market, and other aspects of these investment styles.

Hedge Funds: A Case for Caution

October 6, 2004

I set out my thoughts on the hedge fund movement – the hot topic in the investment world at the time – looking at aspects such as scalability and performance. Importantly, I say, nobody should credit any asset class (including hedge funds) with the birthright of a return. It all comes down to whether mispriced investment opportunities are available and whether the investor has the skill required to identify them.

Risk

January 19, 2006

I discuss what risk really means (not volatility!), why it matters, how to think about measuring it, and much more. Ultimately, it's investors' job to bear risk in the pursuit of profit. To do so wisely, they must understand risk and, of course, ascertain that they're well compensated before deciding to bear it. But they can't simply avoid it and hope for great returns.



Dare to Be Great

September 7, 2006

One of the first and most fundamental decisions for investors is with regard to the question of how far out on a limb they'll venture. This memo reflects my thoughts on how investment management clients might best pursue superior results.

The New Paradigm

October 19, 2006

In this memo, I discuss what can happen to managers' motivations when vast sums become available for management in an asset class, with the accompanying ballooning of potential management fees. Looking at developments in buyout funds, the real estate market, and credit investing, I conclude that it's a good time for increased caution.

Pigweed

December 7, 2006

A memo about the meltdown of a hedge fund called Amaranth Advisors, in which I parse the events surrounding its collapse. The fund had been making aggressive bets, and its successes were mistaken for long-term skill instead of than the reality: short-term luck. As usual, the prospect of exceptional profit earned with limited risk turned out to be a chimera.

The Race to the Bottom

February 14, 2007

This memo describes what happens when investors have too much money to invest and they're too eager to put it to work. It represents a timely warning about the capital market behavior that ultimately led to the subprime mortgage meltdown of 2007 and the ensuing Global Financial Crisis.

It's All Good

July 16, 2007

The "all-good trilogy" offers a reminder that good times are unlikely to last forever. In *It's All Good*, I highlight a few worrisome developments I'd spotted in the market: excessive use of leverage, untested securitization structures, and too-easy access to capital. We all know what happened next.

It's All Good... Really?

July 30, 2007

In this sequel, I describe how the events of July 2007 exemplify the elements that usually serve to initiate the swing back of the market pendulum. It's important to study the way it happened, because while it's folly to think we can know in advance what will cause the market to stop swinging in one direction and start in the other, it's even more unwise to think that time-honored pattern won't repeat.



Now It's All Bad?

September 10, 2007

Just six weeks later, I discussed how rapidly market sentiment had shifted. In this case, a cascade of negative events – coming on top of too much leverage and not enough liquidity – led to a complete reversal of investor psychology. Before the collapse, some market participants believed they'd tamed risk. Well, risk bit back.

The Limits to Negativism

October 15, 2008

This record of the fickleness of investor psychology was written very close to the absolute bottom in the investor sentiment. It describes the violent collapse of investor psychology that followed the bankruptcy of Lehman Brothers, bringing on the Global Financial Crisis. The environment from 2003-07 had been one of excessive positivity, but in 2008 I found it impossible to make assumptions negative enough to satisfy some onlookers. This excessive negativity signaled to me that there were vast opportunities for the stalwart contrarian.

Volatility + Leverage = Dynamite

December 17, 2008

It was levered mortgage-backed securities that were mostly responsible for the Global Financial Crisis, and I wrote this memo to explain that the amount of leverage it's prudent to use is largely a function of the riskiness and volatility of the assets it's used to purchase and the staying power of the asset holder. The combination of risky assets and excessive leverage under the wrong circumstances can prove fatal.

All That Glitters

December 17, 2010

This memo incorporated all my thoughts about investing in gold. I outlined its pros and cons but ended up expressing the view that there's no way to quantify the intrinsic value of assets like gold that don't produce cash flow, and thus no way to invest in them analytically. Gold has worked as a store of value solely because people agreed it would. That's not much of a foundation for a prudent investment.

Déjà Vu All Over Again

March 19, 2012

An exploration of the importance of historical awareness in prudent investing. The lessons of history are regularly forgotten when market sentiment becomes excessively optimistic or pessimistic. As these are the best times for applying a contrarian approach, ignoring historical patterns can be dangerous.



It's All a Big Mistake

June 20, 2012

It's rarely understood that for a buyer to make a bargain purchase, the seller has to sell too cheap. This memo explains that buying at a fair price doesn't generate alpha – it's buying at an unreasonably low one that does. Thus, accessing a bargain requires cooperation from someone who'll sell at a price that's irrationally low . . . but don't despair; sometimes they do. We must try to be the one who profits from these mistakes rather than the one who commits them!

The Outlook for Equities

March 13, 2013

The defining difference between bonds and stocks is that you can't compute prospective returns for the latter. One of the few reliable indicators I find for prospective equity returns is that the better returns have been in the recent past, the less good they're likely to be in the near future.

Getting Lucky

January 16, 2014

In this memo, the most popular through that time, I emphasize how big a part luck plays in both life and investing. This challenges the idea that success is always the result of hard work and skill and highlights the importance of acknowledging factors beyond one's control.

Dare to Be Great II

April 8, 2014

Building on *Dare to Be Great*, written eight years earlier, this memo reiterates that unconventional behavior is the only route to superior investment results, although it's far from sure to work. To engage in it, you have to dare to be different, dare to be wrong, and dare to look wrong for a while even when you're right. This isn't easy, and that's why not everyone can take the steps needed for investment superiority.

Risk Revisited Again

June 8, 2015

A treatise on the essence of investment risk, this memo stresses that whereas in our world risk is often defined as volatility, it really ensues from the fact that there is a range of possible outcomes from every investment, and it can include some that might be unpleasant. Importantly, risk can't be reduced to a number and managed by algorithm. Doing a superior job of it requires superior insight.

It's Not Easy

September 9, 2015

In 2011, Charlie Munger told me, "none of this is easy." I used that phrase as the title for a memo stressing that superior investing requires superior insight, plus the willingness to deviate from the herd, the ability to control one's emotions, and an unrelenting emphasis on the defining role of price in investment decisions.



On the Couch

January 14, 2016

This memo was my attempt to send the markets for a visit to the physiatrist and explore what might be learned there, analyzing investors' irrationality and discussing why many of the things that seem obvious to most investors so often turn out to be wrong.

What Does the Market Know?

January 19, 2016

When people responded to *On the Couch* by asking whether I was sure the market wasn't sending a sell signal, I addressed the error of taking advice from the market. Most of the time, the market's short-term behavior stems from irrational swings of investor perception "from hopeless to flawless," rather than a dispassionate weighing of merit.

This Time It's Different

June 12, 2019

In good times, the notion that "this time it's different" often works its way into the marketplace as investors use it to justify soaring prices for popular assets. This sentiment can be expressed in contexts ranging from questioning the possibility of a recession to supporting the high valuations of unproven companies dealing in the latest miracle. This memo discusses the outlook for nine such theories and how things would truly have to be different for them to prove out.

You Bet!

January 13, 2020

Here I build on the counterintuitive principle that you can't tell the quality of a decision from its outcome, and that the presence of randomness means well-thought-out decisions may fail and poor decisions may succeed. In investing, superior skill will overcome the impact of luck in the long run, but in the short run, luck can swamp skill, and the two can be indistinguishable.

Uncertainty

May 11, 2020

Against the confounding backdrop of the Covid-19 pandemic, a reminder that forecasting is futile and we must admit the limitations on our knowledge. The things we know about the macro environment generally are of no use in gaining an edge – because everyone else knows them too!

Uncertainty II

May 28, 2020

This memo builds on *Uncertainty* as the pandemic continues to rage, but with an important addition: not only do most people lack sufficient expertise to achieve superiority, but they also lack the expertise needed to identify which "experts" do possess it. While individuals often seek comfort in the output of reputable forecasters, they usually end up disappointed but rarely acknowledge the core problem: that macro forecasts are seldom helpful.



Something of Value

January 11, 2021

In *Something of Value*, I say how valuable it was to have my son Andrew and his family move in with us during the pandemic, and I highlight the seeming divide between “value” and “growth” investing as a potentially false dichotomy. In an investment environment marked by fewer bargains and greater efficiency than the one I grew up in, value investors shouldn’t limit themselves to bottom-fishing and instead should expand their toolbox and think about “winners” too.

I Beg to Differ

July 26, 2022

This memo returns to the idea that investors seeking superior performance must have the courage to depart from the pack. Thinking differently and better than others is essential, because to outperform in investing, it’s not enough to be right. You have to be more right than most.

The Illusion of Knowledge

September 8, 2022

A huge number of factors must be correctly predicted in order for a macro forecast to be accurate. As no forecast can be better than the ability of its algorithm to capture the workings of an incredibly complex world, why would anyone expect their forecast to be more accurate than the rest?

What Really Matters?

November 22, 2022

This memo argues that short-term performance, hyperactivity, and volatility don’t matter; instead, what I call “asymmetry” is the cornerstone of investing excellence. Superior investors achieve success by delivering returns that are more than commensurate with the risk they bear. This requires superior skill and insight, attributes that only the best possess.

Sea Change

December 13, 2022

Hopefully a seminal memo, *Sea Change* reviews the impact of 40 years of declining interest rates, brought to a halt by the need to fight post-pandemic inflation. This leads to an important observation: when the investing environment undergoes fundamental change, one’s strategy must undergo a thorough review.

Taking the Temperature

July 10, 2023

A look back at my five main market calls. Making such calls isn’t common practice for me, but I made each of the five because I found the market crazily elevated or depressed. They weren’t based on crunching financial data or on expertise regarding the specific investments in question, but on the clear-eyed assessment of investor psychology. Having identified these extremes, I felt comfortable calling for an adjustment of Oaktree’s risk posture.



Fewer Losers, or More Winners?

September 12, 2023

In the pursuit of superior risk-adjusted returns (or winning tennis), a participant's game plan requires choosing between the two main paths: either experiencing fewer losers or finding more winners. I argue that in credit, having fewer losers will generally serve best, but smart credit investing should be based on risk control, not risk avoidance.

The Indispensability of Risk

April 17, 2024

With investors facing intelligent competitors, as we do every day, no one should expect to achieve significant returns without bearing risk. But they also shouldn't expect to achieve them simply for bearing risk. It has to be done consciously and skillfully.

Ruminating on Asset Allocation

October 22, 2024

This memo offers my articulation of the fundamental difference between equity and debt: a generous but uncertain expected return with both upside and downside potential from the former, versus a more modest contractual return accompanied by much less uncertainty from the latter. This difference is the essential consideration in portfolio construction, in which investors must determine their appropriate risk posture and combine ownership and lending assets in a portfolio that gets them there.

The Calculus of Value

August 13, 2025

An assessment of the essence of value and price and the critical relationship between the two. I argue that in the long run, increases in value – usually stemming from growth in earnings – provide most of the impetus for investment returns, and value exerts a magnetic influence on price. That means the current relationship of price to value should be expected to strongly influence future investment performance, with high valuations presaging low subsequent returns, and vice versa.

Addendum to Third Quarter Client Letter

From: Howard S. Marks

Re: The Route to Performance

We all seek investment performance which is above average, but how to achieve it remains a major question. My views on the subject have come increasingly into focus as the years have gone by, and two events in late September -- and especially their juxtaposition -- made it even clearer how (and how not) to best pursue those superior results.

First, there was an article in the Wall Street Journal about a prominent money management firm's lagging performance. Its equity results were 1,840 basis points behind the S&P 500 for the twelve months through August, and as a result its five-year performance had fallen behind the S&P as well. The president of the firm explained that its bold over- and under-weightings weren't wrong, just too early. Here is his explanation, with which I strongly disagree:

If you want to be in the top 5% of money managers,
you have to be willing to be in the bottom 5%, too.

The above calls to mind a convertible mutual fund I discussed in my second quarter 1988 letter to convertible clients. The fund held large amounts of common stock in the first eight months of 1987 and cash after that. As a result, its return was more than 1,600 basis points better than the average convertible fund for the year, and 945 b.p. ahead of the second-place fund. In the next half year, its tactics were equally divergent ... but wrong this time, producing performance which was far enough behind to negate the majority of its 1987 achievement and pull its 18-month results well back into the pack. My observation at that time mirrored the fund manager quoted above, but from a negative viewpoint:

. . . in order to strive for performance which
is far different from the norm and better, you
must do things which expose you to the possibility
of being far different from the norm and worse.

These cases illustrate that bold steps taken in pursuit of great performance can just as easily be wrong as right. Even worse, a combination of far above-average and far below-average years can lead to a long-term record which is characterized by volatility and mediocrity.

As an alternative, I would like to cite the approach of a major mid-West pension plan whose director I spoke with last month. The return on the plan's equities over the last

fourteen years, under the direction of this man and his predecessors, has been way ahead of the S&P 500. He shared with me what he considered the key:

We have never had a year below the 47th percentile over that period or, until 1990, above the 27th percentile. As a result, we are in the fourth percentile for the fourteen year period as a whole.

I feel strongly that attempting to achieve a superior long term record by stringing together a run of top-decile years is unlikely to succeed. Rather, striving to do a little better than average every year -- and through discipline to have highly superior relative results in bad times -- is:

- less likely to produce extreme volatility,
- less likely to produce huge losses which can't be recouped and, most importantly,
- more likely to work (given the fact that all of us are only human).

Simply put, what the pension fund's record tells me is that, in equities, if you can avoid losers (and losing years), the winners will take care of themselves. I believe most strongly that this holds true in my group's opportunistic niches as well -- that the best foundation for above-average long term performance is an absence of disasters. It is for this reason that a quest for consistency and protection, not single-year greatness, is a common thread underlying all of our investment products:

In convertibles, we insist that our call on potential appreciation be accompanied by above average resistance to declines.

In high yield bonds, we strive to raise our relative performance by avoiding credit losses, not by reaching for higher (but more uncertain) yields.

In distressed company debt, we buy only where we believe our cost price is fully covered by asset values.

There will always be cases and years in which, when all goes right, those who take on more risk will do better than we do. In the long run, however, I feel strongly that seeking relative performance which is just a little bit above average on a consistent basis -- with protection against poor absolute results in tough times -- will prove more effective than "swinging for the fences."

October 12, 1990

Memo to: Clients

From: Howard Marks
Trust Company of the West

Re: First Quarter Performance

The mood swings of the securities markets resemble the movement of a pendulum. Although the midpoint of its arc best describes the location of the pendulum "on average," it actually spends very little of its time there. Instead, it is almost always swinging toward or away from the extremes of its arc. But whenever the pendulum is near either extreme, it is inevitable that it will move back toward the midpoint sooner or later. In fact, it is the movement toward an extreme itself that supplies the energy for the swing back.

Investment markets make the same pendulum-like swing:

- between euphoria and depression,
- between celebrating positive developments
and obsessing over negatives, and thus
- between overpriced and underpriced.

This oscillation is one of the most dependable features of the investment world, and investor psychology seems to spend much more time at the extremes than it does at a "happy medium."

In late 1990, the securities markets were at a negative extreme as concerns about the economy and Iraq produced exaggerated risk aversion and thus drastic under-valuation of all securities considered to be of less than "gilt-edge" quality. The subsequent first quarter swing toward more reasonable valuations imparted to our portfolios some of the best quarterly performance in our history.

With investors worrying less about default rates and forced selling, our high yield bonds returned more than at any time since the second quarter of 1980. The rebirth of interest in smaller and second-tier stocks produced a quarterly return for our convertibles above any since the fourth quarter of 1982. Lastly, suspension of "end-of-the-world" thinking and an increased willingness to envision possible solutions caused our distressed-debt Special Credits portfolios to gain even more than either high yield bonds or convertibles.

It would be wonderful to be able to successfully predict the swings of the pendulum and always move in the appropriate direction, but this is certainly an unrealistic expectation. We consider it far more reasonable to try to (1) stay alert for occasions when a market has reached an extreme, (2) adjust our behavior slightly in response and, (3) most importantly, refuse to fall into line with the herd behavior which renders so many investors dead wrong at tops and bottoms.

The first quarter's swing back from the negative extreme has been rapid and impressive. No one can say whether it came too soon or went too far, and we are cautious that these dramatic results may have been realized without great improvement in the fundamental economy. However, we feel "fair" does a much better job of describing the prices which resulted than would "excessive." That is, the pendulum is closer to the midpoint at this time than to an extreme.

The bargains which were so readily available in the fourth quarter of 1990 are no longer there to the same extent, and we are not acting as if they were. And we certainly are not planning on a continuation of the first quarter's performance. Instead, from today's more reasonable prices, we consider our three areas to be poised for a continuation of their "normal" above-average risk-adjusted performance.

April 11, 1991

Memo to: Oaktree Clients and Friends

From: Howard Marks

Re: How the Game Should Be Played

One of the questions asked most often in connection with our leaving to form Oaktree -
- perhaps second only to "where'd the name come from?" -- is "why did you do it?"

The answer is that we concluded we had an opportunity to create our own investment management firm, all of which would run our way, according to our philosophies, beliefs and standards.

But what do we mean when we say "our way?"

Well, an article about sports in the April 2 New York Times Sunday Magazine provided an excellent metaphor through which to illustrate the point. In it, the author wrote of Babe Ruth that he represented

... The Credo of the Home Run: A man can never be faulted, even if he's wrong, for the bold, aggressive action in pursuit of victory; a real man must be willing to strike out, to go down swinging.

I believe this is the way much of the investment world thinks, but it's the opposite of what we believe in. In fact, I wrote a memo in 1990 to take issue with a money manager who justified his poor recent performance by saying "If you want to be in the top 5% of money managers, you have to be willing to be in the bottom 5%, too."

"Our way" is never to tolerate poor performance, and certainly not to consider it an acceptable side-effect of swinging for the fences. While we strive to be somewhat above average each year, our philosophy mandates that we put the greatest emphasis on trying to avoid losing our clients' money.

And that brings me to what I feel is a much more appealing sports metaphor, which I clipped from the Wall Street Journal in 1992 but never had occasion to cite until now: the story of golfer Tom Kite. The article was about Kite's having won a major tournament, but the part that interested me dealt with his record up to that time:

The bespectacled 42-year-old had won ... over the past 20 seasons some \$7.2 million in official prize money, more than any other golfer -- ever. But [he had never before won] one of the sport's "majors" (the U.S. and British Opens, Masters and PGA Championship).

That's the way we think it should be done: by consistently finishing in the money, but with no need for headline-grabbing victories. What we think matters isn't whether you hit a home run or win the Masters on any given day, but rather what your long-term batting average is.

Many money managers, it appears, believe either (a) that they really can predict what's in store for the markets and which issues will do best, or (b) that their clients expect them to be able to, and to act as if they can. Thus they swing for the fences each year with a portfolio which will earn big rewards if their forecasts are right ... and vice versa.

The record suggests very few managers truly know what the future will bring, and yet many keep trying to make money through stock picking and market timing in even the most efficient markets. When their holdings appreciate, they recount their insights and take credit, never admitting when they've been right for unforeseen reasons. When they're wrong, they complain about the circumstances that conspired against them and explain that they were fundamentally right but just off in terms of timing or betrayed by chance. Then they go on espousing new predictions without ever publishing a scorecard from which to judge their record as forecasters.

Our response on this subject is simple:

- (1) We accept that we're among the many who do not know what the big-picture future holds.
- (2) It is for this reason that we choose to work in inefficient markets where specialization, skill and hard work can add value and lead to above-average performance over time.
- (3) Lastly, we feel that because we're not clairvoyant, it's important to acknowledge our limitations and put the highest priority on avoiding losses, not executing bold strategies.

I was raised on an adage which had good things to say for "he who knows and knows he knows" but warned about the danger of following "he who knows not but knows not he knows not." Or, as expressed in my favorite quotation, from Stanford behaviorist Amos Tversky,

... It's frightening to think that you might not know something, but more frightening to think that, by and large, the world is run by people who have faith that they know exactly what's going on.

We never forget how risky it is to join that group. Thus our "game plan" is directed at avoiding strikeouts and building a high batting average over time, not at hitting a home run each trip to the plate.

May 26, 1995

Memo to: Oaktree Clients

From: Howard Marks

Re: bubble.com

The book "Devil Take the Hindmost" by Edward Chancellor does an excellent job of chronicling the history of financial speculation. In doing so, it recounts the story of "the South Sea Bubble" and provides a backdrop against which I'd like to examine some of the events of today.

The South Sea Company was formed in 1711 to help deleverage the British government by assuming some of the government's debt and paying it off with the proceeds of a stock offering. In exchange for performing this service for the Crown, the company received a monopoly for trading with the Spanish colonies in South America and the exclusive right to sell slaves there. Demand for the company's stock was strong due to the expectation of great profits from these endeavors, although none ever materialized. In 1720, a speculative mania took flight and the stock soared.

Sir Isaac Newton, who was the Master of the Mint at the time, joined many other wealthy Englishmen in investing in the stock. It rose from £128 in January of 1720 to £1,050 in June. Early in this rise, however, Newton realized the speculative nature of the boom and sold his £7,000 worth of stock. When asked about the direction of the market, he is reported to have replied "I can calculate the motions of the heavenly bodies, but not the madness of the people."

By September 1720, the bubble was punctured and the stock price fell below £200, off 80% from its high three months earlier. It turned out, however, that despite having seen through the bubble earlier, Sir Isaac, like so many investors over the years, couldn't stand the pressure of seeing those around him make vast profits. He bought back the stock at its high and ended up losing £20,000. Not even one of the world's smartest men was immune to this tangible lesson in gravity!

* * *

It's obvious from "Devil Take the Hindmost" that many elements of speculative behavior were present during the South Sea Bubble. I'll cite some of its passages below and point out the parallels to today that I see:

"The ideology of self-interest had recovered after the battering it received after the crisis of the mid-1690s ... its thesis [was] that private vices - avarice, prodigality, pride and luxury - produced public benefits." [Sounds like the "greed is good" rationalization of the 1980s.]

The success of South Sea spawned talk of any number of speculative schemes, some of which was probably apocryphal. “The most famous of the legendary bubble companies was that ‘for carrying on an undertaking of great advantage but no one to know what it is.’” [I can’t understand what it does, but that’s okay; just tell me the name, ■■■. or maybe the symbol’s enough.]

Despite their lack of profits, companies like South Sea were able to finance their operations by issuing stock at higher and higher prices. “The circularity inherent in the scheme made a rational calculation of the shares’ fair value difficult to compute. Some argued that the higher the shares rose, the more they were actually worth ‘Was there ever such a delusion from the beginning of the world ... according to this Way of Computing, no Person can Purchase at too high a Rate, since his Profit will increase in Proportion to the Price he gives.’” [There’s no such thing as too high a price if the concept is right, and the ability to issue stock at rising prices will lead to profitability.]

"Adam Anderson, a former cashier of the South Sea Company, later claimed that many purchasers of shares ... bought knowing that their long-term prospects were hopeless, since they aimed to get 'rid of them in the crowded alley to others more credulous than themselves.'" [The greater fool theory is nothing new.]

“As Edward Ward observed in his poem ‘A South Sea Ballad’:

Few Men who follow Reason's Rules,
Grow fat with South-Sea Diet,
Young Rattles and unthinking Fools
Are those that flourish by it.”

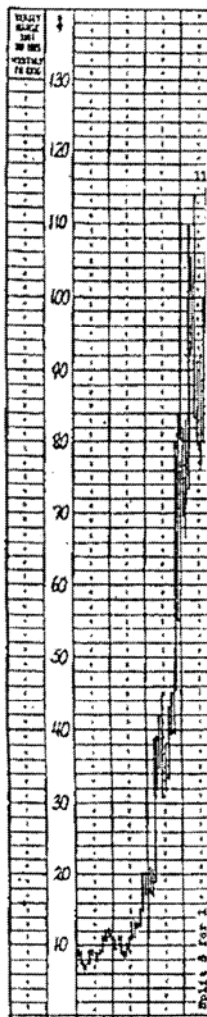
[The profits went to those unrestrained by reason or experience.]

Robert Digby wrote “The South Sea Company is continually a source of wonderment. The sole topic of conversation in England revolves around the shares of the Company, which have produced vast fortunes for many people in such a short space of time. Moreover it is to be noted that trade has completely slowed down, that more than one hundred ships moored along the river Thames are for sale, and that the owners of capital prefer to speculate on shares than to work at their normal business.” [The name of the company was on everyone’s lips, the fortunes it created were front-page news, and the average Joe was willing to give up his day job to participate ... sound familiar?]

I will devote the rest of this memo to what certainly seems to me to be another market bubble. Before doing so, however, I must point out a few things: First, as usual, little that I will write will be original; instead, I hope to add value by pulling together ideas from a number of sources. Second, a single word suffices to describe my recent caution regarding the stock market: wrong. Nevertheless, I’ll admit my negative bias and

the fact that I have found the bears convincing and the bulls Pollyanna, and then move on to discuss the effect on the market of technology as we move into a new millennium. In short, I find the evidence of an overheated, speculative market in technology, Internet and telecommunications stocks overwhelming, as are the similarities to past manias.

- **Changing the world** -- Of course, the entire furor over technology, e-commerce and telecom stocks stems from the companies' potential to change the world. **I have absolutely no doubt that these movements are revolutionizing life as we know it, or that they will leave the world almost unrecognizable from what it was only a few years ago. The challenge lies in figuring out who the winners will be, and what a piece of them is really worth today.**



The graph at the left shows the stock price performance of the leading company in an industry that was thought capable of changing the world. For that reason, the stock followed the explosive price pattern that has become typical for technological innovators. The predictions were correct: the industry did change the world, and the company was its big winner.

The industry was radio. In the 1920s it was expected to change the world, and it did. Its ability to communicate without wires created entertainment in the home, electronic advertising and the live delivery of events. The company was RCA, and as the industry leader its stock rose from \$8 in mid-1927 to \$114 in mid-1929.

While part of the stock's appreciation was due to the market boom in which it shared, certainly part was also due to an overvaluation of its potential. After the onset of the Great Crash, RCA's stock fell from that high of \$114 to \$2½ within three years. The Depression can be blamed for some of this decimation, but it is worth noting that even 25 years after the 1929 peak, when the Depression and World War II were well over and the post-war recovery was underway, RCA's stock had yet to get back to a third of its earlier high. The times, the industries and the companies are certainly different today, but it makes one wonder whether investors aren't again overpaying for the ability to change the world.

Similarly, a recent article in Fortune reported Warren Buffet's observation that airplanes and automobiles had been expected to change the world and did ... and almost all of the manufacturers of both are now gone. Few things have had the impact on the world that aviation did, but from its founding through 1992, the cumulative profit of the airline industry was zero!

As usual, Buffet puts it as succinctly as anyone could: **“The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage.** The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors.” (Emphasis added) (Three years ago, everyone wanted to be Warren Buffet, or at least read books about him. Now, appearing to have missed out on the technology movement, he and his investment approach are dismissed as passe by the dot-com gang.)

- **Altered lives** -- During the South Sea bubble, as described above, boats were put up for sale and people with capital shifted from being workers to being investors. In a striking parallel, the Internet-commerce revolution is also changing lives. Of course, we know that thousands of Americans have become on-line traders either full- or part-time. Articles describe people who are trying to "ride the trend" of hot stocks and benefit from their momentum, but there's little indication that they have any idea what makes companies do well or stocks go up (or even what some of their companies do). The Wall Street Journal of December 7 cited an individual who has spent his full time in the prior five months trading the stock of one company, CMGI, which invests in Internet ventures; he doesn't know the CEO's name.

Also striking is the effect this is having on business education and young careers. A front-page article in the New York Times of November 28 reported that applications at many business schools were flat or down, the number of Americans taking the GMAT exam was down sharply, and not-insignificant numbers of MBA students were dropping out after the first year to join the hot fields. As a professor of entrepreneurship told me, all of the e-commerce claims will be staked out in the next year or two; students can't risk staying in school and seeing someone else act on their ideas. Five years ago, the hot area for new MBAs was investment banking. Now, I hear, investment banks can't get the top students to sign up for interviews and are having trouble meeting their recruiting goals.

The pressure to move toward the high-change areas is great, and people are succumbing. Everyone in the investment profession knows (or knows of) somebody who has made hundreds of millions (or a billion) this year on a dot-com investment. One can imagine that this makes the buyout specialists who built fortunes over a lifetime feel like underachievers. Private equity firms are getting involved in companies at earlier stages, and with the dot-coms. On November 30, a Wall Street Journal article about defections of buyout specialists to venture capital firms cited a KKR partner who had resigned to do just that.

Venture capitalists and technologists, in turn, are moving to Internet firms. As a sign that it's even becoming hard for more mature technology firms to hold onto people, the CFO of Microsoft recently quit to join a fiber-optic company. Remember, Microsoft has already been public 17 years; the gold-rush is over at the established firms, and the overnight fortunes have been made. Even investment bankers are in transit; on December 14, a New York Times article on the subject was headlined “Wall St. Is Flush With Cash But Also Green With Envy.” A Harvard Business

School professor aptly mixes his metaphors, likening the rush of executives to Internet-related ventures to “a tsunami of people chasing a pot of gold.”

- **The lure of venture capital** - I recently presented the case for distressed debt to three classes in entrepreneurial finance at the University of Chicago Graduate Business School. The response of half the students was simple: Why settle for 20-25% per year when you can make 100% in venture capital?

Just as venture capital is attracting young businesspeople, it is also turning heads in the investment community. One university treasurer told me his school's \$29,000 investment in Yahoo! via a venture fund grew to \$54 million (and would be more than twice that today if it hadn't been sold). Why do anything else, indeed?!

Before we succumb to this reasoning, however, (and run out to start the OCM Venture Capital Fund), we should first review the data concerning venture capital's brief history.

- For funds raised between 1984 and 1989, the median return to Limited Partners ranged from 7.5% to 15.1%. For funds raised between 1990 and 1994, it ranged from 20.4% to 29.7%. These are healthy returns, but certainly the typical v.c. investor enjoyed no bonanza in that period. A quarter or more of the funds raised in almost every year provided returns ranging downward from 10% to negative territory.
- It's only for funds started in the mid-to-late 1990s that the returns have been so eye-popping. For each vintage year beginning in 1994, there has been at least one fund with a return above 200%/year. And yet, the median returns thus far for vintage years between 1994 and 1999 range only from zero to 33.7% (although it can be argued that it's still early).
- While it's hard to settle on a "typical" vintage year for venture capital, 1994 is a reasonable candidate. Its funds are five years old, so there has been time to bring companies to fruition and to market. And certainly, the environment has been positive. In fact, 1994's top fund has returned 235%/year so far, and the average fund has returned 45%/year, an impressive figure. But averages can be deceiving, and this one has certainly been pulled up by the best performers. The median fund is up only 22.5%/year. Half the funds have annual returns below that (by definition), and the returns in the bottom quartile range from 6.4% to minus 13.2%.
- The recent years all show similar patterns (although it's too early for meaningful results to be in): phenomenal for the big winners, good on average, but certainly not universally successful yet.

Having reviewed the historic data, what can we say about the future? Certainly, the venture capital funds are "where it's at": the toll bridge through which world-changing companies are likely to pass. Does that mean they're a good investment today?

I feel strongly that no investment opportunity is so good that it can't be screwed up by the wrong relationship between supply and demand. Too much money for too few ideas can mean ruinous terms and purchase prices that are too high. To my mind, the immediate outlook for venture capital is called into question by:

- the ardor that has been ignited by recent "headline" returns,
- thus the huge amount of money looking for a home in ventures,
- the expanded amounts that v.c. firms are accepting in their new funds,
- the strengthened negotiating position of entrepreneurs relative to venture capitalists,
- thus the need among v.c. firms to compete in haste to make investments,
- the ease with which junior members can leave v.c. firms to start their own funds,
- the strengthened negotiating position of venture capitalists relative to their investors, and
- thus the ability of v.c. firms to raise their incentive fee percentage.

In my experience, the big, low-risk profits have usually come from investments made at those times when recent results have been poor, capital is scarce, investors are reticent and everyone says "no way!" Today, great results in venture capital are in the headlines, money is everywhere, investors are emboldened and the mantra is "of course!"

In this context, it's very much worth noting that in 1994, someone looking at venture funds formed from 1981 to 1992 would have seen only one vintage year with an average net return above 12%, and nine out of twelve years with single digit average returns. Despite the lukewarm results as of that date, a few forward-looking investors were willing to commit \$7.8 billion to venture capital funds, and it is they who are earning the returns we see. In 1998, on the other hand, the 200%+ results on the top funds formed in recent years egged investors on to commit more than three times that amount: \$26.1 billion. Today one hears only that investors want to put more into venture capital but can't get access to the most desirable funds. I'll leave it to you to deduce the implications for future returns.

- **The role of the IPO:** A "mania-within-a-mania" has taken flight in the high-tech investment world, and it surrounds Initial Public Offerings. In years past, new issues had to be priced to sell, and companies accessing the public equity market for the first time had to hope they could get investors to pay a fair price. Now, investors are sure that buying stock on a new issue - at the price the founders are willing to sell at - is the ticket to easy money. And to date it has been.

It is reported that the average new issue of 1999, which on average is probably about six months old, is selling roughly 160% above its issue price (for four times the average gain in the next-best year). For an example, The Wall Street Journal of December 8 described the case of Akamai, which went public on October 29 at a price of \$26. It closed that day at \$145, for an equity market value of \$13 billion. "Fourteen months earlier, ... it could never have gotten such a reception," The Journal added. "It didn't exist." Akamai's price

is \$328 today, bringing its market capitalization to \$29 billion. (By the way, in the first nine months of 1999, Akamai lost \$28 million on \$1.3 million of sales.)

The ability to participate in IPOs has become a major perk. Investment banks compete with other money managers by promising wealthy individuals allocations in their IPOs. Technology companies allocate IPO shares to their customers as a way to cement business relationships.

As usual, I don't think investors are thinking this through. The Akamai IPO was priced at 18% of the first day's closing price. So either (a) the founding entrepreneurs and investors sold it 82% below its fair price (and who would know better than they would?) or (b) the market's wrong. It may well be that issuers intentionally underprice their offerings so that the first day's rise will create the "buzz" that will enable (1) the companies to finance their losses and their expansion through additional stock issuance and (2) the founders to sell their remaining shares. I'm sure some of that is at work here, but how much? If the closing price of \$145 was "right," Akamai left almost \$1 billion on the table in the IPO by selling eight million shares at \$26.

Further, how much due diligence is being done on each new issue? How experienced are the people doing it? How strict are the valuation parameters they're using? How will the post-deal prices hold up when the lock-up periods end and the founding entrepreneurs and venture capitalists start selling the 80-90% of the stock that they still own? And what will happen when the options used to attract employees - and to pay service providers - begin to be exercised and the shares sold? What price will supply/demand dictate when the supply of stock increases five or ten times?

Today, it seems companies are formed and start-up financing is raised not through discussions of the companies' profit potential, but with reference to the possible timing and pricing of an IPO. The recent book "The New, New Thing" by Michael Lewis, about the career of venture capitalist Jim Clark (Silicon Graphics, Netscape, Healtheon), makes it clear that in many cases, today's entrepreneur isn't thinking idea/startup/company as might have been the case in the past; rather, it's idea/startup/IPO. Cashing in used to be the result of successful company-building. Now it's often the end in itself. It's the IPO that's "the thing."

- **How will the companies make money?** -- Many of the new firms have great ideas for making money, but it's appropriate to wonder whether they'll work, how the competition in each "space" (that's the dot-com term for a business niche) will develop, whether profits will materialize, and whether they'll be sufficient to justify today's stock prices.

I don't think anyone would disagree that it's one thing to innovate and change the world and another thing entirely to make money. Business will be different in the future, meaning that not all of the old rules will hold. On the other hand, profits come from taking in more in revenue than you payout in expense, and I don't think that's going to change. I'll highlight below just three of the areas in which I have questions about profitability.

First, will the Internet and dot-com companies be able to charge enough for their products to make money? Front page articles in The New York Times (October 14) and The Wall Street Journal (July 28) discussed the fact that many of the Internet's offerings are free. Decades ago, merchants discovered that they could sell more if they cut prices. The Internet firms have taken that one step further: they can move even more merchandise if they give it away. As the CEO of Egreetings Network says, "Charging for [greeting] cards was a small idea. Giving them away is a really big idea." Says a venture capitalist, "... it's a fact of life on the Internet: People expect a lot of things for free. And if you don't give it away, some other start-up will."

Internet firms are giving away faxes, long-distance phone calls, music, web browsers and even Internet service itself. "The marginal cost of adding another user is practically zero," says one venture capitalist. The trouble as I see it is that the marginal revenue is exactly zero. Obviously, these firms are giving their services away in order to build traffic, tie up market share early and/or sell advertising space. It's far from clear that profits will follow.

As I read the articles mentioned above I was reminded of a great series of jokes my father told when I was young:

"I lose money on everything I sell."
"Then how do you stay in business?"
"I make it up on volume."

"I lose money on everything I sell."
"Then how do you stay in business?"
"I'm closed Sundays."

"I sell everything at cost."
"Then how do you stay in business?"
"I buy below cost."

The riddle of profitability is very much present in this area. I'm sure some firms will solve it - but far from all of them.

Second, how practical are the business models of the dot-com firms? It seems like ancient history, but I seem to remember that doing business in cyberspace was going to eliminate the need for conventional advertising, and "virtual inventories" were expected to replace brick-and-mortar warehouses filled with merchandise. Now we read about the huge sums Amazon.com is spending on warehouses, and media advertising is sold out at high prices because the Internet firms are bidding for it so aggressively. EToys will do business without stores and will just own warehouses, but what is a Toys 'R' Us store other than a warehouse with the front prettied up? Webvan Group sell groceries over the Internet, saving on store costs but providing free delivery. According to the December 15 Journal, however, "as of Sept. 30, Webvan's average order size was \$72 -too small to absorb the costs of home delivery. For the first nine months of 1999, in fact, Webvan

had a \$95 million loss on revenue of just \$4.2 million.”

Lastly, what will be the effect of competition? It will take time, and there will be big cannibalization issues, but eventually the incumbents in each area will move to defend their businesses against the e-commerce firms. Merrill Lynch bit the bullet and decided to enable customers to trade on line as a response to E*Trade. Albertson's and Kroger have announced that they'll mount experimental home delivery systems rather than let firms like Webvan have the grocery business. The December 17 L.A. Times reported that Toys 'R' Us and Walmart had opened online shopping sites in competition with EToys. (EToys' stock is now off 70% from its high three months ago, wiping out \$7.1 billion of market value). Dot-com companies will get there early, make inroads and drive up costs for the conventional firms, but they will face determined competition from incumbents fighting for their lives.

Even among just the dot-coms, competition is bound to delay and limit profitability. Most of today's e-commerce companies can, at best, boast of early entry and leading market share (the so-called "first-mover advantage"). Rarely is there patent protection, meaningful product differentiation or other substantial barriers to entry. The companies can't count on brand loyalty, because it's all just about low price. There'll always be someone waiting in the wings to cut price (perhaps to zero) for market share, and given the ease of gathering information on the Web, consumers will always be able to immediately find the lowest price. Location won't matter, because in cyberspace, everyone is everywhere. I think factors like these are likely to render profitability elusive and transitory.

- **What are the companies worth?** - Eventually, this is what it comes down to. It's not enough to buy a share in a good idea, or even a good business. You must buy it at a reasonable (or, hopefully, a bargain) price.

Vast amounts of ink have been devoted to the valuations being put on the new companies. For The New York Times's time capsule, David Letterman compiled a list of The Top 10 Things People in the Year 3000 Should Know About Us. As a sign of the times, he included “If you wanted a billion dollars, all you had to do was think of a word and add dot com.”

- Priceline.com, which auctions off discount air tickets, (September quarter sales of \$152 million, net loss of \$102 million) has a market capitalization of \$7.5 billion, while United and Continental Airlines (\$7.1 billion sales, \$469 million earnings) are worth a combined \$7.3 billion.

- Webvan Group, which started up in business in 1999, had sales of \$3.8 million and a \$350,000 profit in the September quarter. The stock market currently values it at \$7.3 billion.
- On December 9, VA Linux went public at \$30 and soared 698% that day to \$239, for a market value of \$9.5 billion, half that of Apple. To that date, the company's 1999 sales were \$17.7 million and it had lost \$14.5 million (versus Apple's profit of \$600 million in the most recent twelve months). (VA Linux broke the record for an opening day rise. It had been held since November 1998 by theglobe.com, whose stock rose 606% on the first day, from \$4½ to almost \$32. Now it's at \$8.)

Among non-Internet tech companies, Yahoo! is worth \$119 billion, more than General Motors and Ford together. At the current stock price of \$432, its p/e ratio on 1999 estimated earnings is just over 1,000. America Online trades at almost 250 times projected earnings for the June year currently underway, and Cisco trades above 100 times. Charles Schwab, the apparent winner among brokers in the new era, trades at 54 times estimated 1999 earnings, triple the multiple for Goldman Sachs. According to Barron's, the price/earnings ratio of the Nasdaq crossed 170 in November and may have reached 200 at year-end ... and that's the average.

An analysis by Sanford Bernstein shows that on September 30, you could have bought America Online and Microsoft for \$625 billion and gotten \$25 billion of sales and \$7 billion of earnings. Alternatively, for \$635 billion you could have bought 70 industrial, financial, transportation and utility companies including Bank of America, Chubb, Federated Department Stores, Litton, Philip Morris, Ryder and Whirlpool and gotten \$747 billion of sales and \$43 billion of earnings. The future certainly looks better for AOL and Microsoft than for those other companies, but does the differential warrant a p/e ratio 6 times as high (89 versus 15)?

And that's for “established” companies. Because the price/earnings ratios of Internet companies are so outlandish - usually negative - one may be forced to look to the price/sales ratio in order to speak about valuation. Red Hat, for example, sells at about 1,000 times its annualized revenues in the August quarter. Many of the Internet and tech companies are just concepts, and their stocks have truly slipped the valuation moorings.

Under these unusual circumstances, The Journal wrote on December 10, “stock valuations take on an unusually large importance in gauging a business's performance.” In other words, in the absence of other signs, people must look to the share price for an indication of how the company is doing. Isn't that backwards? In the old days, investors figured out how the business was doing and then set the share price.

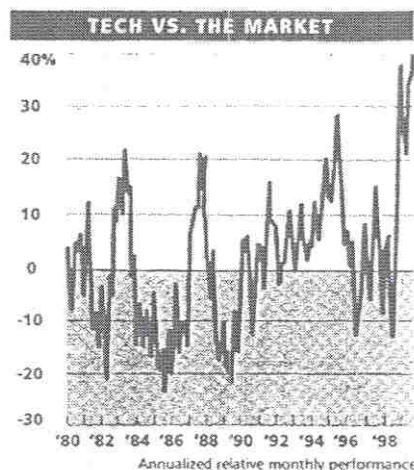
In this valuation parameter vacuum, a “lottery ticket mentality” seems to govern the purchase decision. The model for investments in the tech and dot-com companies isn't the likelihood of a 20% or 30% annual return based on projected earnings and p/e ratios, but a shot at a 1,000% gain based on a concept. The pitch might be “We're looking for first-round financing for a company valued at \$30 million that we think we can IPO in two years at \$2 billion.” Or maybe it's “The IPO will be priced at \$20. It may end the

day at \$100 and be at \$200 in six months.” Would you play? Could you stand the risk of saying no and being wrong? The pressure to buy can be immense.

There have always been ideas, stocks and IPOs that produced great profits. Yet the pressure to participate wasn't as great as it is today because in the past the winners made millions, not billions, and it took years, not months. The upside in the deals that've worked so far has been 100-to-1 (give or take a zero). With that kind of potential, (a) the upside becomes irresistible and (b) it doesn't take a very high probability of success to justify the investment. I have said in the past that while the market is usually driven by fear and greed, sometimes the strongest motivator is the fear of missing out. Never was that as true as today. This only intensifies the pressure to join in and crawl further out on that limb of risk.

With broader relevance than just the dot-com stocks, the relative performance chart below from Barron's of September 27 (already quite outdated) shows two things:

1. over the last two decades, technology stocks have had periods of both underperformance and overperformance relative to the large-cap universe, and
2. the recent outperformance is unparalleled even in this bullish period.



Nothing in this chart suggests that it'll be easy money in technology from here. As Alan Abelson wrote when he ran the graph, “Our reservation here is that (a) technology, like everything else in life, is cyclical; and (b) **there's something goofy about the price of a stock discounting as much as a century of earnings for a company in a field where change is the only constant and where the pace of change is constantly quickening.**” (Emphasis added)

In September Steve Ballmer, President of Microsoft, said he thought tech stocks were overvalued. The stocks are much higher today, and his own is up more than 20%. Whose opinion matters? Is there a price that's too high?

Barton Biggs, Chairman of Morgan Stanley Dean Witter Asset Management, is a well-respected observer who has been somewhat cautionary to date (and wrong). His November 29 strategy piece was without equivocation. I'll let him sum up.

The technology, Internet and telecommunication craze has gone parabolic in what is one of the great, if not the greatest, manias of all time ... The history of manias is that they have almost always been solidly based on revolutionary developments that *eventually* change the world. Without fail, the bubble stage of these crazes ends in tears and massive wealth destruction ... Many of the professional investors involved in these areas know that what is going on today is madness. However, they argue that the right tactic is to stay invested as long as the price momentum is up. When momentum begins to ebb, they will sell their positions and escape the carnage. Since they have very large positions and since they all follow the same momentum, I suspect they are deluded in thinking they will be able to get out in time, because all other momentum investors will be doing the same thing. (Emphasis added)

* * *

I am convinced that a few essential lessons are involved here.

1. The positives behind stocks can be genuine and still produce losses if you overpay for them.
2. Those positives - and the massive profits that seemingly everyone else is enjoying - can eventually cause those who have resisted participating to capitulate.
3. A "top" in a stock, group or market occurs when the last holdout who will become a buyer does so. The timing is often unrelated to fundamental developments.
4. "Prices are too high" is far from synonymous with "the next move will be downward." Things can be overpriced and stay that way for a long time ... or become far more so.
5. **Eventually, though, valuation has to matter.**

To say technology, Internet and telecommunications stocks are too high and about to decline is comparable today to standing in front of a freight train. To say they have benefited from a boom of colossal proportions and should be examined very skeptically is something I feel I owe you.

January 2, 2000

P.s.: The apocalyptic view of the current situation states that the world economy is dependent on the prosperity of the United States; the prosperity of the United States is based on the health of its stock market; the performance of the stock market is being driven by gains in a relatively small number of tech, Internet and telecommunications stocks; and therefore, when the inevitable correction comes in those few stocks, the ramifications will be worldwide. No one knows the extent to which this hypothesis will be proved correct. The column below, from The New York Times of January 1, 2000, presents a more benign and enjoyable view.

FLOYD NORRIS

Remembering Wealth: Life in Post-Crash Silicon Valley

My New Year's resolution is to file my columns early. This one was written 10 years before deadline.

SAN JOSE, Calif., Dec. 30, 2009

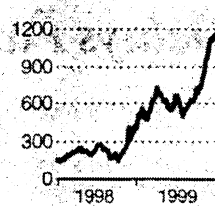
ONLY a decade ago, the Silicon Valley of California was viewed as technology's promised land, a place where bungalows cost \$1 million and even the youngest computer programmer had stock options that seemed likely to be worth millions soon.

But now, years after the Internet crash of 2000, it has become a region of jealousies and recriminations. Working relationships were poisoned when employees learned that top executives secretly hedged their positions, and thus did not suffer. Banks sued formerly wealthy entrepreneurs, saying they hid assets to avoid paying their debts.

All that has happened even though many of the Valley's technology companies remain very successful, and the Internet-based economy continues to gain at the expense of the older bricks-and-mortar economy. But few of the companies have lived up to the high expectations that were factored into stock prices before they fell. Many of the highest fliers have vanished from the landscape, either going out of business or being acquired by competitors for a fraction of the prices their shares once fetched.

Among the survivors, employees scarred by the col-

TheStreet.com
Internet index.



lapsing value of their stock options now prefer the certainty of higher salaries.

It is the fate of the once-bountiful stock options that has most determined the current pecking order in Silicon Valley. At the top are those who cashed in their options before the fall. Next come those who worked for companies that prospered.

Their salaries have helped to offset the paper losses, and many companies repriced their options after prices fell, thus saving some value for the employees, before angry shareholders forced a halt to that practice.

At the bottom, and perhaps the largest group, are those who did not cash out and whose companies were not among the winners. While many of them landed jobs at other companies, their wealth has vanished and some have lost their homes. Housing prices fell sharply after the options lost value, and have only recently begun to recover.

Some financial institutions were severely damaged when loans secured by stock options became uncollectible.

The inevitable jealousies reflect the seeming randomness of success and failure. There are tales of employees who did poor jobs but ended up rich, while their more competent and creative neighbors went bankrupt. Younger engineers are angry that they have no chance for the quick wealth their elders gained, and scornful of those who lost it.

Nationally, the effect on the economy has not been as great as was feared. While some other regions with big stakes in the Internet economy were hurt, most notably Seattle and New York City, the effect on most of the country was limited. Consumers cut back, but not by as much as was expected considering the declining value of investment portfolios. Growth since 2003 has been far higher than it was in Japan in the years after that country's bubble burst in 1990. In part, that was because American non-technology stocks were not nearly as overvalued.

Investors have grown much more cautious. That is reflected in the diminished amount of capital available for start-ups, and in other ways as well. Even Microsoft, which became the world's most valuable company long before it paid its first dividend in 2004, now finds that it must raise its payout every year to attract investors.

Memo to: Oaktree Clients

From: Howard Marks

Re: What's It All About, Alpha?

With apologies to Burt Bacharach and Dionne Warwick, whose 1966 rendition for the movie "Alfie" was much more artistic, I couldn't resist adapting their title for a memo on investment theory.

What's it all about, indeed? Everyone talks about alpha . . . and beta, risk and return, and efficiency and inefficiency. But I believe few people use them to mean the same thing, or correctly. Thus the thinking I did about alpha while writing "Safety First" in April has convinced me to set out my views on all of these subjects.

In this connection, my 1967-69 attendance at the University of Chicago Graduate School of Business was pivotal. I had previously been at a non-theoretical Wharton, where I learned investment practice à la Graham and Dodd but not one word on what I'm about to discuss. At Chicago I found a new theory of investments that would revolutionize the field. My exposure to it was eye-opening and kept me from becoming an unquestioning member of what I call the "I know" school of investing (where people think a little effort is all it takes to know the future direction of any stock or market). The 32 years since Chicago have given me enough time to forget a lot of the theory I learned . . . but also, most importantly, the real-world experience needed to leaven it, leading to my own synthesis of theory and practice.

Market efficiency – A great deal of how one views the investment world depends on one's position on the subject of market efficiency. Rather than reinvent my own wheel, I'll lift parts of my memo "Irrational Exuberance" from May 2000. (Thankfully, when you copy from yourself it's not plagiarism.)

First, I'll provide my take on the efficient marketeers' view. Then, I'll describe my own version of market efficiency. I'll admit again that academicians don't share my view and theory says I'm wrong. But my approach works for me, and I'll restate it below.

While at Chicago, one of the first things I studied was the Efficient Market Hypothesis, which states:

- There are many participants in the markets, and they share roughly equal access to all relevant information. They are intelligent, highly motivated and hard working. Their analytical models are widely known and employed.
- Because of the collective efforts of these participants, **information is reflected fully and immediately in the market price of each asset.**

- Thus, market prices provide accurate estimates of assets' intrinsic value, and no participant can consistently identify and profit from instances when they are wrong.
- Assets therefore sell at prices from which they can be expected to deliver risk-adjusted returns that are "fair" relative to other assets. Riskier assets must offer higher returns in order to attract buyers. The market will set prices so that appears to be the case, but it won't provide a "free lunch." That is, there will be no incremental return that is not related to (and compensatory for) incremental risk.

I believe strongly that some markets are quite efficient, including those for the world's leading stocks and bonds. Take international fixed income, for instance. Here, people try to decide whether British, French or German government bonds are the cheapest at a given time and establish portfolio weightings accordingly. The primary differences between these bonds, it seems to me, relate to their issuing countries' rates of economic growth and inflation. But it's to make allowance for those differences that there exist differential interest rates and floating exchange rates. And aren't those some of the world's most closely watched phenomena, with hundreds of sophisticated financial institutions on both sides of every question? Can any one participant realistically expect to be able to do a superior job in such a market?

Stocks are less homogenous, and there's more to choose between them, but I still think the market for popular stocks is efficient. That's the reason why, when I left equity research in 1978, I told Citibank I would "do anything other than spend the rest of my life choosing between Merck and Lilly." I believed in efficient markets then, and I believe in them now. But what do I mean?

When I say efficient, I mean it in the sense of "**speedy**," not "right." I agree that because investors work hard to evaluate every new piece of information, asset prices immediately reflect the **consensus view** of the information's significance. I do not, however, believe the consensus view is necessarily correct. In January 2000, Yahoo! sold at \$237. In April 2001 it was at \$11. Anyone who argues that the market was right both times has his head in the clouds; it has to have been wrong on at least one of those occasions. But that doesn't mean many investors were able to detect and act on the market's error.

If prices in efficient markets already reflect the consensus, then sharing the consensus view will make you likely to earn just an average return. To beat the market you must hold an idiosyncratic, or non-consensus, view. But because the consensus view is as close to right as most people can get, a non-consensus view is unlikely to make you more right than the market (and thus to help you beat the market).

The bottom line for me is that, **although the more efficient markets often misvalue assets, its not easy for anyone person – working with the same information as everyone else and subject to the same psychological influences – to consistently hold views that are different from the consensus and closer to being correct.** That's what makes the mainstream markets awfully hard to beat – even if they aren't always right.

Inefficiency – Although I spent a lot of time last year discussing efficiency, I didn't touch on inefficiency. This is a word I've heard misused terribly, usually as a synonym for "cheap," as in "the oils were fully priced last year but now they're really inefficient." First of all, inefficiency doesn't come and go in quick bursts. Markets are inefficient for longer-term structural reasons relating primarily to shortcomings on the part of their participants and infrastructure. Second, "inefficient" absolutely does not mean "cheap" (or "dear").

To me, an inefficient market is one that is marked by at least one (and probably, as a result, by all) of the following characteristics:

- Market prices are often wrong. Because access to information and the analysis thereof is highly imperfect, market prices are often far above or far below intrinsic values.
- The risk-adjusted return on one asset class can be far out of line with others. Because assets are often valued at other-than-fair prices, an asset class can deliver a risk-adjusted return that is significantly too high (a free lunch) or too low relative to other asset classes.
- Some investors can consistently outperform others. Because of the existence of (a) significant misvaluations and (b) differences between participants in terms of skill, insight and information access, it is possible for misvaluations to be identified and profited from with regularity.

This last point is very important in terms of what it does and does not mean. **Inefficient markets do not necessarily give their participants generous returns. Rather, it's my view that they provide the raw material – mispricings – that can allow some people to win and others to lose on the basis of differential skill.** If prices can be very wrong, that means it's possible to find bargains or overpay. For every person who gets a good buy in an inefficient market, someone else sells too cheap. One of the great sayings about poker is that, "In every game there's a fish. If you've played for 45 minutes and haven't figured out who the fish is, then it's you." The same is certainly true of inefficient market investing.

In inefficient markets, then, it's essential that a manager have superior personal skill, or "alpha" (see below). It's actually far more important than in efficient markets, where prices are so well aligned that it's hard to perform far off the average. Good evidence on this subject is found in the table on the next page, from "Pioneering Portfolio Management" by David Swenson of Yale.

Dispersion of Active Management Returns
Identifies Areas of Opportunity
Asset Returns by Quartile, Ten Years Ending December 31, 1997

Asset Class	First Quartile	Median	Third Quartile	Range
U.S. fixed income	9.7%	9.2%	8.5%	1.2%
U.S. equity	19.5	18.3	17.0	2.5
Int'l equity	12.6	11.0	9.7	2.9
Real estate	5.9	3.9	1.2	4.7
Leveraged buyouts	23.1	16.9	10.1	13.0
Venture capital	25.1	12.4	3.9	21.2

As the table shows, the range between the 25th percentile and the 75th percentile of investors in what I think are relatively inefficient markets (venture capital and leveraged buyouts) is much broader than it is in more efficient markets (mainstream stocks and bonds). This supports the belief that in inefficient markets, either (a) prices diverge more from intrinsic values, (b) there's more variation among investors in terms of skill, (c) that variation has more impact, or (d) all of the above. Any way you slice it, hiring a superior manager is more crucial in the inefficient markets.

Return – The terms alpha and beta are derived from the basic form of an algebraic equation, which is:

$$y = a + bx$$

Thus in investments we say a portfolio's result can be predicted by the equation:

$$\text{return} = \text{alpha} + (\text{beta} \times \text{the market's return})$$

Beta is a coefficient equal to the proportion of the market's return that the portfolio can be expected to capture. It can best be described as "degree of responsiveness" to the market, or "relative volatility." An S&P index fund will have a beta of 1.0 relative to the S&P 500 (that is, it will go up and down at the same rate as the S&P). An S&P index fund leveraged two to one would have a beta of 2.0 (i.e., it will have twice the response). A portfolio consisting of half S&P index fund and half cash will have a beta of .5. A defensive equity portfolio might be expected to have a beta of .7.

Turning up your beta, whether through the use of leverage or by emphasizing more volatile holdings, is certainly one way to try to add to your return. Under investment theory it's the only way, since "beta x the market's return" is the only non-zero term in the above equation (more on this later). The trouble with relying on a high beta to enhance your return is that it's entirely symmetrical. It cuts both ways, subtracting as much when it's wrong as it adds when it's right, which means that it does nothing to increase your expected return unless the underlying decisions are right. It epitomizes the Las Vegas

saying that "the more you bet, the more you win when you win" (but also, as I like to point out, the more you lose when you lose).

Alpha is a variable equal to the contribution resulting from the skill of the portfolio manager. As I wrote in "Safety First," alpha is the ability to profit consistently from things other than the movements of the market, to add to return without adding proportionately to risk, and to be right more often than is called for by chance. Examples of its ingredients include superiority in (a) collecting and analyzing information, (b) discerning which factors are most important in determining future value, and (c) resisting the market's manic-depressive fluctuations.

Alpha is what's lacking when a market is efficient. But just as I believe there are some relatively efficient markets, I'm also sure people with alpha exist, as well as less efficient markets where it can be put to good use.

It's essential to recognize that investment skill isn't distributed evenly – that the investment world isn't democratic or egalitarian. That's why Peter Vermilye, the Citibank boss who steered me toward convertibles and high yield bonds, says only the top 10% of analysts contribute anything. It's also why I think so little of investment management firms that describe their edge in terms of head count; an army of average analysts will do you no good.

That's because, in my view, alpha is best thought of as "differential advantage," or skill that others don't possess. Alpha isn't knowing something, **it's knowing something others don't know**. If everyone else shares a bit of knowledge, it provides no advantage. It certainly won't help you beat the market, given that the market price embodies the consensus view of investors – who on average know what you know.

Alpha is entirely personal. It's idiosyncratic, an art form. It's superior insight; some people just "get it" better than others. Some of them are mechanistic quants; others are entirely intuitive. Hard work is a common thread among the best investors I know, but hard work alone is absolutely insufficient to explain their superior performance.

Alpha is zero for someone with no skill (i.e., a dart thrower). Warren Buffett, on the other hand, seems to have lots of alpha – even in a market most people think of as efficient. It's possible to have negative alpha if you're wrong more often than not. Someone who's always wrong would have lots of negative alpha, but he'd be a great guy to know (since you could be right all the time by doing the opposite of what he says).

Everyone knows it's a cornerstone of investment theory that there's no such thing as alpha . . .

Clearly this underlies the Efficient Market Hypothesis. The market is more right than any investor. No investor is better than any other. No one is capable of consistently outperforming. Anecdotal evidence of superior performance is dismissed by academicians who attribute it to luck or a too-short trial period.

... but there's something of an oxymoron afoot. Even though thousands of people expect to make a living from active investment management, much of traditional investment thinking is built on the realization that alpha is severely limited (even though the practitioners don't state it that way).

Why do I say that? Most investors claim they can outperform the market – that is, can see, assess and understand better than the average investor – because of superior intelligence and hard work. Doesn't everyone think he can beat the market? But much of what's actually practiced, even by Oaktree, subtly acknowledges that the ability to know more – and if you think of it, that's a lot of what alpha really is – is quite limited.

It's a common assumption that if an investor's portfolios are highly concentrated, they're risky. But that assumes he can't see the future. If he could, it would be perfectly safe to have a low level of diversification. In fact, if his foresight were perfect, then the safest portfolio would hold only one asset, because that's the one he would think of most highly (and, since he could see the future, he would of course be right). Thus diversification, which is widely practiced even in the "I know" school of investing, represents a tacit acknowledgement that there's a lot that investors don't know.

Investors' strong preference for liquidity is another indicator that this limitation is accepted. Even the "I know" investors, who buy on the assumption they're right, insist on liquidity – because they know there's a good chance they'll be wrong and need to beat a retreat. But the more you can see the future, the less likely you'll be wrong, and the less risk there is that exiting could be difficult.

In reality, then, not just investment theory, but also a great deal of everyday practice, is built around the acknowledgement that alpha – skill and foresight – is a scarce commodity.

Risk – It's essential that investors consider risk. In the time since I entered the investment field, return has increasingly come to be evaluated in risk-adjusted terms. Everyone knows that if two portfolios return 8% a year for five years, the two managers didn't necessarily do an equally good job of investing. If one did it with T-bills and the other with emerging market stocks, the first manager almost certainly did a better job – since he earned the same return with far less risk. That's real added value, just like earning more return with the same or less risk. **To know how good a job a manager did, then, you have to have a good idea how much risk he took.**

Yet I think risk may be the area where both theory and many aspects of practice are furthest from right. The first thing you learn in investment theory, and one of the most widely agreed-on assumptions in practice, is that "volatility equals risk." This premise underlies a great deal of portfolio theory, asset allocation, portfolio optimization and performance assessment. But what are its merits?

I believe the academicians of the 1950s and '60s were influenced to accept volatility as the measure of investment risk by its two outstanding virtues: it is (a) absolute and (b) quantifiable. They can tell you precisely what the standard deviation of a stock or a portfolio's return was in the past, and thus it only takes a little extrapolation to project what it's going to be in the future.

I will suggest some other ways to think about risk, but (a) they will vary from person to person and from situation to situation, and/or (b) they will not be easily quantified. Thus they won't permit you to say that one asset or portfolio would be riskier than another (other than possibly in a given application). You won't even be able to say how risky an asset or portfolio was in the past.

What is risk? First of all, I don't think risk is synonymous with volatility. And second, the indicia of risk vary by asset class.

At Oaktree, when we think about adding an asset to a portfolio, we ask whether the risk entailed is tolerable (i.e., within our charter from our clients) and offset by the likely return. And by risk we mean the chance of losing our clients' money.

In high yield bonds we concentrate on the risk of default and how much principal would likely be unrecoverable. In distressed debt we wonder whether the company's assets will turn out to be worth less than we think or the reorganization will go against us. In convertibles and emerging market equities we worry about the chance a stock will decline and the likelihood that our protective efforts will fail to insulate us.

We do not think about volatility. With our capital in either locked-up funds or long-term relationships, we worry only about whether the ultimate result, perhaps years down the road, will be positive or negative, and by how much. We think this is what our clients pay us to do.

But we make no claim that this approach to risk is subject to quantification or numerical manipulation. Bruce Karsh probably couldn't have quantified the riskiness of Consec bonds at the time we bought them last June. Richard Masson and Matt Barrett probably wouldn't have agreed with him, or with each other, on the probability of loss. Any figure they settled on probably wouldn't have been in a form that could be equated with risk. **And even today, a year later and after having sold the bonds, we still can't quantify the risk we took.** It's a concept, a notion, a worry . . . but not a number.

This might be the right way to think about risk – it's certainly how we do it – but it wouldn't work at all for a "quant." He'd have no way to state our portfolio's risk, or its risk-adjusted return, or tell whether our performance was superior or inferior.

Will an investment lose money? Will a pension fund fail to earn its actuarial assumption? Will an endowment be unable to cover its spending rate? Will a retiree have less than he needs to live on? Will a manager lose an account? These are the risks – the perils – that we think matter.

Most pension funds have a very long time horizon, and for a university endowment it's theoretically infinite. Volatile quarterly returns wouldn't be a meaningful source of risk for them as they would be for a retiree scraping by. But once you say a given portfolio is risky for one investor but not another, there ceases to be a unique number that measures its absolute riskiness. In that case, how can you talk about its risk, or its risk-adjusted return?

Correlation – The final analytical element to be considered when assembling securities into portfolios is their degree of connectedness, or **correlation**. As discussed above, a one-asset portfolio would be optimal for someone who can see the future. The main reason for holding more than one asset is diversification. But the principal virtue of diversification, protection from catastrophic error, is wiped out if the underlying assets will react the same to environmental change and move together.

Thus it's not enough to be able to estimate return and risk in isolation; we must understand correlation. Even if we can estimate the separate potential of two assets, we cannot know how a portfolio combining them will behave unless we know how they will move relative to each other. Two stocks in the same industry may be highly correlated, but two companies whose products compete directly may not (that is, whichever one wins, the other is likely to lose).

Let's say there are two assets with high prospective return and risk. A portfolio consisting of the two can have high risk if they are correlated but low risk if they are not. Thus adding an uncorrelated, high-risk asset can reduce the overall riskiness of a portfolio. This understanding revolutionized investing by enabling risk-averse investors to hold high-return, high-risk assets as long as they are uncorrelated with the rest of their portfolio. Certainly Oaktree owes much of its very existence to the understanding of how assets behave in combination.

Tracking error, which lately has been of increased interest, refers to a specific type of connectedness: that between a portfolio and a benchmark. More and more, clients are asking about managers' tracking error in the past and monitoring it after hiring them.

A client hires managers to play specific roles in its portfolio, and it wants to be sure they will do so. In considering whether to include high yield bonds in its portfolio, for example, the client may model the performance of the portfolio incorporating the Salomon Cash-Pay Index as a proxy for the high yield bond component. Then if the client hires a manager, it wants to be sure the manager will track the Salomon Index closely (of course while outperforming!)

Thus clients have reason to want low tracking error. But if you think about it, the two principal sources of tracking error are (a) over- and under-weightings of the securities in the index and (b) inclusion of off-index securities. So it's obviously possible for tracking error to be too low; an index fund would have zero tracking error, but that's not what clients hire active managers to create. Thus we have a client who monitors our tracking error and complains when it's too low, because they want to see active bets being made.

* * *

This last point illustrates what I think should be the role of theory in our industry. In short, I think, **theory should inform our decisions but not dominate them.**

If we entirely ignore theory, we can make big mistakes. We can fool ourselves into thinking it's possible to know more than everyone else and regularly beat heavily populated markets. We can buy securities for their returns but ignore their risk. We can buy fifty correlated securities and mistakenly think we've diversified. When I think of the impact of being blind to theory, I flash back to 1970 and the frighteningly simplistic rationale behind my colleagues' expectation of 12% a year from stocks: if they could emulate the historic 10% return with ease through indexing, it should be a snap to add a couple of percent with just a little effort.

But swallowing theory whole can make us turn the process over to a computer and miss out on the contribution skillful individuals can make. The image here is of the efficient-market-believing finance professor who takes a walk with a student. "Isn't that a \$10 bill lying on the ground?" asks the student. "No, it can't be a \$10 bill," answers the professor. "If it were, someone would have picked it up by now." The professor walks away, and the student picks it up and has a beer.

So how do we balance the two? By applying informed common sense. At Chicago, I spent a wonderful semester with Professor James Lorie. Students loved his anecdote-filled course, which we nicknamed "Lorie's Stories," and its visits from active investors. True-believing theorists may have sneered at it, but it was this class that inspired me to integrate my practical Wharton foundation and the Chicago theory, rather than stick exclusively to either one.

A year after graduating, I had lunch with Jim Lorie and asked – off the theoretical record – how he would manage a portfolio. His simple advice was informed by theory but realistic: "I would index the core and manage the hell out of the periphery."

* * *

The key turning point in my investment management career came when I concluded that hard work and skill would pay off best in inefficient markets. Theory informed that decision and prevented me from wasting my time elsewhere, but it took an understanding of the limits of the theory to keep me from completely accepting the arguments against active management. Theory and practice have to be balanced in this way. Certainly neither alone is enough.

July 11, 2001

Memo to: Oaktree Clients

From: Howard Marks

Re: You Can't Predict. You Can Prepare.

Those who have been readers of my memos for any meaningful period of time know there are a few things I dismiss and a few I believe in thoroughly. The former include economic forecasts, which I think don't add value, and the list of the latter starts with cycles and the need to prepare for them.

"Hey," you might say, "that's contradictory. The best way to prepare for cycles is to predict them, and you just said it can't be done." That's absolutely true, but in my opinion by no means debilitating. All of investing consists of dealing with the future, as I've written before, and the future is something we can't know much about. But the limits on our foreknowledge needn't doom us to failure as long as we acknowledge them and act accordingly.

In my opinion, the key to dealing with the future lies in knowing where you are, even if you can't know precisely where you're going. **Knowing where you are in a cycle and what that implies for the future is very different from predicting the timing, extent and shape of the next cyclical move.** And so we'd better understand all we can about cycles and their behavior.

Cycles in General

I think several things about cycles are worth bearing in mind:

- Cycles are inevitable. Every once in a while, an up-or down-leg goes on for a long time and/or to a great extreme and people start to say "this time it's different." They cite the changes in geopolitics, institutions, technology or behavior that have rendered the "old rules" obsolete. They make investment decisions that extrapolate the recent trend. And then it turns out that the old rules do still apply, and the cycle resumes. In the end, trees don't grow to the sky, and few things go to zero. Rather, most phenomena turn out to be cyclical.
- Cycles' clout is heightened by the inability of investors to remember the past. As John Kenneth Galbraith says, "extreme brevity of the financial memory" keeps market participants from recognizing the recurring nature of these patterns, and thus their inevitability:

... when the same or closely similar circumstances occur again, sometimes in only a few years, they are hailed by a new, often youthful, and always supremely self-confident generation as a brilliantly innovative discovery in the financial and

For the title of this memo I've borrowed the tagline from Mass Mutual's advertising campaign.

larger economic world. There can be few fields of human endeavor in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present.

- Cycles are self-correcting, and their reversal is not necessarily dependent on exogenous events. The reason they reverse (rather than going on forever) is that trends create the reasons for their own reversal. Thus I like to say **success carries within itself the seeds of failure, and failure the seeds of success.**
- Seen through the lens of human perception, cycles are often viewed as less symmetrical than they are. Negative price fluctuations are called "volatility," while positive price fluctuations are called "profit." Collapsing markets are called "selling panics," while surges receive more benign descriptions (but I think they may best be seen as "buying panics"; see tech stocks in 1999, for example). Commentators talk about "investor capitulation" at the bottom of market cycles, while I also see capitulation at tops, when previously-prudent investors throw in the towel and buy.

I have views on how these general observations and others apply to specific kinds of cycles, which I will set forth below.

The Economic Cycle

Few things are the subject of more study than the economy. There's a whole profession built around doing so. Academics try to understand the economy, and professionals try to predict its course. Personally, I'd stick to the former. I think we can gain a good grasp of how the economy works, but I do not think we can predict its fluctuations.

I have written *ad nauseam* on this subject, but I will repeat a few of the observations I consider relevant:

- There are hundreds, or more likely thousands, of people out there trying to predict the movements of the economy, but no one has a record much better than anyone else. Certainly no one who was consistently capable of accurately predicting the economy's movements would be among those distributing their forecasts gratis.
- The markets already incorporate the views of the consensus of economists, and thus holding a consensus view can't help you make above-average returns (even if it's right).
- Non-consensus views can make money for you, but to do so they must be right. Because the consensus reflects the efforts of a large number of intelligent and informed people, however, it's usually the closest we can get to right. In other words, I doubt there's anyone out there with non-consensus views that are right routinely.

- Most of the time, the consensus forecast extrapolates current observations. Most predictions for growth, inflation and interest rates bear a strong resemblance to the levels prevailing at the time they're made. Thus they're close to right when nothing changes radically, which is the case most of the time, but no prediction can be counted on to foretell the important sea changes. And it's in predicting radical changes that extraordinary profit potential exists. In other words, **it's the surprises that have profound market impact (and thus profound profit potential), but there's a good reason why they're called surprises: it's hard to see them coming!**
- Each time there's a radical change, there's an economist who predicted it, and that person gets to enjoy his fifteen minutes of fame. Usually, however, he wasn't right because of a superior ability to see the future, but rather because he tends to hold extreme positions (or perhaps he's a dart thrower) and this time the phenomenon went his way. Rarely if ever is that economist right twice in a row.

So forecasts are unlikely to help us foresee the movements of the economic cycle. Nevertheless, we must be aware that it exists and repeats. The greatest mistakes with regard to the economic cycle result from a willingness to believe that it will not recur. But it always does – and those gullible enough to believe it won't tend to lose money.

When we marketed our first distressed debt fund in 1988, most of the resistance came from people who said, "maybe there won't be a recession, and thus nothing for you to buy." Of course, we were deep into a recession within two years, and our 1988-92 distressed debt funds found lots to buy and produced excellent returns.

Eminent observers concluded again in the 1990s that the cycle had been eliminated and there would be no recession. In 1996, the Wall Street Journal wrote:

From boardrooms to living rooms and from government offices to trading floors, a new consensus is emerging: The big, bad business cycle has been tamed.

Top business leaders were quoted as saying "There is no natural law that says we have to have a recession" and "I don't see what could happen to make a cyclical downturn." (These quotes are reminiscent of – and look no less silly than – some of my favorites from 1928: "There will be no interruption of our present prosperity" and "I cannot help but raise a dissenting voice to the statements that . . . prosperity in this country must necessarily diminish and recede in the future.")

Those quoted in 1996 might insist they weren't saying there would never be another recession, but rather that the tendency toward cyclical fluctuation had been dampened and there wouldn't be a recession soon. And they might say they were right in 1996, because there wasn't one until 2001. If managers had feared a recession in 1996, they might have pulled in their horns and missed some of the profits of the late 1990s. But they also might have avoided over-expanding and participating fully in the recession of 2001.

The important thing is to recognize that cycles reverse, and to allow for it. I described in my last memo, "What Lies Ahead?," the manner in which a recession continues until, at the margin, a few participants stop cutting back and decide instead to act in anticipation of better times. I believe this process, and the reverse process that eventually causes growth to stall out, will go on forever. No one knows when the turn will occur, or how far the correcting leg will go, but the odds are against anyone who says, "the business cycle is dead."

How can non-forecasters like Oaktree best cope with the ups and downs of the economic cycle? I think the answer lies in knowing where we are and leaning against the wind. For example, when the economy has fallen substantially, observers are depressed, capacity expansion has ceased and there begin to be signs of recovery, we are willing to invest in companies in cyclical industries. When growth is strong, capacity is being brought on stream to keep up with soaring demand and the market forgets these are cyclical companies whose peak earnings deserve trough valuations, we trim our holdings aggressively. We certainly might do so too early, but that beats the heck out of doing it too late.

The Credit Cycle

The longer I'm involved in investing, the more impressed I am by the power of the credit cycle. It takes only a small fluctuation in the economy to produce a large fluctuation in the availability of credit, with great impact on asset prices and back on the economy itself.

The process is simple:

- The economy moves into a period of prosperity.
- Providers of capital thrive, increasing their capital base.
- Because bad news is scarce, the risks entailed in lending and investing seem to have shrunk.
- Risk averseness disappears.
- Financial institutions move to expand their businesses – that is, to provide more capital.
- They compete for market share by lowering demanded returns (e.g., cutting interest rates), lowering credit standards, providing more capital for a given transaction, and easing covenants.

At the extreme, providers of capital finance borrowers and projects that aren't worthy of being financed. As The Economist said earlier this year, "the worst loans are made at the best of times." This leads to capital destruction – that is, to investment of capital in projects where the cost of capital exceeds the return on capital, and eventually to cases where there is no return of capital.

When this point is reached, the up-leg described above is reversed.

- Losses cause lenders to become discouraged and shy away.
- Risk averseness rises, and along with it, interest rates, credit restrictions and covenant requirements.
- Less capital is made available – and at the trough of the cycle, only to the most qualified of borrowers.
- Companies become starved for capital. Borrowers are unable to roll over their debts, leading to defaults and bankruptcies.
- This process contributes to and reinforces the economic contraction.

Of course, at the extreme the process is ready to be reversed again. Because the competition to make loans or investments is low, high returns can be demanded along with high creditworthiness. Contrarians who commit capital at this point have a shot at high returns, and those tempting potential returns begin to draw in capital. In this way, a recovery begins to be fueled.

I stated earlier that cycles are self-correcting. The credit cycle corrects itself through the processes described above, and it represents one of the factors driving the fluctuations of the economic cycle. **Prosperity brings expanded lending, which leads to unwise lending, which produces large losses, which makes lenders stop lending, which ends prosperity, and on and on.**

In "Genius Isn't Enough" on the subject of Long-Term Capital Management, I wrote "Look around the next time there's a crisis; you'll probably find a lender."

Overpermissive providers of capital frequently aid and abet financial bubbles.

There have been numerous recent examples where loose credit contributed to booms that were followed by famous collapses: real estate in 1989-92; emerging markets in 1994-98; Long-Term Capital in 1998; the movie exhibition industry in 1999-2000; venture capital funds and telecommunications companies in 2000-01. In each case, lenders and investors provided too much cheap money and the result was over-expansion and dramatic losses. In "Fields of Dreams" Kevin Costner was told, "if you build it, they will come." **In the financial world, if you offer cheap money, they will borrow, buy and build – often without discipline, and with very negative consequences.**

The credit cycle contributed tremendously to the tech bubble. Money from venture capital funds caused far too many companies to be created, often with little in terms of business justification or profit prospects. Wild demand for IPOs caused their hot stocks to rise meteorically, enabling venture funds to report triple-digit returns and attract still more capital requiring speedy deployment. The generosity of the capital markets let companies sign on for huge capital projects that were only partially financed, secure in the knowledge that more financing would be available later, at higher p/e's and lower interest rates as the projects were further along. This ease caused far more capacity to be built than was needed, a lot of which is sitting idle. Much of the investment that went into it may never be recovered. Once again, easy money has led to capital destruction.

In making investments, it has become my habit to worry less about the economic future – which I'm sure I can't know much about – than I do about the supply/demand picture relating to capital. Being positioned to make investments in an uncrowded arena conveys vast advantages. Participating in a field that everyone's throwing money at is a formula for disaster.

We have lived through a long period in which cash acted like ballast, retarding your progress. **Now I think we're going into an environment where cash will be king.** If you went to a leading venture capital fund in 1999 and said, "I'd like to invest \$10 million with you," they'd say, "Lots of people want to give us their cash. What else can you offer? Do you have contacts? Strategic insights?" I think the answer today would be different.

One of the critical elements in business or investment success is staying power. I often speak of the six-foot-tall man who drowned crossing the stream that was five feet deep on average. Companies have to be able to get through the tough times, and cash is one of the things that can make the difference. Thus all of the investments we're making today assume we'll be going into the difficult part of the credit cycle, and we're looking for companies that will be able to stay the course.

The Corporate Life Cycle

As indicated above, business firms have to live through ups and downs. They're organic entities, and they have life cycles of their own.

Most companies are born in an entrepreneurial mode, starting with dreams, limited capital and the need to be frugal. Success comes to some. They enjoy profitability, growth and expanded resources, but they also must cope with increasing bureaucracy and managerial challenges. The lucky few become world-class organizations, but eventually most are confronted with challenges relating to hubris; extreme size; the difficulty of controlling far-flung operations; and perhaps ossification and an unwillingness to innovate and take risks. Some stagnate in maturity, and some fail under aging products or excessive debt loads and move into distress and bankruptcy. The reason I say failure carries within itself the seeds of success is that bankruptcy then permits some of them to shed debt and onerous contracts and emerge with a reborn emphasis on frugality and profitability. And the cycle resumes . . . as ever.

The biggest mistakes I have witnessed in my investing career came when people ignored the limitations imposed by the corporate life cycle. In short, investors did assume trees could grow to the sky. In 1999, just as in 1969, investors accepted that ultra-high profit growth could go on forever. They also concluded that for the stocks of companies capable of such growth, no p/e ratio was too high. People extrapolated earnings growth of 20%-plus and paid p/e ratios of 50-plus. Of course, when neither the growth nor the valuations turned out to be sustainable, losses of 90%-plus became the rule. As always, the folly of projecting limitless growth became obvious in retrospect.

The exigencies of the corporate life cycle usually render ultra-high growth rates unsustainable. Regardless of the improbability, however, investors indulge in "the willing suspension of disbelief" (which I always bring to the movies but check at the door when I come to work). They assume that successful companies will be able to attract enough talent, develop enough new products, access enough new markets, fend off competition while protecting high profit margins, and correctly make the strategic adaptations needed to keep growing . . . but it rarely works that way.

In February an article in Fortune magazine, covering 1960-80, 1970-90 and 1980-99, showed that out of 150 candidates among large companies, only four or five in each period were able to grow earnings per share at 15% per year on average. Only one, Philip Morris, grew at that rate for all three periods. The key for Philip Morris wasn't a technological miracle or a fabulous new growth product; it was solid blocking and tackling in areas of stable consumer demand. So the latest "wonder-company" with a unique product rarely possesses the secret of rapid growth forever. I think it's safer to expect a company's growth rate to regress toward the mean than it is to expect perpetual motion.

Business Fads and Fancies

We all laugh about hemlines, which fluctuate from year to year and add nothing to society but cost. The truth is, there's no place for them to go but up and down . . . and so they do. Likewise, there are business trends that have nowhere to go but back and forth . . . and so they do.

Take corporate diversification, for example. As a new equity analyst in 1970, one of my first assignments was to study conglomerates, starting with Litton, ITT, Whittaker, Teledyne and City Investing. It was widely held that their diversification and synergies (along with the magic of acquisition accounting and high p/e "funny money") could produce rapid growth forever. They pursued large numbers of acquisitions (ITT made 52 one year) and were rewarded with very high p/e ratios (which enabled them to prolong their growth for a while through further anti-dilutive acquisitions).

It wasn't long, however, before their dependence on sky-high multiples was recognized and difficulties surfaced in connection with the management of their diverse organizations. Their managers switched to stressing the benefits of specialization (as opposed to diversification), and the head of Whittaker wrote a paper extolling the virtues of a process he called "distillation of the product centroid." Units began to be sold off and the companies deconglomerated. It's interesting to note that none of those five companies exists today.

Diversification or specialization? Centralization or decentralization? Savings through just-in-time inventories or protection from stockpiles and redundancy? Tough goal-oriented management or warm-and-fuzzy work environments? Leverage on the upside through maximum debt or the safety that comes from a large equity cushion? The

pendulum in each of these continua can do nothing but swing back and forth, and so it does. The answer is that there is no perfect answer. Companies move toward one extreme as it becomes more popular. Then the drawbacks surface and they move back toward the other. There's no place else for companies to move with regard to each of these questions, and so they cycle from one extreme to the other.

Likewise, there are cyclical fluctuations in how business phenomena are viewed. People move *en masse* toward one view, and when it turns out that no view can hold the answer, they move away from it.

For example, in the 1990s, information technology was thought to hold the answer to increased corporate efficiency. A great deal of the decade's bull market was fed by gains in productivity, which contributed greatly to both earnings and the p/e ratios investors applied to them. Technology-derived gains in productivity were embraced as having fundamentally altered the growth potential of companies and the economy. In testimony to the House of Representatives on February 23, 2000, Alan Greenspan said:

. . . there are few signs to date of slowing in the pace of innovation and the spread of our newer technologies that, as I have indicated in previous testimonies, have been at the root of our extraordinary productivity improvement. Indeed, some analysts conjecture that we still may be in the earlier stages of the rapid adoption of new technologies and not yet in sight of the stage when this wave of innovation will crest.

Well, I know what did crest within 30 days: the stock market. And on October 24, 2001, just twenty months later, a less expansive Mr. Greenspan was quoted in the Wall Street Journal as saying:

What the events of September 11 did was to introduce a whole new set of uncertainties which information technology is not going to improve our insight into. And so it is a reversal of some of the forces that engendered the productivity acceleration of the last five years.

In other words, what had been thought to be a fundamental and durable change has proved to be one more development whose ability to wax and wane has to be acknowledged and watched. The gains from productivity are proving to be cyclical, and the cycle shorter than had been expected.

The Market Cycle

At the University of Chicago, I was taught that the value of an asset is the discounted present value of its future cash flows. If this is true, we should expect the prices of assets to change in line with changes in the outlook for their cash flows. But we know that asset prices often rise and fall without regard for cash flows, and certainly by amounts that are entirely disproportionate to the changes in cash flows.

Finance professors would say that these fluctuations reflect changes in the discount rate being applied to the cash flows or, in other words, changes in valuation parameters. Practitioners would agree that changes in p/e ratios are responsible, and we all know that p/e ratios fluctuate much more radically than do company fundamentals.

The market has a mind of its own, and its changes in valuation parameters, caused primarily by changes in investor psychology (not changes in fundamentals), that account for most short-term changes in security prices. This psychology, too, moves in a highly cyclical manner.

For decades – literally – I've been lugging around what I thought was a particularly apt enumeration of the three stages of a bull market:

- **the first, when a few forward-looking people begin to believe things will get better,**
- **the second, when most investors realize improvement is actually underway, and**
- **the third, when everyone concludes everything will get better forever.**

Why would anyone waste time trying for a better description? This one says it all.

Stocks are cheapest when everything looks grim. The depressing outlook keeps them there, and only a few astute and daring bargain hunters are willing to take new positions. Maybe their buying attracts some attention, or maybe the outlook turns a little less depressing, but for one reason or another, the market starts moving up.

After a while, the outlook seems a little less poor. People begin to appreciate that improvement is taking place, and it requires less imagination to be a buyer. Of course, with the economy and market off the critical list, they pay prices that are more reflective of stocks' fair values.

And eventually, giddiness sets in. Cheered by the improvement in economic and corporate results, people become willing to extrapolate it. The masses become excited (and envious) about the profits made by investors who were early, and they want in. And they ignore the cyclical nature of things and conclude that the gains will go on forever. That's why I love the old adage "What the wise man does in the beginning, the fool does in the end." Most importantly, in the late stages of the great bull markets, people become willing to pay prices for stocks that assume the good times will go on *ad infinitum*.

But they cannot. When the tech bubble was roaring ahead in late 1999, no one could think of any development that might be capable of bringing it to an end. Technology was certain to revolutionize everyday life, creating a new investment paradigm. Revenue growth (or at least the growth in "eye-balls") was strong. Capital was freely available, enabling expansion to continue and new, innovative companies to be formed. Cash flows into mutual funds and 401(k)s guaranteed steady demand for the stocks. Each time another tech stock was added to an index, a whole new group of forced buyers was created among index funds and the active managers benchmarked against that index. No

portfolio manager could take the risk of under-owning these stocks; **they had to buy them regardless of price!** Eureka! There was no way they could stop going up. The perpetual motion machine had been built.

But somehow, the stocks did stop going up. And then they started going down. I don't think anyone can say just what it was that caused the tech bubble to burst. Certainly I can't think of any one thing – even in hindsight, which is usually 20:20. Maybe the groundwork was laid for declines when it was shown merely that the rise could slow. Maybe a few smart people, to paraphrase the third of the three stages, concluded that everything wouldn't get better forever. The best explanation probably is that the prices just collapsed under their own weight.

Anyway, the market proved – once again – that it can't move in one direction forever. **It has to be appreciated in cyclical terms, with increases followed by decreases, and in fact with increases causing decreases.**

In April 1991, in just my second general memo to clients, I described the market as follows:

The mood swings of the securities markets resemble the movement of a pendulum. Although the midpoint of its arc best describes the position of a pendulum "on average," it actually spends very little of its time there. Instead, it is almost always swinging toward or away from the extremes of its arc. But whenever the pendulum is near either extreme, it is inevitable that it will move back toward the midpoint sooner or later. In fact, it is the movement toward an extreme itself that supplies the energy for the swing back.

Investment markets make the same pendulum-like swing:

- between euphoria and depression,
- between celebrating positive developments and obsessing over negatives, and thus
- between overpriced and underpriced.

The swing of the pendulum? The oscillation of the cycle? Either way's fine – just don't tell me it'll be a straight line.

In 1999, the Wall Street Journal ran a number of OpEd pieces by James Glassman and Kevin Hassett trumpeting the theory behind the book "Dow 36,000." I couldn't think of anything that made less sense. By last month, it seemed the Journal's story had changed:

With economic conditions turning downward so quickly, pushed along by the events of Sept. 11, a lot of business books have been rendered irrelevant, even silly. Anyone remember "Dow 36,000"?

How quickly views change, and how quickly the logical-sounding rationale for lofty or depressed prices is shown in retrospect to have been "silly."

* * *

The risks entailed in ignoring the inherently cyclical nature of things are manifold, and the various cycles interact, often in ways that surprise the optimists. On October 26 the beautifully written (but inaptly-titled) "Grant's Interest Rate Observer" described the situation at a fallen telecommunications giant as follows:

In the New Economy, the front office seemed persuaded, there would be no recession (let alone a global recession) and no bear market (especially one concentrated in technology). There would be no pause in the growth of the demand for broadband, no collapse in the price of broadband access and no credit contraction. What we are looking at . . . is compressed cash flow at the trough in a cyclical business so new that its proponents have yet to discover that it is, in fact, cyclical.

This example represents a four-bagger. It seems the company's management ignored the cyclicity of (1) the economy, (2) the stock market, (3) the availability of credit, and (4) the demand and price for its product. As in this case, the failure to prepare for cycles usually leads to what later are perceived as obvious, easily-avoided mistakes.

Cycles and How To Live With Them

No one knew when the tech bubble would burst, and no one knew what the extent of the correction could be or how long it would last. But it wasn't impossible to get a sense that the market was euphoric and investors were behaving in an unquestioning, giddy manner. That was all it would have taken to avoid a great deal of the carnage.

Having said that, I want to point out emphatically that many of those who complained about the excessive market valuations – including me – started to do so years too soon. And for a long time, another of my old standards was proved true: "being too far ahead of your time is indistinguishable from being wrong." Some of the cautious investors ran out of staying power, losing their jobs or their clients because of having missed the gains. Some capitulated and, having missed the gains, jumped in just in time to participate in the losses.

So I'm not trying to give the impression that coping with cycles is easy. But I do think it's a necessary effort. We may never know where we're going, or when the tide will turn, but we had better have a good idea where we are.

November 20, 2001

Memo to: Oaktree Clients

From: Howard Marks

Re: The Realist's Creed

Early this year, I was asked to write an article for "Trusts & Estates" magazine. Here it is, in part cobbled together from things I've written in the past, and slightly changed from the version that was published in April.

The editors wanted me to recommend a course of investment action for beneficiaries and their fiduciaries. To most people that means deciding how much to put into stocks and bonds (and which ones), and whether private equity and hedge funds should be included. It usually sounds easy: all you have to do is make a few simple judgments about the future. I decided to write a very different article: it's going to tell you how hard investing is, and how you can best equip yourself for the task.

First, I think investing must be based on a firmly held belief system. What do you believe in, and what do you reject? Put another way, what are the principles that will guide you?

For me, the starting point consists of deciding which approach to take in dealing with the future. That decision primarily revolves around choosing between two polar opposites: what I call the "I know" school and the "I don't know" school.

Most of the investment professionals I've met over my 33 years in the industry fall squarely into the "I know" school. These are people who believe they can discern what the future holds, and in their world investing is a simple matter:

- First you decide what the economy is going to do in the period under consideration.
- Then you figure out what the impact will be on interest rates.
- From this you infer how the securities markets will perform.
- You choose the industries that will do best in that environment.
- You make judgments about how the industries' companies will fare in terms of profits.
- Based on all of this information, you pick stocks that are bound to appreciate.

End of story. Of course, the usefulness of this approach depends entirely on people's ability to make these decisions correctly. What if you're wrong about the economy? What if you're right about the economy but wrong about its impact on a company's profits? Or what if you're right about profits but the valuation parameters contract, and thus the price? The bottom line is that the members of this school think these things are knowable. I know lots of people who are perpetually and constitutionally optimistic about both the long-term future for stocks and their ability to make these judgments correctly.

On the other hand, I and most of the investors with whom I feel an affinity belong to the "I don't know" school. In short, (1) we feel it's impossible for anyone to know much about a vast number of things, (2) we consider it especially difficult to outperform by guessing right about the direction of the economy and the markets, (3) we spend our time trying to know more than the next person about specific micro situations, and (4) we think more about what can go wrong than about what can go right. In contrast to the "I know" school, people in this group are more cautious and feel a strong need for downside protection.

Sticking to this approach requires some solid building blocks. One of those is **contrarianism**. Basically that means leaning away from the direction chosen by most others. Sell when they're euphoric, and buy when they're afraid. Sell what they love, and buy what they hate. In general, I think you'll find few bargains among the investments that everyone knows about, understands, feels comfortable with, is impressed by and is eager to own. Instead, the best bargains usually lie among the things people aren't aware of, don't fully understand, or consider arcane, unseemly or risky.

Closely related to contrarianism is **skepticism**. It's a simple concept, but it has great potential for keeping investors out of trouble: **If it sounds too good to be true, it probably is**. That phrase is always heard after the losses have piled up – be it in portfolio insurance, "market neutral" funds, dot-coms, or Enron. My career in money management has been based on the conviction that free lunches do exist, but not for everyone, or where everyone's looking, or without hard work and superior skill. Skepticism needn't make you give up on superior risk-adjusted returns, but it should make you ask tough questions about the ease of accessing them.

Thus I also advocate **modest expectations**. To shoot for top-quartile performance every year, you have to hold an idiosyncratic portfolio that exposes you to the risk of being outside the pack and dead wrong. It's behavior like that that leads to managers being carried off the field when things go poorly – and to clients losing lots of money. It's far more reasonable just to try for performance that's consistently a little above average. Even that's not easy to achieve, but if accomplished for a long period it will result in an outstanding track record.

I think **humility** is essential, especially concerning the ability to know the future. Before acting on a forecast, we must ask whether there's good reason to think we're more right than the consensus view already embodied in prices. I think it's possible to get a knowledge advantage with regard to under-researched companies and securities, but only through hard work and skill.

Finally, I'm a strong believer in **investing defensively**. That means worrying about what one may not know, about what can go wrong, and about losing money. If you're worried, you'll tend to build in greater margin for error. Worriers gain less when everything goes right, but they also lose less – and stay in the game – when things return to earth. All of Oaktree's activities are guided more by one principle than any other: **if we avoid the losers, the winners will take care of themselves**. We're much more concerned about

participating in a loser than we are about letting a winner get away. In my experience, long-term investment success can be built much more reliably on the avoidance of significant losses than it can on the quest for outsized gains. A high batting average, not a swing-for-the-fences style, offers the most dependable route to success.

Second, I'd advise you to approach the entire subject of forecasts and forecasters with extreme distrust. Reduced to the absolute minimum, investing consists of just one thing:

Making judgments about the future. And the future is inherently uncertain. Everyone looks for help in dealing with this uncertainty, and their usual recourse is to put faith in forecasters. How could they not? Most forecasters are highly articulate, represent prestigious institutions, and exude total confidence in their knowledge of the future.

The problem, however, is that they're not often right, or at least not consistently more right than others. And almost never do they (or anyone else) record and assess their accuracy over time. Here's the way I view the forecasting game.

- There are hundreds, or more likely thousands, of people out there trying to predict the future, but no one has a record much better than anyone else. **Given how valuable superior forecasts can be, recipients should wonder why anyone who was capable of consistently making them would distribute them gratis.**
- Market prices for assets already incorporate the views of the consensus of forecasters. Thus holding a consensus view, even if it's right, can't help you make above-average returns.
- Non-consensus views can make you a lot of money, but to do so they must be right. Because the consensus reflects the forecasting efforts of a large number of intelligent and informed people, however, it's usually the closest we can get to right. In other words, I doubt there's anyone out there with non-consensus views that are right routinely.
- Most of the time, the consensus forecast extrapolates current observations. Predictions for a given parameter usually bear a strong resemblance to the level of the parameter prevailing at the time they're made. Thus predictions are often close to right when nothing changes radically, which is the case most of the time, but they can't be counted on to foretell the important sea changes. And as my friend Ric Kayne says, "everything important in financial history has taken place outside of two standard deviations." It's in predicting radical change that extraordinary profit potential exists. In other words, **it's the surprises that have profound market impact (and thus profound profit potential), but there's a good reason why they're called surprises: it's hard to see them coming!**
- Each time a radical change occurs, there's someone who predicted it, and that person gets to enjoy his fifteen minutes of fame. Usually, however, he wasn't right because

of a superior ability to see the future, but rather because he regularly holds extreme positions (or perhaps he's a dart thrower) and this time the phenomenon went his way. Rarely if ever is that person right twice in a row.

So forecasts are unlikely to help us gain an advantage, but that doesn't make people stop putting their faith in them. It's unsettling to realize how much in the dark we investors are concerning future developments. But there's one thing worse: to ignore the limits of our foresight. The late Stanford behaviorist Amos Tversky put it best: **"It's frightening to think that you might not know something, but more frightening to think that, by and large, the world is run by people who have faith that they know exactly what's going on."**

Third, I think it's essential to remember that just about everything is cyclical.

There's little I'm certain of, but these things are true: Cycles always prevail eventually. Nothing goes in one direction forever. Trees don't grow to the sky. Few things go to zero. **And there's little that's as dangerous for investor health as insistence on extrapolating today's events into the future.**

The economy will not rise forever. Industrial trends won't continue indefinitely. The companies that succeed for a while often will cease to do so. Company profits won't increase without limitation. Investor psychology won't go in one direction forever, and thus neither will security prices. An investment style that does best (or worst) in one period is unlikely to do so again in the next.

That was really the problem with the technology bubble. Investors were willing to pay prices that assumed success forever. They ignored the economic cycle, the credit cycle and, most importantly, the corporate life cycle. They forgot that profitability would bring imitation and competition, which would cut into – or eliminate – profitability. They overlooked the fact that the same powerful force that made their companies attractive – technological progress – could at some point render them obsolete. And they failed to consider that the investing fads in favor of these technologies, companies and stocks could reverse, with dire consequences.

Fourth, investors should bear in mind the role played by timeframe. It seems obvious, but long-term trends need time in order to work out, and time can be limited. Or as John Maynard Keynes put it, "Markets can remain irrational longer than you can remain solvent." Whenever you're tempted to bet heavily on your conviction that a given phenomenon can be depended on in the long run, think about the six-foot tall man who drowned crossing the stream that was five feet deep on average.

One of the great delusions suffered in the 1990s was that "stocks always outperform." I agree that stocks can be counted on to beat bonds, cash and inflation, as Wharton's Prof. Jeremy Siegel demonstrated, but only with the qualification "in the long run." If you have thirty years, it's reasonable to expect equity returns to be superior to those on bonds. For someone with a thirty-year timeframe, the NASDAQ's decline since 2000 may turn out to be a matter of indifference. But it hasn't felt that way to the people holding the stocks.

The need for time came into play in another way for the technology and telecommunications entrepreneurs. Many raised the money they needed for a year or two and proceeded to burn it up. They counted on being able to raise more later, but in 2000-02 capital has been denied even to worthwhile ideas. Lots of companies never got the chance to reach profitability. They simply ran out of time.

Fifth, you must never forget the key role played by valuation. Investment success doesn't come primarily from "buying good things," but rather from "buying things well" (and the difference isn't just grammatical). **It's easy for most people to tell the difference between a good company and a bad one, but much harder for them to understand the difference between a cheap stock and an expensive one.** Some of the biggest losses occur when people buy the stocks of great companies at too-high prices. In contrast, investing in terrible companies can produce huge profits if it's done at the right price. Over time, investors may shift their focus from dividend yield to p/e ratio, and they may stop looking at book value, but that doesn't mean valuation can be considered irrelevant.

In the tech bubble, buyers didn't worry about whether a stock was priced too high because they were sure someone else would be willing to pay them more for it. Unfortunately, this "greater fool theory" only works until it doesn't. They also thought the technological developments were so great that the companies' stocks could be bought regardless of price. In the end, though, when newness becomes old, flaws appear and investor ardor cools, the only thing that matters is the stock's price . . . and it's usually much lower.

Most shortages – whether of commodities or securities – ease when high prices inevitably cause supply to rise and satisfy the demand. And no fad lasts forever. Thus valuation eventually comes into play, and those who are holding the bag when it does are forced to face the music.

Sixth, beware the quest for the simple solution. Two important forces drive the search for investment options: the urge to make money and the desire for help in negotiating the uncertain future. When a market, an individual or an investment technique produces impressive returns for a while, it generally attracts excessive (and unquestioning) devotion. I call this solution-du-jour the "silver bullet."

Investors are always looking for it. Call it the Holy Grail or the free lunch, but everyone wants a ticket to riches without risk. **Few people question whether it can exist, or why it should be available to them.** At the bottom line, hope springs eternal. Thus investors pursued Nifty-Fifty growth stock investing in the 1970s, portfolio insurance in the '80s, and the technology boom of the '90s. They aligned themselves with "geniuses" they thought would make investing easy – be it Joe Granville, Elaine Garzarelli or Henry Blodgett.

But the silver bullet doesn't exist. No strategy can produce high rates of return without risk. And nobody has all the answers; we're all just human. **Markets are highly dynamic and, among other things, they function over time to take away the**

opportunity for unusual profits. Unskeptical belief that the silver bullet is at hand eventually leads to capital punishment.

Seventh, you must be aware of what's going on around you in terms of investor psychology. I don't believe in the ability of forecasters to tell us where prices are going, but an understanding of where we are in terms of investor psychology can give us a hint. When investors are exuberant, as they were in 1999 and early 2000, it's dangerous. When the man on the street thinks stocks are a great idea and sure to produce profits, I'd watch out. When attitudes of this sort make for stock prices that assume the best and incorporate no fear, it's a formula for disaster.

I find myself using one quote, from Warren Buffett, more often than any other: "**The less prudence with which others conduct their affairs, the greater prudence with which we should conduct our own affairs.**" When others are euphoric, that puts us in danger. When others are frightened and pull back, their behavior makes bargains plentiful. In other words, what others are thinking and doing holds substantial ramifications for you. And that brings us full circle to the importance of contrarianism.

* * *

I've cataloged above the "mental arsenal" I feel is needed in the battle for investment success. I'll proceed below to illustrate the application of some of these concepts to two key asset classes: **common stocks**, the grand-daddy of all active investments, and **hedge funds**, a much smaller area that is in the process of attracting a lot of attention (and capital).

Common stocks – Among the mantras that were repeated in the past decade, few received as much credence as "stocks outperform." Wharton's Professor Jeremy Siegel documented in his book, "Stocks for the Long Run," that equities have beaten bonds, cash and inflation over almost all long periods of time. In fact, his graph of the movements of the stock market since 1800 looks like a straight line rising from lower left to upper right. Evidence like this allowed people to invest heavily in the stock market while continuing to sleep well. Little did they know that the price gains that made them feel so sanguine about their positions were dramatically increasing their risk.

I am a great believer in common stock investing, but I hold tight to a few caveats:

- Return expectations must be reasonable.
- The ride won't be without bumps.
- It's not easy to get above-market returns.

We live in the world's most productive economy, under a very effective capitalist system, at a wonderful point in time. In general, it's great to own productive assets like companies and their shares. **But occasionally, people lose track of the fact that in the long run, shares can't do much better than the companies that issue them.** Or to

paraphrase Warren Buffett, when people forget that corporate profits grow at 8 or 9% per year, they tend to get into trouble.

It's never clear what base period makes for a relevant comparison, but between 1930 and 1990, annual returns from stocks averaged about 10% year. Periods when they did better were followed by periods when they did worse. The better periods were usually caused by the expansion of p/e ratios, but valuations tended to return from the stratosphere, and in the long run, returns roughly paralleled profit growth.

There always will be bull markets and bear markets. The bull markets will be welcomed warmly and unskeptically, because people will be making money. These markets will be propelled to great heights, usually by the rationalization that "it's different this time"; that productivity, technology, globalization, lower taxation – something – has permanently elevated the prospective return from stocks.

The bear markets will come as a shock to the unsuspecting, demonstrating that, most of the time, the world doesn't change that much. For example, when you look at Siegel's 200-year straight-line stock market graph, no hiccup is visible in 1973-74. Try telling that to the average equity investor, who lost half his money.

The bottom line is that risk of fluctuation always is present. Thus stocks are risky unless your time frame truly allows you to live through the downs while awaiting the ups. Remember what Lord Keynes said about the ability of markets to remain irrational for long periods of time. And remember that it's possible for you to be forced to sell at the bottom – by emotions, competitive pressure or the need for liquidity – turning temporary volatility (the theoretical definition of risk) into very real permanent loss.

In order to get more out of the ups of stocks and try to lessen the pain of the downs, most people turn to active management via market timing, group rotation, industry emphasis and stock selection. But it's just not that easy. The American Way – earnestly applying elbow grease – doesn't often payoff. **For a model, don't think about the diligent paperboy on his route; think about trying to profit from flipping a coin.**

I say that because I believe most markets are relatively "efficient," and that certainly includes the mainstream stock market. Where large numbers of investors are aware of an asset's existence, have roughly equal access to information and are diligently working to evaluate it, the market operates to incorporate their collective interpretation of the information into a market price. While that price is often wrong, very few investors are capable of consistently knowing when it is, and by how much, and in which direction.

The evidence is clear: most investors underperform the market. They (a) can't see the future, (b) make mistakes that keep them at a disadvantage, (c) accept high risk in their effort to distinguish themselves, and (d) spend money trying (in the form of market impact and transaction costs).

Of course, there are individuals who beat the market by substantial margins, and they become famous. The mere fact that they attract so much attention proves how rare they are. (That's the meaning of the adage "it's the exception that proves the rule.") Adding to return without adding commensurately to risk requires rare understanding of how money is made and what constitutes value. Far more managers promise it than deliver.

Most active managers go through times when their biases or their guesses lead them to do things that beat their assigned benchmark, which they attribute to their skill, and times that are the opposite, which they attribute to being blindsided by the unforeseeable (or to some defect in the benchmark). But these are two sides of the same coin, and in the long run the average manager adds little. Usually, active management will not allow you to beat the stock market, or to enjoy the fruits of the market without fully bearing its risk.

How do I view the outlook for stocks? The period since I started managing money in 1978 has been incredible. There were a few bad days and quarters, but through 1999 there wasn't a single year when the S&P 500 lost 5%. From 1978 through 1999, the return on the S&P 500 averaged 17.6% per year. That rose to 20.6% for 1991-99 and 28.3% for 1995-99. I doubt there's ever been a better 22-year run; to ask for more would be just plain piggish. But I don't think it'll be anything like that in the years just ahead, and of course there's been a considerable correction already.

The observers I most respect foresee single digit average returns for common stocks, and I agree. Equity returns have three components: profit increase, multiple expansion and dividend yield. The last is minimal and the second can't be counted on from here. So that means we're down to the rate of increase in corporate profits, which is likely to be in single digits. Single digit returns would be below the historic average, but after such a great 22-year run, a little less wouldn't be unreasonable.

Hedge Funds – Perhaps because they were new to the market, many who participated in the equity boom of the late 1990s were surprised by the suddenness with which their profits evaporated in the subsequent correction. Now they're looking for a new path to profit without risk, and many think they've found it in hedge funds. Their reasons for migrating include the good performance of hedge funds, especially amid the recent chaos, and the modest prospective returns available in the mainstream stock and bond markets.

First, how about a definition. Generally speaking, a hedge fund is an unregulated, private investment partnership whose manager receives a percentage of the profits. To "hedge" is to intentionally include positions that can be depended on to move counter to each other under most circumstances, and thereby to mitigate exposure to developments in the environment. "Hedge fund" is a misnomer for many of today's funds, however, because unlike the days when the term first arose, hedging has become far from universal.

The funds I'm interested in do hedge. They're designed to systematically take advantage of market inefficiencies and to capture managers' skill while limiting susceptibility to market fluctuations. Arbitrage, long/short, hedge and market-neutral strategies fall into

this category. Most strive to earn returns in the teens on a consistent basis, with relative indifference and insensitivity to the performance of the mainstream markets. If they can do it, they're a great idea.

Today, hedge funds, also sometimes called "absolute return" funds, are being promoted heavily by brokerage firms, mutual fund organizations and investment advisers and popularized by the media. They are in the process of becoming the next investment fad. And there's good reason why they should. Especially given the weak competition I see coming from mainstream investment media like stocks, an appropriate mantra for the coming decade might be "low double digits ain't bad." If you can identify investment managers who possess enough skill to consistently deliver such returns, you should hire them. And there's a better-than-average chance they'll be found in the hedge fund arena, where the managers get to share in the profits.

However, a few caveats are in order:

- **Expectations still must be reasonable.** Investors must realize that very few managers are truly capable of earning before-fee returns of 12% or 15% steadily and with low correlation to the mainstream markets. Anything approaching 20% is Herculean.
- **Most returns really won't be "absolute."** I have seen lots of "hedge funds" and "market neutral funds" drop precipitously. That's because it's unusual for portfolio returns to be entirely divorced from their environment. "Zero correlation" with the market is rarely attainable; "low correlation" may have to suffice.
- **Money flows will play a big role.** In general, the good records have been built on small amounts of money. And those records will attract large amounts of money. There are several consequences.

First, records simply may not be capable of extrapolation. **To handle more money, a manager may have to invest faster, reduce selectivity, put more dollars into each position, put on a larger number of positions, broaden the fund's range of activities, and/or add new staff members. All of these can have negative implications for returns.**

Second, many of the best managers with skill and discipline are already closed to new money, or will reach the point when they are. Thus in the extreme, as Groucho Marx would have put it, "I would never invest my money with anyone who'd take it."

And third, when there's too much money in an area, even funds that are closed can be affected. Long-Term Capital Management found others emulating its trades and eventually lost its opportunity because too much money had piled into its niches.

- **The wrong people will get money.** The rush to invest in an area gives money to managers who shouldn't get it. **When the best are closed, the rest will be funded.**

Second-string managers will split off from established groups and get money based on their old fund's record (regardless of how much of it they were responsible for). Thus, as the amount of money in the area rises, the average quality of the managers may fall.

- **Fees can eat up skill.** When the demand for funds outstrips supply, fund managers have the ability to raise fees and thereby appropriate for themselves a larger portion of their funds' returns.
- **Disappointments will be many.** Due to the factors enumerated above, the next few years will see many investors fail to get what they hoped for . . . as usual. One of my favorite sayings is "**what the wise man does in the beginning, the fool does in the end.**" Over the last 20-30 years, a few talented hedge fund managers built successful records with relatively small amounts of capital. I believe the period ahead will see lots of people raise more than they should; thus it will have to be navigated with care.

All investment trends run a high risk of being carried to extremes. (For a shining example, take a look at venture capital in 2000.) Despite this, I think absolute return investing deserves your attention. But you should commit only after a lot of investigation and with your eyes wide open. Remember, there is no such thing as a silver bullet.

* * *

The main thing I've tried to indicate here is that investing isn't easy. Or better put, superior investing isn't easy. It's easy to do average. In fact, there are vehicles – index funds – that exist for the explicit purpose of delivering average performance at low cost, and they are completely capable of doing so.

But most people want to do better than the average. They want higher returns, and achieving higher returns without assuming commensurately higher risk is the hard part.

It's easy to make guesses about the future but hard to be consistently more right in those guesses than your fellow investor, and thus hard to consistently outperform. Doing the same thing others do exposes you to fluctuations that in part are exaggerated by their actions and your own. It's certainly undesirable to be part of the herd when it stampedes off the cliff, but it takes rare skill, insight and discipline to avoid it.

The thing I'm surest of is that the solution doesn't lie in making guesses about the big-picture future. Rather, it lies with investors who possess skill, insight and discipline. There are times when they'll underperform – times like 1998-99, when aggressiveness was rewarded far more than caution. But if you can find those people, you should stick with them. For me, the laundry list of their desired characteristics is clear:

- adherence to the "I don't know" school of thought
- contrarianism, skepticism, modest expectations, humility and defensiveness
- eschewing of macro forecasts

- attention to the cyclical nature of things
- consciousness of timeframe
- concentration on valuation
- disdaining the hunt for the silver bullet
- awareness of prevailing investor psychology

You can go with opinions about the future. Everyone's got them, and what they call for in terms of investment behavior usually is obvious. In other words, the "I know" school makes investing sound easy – although in my opinion it's not often right.

Or you can join me in the "I don't know" school, where you must:

- face up to the uncertainty that surrounds the macro future;
- concentrate on avoiding pitfalls;
- invest in a few areas of specialization based on in-depth analysis, conservatively estimated tangible values and modest purchase prices; and
- be prepared for returns that trail the risk-takers when markets are hot.

This may be the less common path, and certainly the less rosy, but it's the one I'd much rather count on for success in the long run.

May 31, 2002

Memo to: Oaktree Clients

From: Howard Marks

Re: Returns and How They Get That Way

"Where do babies come from?" When I was a kid, this was the subject of a great many jokes, and the answer was always the same: "The stork brings them." Now it's fifty years later, and no one jokes about the stork any more. Maybe that's because today's kids learn the real answer so much sooner than we did.

Where do equity returns come from? Fewer people ask this question than asked about the stork fifty years ago, . . . and even fewer have the answer. I'll give you one hint: **it's not from the stork.**

The Source of Equity Returns

In the late 1990s, stock prices exploded upward, along with the number of people buying them. And as long as stock prices rose, the new investors felt they knew all they had to about where equity returns came from: They came from rising prices. And surely you could depend on prices to rise.

What was it that investors thought would cause a given stock's price to rise?

- It's been performing like a rocket.
- It's the subject of a brokerage house recommendation, a TV or magazine story, or some chat room hype.
- Someone (I don't remember who) is recommending it.
- It's selling below an analyst's target price.
- Other people can be counted on to buy it, taking it ever higher.
- In fact, investors have to buy it, because money will keep flowing to stocks and people can't risk omitting this one from their portfolios.
- Or maybe it'll become part of the S&P 500, and indexers and closet indexers will have to add it to their portfolios.

As always, however, the post mortem is more thorough than the simplistic thought process that preceded it, and the results are a lot less pleasant. Dreams of ever-rising prices aren't enough. Now we know there has to be a reason why prices should rise.

Today, cooler heads point out that long-term equity returns are driven by dividends and earnings growth. "Huh?" say the people who entered the market in the late '90s.

I remember having a spirited discussion on this topic with my father in the late 1960s. I came home from the University of Chicago filled with the notion that the value of a share of stock is the present value of its future dividends. "Baloney," my father said, "no one buys stocks for the dividends; they buy them for appreciation." "But what makes them appreciate?" I asked. We never have reached agreement on this matter.

I think we were both right and both wrong. Certainly in a real-world sense, people don't buy stocks for dividends. Dividends provided a small portion of the total return on stocks in the 1960s and far less in the 1990s. Yes, most people buy stocks for appreciation. **But what causes appreciation? There has to be an underlying process at work. We're in trouble if all we can say is "we buy stocks in the hope they'll go up, and they'll go up if new buyers are willing to pay more than the last price."** To explain what'll make the buyers pay more than the last price, we either have to (1) identify what I call an underlying process or (2) fall back on the bromides listed above that led investors off the cliff in the 1990s.

The "underlying process" has to be related to financial parameters. By that I mean the asset values and/or cash flows must be recognized as being worth more than the last price paid. That's what causes appreciation.

Because so few stocks are bought today for asset values, we essentially can disregard them. The vast majority of stocks are bought for the stream of earnings the companies produce.

But how do those earnings affect investors – get through to investors – if not in the form of dividends? That's the question that drove me in the 1960s. It almost verges on metaphysical. If a company has great earnings but those earnings aren't ever paid out in dividends, are they still of value to investors? If it makes a bunch of money but just hoards it, or reinvests it in new products and facilities that generate future earnings that also are not paid out, in what way are its profits of value to investors? That's kind of like the old question, "if a tree falls in the forest but there's no one around to hear it, does it still make noise?"

There are two possible answers:

- Eventually, earnings must be paid out. Common sense tells us that, sooner or later, every company will run out of good reinvestment opportunities, and the cash will then go to dividends, or to stock buy-backs, which have the same effect but better tax treatment. (Of course, the record suggests that when they run out of good reinvestment opportunities, companies often prefer bad reinvestment opportunities to giving the money to the shareholders.)
- Alternatively, if cash builds up in a company and its stock doesn't rise to reflect the buildup but instead languishes "too cheap," someone will bid the stock up in order to take over the company. This is economics at work: the value of every asset is the

present value of the cash flows it will produce in the future, and eventually the market will price the asset to reflect that value, because there are ways to reap it.

So What Makes Stocks Worth More?

The equation defining the price of a share of stock is a very simple one:

$$P = E \times P/E$$

The price of a share of stock is equal to the earnings per share times the ratio of the stock price to the earnings. On one hand this explains how prices are set, and on the other hand it's just tautological: divide both sides of the equation by E and you get $P/E = P/E$. Even I can't argue with that one.

This gives rise to another simple equation:

$$\Delta P = \Delta E + \Delta P/E$$

Change in price is powered by one or more of the following factors:

increased earnings eventually are turned into increased dividends, the undistributed earnings are reinvested to power future earnings growth, and/or the likely stream of future earnings comes to be viewed as being worth more than the last price paid, causing an increase in the P/E ratio.

"Growth investors" pursue companies whose earnings are growing the fastest. As per the equation, if the P/E ratio holds, earnings growth will be translated directly into stock price appreciation. And if there's an increase in investor recognition of the company's growth potential, the P/E ratio can expand as well, producing appreciation at a rate that exceeds the rate of earnings growth.

"Value investors," on the other hand, invest primarily in companies where (1) earnings, while perhaps lacking rapid trendline growth potential, are temporarily depressed and likely to rebound, and/or (2) the stock's price is unduly low relative to even the low-growth earnings, and thus the P/E ratio can be expected to expand.

Any way you slice it, the truth is that changes in a stock's price will be determined by changes in the earnings per share and changes in the multiple at which investors value those earnings. So those who want to predict the movement of a stock's price, or of the whole market, have to predict those two things. To get to total return, you simply add the dividend yield to the rate of price appreciation.

The Outlook for Equity Returns

Clearly, equity returns primarily come from price appreciation. And the dominant consideration in long-term appreciation is earnings growth. Why do I say "long term appreciation"? Because even though P/E ratios jump around much more in the short run than do earnings, they tend to move within relatively fixed boundaries and, in the long run, their fluctuations should cancel out.

The simple view – which I tend to take – is that P/E ratios reached ridiculous levels in the 1990s and now, even after significant price declines, still are higher in absolute terms than they were at many previous market **tops**. Thus, you can assume that P/E ratios will stay where they are, and thus that earnings growth will translate into parallel price appreciation. Or you can assume multiple contraction, in which case appreciation will lag earnings gains. But I doubt that a prudent investor can count on P/E ratio expansion as a source of future stock price appreciation. Thus, any positive returns will be determined primarily by the rate of earnings growth.

Over the years I've quoted Warren Buffett as saying something like "people get into trouble when they forget that corporate profits tend to grow at 9% a year." In September I had a chance to ask him if he actually said that. "No," he said, "what I said is 'people get into trouble when they forget that in the long run, stocks won't appreciate faster than the growth in corporate profits.'" Other people spend a lot more time than me studying how fast corporate profits have grown and will grow. However, the evidence I'm familiar with suggests a figure somewhere in mid-single digits.

So with dividends minimal and multiples unlikely to expand (at best), normal historic profit growth seems like a reasonable starting point for equity returns in the long-term future. (Of course, extrapolating historic corporate profit growth implies extrapolating the historic price increases and profit margins. Neither of these is assured, but why go there?) What I'm left with is trendline price appreciation somewhere in mid-single digits. Where in that range, I'll leave to others.

Adding to Returns Through Active Management

I have written a great deal on the subject of active management (see especially "Safety First . . . But Where?," April 2001) and have no interest in reiterating. But I will discuss the active management industry.

An enormous infrastructure has been built up over the last century for the purpose of beating the stock market. Fifty or seventy-five years ago, that sentence would have read, " . . . for the purpose of managing stock market investments." However, the index fund industry has grown up in the last thirty years and made it clear that average performance can be accessed much more cheaply and dependably through passive management than through active management. Thus the *raison d'être* of the active managers became beating the market.

To do so, the investment management industry invests in analysts, portfolio managers and traders, not to mention accountants, salespeople and risk managers – plus wood paneling, oriental rugs and seascapes. All of this costs money, and the management firms want a return on their spending. So they charge healthy fees. The people whose money the firms manage also bear other costs entailed in active management, such as commissions, market impact, and taxes on short-term gains caused by active trading. The question is, "What are they getting for their money?"

The problem is that there has been no documentation that active equity management consistently provides an edge in the mainstream stock market. Some individuals never beat the market, but even those who do usually see their success limited to brief periods of time. A given strategy works for a while and then stops. It's usually a matter of being patient and waiting until your ship comes in. Very few people are skillful enough to outperform through thick and thin. As I've said before, the attention paid to people like Warren Buffett and Peter Lynch is a tribute to their uniqueness and demonstrates the meaning of the phrase, "it's the exception that proves the rule." The rule is that few people can beat the market for long.

We've already established that equity returns primarily come from appreciation. When seeking appreciation, you can look for one or more of the following:

- 1 increases in an asset's intrinsic value (earnings or asset values),
- 2 movement of the asset's price from a discount toward its intrinsic value (that is, from undervaluation to fair value), and/or
- 3 movement of the price from intrinsic value toward a premium (that is, from fair value to overvaluation).

In my opinion, superior returns come most dependably from buying things for less than they're worth and benefiting from the movement of price from discount to fair value. Making money this way doesn't require increases in intrinsic value, which are uncertain, or the attainment of prices above intrinsic value, which is irrational.

The attractiveness of buying something for less than it's worth makes eminent sense. However, doing so requires cooperation from someone who's willing to sell it for less than it's worth. It's the SEC's goal to make sure that everyone has the same corporate information. So how is one to find bargains in efficient markets? You must bring exceptional analytical ability, insight or foresight. But because it's exceptional, few people have it. Once in a while someone will find an undervalued stock or guess right about the direction of the market, but very few people are able to do those things consistently over time.

So What's To Do?

You can try harder, but everyone's already trying their hardest. Or you can ratchet up the risk level of your portfolio – counting on the long-run relationship between risk and return – but once in a while that'll get you killed. Or you can look for inefficient markets.

In inefficient markets, not everyone has the same access to information. I feel bargains are found most consistently among the things that are not widely known, not understood, or considered to be risky, complex, unfashionable, controversial, or unseemly. When you combine unequal access to information, uneven ability to analyze that information, and the effects of negative biases, it's possible for things to sell for less than they're worth. In inefficient markets, it's possible for a superior investor to consistently identify those bargains, and thus to beat the other players consistently. It's also possible to achieve risk-adjusted returns above those available in other market niches. All it takes is hard work and superior skill.

However, it makes sense to assume that since the greatest reward for active management is found in the inefficient markets (along with incentive fees for the successful managers), that's also where sharp-eyed specialists will focus their efforts. (Think of card counting in blackjack versus betting on the spin of a roulette wheel; where do you think you'll find the Ph.D.s?)

In addition, it must be borne in mind that few sectors remain so inefficient that they can be counted on to provide a free lunch for long. Over the years, many strategies have been thought to represent a sure thing, but most fizzled out. Computer software stocks, the nifty-fifty, oil stocks, emerging markets, and most recently tech-media-telecom – all of these groups have in turn been deified and decimated. Likewise, a number of investment techniques have had their day in the sun and then been eclipsed: covered call writing, portfolio insurance and "market neutral" funds are just a few. **Nothing can be relied on for high risk-adjusted returns just because of what it's called. No investment area has that birthright. It's all a matter of the ability to identify bargain-priced opportunities and implement with skill.**

The bottom line might be that inefficient markets can be the source of superior returns and can be less heavily populated, but the players there are, on average, more competent. Because returns in inefficient markets are more dependent on investors' individual skill (which is highly variable) than they are on the market's overall return, there'll be a greater dispersion of results there. And that means lesser investors should be expected to underperform greater investors by a wide margin.

Sources of Return for Active Managers

The best way to look at portfolio return (y) is as follows:

$$y = \alpha + \beta x$$

In this simple equation, α is the symbol for alpha, β represents beta, and x is the return of the market. Alpha is best thought of as a portfolio manager's differential skill or value added. **It is the ability to generate performance unrelated to movement of the market.** Index funds don't aspire to alpha. They're managed by people who know they don't have alpha (actually, most believe no one has any), and they simply strive to reflect the market's movements – no better and no worse. Active managers manage actively because they think they have alpha. They charge for it, and they should be able to demonstrate it. However, many without it seem to have gotten away with charging for it over the years.

Beta is the extent to which a portfolio reflects the return of the market. A portfolio with a beta of 1 and no alpha will move up and down exactly as does the market. A beta of 2 means it will move twice as fast in both directions. A beta of .5 means it'll move half as fast. A beta of zero means a total lack of correlation – the much sought-after "market neutral" fund, where all of the return comes from investor skill. A negative beta means an inverse correlation (a short position on an index fund is the best example).

I believe the alpha/beta model is an excellent way to assess portfolios, portfolio managers, investment strategies and asset allocation schemes. **It's really an organized way to think about the question, "how much of the return comes from what the environment provides, and how much from the manager's value added?"** When one considers these things, some relevant inquiries are:

- Where did the return come from in the past?
- Where is the return expected to come from in the future?
- How exposed is a given strategy (or my overall portfolio) to market movement or dependence on claims of alpha? How much of my future return am I betting on the direction of the market, and how much on manager skill?
- What assumptions am I willing to make about the outlook for those two things?

A lot is written about the tyranny of benchmarks. Excessive benchmarking (and an overemphasis on minimizing tracking error) can force managers to migrate toward benchmark asset weightings in order to reduce their risk of negative performance comparisons. Clearly, if a manager has real skill, this process can suppress it.

However, there are very valid roles for benchmarking. Perhaps the best is in helping to attribute performance between market impact and the manager's value added. In fact, this can't be done without reference to an effective benchmark.

It's obvious that this manager doesn't have any skill:

Period	Benchmark Return	Portfolio Return
1	10	10
2	6	6
3	0	0
4	-10	-10
5	20	20

But neither does this manager (he just moves half as much as the benchmark):

Period	Benchmark Return	Portfolio Return
1	10	5
2	6	3
3	0	0
4	-10	-5
5	20	10

Or this one (he moves twice as much):

Period	Benchmark Return	Portfolio Return
1	10	20
2	6	12
3	0	0
4	-10	-20
5	20	40

This one has a little:

Period	Benchmark Return	Portfolio Return
1	10	11
2	6	8
3	0	-1
4	-10	-9
5	20	21

While this one has a lot:

Period	Benchmark Return	Portfolio Return
1	10	12
2	6	10
3	0	3
4	-10	2
5	20	30

This one has a ton, if you can live with the volatility.

Period	Benchmark Return	Portfolio Return
1	10	25
2	6	20
3	0	-5
4	-10	-20
5	20	25

Chasing Alpha

There are people who seem able to make money or beat the market year in and year out. It's not certain, however, that they'll manage portfolios long enough to convince the statisticians that alpha exists and that they have it. They might make so much money that they'll stop managing portfolios for others, and thus their performance will cease to be public. Or they might not live long enough for their records to attain statistical significance. (At the University of Chicago they told me it takes 64 years to be sure someone is good rather than lucky; more on this later.) But I know managers, including those I work with every day, who I'm convinced can add to return without adding commensurately to risk – and in fact while reducing risk.

How do these "alpha managers" do it? As I described in "The Realist's Creed," the alpha managers I know come from the "I don't know" school. They don't expect to know more than others about the future direction of economies and markets, and thus they eschew market timing and other forms of macro decision-making. They just try to gain an edge by knowing more than others do about micro matters. As contrarians, they prefer to buy things that are out of favor. They invest defensively, thinking more about what they don't know than about what they do, and worrying more about losing money than about missing winners. They build their records on high batting averages and the absence of losers, rather than on occasional homeruns within a hit-or-miss pattern of returns.

Most of them are hard working and driven. They take their jobs very seriously and think about their portfolios night and day. They tend to talk investments with each other, not football or movies. Many are "early adapters" who use technology to access diverse information sources in order to gain a knowledge advantage. They look for hard asset values or under-appreciated situations. They buy with confidence in their analysis, and if the price of the asset falls, they tend to like it more – and buy rather than sell. **Most important is that intangible something – they just "get it" better than others.**

While going over this list of the characteristics I'd look for in a manager, I want to take a moment for an essential caveat. One thing these criteria guarantee is that there'll be times when investors from the "I don't know" school will look terrible. In times of euphoria, qualities like emphasis on value, contrarianism, skepticism and defensiveness are guaranteed to produce performance that sorely lags the hot sectors and the risk takers. This was amply demonstrated in 1998-99, when the best managers I know watched from the sidelines as others got rich . . . temporarily. People who employ alpha managers might feel pangs of regret over what they pass up in boom times, but they should know the route to performance they've chosen is far more reliable.

Clearly, managers with alpha, **once identified**, can be depended on to a much greater extent than those whose returns are generated primarily by market movements. Having said that, however, I don't want to appear to underestimate the difficulty of finding managers with alpha. I've been on the receiving end of many presentations from managers pursuing foundation business, and I can certify that it's not easy to distinguish

those who sound good and are from those who sound good but aren't. (People who don't sound good usually aren't allowed out to make presentations.)

Certainly the search for alpha managers is a tough one. Not only is it hard to know which managers have it, but:

- The search for them will be littered with mistakes and losses.
- Good managers are likely to close their funds before their limits are exceeded.
- Managers talented enough to exploit inefficiencies will be able to appropriate a fair bit of the excess return for themselves in the form of fees.
- The limited size of inefficient markets and the limited capacity of the managers probably mean very large investment pools can't expect to invest enough with alpha managers to greatly affect their results. And their attempts to pump in large amounts of capital can ruin the opportunity for everyone.

There certainly are stumbling blocks in the search for alpha managers, but it's worth trying. If you aren't satisfied with doing average in efficient markets, what else is there? Invest with managers who claim they know what the future holds and can otherwise out-invest everyone else in the same mainstream stocks? I doubt that's the way. To paraphrase Professor James Lorie of the University of Chicago (circa 1970), I'd rather "index the core of a portfolio and manage the heck out of the periphery" – hopefully with help from managers with alpha.

The Role of Luck

To end this memo on returns, I want to spend a few pages discussing the part played by randomness (or luck or chance). A new book on this subject is being passed around the alpha manager world more than Playboy was passed around when I was in the ninth grade. It's "Fooled By Randomness" by Nassim Taleb, a Ph. D. hedge fund manager and self-described aesthete.

My "Realist's Creed" list of required ingredients for intelligent investing started with membership in the "I don't know" school; progressed through contrarianism, humility and skepticism; and ended with awareness of prevailing investor psychology. **Taleb's book reminded me of one other essential: being conscious of the role of luck.**

This book can be difficult to read. Here are just two examples:

Popper believed that any idea of Utopia is necessarily closed in the fact that it chokes its own refutations.

... to be technical, these "randomizations" are frequently done during optimization problems, when one needs to perturbate a function.

Nevertheless, I found its contents profound. In "Investment Miscellany" I discussed an article by Richard Bookstaber of Moore Capital and stated that, "What smart people do is put into logical words the thoughts we may have had but never formulated or expressed." Taleb is such an individual. As I did with Bookstaber's article, I will attempt below to communicate and explain some of his salient points, supported by excerpts from the book.

Randomness (or luck) plays a huge part in life's results, and outcomes that hinge on random events should be viewed as different from those that do not.

Thus, when considering whether an investment record is likely to be repeated, it is essential to think about the role of randomness in the manager's results, and whether the performance resulted from skill or simply being lucky.

\$10 million earned through Russian roulette does not have the same value as \$10 million earned through the diligent and artful practice of dentistry. They are the same, can buy the same goods, except that one's dependence on randomness is greater than the other. To your accountant, though, they would be identical. . . . Yet, deep down, I cannot help but consider them as qualitatively different. (p. 28)

Every record should be considered in light of the other outcomes – Taleb calls them "alternative histories" – that could have occurred just as easily as the "visible histories" that did.

Clearly my way of judging matters is probabilistic in nature; it relies on the notion of what could have probably happened. (p.29)

If we have heard of [history's great generals and inventors], it is simply because they took considerable risks, along with thousands of others, and happened to win. They were intelligent, courageous, noble (at times), had the highest possible obtainable culture in their day – but so did thousands of others who live in the musty footnotes of history. (p. 35)

Think about the aggressive backgammon player who can't win without a roll of double sixes. He accepts the cube – doubling the stakes – and then gets his "boxcars." It might have been an unwise bet, with its one-in-36 chance of success, but because it succeeded, everybody considers him brilliant. We should think about how probable it was that something other than double sixes would materialize, and thus how lucky the player was to have won. **This says a lot about his likelihood of winning again.**

As my friend Bruce Newberg says over our backgammon games, "there are probabilities, and then there are outcomes." **The fact that something's improbable doesn't mean it won't happen. And the fact that something happened doesn't mean it wasn't improbable. (I can't stress this essential point enough.) Every once in a while, someone makes a risky bet on an improbable or uncertain outcome and ends up**

looking like a genius. But we should recognize that it happened because of luck and boldness, not skill.

In the short run, a great deal of investment success can result from just being in the right place at the right time. I always say the keys to profit are aggressiveness, timing and skill, and if you have enough aggressiveness at the right time, you don't need that much skill. My image is of a blindfolded dart thrower. He heaves it wildly just as someone knocks over the target. His dart finds the bulls-eye and he's proclaimed the champ.

. . . at a given time in the markets, the most profitable traders are likely to be those that are best fit to the latest cycle. This does not happen too often with dentists or pianists – because of the nature of randomness. (p.74)

The easy way to see this is that in boom times, the highest returns often go to those who take the most risk. That doesn't say anything about their being the best investors.

Warren Buffett's appendix to the fourth revised edition of "The Intelligent Investor" describes a contest in which each of the 225 million Americans starts with \$1 and flips a coin once a day. The people who get it right on day one collect a dollar from those who were wrong and go on to flip again on day two, and so forth. Ten days later, 220,000 people have called it right ten times in a row and won \$1,000. "They may try to be modest, but at cocktail parties they will occasionally admit to attractive members of the opposite sex what their technique is, and what marvelous insights they bring to the field of flipping." After another ten days, we're down to 215 survivors who've been right 20 times in a row and have won \$1 million. They write books on "How I Turned a Dollar into a Million in Twenty Days Working Thirty Seconds a Morning" and sell tickets to seminars. Sound familiar?

Thus randomness contributes to (or wrecks) investment records to a degree that few people appreciate fully. As a result, the dangers that lurk in thus-far-successful strategies often are under-rated.

Reality is far more vicious than Russian roulette. First, it delivers the fatal bullet rather infrequently, like a revolver that would have hundreds, even thousands of chambers instead of six. After a few dozen tries, one forgets about the existence of a bullet, under a numbing false sense of security. . . . Second, unlike a well-defined precise game like Russian roulette, where the risks are visible to anyone capable of multiplying and dividing by six, one does not observe the barrel of reality. . . . One is thus capable of unwittingly playing Russian roulette – and calling it by some alternative "low risk" name. (p. 28)

Perhaps a good way to sum up Taleb's views is by excerpting from a table found on page 3 of his book. He lists in the first column a number of things that easily can be mistaken for the things in the second column.

Luck

Skill

Randomness	Determinism
Probability	Certainty
Belief, conjecture	Knowledge, certitude
Theory	Reality
Anecdote, coincidence	Causality, law
Survivorship bias	Market outperformance
Lucky idiot	Skilled investor

The table reminds me of a key difference between the "I know" and "I don't know" schools. "I don't know" investors are acutely conscious of the things in the first column; "I know" investors routinely mistake them for things in the second.

I think Taleb's dichotomization is sheer brilliance. We all know that when things go right, luck looks like skill. Coincidence looks like causality. A "lucky idiot" looks like a skilled investor. Of course, knowing that randomness can have this effect doesn't make it easy to distinguish between lucky investors and skillful investors. But we must keep trying.

I find that I agree with essentially all of Taleb's important points.

- **Investors are right (and wrong) all the time for the "wrong reason."** Someone buys a stock because he expects a certain development; it doesn't occur; the market takes the stock up anyway; he looks good (and invariably accepts credit).
- **The correctness of a decision can't be judged from the outcome.** Nevertheless, that's how people assess them. A good decision is one that's optimal at the time it's made, when the future is by definition unknown. **Thus correct decisions are often unsuccessful, and vice versa.**
- **Randomness alone can produce just about any outcome in the short run.** The effect of random events is analogous to the contribution from beta discussed on page six. In portfolios that are allowed to reflect them fully, market movements can easily swamp the skillfulness of the manager (or lack thereof). But certainly market movements cannot be credited to the manager (unless he's the rare timer who's capable of getting it right repeatedly).
- **For these reasons, investors often receive credit they don't deserve.** One good coup can be enough to build a reputation, but clearly a coup can arise out of randomness alone. Few of these "geniuses" are right more than once or twice in a row.
- **Thus it's essential to have a large number of observations – lots of years of data – before judging a given manager's ability.**

* * *

The bottom line for me is as follows:

Equity returns should be expected to average in single digits at best for the next few years. This is because dividends will be moderate and P/E ratio expansion can't be counted on.

Most investors are unlikely to find this market return satisfactory, and thus they will continue to try for more through active management. However, because of the great deal of attention paid to them, most mainstream markets are efficient. This means very few investors there will dependably achieve superior risk-adjusted returns or consistently beat the other market participants.

To be able to earn better risk-adjusted returns and beat the market and the competition, one had better look in less thoroughly explored, inefficient markets. Even there, however, it's essential that one be, or employ, a superior manager possessing "alpha."

It's hard to separate good managers from not-so-good managers, and to do so it's essential that we identify returns earned through genuine, repeatable skill, not just good fortune. In that regard, records that have been rendered above average by occasional flashes of greatness tell us much less than records that consistently have been even modestly superior over long periods of time, and those that demonstrate a dependable ability to avoid losses in tough markets.

November 11, 2002

Memo to: Oaktree Clients

From: Howard Marks

Re: What's Your Game Plan?

As the summer ends, my thoughts turn to the tennis game I've been hoping to improve, the baseball season that's moving toward a conclusion, and the football season that's just getting started. It's enough to remind me of the role sports play in our lives . . . and in our thoughts about investing.

How Oaktree Plays the Game

Sometimes I feel I should apologize for the frequency with which I use sports metaphors to express my views on investing. And I worry that they'll fall flat in Europe and Asia. But that doesn't seem to stop me.

“The key to investment success isn't hitting home runs; it's avoiding strikeouts and inning-ending double plays.” I say this over and over . . . and over . . . as you've no doubt experienced. But I truly believe it.

Investing is a testosterone-laden world where too many people think about how good they are and how much they'll make if they swing for the fences and connect. Ask some I-know-school investors to tell you what makes them good, and you'll hear a lot about home runs they've hit in the past and the home runs-in-the-making that reside in their current portfolio. How many talk about consistency, or the fact that their worst year wasn't too bad?

One of the most striking things I've noted over the last 35 years is how brief most outstanding investment careers are. Not as short as the careers of professional athletes, but shorter than they should be in a physically non-destructive vocation.

Where are the leading competitors from the days when I first managed high yield bonds 25 or 20 years ago? Almost none of them are around anymore. And astoundingly, not one of our prominent distressed debt competitors from the early days 15 or even 10 years ago remains a leader today.

Where'd they go? Many disappeared because organizational flaws rendered their game plans unsustainable. And the rest are gone because they swung for the fences but struck out instead.

That brings up something that I consider a great paradox: I don't think many investment managers' careers end because they fail to hit home runs. Rather, **they end up out of the**

game because they strike out too often – not because they don’t have enough winners, but because they have too many losers. And yet, lots of managers keep swinging for the fences.

- They bet too much when they think they have a winning idea or a correct view of the future, concentrating their portfolios rather than diversifying.
- They incur excessive transaction costs by changing their holdings too often or attempting to time the market.
- And they position their portfolios for favorable scenarios and hoped-for outcomes, rather than ensuring that they’ll be able to survive the inevitable miscalculation or stroke of bad luck.

At Oaktree, on the other hand, we believe firmly that “if we avoid the losers, the winners will take care of themselves.” That’s been our motto since the beginning, and it always will be. We go for batting average, not home runs. We know others will get the headlines for their big victories and spectacular seasons. But we expect to be around at the finish because of consistent good performance that produces satisfied clients.

For Me, It Started With Tennis

In July, Larry Keele and I met with the Directors of the Vanguard Convertible Securities Fund to report on Oaktree’s performance as the fund’s manager. I was extremely pleased to see Charles Ellis of Greenwich Associates, one of the great thinkers in the investment field, whom I hadn’t come across in many years. I was especially pleased to have a chance to tell him about the seminal part his 1975 article, “The Loser’s Game,” had played in the development of my thinking. The article employed a metaphor that was simple but profound.

Charley’s article described the perceptive analysis of tennis contained in “Extraordinary Tennis for the Ordinary Tennis Player” by Dr. Simon Ramo, the “R” in TRW. Ramo pointed out that professional tennis is a “winner’s game,” in which the match goes to the player who’s able to hit the most winners: fast-paced, well-placed shots that his opponent can’t return. But the tennis the rest of us play is a “loser’s game,” with the match going to the player who hits the fewest losers. The winner just keeps the ball in play until the loser hits it into the net or off the court. **In other words, in amateur tennis, points aren’t won; they’re lost.** I recognized in Ramo’s loss-avoidance strategy the version of tennis I try to play.

Charley took Ramo’s idea a step further, applying it to investments. His views on market efficiency and the high cost of trading led him to conclude that the pursuit of winners is unlikely to pay off. Instead, you should try to avoid hitting losers. I found this view of investing absolutely compelling. I can’t remember saying, “Eureka; that’s the approach for me,” but the developments over the last three decades certainly suggest his article was an important source of my inspiration.

Because of his conviction that markets are efficient, Charley recommended passive investing as the best way to end up the winner – let others try the tough shots and fail. Oaktree’s view is a little different. Although we believe in the existence of inefficient markets as well as efficient ones, we still view the avoidance of losers as a wonderful foundation for investment success. Thus we diversify our portfolios, limit the fundamental risk we’ll take, try to buy things that provide downside protection, and emphasize senior securities. **We, too, try to win by not losing.**

Which Team Do You Want Out There?

I recently came up with a new sports metaphor that handily illustrates a crucial choice each investor has to make. It goes like this:

Think about a football game. The offense has the ball. They have four tries to make ten yards. If they don’t, the referee blows the whistle. Off the field goes the offense and on comes the defense, whose job it is to stop the other team from advancing the ball.

Is football a good metaphor for your view of investing? **Well I’ll tell you, it isn’t for mine.** In investing there’s no one there to blow the whistle; you rarely know when to switch from offense to defense; and there aren’t any time-outs during which to do it.

No, I think investing is more like the “football” that’s played outside the U.S. – soccer. In soccer, the same eleven players are on the field for essentially the whole game. There isn’t an offensive squad and a defensive squad. The same people have to play both ways . . . have to be able to deal with all eventualities. Collectively, those eleven players must have the potential to score goals and stop the opposition from scoring more.

A soccer coach has to decide whether to field a team that emphasizes offense (in order to score a lot of goals and somehow hold the other team to fewer) or defense (hoping to shut out the other team and find the net once), or one that’s balanced. **Because the coach knows he won’t have many opportunities to switch between offensive and defensive personnel during the game, he has to come up with a winning lineup and stick with it.**

That’s my view of investing. Few people (if any) have the ability to switch tactics to match market conditions on a timely basis. So investors should commit to an approach – hopefully one that will serve them through a variety of scenarios. They can be aggressive, hoping they’ll make a lot on the winners and not give it back on the losers. They can emphasize defense, hoping to keep up in good times and excel in bad times. Or they can attempt to balance offense and defense, giving up on tactical timing but aiming to win through superior security selection in both up and down markets.

Oaktree’s preference for defense is clear. In good times, we feel it’s okay if we just keep up with the indices (and in the best of times we may even lag a bit). But even average investors make a lot of money in good times, and I doubt many managers get fired for

being average in up markets. Oaktree portfolios are set up to outperform in bad times, and that's when we think outperformance is essential. Clearly, if we can keep up in good times and outperform in bad times, we'll have above average results over full cycles with below average volatility, and our clients will enjoy outperformance when others are suffering. We think that's a winning long-term combination.

Our game plan is built around defense. But that's not enough. We still need players with superior skills.

Finding Your Role Model

An article in the Wall Street Journal of August 8, entitled "Greatness in Our Midst," supplied the immediate impetus for this memo. It attempted to determine "who's the greatest living baseball player?" I'm no expert on baseball, but I liked the Journal's analytical approach and loved its conclusions.

Of the five players discussed, Barry Bonds came in fifth. "If you're looking for a peak-value player – a guy to play one season as well as anyone ever has – this is your guy. His past two campaigns have been other-worldly . . ." Bonds has a ton of ability, but he has yet to prove that he's "the greatest." Lots of fence-swinging investors have had otherworldly years, but few have completed outstanding careers.

Stan Musial placed fourth: outstanding at the plate, but below average on defense according to the Journal. It's tough to be the best without strong defense.

The #3 pick was Willie Mays. He ended his career with excellent stats in many offensive categories and he was an outstanding fielder, having made what has to be the most famous catch in baseball history. **Surprisingly, however, "in a career full of milestones, such as 3,000 hits and 600 homers, Mr. Mays doesn't own a single significant major-league record."** Records aren't what it's about; I think it's competence, consistency, and an absence of weaknesses.

I like the way Ricky Henderson made it to runner-up. "Walks aren't sexy and steals aren't trendy," but Henderson holds the career record in both, and they positioned him to score. "And no one's done this more often than Mr. Henderson." It's kind of like being a steady performer in an unfashionable niche like convertibles, underdeveloped real estate or power infrastructure.

The Journal's pick for greatest living player: Henry Aaron. Unlike Willie Mays, the Journal says, "Hammerin' Hank holds more important records than any player in history: home runs, runs batted in, total bases, extra-base hits and Aggregate Bases," (which it defines as the sum of hits, extra bases, walks and steals). And I love the way he did it: **"Mr. Aaron's best seasons don't compare with those of Messrs. Bonds, Mays or Musial, but he played at a high level longer than any player in the history of the game."** In my book, that's the definition of #1.

Few people, in any field, can hope to have talents and abilities like these men. But each of us can try to apply the same work ethic, and we can select our role models and decide how to conduct ourselves professionally. I want an Oaktree that's like Willie and Hank. **An exceptional career, even if it doesn't result in entries in the record books. Or a number of records, but for a lifetime, not a single great year.**

"Steady Eddie" Murray was inducted into the Baseball Hall of Fame just six weeks ago. He drove in at least 75 runs a year for a major league-record 20 consecutive seasons. **I'd like Oaktree's play to be described as "Steady Eddie."**

Sandy Koufax was pretty steady, too. In the six years 1961-66, he was named an All-Star six times and led the league in earned run average five times, in strikeouts per inning five times, in hits allowed per inning five times, in hits and walks allowed per inning four times, in shutouts three times, in innings pitched twice, in won-lost percentage twice, and in complete games twice. He pitched a no-hit game every year from 1962 to 1965, and the last of those was a perfect game. Over that period, he essentially had no weaknesses.

And, of course, I can't fail to mention Cal Ripken, Jr. He played all of his 21 seasons with the Orioles, a great oddity in a time when there's little constancy. And speaking of constancy, Cal is well known for his record of playing in 2,632 consecutive games, spanning a 15-year period. He also played 8,243 innings without missing one. Always there for his teammates and fans, he was chosen to start at shortstop in 17 consecutive All-Star games.

These are my baseball heroes. They personify my aspirations for Oaktree.

Playing Within Yourself

An expression from the broadcasting booth that's relevant to investing relates to the need to avoid pushing too hard. "Playing within yourself," they call it. **It means not trying to do things you're not capable of, or things that can't be accomplished within the environment as it exists.**

When the defenders drop back to cover the deep receivers, the intelligent quarterback throws short passes until they move up. That opens up the downfield routes, enabling him to complete the long bomb. **"He's taking what they give him," the commentators say, approvingly. It's what we all must remember to do.**

We simply cannot create investment opportunities when they're not there. In its first year, our newest distressed debt fund produced a 64% net IRR that's eye-popping . . . and impossible to replicate any time soon. So what should we do now? Rather than take profits and distribute the proceeds, should we prolong our holding periods or try to repeat our gains in new positions? And would it be smart to raise a big new fund? None of these, if the prospective returns on our holdings are inadequate and new investment

opportunities are limited.

The dumbest thing we could do is to insist on perpetuating our high returns – and give back our profits in the process. If it's not there, hoping won't make it so. **All we ever can do is take what they give us.**

What's Better, Investing or Sports?

When people ask me what I like so much about investing, I usually go to the well for more comparisons to sports.

- It's competitive – some succeed and some fail, and the distinction is clear.
- It's quantitative – you can see the results in black and white.
- It's a meritocracy – in the long term, the better returns go to the superior investors.
- It's team-oriented – an effective group can accomplish more than one person.
- It's satisfying and enjoyable – but much more so when you win.

Many of the things that make sports fun to watch and participate in are the same things that make investing a great area in which to work. However, Warren Buffett came up with one way in which the investor has it better than the athlete.

In Berkshire Hathaway's 1997 Annual Report, Buffett talked about Ted Williams – the "Splendid Splinter" – one of the greatest hitters in history. A factor that contributed to his success was his intensive study of his own game. By breaking down the strike zone into 77 baseball-sized "cells" and charting his results at the plate, he learned that his batting average was much better when he only went after pitches in his "sweet spot." Of course, even with that knowledge, he couldn't wait all day for the perfect pitch; if he let three strikes go by without swinging, he'd be called out.

Way back in the November 1, 1974, issue of Forbes, Buffett pointed out that investors have an advantage in that regard, if they'll just take advantage of it. Because they can't strike out looking, investors needn't feel pressured to act. They can pass up lots of opportunities until they see one that's terrific.

Investing is the greatest business in the world because you never have to swing. You stand at the plate; the pitcher throws you General Motors at 47! U.S. Steel at 39! And nobody calls a strike on you. There's no penalty except opportunity. All day you wait for the pitch you like; then, when the fielders are asleep, you step up and hit it.

Buffett's approach, like that of Williams, rewards patience, selectivity and a superior understanding of the underlying process. These are some of the things Oaktree likes to emphasize.

Back to Tennis for the Wrap-up

Just as this memo was going into the home stretch, the Wall Street Journal's Allan Barra greeted the start of the U.S. Open tennis tournament with an article about Pete Sampras. For me, it provided the ultimate investment/sports metaphor.

Mr. Sampras will need no future historians to make his case as the greatest tennis player of our time. His career credentials – the 14 Grand Slam singles championships; the 63-7 record in Wimbledon and seven Wimbledon titles in eight years; the 71-9 record at the U.S. Open with 87 consecutive service games won there; the six straight seasons of being ranked No. 1 – do that admirably.

. . . Sampras the player wasn't always exciting. Mr. Sampras's outstanding quality was always his uncanny consistency. Was there an athlete of the past 10 to 12 years whose greatness has been harder to capture in highlights? **His highlights were hard to distinguish from his lowlights.** As I wrote in the Wall Street Journal a few years ago: "The definitive book on the man would have to be titled 'Pete Sampras: The Dullness of Excellence.' But who would buy it?" (August 26, 2003; emphasis added)

The sentence I've bolded struck me as particularly thought provoking. You could read it as saying "his best moments weren't much better than his worst moments" – not a very stirring thought. **Alternatively, you could read it as "his worst moments were almost as good as his best." In my view, that would describe a terrific money management career. We hope people will say it about Oaktree.**

* * *

I'm always careful to point out that there are many game plans capable of leading to success. Offense or defense. Home runs or batting average. Go for the long bomb, or pick them apart with short passes. Battle from the baseline or rush the net. There are as many choices as there are sports metaphors. But the best game plan will only take you as far as the starting line or the first pitch. Once the game is underway, it comes down to skillful execution. **The best strategy in the world won't pay off without skillful blocking and tackling.**

And having a talented, disciplined team that stays together – a rarity in sports or investing – doesn't hurt.

September 5, 2003

Memo to: Oaktree Clients

From: Howard Marks

Re: Us and Them

As a kid, I – and probably you – viewed the world in simple terms. There were good guys and bad guys. Americans and commies. Cops and robbers. Settlers and redcoats. The Dodgers I cheered for and the Yankees who always won. **Over time my view of the investment community has settled into an equally clear distinction: us and them.**

You've heard a lot from me about the difference between the "I know" school and the "I don't know" school, concepts I introduced in "What's It All About, Alpha?" (July 2001) and elaborated on in "The Realist's Creed" (May 2002). In the last few years it has become clear to me that "we" don't differ from "them" just in terms of how much we think we know about the future, but in many other ways as well.

Do You Know or Don't You?

Most of the investors I've met over the years have belonged to the "I know" school. This was particularly true in 1968-78, when I analyzed equities, and even in 1978-95, when I had switched to non-mainstream investments but still worked at equity-centric money management firms.

It's easy to identify members of the "I know" school:

- They think knowledge of the future direction of economies, interest rates, markets and widely followed mainstream stocks is essential for investment success.
- They're confident it can be achieved.
- They know they can do it.
- They're aware that lots of other people are trying to do it too, but they figure either (a) everyone can be successful at the same time, or (b) only a few can be, but they're among them.
- They're comfortable investing based on their opinions regarding the future.
- They're also glad to share their views with others, even though correct forecasts should be of such great value that no one would give them away gratis.
- They rarely look back to rigorously assess their record as forecasters.

"Confident" is the key word for describing members of this school. For the "I don't know" school, on the other hand, the word – especially when dealing with the macro-future – is "guarded." **Its adherents generally believe you can't know the future; you don't have to know the future; and the proper goal is to do the best possible job of investing in the absence of that knowledge.**

The Benefits of Membership

As a member of the “I know” school, you get to opine on the future (and maybe have people take notes). You may be sought out for your opinions and considered a desirable dinner guest . . . especially when the stock market’s going up.

Join the “I don’t know” school and the results are more mixed. You’ll soon tire of saying “I don’t know” to friends and strangers alike. After a while, even relatives will stop asking where you think the market’s going. You’ll never get to enjoy that 1-in-1,000 moment when your forecast comes true and the Wall Street Journal runs your picture. On the other hand, you’ll be spared all those times when forecasts miss the mark, as well as the losses that can result from investing based on over-rated knowledge of the future. **But how do you think it feels to have prospective clients ask about your investment outlook and have to say, “I have no idea”?**

For me, the bottom line on which school is best comes from the late Stanford behaviorist, Amos Tversky: **“It’s frightening to think that you might not know something, but more frightening to think that, by and large, the world is run by people who have faith that they know exactly what’s going on.”**

“A group of related or coincident things, events, actions, etc.”

Random House’s secondary definition for the word “syndrome,” shown above, suggests a set of elements that can be viewed separately but take on greater meaning when considered together. **And the more I think about it, the more I see such a pattern in the contrasting styles of investment industry participants.**

Investors don’t just differ in regard to their views on foreknowledge, but in terms of a large number of elements. And the pattern among those elements seems to be consistent – correlated – not random. Ask yourself, for example, whether the “I don’t know” school is evenly divided between bulls and bears. Maybe, but in my experience, members of the “I don’t know” school tend to trust less in the market than those of the “I know” school. That’s an example of the pattern, or syndrome, that I think investors tend to demonstrate in many regards.

In my memo “Returns and How They Get That Way” (November 2002), I gave examples from a brilliant dichotomization propounded by Nicholas Taleeb. His book, “Fooled By Randomness,” has as its theme the pervasive role of luck in investing and the tendency of people to overlook its effect. He provides a table that shows a number of things in the first column that can easily be mistaken for things in the second column.

Luck	Skill
Randomness	Determinism
Probability	Certainty
Belief, conjecture	Knowledge, certitude
Theory	Reality
Anecdote, coincidence	Causality, law
Survivorship bias	Market outperformance
Lucky idiot	Skilled investor

My point here, and my reason for reproducing part of Taleeb's table, is my belief that **there are people who see the things on the left, and there are people who see the things on the right, but few who see some of each.** Some people think their ability to infer causality and analyze data makes them skilled investors capable of producing consistent outperformance. Others understand that luck plays a big part; that a lot of apparent causality is really coincidence; and that the person crowned the most skilled investor in a given year might be nothing more than a "lucky idiot." Very few people mix aspects from both columns.

I can think of many qualities that seem to go together to define one of the two main types of investor but not the other. I'll discuss them below and attribute them to either the "Oaktree-style" investors with whom I tend to associate – "us" – or the other sort of investor – "them."

Personality Type

It would be great to either be middle-of-the-road and dispassionate all the time or, better yet, bullish or bearish at just the right time. But few people can achieve either of those ideals. Most investors are congenitally either bullish or bearish, and I've never seen anyone capable of flipping in an adroit and timely manner from one to the other. For most of us, it's either bullish most of the time or bearish most of the time – right or wrong.

For many of the outstanding investors I've come across, it's the latter. And I shouldn't say bearish – I've just used that word as shorthand for a number of others. But the "us-style" investor tends to be cautious and defensive, while the "they-style" investor tends to be optimistic, confident and aggressive.

And the investors I like most are patient. Because they know they can't be right every time, their real concern is with the long run. On the other hand, the "I know" investor feels he has a good handle on what lies ahead and thus plans to do an above-average job every year – an admirable goal, perhaps, but I don't think highly achievable.

Hunt for Upside or Avoid Downside?

One of the most significant ways in which these differences manifest themselves is in terms of attitude toward risk. If you're confident that you know what the future holds, risk isn't frightening. But if you're convinced that you don't have that good a handle on the future, it's hard to be very cocky.

Our kind of investor is preoccupied by risk, whereas I think the other is often oblivious to it. Our kind worries about what can go wrong, while the other revels in what might go right. Ours tries to avoid mistakes, and the other concentrates on finding winners. **Ours obsesses about the losers he might buy or hold, while the other dwells on the opportunities he might miss.** In short, it's offense versus defense.

Other Aspects of Investment Style

The optimist tends more often than not to be a growth investor; he's confident that above-average growth can be perpetuated and that he can identify the companies that'll do so. The more cautious investor looks for value – for tangible attributes that can be counted on for price support even if confidence in the company proves to be unwarranted.

Our school of investing puts great emphasis on being a contrarian. If you want to buy something of solid value, and you want to buy it for less than it's worth, you'll have a better chance if you look among assets, companies and markets that are out of favor. Thus we're happiest when we're not part of the herd; we prefer to watch the herd's extreme boom-bust behavior and profit from its mistakes. Most other investors seem to be happy when they're part of the herd and following the trend.

Our kind of investor likes to average down. He holds a firm view of his securities' value and wants to increase his holdings at lower prices. Thus he likes to see prices decline (although he's not cocky enough to completely dismiss the possibility that the market's right rather than him). The trend follower wants to see appreciation and is disheartened by initial declines. In fact, I think he prefers to average up as appreciation validates his thesis.

Certain that his forecasts are right and his portfolio is properly positioned, the "I know" investor wants to let his profits ride. The "I don't know" investor is painfully aware of how much he doesn't know; how much of his performance is beyond his control; that good fortune may have contributed to his results to date; and that events can easily turn against him. Thus he's happy taking profits and banking some of his gains. If appreciation occurs beyond his expectations, it makes him stop and think . . . and maybe sell, not just celebrate.

The "we" investor is comfortable holding cash when he can't find attractive investments. At the present time, a number of the investors I most respect are holding or returning significant amounts of cash, or closing their funds. The confident "them" investor is pained by cash – he thinks he always should be able to find something worth buying. And he tends to be more relative-return oriented, and thus worried that an index or competitor might beat him if he isn't fully invested.

I see an extreme dichotomy in the fact that the "us" investor worries about losing money, while the other worries about underperforming. (I can't claim to be 100% the former, because I – and most of Oaktree's clients – think that in the long run, the best manager is the one who beats the others. That's something that's hard to argue with. But my desire for relative performance doesn't make me comfortable with losses.)

Lastly, because the "I don't know" investor is highly conscious of his limitations, he is likely to aggressively limit his assets under management. Most of the "I know" investors, who tend to work in the more liquid mainstream markets, never met a dollar of AUM they didn't like – or didn't feel they could achieve great things with.

Attitudes Toward the Market

The actions of “they” investors are often driven by their views regarding the outlook for the market. They invest more aggressively when the outlook’s positive than they do when it’s negative (although, as I said before, they’re usually positive). “We” investors tend to invest from the bottom up, primarily basing investment decisions on whether attractive individual investment opportunities are available.

In fact, I’m often struck by the fact that “they” are preoccupied with studying and assessing the behavior of “the market” – which collectively means studying themselves. My favorite investors – both inside and outside Oaktree – spend their time almost exclusively looking into individual companies and their securities.

One of the greatest dichotomies is that “they” impute intelligence to the market while “we” are highly skeptical of it. Trillions of dollars were lost after 1998-99 because the mass of investors hadn’t sufficiently questioned the valuations of tech stocks. They’d been told, “The market’s efficient” and assumed that if a stock was selling at a price, that meant the price was justified. **The investors I respect feel the market’s often wrong – either underpricing or overpricing securities – and more than anything else, they look for opportunities to profit from those errors. In their view, as Dickens said about the law, “the market’s an ass.”**

So Where Do We Stand Today?

The market is a big arena where optimists and pessimists engage in a tug of war. When optimism is rising relative to pessimism, meaning more money wants to get put to work than wants to exit, prices rise (and vice versa). The market has been going roughly sideways for the last few months, meaning the two camps are in rough balance. **But that doesn’t mean they’re not both out there.**

Everyone had a great year in 2003, and “they” seem to think it’s going to continue. They’re cheered by signs of economic recovery, corporate profit gains and job growth. “We,” on the other hand, worry about the things that could result in disappointment, like the lackluster economic and employment gains, and the trade and budget deficits. We also worry about structural issues, such as the US’s reliance on foreign capital, the questionable outlook for the dollar, and the consumer’s high level of indebtedness and low level of savings. Lastly, we feel the possibility of domestic terrorism hangs out there like a sword of Damocles.

A particularly striking difference can be seen in current attitudes toward interest rates. Rates do a great deal to influence the vitality of the economy and the price and relative attractiveness of market sectors. Today’s low rates encourage growth and borrowing. They also reduce the competition to stocks posed by bonds and money market securities. Finally, since interest rates are used in present value calculations to discount future cash flows, lower interest rates result in higher valuations for all assets.

Obviously, then, today’s record low rates go a long way to explaining what’s going on in the investment world. With money market securities yielding 1% and Treasury notes at 3-4%, yields of 6-8% on high yield bonds look attractive; market-neutral hedge funds look like a bonanza at 9-11%; and expectations of 15-20% are enough to attract money to private equity

(rather than the old 25-30%). Just as importantly, low interest rates lower the hurdle return for equities and justify p/e ratios in the high 20s.

What sums it up is the line that “stocks aren’t overpriced given the current level of interest rates.” “They” derive comfort from the fact that today’s valuations are consistent with today’s rates, while “we” worry about the impact on valuations that a rise in rates would have.

Rates can’t go down all that much, but there’s plenty of room for them to go up. (I still have the framed notice from 1980 telling me that the rate on my bank loan had reached 22¼%!) **That tells me that p/e ratios can’t rationally go up much more but there’s plenty of room for them to go down.** And if we ignore the threat of a rate rise and merely assume that rates will hold steady, the resulting return on the average stock would be just in line with normal profits growth in mid-single digits.

So the optimist is cheered by the low rates (and their stimulative power), and the pessimist is concerned about the risk implicit in a possible rate rise. **Or, as it seems to me, “we” worry about valuations and “they” feel comfortable on the subject . . . as usual.**

How About an Example

Rather than hold up my Oaktree colleagues as exemplars of astute “us-style” investors (which I think they are), I’d like to propose an unnamed investor for your consideration. I’ll tick off his credentials for inclusion (as I see them) and throw in a few quotes from his recent writings.

- He never bases his investment actions on forecasts for the economy or market. “. . . the cemetery for seers has a huge section set aside for macro forecasters. We have in fact made few macro forecasts . . . , and we have seldom seen others make them with sustained success.”
- Rather, his actions are strictly determined by the availability of attractive investment opportunities. “Under *any* market or economic conditions, we will be happy to buy businesses that meet our standards.”
- He’s a solid investor in value – be it derived from current cash flow, unique market position or special human resources.
- Because of his risk awareness and desire to avoid losers, **he always insists on a generous “margin of safety.”**
- He is absolutely unconcerned if an index or competitor outperforms him for a year or two, but he insists on avoiding losses. **Losing less than his competitors is not his definition of success.**
- When attractive investment opportunities are few, he’s willing to stand at the plate with the bat on his shoulder – something he says he’s doing a lot of nowadays. In 2003, that caused his holdings of cash to triple. **“Our capital is underutilized now It’s a painful condition to be in – but not as painful as doing something stupid.”**

- He seems happiest when betting against the herd. For example, on the subject of distressed bonds, he says “yesterday’s weeds” (which yielded 30-50% in 2002), are being priced as “today’s flowers” (and thus yielding 4-6%). He’s written me that he “liked them better when they were weeds.”
- Certainly he’s a patient long-term investor (and, in fact, not much of a profit taker; he recently expressed some regret about having not sold during The Great Bubble).
- He is very conscious of the effect of increased capital on investment returns. “When [a manager] tells you that increased funds won’t hurt his investment performance, step back: His nose is about to grow.”

There are lots of ways to skin the cat, and certainly there are successful investors among “them.” **But the characteristics enumerated above have provided the foundation for Warren Buffett’s incredible record, and that makes them good enough for me.**

* * *

To help you see the picture I’m suggesting and evaluate the investors you come across, I’ve prepared the quick-and-dirty checklist that appears on the following page. Few people will hit every point on the head, but I think you’ll recognize in the list on the left a lot of the “they” school investors you know, and on the right, hopefully, a few from the “us” school. **Each year – especially in good times – the headlines will go to those on the left who guess correctly. But in the long run I think it’s people on the right who’ll be celebrated most.**

In today’s trend toward hedge funds, I see a growing preference – whether conscious or unconscious – for “us” investors over “them.” Consistent, risk-conscious, non-market-based investing is enjoying great popularity right now. I’ve considered it the ticket for almost three decades.

And by the way, I have one last thing to say: **vive la difference!!** In order for us to be contrarians, there has to be someone to be contrary to. If everyone invested our way, the opportunities we prize would be few and far between. **The best opportunities for investment returns aren’t created by companies, exchanges or paper securities; they result from the mistakes other investors make. It’s Oaktree’s job to take advantage of them.**

May 7, 2004

P.s.: As I wrote this memo, one thing pained me, and I want to address it: I found myself constantly writing “he,” even though I absolutely do not think investing skill is gender-related. It’s just that I hate the thought of using “he/she” each time. (My son Andrew’s school uses s/he.) And I find ungrammatical today’s popular, gender-neutral formulation that “the top-performing investor finds that their gains come from hard work” – a plural pronoun substituting for a singular noun. So please bear with me; I’m really an equal opportunity memo writer.

THEM

“I know”
Bullish by nature
Aggressive
Confident
Comfortable with risk
What might go right?
Worried about winners missed
Trend followers
Attracted to pretty flowers
Comfortable when part of the crowd
Growth/momentum investors
“Great things cost a lot”
Believers
“We’re in a new era”
Cheered by appreciation
Enjoy averaging up
“Let it ride”
Relative return-oriented
Worried about underperforming
Pained by cash
Confident in their powers
Convinced that their good returns
are fully deserved
Impatient
Short term-fixated
Never worried by large amounts
of capital
Engrossed in watching the market
“The market’s efficient”

Everything’s okay:

Economic recovery underway
Corporate profit gains
Increases in productivity
Continuing foreign investment
Ability of weak dollar to bolster exports
Existence of job growth
Optimism implied by willingness to borrow
Strong military capability
Low level of interest rates
Today’s security prices are justified
by low rates

US

“I don’t know”
Bearish by nature
Defensive
Guarded
Obsessed with risk
What might go wrong?
Worried about losers bought
Contrarians
Glad to search among the weeds
Happy when apart from the crowd
Value investors
Insistent on buying cheap
Skeptics
“Trees don’t grow to the sky”
Frightened by excessive appreciation
Enjoy averaging down
Eager to take profits
Absolute return-oriented
Worried about losing money
Comfortable with cash
Aware that much is beyond their control
Highly conscious of the role
played by luck
Patient
Long term-oriented
Aware that it’s possible to have
too much capital
Devoted to watching companies
“The market’s an ass”

Worries abound:

Movement of jobs overseas
Gaping trade deficit
Growing budget deficit
Reliance on foreign capital
Threat to value of the dollar
Halting nature of job growth
Consumers’ high debt/low savings
Risk of terrorism
Risk of interest rate rise
Today’s security prices are reliant
on rates staying low

Memo to: Oaktree Clients

From: Howard Marks

Re: Hedge Funds: A Case for Caution

Once upon a time there was an asset class. It was all over the headlines. Its performance was terrific. Some said “too good to be true,” but that didn’t stanch the flow of money. After all, what other asset class had ever produced returns like these?

The performance brought vast amounts of capital to the sector. Demand exceeded supply, even as funds grew larger. The funds with the best records and discipline saw a deluge of money vastly exceeding their ability to accept it. Investors whose capital they turned away invested with managers who were less disciplined with regard to limits or with new funds. This gave rise to large numbers of start-ups and spin-offs from established firms. Lack of experience didn’t prevent anyone from hanging out a shingle – or raising money. Some of the leading managers increased fees in order to appropriate more of their returns for themselves, and this enabled second-tier and new managers to charge fees that used to go only for proven performance.

Everyone agreed there was “too much money chasing too few ideas,” but they invested anyway, often based on their managers’ supposed skill and the fact that “Everyone’s doing it; I can’t just stand by and watch while they make money.” You could see the end of this tale coming down the track like a locomotive. The perpetual motion machine eventually ground to a halt. **The combination of too much money chasing too few ideas dashed the hopes of those who in 1999-2000 looked for the “silver bullet” in venture capital. “Never again,” they grumbled.**

Hope Springs Eternal

Of course, what they meant was, “Never again until next time.” The fact is, investors never cease to dream of the silver bullet: the asset class or investment technique that can be counted on for high returns with low risk. Whenever one would-be silver bullet is discredited, investors give up on that irrational dream . . . and go looking for the next.

I say over and over that there’s no such thing as a “good” asset class. No asset class or investment technique has the birthright of a particular rate of return, and certainly not of a high return with low risk. No asset can be depended on for good performance irrespective of the price at which it’s bought. And no area can be successfully invested in without regard for the balance between the supply of investment ideas in the area and the amount of money investors want to deploy in it.

In fact, if you could ask just one question about a possible investment and be assured of

one honest answer, I think it should be “what’s the relationship between supply and demand?” If there are lots of assets for sale and few takers, those assets can often be bought cheap. If there are few assets offered and many would-be buyers, bargains are usually few and far between.

While no guarantee of a silver bullet, the former can be the source of some good ammunition. With the latter you’re more likely to shoot yourself in the foot.

The New Solution

This memo’s about hedge funds. They’re the hot topic in the investment world today – the latest would-be silver bullet – largely, I think, because most have yet to disappoint performance-wise and because the big asset classes look unappealing.

Common stocks were the big-picture silver bullet in the 1990s. Professor Jeremy’s Siegel’s “Stocks For the Long Run” assured us there had never been a long period in which stocks didn’t beat bonds, cash and inflation. The authors of another book, “Dow 36,000,” were given space on The Wall Street Journal’s op-ed page. Thus when stocks’ popularity – and their representation in portfolios – hit a peak in early 2000, they were ready for a fall. A swoon that included the first three consecutive losing years since the Depression took the S&P 500 down 49% and the NASDAQ down 78%. As a result, stocks receive much less attention today than they did five years ago; less is expected from them in terms of return (even given today’s lower prices); and they certainly aren’t viewed as the place to put additional capital.

Neither are money market assets (yielding 1%+), Treasury notes and bonds (3-5%) or high-grade corporate bonds (4-6%). Institutional investors find these promised yields unexciting (and far below their portfolio goals of 8%+/-), and the widespread expectation of rising rates makes it seem likely that holding period total returns will be even lower.

With the two biggest markets holding so little appeal – and given the fact that it has to go someplace – money has been flowing to non-mainstream markets such as high yield bonds, buyouts, real estate, oil, timber . . . and hedge funds.

The Hedge Fund Movement

Hedge funds did great in the 1990s, produced moderate gains during the collapse of stocks in 2000-02, and were in double digits in 2003. I think they also exhibit many of the traits associated with the venture capital boom described on page one of this memo, including widespread investor participation. **I don’t think hedge funds will bring losses at all comparable to what happened in venture capital at the peak, but I think their popularity is overdone and likely to lead to disappointment.** Given the

magnitude of the hedge fund movement, a memo on the subject has become inevitable.

First, what are hedge funds? Briefly put, they're unregulated private partnerships that commingle the assets of institutions and wealthy individuals in pursuit of superior investment results. They're evergreen vehicles that offer periodic withdrawal opportunities to their investors, as opposed to closed-end entities such as private equity funds that promise no option to withdraw but begin to liquidate after a certain date and return money as they do.

Except for one other factor, they can have very little else in common. Hedge funds operate in a great many ways. There are arbitrage funds in fixed income, mergers, convertibles and "stat arb"; long/short funds in stocks in general, tech stocks and emerging markets; macro funds which place bets on currencies and world markets; and funds which make mostly-long bets in specialized market niches such as distressed debt. There are small hedge funds and enormous hedge funds. **Some hedge funds hedge – go short or otherwise take offsetting positions designed to reduce risk – and others don't. Thus some aim for steady returns with little volatility and market exposure, and some make massive, unhedged bets in pursuit of massive returns. Some hedge funds can fairly be described as pursuing "absolute return," and in the rest the returns are anything but absolute.**

What's that one remaining thing that hedge funds have in common? It's called "**hedge fund pricing**," meaning the manager gets an annual management fee of at least 1-2% plus a share – usually 20% – of all profits earned in the portfolio. **In a world where the fees paid to long-only managers in traditional asset classes are a fraction of one percent, hedge fund pricing allows managers to make 3-4% or more and represents the *raison d'être* for the hedge fund industry.** One of the cleverest observations I've read is from Paul Isaac of Cadogan Management: "**hedge funds are a compensation system often mistaken for an industry.**"

From little or nothing a few years ago, many institutional investors now have 5-10% or more invested in hedge funds today. This has given rise to a massive expansion of the hedge fund community. There are estimated to be 7,000 hedge funds today, up from 1,640 a decade ago. Their current capital is estimated at between \$850 billion and \$1 trillion, up about ten times in ten years and well over 100% since the end of 2000. We read often of pension plans deciding to commit billions of dollars of additional capital to hedge funds. How will it play out?

Scalability

In my opinion, scalability is the most important issue surrounding hedge funds: can a good little idea become a good big idea? Everyone wonders about the scalability of hedge funds, but I think they're yet another area where most people agree on the existence of the potential problems but invest anyway.

It was in the mid-Seventies that I first began to hear of hedge funds such as Cumberland Partners and Steinhardt, Fine and Berkowitz. **At that time the hedge fund industry consisted of a handful of funds trying to earn superior returns with total capital of a billion dollars or so.** The funds limited their capital; researched smaller companies in greater depth than the mainstream investors; concentrated their portfolios in a handful of good ideas; and used shorting and hedging (but not leverage) to shape the pattern of their returns. For better or worse, their success over the ensuing 30 years led to fame and widespread emulation. **As a result, we now have thousands of funds trying to earn superior returns with roughly a trillion dollars, and with much more on the way.** (On September 13 The Bank of New York predicted that U.S. institutional investors alone would plow an additional \$250 billion into hedge funds by 2008.) Can it still work?

I hope you'll permit me one of my tortured analogies. Have you seen the nature film on TV showing big fish eating? One of the big fellows rips a piece from his prey and moves through the water enjoying his dinner. But due to his poor table manners, he spews small crumbs as he goes. It's for this reason that each big fish is trailed by a hundred little fish. They snack on the scraps he drops, enjoying his leavings. He does the hard work, and they get a free lunch.

Well that's the way I've always thought of the investment world. Mainstream institutional investors emphasize the big asset classes and follow the big companies, creating a relatively efficient market and a context for relative valuation. But their attention wanes as the targets shrink, and their hands are tied by constraints on their behavior.

Little guys such as hedge funds operate in the interstices. They take advantage of small inefficiencies and misvaluations that the big guys create, permit or ignore. They pursue things that are unseemly, esoteric or highly labor intensive. And they can employ tactics like leverage and shorting – and live with levels of portfolio concentration and illiquidity – that aren't tolerated in the mainstream investment world. In other words they, too, benefit from the big guys' leavings.

The critical question is obvious: **How many little fish can thrive in the shadow of each big fish?** A hundred little fish trailing each big one all can do well. But those crumbs won't feed five hundred. Not only will the crumbs be insufficient in number, but the crowd will fight over them in a way that's unhealthy for everyone.

Tortured enough? Maybe so, but I think the analogy holds. **In my time in this business, the institutions have been the big fish of the investment world, and the hedge funds and alternative investment specialists have profited from their biases and limitations. But quintuple the number of "little guys" and maybe they'll no longer exhibit the same brilliance and adroitness.**

- How many under-researched stocks are there, and how much can be invested in them?

- How much of a bargain-priced security can be bought without the price being driven up?
- How big an arbitrage position can be put on without the profit spread shrinking?
- How many shares of an overvalued stock are available for short-sellers to borrow?
- How much of something can the hedge funds collectively own without illiquidity closing their exit window?

When there's an increase in the amount of capital that investors want to put into an area, there's no reason to expect a commensurate increase in the opportunities for good investment. So when the ratio of money to ideas increases, the implications for future performance can't be good.

Now it should be made clear that the venture capital boom, for one example, was based in a very narrow investment segment and dependent on the creation of new companies for the deployment of capital. Hedge funds, on the other hand, collectively are able to invest in any form of asset or security, in all of the world's markets and employing a wide variety of investment techniques, and through shorting they have the ability to profit from "inefficiencies" in overvalued as well as undervalued assets.

Thus the potential universe for hedge fund investments is enormous in the absolute. The real question is whether there are enough inefficiencies in this universe for all of the would-be hedge funds to invest in, and whether the presence of a large and growing number of funds has a deleterious effect on the adequacy of the supply.

Of course, it goes without saying: just as no asset class has the birthright of a given return, giving something the overly broad label of "hedge fund" – and paying its manager "two-plus-twenty" – won't make it a stellar, or even a steady, performer.

The Hedge Fund Manager's Superior Arsenal

A great deal is made of the powerful tools at the hedge fund manager's disposal. The ability to employ leverage – often in unlimited amounts – and the absence of constraints on investment tactics are lauded for their potential to add to results. But no one should forget their potential to do the opposite as well.

Almost every weapon in the investment arsenal is a two-edged sword. The only exception is genuine, sustainable personal skill. Everything else will make you money when it works but lose you money when it doesn't. Leverage and free rein are no exceptions.

Being able to leverage a portfolio means being able to invest a multiple of your equity capital. Why should an investor with \$1,000 be content making \$100 on a price rise of 10%? Why not borrow another \$3,000, invest all \$4,000 in the same assets, and make \$400 on a 10% rise? All you need is access to 3-to-1 leverage . . . oh yes, and the ability to identify assets that appreciate.

In Vegas they say, “the more you bet, the more you win when you win.” Although the logic of this statement is impeccable, it omits the obvious addendum “. . . and the more you lose when you lose.” **Leverage is not a source of alpha; it’s a way of increasing your exposure to a given amount of alpha . . . or lack of alpha.** The 3-to-1 leverager described above will lose 40% of his equity if prices go down 10% instead of up. The ability to use leverage – which is high and rising today given the low cost of money and the lure of the “carry trade” – certainly doesn’t add asymmetrically to investment results.

Neither does freedom from constraints. Institutional investors usually spend lots of time negotiating what tactics a mainstream investor will be permitted to apply and crafting contracts to keep him from straying afield. Then they turn over a bunch of money to a hedge fund manager and say, “do as you please.” (I exaggerate for effect.) Does that make sense? Only in one case: where the manager possesses great skill and discipline.

Investment constraints (1) enable clients to know what style of management they’ll be getting and (2) hopefully limit managers to what they’re good at. Their absence sets the stage for surprises and permits managers to wander into areas where they may have less skill. Thus the results from unrestrained hedge funds are often unforeseeable, and these vehicles should be handled with care.

I think investors should pay above average fees only for asymmetric value added – that is, for a potential increment to returns that isn’t accompanied by a corresponding potential decrement. And I think only genuine skill adds asymmetrically to investment results, not leverage and not the mere ability to use a wide range of investment tactics. The key in hedge fund investing is finding managers who have that skill. It isn’t ubiquitous.

A Few Words on Performance

Frankly, I wonder whether the decision to invest in hedge funds today is fully supported by their performance in 2000-04, their period of great popularity.

I’ve watched institutions decide to join hedge funds. I think most of them invested for “absolute returns” – which I believe were supposed to be in the high single digits after fees – accompanied by low volatility and limited correlation with the mainstream markets. Now most institutions seem to be satisfied with their hedge fund performance and are signing up for more. **But I wonder whether they should be.** For the purposes of the analysis below I’ll use the CSFB/Tremont Hedge Fund Index.

- With the S&P 500 down 9%, 12% and 22% in the 2000-02 bear market, investors in the CSFB/Tremont Index’s average fund were delighted to make money, with the Index returning 4.9%, 4.4% and 3.0% in those years, respectively.

- And fund investors who might have expected much less were thrilled to see 15.4% from the Index in 2003.

On the surface, all seems well: small gains when the stock market cratered, and a pleasant surprise in the big year of 2003. But is everything really all right?

- Were the results in 2000-02 all they should have been? Because everyone was understandably thrilled to make money while stocks collapsed, I don't hear anyone grumbling about modest returns. But should they be? Institutional Investor magazine made the point in February 2003:

Hedge funds had a good year in 2002 – relatively speaking, of course. . . The trouble is, hedge funds are not merely supposed to do better than other investments. They're meant to outperform in absolute terms [I think this should be “perform in absolute terms”]. And most did not do that in 2002.

- Many students of the hedge fund area believe returns should be a function of interest rates, for example “LIBOR plus 500.” In the early years of this decade, far less was achieved. Do the negative returns in the stock market fully explain the difference?

With 2003 one of the best years in history in most markets, was 15.4% enough? In 1996, '97 and '99, the Hedge Fund Index captured a very substantial majority of the S&P's return. Why in 2003 did it garner just over half the gain? Obviously the ability of the average hedge fund to beat the booming S&P in 1999 was an outlier, with active flipping of IPOs and other ways to “pick off” feverish retail investors presenting unusual profit opportunities. 1998's negative return was equally aberrant, with the Index return pulled down by a 38% loss on the average emerging market hedge fund. But with these caveats in mind, why was the capture rate in 2003 so tepid?

Year	CSFB/Tremont Long/Short Index Return	S&P 500 Return	Hedge Fund Return as Percentage of S&P Return
1996	22.2%	22.7%	98%
1997	25.9	33.1	78
1998	-0.4	28.3	n/m
1999	23.4	20.9	112
2003	15.4	28.4	54

- Most recently, the CSFB/Tremont Hedge Fund Index is up just 2.8% in the first eight months of lackluster 2004. **Again we must ask whether modest single digit returns are all that can be expected absent a tailwind from a strong stock market. What happened to the absolute return that would be earned with little reference to what went on in the markets? If the low returns are attributable to**

weak underlying markets, doesn't that suggest more correlation to market movements than was implied by the "absolute return" premise?

In other words, has hedge fund performance since 2000 been good enough? "Single digits in down years and double digits in up years" sounds like a good deal. **"Modest returns in bad years and modest participation in good years" is a little less appealing.**

I can think of four possible explanations for any shortfall from expectations: two benign and two unpleasant:

- If recent returns have been below expectations, this may be attributable to the low level of interest rates. Interest rates influence what funds will earn on their idle balances, proceeds from short sales, and arbitrage positions. So maybe hedge fund returns are due to pick up as short-term rates rise.
- And maybe hedge funds' good returns will be earned on average, rather than every year, and this has just been a below average period.
- But maybe more hungry "fish" with more money crowding into a given market are having the predictable depressant effect on returns. **Maybe there's a fixed amount of excess return available to be earned in a given year, and when it's spread over a lot more capital, the results become less positive. Or, even worse, maybe the combined efforts of all these people make the markets more efficient, reducing the total excess return available for them to share.**
- Perhaps the increase in the number of hedge fund managers has brought a decrease in their average alpha. **Why should we believe the last 20,000 managers to join the sector are as smart as the first 1,000?** One of the rationales for hedge fund investing, as The Wall Street Journal put it on July 7, is that, "Hedge funds still attract the smartest managers, lured by the rich fees." I may be missing something, but why should the appeal of rich fees be limited to smart managers? Can't they attract the not-so-smart as well?

It's my personal guess that there's truth in each of these four possible explanations. But if that's the case, the latter two will have a deleterious effect despite the validity of the former.

Drawbacks and Pitfalls

There are enough people out there trumpeting the benefits of hedge funds; you don't need me to repeat them. I'll just play my normal worrier's role by listing some caveats:

- The performance data on which investors are making the decision to commit to hedge funds is highly imperfect. It is unsystematic, unscientific and covers a short and not-

necessarily-representative period. In addition, it's weakened by post-selection bias (low-return funds are unlikely to volunteer their performance) and survivorship bias (the estimated 25% of funds that go out of business each year are even less apt to do so). Importantly, holdings of illiquid or infrequently marked securities can cause betas and risk to be understated and thus Sharpe ratios to be overstated (Pensions & Investments, August 19, 2002).

- It is obvious that some of the tactics employed by hedge funds entail considerable volatility and illiquidity. And yet, hedge funds give their investors the periodic right to withdraw. **Thus, it's possible for a hedge fund to offer more liquidity than does its underlying investment portfolio.** This can be a formula for disaster. Given that a lot of the capital now in hedge funds is "hot money" prone to exit given a period of underperformance, it's not hard to envision (and in fact the community has seen) rapid-fire withdrawals that lead to downward spirals and penalize the last investors out the door, who can find themselves owning disproportionate amounts of hard-to-value and hard-to-sell securities.
- In most hedge funds, it's hoped that the managers' actions will neutralize the effect of market fluctuations. In other words, you're betting on the managers' skill, not the market direction. **As in any inefficient, alpha-based market niche, the performance gap between superior and inferior managers can be substantial. Thus you'd better find superior managers, and that's not easy. Also, since many of the best and most disciplined managers have closed their funds, you'd better hope the available funds will be able to replicate the returns that attracted you to the area in the first place.**
- With thousands of hedge funds all using computers to screen investment opportunities, there's a tendency for lots of them to move in the same direction at the same time. **This can shrink purchase opportunities, eat into prospective returns and reduce liquidity.** The Wall Street Journal described the situation on June 30: "Increasingly, the growing group of hedge funds pile into the same trades. With so much money chasing similar strategies, good investment returns become more elusive. Moreover, when an attractive idea turns sour, the rush to the exits gets crowded, exacerbating an already tense investment environment."
- We read often about the migration to the hedge fund world of people from elsewhere in the investment industry. This is the same phenomenon as we saw in the dot-coms in 1998-99. When people flood an area because of the easy money to be made there, the results are usually predictable.
- I'm particularly skeptical of the movement of people from traditional portfolio management to hedge funds. **Stock picking ability isn't sufficient for success in managing a hedged and/or leveraged portfolio -- risk management is at least as important. The two are not the same, and the traditional buy-side professional doesn't have much experience in the latter.**

- As has happened in other alternative investment fields, changes in an industry can expose weaknesses in the compensation arrangements. Originally, management fees were intended primarily to cover operating expenses while incentive fees motivated managers to strive for profits. But as funds grow larger, some are at the point where managers can get rich on management fees alone. Recently we've seen investment celebrities start hedge funds with perhaps \$3 billion of capital and management fees of 2% or so. \$60 million a year is a pretty good start if you can get it. Fees like these can motivate managers to put a higher priority on perpetuating the management fee machine than on pursuing portfolio gains. Although hedge funds and private equity funds carry similar fee arrangements, the latter have hurdle rates that motivate their managers to try for double-digit returns. Hedge fund managers probably figure they can hold onto their capital and earn 2-4% a year for themselves with returns in moderate single digits. **I'm not sure that warrants the fees.**
- At the other end of the spectrum from managers able to attract billions in capital and massive management fees, the impatient newcomer with access to incentive fee money faces potential temptation that also might trouble investors: It makes perfect sense for him to start a fund and swing for the fences with highly risky securities, leverage and concentration. Hit a homer and he's rich; strike out and he goes back to his old job.
- We know incentive fees can serve to align interests between investors and their managers when profits are in the offing. But what happens when there are losses? When a fund has run up some serious losses and needs to recover to the "high-water mark" before it can generate incentive fees again, its personnel don't stand to share in gains for a while. So what is there to make them stay around to engineer the recovery, rather than move to a new fund where they can profit from dollar one? On July 15 The Wall Street Journal described one such situation: "Rather than try to dig out of the deep hole, while at the same time not getting paid as much as they could earn elsewhere, Mr. James and his team began to contemplate starting out on their own."
- Finally, I'll list a few other topics that may make hedge funds the subject of negative headlines in the future:
 - o the risk implicit in the combination of leveraged hedge funds, leveraged funds of funds, and leveraged fund investors;
 - o the absence of registration and regulation;
 - o the lack of transparency;
 - o the potential conflicts that arise when hedge funds are run within an organization that also manages non-hedge fund money in the same markets;
 - o hedge funds' involvement in buyouts (do they have the needed skills? will it reduce their liquidity and ability to value the portfolio for subscriptions/redemptions?);
 - o buyout firms' growing involvement in hedge funds (still more competitors?);
 - o possible improprieties in hedge fund marketing;

- o concern over the impact of hedge fund short selling;
- o and, of course, the outright fraud that occasionally arises and always is a threat.

The Outlook for Hedge Fund Investing

As I said earlier, despite the troubling factors enumerated above, I do not envision a boom-bust scenario for hedge fund investors. After all, hedge funds spread their investment over almost all asset classes, and most funds are fairly disciplined in sticking to low-priced investments. So there isn't a single asset or group of assets where we have to worry about hedge funds creating bubble-like appreciation and the usual subsequent collapse.

No, the excesses aren't in the prices of the assets in which hedge funds invest. The excesses are in the trends affecting the industry: too much money coming too fast; too many funds managed by people of uneven skill; and too-high fees relative to the limited excess return the average fund is likely to generate.

I do not expect a debacle, just a disappointing experience. The sad fact is that, on average, hedge funds may go down as just another former silver bullet.

The high single digit return for which I think people invested wasn't a figment of anyone's imagination. It was probably reasonable looking back at the period preceding the current hedge fund boom. After all, in a period when stocks consistently returned double digits, Treasury notes paid 6% and high yield bonds yielded 12%, it's eminently logical that a few highly skilled hedge fund managers could earn 8-9% or more after fees on a low-risk basis.

But that scenario doesn't describe today or tomorrow. There's no reason to expect a near-term repeat of stock and bond returns like those, and certainly the hedge fund arena is far more crowded than it's ever been. So I think the average hedge fund might make 5-6% net of fees in the years just ahead. (That could change after lower prices and higher interest rates re-elevate the prospective returns on stocks and bonds – and after some disappointed capital departs the hedge fund field – but I'm just dealing here with the current environment. And please note that I'm not making a prediction, just a wild guess within a wide range.)

I'll go with 5-6% for the average hedge fund – considerably more from the best managers, less from the worst and, yes, total loss from the occasional risk-management disaster. Is that terrible? No. But the question is whether it will be entirely satisfactory.

- First, I think it may be less than the hedge fund managers and consultants have predicted.
- Second, it will put most institutions further behind their overall investment goals.
- And third, I think it'll look pretty anemic if Treasury note yields return to that range,

as they may, or if stocks can get anywhere close to their long-term 10% historic average.

A net return of 5-6% earned with low risk in a low-return world may sound pretty good to lots of people, especially in light of the pain that long-only common stock investors experienced in 2000-02. **I believe a great deal of current hedge fund investment is motivated by a desire for mid-single digit returns with safety, and also that a lot of funds have been designed to deliver them.** Managers are constraining risk; locking in profits at modest levels; dedicating their efforts to avoiding down months and quarters; and refraining from reaching for the stars. Some of this is good.

But I think paying fees of 2-4% to earn net returns of 5-6% may start to get old, especially if and when returns on mainstream stock and bonds get back to more attractive levels. That's why I worry about the potential for disappointment. **Right now, in a world of 1% money market rates and lackluster returns everywhere, that may be sufficient. But sentiment is inherently unstable, and I'm not sure investors will remain content if they begin to miss out on more elsewhere . . . while paying the highest fees in the investment world to do so.**

To start bringing this memo to a close, I'll cite John Moon and Tim Jensen's apt enumeration of the possible outcomes in our Emerging Markets Fund's second quarter letter:

We have no idea if the hedge fund boom will peter out after several years of mediocre performance, end in another [Long-Term Capital Management] crescendo, or continue until all money is either indexed or run by hedge funds.

In testimony to Congress, Alan Greenspan focused on what I think is the most likely result:

Hedge funds seek out the abnormal rates of profit often found where markets are otherwise inefficient. But these above-normal profits have attracted a large number of new entrants seeking to exploit a possibly narrowing field of inefficiencies. Not surprisingly the rate of return in this activity is reportedly declining. I would not be surprised if, with time, many of the new entrants exited, some presumably following large losses. (The Wall Street Journal, July 23)

* * *

In my treasury of investment sayings, there's a special section reserved for what I call "the classics." None is more dependable than this: **What the wise man does in the beginning, the fool does in the end.** Intrepid pioneering investors get the underpriced gems. Once something has been discovered and the price bid up, the latecomers who come aboard in ever-increasing numbers – lured by past performance – can look forward to less return and more risk.

I can't imagine an investment area whose attractiveness can survive the onslaught of an investor herd thinking it constitutes the silver bullet. It wouldn't make sense for one to exist, given that it's the job of a smoothly functioning market to eliminate opportunities for unusual profits. **"Too much money chasing too few ideas" has been the death knell for investment fad after fad. This will never cease to be so.**

Hedge funds are just like any other investment tool. They are neither a good idea nor a bad idea. They have both plusses and minuses. They're subject to market forces capable of altering their attractiveness. And like any other investment that's in vogue, they should be handled with great care, with eyes wide open.

The right hedge funds may be just what the doctor ordered for investors who place a high priority on stable returns and are willing to trade away a lot of their upside potential for that stability. The key will be finding managers who possess skill, discipline and integrity. Doing so won't prove easy; there's no reason why finding superior managers should be any easier than finding superior investments. But as in other quarters of the investing universe, the rewards for success can be substantial.

There's no question that some of the smartest investment managers are gravitating to the hedge fund arena with its out-sized financial rewards. But they're not the only ones being drawn to the money, and some of the rest will turn out to be incompetent or downright unscrupulous. The tools are there for hedge fund managers to use, but all the tools in the world won't produce superior risk-adjusted returns without superior skill. **Just as all managers can't be in the top quartile, all hedge fund managers are unlikely to be smart enough to identify the markets' mistakes; undoubtedly some of them will be the ones making those mistakes.**

Finally, my personal bottom line: the most important element in the decision to invest in a hedge fund shouldn't be the sheer profit potential, but your comfort in entrusting its managers with the combination of potent investment tactics, high-octane fees and the absence of a hurdle rate.

October 6, 2004

Memo to: Oaktree Clients

From: Howard Marks

Re: Risk

The reading materials for a meeting of a corporate board on which I sit – and what turned out to be an eight-hour meeting of the audit committee (thank you, Messrs. Sarbanes and Oxley) – included an article by Rick Funston, a Principal of Deloitte & Touche LLP and its National Practice Leader for Governance and Risk Oversight. The subject of the article was corporate risk, but many of its points were equally applicable to investment risk. It got me thinking.

We're all preoccupied with the quest for excellent investment returns, and most of us understand that risk management has a lot to do with achieving them. From there, investment orthodoxy often takes over, with the discussion turning to the relationship between return and volatility. But I think that tells so little of the story that I've decided to devote an entire memo to the subject of risk.

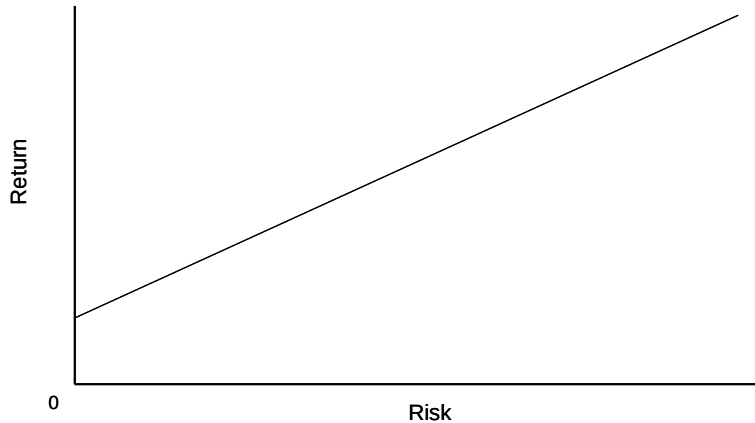
Why Does Risk Matter?

When I joined the investment management industry at the tail end of the 1960s, everyone talked about returns but few people talked about risk-adjusted returns, or the idea that risk matters. I was fortunate, however, to have attended the University of Chicago in the preceding years, during which Capital Market Theory had begun to be discussed.

Of course, nothing underlies the Capital Market approach as much as the relationship between risk and return. This plays out as follows:

- First, because people are risk averse, riskier investments have to offer higher returns in order to attract capital.
- Second, if investors are skillful, they should be able to capture higher returns on their riskier investments, and thus they should show higher average returns in the long run.
- But investors' returns tell just half the story. We have to know how much risk they took to get those returns before we can judge whether they did a good or a bad job. Thus developed the concept of risk-adjusted returns.

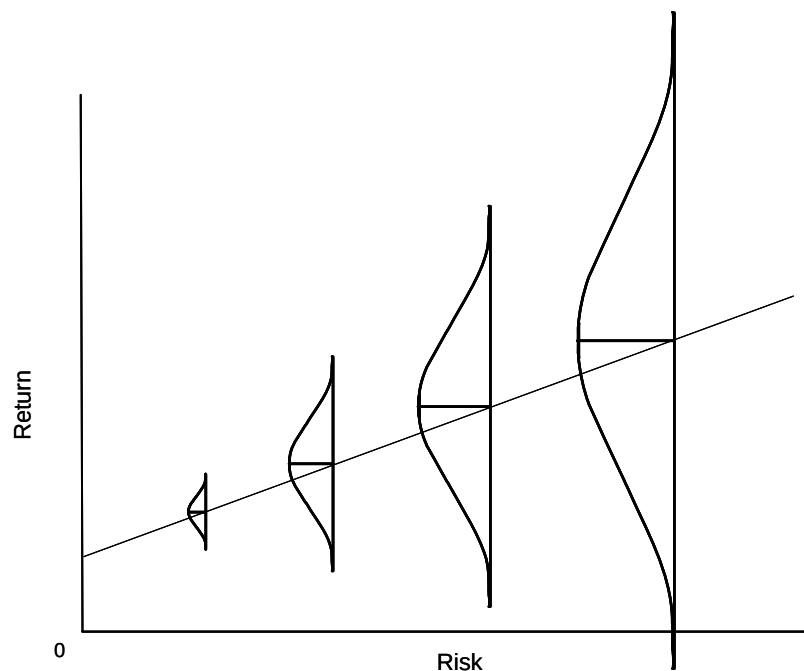
It is from the relationship between risk and return that arises the graphic representation that has become ubiquitous in the investment world. It shows a "capital market line" that slopes upward to the right, indicating the positive relationship between risk and return that is essential.



Before going further, I want to stop for a brief tirade. **In my opinion, especially in good times, far too many people can be overheard saying, “Riskier investments provide higher returns. If you want to make more money, the answer is to take more risk.” But riskier investments absolutely cannot be counted on to deliver higher returns. Why not? It’s simple: if riskier investments reliably produced higher returns, they wouldn’t be riskier!**

The correct formulation is that in order to attract capital, riskier investments have to offer **the prospect of higher returns**, or higher promised returns, or higher expected returns. But there’s absolutely nothing to say those higher prospective returns have to materialize.

The way I conceptualize the capital market line makes it easier for me to relate to the relationship underlying it all:



Riskier investments are those where the outcome is less certain. That is, the probability distribution of returns is wider. When priced fairly, riskier investments should entail:

- higher expected returns,
- the possibility of lower returns, and
- in some cases the possibility of losses.

The traditional graph shown first above is deceptive, because it communicates the positive connection between risk and return but fails to suggest the uncertainty involved. It has brought a lot of people a lot of misery through its unwavering intimation that taking more risk leads to making more money.

I hope my version of the graph is more helpful. It's meant to suggest both the positive relationship between risk and expected return **and** the fact that uncertainty about the return and the possibility of loss increase as risk increases.

What Is Risk?

According to the academicians who developed Capital Market Theory, risk equals volatility, because volatility indicates the unreliability of an investment. I take great issue with this definition of risk.

It's my view that – knowingly or unknowingly – academicians settled on volatility as the proxy for risk as a matter of convenience. They needed a number for their calculations that was objective and could be ascertained historically and extrapolated into the future. Volatility fits the bill, and most of the other types of risk do not. The problem with all of this, however, is that I just don't think volatility is the risk most investors care about.

There are many kinds of risk, and I'll discuss some of them below. But volatility may be the least relevant of them all. Theory says investors demand more return from investments that are more volatile. **But for the market to set the prices for investments such that more volatile investments will appear likely to produce higher returns, there have to be people demanding that relationship, and I haven't met them yet.** I've never heard anyone at Oaktree – or anywhere else, for that matter – say, “I won't buy it, because its price might show big fluctuations,” or “I won't buy it, because it might have a down quarter.” Thus it's hard for me to believe volatility is the risk investors factor in when setting prices and prospective returns.

In addition, volatility has a number of shortcomings that aren't often addressed in the literature but are obvious to investment practitioners:

- A stock that meanders from \$50 to \$80 is likely to have the same statistical volatility as one that goes from \$50 to \$20. However, most of us would have trouble saying that proves the former was as risky as the latter.

- A stock that over a few years goes from \$20 to \$80 in a straight line will be described as low in risk, but if it suddenly declines from \$80 to \$50 it will be said to have become more risky. It's hard to think of a given stock as riskier at \$50 than it was shortly before at \$80.
- Generally, those who equate volatility with risk look to the historic volatility of an asset as the indicator of its future risk. But most of us know the future will not necessarily be like the past. And one good way to add value in the investment process is by predicting changes in riskiness, whereas no value is ever added through extrapolation.

For all of these reasons, I find it hard to accept volatility as a comprehensive, sufficient or highly useful measure of risk.

If Not Volatility, Then What?

Rather than volatility, I think people decline to make investments primarily because they're worried about a loss of capital or an unacceptably low return. To me, "I need more upside potential because I'm afraid I could lose money" makes an awful lot more sense than "I need more upside potential because I'm afraid the price may fluctuate." **No, I'm sure "risk" is – first and foremost – the likelihood of losing money.**

There are other kinds of risk, most of which affect each of us differently. That means they're subjective and personal – rather than intrinsic to the investment itself – and thus they're unlikely to be behind the market prices set by the consensus of investors. Here are a few:

- Falling short of one's goal – Investors have differing needs, and for each investor the failure to meet those needs poses a risk. A retired executive may need 4% per year to pay his bills, whereas 6% would represent a windfall. But for a pension fund that has to average 8% per year, a prolonged period returning 6% would entail serious risk. Obviously this risk is personal and subjective, as opposed to absolute and objective. A given investment may be risky in this regard for some people but riskless for others. Thus this cannot be the risk for which "the market" demands compensation in the form of higher prospective returns.
- Underperformance – Let's say an investment manager knows she can't get more money from a client no matter how well she does, but she's sure she'll lose the account if she fails to keep up with some index. That's "benchmark risk," and she can eliminate it by emulating the index. But every investor who's unwilling to throw in the towel on outperformance, and who chooses to deviate from the index in its pursuit, will have periods of significant underperformance. In fact, since many of the best investors stick most strongly to their approach – and since no approach will work all the time – the best investors can have some of the greatest periods of underperformance. Specifically, in crazy times, disciplined investors willingly accept the risk of not taking enough risk to keep up. (See Warren Buffett in 1999. That year, underperformance was a badge of courage, because it denoted a refusal to participate in the tech bubble.)

- Career risk – This is the extreme form of underperformance risk. Dean LeBaron of Batterymarch wrote an article that cited “agency risk,” or the risk that arises when the people who manage money and the people whose money it is are different people. In those cases, the managers may not care much about gains, in which they won’t share, but may be deathly afraid of losses that could cost them their jobs. The implication is clear: risk that could jeopardize return to an agent’s firing point is rarely worth taking.
- Unconventionality – Along similar lines, there’s the risk of being different. Everyone who aspires to superior results has to be mindful of John Maynard Keynes’s observation: “Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally . . .” Understandably, stewards of other people’s money can be more comfortable turning in average performance, regardless of where it stands in absolute terms, than with the possibility that unconventional actions will prove unsuccessful and get them fired. As David Swenson wrote in his excellent book, “Pioneering Portfolio Management,”

. . . active management strategies demand uninstitutional behavior from institutions, creating a paradox that few can unravel. Establishing and maintaining an unconventional investment profile requires acceptance of uncomfortably idiosyncratic portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom.

Concern over this risk keeps many people from superior results, but it also creates opportunities in unorthodox investments for those who dare to be different.

- Illiquidity – If an investor needs money with which to pay for surgery in three months or buy a home in a year, he may be unable to make an investment that can’t be counted on for liquidity that meets his schedule. Thus, for him, risk isn’t just losing money or volatility, or any of the above. It’s being unable when needed to turn an investment into cash at a reasonable price. This, too, is a personal risk. Theoretically, a fund whose life is perpetual and whose liquidity needs are predictable shouldn’t be sensitive to this risk and thus should be able to bear it for profit.

The bottom line is that investment risk comes in many forms. Many risks matter to some investors but not to others, and they may make a given investment seem safe for some investors but risky for others. **Rejecting risk as synonymous with volatility, as I do, eliminates the one measure of risk that’s entirely quantifiable, objective and absolute. This, in turn, makes it hard to argue that the market’s an efficient machine that precisely assesses the risk of each investment and allocates prospective return proportionately.**

Measuring Risk Prospectively

I’m sure we agree that investors should and do demand higher prospective returns on riskier investments. And hopefully we can agree that losing money is the risk people care about most in demanding prospective returns, and thus in setting prices for investments. An important question remains: How do they measure that risk?

- First, it clearly is nothing but a matter of opinion: hopefully an educated, skillful estimate about the future, but still just an estimate.
- Second, the standard for quantification is nonexistent. With regard to a given investment, some people will think the risk is high and others will think it's low. Some will state it as the probability of not making money, and some as the probability of losing a given fraction of their money (and so forth). Some will think of it as the risk of losing money over one year, and some as the risk of losing money over the entire holding period. Clearly, even if all the investors involved met in a room and showed their cards, they'd never agree on a single number representing an investment's riskiness. And even if they could, that number wouldn't likely be capable of being compared against another number, set by another group of investors, for another investment.
- Third, risk is deceptive. Conventional considerations are easy to factor in, like the likelihood that normally recurring events will recur. But freakish, once-in-a-lifetime events are impossible to quantify or prepare for. The fact that an investment is susceptible to a particularly serious risk that will occur infrequently if at all – what I call the “improbable disaster” – means it can seem safer than it really is. As Nassim Nicholas Taleb wrote in “Fooled by Randomness,”

Reality is far more vicious than Russian roulette. First, it delivers the fatal bullet rather infrequently, like a revolver that would have hundreds, even thousands of chambers instead of six. After a few dozen tries, one forgets about the existence of a bullet, under a numbing false sense of security. . . . Second, unlike a well-defined precise game like Russian roulette, where the risks are visible to anyone capable of multiplying and dividing by six, one does not observe the barrel of reality. . . . One is thus capable of unwittingly playing Russian roulette – and calling it by some alternative “low risk” name.

The bottom line is that, looked at prospectively, much of risk is subjective, hidden and unquantifiable. **But I think one of the most interesting aspects of risk – and one of the least appreciated – is the fact that it isn't quantifiable even in retrospect.**

Measuring Risk After the Fact

Let's say someone makes an investment that works out as expected (or better). Does that mean it wasn't risky? Or let's say the investment produces a loss. Does that mean it was risky? Or that it should have been perceived as risky at the time it was analyzed and entered into?

If you think about it, the response to these questions is simple: **The fact that something happened doesn't mean it was likely, and the fact that something didn't happen doesn't mean it was improbable. Improbable things happen all the time, just as likely things often fail to occur.**

Taleb's book is the bible on this subject as far as I'm concerned, and in it he talks about the "alternative histories" that could have unfolded but didn't. Alexander the Great mapped out his battle strategy, and it succeeded under the circumstances that unfolded. But were those circumstances predictable or just a matter of chance? Thus was Alexander wise to count on them or foolhardy? And did he prudently anticipate and plan for them, or did he overlook them and just get lucky? Lastly, was there a much wiser general somewhere else, who more systematically considered the possibilities and whose plan was more likely to work, but who fell victim to bad fortune (and thus anonymity) when random events conspired against him? Which man deserves to be in the history books: Alexander the Great or Bob the Unlucky?

What a wonderful way this is to look at things! How many people do you suspect of having succeeded despite themselves, rather than because of skill? How many bear out the adage "it's better to be lucky than good"? Certainly many in business have derived fame and fortune from being right once in a row. Was it skill or luck? Can they do it again? Did they accurately assess the risk? Who can tell? Who cares?

In the investing world, one can live for years off one great coup or one extreme but eventually accurate forecast. But what's proved by one success? When markets are booming, the best results often go to those who take the most risk. Were they smart to anticipate good times and bulk up on beta, or just congenitally aggressive types who were bailed out by events? **Most simply put, how often in our business are people right for the wrong reason?** These are the people Taleb calls "lucky idiots," and in the short run it's certainly hard to tell them from skilled investors.

The point is that even after an investment has been closed out, it's impossible to tell how much risk it entailed. Certainly the fact that an investment worked doesn't mean it wasn't risky, and vice versa. With regard to a successful investment, where do you look to learn whether the favorable outcome was inescapable or just one of a hundred possibilities (many of them unpleasant)? And ditto for a loser: how do we ascertain whether it was a reasonable but ill-fated venture, or just a wild stab that deserved to be punished?

Did the investor do a good job of assessing the risk entailed? That's another good question that's hard to answer. Need a model? Think of the weatherman. He says there's a 70% chance of rain tomorrow. It rains; was he right or wrong? Or it doesn't rain; was he right or wrong? It's impossible to assess the accuracy of probability estimates other than zero and 100 except over a very large number of trials.

The celebrated investor is one whose actions yielded good results. Was she lucky or good? How much risk did she take? Since it's risk-adjusted return that counts, can we tell whether her return was more than commensurate with the risks borne or less than commensurate? I'm confident that the answers lie in skilled, subjective judgments, not highly precise but largely irrelevant ratios of return to volatility.

So Is It Risky Or Not?

Casual onlookers rarely see that as a tough question. **But like most aspects of investing, the more obvious the answers seem, the less likely they are to be true.**

Many considerations on the subject of risk are actually paradoxical. Investing requires us to deal with the future, and the difficulty of cracking the future is the source of most of the risk. The actual riskiness of many aspects of investing depends on the extent to which an investor is capable of knowing something about the future, or – perhaps better put – of knowing more than the average investor.

For example, let's consider diversification versus concentration. **Is concentration risky? Not if you know what the future holds.** Diversification by definition implies a willingness to trade off return for safety, motivated by acceptance of the fact that knowledge of the future is imperfect. Most investors rank their stocks by potential return, formally or informally, but no one I know buys just the one they expect to deliver the highest return. Why? Because they know their rankings might be wrong and don't want to bet it all on black and see red come up. Concentration is risky for investors who can't see the future with much clarity, but it wouldn't be for one who can. For the latter, it's the way to maximize performance, and diversification can hold it back.

What about illiquidity? Conventional wisdom says liquid investments are safer than illiquid ones. And small holdings are safer than large blocks. So what's up with Warren Buffett and Charlie Munger? They regularly amass stock positions for which there are no other buyers. And in fact, they seem to be more comfortable owning whole companies than public stocks they could sell off. Yet their record continues to be highly superior. The answer lies in the fact that they know what they're doing. They're able to tell good companies from bad ones, and when the price is right. And given that their portfolios are unlikely to go into forced liquidation (and as far as I know, they don't think about losing their jobs), illiquidity isn't a risk they worry about.

Finally, what about buying risky assets? People ask me all the time to answer a simple question: "Are Bruce Karsh's distressed debt funds risky?" They certainly are, in that he buys the debt of troubled and ultimately insolvent companies; the promises of interest and principal payments on the debt he buys invariably are out the window; the range of possible outcomes is extremely wide; his holdings are often illiquid; and he diversifies far less than Sheldon Stone does in his high yield bond portfolios. On the other hand, Bruce often buys in at extremely low prices; he has a lot of experience and a highly skilled team; and the record suggests that he, too, knows what he's doing. Thus one might conclude Bruce's funds aren't risky, and the results to date support this view: in seventeen years he hasn't had a fund that lost money or a year when the aggregate return of his funds was negative. (Of course, this historic record says nothing about future performance.) You can be the judge, but a lot will depend on your definition of risk.

So my answer's the same here: There's no right answer. No one number can tell you how much risk an investor took, or how much risk a prospective investment entails. Few investment assets, strategies or tools are risky or safe in and of themselves. And no answer on this subject is likely to hold true for every investor and every potential application. That's one of the reasons why investing is never easy . . . but always interesting.

Complexity in Risk Assessment

It is my purpose in this section to highlight a few reasons why risk assessment is not simply a matter of one number (as implied by the attention paid to volatility), but multi-dimensional instead. Rick Funston of Deloitte pointed out in our board briefing materials that risk assessment requires us to deal with four complicating factors:

- Scenarios
- Offsets
- Correlations
- Domino effects

By “scenarios,” Rick refers to alternative or abnormal future scenarios that go beyond the normal range of outcomes – in his words, “the possible but unusual.”

“Offsets” translate in the investment world into something very familiar: diversification. Intelligent diversification means not just investing in a bunch of different things, but in things that respond differently to the same factors. In a well-diversified portfolio, something that negatively influences investment A might have a positive and offsetting influence on investment B.

“Correlations” are somewhat the opposite. The term refers to the chance that a number of investments will respond in the same way to a given factor. Be alert, however, to the fact that when things in the environment turn really negative, seemingly unconnected investments can be similarly affected. “In times of panic,” they say, “all correlations go to one.”

Finally, “domino effects” refer to the likelihood that a given factor will cause trouble for investment A, which will be a problem for investment B, which will hurt investment C, and so on. Obviously, domino effects can result in combinations that are bigger than any one issue alone and quite hard to anticipate.

Clearly, because of these factors among so many others, risk can’t be reduced to a single number or handled simplistically. Because of its multi-dimensional nature, it can only be dealt with by skilled and experienced individuals making judgments that are by their nature subjective. And even those individuals must always be conscious of how much they don’t know.

When the emerging markets melted down in 1998, accompanied by the collapse of Long Term Capital Management and the crisis in Russia, most investors thought their risk was limited to their holdings of emerging market securities. But they soon saw firsthand the ability to be affected through the stocks of U.S. companies doing business in emerging markets, high yield bond funds that had dabbled in sovereign debt, and private equity investments exposed to the economies in question.

Fault lines run through every portfolio, adding to the complexity of managing risk. It’s hard to anticipate all of them, but trying to do so lies at the heart of effective risk management.

Bring in the Risk Management Professionals

Given the myriad reservations about risk measurement expressed above, I want to inveigh against over-reliance on using outside “experts” to assess the risk the investment people are taking, and on models like VAR (value at risk) to do the assessing.

First of all, given the inextricable linkage between analyzing a potential investment and assessing its risks, I question whether anyone else can know as much about this subject as the investment professionals directly involved. To me, “risk measurement officers” sound like armchair quarterbacks who’re brought in to tell the investment pros how they’re doing (although I concede that they may be useful in looking across the “silos” in multi-strategy portfolios to aggregate risk and look for fault lines).

Second, I sincerely doubt that the risks that really matter are subject to modeling. Models can tell us what will happen most of the time, and how much risk will be entailed under “normal circumstances.” But, as my friend Ric Kayne says, everyone understands the things that happen within two standard deviations, but everything important in financial history takes place outside of two standard deviations.

Rick Funston performs a service by organizing risks into two categories: those that are suitable for probabilistic modeling and those that aren’t. He includes among the elements that render a risk suitable for modeling (1) recurring situations, (2) processes that are subject to known rules, (3) conditions that can be counted on to remain stable, (4) controllable environments, (5) a limited range of outcomes, and (6) certainty that combinations of things will lead to known results. **What could be less descriptive of investing?**

Given the non-recurring situations we face, the fact that many of the rules are unknown, and the largely unlimited range of outcomes (among other things), I would argue strongly that models and modelers are of very limited utility in measuring investment risk at the extremes, where it really matters.

Bearing Risk for Profit

A few years ago, one of my memos quoted Lord Keynes as having said, “. . . a speculator is one who runs risks of which he is aware and an investor is one who runs risks of which he is unaware.” (I admitted at the time that I’d been unable to verify that he actually said it, but now I’ve identified the source.) Keynes makes an essential point. **Bearing risk unknowingly can be a huge mistake**, but it’s what those who buy the securities that are all the rage and most highly esteemed at a particular point in time – to which “nothing bad can possibly happen” – repeatedly do. **On the other hand, the intelligent acceptance of recognized risk for profit underlies some of the wisest, most profitable investments** – even though (or perhaps due to the fact that) most investors dismiss them as dangerous speculations.

I believe in the principles underlying the Capital Market approach. We are (or should be) risk averse, meaning that, if the prospective returns are equal, we prefer safer investments to the more

risky. Thus, we must be induced to make riskier investments by the offer of higher prospective returns. We could accept the risk-free rate available on Treasury bills, but most of us choose instead to strive for more by taking on incremental risk. **When you boil it all down, it's the investor's job to intelligently bear risk for profit.** Doing it well is what separates the pros from the rest.

What does it mean to intelligently bear risk for profit? I'll provide an example. In the early 1980s, a reporter asked me, "How can you invest in high yield bonds when you know some of the issuers will go bankrupt?" Somehow, the perfect answer came to me in a flash: "The most conservative companies in America are the life insurance companies. How can they insure people's lives when they know they're all going to die?" Both activities involve conscious risk bearing. Both can be done intelligently (or not). The ability to profit from them consistently depends on the approach employed and whether it's done skillfully. For companies selling life insurance, I said, the keys to survival and profitability are the following:

- **It's risk they're aware of.** They know everyone's going to die. Thus they factor this reality into their approach.
- **It's risk they can analyze.** That's why they have doctors assess applicants' health.
- **It's risk they can diversify.** By ensuring a mix of policyholders by age, gender, occupation and location, they make sure they're not exposed to freak occurrences and widespread losses.
- **And it's risk they can be sure they're well paid to bear.** They set premiums so they'll make a profit if the policyholders die according to the actuarial tables on average. And if the insurance market is inefficient – for example, if the company can sell a policy to someone likely to die at age 80 at a premium that assumes he'll die at 70 – they'll be better protected against risk and positioned for exceptional profits if things go as expected.

We do exactly the same things in high yield bonds, and in the rest of Oaktree's strategies. We try to be aware of the risks, which is essential given how much our work involves assets that some simplistically call "risky." We employ highly skilled professionals capable of analyzing investments and assessing risk. We diversify our portfolios appropriately. And we invest only when we're convinced the likely return far more than compensates for the risk.

We've said for years that risky assets can make for good investments if they're cheap enough. The essential element is knowing when that's the case. That's it: the intelligent bearing of risk for profit, the best test for which is a record of repeated success over a long period of time.

Risk Management vs. Risk Avoidance

Clearly, Oaktree doesn't run from risk. We welcome it at the right time, in the right instances, and at the right price. We could easily avoid all risk, and so could you. But we'd be assured of avoiding returns above the risk-free rate as well. Will Rogers said, "You've got to go out on a limb sometimes because that's where the fruit is." None of us is in this business to make 4%.

So even though the first tenet in Oaktree's investment philosophy stresses "the importance of risk control," this has nothing to do with risk avoidance.

It's by bearing risk when we're well paid to do so – and especially by taking risks toward which others are averse in the extreme – that we strive to add value for our clients. When formulated that way, it's obvious how big a part risk plays in our process.

Rick Funston said in the article that prompted this memo, **"... you need comfort that the ... risks and exposures are understood, appropriately managed, and made more transparent for everyone ... This is not risk aversion; it is risk intelligence."** That's what Oaktree strives for every day.

January 19, 2006

Memo to: Oaktree Clients

From: Howard Marks

Re: Dare to Be Great

In one of the most colorful vignettes of the early 1970s, Glenn Turner, the head of Koscot Interplanetary, would fly into a small Midwestern town in his Learjet (when that was a huge deal). Two dwarfs would hop out and unroll a red carpet. Turner would emerge under a banner reading “Dare to Be Great” and vacuum up money through a pyramid marketing scheme based on selling motivational tapes containing the secret of getting rich. **Turner’s long gone from the scene, but daring to be great still deserves our consideration, even in the absence of a surefire recipe for success.**

This memo stems from an accumulation of thoughts on the subject of how investment management clients might best pursue superior results. Typically my thoughts pile up, and then something prompts me to turn them into a memo. In this case, the impetus came while I read “Hedgehogging” by Barton Biggs. I’ll come back to it later.

How Can We Achieve Superior Investment Results?

The answer is simple: not only am I unaware of any formula that alone will lead to above average investment performance, but I’m convinced such a formula cannot exist. According to one of my favorite sources of inspiration, the late John Kenneth Galbraith:

There is nothing reliable to be learned about making money. If there were, study would be intense and everyone with a positive IQ would be rich.

Of course there can’t be a roadmap to investment success. First, the collective actions of those following the map would alter the landscape, rendering it ineffective. And second, everyone following it would achieve the same results, and people would still look longingly at the top quartile . . . the route to which would have to be found through other means.

I’ll make a few suggestions below on what investors should and shouldn’t do. In the end, though, the things I suggest will be of little help without highly skilled implementation, and the results will depend almost entirely on that implementation and rather little on my suggestions.

First, Get Out of Lake Wobegon

Nori Gerardo Lietz of Pension Consulting Alliance, in a paper on the performance of real estate opportunity funds, was the latest to remind me about Garrison Keillor’s fictional Lake Wobegon, where all the children are above average. **Investing, likewise, is a world where it seems everyone claims to be terrific and can back it up with performance data.** Especially in

alternative investing areas such as real estate and private equity, the managers make it sound like they've done great. But the long-term average returns in most such areas have been lackluster, and many managers' records are inconsistent. One of my favorite quotes came from "Dandy Don" Meredith while announcing on Monday Night Football: "They don't make 'em anymore the way they used to," he said, "but then again they never did." Rarely are the real records as good as the ones people (and especially the managers who created them) fondly remember.

Take a look at the performance over time in venture capital, buyouts and real estate and you'll see results for the median manager that are far from exciting. Professor Steven Kaplan, head of the entrepreneurial studies department at the University of Chicago's Graduate School of Business, authored a paper showing that a dollar invested in the totality of buyout funds between 1980 and 1997 did no better than a dollar invested in the S&P 500. And that was despite the fact that the buyout funds were leveraged in a rising equity market and the S&P wasn't.

The eye-popping results of the funds at the top of the performance range draw money magnetically to alternative investment areas, while the average return usually deserves a big yawn. **For superior results, it's absolutely essential to invest with superior managers.**

My old boss at Citibank, Peter Vermilye, is famous for saying that only 5% of analysts add value. That's probably true as well of portfolio managers, consultants and investment committees and their members. (Of course you and I are in that 5%, but I have my doubts about the others.)

The consensus opinion of market participants is baked into market prices. Thus, if investors lack insight that is superior to the average of the people who make up the consensus, they should expect average risk-adjusted performance. Few people are able to consistently identify cases where the market price is wrong and act on them to their advantage. "But how about Peter Lynch?" people respond. That's just the point. His singular reputation is proof how rare the Peter Lynches are. As my mother used to say, it's the exception that proves the rule.

So, the first job in trying to access superior performance consists of getting in with the best funds and managers. Everyone wants above-average results, but far from everyone can achieve them. (Of course, the chore is complicated by the fact that the investment capacity of superior investment vehicles is limited, and the inrush of money can itself render them less superior, since the cost of investing will be pushed up as the money arrives.)

Escape From the Crowd

This just in: you can't take the same actions as everyone else and expect to outperform.

The search for superior results has to lead to the unusual, perhaps the idiosyncratic. Take manager selection.

Above-average managers aren't easy to find. When you choose on the basis of a manager's track record, it's the same record that everyone else sees. In order to make superior choices, clients have to do in-depth analysis; get to know more than the record, reputation and printed word; fully understand managers' approaches; make judgment calls based on that knowledge;

and take chances. Especially as to that last point, **unusual success cannot lie in doing the obvious**. Two specific examples:

- New managers – Someone has to fund them (or else they'll never become established managers). But clearly that decision can't be based on reams of data. It involves making a bet on people and their investment approaches. Hiring new managers can pay off very well . . . when it's done right.
- Underperforming managers – Retain or fire . . . or add money? That's the real question. Good investors hold fast to their approach and discipline. But every approach goes out of favor from time to time, and the manager who adheres most firmly can do the worst. (Page 217 of the book "Hedgehogging" provides fascinating data on some great managers' terrible times.) A lagging year or two doesn't make a manager a bad one . . . maybe just one whose market niche has been in the process of getting cheap. But how often are managers given more money when they're in a slump (as opposed to being fired)?

Buck the Trend

As in manager selection, bucking the trend is a key element in all aspects of the pursuit of superior investment results. First, going along with the crowd will, by definition, lead to average performance. Second, the crowd is usually in broad agreement – and wrong – at the extremes. That's what creates the extremes (and the highly profitable recoveries therefrom). But going against the crowd isn't easy. As Yale's David Swensen puts it,

Establishing and maintaining an unconventional investment profile requires acceptance of uncomfortably idiosyncratic portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom.

Non-consensus ideas have to be lonely. **By definition, non-consensus ideas that are popular, widely held or intuitively obvious are an oxymoron.** Thus such ideas are uncomfortable; non-conformists don't enjoy the warmth that comes with being at the center of the herd.

Further, unconventional ideas often appear imprudent. The popular definition of "prudent" – especially in the investment world – is often twisted into "what everyone does." When courts interpret Prudent Man laws, they take them to mean "what most intelligent, careful people would do under those circumstances." **But many of the things that have worked out best over the years – betting on start-ups, buying the debt of bankrupt companies, shorting the stocks of world-altering tech companies – looked downright imprudent to the masses at the time. (If they weren't so out of favor, they couldn't have been implemented at such advantageous prices and produced such huge returns.)**

Bucking the trend does not have to be synonymous with taking a lot of investment risk. In fact, it's following the crowd that's risky, since the crowd's actions take security prices to such extremes.

Staying away from tech stocks in the late 1990s meant refusing to pay ridiculously high prices. It wasn't risky in fundamental terms, but in that it required daring to be different. Those who moved to underweight tech stocks when they first became overpriced were on the hot seat for a long time. I don't think any other stock group in history has done as well as the techs in the late 1990s, and the 1999 divergence between growth stock returns and value stock returns was the greatest ever. In the years leading up to March 2000, lots of managers were fired for having underweighted tech stocks. That didn't make them wrong – just too early. While it wasn't easy for them to stick to their guns – or for their clients to stay with them – it sure paid off.

Unconventionality

Unconventionality is required for superior investment results, especially in asset allocation. As I mentioned above, you can't do the same things others do and expect to outperform.

Unconventionality shouldn't be a goal in itself, but rather a way of thinking. In order to distinguish yourself from others, it helps to have ideas that are different and to process those ideas differently. I conceptualize the situation as a simple 2-by-2 matrix:

	Conventional Behavior	Unconventional Behavior
Favorable Outcomes	Average good results	Above-average results
Unfavorable Outcomes	Average bad results	Below-average results

Of course it's not easy and clear-cut, but I think that's the general situation. If your behavior and that of your managers is conventional, you're likely to get conventional results – either good or bad. **Only if the behavior is unconventional is your performance likely to be unconventional . . . and only if the judgments are superior is your performance likely to be above average.**

Contrarian investing, which is akin to unconventional investing, has been behind many of the greatest successes. But that's not the same as saying all contrarian decisions are successful. As is the case with unconventionality, you should not aim for contrarianism for its own sake, but only when the reasons are good and the actions of the crowd look particularly foolish. If your actions aren't founded on solid logic, (a) they're unlikely to work consistently, and (b) when the going gets tough, you might find it hard to hold on through the lows. David Swensen puts it well in his book, "Pioneering Portfolio Management":

Contrarian, long-term investing poses extraordinary challenges under the best of circumstances. . . . Unfortunately, overcoming the tendency to follow the crowd, while necessary, proves insufficient to guarantee investment success. . . . While courage to take a different path enhances chances for success, investors face likely failure unless a thoughtful set of investment principles undergirds the courage.

I like to say Oaktree buys when people say “no way” and sells when they say “no sweat.” We bought Tumi in 2002, when people believed that because of 9/11, nobody would ever travel again (or need luggage), and we sold it in 2004 when no one remembered having felt that way. We gained control of Regal, Loews, Edwards and Landmark when people thought overexpansion had sounded the death knell for the movie exhibition industry, and we began to sell when industry capacity was rationalized and profitability rebounded. We bought land in Chicago when everyone was sure there would never be another skyscraper built in the Loop, and we sold it when they decided more were in fact needed. These transactions were highly profitable.

When someone says, “I wouldn’t buy that at any price,” it’s as illogical as, “I’ll take it regardless of price.” The latter can get you killed (see Nifty-Fifty growth stocks in 1969 and tech stocks in 1999), and the former can make you miss an opportunity. When everyone’s eager to buy the same thing, it’s probably overpriced. And when no one is willing to buy something, it’s equally likely to be underpriced.

Be a Pioneer

In my experience, many of the most successful investments have entailed being early. **That’s half the reason why I consider the greatest of all investment adages to be: “What the wise man does in the beginning, the fool does in the end.”**

While there’s no surefire route to investment success, I do believe one of the easiest ways to make money is by buying things whose merits others haven’t yet discovered. You ask, “When do you get that chance?” Not often, (and certainly not easily today), but not never.

In 1978, Bache asked Citibank to manage a new mutual fund for it. Citibank turned the job over to me: “There’s some guy named Milken or something who works for a small brokerage firm in California, issuing and trading high yield bonds. Can you find out what that means?”

Few people had ever heard of high yield bonds. There wasn’t much historic performance data, and what little there was came from a few obscure mutual funds. Buying bonds with a meaningful probability of default certainly seemed imprudent. Most institutional portfolios had an inviolate minimum credit rating for bonds of single-A or triple-B. Corporate CEOs said, “My buddy’s company was just threatened by a corporate raider backed by junk bonds; our pension fund will never own any!” And no public or union pension trustee wanted the headline risk associated with bankruptcy. **In other words, the perfect buying opportunity.**

Thus, our high yield bond portfolios have outperformed high grade bonds for two decades-plus, by more than enough to compensate for their defaults, volatility and illiquidity. It’s been a long-term free lunch, and **the earliest investors got the biggest helping.**

Everyone craves market inefficiency, but most people are vague on what it means or where it comes from. I’ve always thought a likely source can be a market niche that most people don’t know about, don’t understand and don’t feel comfortable with. That certainly describes high yield bonds in 1978. It helps to be a pioneer.

Likewise, we were fortunate to turn to distressed debt in 1988. There weren't any distressed debt funds from mainstream financial institutions, and the area was a little-known backwater. What could be more unseemly – and less intuitively attractive – than investing in the debt of companies that are bankrupt or sure to become so? Actually, what else could have been as profitable? Distressed debt buyers have reaped high returns while enjoying the relative safety that comes with paying low prices, investing in asset-rich companies and deleveraging their capital structures.

To take early advantage of areas like these, you have to put your faith in concepts and people, based on logical arguments and analyses but without the benefit of historic performance data. That's how you make the big bucks.

(Today, of course, everyone is willing to do anything to make money. Moreover, everyone assumes that the more *outré* the concept, the more likely it is to produce high returns. Thus, today (a) few if any free lunches are available, and (b) risk-taking is likely to generate sub-par rewards. **That brings me to the second half of my favorite adage, regarding that which “the fool does in the end.”**)

Up Against the Institution

Large investment management firms, pension funds, endowments, investment committees; they're all institutions. As such, they tend to engage in what is described as “institutional behavior” – an oft-heard phrase that's rarely intended as a compliment. We all know what's implied: shared decision making, diffused responsibility, personal risk minimization, and go-along-to-get-along interaction. All of these things work to discourage unconventionality, and thus to render superior investment results elusive.

David Swensen takes direct aim at institutional behavior. In fact, he makes repeated use of the word “institution,” as if invoking a negative mantra.

... active management strategies demand uninstitutional behavior from institutions, creating a paradox that few can unravel. (my personal favorite, emphasis added)

By operating in the institutional mainstream of short-horizon, uncontroversial opportunities, committee members and staff ensure unspectacular results, while missing potentially rewarding longer-term contrarian plays.

Creating a governance process that encourages long-term, independent, contrarian investing poses an enormous challenge to endowed institutions.

Whether the connotation has to be negative is unclear. **But certainly it is true that “idiosyncratic” and “unconventional” seem to go with “unusual investment results,” but probably not with “institutional” and “bureaucratic.”** I encourage everyone to examine the

sorts of behavior that characterize their organizations and see if anything can be changed to increase the likelihood of success.

Committees

I don't like being on committees. I was on five of them at Citibank (before moving downward in the organization from Director of Research to just-plain portfolio manager in 1978), and thus I had eleven hours of meetings scheduled per week before I walked in the door each Monday morning. I've always felt that committee meetings tend to last as long as the person who wants them to last the longest wants them to last. Since that's never me, they make me impatient (unless they're doing really interesting stuff). Oaktree generally doesn't have committees, but it's a matter of local option; our Principal Group works through investment committees that everyone seems happy with and that have produced great results.

In "Hedgehogging," under the heading "Groupthink Stinks," Barton Biggs lists a number of the shortcomings of committees, borrowing from Yale psychologist Irving Janis. He says these structures encourage:

- collective rationalization of shared illusions generally believed,
- negative stereotypes of out-of-favor groups, techniques and individuals,
- unwarranted confidence in chosen approaches,
- unanimity, suppression of doubts and pressure on dissenters,
- docility on the part of individual members,
- free-floating conversations during meetings, and
- non-adherence to standardized methodologies.

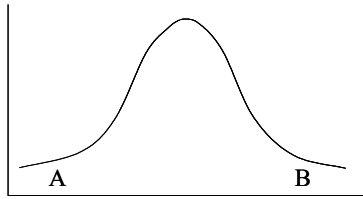
It's easy to believe that these elements are fostered in decision making groups. And certainly they are undesirable and must be guarded against. As Barton Biggs puts it,

. . . groups of intelligent people have so many inherent liabilities that a lone individual has a far better chance of making good decisions. The collective intelligence of the group is surely less than the sum of its parts, and the more people on a committee, the less chance it has to be wise and crisp in its decision making.

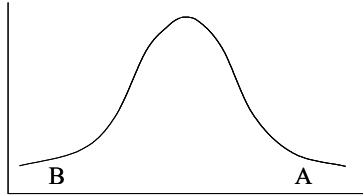
I'd rather say, "The collective intelligence of the group often is less than the intelligence of its one or two smartest members." By that I mean committees rarely aggregate the insights of their members; rather they tend to reflect the average insightfulness of their members.

At Citibank in the mid-1970s, the senior-most panel, the Investment Policy Committee, would go off-site for semi-annual retreats. The high point consisted of voting on which industries' stocks would perform best over the coming year.

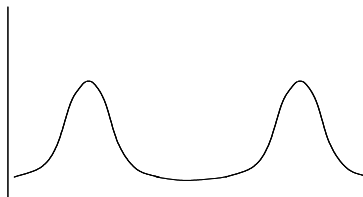
For some people, the result was a bell-shaped curve.



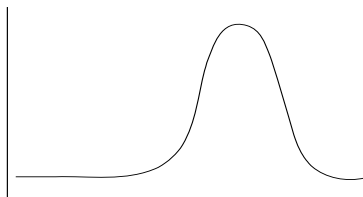
For others it was also bell-shaped, but with the placement of the industries reversed.



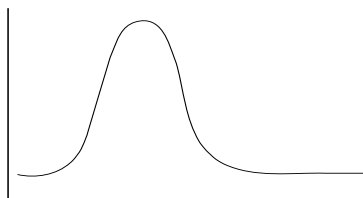
Some saw only big winners and big losers.



The bulls thought most would do average or better.



The bears thought most would do average or worse.



And the agnostics thought they'd all do about the same.



It was my sense that if you added up the members' individual distributions of expected performance, you'd get a summary distribution that was pretty close to what would have been generated randomly, and one largely devoid of valuable information. Certainly any unique insight that a member of the committee might have would be lost in such an aggregation process.

Committees rarely take high-risk positions for which the members can be criticized. They rarely embrace idiosyncratic opinions. They rarely capture the most insightful member's uniqueness, as expressed in a lone non-conformist viewpoint. And thus they rarely produce highly superior investment results. It's not impossible, just against the odds. Barton Biggs says the chances of its happening can be improved if one or two members seize more-than-equal power. It'll also help if it's the right ones who do so.

I think the key to successful committee efforts lies in "sparks." There should be intellectual friction capable of generating heat and light: spirited discussion leading to unique insight. Professor Janis urges the leader to create an atmosphere that fosters "intellectual suspicion amidst personal trust." Barton Biggs suggests praising those who disagree with the trend; designating devil's advocates; and holding second-chance meetings where members can take another, skeptical look at decisions the group has made. He says, **"harmonious, happy meetings may be a warning of groupthink and complacency, whereas agitation, passionate arguments and some stress are good signs."** While these latter things are no guarantee of correct, unconventional decisions, such decisions may prove elusive without them.

Agency Risk

Why don't investing institutions strive for unconventionality as often as they should? When they don't dare to be great, why is that the case? One reason is the limitations inherent in institutional behavior and committee decision making, as described above. Another is agency risk.

I first read about agency risk in 1983, in an article by Dean LeBaron of Batterymarch. It's risk that arises when agents are hired to do a job in lieu of their principals, and it arises because the agents' motivations may diverge from those of the principals. **When you manage your own money, the decisions are made according to your view of what's best for you. When other people manage your money, the decisions may also be influenced by what's best for them.** How many times have you heard a hired hand say, "It's not worth my while to take that risk"?

The most basic agency issue arises because staff and investment committee members may gain relatively little if their decisions are successful but can lose a lot (like their jobs and reputations) if the decisions are unsuccessful. All else being equal, this can lead them to care more about limiting risk than about achieving gains. (On the other hand, because hedge fund managers participate in profits but not losses, this can make them care more about achieving gains than about limiting risk.)

The litany of agency risks goes on, per David Swensen, "from trustees seeking to make an impact during their term on the investment committee, to portfolio managers pursuing steady fee

income at the expense of investment excellence, to corporate managers diverting assets for personal gain.”

Whenever parties other than the owners are engaged in a process, there’s a chance that they will act (wittingly or unwittingly) in their own interests in addition to (or instead of) the interests of the owners. This is inescapable, but not unmanageable.

The best way to deal with an issue is usually to put it on the table. Sunlight is a great disinfectant. All decision-making processes should recognize and take into consideration the factors influencing the decision makers. Candid discussion is usually the first step.

Another way to address the issue is through incentives, to which creative principals should pay a lot of attention. An experienced director told Forbes in the early 1990s, “I’ve given up on trying to get people to do what I tell them to do; they do what I pay them to do.” To the extent possible, people involved in the investment process should be able to look forward to rewards for attempts at nonconformity, not just penalties for decisions that don’t work. That might be the best response to John Maynard Keynes’s observation: **“Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.”**

Insist on Using Consultants Constructively

Consultants are what you make of them. They can bring expertise and data that only the largest of institutional investors can build internally. They can introduce ideas they’re seeing in use elsewhere. They can support investors’ efforts to innovate while making sure they don’t go so far as to endanger the corpus. Because few institutions can afford to home-grow all of the resources that a good consultant has, consultants truly can be additive.

Or, they can just be used as a source of cover. Their stamp of approval can be sought as protection against potential criticism. They can be used to ensure that the portfolio is never different enough from the herd to stand out. They can be hired – and motivated – to preclude innovation. Frighteningly, a consultant once told me, “I never initiate; if I did, I could be criticized for being wrong. I just opine when asked.”

By supplying new ideas and needed data in support of an effort to be great, consultants clearly can add value. But left in bureaucratic mode, it is possible for them to contribute nothing other than protection. The choice – of consultant and *modus operandi* – is up to the client.

Recognize That All Investors Aren’t Created Equal

Wouldn’t it be great if the rules in Las Vegas were changed so there would be winners but no losers? Can’t capitalism allow some businesses to thrive without requiring that some fail? Can’t we have survival of the fittest without the demise of the less fit? Wouldn’t it be nice?

And wouldn’t it be nice if everyone could make an equally positive contribution to investment results? But they can’t.

Investment committee decisions can't be improved by members possessing below average skill, experience and expertise. The bottom 50% of the universe may help by giving the top participants a manager median they can beat, but they do not contribute to the pursuit of superior results for themselves or those who employ them.

Some investment organizations are egalitarian and democratic. Participation in the investment process is broad and diffuse. Everyone gets a little money to manage, or everyone gets a vote. This approach doesn't appeal to me, because of my conviction that investment skill isn't distributed evenly.

Every team includes some members who are more skilled than others. It is they who should have greater influence in the decision making process. It's nice to see the junior members developed as professionals and given valuable experience, but bringing more people into the process doesn't necessarily enhance performance in the short run.

I've watched an investment organization at work where the portfolio was divided up among several professionals, each of whom ran his portion separately. It seemed to me that each one engaged in individual stock-picking; no one was responsible for considering the portfolio's overall diversification and risk; and, in fact, each person relied (without justification) on the others to balance out the extremeness of his actions. The resulting portfolios represented little more than a bunch of concentrated bets on personal favorites thought to have home run potential.

Systems do exist in which responsibility for portfolio management is apportioned, and they can work. But they have to incorporate rigorous coordination and overall risk management. They can achieve camaraderie, personnel development and results that are mostly down the middle of the fairway with contributions from several minds – all good things. But I don't believe that broadly sharing or dispersing portfolio management responsibility is likely to lead to highly superior returns.

We get a lot of questionnaires asking, "Which portfolio manager will be assigned to our account? What assurance do we have that our manager won't deviate from your standards?" Our answer is simple: all the portfolios in each Oaktree strategy are managed by a single individual or team. I don't believe in broadly dispersed portfolio management responsibility, and I don't think you should, either.

Avoid Common Mistakes

Lastly, I want to mention some of what I believe are mistakes I've seen made by investors and investment committees. Hopefully this will help stamp out some of them.

- Over-diversifying – It's common for portfolios to have rules stating that they can't invest more than x% per manager or per fund. However, it's probably only on rare occasions that they approach those limits. In my opinion, most portfolios are spread too thin. **While it's true that only large positions can get you into trouble, it's equally true that only large positions can make a big contribution. (This is one of the great dilemmas in investing.)**

When I see 1% or ½% of portfolio capital invested with a trusted (and diversified) fund or manager, it strikes me as too little. A manager who has earned his clients' confidence should be entrusted with enough money to make a difference in overall portfolio results. One pension plan was bold enough to let Oaktree manage 70% of its alternatives portfolio, and this led to a relationship that was wildly successful for both sides. How many investors would have taken that chance?

- Limiting the percentage of a manager's AUM – As a counterpoint to the above, I've heard committees say, "We don't want to represent more than x% of the manager's assets under management, or of the fund's total capital." But why not? **Is the goal better performance, or is it safety in numbers?** If you're considering investing \$10 million with a manager, why does it matter how much money she manages? Why is investing \$10 million safe if she manages \$1 billion but risky if she manages \$50 million? If a manager is unusually skillful, aren't you better off as her client (all else equal) if she manages less money rather than more? And if a manager was really good, wouldn't you prefer that she managed only your money? Wouldn't that be a great way to differentiate your performance (assuming you're right)? The pension client referred to above committed 40% of the capital for the initial fund in a new Oaktree strategy. Mistake? Not with an after-fee gain of 118% over the next three years.
- Moderating – Committees often prefer to take baby steps, go slow, and invest less than the maximum possible. **But in the pursuit of superior investment results, moderation is not a virtue in and of itself.** When you look at the portfolios that do better than others over time, like the Yale and Harvard endowments, you usually see very substantial commitments to individual strategies, managers and funds. In fact, you invariably see commitments that could have gotten the decision makers into trouble if they'd gone wrong.
- Managing toward peer allocations – Finally, I often see investors make reference to their peers' portfolios when setting allocations. It's unlikely that they're looking for the "right" allocation, but rather one ensuring that performance won't be far below the pack. **But if you've mirrored the pack enough to be sure you can't underperform, then it's also likely that you won't outperform.** Like everything else in the investing world (other than "alpha," or genuine personal skill), emulating the pack cuts both ways.

My most specific and most heartfelt advice is this: The surest way to achieve superior performance is by investing significant amounts with individuals and firms that can be depended on for investment skill, risk control, and fair treatment of clients.

When you're dealing with investments where reliable probabilities can't be assigned to the possible outcomes, or which entail the possibility of significant risk to the corpus (make-it-or-break-it-type risks), failing to diversify can be a big mistake. But when you know of managers and strategies that appear to offer high returns with bearable, controlled risks, and when reasonable judgments can be made about the probable outcomes, it's failing to concentrate that can be the big mistake.

In short, if you can get money to work with people that your experience shows you can rely on, load up!

* * *

The bottom line on striving for superior performance has a lot to do with daring to be great. **Especially in terms of asset allocation, “can’t lose” usually goes hand-in-hand with “can’t win.”** One of the investor’s or the committee’s first and most fundamental decisions has to be on the question of how far out the portfolio will venture. **How much emphasis should be put on diversifying, avoiding risk and ensuring against below-pack performance, and how much on sacrificing these things in the hope of doing better?**

I learned a lot from my favorite fortune cookie: **The cautious seldom err or write great poetry.** It cuts two ways, which makes it thought-provoking. Caution can help us avoid mistakes, but it can also keep us from great accomplishments.

Personally, I like caution in money managers. I believe that in many cases, the avoidance of losses and terrible years is more easily achieved than repeated greatness, and thus risk control is more likely to create a solid foundation for a superior long-term track record. Investing scared, requiring good value and a substantial margin for error, and being conscious of what you don’t know and can’t control are hallmarks of the best investors I know.

But in assembling a portfolio of managers and strategies, there has to be an element of boldness if you hope to enjoy superior returns. Too large a dose of caution in asset allocation can keep portfolios from outperforming the norm.

Two additional factors bear on the integration of risk management in asset allocation, with its pivotal role in portfolio construction:

- First, as Professor William Sharpe demonstrated, adding a risky strategy to a portfolio with which it is uncorrelated can reduce the overall riskiness of the portfolio.
- Second, it should be borne in mind that when one portfolio places a greater emphasis than another on managers who lean toward risk control, that portfolio can allocate more of its capital to risky strategies without having a higher overall quantum of risk. Thus, while restricting your total risk to your targeted level, **would you rather allocate more money to the aggressive asset classes via risk-controlling managers, or less money with free-wheeling managers?**

* * *

I hope this memo won’t come across as preachy. The things discussed here are challenging, and I don’t claim to be much better at them than anyone else. I’ve sat on the investor’s side of the table. I’ve been a member of several investment committees. I know it’s a tough job. Committee and staff members have to act in what they consider to be the best interests of the beneficiaries, trying for superior returns but avoiding unacceptable losses. They also have to

choose investment managers, separating the ones that sound good and are from the ones that sound good and aren't. (The ones that don't sound good usually aren't let out on the road.) All we can do is our best.

The right approach to portfolio construction has to combine discipline and hard work; skillful, intelligent risk bearing; and insight, flair and talent. In that regard, I'll cite the last three words of Barton Biggs's chapter on groupthink: "It's not easy."

September 7, 2006

Regulations require me to point out that the performance of the investments mentioned herein may be more favorable than, and not representative of, other investments made by Oaktree. If you would like information regarding investments other than those presented here, please contact your client representative. We make no representation, and it should not be assumed, that past investment performance is an indication of future returns. Moreover, wherever there is the potential for profit there is also the possibility of loss.

Memo to: Oaktree Clients

From: Howard Marks

Re: The New Paradigm

When I was a kid, no one ate kiwi fruit or heirloom tomatoes – or had ever heard of them, for that matter. And then, all of a sudden, they were everywhere. The same is true for the word “paradigm”: no one had heard the word, and then one day it was part of everyday speech, especially that of management consultants and other savants.

“Paradigm” seems to invariably be used along with the word “new.” No one ever talks about the old paradigm. Just as there’s newness to the word, there’s usually newness to the subject it describes. And there’s usually a connotation that the new paradigm represents progress.

I believe a new paradigm has taken hold in the investment world, bringing with it vast changes – and not necessarily for the better. The situation today is very different from that of just five or six years ago, and the implications for the future are nothing short of profound. But I haven’t seen this overall subject given much attention.

The Good Old Days

In the old days – meaning prior to the current millennium – the investment world was different from that of today in a number of important ways:

- **Risk capital was in limited supply.**
- **Risk aversion was reasonably present, such that in order for risky investments to be undertaken, that risk aversion had to be overcome by high promised returns.** The reluctance to make risky investments also meant that they had to be supported by research and analysis performed by skeptical experts.
- **There was a particular aversion to new, unproven and “alternative” forms of investment.** Fiduciary caution was an overarching consideration. With the returns from U.S. equities expected to handily exceed the overall return needs of pension funds and endowments, alternative investments were something of an exotic luxury: tempting but also non-essential and somewhat forbidding.
- Because the amounts of capital pursuing alternative investments were limited, **investors had negotiating power** and were able to insist on, among other things, an incentive system that aligned their interests with those of their money managers, in which fixed fees merely covered managers’ expenses and incentive fees offered managers the hoped-for brass ring.

The Great New Days

In my view, all of the elements listed above have changed drastically in the last few years. (You've seen some of this from me before, but not all in one place.)

- **The stock market's losses in 2000-02 substantially cooled investors' ardor for equities.** Instead of 9-11%, U.S. stocks now are universally expected to return just 5-7%. **Thus pension funds and endowments that need 8% or more are looking elsewhere for return.** That "elsewhere" means non-traditional market niches such as buyouts, venture capital, hedge funds, real estate and emerging market equities and debt.
- **This stretch for return has overcome innate caution.** Any aversion to the risks entailed in these markets has been wiped away by the combination of (1) the perceived paucity of return in traditional stocks and bonds, (2) the high returns achieved recently in the alternate markets, and (3) the failure of risk to turn into loss in the last few years. Recent successes have erased from the collective consciousness any reluctance to undertake the new, unproven or risky.
- **As a result, large amounts of money are demanding access to the alternative markets.** However, these markets are much smaller than the traditional stock and bond markets that now seem uninteresting. (The Financial Times reported on September 11 that according to JPMorgan, the alternative investment world amounts to \$3 trillion, while the size of the mainstream bond and equity world is estimated at \$60 trillion.) Thus the amounts people are trying to invest can overwhelm these markets. **For this reason, investors may attach more importance to the ability to put large sums to work than to being able to attain historic returns and risk premiums, clear high due diligence hurdles, or structure fee arrangements that channel managers' energies for the benefit of clients.**
- **For now, the high level of liquidity is creating a "virtuous cycle."** The inflows have (1) given rise to asset appreciation, high returns and further demand, and (2) made it easy for weak companies to finance their way out of trouble, thus contributing to the impression that the level of risk is low.
- **The business model for managers in these areas has been completely altered by these developments.** Because the amounts under management are so large (and the ability to charge high management fees is so great), managers can get rich off management fees and deal fees alone. **For managers, then, high returns may be a nice-to-have, not a need-to-have, and avoiding endangering the fee machine can become a greater preoccupation.**

It is my view that, in combination, these developments have had a number of undesirable effects on the investment environment such that:

- Willingness to bear risk is up.
- Insistence on high risk premiums is down.
- Skepticism is down, and there's widespread willingness to suspend disbelief.
- Demand for t-crossing and i-dotting is in retreat.
- Quantity can replace quality as the *sine qua non* for portfolio construction.

I'll provide a few examples below to illustrate what I think is going on in the alternative markets.

Buyouts: Where's the Magic?

A startling revolution has taken place among buyout funds in the last year or so. Let's take a look at how we got here.

So many of the big-name, highly leveraged buyouts of the late 1980s went bankrupt in 1990 – Macy's, Federated, National Gypsum, etc., etc. – that the industry had to recreate itself, dropping the discredited word “leveraged” and the previously ubiquitous acronym LBO. Instead, the industry began to call what it does “buyouts” or “private equity.” It switched its model from loading massive leverage on venerable, multi-billion dollar companies to the mantras of “platform and buildup” and “consolidate the industry.”

In the 1990s, the low levels of leverage permitted by chastened lenders kept the buyout boys from closing any landmark acquisitions, but also from loading on enough debt to render their companies vulnerable to distress. In order to lose huge amounts of capital, buyout funds had to venture into the tech and telecom arenas, and relatively few rose to the occasion. Thus buyout funds got through the 2002 debt debacle largely unscathed. The buyouts of the 1990s did not give rise to a high level of bankruptcies, but neither were the returns spectacular, even with leveraged equity in a rising stock market.

The pioneers of the buyout business – like KKR, Warburg Pincus and Apax Partners – enjoyed the spectacular success that can come with early entry and good execution. But as a result of the trends since the mid-1980s, results for most buyout funds have been anything but spectacular. As I mentioned in “Dare to be Great,” from 1980 to 1997 the typical fund performed just in line with the unleveraged S&P 500. So what's happened since then?

- The stock market declined for three consecutive years for the first time since the 1930s.
- Buyout funds did okay.
- Expectations for returns from stocks have been almost halved.
- Financial engineering (in an extremely benign capital market) has enabled buyout funds formed in the last few years to report sky-high internal rates of return on their early winners.

As a result of the above, the demand for funds in the buyout field – and especially “big buyout” – is absolutely booming. I believe that in 2000, KKR couldn't get \$10 billion for its Millennium Fund and closed at \$6+ billion instead. Their current fund is at \$15 billion, and that on top of \$5 billion they raised through a public offering in Amsterdam earlier this year. Several funds have

been raised with capital in eleven figures, and \$15 billion has become the new \$5 billion. \$6 billion is considered a mid-sized fund, and \$2-3 billion feels like small-fry.

What's behind the boom? As elsewhere in the investment business, the buyout managers talk a great game, and the best have produced excellent results over the years – although perhaps not always as good as they intimate. In 1999, I explained distressed debt investing to a state pension fund and said I thought we could make 20% before fees. “Buyout fund x was just in here,” they said, “and they think they can make 30%.” I'm confident that most 1999 vintage buyout funds didn't make 30%.

But in the last couple of years, cheap money made available by avid lenders – willing even to lend money that would be paid out immediately to stockholders, increasing indebtedness but not adding to assets, revenues or profits – has enabled buyout funds to shrink their equity investments and supercharge their IRRs. Not always larger dollar profits or higher ratios of terminal value to committed capital, but higher reported rates of return – probably in many cases on small amounts of equity for brief periods of time (See “You Can't Eat IRR”). But people are turned on by high percentage returns, and the dollars have followed.

I believe the largest pools of investment capital have given up on getting the returns they need from now-debased equities and have turned to buyouts and the like for help. I imagine a thought process that goes like this: “Historically, good buyout funds have had returns in the high teens net of fees. Even though the environment isn't what it used to be, it should be a lay-up for them to reach the low teens. I'd even be happy with 10%; it would certainly help me with my 8% required return. And I can put a billion to work in one phone call.”

Well, I'm not sure many buyout firms have produced historic average returns in the high teens. (According to Bloomberg, “U.S. buyout funds produced returns of 13.3% during the past two decades.”) And even if the best did, that doesn't mean earning even low teens will be easy in the environment ahead. Finally, I'm not convinced that returns in the low teens are enough to make it worth bearing the risk that comes with leverage, illiquidity and competition for deals. But the money flowing into buyout funds makes it clear that I'm in the minority.

The Outlook for Buyout Returns

Investors – in any field – can make money in four broad ways: buy cheap, add value, apply financial engineering and sell dear. Let's examine each one as it applies to buyouts.

Buying cheap – The golden age of buyouts lasted from approximately the mid-1970s to the mid-1980s. What was the environment like as that period began?

- The stock market was in a terrible slump, with Business Week heralding “The Death of Equities.”
- Companies could be bought cheaper through the stock market than they could be built for.
- Historically, before the age of leverage, one company could buy another only if the would-be acquirer was larger than the target. Thus the competition to acquire was limited.

- As the LBO era dawned, only a few organizations had the inclination and know-how required to buy companies bigger than themselves.
- Buyout funds were tiny, and their *modus operandi* consisted of paying bargain prices for small, little-known companies or orphaned divisions of larger companies with stable cash flows.

Today's environment bears little resemblance to that one. As I mentioned in a memo earlier this year, I'd heard a buyout mogul say, "It's our job to buy good companies at fair prices and make them better." I doubt he was content with fair-priced purchases thirty years ago.

- Listed companies are cheaper today than they were in 1999, but not nearly as cheap as in 1976. The P/E ratio on the S&P 500 is 17.5 today versus 10.3 at the inception of the LBO movement three decades ago.
- To deploy unspent capital that in August was estimated by The Financial Times at \$297 billion, buyout funds will have to acquire companies worth roughly \$1.5 trillion in the years ahead. That's a few percent of all of the world's stock markets.
- The buyout funds are competing with each other to spend their capital, and they also have to compete against strategic corporate buyers that have enjoyed strong profitability and are cash-rich. (Nevertheless, buyout funds often outbid strategic buyers, who in theory should be able to pay more because they can combine the acquiree's operations with their own and garner efficiencies.)
- In some cases, activist shareholders and cash-swollen hedge funds are pushing managements (and boards under increased scrutiny) to demand higher prices before turning over their companies to buyout funds, and escalating purchase prices are frequently the result.

Under this combination of circumstances, are there still bargains to be found? Here's the big question that's nagging at me: **Everyone is convinced that investing in listed U.S. equities at today's prices will produce gross returns of 5-7% in the years ahead. If that's true, then how can buyout funds go into that same market, pay substantial control premiums over their target companies' stock prices, and generate double-digit annual returns after deducting 2-4% per year in management fees, deal fees and incentive fees? Will there be enough "value added" and financial engineering to bridge that gap?**

Adding value – The buyout funds claim that they'll be able to create gains by making companies better. But many companies have been working hard for years to improve their efficiency and profitability. There's always room for improvement, but it's a lot harder to make money this way than by buying something cheap and selling it at a fair price. **As in everything else, the best managers will add substantial value, but if it was easy enough for everyone to do it, it probably would have been done already.**

Financial engineering – Between the two, I'd rather bet on fundamental improvement than smoke and mirrors. Withdrawing equity in order to leverage up the IRR doesn't add any value. It couldn't be done in the stingier debt market of five years ago, and it may not be doable five years from now if a business slowdown shows lenders its folly. Rising interest rates would be a negative, and factoring in a more restrictive capital market would ring the bell on radical financial engineering for a while.

Selling dear – Of course, you can always hope to sell at valuation multiples higher than you paid, but it's not reasonable to count on being able to do so all the time. Purchase multiples below the historic norms could buttress such an expectation, but we're not there now. Today's valuation multiples are being supported by low interest rates (prices of financial instruments rise as demanded yields decline, and vice versa), and higher interest rates would be expected to reduce sale prices for companies. And as the subject companies get bigger and bigger, the number of possible buyers shrinks. For the \$30 billion companies that are being talked about today, the stock market may be the only exit, and that's something that can't be counted on year-in and year-out.

So in contrast to the description of the golden days of buyouts on the previous page, today we have:

- A buyout phenomenon that everyone's aware of and eager to play.
- A stock market that can't be described as cheap.
- Heavy competition to buy target companies.
- Dependence on financial engineering based on low interest rates and generous capital markets that may not stay that way forever.

We also see companies being sold from one buyout fund to another. What does that imply? In most transactions, one party's right and the other's wrong. Generally, the buyer can't be getting a bargain unless the seller is accepting less than he should. And shouldn't the seller know the company best (and be expected to have made the available improvements)? So are the selling buyout funds being generous? Are buyers overpaying? Or are the transactions motivated by a desire to lock in incentive fees and generate further deal fees? If there is a free lunch, where's it coming from? I'll leave those questions to you.

Buyout prices have been rising as a multiple of company earnings, and companies are being bought with greater proportions of debt in an attempt to squeeze out higher returns on the buyout firms' equity. As companies become more highly geared, the outcomes become more dependent on a favorable environment. As they say in Las Vegas, "The more you bet, the more you win when you win." **But, simply put, when you increase leverage, the probability of getting into a jam increases and the consequences of that jam worsen.** Certainly this is not a cautious, capital-starved environment for buyouts in which people have girded for tough times.

I have to admit it: if I could push the fast-forward button and see how a movie ends, it would be this one. Like most "silver bullets," I think buyouts will fail to live up to the highest expectations of those who're making it the darling of the investment world today.

I find the outlook for funds in the "big buyout" category particularly intriguing. Certainly the managers spin a convincing tale: Because there are so few buyers capable of tackling the biggest transactions, the competition to buy will be limited and transaction prices will be kept low. The few big funds will tend to join forces in "club deals," further precluding bidding wars. And, based on the supposed correlation between corporate bigness and inefficiency, it's claimed that vast gains will be wrought from streamlining the acquired companies. We'll see.

How About Real Estate?

The other day, I was privileged to hike with a friend who I consider one of the very best value-added real estate investors, Dean Adler of Lubert-Adler. I thought I was listening to a tape of my worrisome self. Dean told a tale that I found scary – even though I don’t stand to lose a penny if his warnings hold true. Here’s what he says is going on in the real estate arena:

As in other parts of the world of investment and finance, the ability to borrow is what’s keeping the wheels turning. And the ability to borrow for real estate investments is under the control of a group of people called appraisers.

Dean’s firm spends months performing in-depth analysis on the properties it owns and wants to finance, and on those it wishes to buy. Then it takes the data to lenders . . . who don’t care. All that matters, they say, is what the appraiser thinks. If the appraiser says your property is worth 100, you can borrow 80. But if he says it’s worth 50, you can only borrow 40.

Interestingly, the data generated by Lubert-Adler through months of analysis is dismissed by the lender, but the opinion of the appraiser – who spends perhaps a week or two looking at the property – is accepted unquestioningly. But – I have to say it – if the appraiser was as good as Dean at putting values on property, wouldn’t he be a leading real estate investor rather than an appraiser?

The real estate story has other negative aspects. The first is that whereas I posit being able to borrow 80% of appraised value, it has become possible to borrow more than 100%, as lenders will finance not just the purchase price, but development and other expenses as well. In “Field of Dreams,” they said “If you build it, they will come.” In real estate, it’s more like, “If you’ll lend them money, they will buy or build.” Just imagine what goes through the heads of real estate dreamers when the capital markets allow them to take risks with other people’s money.

Lastly, Dean pointed to construction loans. These short-term (and, in today’s market, low-rate) loans bear the substantial risks associated with delays, cost overruns and the like. And yet they are being made by hedge funds that lack real estate expertise, experience and infrastructure.

If having a sense for the behavior going on around us can be highly instructive, as I feel it can, then these observations from the real estate industry should be cautionary. As I often quote Warren Buffett as saying, “The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs.” Dean Adler’s description of the state of affairs in real estate doesn’t suggest there’s a lot of prudence out there, meaning it’s time for us to apply our own.

Give Me Structure

Ten years ago, we would raise \$100 from a client and use it to buy \$100 worth of high yield bonds. We still do it that way, but in many quarters, that \$100 is used as the equity for a structured investment vehicle, such as a CDO, CBO or CLO, in which it supports the purchase of \$1,000 worth of (management fee-generating) bonds.

Collateralized Debt Obligations, Bond Obligations and Loan Obligations are entities that collect capital from investors and lenders with which to construct portfolios of the relevant instruments. The capital structure of the entity is tiered, so that the providers of capital have varying priorities in terms of being repaid and participating in losses.

The senior-most lender enjoys security from the entire portfolio, and because his loan is thus heavily over-secured and highly rated, he demands only a low rate of return. The second-most-senior loan is a bit less well secured and less highly rated, and thus the rate demanded on his debt is a bit higher, and so forth. Because the interest rates promised to the senior lenders are below the average coupon on the portfolio, there should be a lot of cash left over for the junior lenders and the equity investors – if things go well. But the equity is also in the first-loss position, so it's truly a make-it-or-break-it proposition.

Vast sums have been raised for this “silver-bullet” solution to the problems of allocating risk, leveraging returns and putting money to work. Clearly, the key to seeing all this work out lies in enough credit expertise being present for risks to be controlled and defaults minimized. But today the necessary ingredient for the establishment of these structured vehicles isn't credit expertise, but the ability to structure the entity so as to win high-enough ratings on the senior tranches to attract capital and permit a lot of leverage. This distinction is highly significant. In a clear analogue to real estate appraisers, the people controlling the all-important credit spigot are the financial structurers assembling the entities and the CDO analysts at the credit rating agencies.

In a June 2 article entitled “Structured Complacency,” the often-brilliant “Grant's Interest Rate Observer” went into great (and, as usual, critical) detail on this phenomenon. As to the popularity of structured vehicles, it wrote, **“Credit markets are sanguine. Structured credit is proliferating. Could the first fact be related to the second?”** And as a key part of this trend, it says, **“Financial engineering is displacing credit analysis.”** What's the difference? **“Financial engineering is the science of structuring cash flows; credit analysis is the art of getting paid.”**

Why the declining interest in credit analysis? Grant's advances the thesis that it is linked to disintermediation, in which many lenders no longer hold on to the loans they make, but more often syndicate or sell them onward to other providers of capital. Holding the keys in this process are the risk manager who structures the entity based on statistical likelihoods and the rating agency that applies the stamp of approval for buyers lacking direct knowledge of the underlying instruments and the ability to understand the structure. Grant's quotes the IMF's 2006 Global Financial Stability Report:

Not surprisingly, the development of structured credit markets has coincided with the increasing involvement of people with advanced financial engineering skills required to measure and manage these often complex risks. In fact, for many market participants, the application of such skills may have become more important than fundamental credit analysis. . . .

Discussions with market participants raised questions as to whether the increased focus on structuring skills, relative to “credit” analysis, may itself present a concern.

The structurers are “risk managers.” They assemble mathematical models that extrapolate historic default rates and recovery rates (which may or may not have relevance in today’s environment). They look at probabilities, expected values and correlations. But they count heavily on the statistical properties of the universe as it has been and may know rather little about the actual assets contained in the portfolios. **Of course, this sort of reliance on statistically derived expectations was behind the undoing of Long Term Capital Management in 1998 – of which so little seems to be remembered.**

Grant’s describes an interview with a junior analyst at a rating agency whose job it is to monitor the health of a large number of CDOs each day, plugging numbers into an Excel spreadsheet. According to Grant’s, “he doubts that many people really understand what these structures own, how their assets are correlated, or what might happen to them in the liquidation portion of a credit cycle.” To wrap up, Grant’s quotes Michael Lewitt of Harch Capital Manager, a manager of bank loans:

... having a credit market priced on a non-credit basis – meaning priced off quantitative and arbitrage bases, and not on credit fundamentals – is not a healthy thing.

Interestingly in this connection, Wachovia Structured Products reports that as of April, of the 47 Collateralized Loan Obligations that had gone full cycle, 30 generated positive returns for their equity. Put the other way around 17, or 36%, had lost money. I doubt that was the expectation on which they were sold. And that in relatively good times.

My favorite investment adage warns about the things “the fool does in the end.” Clearly, turning over the administration of credit to appraisers, raters and structurers who know relatively little about the underlying assets they’re dealing with – and who are hired hands without their own capital at risk – signals a dangerous late stage of the inevitable cycle.

It’s Time to Hedge

Given the laxness, euphoria and credulousness that I detect in the market for money today, it’s time for caution. Where better to find it than in funds that hedge?

Well, of course, today the term “hedge fund” has nothing to do with hedging and everything to do with incentive fees. In no way does that label connote risk control. And whereas the shortcomings of the structured entities described above go along with the activities fitting their charter, most hedge funds have unlimited charters and can roam free in search of return. Here are a few recent trends:

- Hedge funds are making “second lien loans” in large numbers. In some cases, however, there are no assets left (after the claims of first lien loans) to have a lien against. They may

or may not be made by people who have previously been lenders. Those people may or may not possess workout experience. And it's an open question how hedge funds holding large portfolios of small loans will behave when companies get into financial hot water. Lately I've heard mention that hedge funds might be making these loans to gain control of companies that default. But it isn't clear to me how appreciation will routinely be wrung from loans that are made at par and subsequently become non-performing.

- Since I moved to Los Angeles in 1980, my friends in "The Industry" have been unanimous in one piece of advice: never invest in movies. Yet The Wall Street Journal of April 29 carried a story headlined, "Defying the Odds, Hedge Funds Bet Billions on Movies."

For decades, movie studios have gladly accepted millions of dollars from a group of investors collectively dismissed as "dumb money": deep-pocketed dentists, oil tycoons and other wealthy individuals eager for a piece of the glamorous but high-risk game of film production. But the biggest influx of money in Hollywood these days is coming from sharks, not suckers: hedge funds, private equity funds and investment banks.

Take the example of "Poseidon," which was co-financed by hedge fund-backed Virtual Studios. It has brought in gross revenues of \$180 million worldwide since May against its production budget of \$160 million, meaning that after the deduction of at least half the revenues for distribution charges, advertising costs and exhibitors' fees, it's still a big loser.

- If there's one thing I've never claimed to understand, it's how you put a price on a highly improbable disaster. Thus I have a lot of respect for anyone who can do a consistently superior job of underwriting catastrophe insurance against earthquakes, hurricanes and terrorist events. Is the right premium for insuring a Caribbean hotel against hurricanes \$1 million or \$5 million, given that the loss may be zero or \$100 million? The difficulty of setting these premiums isn't keeping hedge funds from filling the gap in the "cat insurance" market.
- Along similar lines as catastrophe insurance, hedge funds are among the leading writers of Credit Default Swaps, the equivalent of issuing insurance against bond defaults. Hedge funds find it attractive to write this coverage for multi-year periods, perhaps in part because the premiums are taken into earnings each year, adding to returns and giving rise to incentive fees, while the defaults are likely to come later. **As in any form of risk transfer, the ultimate profitability of this proposition will depend on how well the insurers know the risks and on what they're able to charge in terms of premiums.** When lots of hedge funds are eager to sell CDS, however, premiums are driven down, and they can easily prove inadequate when defaults occur down the road.
- In recent months we've seen hedge funds take major losses (sometimes prompting them to close their doors) in natural gas trading and unhedged emerging market equities. I've read of hedge funds that trade in carbon dioxide emissions and one backing a fledgling fashion designer. And hedge funds are making the construction loans that Dean Adler discussed.

None of these activities is imprudent in and of itself. But they all involve substantial risk and should be undertaken only by people possessing the essential edge: sufficient expertise in the relevant field to be able to know when the opportunities are truly attractive.

Why This Appetite for Risk?

In my memo on hedge funds of two years ago, I cited an insightful piece from Byron Wien of Morgan Stanley called “In Praise of Hedge Fund Volatility.” In it, he observed that many hedge funds have become asset gatherers for whom the retention of assets and the receipt of management fees have become more important than the achievement of high returns and the earning of incentive fees. Thus low volatility has supplanted high return in the pantheon of virtues.

In my view, this trend has reached beyond hedge funds to additional corners of the alternative investing world. The concept of management fees sufficient to “pay the light bill” seems obsolete. For example, even at just 1¼% per annum, a \$15 billion buyout fund can generate more than \$1 billion of management fees over its lifetime. Add to that the “deal fees” and “monitoring fees” commonly charged and it’s easy to picture managers becoming wealthy irrespective of performance. Indeed, the ancillary fees can be so massive that even where some or all of them must be applied to offset management fees, managers can receive total fees that far exceed the stated management fee percentage.

Of course, if a fund can generate \$1 billion or more in fees, you as its manager would love to perpetuate that flow. While you don’t need high returns in order to get rich, it would be nice to be able to repeat this process, so returns should be good enough to permit further funds to be raised. **But the notion of managers who are entirely dependent on high returns for the achievement of their financial dreams may to some extent have become a thing of the past.**

So what’s the new paradigm?

- **First, raise a lot of money.**
- **Second, try for a rate of return that clients will find acceptable.**
- **Third, don’t take enough risk to possibly preclude an encore.**
- **Fourth, invest as fast as is prudently possible, so that another fund can be raised while the market remains accommodating.**

I believe this last point may be part of the reason for managers’ ever-growing willingness to invest in large transactions and afield from the tried-and-true. In view of today’s incentive structure for managers, speed and size can count for more than investment excellence. Some managers will sell out knowingly, even proactively. Others may be influenced more insidiously. And some will be egged on by clients emphasizing their desire to invest large amounts of money with low volatility and downplaying the need for high returns. Managers who do not want to be so affected (and their clients) must strongly resist this trend. Recognizing it is the first step in doing so.

* * *

It doesn't give me pleasure to talk about an environment in which risk aversion is in short supply, risk premiums are skimpy and danger lurks. Or in which there's a new paradigm capable of contributing to a misalignment of interests between investors and their managers.

But it is what it is. Take a look at the lists of elements on pages 2, 3 (top), 6 and 11 and tell me which ones you think aren't described accurately. **If you agree that the investment world of today is captured in those lists, then the prescription is unambiguous: it's time for caution and risk control.**

The workings of free capital markets require that in order to overcome investors' innate aversion to risk, seemingly riskier investments must offer the possibility of higher returns providing "risk premiums." But when risk aversion is at cyclical lows, risk premiums needn't be generous; people will invest anyway. Too many people trying to dine at the buffet simultaneously can lead to a disorderly process and skimpy portions. I recommend that you look twice at the cost of admission and – if you do decide to partake – proceed carefully.

For the last few years, my mantra has been "special niches, special people." By the "special people" part I mean it's important to find managers who possess the skills required to safely pursue return in high-priced markets. It's at least as important in the current environment, however, that they also can be counted on to resist the conditions described above in the interest of serving their clients.

October 19, 2006

Memo to: Oaktree Clients

From: Howard Marks

Re: Pigweed

At Citibank back in the '70s, Chief Investment Officer Peter Vermilye placed a lot of emphasis on building team spirit. His tools included skits at our annual staff outings, and he never hesitated to participate in costume. My favorite was his portrayal of Johnny Carson's savant, "Carnac the Magnificent." He would hold a sealed envelope to his forehead and intone "Schlum-bair-zhjay," as the French pronounce the oil service company's name. Upon opening the envelope, he would read, "What they call it at \$75." Holding up the next envelope, he'd say "Slum-burger." The explanation inside: "What they call it at \$15."

In other words, investors love things as long as they're riding high but lose all respect when they're brought low. It doesn't take long to become discredited in the investment world. And so it is for Amaranth Advisors, which now might be relabeled "pigweed" – another word for the plant that gave the fund its name.

For those who've been incommunicado over the last few months, Amaranth is a hedge fund that was formed in 2000. In the beginning it stressed relatively safe strategies like convertible arbitrage. But more recently it ventured into other things and in 2004 hired a young man named Brian Hunter to engage in energy trading, leading to the recent events. On September 18, it announced that it had lost 40% of its \$9.5 billion of total capital on natural gas trading, a percentage that was revised upward to 65% over the next few days. The fund sold off its energy trading book, Brian Hunter departed, and Amaranth threw in the towel and is liquidating.

Now that Amaranth's collapse has earned it a place on the list of investment disasters, we should consider the lessons that can be learned from it. I'll try to provide some useful insights regarding Amaranth, as usual without claiming to be an expert on the subject.

You Bet!

As I read about Amaranth, one thing stood out: the repeated use of the words "trade" and, especially, "bet." Nothing about "invest" or "own." And certainly no reference to "value." The pattern really is striking.

Of course, part of this change in attitude could be attributable to the defrocking described above. Six months ago, the articles might have described Amaranth as an astute energy investor, rather than the reckless gambler it's considered today. But certainly the new nomenclature is everywhere, and I find it appropriate.

What's the distinction? Investors want to own things for the long run, under the belief they'll grow and strengthen over time (or that today's values will come to be better appreciated).

Traders buy and sell, usually in short order, to take advantage of momentary phenomena. I usually think of them as betting on the direction of the next price move. Certainly we can say their timeframe is hours or days, or maybe weeks, but rarely months and never years.

And what is a “bet”? That’s one of those words we all know the meaning of but would be hard-pressed to define without using the synonym “wager” or the word “bet” itself. I consulted The Random House Dictionary of the English Language and found a very useful definition: a bet is “a pledge of a forfeit risked on some uncertain outcome.” In other words, you attempt to profit from an uncertain event, and if it doesn’t go as you hope, you forfeit something of value. Well then, Amaranth certainly was a bettor.

One question: If it’s so obvious today that Amaranth was “betting,” were people equally aware of that fact a few months ago? I don’t think so. **Gains are often presumed to be the result of carefully considered investments, while it’s usually losing ventures that are described as having been bets.**

What Was Their Game?

Amaranth’s energy trading operation was in business to bet (there I go!) on short-term movements in energy prices. But it didn’t base its activities on saying “we want to own natural gas” or “we want to be short.” That would be risky.

Instead, it said things like this: “The price of natural gas is always higher in the winter than in the summer, as is proper, because cold weather causes the demand for gas to increase. But right now, we think the price discrepancy is wider than it should be: January gas is too high relative to July gas. So we’ll short January gas and buy an equal amount of July gas.” Under this approach, there’s no net exposure to the overall direction of gas prices, just a bet (if you will) on the wideness of the spread. The fund won’t gain if the price of gas rises or lose if it falls. Instead, it’ll gain if the spread narrows in a reversion to the mean, or it’ll lose if the spread anomalously widens further.

This is a true hedged position: an arbitrage. I define arbitrage as **taking largely offsetting positions in the same or closely related assets exhibiting a price discrepancy, with the goal of profiting, with very little risk, when the mispricing corrects.** Its aim is to profit from the movement of asset prices relative to each other (the relationship between which usually can be counted on to stay within a normal range), not from the movement of the price of a single asset (which can behave any way at all in the short run). This is a very valid approach for a hedge fund to take. It epitomizes hedging, something that most hedge funds now seem to engage in infrequently or not at all.

So where did Amaranth’s risk – and the possibility of catastrophic loss – come in? The answer’s simple: **Positions that are low in risk can be rendered quite risky with the help of leverage.**

Back in ancient history (1998), a fixed income hedge fund called Long-Term Capital Management pursued arbitrage transactions like Amaranth’s (on a much more diversified basis but with more leverage) and experienced a similar meltdown. I noted that earlier, when things

were going well, one of Long-Term's principals had said, **"We're going around the world scooping up nickels and dimes."** There's great appeal to his notion of profiting from a large number of small mispricings that others aren't smart enough to seize upon. But he had left off a few key words from the end of his sentence: **"... in front of a steamroller."** The steamroller enters the picture when so much leverage is employed that a fund can't survive a moment of aberrant market behavior.

In a memo on hedge funds in October 2004, I mentioned that when there's a big increase in the number of little fish attempting to live off each big fish's leavings (or in the number of hedge funds relative to mainstream investors), the pickings become slimmer. Given the increased efforts to exploit inefficiencies today and the fact that strong cash inflows and resultant high prices have depressed prospective returns in many markets, managers are often resorting to increased leverage in order to reach their return targets. **But it's essential to remember that leverage is the ultimate two-edged sword: it doesn't alter the probability of being right or wrong; it just magnifies the consequences of both.**

The Perils of Diversification

The Amaranth saga demonstrates that the riskiness of a portfolio is not just a function of the fundamental nature of its holdings, but also of things like concentration and leverage. I often say there is no investment so good that it can't be ruined by too-high an entry price. **There's also no investment so safe that can't be rendered risky by buying too much of it with borrowed money.**

Diversification has long been considered a pillar of conservative investing. It's a simple concept: "Don't put all your eggs in one basket." Spreading your capital among a number of assets or strategies reduces the likelihood of a disaster.

In the 1960s, Bill Sharpe pointed out that adding in a risky but uncorrelated asset can reduce a portfolio's overall riskiness. It has become accepted wisdom that overall risk can be reduced (and return increased) by adding alternative investments to a portfolio of stocks and bonds.

But people don't always take note of a dangerous outgrowth of these dicta: **that diversifying into uncorrelated assets with borrowed money can increase, not reduce, the risk of the portfolio.**

Let's say you have \$100 invested in U.S. stocks. You realize how undiversified your portfolio is, and that a market crash can bring a substantial loss. So you sell off \$75 worth of stocks and put \$25 each into emerging market stocks, high yield bonds and natural gas futures. Now your portfolio is invested equally in four asset classes rather than one and thus probably safer.

But what if, instead, you hold onto your \$100 worth of U.S. stocks and borrow another \$300, investing \$100 in each of those three new asset classes. You're again invested equally in four asset classes. **Equally diversified but much less safe.** That's because leverage has magnified the sensitivity of your portfolio to market movements.

A crash that wipes out one of the four asset classes in the diversified \$100 portfolio will reduce your net worth by 25%. But that same crash, when experienced in the leveraged and equally diversified \$400 portfolio, will eliminate your entire net worth. So investors should always consider the combined effect of diversification and leverage. Amaranth was much safer when it was all in convertible arbitrage than after it increased its leverage in order to diversify into energy trading. **Diversification is a good thing, but a lot depends on how you finance it.**

“Multi-strategy” is one of today’s hot buzz words. But as Orin Kramer puts it (see page 12 for who he is), “Amaranth is a reminder that a multi-strategy structure is not a proxy for risk diversification.” That is, I think, multi-strategy + risk control = protective diversification, while **multi-strategy + leverage = more ways to lose.**

Generating Alpha

I want to say up front that I have absolutely no idea how one dependably achieves above average profits from trading or investing in commodities, precious metals or currencies. That’s not to say it can’t be done. There are people who’ve gotten very rich that way, managing both their own money and that of others.

Of course, the efficient market crowd would say someone will get rich doing everything – even playing the lottery or flipping coins – simply because the tails of a probability distribution usually aren’t entirely unpopulated. **But who it is that gets rich that way may be purely random. If that’s the case, the mere existence of a few winners doesn’t in itself prove that something is an “alpha” activity in which hard work and skill will produce consistent performance, or that large numbers of people can pull it off.**

I believe firmly that the markets for commodities and currencies are generally efficient. That means a lot of highly motivated people participate; many are intelligent and computer-literate; they all have access to similar information; and they’re willing to take either side of most propositions. These people cause all of the available information to instantly be incorporated in the market price of each asset, such that the market price always reflects the consensus view of the significance of the available information. As a further consequence, few people if any can dependably identify and profit from instances when the market price is wrong. **That, in turn, makes it difficult to consistently achieve high absolute returns or perform better than others. That difficulty constitutes the ultimate proof that a market’s efficient.**

Take currencies for example. Exchange rates exist so that currencies will be valued fairly relative to each other in view of countries’ differing growth rates, interest rates, inflation prospects and fiscal and trade deficits, etc. Further, exchange rates change as the outlook for these things changes. Their current status is widely known, and predicting changes is something few people can do right more often than others. Thus it seems unlikely that some people will be able to regularly generate higher returns than others.

If it’s so hard to value currencies, commodities and precious metals, why do I think we can invest intelligently in equities, corporate debt and whole companies? It’s because these things generate income, and an expected stream of future income can be translated into a current value.

But how do you determine the intrinsic value of a Euro, a bar of gold or a barrel of oil? You can talk about the positives and the negatives associated with these goods. But how do you convert those things into a price?

For example, the factors that argue for high oil prices are obvious. “The supply is finite.” “We’re using it up at an accelerating rate.” “Environmental issues in the U.S. will constrain the domestic supply.” “Much of the foreign supply is in the hands of hostile or unpredictable governments: Iran’s a worry, Venezuela is turning anti-American, and Saudi Arabia is subject to instability.” Sure they make oil a valuable good, but how valuable? How do we know the current price doesn’t adequately reflect these things already? What’s the right price for it?

We had a particularly instructive lesson in July. The price of oil had been strong, and the outlook was for more of the same. With the price at \$77 per barrel, it was reported that the Alaskan pipeline had to be shut down to repair damage. With domestic shipments restricted, the price had to rise; oil had to be a buy. But the \$77 price at which oil traded on the day of the announcement hasn’t been seen since. Within just four months, the price of oil fell to \$55 (down 28%) – and the factors listed above were just as true at \$55 as they were at \$77. Without the ability to reliably convert fundamentals into prices, I don’t see how one can achieve consistently superior risk-adjusted gains.

Above average investment performance (in any market) has to be the result of either unusual insight into values or the intersection of risk taking and luck. It’s hard to tell the difference between the two in the short run, but the truth always becomes clear in time, because luck rarely holds up for long.

The Short-Term Performance Trap

That leads me to Amaranth’s experience in natural gas, and to the key lesson to be learned from it. Is anyone capable of regularly generating skilled-based (as opposed to luck-based) returns at an ultra-high level by trading natural gas? I don’t know for sure, but I would think not.

I’m not saying no money can be made that way. But while the capital markets might permit one to steadily earn 5-8% a year (or maybe even 8-10%) by committing capital to this activity, returns in the teens should be infrequent, and **returns above 20% probably should be considered the result of extreme good fortune (and thus as having been just as likely to go the other way)**. There are exceptions, but a good statistician can live with a few exceptions without feeling they disprove the main point.

I think it’s essential to realize that Amaranth’s troubles in natural gas didn’t start this year, with the positions that didn’t work. They started with the \$1 billion in profits that Hunter generated in 2005, which permitted Amaranth to report a return roughly double that of the average hedge fund.

In the investment business, clients love high returns and hate low returns. That makes sense. And when the market’s up 10% and their manager is up 20%, clients are really happy. But that’s my pet peeve. Rarely does anyone say, “Whoa. That return’s too high. How did it happen?”

How much risk did my manager take in order to generate that?” **No, in the investment world few people find high returns worrisome.**

Everyone talks about beta, (which I’m tempted to pronounce “bee-tah” now that I’ve spent six weeks in London), but few people dwell on it when returns are soaring. Credulous investors think the manager who generated 20% in an up-10% market contributed alpha of 10%. But maybe he had zero alpha and a beta of 2 instead . . . or maybe negative alpha of 20% and a beta of 4. Regardless, I almost never hear people talk about returns being so high that they’re suspect.

According to Hillary Till of Premia Capital Management (in her report on Amaranth published by France’s EDHEC Business School), “Since May, investors knew [Amaranth’s] energy portfolio had typical up or down months of about 11%. . . . Therefore, it would not have been unusual for the fund’s energy trades to lose 24% in a single month. . . .” But nobody seemed to care, since the energy book gained \$2 billion in just the first four months of 2006. In other words, Amaranth had enjoyed the up months. That certainly didn’t imply that down months weren’t lurking. In fact, just the opposite.

Here’s the most important thing: My wife Nancy often quotes a few lines from Rudyard Kipling’s poem, “If”:

If you can meet with Triumph and Disaster
And treat those two Impostors just the same; . . .
Yours is the Earth and everything that's in it,
And – which is more – you’ll be a Man, my son!

Likewise, short-term gains and short-term losses are potential impostors, as neither is necessarily indicative of real investment ability (or the lack thereof).

Surprisingly good returns are often just the flip side of surprisingly bad returns. One year with a great return can overstate the manager’s skill and obscure the risk he took. Yet people are surprised when that great year is followed by a terrible year. Investors invariably lose track of the fact that they both can be impostors, and of the importance of digging deep to understand what underlies them.

One gets the impression that no one at Amaranth asked the right question when Brian Hunter shot the lights out in 2005: “How’d you do that?” Or if they asked, they were satisfied with what turned out to be the wrong answer: skill, rather than leveraged aggression combined with luck. They let him move to Calgary, and they gave him a large enough capital and/or risk budget to enable him to bring down the firm.

But The Wall Street Journal of September 19 laid out how this came about. “. . . late last year, the double-whammy of Hurricanes Katrina and Rita made Mr. Hunter a hero at Amaranth and a minor legend on Wall Street, as he made \$1 billion for Amaranth.” Hunter liked to buy deep-out-of-the-money options. While these things expire worthless most of the time, a major, unexpected price move in the underlying asset can produce huge profits.

But does betting on a long shot and profiting from a freak occurrence make someone a skilled investor, or just the “lucky idiot” that Nassim Nicholas Taleb describes in “Fooled by Randomness”? Should that kind of performance inspire reverence or concern? Well, Amaranth’s 2005 gas profits produced awe, but anyone looking behind them should have been worried. What would have happened, investors might have asked, if events had unfolded differently? Taleb’s “alternative histories” are always worthy of consideration (see below).

The events in the gas market that decimated Amaranth in 2006 may have been unforeseeable and unprecedented. But those adjectives might apply just as well to the elements that made it successful in 2005, and no one – especially not the fund’s managers – seems to have mentioned that fact at the time. When people profit from such things, it’s considered all right and good, but then when they reverse into losses, it comes as a shock. **They’re two sides of the same coin, but investors have a really tough time keeping that in mind.**

What’s Real?

To be able to attach the proper significance to short-run performance, it’s essential that one understand the idea of “alternative histories.” I came across it in Taleb’s book, which I consider the bible on such topics.

This concept is related to Orin Kramer’s description of past performance as “the interaction of particular historical and market conditions and the judgments and beliefs of managers during that period.” **In other words, investment performance is what happens to a portfolio when events unfold.** People pay great heed to the resulting performance, but the questions they should ask are, “Were the events that unfolded (and the other possibilities that didn’t unfold) truly within the ken of the portfolio manager? **And what would the performance have been if other events had occurred instead?**” **Those other events are Taleb’s “alternative histories.”** How about an example of the right way to view outcomes? Well, with the college football bowl season upon us, I’d like to discuss last year’s championship game, something I’ve been musing about for almost a year.

The University of Southern California football team was undefeated in the 2005 regular season. It boasted two successive years’ Heisman Trophy winners and many other great players. It won its games in spectacular fashion and was widely touted as one of the best college football teams of all time. In fact, in the week leading up to the championship game against the University of Texas, ESPN ran daily segments that compared USC against a top team from the past, each time stating that USC was better, and why.

When it came down to game time, however, Texas played very well and USC couldn’t contain their talented quarterback, Vince Young. With two minutes to go in the game, holding a slim five-point lead, USC’s coach, Pete Carroll, chose to “go for it” on fourth down, rather than punt the ball downfield – undoubtedly out of concern that if Texas got the ball with two minutes left on the clock, his team would be unable to keep them from scoring. USC failed to make a first down, and Texas got the ball with good field position, scored a touchdown and won the game.

If USC had made the two yards they needed on that fourth down play, it's extremely likely they would have won the game. And if they'd won the game, they doubtless would be described today as the best college football team in history. But it didn't happen that way, and no one talks anymore about their being the best, or even the second best. Now they're considered just another great team. **What this shows is how tenuous the connection can be between outcomes (which most people take for reality) and the real, underlying reality.** What do I mean by that distinction?

Consider this: What's the probability that if USC had made the needed two yards – and today was considered the best team ever – they really would **be** the best team ever? Certainly not 100%. And just as interestingly (or to me maybe more so), what's the probability that, even though they **didn't** make the two yards, they **actually are** the best team that ever played? Certainly not zero. But since USC lost that game, most people would find nonsensical a suggestion that they're the best team in history. To contemplate that possibility, they would have to consider an alternative history in which USC made those two yards.

Can the result of one play really decide the issue? That's the one thing we all can probably agree shouldn't be the case. "Everyone knows" that the score of a game doesn't necessarily tell you which is the better team. So then outcomes aren't necessarily indicative of reality, meaning that alternative histories **should** be given significant weight. (I guess the ultimate step would be to suggest that USC actually won the game, the score notwithstanding. That would be going too far . . . although we often hear a losing team's fans say, "We won that game.")

While we're looking deeply into things, let's spend a minute on Pete Carroll's decision to go for it on fourth down. Was he right or wrong? He has gone for it on fourth down many times in his coaching career, and most of the time it worked. In fact, USC twice had run on fourth down earlier in the championship game, making the needed yardage once and scoring a touchdown. But on that final attempt they were unsuccessful. Does that mean Pete made a wrong decision? Or was it a right decision that just happened not to work on that occasion? One of the first things I learned at Wharton in 1963 was that **you can't judge the correctness of a decision from the outcome.** This is another concept that many people find nonsensical. But good decisions fail to work all the time – just as bad ones lead to success – simply because it's so hard to predict which history will materialize.

It seems ridiculous for something as momentous as the label "best team ever" – and the measure of a team's real worth over an entire season – to hinge on the outcome of one play that took four seconds. Clearly that's a distortion, but no less of a distortion than many people's response to short-term investment performance, both good and bad.

King for a Day

In the current environment, there can be little ability to restrain a hot manager. According to Amaranth's head of Human Resources until 2004, the CEO of the fund ". . . sought to centralize oversight of traders and keep big discretionary trading authority on the fund's Greenwich trading floor. After big gains in 2005, Mr. Hunter was allowed to trade from Calgary. 'To have a

relative newcomer . . . receive so much discretion is just shocking to me.’ ” (The Wall Street Journal, September 20)

But today, if a hedge fund CEO tells a trader who’s been generating great performance that he can’t have more capital, or take risky positions, or pursue the maximum imaginable incentive fee, or move to Calgary, he’ll lose him. There’s always another employer who’ll meet a hot trader’s demands. No, this isn’t a time when discipline and risk control come easy.

In this climate, even an earlier dust-up at Deutsche Bank regarding Brian Hunter’s gas trading and bonus wasn’t enough to keep him from becoming the linchpin of a \$9.5 billion fund, managing half its capital. And it wouldn’t have deterred others from hiring him if he quit because Amaranth had tried to restrain him.

A decade ago, if an employee who’d run up big profits in his first year asked for a huge bonus, we’d say, “Come back after you’ve put together a few good years.” But in today’s climate, if a hedge fund doesn’t come up with an out-sized bonus after one good year, it’s unlikely the employee will stick around to give it a second. **Thus Brian Hunter was paid \$75 to \$100 million in 2005, his first full year at Amaranth, arguably for betting right on the weather.**

It doesn’t take much to be venerated today. One or two good years make somebody a “top trader.” Three years can enable someone to raise a billion-dollar hedge fund. In fact, even after the fall, The Wall Street Journal described Brian Hunter as an “experienced manager” . . . at 32. Doesn’t anyone think that before someone is elevated to the investment peerage, he or she should have a record spanning more than a few years, and have been tested in down markets? I knew the world had been turned on its head when I read on “dailyii.com” about Hedge Funds Investment Management, a London fund of funds that **will invest only with people who’ve been in the business for 3½ years or less.**

Unlikely Things Happen

The EDHEC report mentioned above makes a number of interesting observations concerning Amaranth’s portfolio:

- As of June 2006, energy trades accounted for about half of Amaranth’s capital and generated 75% of its profits.
- Amaranth had 6,700 energy positions, leveraged 4.5 to one, including open positions to buy or sell tens of billions of dollars of commodities.
- Amaranth was responsible for a substantial portion of all of the gas trades that took place.
- In the far-out months, in which fewer traders participate, “the fund’s positions were indeed massive.”
- Many of Amaranth’s trades probably had “physical-market participants” on the other side, people who had taken positions to hedge risks intrinsic to their business. Because they would be unlikely to unwind their trades at Amaranth’s convenience, exits were problematic.
- In view of all of the above, “the magnitude of Amaranth’s energy position-taking was inappropriate relative to its capital base.”

Hillary Till describes Amaranth's loss as a 9-standard-deviation event (Long-Term Capital's is estimated at "8-sigma"). By way of reference, 5 standard deviations include the central 99.99994% of a normal probability distribution. A 5-sigma event below that range should happen about three times in every ten million trials (thus a given daily occurrence should happen once every 10,000 years). **But it's amazing how often this kind of event seems to occur when derivatives are combined with leverage.**

Everyone speaks about preparing for "worst-case" outcomes, but invariably things can get even worse. Statistical reassurance should be relied on only to a reasonable extent. Common sense has to come into play as well.

Risk Management and Risk Managers

You know from my memo of February entitled "Risk" that I'm not a big fan of quantitative risk management. It's often said of a man that "he knows the price of everything but the value of nothing" – and it's not meant as a compliment. Likewise, I feel effective assessment of portfolio risk is less likely to come from Ph.D. statisticians who lack intimate knowledge of the assets in the portfolio than through wise judgments made subjectively by investors possessing "alpha."

In the memo on risk, I enumerated several criteria that should be present if modeling is to prove effective. I also observed that most of them are lacking in the investment world. In an article in the Financial Times of October 10, John Kay wrote of the risk that arises because of "uncertainty about whether the model you have developed describes the world accurately." He concluded that **"mathematical modeling of risk can be an aid to sound judgment but never a complete substitute."** My first boss, George Egbert, Jr., Citibank's Director of Research in the 1960s, used to say of economists, "They should be on tap but not on top." Reliance on risk modeling should be similarly limited.

"What Brian is really good at is taking controlled and measured risk." Thus spoke Nick Maounis, the CEO of Amaranth, less than a month before its collapse. He cited the more than a dozen members of his risk management team who served as a check on his star gas trader, and he said "spreads and options are of their very nature instruments for positions which are designed to allow the user to capture upside with a much clearer understanding with respect to downside exposure" (The Wall Street Journal of September 19 and 20). **But in the end, outsized profit potential without risk turned out to be a pipe dream as usual.**

Amaranth's systems didn't appear to measure correctly how much risk it faced and what steps would limit losses effectively. The risk models employed by hedge funds employ historic data, but the natural gas markets have been more volatile this year than any year since 2001, making models less useful. They also might not predict how much selling of one's stakes to get out of a position can cause prices to fall.

"It was a total failure of risk control to put your entire business at risk and not seem to know it," says Marc Freed [of Lyster Watson & Co., an advisory firm that

invests in hedge funds]. “They were more leveraged than they realized.” (The Wall Street Journal, September 20)

After the fall, the Journal quotes Mr. Maounis as saying Amaranth’s traders “were surprised not only by adverse market moves that triggered the losses but also by the lack of ability to exit the losing positions.” **That’s it, right there: the word “surprise.”** It’s one thing to make an investment you know is risky and have it come out wrong. It’s something entirely different to make an investment that entails risk of which you’re unaware.

Mr. Maounis and Amaranth’s risk managers shouldn’t have been surprised. They should have been alerted by the volatility of the fund’s energy results. According to Till, its LPs should have been as well. “Investors would not have needed position-level transparency to realize that Amaranth’s energy trading was quite risky.” **But the evidence of that potential risk came primarily in the form of outsized gains, and these are rarely recognized as the red flag they are.**

Amaranth’s investors relied heavily on its vaunted risk management capability and on the assurance that risk was under control. But the fund failed to survive its seventh year. Quantitative risk managers can only opine on whether a disaster is likely or not. Even if they’re right about that, it’s up to you to decide whether you’re willing to bear the risk of an improbable disaster. They do happen!

Classic Investment Mistakes

Hemlines go up and down. Ties go from wide to narrow and back again. There are only so many ways in which things can vary. Likewise, there are only a few mistakes one can make in investing, and people repeat them over and over. It seems Amaranth made several.

- **Borrowing short to buy long (and illiquid).** This cardinal sin is at the root of most great investment debacles. A fund’s capital should be as long-lived as its commitments. And no fund should promise more liquidity than is provided by its underlying assets. You can successfully invest in volatile assets if you’re sure of being able to ride out a storm. But if you lack that certainty and face the possibility of withdrawals or margin calls, a little volatility can mean the end. In the case of Amaranth, just as had been true of Long-Term Capital Management and the big junk bond holders that were forced to sell out at the 1990 lows, many of the losses would have turned back into profits if they had just been able to hold on through the crisis. That’s why I always caution, “Never forget the six-foot-tall man who drowned crossing the stream that was five feet deep on average.” It’s not enough to be able to get through on average; you have to be able to survive life’s low points.
- **Confusing paper profits with real gains.** The Wall Street Journal of September 20 points out that Hunter was encouraged by the positive marks to market showing up in his statements, so much so that he added further to his positions. But he seems not to have asked whether the gains were real and realizable. The Journal also points out that Hunter was such a big buyer in thin markets that his buying often supported prices and created the very profits he found so encouraging. But if the profits were the product of his buying, and thus

dependent on it for their continued existence, he clearly had no way to realize them. My father used to tell a joke about the guy who insisted that his hamster was worth thousands more than he had paid for it. “Then you should sell it,” his friend urged. “Yeah,” he responded, “but to whom?”

- **Being seduced by loss limitation.** Hunter is said to have liked buying deep-out-of-the-money options, and everyone knows that one great thing about buying options is that in exchange for a small option premium you receive the right to benefit from price movements on lots of assets. You can only lose 100% of the amount you put up . . . and in deep-out-of-the-money options people do just that all the time.
- **Misjudging liquidity.** People often ask me whether a given market is liquid or not. My answer is usually, “that depends on which side you’re on.” Markets are usually liquid in one direction or the other but not necessarily both. When everyone is selling, a buyer’s liquidity is great, but a seller will find the going difficult. When sellers’ urgency increases, they’re likely to have to give on price in order to achieve the “immediacy” they crave (see my memo “Investment Miscellany,” November 16, 2000). If their desire for immediacy is extreme, the bids they see might be absurdly low. Thus markets can’t be counted on to accommodate a seller’s need to realize fair value.
- **Ignoring the impact of others.** In small markets, everyone may know about your trades. That means they can copy them (making buying tough and adding to the crowd that will eventually jam the exits), and they can deny you fair prices if they know you have to sell. Aggressive traders, especially at hedge funds, don’t wear kid gloves.
- **Underestimating correlation.** There’s another old saying: “In times of crisis, all correlations go to one.” It means that assets with no fundamental or economic connection can be caused by market conditions to move in lockstep. If a hedge fund experiences heavy withdrawals during a period of illiquidity, assets of various types may have to be dumped at once, and thus they can all decline together. Further, hidden fault lines in portfolios can produce unexpected co-movement. Let’s say you’re long sugar and gas, two unrelated commodities. Unusually warm weather can reduce the demand for gas for heating and also cause a record sugar crop (as happened this year). Thus the prices of seemingly unrelated goods can decline together. **Intelligent diversification doesn’t mean just owning different things; it means owning things that will respond differently to a given set of environmental factors. Thus it requires a thorough understanding of potential connections.**

The case of Amaranth is highly and painfully instructive, and it bears out another of my favorite expressions: **Experience is what you got when you didn’t get what you wanted.**

* * *

Orin Kramer manages the Kramer-Spellman hedge fund and, more famously, chairs the State of New Jersey Investment Council, which oversees the state’s \$80 billion pension fund. He is

extremely knowledgeable concerning risk and return, herd behavior and the vicissitudes of investing in an institutional setting. In a speech a few weeks ago, he made some excellent points:

My own view is that we exaggerate the utility of standard performance measures. In general, past performance reflects the interaction of particular historical and market conditions and the judgments and beliefs of managers during that period. In particular, managers may consciously or unconsciously pursue strategies which assume the risk of low-frequency, high-severity outcomes. Strategies which can only be torpedoed by low-frequency events will mostly produce favorable outcomes; identifying the tail risk implicit in such strategies is an extraordinary challenge. **The absence of the severe negative outcome is not, regrettably, proof that it cannot occur.** (Emphasis added)

In other words, (1) short-term investment performance is not a helpful indicator of ability, (2) good results can arise just because a manager chose a high-risk course and was bailed out by events, and (3) that same course could just as easily have led to disaster . . . and certainly could do so next time. However, it's rare for either managers or clients to recognize the unreliability implicit in short-term results, especially when they're good.

Orin also notes that Amaranth "occurred when the skies were blue; the fund unraveled because a small and volatile commodity behaved in an unpredicted fashion." This collapse didn't require an adverse economic environment or a market crash. The combination of arrogance, failure to understand and allow for risk, and a small adverse development can be enough to wreak havoc. **It can happen to anyone who doesn't spend the time and effort required to understand the processes underlying his portfolio.**

December 7, 2006

Memo to: Oaktree Clients

From: Howard Marks

Re: The Race to the Bottom

Cheapening Money

If you make cars and want to sell more of them over the long term – that is, take permanent market share from your competitors – you’ll try to make your product better. (You might cut your prices or increase your advertising, but neither of those will work for long if your cars are demonstrably inferior.) “Building a better mousetrap” should also be effective for sellers of toothpaste, computers, televisions, magazines, movies and dresses, or any other product that can be differentiated from its competitors. That’s why – one way or the other – most sales pitches say, “Ours is better.”

However, there are products that can’t be differentiated, and economists call them “commodities.” These are generic goods like gold, West Texas crude oil, pork bellies, steel ingot, orange juice, electricity and telecommunications bandwidth. They’re goods where no seller’s offering is much different from any other. They tend to trade on price alone, and each buyer is likely to take the offering at the lowest delivered price.

Thus, if you deal in a commodity and want to sell more of it, there’s generally one way to do so: cut your price. It’s futile to make claims for product superiority, and advertising is unlikely to alter buying habits. Thus in order to gain market share, **you have to make your product cheaper than someone else’s.**

It helps to think of money as a commodity just like those others. **Everyone’s money is pretty much the same.** Yet institutions seeking to add to loan volume, and private equity funds and hedge funds seeking to increase their fees (see “The New Paradigm”), all want to move more of it. **So if you want to place more money – that is, get people to go to you instead of your competitors for their financing – you have to make your money cheaper.** As with the other commodities, low price is the most dependable route to increased market share.

One way to lower the price for your money is by reducing the interest rate you charge on loans. A slightly more subtle way is to agree to a higher price for the thing you’re buying, such as by paying a higher p/e ratio for a common stock or a higher total transaction price when you’re buying a company. **Any way you slice it, you’re settling for a lower prospective return. But there are other ways to cheapen your money, and they’re the primary subject of this memo.**

Congratulations!

What else is there – besides return – that you can accept less of in order to accelerate the pace at which you put out your money? The answer is simple: safety.

So a provider of capital who wants to increase market share – that is, make a bigger percentage of the loans or investments that are made – will accept risks that others won't. That's another way to get the deal instead of having it go to someone else.

I sometimes buy at auctions. When the bidding's over, the auction house personnel come up and say "congratulations." I usually say, "On what? All I did is pay more than anyone else would pay." That's how auctions work – most market mechanisms, in fact: **the deal goes to the person who'll pay the most for the goods (or, looked at conversely, get the least for his money). The capital markets are no different.**

Of course, when the subject is price, it's obvious that the person who's willing to pay the most wins the auction. It's a little more subtle that, when it comes to quality and safety, the person who'll accept the least is likely to be congratulated as the "winner." Winner in quotes, that is, because **in putting out capital, the person who gets the deal is likely to be a loser if he accepts a level of safety that turns out to be inadequate.**

That leads me to one of my pet peeves. The "industry rags" in private equity are devoted almost exclusively to reporting who bought what company, with accounts of how competitors were outbid and innovative financing arranged. But the articles should focus instead on whether the price was right, and the champagne should probably be kept on ice until the company has been sold at a profit. Buying shows who was the highest bidder, not necessarily the smartest bidder.

(Let me hasten to point out here that while I generalize as usual for simplicity and effect, there are always exceptions. Oaktree routinely gains admittance to deals because we provide prompt commitments, certainty of closure, assistance in structuring and/or the promise of constructive behavior should problems arise. But much of the time – especially today – deals go to the capital providers who'll pay the most and/or accept the least. We try to gain access to deals by adding value, not by paying the most.)

The Auction's On

While the last few years have given me many opportunities to marvel at excesses in the capital markets, in this case the one that elicited my battle cry – "that calls for a memo" – hit the newspapers in England during my last stay. As the Financial Times reported on November 1,

Abbey, the UK's second-largest home loans provider, has raised the standard amount it will lend homebuyers to five times either their single or joint salaries, eclipsing the traditional borrowing levels of around three and a half times salary. It followed last week's decision by Bank of

Ireland Mortgages and Bristol and West to increase standard salary multiples from four to 4.5 times.

In other words, there had been a traditional rule of thumb saying that borrowers can safely handle mortgages with a face amount equal to three-plus times their salaries. But now they can have five times – roughly 50% more. What inference should be drawn? There are at least four possibilities:

1. The old standard was too conservative, and the new one's right;
2. Conditions have changed, such that the new standard is as conservative for today as the old one was for its times;
3. It's reasonable for mortgage lenders to accept higher default experience, and thus lower net returns, because their cost of capital has declined; or
4. The rush to place money has caused a supplier of capital to loosen its standards.

Now, I am no expert on the UK mortgage market, and it's my intention in this memo to comment on general capital market trends, not any one sector. Further, it's certainly true that today's lower interest rates mean a given salary can support a bigger mortgage (and that's likely to hold true so long as (1) borrowers keep their jobs and (2) their mortgages carry fixed rates). But if you think Abbey's reason for taking this step might be a logical one like that, the question to ask is "why now?"

Logical reasons and sober decision making might be involved here. But so might competition to put out money and the usual late-stage belief that "it's different this time." Lenders and investors invariably depart from time-honored disciplines when cycles move to extremes, out of a belief that current conditions are different from those that prevailed in the past, when those disciplines were appropriate. And just as invariably, they're shown that cycles repeat and nothing really changes.

What did we see in the U.S. mortgage market as home prices rose and interest rates declined? First, low teaser rates. Then higher loan-to-value ratios. Then 100% financing. Then low-amortization loans. Then no-amortization loans. Then loans requiring no documentation of employment or credit history. These things made it possible for more buyers to stretch for more expensive homes, but at the same time they made mortgages riskier for lenders. And these developments took place when home prices were at sky-high and interest rates were at multi-generation lows. In the end, buyers took out the biggest mortgage possible given their incomes and prevailing interest rates. Such mortgages would land them in the houses of their dreams . . . and leave them there for as long as conditions didn't deteriorate, which they invariably do.

Do you remember the game Bid-a-Note from the TV show "Name that Tune"? Contestant x said, "I can name that tune in six notes." Then contestant y said, "I can name that tune in five notes." Then contestant x said, "I can name that tune in four notes." The contestant who eventually got the chance to guess the name of the tune was the one who was willing to accept the riskiest proposition – to try on the basis of the least information.

So the Bank of Ireland entered the competition to lend money for home purchases and said, “I’ll lend four and a half times the borrower’s salary.” And Abbey said, “I’ll lend five times.” The so-called winner in this auction is the one who’ll put out the most money with the least safety. Whether that’s really winning or losing will become clear when the cycle turns, as it did in the U.S. last year. But certainly there’s a race to the bottom going on . . . a contest to become the institution that’ll make loans with the slightest margin for error.

By the way, were the people who made those U.S. mortgages loans big losers? Defaults spiked last year, but often the originators of the loans had escaped by selling the loans onward to others, some of whom packaged them into mortgage-backed securities or CLOs and sold them once again or borrowed against them on a non-recourse basis. Since many of the people who make loans today flip them quickly, an aspect of “moral hazard” has entered the equation, in which decision makers are insulated from the consequences of their actions.

Any way you slice it, standards for mortgage loans have dropped in recent years, and risk has increased. Logic-based? Perhaps. Cycle-induced (and exacerbated)? I’d say so. The FT quoted John Paul Crutchley, a banking analyst at Merrill Lynch, as saying “When Abbey are lending a multiple of five times salary, that could be perfectly sensible – or it could be tremendously risky.” Certainly mortgage lending was made riskier. We’ll see in a few years whether that was intelligent risk taking or excessive competitive ardor.

Everyone’s Got a Favorite

A lot of Oaktree’s activities center around buying bonds, making loans and trying to profit when debt that others hold goes bad. So who better than my colleagues for me to turn to for examples of mistakes in the making? I asked for examples of the race to the bottom, and the response was immediate and substantial. I won’t embarrass individual issuers or borrowers by describing specific transactions; the names have been omitted to protect the guilty. But here are some of the themes our people told me about:

- **Hot potato** – There’s big money today in buying companies and then having them borrow money with which to pay you a dividend, even if doing so reduces the companies’ creditworthiness. Just a few years back, companies generally wouldn’t have been able to issue bonds or loans where the projected use of proceeds was dividends to their equity owners. But since people are so eager to invest today, they’ll lend to companies where much or all of the equity paid in – or maybe more than all of it – will be dividended out. They’re doing so on the expectation that they’ll be able to exit before risk turns into loss. **“If things take a turn for the worse, I’ll get out” is a refrain that accompanies most market excesses (tech stocks in 1999 and condos in 2005 come immediately to mind), but rarely does it turn out that way.**

- Heads We Win/Tails You Lose – Part of being willing to pay more for less relates to the balance between upside potential, downside risk and who gets what. SPACs – or Special Purpose Acquisition Companies, also known as “blank check companies” or “blind pools” – seem like a good example of miscalibration. People put equity capital into a SPAC with no certainty as to what will be done with it. The SPAC’s “portfolio” is likely to consist of just one company. And the investors will get no return on their money as long as it remains unspent, which can be up to 18 or 24 months. The sponsor, on the other hand, gets 20% of any profits, as there’s no preferred return. It does so through warrants, which it can liquidate even without having sold the acquired company. And if it can’t make an acquisition, it just returns the money without penalty – usually reduced by banking and other fees.
- Not My Problem – One of the stories I was told pertained to a company whose accounting problems had prevented it from issuing audited financial statements for a relatively long period of time. After the company went bankrupt, we were determined to learn more about its accounting issues than anyone else and then intelligently make a debtor-in-possession loan, through which we might gain ownership of the company. But before we could make the loan, someone else made the company a better offer: more leverage on cheaper terms, with no provision for accounting due diligence. When later we were able to ask about why we had lost out, we were told that one reason the other lender was able to be more aggressive than Oaktree was the fact that it had “pre-syndicated” most of the loan to hedge funds. This was accomplished in the absence of financial statements or accounting due diligence, but with validation from the high trading price of the company’s public securities (which was being set, again, in a financial-statement void). Okay, so the lender’s risk was limited. But how about the funds that bought the loan?
- Complexity Outruns Analysis – Wall Street is incredibly inventive. It’s staffed by bright people, pursuing massive incentives, trying to out-think their competitors in order to win assignments to serve companies’ financial needs. Sometimes this results in structures that few people understand, fraught with hidden risks. My latest nominee is the CPDO, or Constant Proportion Debt Obligation. CPDOs provide capital to finance structured entities writing credit insurance on investment grade debt. Because this debt entails little credit risk, the returns that can be earned from writing credit insurance on it are similarly low. Thus, these entities have to lever up substantially – typically 15-to-1 – to provide the LIBOR+200 returns promised on the bottom-tier CPDO. The rating agencies bestow triple-A ratings on the CPDOs because (a) the riskiness of investment grade bonds is low and (b) the projected interest spreads and the net asset values initially are far more than sufficient to satisfy the covenants. But because the portfolios are so highly leveraged, these cushions can evaporate quickly.

I find two things about CPDOs worthy of particular note. First, this is the first-loss equity piece beneath a highly leveraged entity where consequences can be triggered by breaches of income and market value covenants. Thus, the equity

beneath a portfolio of bonds averaging single-A, leveraged up 15-to-1, gets a triple-A rating. Huh? Second, as the Financial Times wrote on November 13, “if there are losses and the CPDO’s net asset value begins to fall from its target, the leverage is increased to try to earn more at a faster rate.” **In other words, if you did a little of something and it didn’t work, try to recoup your losses by doing a lot.**

- What Due Diligence? – The other day, Orin Kramer (see “Pigweed”) observed skeptically that “the most profitable way to be a lender today is to have no underwriting department.” In other words, default rates are too low, and the market is too competitive, for credit analysis to be worth paying for. In December, Reuters described a takeover bid whose competitiveness was enhanced by a reduced due diligence period and a short list of information requirements. And most interestingly, one of the major investment banks told us recently that on most syndicated loans, about 70% of the buyers never visit the data rooms set up to facilitate due diligence.
- Put the Pedal Down – FT.com pointed out on January 21 that, “One-tenth of the capital committed [to private equity funds] in 2002 was . . . put to work within one year. For funds invested in 2005, the corresponding proportion was almost 30 percent.” If the amount raised in 2005 was triple the 2002 level, as I believe was the case, that means private equity funds deployed capital in 2005 roughly nine times as fast as they had in 2002.

No one of these is evidence of misfeasance or terminal laxness by itself. But together they describe a market where a desire for quantity and speed has taken over from an insistence on quality and caution. And with that insistence goes the margin of safety that Warren Buffett urges investors to demand.

The Amazing Disappearing Covenant

Evaluating and negotiating covenants is an important part of the high yield bond investor’s job. The law says a company’s board of directors has a fiduciary duty to its shareholders, but generally speaking there is no analogous duty to creditors such as banks and bondholders. In fact, some companies behave as if they feel a responsibility to actively take value from creditors and transfer it to the shareholders. Because companies can do anything to creditors that isn’t prohibited by law or the bond indenture, covenants are a key component in creditor safety.

It’s important to bondholders, for example, that the companies to which they lend money remain as little changed as possible. They want the creditworthiness they lend against to still be there years down the road, and strong covenants can do a lot to ensure that’s the case. Bondholders can’t prevent problems in the economy, the company’s markets, its products’ competitiveness or its executive suite. But with good covenants, they can put limits on leverage, acquisitions, cash distributions or asset transfers, and they can tighten financial tests and insist on rights that will be triggered if cash flow falls below a

specified multiple of the company's indebtedness or interest obligation. On the other hand, just as people who are eager to buy bonds can increase their chances of being able to do so by accepting less interest, they also can do so by settling for weaker covenants.

When credit markets are tight and providers of capital are reticent, money can be hard to come by. Companies' demand for financing can exceed the supply, putting negotiating power in the hands of the lenders. Thus lenders can insist on – and obtain – strict covenants, and bonds issued in such an environment are likely to be relatively safe.

But when usually disciplined bond buyers have to compete against others who aren't acting in a disciplined fashion, their ability to insist on covenant protection goes out the window. In economics, Gresham's Law says "bad money drives out good." That's why, when paper money joined gold as legal tender, gold was put in the strongbox rather than spent, and only paper money circulated. The same thing happens in the investing world: **bad investors drive out good.** When undisciplined investors are out there with lots of money to get rid of, there's less scope for disciplined investors to insist on strong covenants. That's why the level of covenant protection is a good barometer of the market climate.

Covenants are the province of a special breed of analysts who are willing to "sweat the details" and able to make sense of paragraph-long, highly technical sentences. "A Review of Covenant Trends in 2006" by Adam B. Cohen is no less challenging reading. It reviews last year's trends in a number of complex indenture provisions, but I'll limit myself to quoting its general conclusions:

For years, investors have periodically lamented the declining quality of high yield bond covenants but the trends have become especially pronounced amidst a flurry of leveraged buyout (LBO) financings a careful review of covenant packages – particularly in sponsor-backed [i.e., LBO] offerings – during 2006 reveals a systematic dismantling of longstanding covenant protections . . .

And as Reuters reported on February 6, Standard and Poor's added the weight of its opinion:

While credit quality is under even greater pressure, the amount of cash on offer has meant private equity sponsors have been able to dilute lenders' rights through weaker covenants and loan documentation, [S&P] said. "Loan structures have become so borrow-friendly that private equity sponsors can write their own term sheets, using their last term sheet as the template for their next."

And, in our view, that template usually serves as the starting point for the next round of erosion of covenants and terms.

Effects Short-Term and Long

In the short term, the effect of generous capital market conditions is to make more money available to more companies for more reasons, at lower rates of interest and with fewer covenants. This leads to higher levels of acquisitions, buyouts and corporate expansion (not to mention rapid recapitalizations of buyout companies and thus high short-term rates of return). In the short run, this contributes to a high level of general financial activity.

Another effect is to forestall financial stringency at weak companies. When lenders are strict and covenants are tight, operating problems can lead quickly to both technical defaults (violations of covenants) and “money defaults” (non-payment of interest or principal). But looser conditions can permit default to be forestalled: if covenants are lax; if borrowers have the option to convert cash-pay bonds into payment-in-kind bonds (through a recent innovation, “toggle bonds”); or if they can raise money and thus postpone the day of reckoning.

Eventually, one would think, many of the forestalled defaults will demonstrate their inevitability, with the companies falling from more highly leveraged heights. And certainly the capital markets’ willingness to finance less-than-deserving companies will lead ultimately to a higher level of corporate distress. **Thus, everything else being equal, the bigger the boom – the greater the excesses of the capital markets in the upward direction – the greater the bust.** Timing and extent are never predictable, but the occurrence of cycles is the closest thing I know to inevitable. And usually, the air goes out of the balloon a lot faster than it goes in.

* * *

Today’s financial market conditions are easily summed up: There’s a global glut of liquidity, minimal interest in traditional investments, little apparent concern about risk, and skimpy prospective returns everywhere. Thus, as the price for accessing returns that are potentially adequate (but lower than those promised in the past), investors are readily accepting significant risk in the form of heightened leverage, untested derivatives and weak deal structures. The current cycle isn’t unusual in its form, only its extent. There’s little mystery about the ultimate outcome, in my opinion, but at this point in the cycle it’s the optimists who look best.

As is often the case, I could have made this a shorter memo by simply invoking my two favorite quotations, both of which have a place here.

The first is from John Kenneth Galbraith, who passed away last year. I was fortunate to be able to spend a few hours with Mr. Galbraith a year and a half earlier and to have the

benefit of his wisdom firsthand. This quote, however, is from his invaluable book, “A Short History of Financial Euphoria.” It seems particularly apt under the current circumstances:

Contributing to . . . euphoria are two further factors little noted in our time or in past times. The first is the extreme brevity of the financial memory. In consequence, financial disaster is quickly forgotten. In further consequence, when the same or closely similar circumstances occur again, sometimes in only a few years, they are hailed by a new, often youthful, and always supremely self-confident generation as a brilliantly innovative discovery in the financial and larger economic world. There can be few fields of human endeavor in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present.

The second is Warren Buffett’s bedrock reminder of the need to adjust our financial actions based on the investor behavior playing out around us. Fewer words, but probably even more useful:

The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs.

This memo can be summed up simply: there’s a race to the bottom going on, reflecting a widespread reduction in the level of prudence on the part of investors and capital providers. No one can prove at this point that those who participate will be punished, or that their long-run performance won’t exceed that of the naysayers. But that is the usual pattern.

If you refuse to fall into line in carefree markets like today’s, it’s likely that, for a while, you’ll (a) lag in terms of return and (b) look like an old fogey. But neither of those is much of a price to pay if it means keeping your head (and capital) when others eventually lose theirs. In my experience, times of laxness have always been followed eventually by corrections in which penalties are imposed. It may not happen this time, but I’ll take that risk. In the meantime, Oaktree and its people will continue to apply the standards that have served us so well over the last twenty years.

February 14, 2007

Memo to: Oaktree Clients

From: Howard Marks

Re: It's All Good

Readers of my memos know that one thing I believe in most strongly – and harp on most frequently – is the inevitability of cycles. They're something we can depend on absolutely.

Several of my memos have dealt with cycles, starting from the very beginning: "First Quarter Performance" (April 11, 1991), "Will It Be Different This Time?" (November 25, 1996), "You Can't Predict. You Can Prepare." (November 20, 2001) and "The Happy Medium" (July 21, 2004). I've said in the past that I consider "You Can't Predict," a primer on cycles, to have been one of my best, and also that it evoked the least response of any memo in this decade. Thus I'm offering it as a twofer with this memo; copies are available on request at no additional cost.

I always say that while we can't know where we're going, we ought to know where we are (in cyclical terms). Understanding our environment can help us decide what tactics to employ, how aggressive to be, and which potential mistakes we should try hardest to avoid. Being conscious of cycles can be extremely helpful, even if we can't see the future.

Thus I'm going to devote this memo to the cycle that's been underway for the last few years. **In terms of amplitude, breadth and potential ramifications, I consider it the strongest, most heated upswing I've witnessed. A lot of this is because people seem to think everything's good and likely to stay that way.**

Cycles in the World of Investing

The basics of cycles are simple. The economic cycle gives rise to recessions and recoveries, creating the business environment. This produces a business cycle marked by rising and falling sales and profits. The credit cycle swings more radically, such that capital market conditions alternate between irrationally generous and unfairly restrictive. Likewise, market cycles fluctuate much more than do the more "fundamental" economic and business cycles, due largely to the volatile cycle in investor psychology.

In this latter regard, I'll reprint a few paragraphs from "First Quarter Performance," the 1991 memo cited above. I think they capture investors' pattern of behavior.

The mood swings of the securities markets resemble the movement of a pendulum. Although the midpoint of its arc best describes the location of the pendulum "on average," it actually spends very little of its time there. Instead, it is almost always swinging toward or away from the extremes of its arc. But whenever the pendulum is near either extreme, it is inevitable that it will move back toward the midpoint sooner or later. In fact, it is the movement toward the extreme itself that supplies the energy for the swing back.

Investment markets make the same pendulum-like swing:

- between euphoria and depression,
- between celebrating positive developments and obsessing over negatives, and thus
- between overpriced and underpriced.

This oscillation is one of the most dependable features of the investment world, and investor psychology seems to spend much more time at the extremes than it does at the “happy medium.”

Polar Opposites

My 2004 memo, “The Happy Medium,” took its title from this last phrase and went beyond the three listed above to discuss additional pairs of opposites between which the investment pendulum oscillates:

- between greed and fear,
- between optimism and pessimism,
- between risk tolerance and risk aversion,
- between credence and skepticism,
- between faith in value in the future and insistence of concrete value in the present, and
- between urgency to buy and panic to sell.

I find particularly interesting the degree to which the polarities listed above are interrelated. When a market has been rising strongly for a while, we invariably see all nine of the elements listed first. And when the market’s been declining, we see all nine of the elements listed second. Rarely do we see a blend of the two sets, given that the components in each are causally related, with one giving rise to the next.

Usually, when either set of polar extremes is in the ascendancy, that fact is readily observable, and thus the implications for investors should be obvious to objective observers. **But of course, the swing of the market pendulum to one set of extremes or the other occurs for the simple reason that the psyches of most market participants are moving in the same direction in a herd-like fashion.** Few of the people involved actually are objective. To continue a thread from my last memo, “Everyone Knows,” **expecting widespread clinical observation during a market mania makes about as much sense as saying “everyone knows the market has gone too far.”** If many people recognized that it had gone too far, it wouldn’t be there.

Between the two sets of cyclical extremes, I have no doubt that the environment of the last few years has been marked by the elements listed first above, not second: euphoria, greed, optimism, risk tolerance and credence; not depression, fear, pessimism, risk aversion and skepticism. Certainly it’s been the recent consensus of investors that, “It’s all good.”

Unusual Breadth

In the past we've seen bull markets in equities, commodities and real estate. And we've seen bull markets in the U.S., Japan and the emerging markets. But this time around, we've been seeing a near-global bull market, where the participating sectors vastly outnumber those left out.

In his April letter to investors, entitled "The First Truly Global Bubble," Jeremy Grantham summed up the worldwide nature of the good times.

Never before have all emerging countries outperformed the U.S. in GDP growth over a 12-month period until now, and this when the U.S. has been doing well. Not a single country anywhere – emerging or developed – out of the 42 listed by *The Economist* grew its GDP by less than Switzerland's 2.2%! Amazingly uniform strength, and yet another sign of how globalized and correlated fundamentals have become, as well as the financial markets that reflect them.

Bubbles, of course, are based on human behavior, and the mechanism is surprisingly simple: perfect conditions create very strong "animal spirits," reflected statistically in a low risk premium. Widely available cheap credit offers investors the opportunity to act on their optimism. Sustained strong fundamentals and sustained easy credit go one better; they allow for continued reinforcement: the more leverage you take, the better you do; the better you do, the more leverage you take.

A critical part of the bubble is the reinforcement you get for your optimistic view from those around you. And of course, as often mentioned, this is helped along by the finance industry, broadly defined, that makes more money when optimism and activity are high. . . . To say the least, there has never ever been anything like the uniformity of this reinforcement.

The March issue of Marc Faber's Gloom, Boom & Doom Report described the pervasiveness of the positive effect on markets. He listed four "bubbles of epic proportions" that he has witnessed: metals, mining and energy in the 1970s; Japanese equities and real estate and Taiwanese equities in the late 1980s; emerging markets in the 1990s; and TMT at the end of the 1990s. In contrast to the present experience, he pointed out,

. . . all had one common feature: they were concentrated in just one or very few sectors of the economic or investment universe and were accompanied by a poor performance in some other asset classes. . . . Currently, looking at the five most important asset classes – real estate, equities, bonds, commodities, and art (including collectibles) – I am not aware of any asset class that has declined in value since 2002! Admittedly some assets have performed better than others, but in general every sort of asset has risen in price, and this is true everywhere in the world.

It's interesting not only to see just about everything rise at the same time, but also to see people act as if this is likely to continue for a prolonged period. Usually that just doesn't happen.

It's Different This Time

My memos are full of quotations, adages and old saws. I'm attached to a few and tend to use them over and over. Why reinvent the wheel, especially if the old one can't be improved upon? Hopefully the things I borrow contain enough wisdom to make them worth repeating.

Equally worth repeating are the statements I cite as investor mistakes. They, too, are highly instructive . . . in the sense that they're heard often and must be recognized for how potentially toxic they are. **None is as dangerous as "it's different this time." Those four little words are always heard when the market swings to dangerously high levels. Like so many of the polar opposites enumerated above, it's not just the sign of an absurd condition. It's a prerequisite.**

I first came across the phrase in what for me was a seminal article, "Why This Market Cycle Isn't Any Different," by Anise C. Wallace (New York Times, October 11, 1987). The stock market's rapid ascent at the time was being attributed to (or excused by), among other things, (1) the outlook for continued economic growth, given that the economy had learned how to correct itself painlessly, (2) the likelihood of continued buying of U.S. stocks by foreign investors piling up dollars with no better place to go, and (3) the fact that stocks weren't overvalued compared to other assets, which had also appreciated.

But Ms. Wallace countered as follows: "No matter what brokers or money managers say, bull markets do not last forever. In general, investment professionals say, cycles and markets differ only by degree." **And of course, in the next eight days the Dow fell 30%.**

It wasn't just 1987. People also came to believe the business cycle had been tamed in 1928 and in the late 1990s. And wouldn't you know, I'm hearing it again today:

- The Fed's skillfully walking the tightrope between stimulus and restrictiveness. (A few years ago people felt Greenspan was indispensable; now there's suddenly faith in Bernanke.)
- A service economy is less volatile than a manufacturing-based economy.
- As the Chinese and Indians get rich, their purchases from us will buoy our economy.

The truth is, we couldn't have great cyclical extremes if people didn't occasionally fall for a justification that's never held true before. How else might investors rationalize holding or buying despite highly elevated valuation parameters, low prospective returns and just-plain-wacky security structures? I still believe what I wrote in "The Happy Medium":

Cycles are inevitable. Every once in a while, an up- or down-leg goes on for a long time and/or to a great extreme and people start to say "this time it's different." They cite the changes in geopolitics, institutions, technology or behavior that have rendered the "old rules" obsolete. They make investment decisions that extrapolate the recent trend. And then it turns out that the old rules do still apply, and the cycle resumes. In the end, trees don't grow to the sky, and few things go to zero. Rather, most phenomena turn out to be cyclical.

I'm hearing again – as often in the past – that we're in a Goldilocks economy. It's not so hot that there's risk of inflation accelerating, which would require restrictive measures on the part of the Fed.

Or so cold that business will slow, with a depressing effect on profits. No, it's just right. Of course, this condition has never held for long in the past.

Earlier this year, Kenneth Lewis, chairman of Bank of America, summed it up candidly and simply: "We are close to a time when we'll look back and say we did some stupid things . . . We need a little more sanity in a period in which everyone feels invincible and thinks this is different."

And while I'm on the subject, I want to offer an important observation. No matter how favorable and steady fundamentals may be, the markets will always be subject to substantial cyclical fluctuation. The reason is simple: even ideal conditions can become overrated and therefore overpriced. And having reached too-high levels, prices will correct, bringing capital losses despite the idealness of the environment (see tech stocks in 2000). So don't fall into the trap of thinking that good fundamentals = positive market outlook (and especially not forever). As I said in "Everyone Knows," profit potential is all a matter of the relationship between intrinsic value and price. There is no level of fundamentals that can't become overpriced.

Willing Suspension of Disbelief

One of the key requisites for enjoying a trip to the movies is a willingness to suspend disbelief. If they wanted to, moviegoers invariably could find plot glitches, technological impossibilities or historical inaccuracies. But they tend to overlook them in the interest of having a good time.

Similarly, investors' recurring acceptance that it's different this time – or that cycles are no more – is exemplary of a willing suspension of disbelief that springs from glee over how well things are going (on the part of people who're in the market) or rationalization of the reasons to throw off caution and get on board (from those who've been watching from the sidelines as prices moved higher and others made money).

The fact is, the higher asset prices go, the more people think assets are worth, and the more eager they become to buy them. A rip-roaring rally fuels buying appetites rather than make people think the appreciation may have moved prices to precarious levels. In the same way, price collapses cause people to worry rather than start combing the market for bargains.

In this way, the bullish swing of the investment cycle tends to cause skepticism and risk tolerance to evaporate. Faith, credence and open-mindedness all tend to move up – at just the time that skepticism, discrimination and circumspection become the qualities that are most needed.

Financial Innovation

Another element that I notice tends to rise and fall with the cycles is the level of financial innovation. Again, this is a cycle that's easily understood.

Wall Street exists to develop and sell new products, no less so than toothpaste manufacturers and movie studios. So why is it that some periods are rife with innovation and other periods totally lacking? It's because it's only in bullish times that investors accept financial inventions. When the market's in an up-swing, people tend to say, "Sure, I'll give it a chance" or "Good, I've

been looking for new ways to make money.” But when the market has been moving down and people are tallying their losses, they tend to be much less open to new ideas. **In the financial world, the mother of invention isn’t necessity, its salability.**

In the roaring 1960s we saw Nifty-Fifty investing, dual shares from mutual funds and discounted shares issued through unregistered private placements without any mechanism for subsequent liquidity. In the ’80s we saw portfolio insurance – a surefire way to enjoy the appreciation potential that comes with large commitments to equities, but with much less risk. And in the ’90s, no one could think of a reason why every dot-com, e-tailer, media aggregation and venture capital fund wouldn’t be successful. Of course, all of these things failed to function as promised and either disappeared forever or experienced severe corrections.

And what have we seen in the last few years? CDOs, CLOs, CPDOs, SPACs and securitizations of every type. In the current environment – marked by decent returns; disinterest in conventional, safe assets; and openness to risky investments – few people seem to dwell on the reasons why something new might not work. No one asks why, if a \$2 billion fund was successful, a \$20 billion fund shouldn’t be as well.

Derivatives deserve particular attention in this regard. On July 8 The Wall Street Journal noted that,

Over the last six years, global futures trading on exchanges has grown nearly 30% a year. The total derivatives market is valued at about \$500 trillion, four times the value of all publicly traded stock and bonds. . . . The four biggest futures exchanges have launched more than 300 new derivatives products in just the last few years . . .

Particularly intriguing, it seems the value of outstanding credit default swaps – insurance against defaults among corporate debt instruments – exceeds the value of the instruments insured. How will this work if a wave of defaults occurs? How well are the provisions of these insurance contracts documented? How readily will the writers of the insurance pay up? What will be the effect if conditions are chaotic? No one knows the answers to these questions. **Inventions originate in up markets, but they’re tested in down markets. Rarely do they work entirely as hoped.**

In down markets, people see potential risks that can’t be argued away. But in markets like this one, they see opportunities they must seize to avoid being left behind. Thus, like the other things I’m discussing, a high level of financial innovation is symptomatic of a market that’s been rising for a good while and may be behaving in an overconfident manner.

What, Me Worry?

Two recent innovations deserve particular attention here: structured entities and what the British call “selling onward.” **Both embody an impractical expectation: that financial engineering can eliminate risk. Combined, they’re particularly dangerous.**

In creating structured entities such as CDOs, managers bring together investors with different risk/return appetites. To satisfy those varying appetites, the investors are sold claims with different priorities with regard to the entity’s portfolio and cashflows, and with projected returns that are proportional. The managers use the investors’ capital to assemble a portfolio of assets. And each investor receives a security with risk and return tailored to its needs.

It should work . . . in theory. My biggest knocks on structuring are these: First, many of the people who develop the structured entities and rate their securities know more about probabilities than they do about the specific assets in the portfolio, something that's particularly dangerous when portfolios are highly leveraged. And second, there seems to be a belief that this process – at Oaktree we call it “slicing and dicing” – can reduce the overall risk in the system.

If risk is reduced, I'd like to know where the eliminated part goes. If ten people each hold a share of ten highly correlated risky assets, I don't think the overall system is much less risky than if each of the ten people held one entire risky asset. At the extreme, however, it may be true that risk sharing reduces the likelihood that a spate of failures will precipitate a generalized credit crunch.

Selling onward is the process through which the originating of assets and the owning of assets are separated. In the old days, banks made loans and mostly held on to them, syndicating a bit to build relationships and limit risk. Nowadays, banks originate loans largely to generate loan and syndication fees, and actually living with the loans is much less prevalent. After they're originated, assets such as corporate loans, mortgages, auto paper and credit card receivables are often packaged and sold, sometimes in the form of securities. There's a belief that this process, too, makes the world less risky.

I fail to see net benefits here as well. Instead, I think this process introduces great moral hazard. When the people making loans aren't going to remain dependent on the borrowers they give money to, they have little incentive to actively police risk. Thus I have grave doubts about a lot of the credit decisions being made.

For an extreme example, take a look at the subprime mortgage brokers. Were they motivated to make prudent credit decisions? No; they were motivated to create a lot of paper. **There's something wrong when it's in someone's best interests to lend money to unqualified borrowers, but this was the case in subprime mortgages.** Obviously this occurred because mortgage brokers weren't risking their own money. With selling onward so prevalent, an originator just had to hope the borrower would make the first few payments, so that delinquencies wouldn't surface before the originator's repurchase obligation expired and the loans became the buyer's problem. How could buyers have been silly enough to purchase loans made by brokers operating under this set of incentives?

Now, let's combine structuring and selling onward. Here's how I see it working:

- A mortgage broker makes a bunch of loans without knowing much about creditworthiness (think about so-called “liar loans”) or caring much about creditworthiness (because he intends to sell them momentarily).
- An investment banker buys a few hundred of these loans, also without knowing much about them (because of their sheer numbers), in order to package them into residential mortgage-backed securities (RMBS) and sell them onward.
- An investment manager buys a few dozen RMBS, about which he doesn't know much (also the numbers) or care much (because the fees and potential profits incentivize him to put a lot of money to work fast). They become part of the portfolio of a CDO, against which debt is issued.
- A rating agency analyst assigns ratings to the CDO debt, about which he can't know much (lack of specialized expertise; vast number of underlying assets; structural complexity and the newness

- A hedge fund manager buys CDO debt about which he doesn't know much (with thousands of underlying mortgages having been sliced and diced) or worry much (given the high debt ratings).

Concoctions like this are tolerated only in heady times. Clearly the results can be incendiary. We're waiting to see the final outcome – and perhaps to pick among the ashes.

One last thought: **Let's say slicing, dicing and selling onward do have the potential to reduce the overall level of risk in the system, all other things being equal. Even if that were true, the other things wouldn't remain equal; market participants would adjust their behavior to the new reality and in so doing return risk to its old level.** On May 23, the Financial Times said this about trying to reduce risk by selling onward and by obtaining credit insurance via derivatives:

This makes banks less vulnerable to individual defaults. **But it could also be making them feel so comfortable about lending risks that they are making more risky loans.** Outside investors such as hedge funds are gobbling them up, either because they also think they are protected with credit derivatives or because they are desperate to find somewhere to place their cash. This has triggered a collapse in the standards used to conduct and fund deals. (Emphasis added)

Again, no matter how good fundamentals may be, humans exercising their greed and propensity to err have the ability to screw things up. **Perhaps Myron Scholes put it most succinctly (The Wall Street Journal, March 6): "My belief is that because the system is now more stable, we'll make it less stable through more leverage, more risk taking."**

The L Word

Some of the most glaring innovation this time around has taken place in the area of leverage. It's not that leverage hasn't been available and been used before: In the late 1980s, companies like RJR were the subject of leveraged buyouts in which 95% of the purchase price was borrowed. Nowadays, debt rarely constitutes much more than 80% of buyout capital structures, but the terms of the debt and the ease of obtaining it are startlingly accommodating.

Unlike the historic norm, it's routine today to issue CCC-rated bonds. It's easy to borrow money for the express purpose of distributing cash to equity holders, magnifying the company's leverage. It's so easy to issue bonds with little or no creditor protection in the indenture that a label has been coined for them: "covenant-lite." And it's possible to issue bonds whose interest payments can be paid in more bonds at the option of the borrower.

The first requirement for an elevated opportunity in distressed debt is the unwise extension of credit, which I define as the making of loans which borrowers will be unable to service if things get a little worse. This happens when lenders fail to require a sufficient margin of safety.

Here the interrelatedness of cycles is quite evident. Good economic times bring rising profits. Rising profits cause the default rate to subside. And the low default experience erases lenders' reticence. Among other things, they become willing to lend money so that troubled companies can

stay afloat and hopefully outgrow their problems. Today that's called "rescue finance"; in less rosy times it might be called "throwing good money after bad."

The default rate in the high yield bond universe is at a 25-year low on a rolling-twelve-month basis. Under such circumstances, how could the average supplier of capital be expected to maintain a high level of risk aversion and prudence, especially when doing so means ceding all the loan making to others? It's not for nothing that they say "The worst of loans are made in the best of times."

The Downside of Leverage

If lenders are acting in an imprudent fashion, what's the effect on the borrowing companies? If loans are available too readily, is it right or wrong to borrow? These are among the most interesting questions of the day.

Lots of good things have been said about leverage. In the late 1980s, when venerable American companies were being bought in leveraged buyouts structured with debt/equity ratios of 25-to-one, we were told that an underleveraged balance sheet is indicative of a sub-optimal capital structure and excessive use of high-cost equity, and that significant leverage sharpens management's focus on cash flow and leads to better expense control.

The only thing omitted was the reminder that equity – which doesn't require the periodic payment of interest or the repayment of principal at maturity – represents a company's margin of safety. It's the capital layer that absorbs the first blow in tough times without occasioning an event of default. **While leverage may magnify gains in good times, it's a healthy layer of equity that gets companies through the bad times.**

It's inescapable that, all other things equal, greater leverage increases a company's likelihood of experiencing financial distress. Thus, with lenders enjoying a carefree recent experience and consequently financing some unwise deals – and with borrowers eager for the enhanced upside potential that comes with leverage – it seems clear that we'll see rising rates of default and bankruptcy a few years down the pike. This is especially true if, as has often been the case recently, debt is incurred not just to leverage the company's equity, but to finance payouts to equity holders that reduce or eliminate the equity.

So then, are private equity funds – raising much more equity capital than ever, and doing the biggest deals in history at a rapid-fire pace, at rising transaction prices and rising leverage ratios – doing a smart thing or making a mistake? It all depends on how you look at things. The funds seem to be looking in terms of optionality.

Ketchup, Easy Money and Optionality

I was a picky eater when I was a kid, but I loved ketchup, and my pickiness could be overcome with ketchup. I would eat hamburgers, frankfurters, veal cutlets, filet of sole and frozen fish sticks, but as far as I was concerned, they were all just vehicles for ketchup. The ketchup of today is easy borrowing, and private equity managers are entering into a large number of transactions to access it.

Let me illustrate what I consider to be the thought process: If you were offered the chance to buy companies with 100% debt financing and no money of your own, how many would you buy? The smart answer is, “All of them.” Not just the well-run ones? Or the growing ones? Or the profitable ones? No; all of them. Some would produce positive cash flow and/or appreciation, which you’d welcome. The others would be unsuccessful, but with none of your own money invested, you’d just walk away. That’s optionality.

Optionality is a new-age finance term for the ability to cheaply obtain a call on asset appreciation, creating the possibility of profits out of proportion to potential losses. That’s the way it is in venture capital: all you can lose is your investment, but you can multiply it hundreds of times simply by finding the next Google. Even though venture capital investing produces only occasional success, it’s justified by the occasional outsized payoff.

I think that’s the deal today in mega-private equity. In their highly successful first decade of 1975-85, LBO funds invested in small, underpriced industrial concerns or orphaned corporate spinoffs. They paid low prices for stable companies, financed their purchases with moderate amounts of debt, and put a lot of energy into improving the companies’ operations. Both their batting averages and their overall rates of return were attractive.

But I’m not sure that’s the model today. Few companies are languishing on the bargain counter, and everyone knows that if buyout funds bid for a company, the shareholders had better take a good look at what they’re giving up. Likewise, buyout funds are buying well into a period of economic expansion, and the scope for improvement in operations may be limited.

No, the model today seems different: pay premiums to open-market prices for prominent, multi-billion dollar companies, sometimes after the boards, shareholders or other bidders have forced prices higher. Borrow large sums to finance the deals. Generate whatever fundamental improvement you can. Hope the market will provide a highly leveraged payoff. And, given the enormity of the scale, get rich off management fees, ancillary fees and the profits from the ones that work.

In other words, it seems that, relative to the past, the thought process in mega-private equity is based on the combination of (1) ultra-cheap financing, (2) high fees, (3) quick withdrawal of equity capital and (4) a lower batting average but big payouts on the winners. The optionality is certainly on the GPs’ side. Let’s hope it works for the LPs as well.

If the Lender’s a Sap, Is the Borrower a Genius?

I have a lot of experience looking at leveraged transactions from the standpoint of the lender, but less experience as a borrower. Thus I found it novel – even surprising – to read a January memo on this subject from Carlyle founder William Conway to his colleagues, with thoughts echoing mine:

As you all know (I hope), the fabulous profits that we have been able to generate for our limited partners are not solely a function of our investment genius, but have resulted in large part from a great market and the availability of enormous amounts of cheap debt. This cheap debt has been available for almost all maturities, most industries, infrastructure, real estate, and at all levels of the capital structure. Frankly, there is so much liquidity in the world financial system, that lenders (even “our” lenders) are making very risky credit decisions. . . .

I know that this liquidity environment cannot go on forever. I know that the longer it lasts the more money our investors (and we) will make. I know that the longer it lasts, the greater the pressures will be on all of us to take advantage of this liquidity. And I know that the longer it lasts, the worse it will be when it ends. And of course when it ends the buying opportunity will be a once in a lifetime chance. But, I do not know when it will end. . . .

Last year, I asked you to be humble, ethical and optimistic. This year I am asking you to be careful as well.

In 1990-91, our distressed debt funds made a fortune buying the obligations of companies that had been loaded up with too much debt in LBOs in the late '80s. Chastened by that experience, lenders in the '90s didn't provide enough leverage to make buyout companies much of a factor in the debt collapse of 2002. But with the memory of having 1990-91 faded, leverage became freely available in the last few years, and thus we have little doubt we'll be buying a great deal of distressed LBO debt the next time around.

When all the above is taken together, it seems likely that a few years out, we'll see a landscape littered with companies that were crippled with excessive debt loads and lenders who weren't repaid. What happens to private equity funds and their investors will depend on the outcome of a game of hot potato: will they get their capital – and their gains – out of the over-leveraged companies before they go sour? We'll see.

But Don't the Borrowers Have a Free Pass?

Much is being made of the possibility that today's debt is default-proof. "Toggle bonds" give borrowers the option of paying interest in the form of more bonds for a while. And covenant-lite indentures mean the likelihood of an interim technical default has been reduced. Do these developments reduce the overall risk?

This, too, goes back to the concept of optionality. The value of an option is greater the longer it has to run, and options that can't be extinguished early are worth more than those that can.

Think of someone who issues ten-year bonds to raise the money with which to buy a company. On the surface, it seems he has ten years for his purchase to work out profitably, at the end of which period he has to repay his lenders. In other words, he has a ten-year option on the company's appreciation potential. But what if the company gets in a bind in the early years and misses an interest payment? Or if an economic slowdown causes a technical breach of a covenant? In past downturns, these things have forced borrowers to pay lenders for extensions or forbearance, and they have led to defaults. Those things may be somewhat less likely nowadays.

It is true that payment-in-kind and covenant-lite loans reduce the likelihood of interim defaults. But does that mean the credit landscape is risk-free and lenders can breathe easy? Sooner or later, debt has to be repaid or refinanced, and the credit market may not be accommodating at that moment; this is especially true if the company's fortunes have deteriorated. Not enough of a company's debt may be default-proof to make it invulnerable. The price of the debt may decline with the fundamentals,

even if default isn't an immediate threat. And the free pass in the interim may just delay – but also worsen – the eventual outcome.

Under a traditional structure, a company might default in the third year of a bond's life, by which time 20% of its value may have evaporated. But with these new wrinkles, it might not happen until year five . . . when 60% of the value is gone. **Yes, lenders are giving borrowers more rope. But will it prove to be a lifeline for the company or a hangman's noose?** A lot will depend on how things go while the postponed default is in abeyance.

This is yet another area where up-cycle faith that risk has been reduced can convince people to add back the risk. As The Wall Street Journal said of standby revolvers on May 11, "Thanks to debt arrangements like this, some private-equity buyers say they are doing deals they would otherwise not do."

What Could Cause This Upward Cycle to Falter?

Since I insist that the good times can't roll on forever, I'm often asked what might make them stop. I don't have any inside information on this subject, but I can enumerate the possibilities:

1. economic slowdown,
2. reduced willingness to lend or insistence on higher interest rates, perhaps due to increased worry about credit risk,
3. systemic problems like a crisis in derivatives or a cluster of hedge fund meltdowns,
4. exogenous factors such as \$100 oil, a dollar crisis, terrorist acts, and
5. the things I haven't thought of.

First, I want to point out that these things are not unrelated. A reduction in lenders' willingness to lend may stem from an economic slowdown. An economic slowdown could be brought on by an exogenous event. It's when there's a confluence of these things that the debt market gets into real trouble, as was the case in 1990 and 2002.

Second, these things are often unpredictable. I like to remind people that the best buying opportunity we ever had in distressed debt arose in the summer of 2002, when recession, credit crunch, 9/11, Afghanistan, telecom meltdown and the scandals at Enron et al. occurred all at once. Few if any of these were predictable twelve months earlier.

And third, the one we should worry about most is number five. Investors can cope with the things they can anticipate, analyze and discount. They have more trouble with the rest. I love hearing people from the "I know" school say, "I'm not anticipating any surprises." Those are the developments that can knock a market into a cocked hat. As Martin Wolf wrote in the Financial Times on May 2, "The most obvious reason for taking today's euphoria with a barrel of salt is that nobody ever expects shocks. That is what makes them shocks."

Where do we stand in the cycle? In my opinion, there's little mystery. I see low levels of skepticism, fear and risk aversion. Most people are willing to undertake risky investments, often because the promised returns from traditional, safe investments seem so meager. This is true even though the lack of interest in safe investments and the acceptance of risky investments have rendered

the slope of the risk/return line quite flat. Risk premiums are generally the skimpiest I've ever seen, but few people are responding by refusing to accept incremental risk.

Peter Bernstein put it this way in the February 15 issue of *Economics and Portfolio Strategy*:

I hear over and over that we live in an era of low expected returns. The rational response to low expected returns is to withdraw and wait until expected returns are higher. That response to low expected returns appears to have gone out of fashion. Today's response is to seek higher returns from higher risks in a low-risk environment – or, worse, to underestimate the risks taken. [Of course, I am less certain than Peter that we are in a low-risk environment.]

Markets have tended recently to move up on positive developments and to recover easily from negatives. I see few assets that people are eager to get rid of, and few forced sellers; instead, most assets are strongly bid for. As a result, I'm not aware of any broad markets that I would describe as under-priced or uncrowded. I will say, however, that some of the excess confidence that usually accompanies booms may be missing. Some of the people making risky investments today seem to be doing so with their fingers crossed. And even though they're optimistic enough to make these prosperity-oriented investments, they're also wary enough to want to hedge their bets by participating in distressed debt as well.

It is what it is. We've been living in optimistic times. The cycle has been swinging strongly upward. Prices are elevated and risk premiums are slender. Trust has replaced skepticism, and eagerness has replaced reticence. Do you agree or disagree? That's the key question. Answer it first, and the implications for investing become clear.

In the first quarter of this year, significant delinquencies occurred in subprime mortgages. Those directly involved lost a lot of money, and onlookers worried about contagion to other parts of the economy and other markets. In the second quarter, the impact reached CDOs that had invested in subprime mortgage portfolios and hedge funds that had bought CDO debt, including two Bear Stearns funds. Those who had to liquidate assets were forced – as usual – to sell what they could sell, not what they wanted to sell, and not just the offending subprime-linked assets. We began to read about ratings downgrades, margin calls and fire-sales, the usual fuel for capital market meltdowns. And in the last few weeks we've begun to see investor reticence on the rise, with new low-grade debt issues repriced, postponed or pulled, leaving bridge loans un-refinanced.

It is in this way that awareness of the inevitability of cycles is reawakened, and it is for reasons like these that the pendulum starts to swing back from one extreme toward the center of its arc . . . and then the other extreme. We never know whether a little jiggle is the start of the swing back and, if so, how far it will go. But we always should be aware that reversion will occur.

The last 4½ years have been carefree, halcyon times for investors. That doesn't mean it'll stay that way. I'll give Warren Buffett the last word, as I often do: "It's only when the tide goes out that you find out who's been swimming naked." **Pollyannas take note: the tide cannot come in forever. Time, tide and cycles wait for no man.**

July 16, 2007

Memo to: Oaktree Clients

From: Howard Marks

Re: It's All Good . . . Really?

As I worked on "It's All Good" during my vacation in late June – and even when I issued it two weeks ago – I had no reason to believe that the universally upward cycle about which I was writing could be curtailed before the end of July. But the good times certainly have stopped rolling in many areas, at least for now. I think it's extremely important to study the way this has happened, as it provides a highly instructive object lesson.

It's folly to think we know in advance just what it is that will cause the market pendulum to stop swinging in one direction and start in the other, but it's even greater folly to think that nothing of that nature will happen. That's my twist on one of my favorite quotes, from behaviorist Amos Tversky:

It's frightening to think that you might not know something, but more frightening to think that, by and large, the world is run by people who have faith that they know exactly what's going on.

My friend Bruce Newberg thinks a quote attributed to Mark Twain says it best, and he may be right:

It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so.

Over the last few years, some people went around saying, "We don't know what bad thing will happen, but something will," and others said, "We're confident that nothing bad will happen." Now, as is often the case, unassuming caution seems to be winning out over cocksure optimism.

The Seed

This memo isn't about the events of July 2007, but rather how recent events exemplify the time-honored pattern that kicks off the swing back of the pendulum. That pattern often begins with a single seed, and sometimes one that's hard to identify. That difficulty isn't there this time; it's just that the seed seems so small compared with the repercussions.

The seed of the current cyclical downturn sprouted in the area of subprime mortgages, residential loans made to homeowners with less-than-stellar creditworthiness. The mere

making of those loans didn't create the problem. Rather, it's the fact that both borrowing and lending decisions were quite poor and in many cases misguided.

As I described in "It's All Good," loan originators and mortgage brokers were incentivized by fees to generate loan volume and often were able to do so without having to risk their own capital. They were paid to produce quantity, not quality, and – surprise! – they did. Capital providers' lack of concern regarding creditworthiness enabled borrowers to borrow more than they could repay and more than was justified under prudent lending standards . . . at adjustable rates even if the borrowers couldn't withstand an upward adjustment . . . often supported by inadequate documentation regarding incomes and assets. Deficiencies in due diligence even permitted numerous cases of mortgage fraud, where borrowers bought houses, marked them up through sales to related parties, and then borrowed against them in amounts far in excess of their actual value (and their cost).

It's not surprising that these circumstances combined to produce a high volume of deficient loans. In fact, it would be amazing if they hadn't. Who could have looked at this system without expecting this outcome?

Okay – bad loans were made, and delinquencies and foreclosures have been rising among the weakest of mortgage borrowers. How can these isolated developments have jumped the rails to affect commercial real estate? How could they possibly have led to difficulty for the private equity industry, which does no mortgage lending? And how can these specific linkages have been generalized into widespread repercussions on the economy and the credit and equity markets?

Contagion

Among the many cyclical phenomena that recur regularly, one of the most interesting is the attitude toward contagion. When the environment is rosy and market participants are optimistic, negative developments are described as "isolated incidents." Market participants find it easy to maintain their equilibrium, and the possibility of repercussions is easily dismissed. This is no more realistic than what we see at the pessimistic end of the pendulum's swing, where negatives are generalized into epidemics, contagion is overstated and participants totally lose their cool.

Early in June, I met with Marty Fridson of FridsonVision. Marty is a longtime friend and one of the deans of the high yield bond business – by any standard an expert on credit. In his discussion of the subprime crisis, Marty referenced a complex flowchart labeled "Possible Paths to Contagion." It showed a number of ways in which the subprime problem could affect high yield bonds. Linkages like these can be foreseen if you're thoughtful and willing to look ahead. Marty focused on contagion to high yield bonds, but I'll discuss below how this small problem has spread far more broadly.

Animal, Vegetable or Mineral?

These were the categories into which things fell on the old TV quiz show “Twenty Questions,” and they were always the subject of the panelists’ first question. In the case of the subprime crisis, the factors contributing to contagion can be sorted into three other categories: fundamental, psychological and technical. Here are some examples:

Fundamental influences are those with tangible consequences for business. When mortgage delinquencies rise sharply, first there are the obvious direct effects:

- Lenders lose money, and some go bankrupt.
- Real estate brokers’ commissions dry up.
- Homebuilders see less demand for their product.
- Building materials companies see lower volumes.

Then there are the second-order consequences, or what the British would call the “knock-on effects”:

- Home prices fall. Mortgages based on the old, high prices cannot be refinanced, and simple economics makes it smarter to default rather than service a \$500,000 mortgage on what is now a \$400,000 house. Thus delinquencies rise further.
- Lower home prices at the bottom of the ladder ripple through other sectors of the housing market.
- All consumers feel poorer due to the negative wealth effect and curtail their expenditures, crimping revenues at retailers and then manufacturers.
- Borrowing declines, depressing the level of business at financial institutions.

All of these things have direct consequences for the economy and the markets – from just the little seed of bad subprime loans. But there will also be extensive **psychological repercussions**:

- Losses that are experienced – or even just imagined – cause investors and providers of capital to realize they’ve been overstating positives and understating negatives.
- Their confidence ebbs and they start to worry. Thus they make less capital available for risky investments, or they charge more for the capital they will provide.
- Thus risk premiums and expected returns must rise if investors are to be induced to make further risk-bearing investments. One way this happens is through higher interest rates – depressing consumer and business activity.
- Another way prospective returns are raised is through price declines for existing assets, and these can course through many markets.

Finally, the environment is altered by **technical factors** that influence the supply/demand balance for capital and assets.

- As capital dries up, deals become less attractive (because the cost of capital is higher) and maybe downright impossible to execute (because capital is unavailable).

- If portfolio holdings have to be sold to reduce leverage or raise cash to meet actual or feared withdrawals, this has a depressant effect on asset prices that reinforces the cycle.
- Lower asset prices may lead to margin calls, and thus possibly to fire sales.
- Forced sellers sell what they can sell, not necessarily what they want to sell. As a result, the prices of assets that are entirely unrelated to the fundamental problem can join the downward spiral. It's for this reason that they say, "In times of crisis, all correlations go to one."

Every one of the above factors has been seen in the last few weeks – all growing from just the subprime seed. **The economy is still showing good strength overall and most companies are doing fine; the default rate among high yield bonds continues to run at 25-year lows. But strong fundamentals mean little if technical factors combine with a fundamental problem to profoundly depress investor psychology.**

It's important to remember the extent to which these factors interrelate. Fundamentals influence psychology, which determines technicals, which feed back to further affect fundamentals. **Just as these things can create a virtuous circle on the upside – such as the one that has prevailed since late-2002 – they're now behind the apparent start of a vicious circle on the downside.**

The L Word Revisited

Most explanations of the financial dynamism of the last few years have centered on something called "excess liquidity." Vast amounts of liquidity in the hands of investors, it's been said, caused them to avidly pursue investments, neglect due diligence, accept low prospective returns, and therefore bid up asset prices.

But where does excess liquidity come from? Not from more currency. The amount of currency in the world is somewhat fixed, and each person's receipt is another person's expenditure. The fact that China has massive reserves to invest merely means those sums came out of someone else's account.

I think the "L word" that should be focused on isn't liquidity, but leverage. This is the one I discussed in "It's All Good," and the element behind many of the excesses of late. High levels of lending and borrowing relative to capital balances can increase buying power and fire up economies and markets. The question is whether that expansion will be maintained and increased. If not, this source of growth will peter out . . . as has been the case in the last few weeks.

A decade or so back, the ability of parties other than the Fed to increase the leverage in the system was limited. Margin debt for purchases of stock couldn't exceed 100% of an investor's equity, and bank loans likewise were restricted to a multiple of capital. But in recent years, some new factors have meaningfully changed the picture, including derivatives, hedge funds and non-bank lending. All three of these – among which there is

significant overlap – have negated the old limits and made vast amounts of leverage available to investors and asset buyers.

This leveraging up was the greatest single element in the asset surge of the last few years. In fact, the breadth of the gains tells me we didn't have an "asset bubble," but rather a "leverage bubble." As Jeremy Grantham points out in his latest letter, leveraged loans (so-called "bank loans" often funded by hedge funds rather than banks) are a good candidate for the "bubble" label, as their volume in the first half of 2007, at \$545 billion, was up 60% over the same period in 2006, which showed a similarly dramatic increase over 2005. Leverage (along with the lowered standards that resulted from eagerness to put borrowed capital to work) was the common thread in much of the appreciation that took place across asset classes and regions.

Now we're having a chance to see – once again – that the process works in both directions. And as so often is the case, the air tends to come out of the balloon far faster (and more violently) than it went in. The process is mesmerizing – like watching a train wreck happen.

The Engine of Growth Seizes Up

The pervasiveness of leverage throughout the financial system means the slowing process comes in many forms and takes many twists and turns. It's not possible – or necessary – to enumerate all of them. All we need are a couple of examples. For these we'll take a look at collateralized debt obligations, or CDOs.

For a simple example, consider commercial mortgage-backed securities, or CMBS. Over the last few months, Bruce Karsh has pointed out that prices for CMBS were falling even though the business of being a landlord was good and prices of buildings were increasing.

His explanation has been that many CDOs held both subprime paper and the riskier tranches of CMBS. Because of the developments in the subprime area, (1) they were affected by psychological contagion, (2) new ones couldn't be formed, meaning CDOs ceased to be buyers of new CMBS, and (3) some faced the need to reduce their leverage and raise cash. Unable to sell subprime assets (or not wishing to recognize losses if they could be deferred), they've been selling CMBS, putting downward pressure on prices. That's how problems in one asset class can depress prices in another.

Now let's look a little deeper. Bear in mind that CDO managers are paid to (1) issue debt in tranches that vary in terms of seniority and promised return and (2) use the proceeds to assemble portfolios of debt instruments. Borrow and buy, borrow and buy. A CDO manager's compensation increases in proportion to the amounts involved and is locked in for the term of the CDO. Thus CDO managers, like mortgage brokers, were motivated to play a major part in what I described in "The Race to the Bottom" in February: **"a market where a desire for quantity and speed has taken over from an insistence on**

quality and caution.” Not all managers succumbed to this temptation, of course, but it was there.

CDOs have been among the greatest contributors to the recent upswing. To a large extent they were a bottomless pit that could never be filled, a prime source of demand for debt. Why was their growth so strong? Because they offered a terrific deal, attracting vast quantities of money that had to be invested. What was that deal? Simple: high-rated debt at low-grade yields.

Too good to be true? Of course. The ratings were too high because rating agency analysts had to rate exotic structured products with which they had no experience (and probably no true understanding). And I’m confident the CDO managers were very persuasive, using sophisticated statistical models to explain how safe they were thanks to portfolio diversification and over-collateralization. For this reason, many tranches of CDOs stuffed with non-investment grade debt received investment grade ratings, looked cheap based on their attractive promised yields, and thus sold out rapidly.

CDOs were among the greatest buyers of residential mortgage-backed securities (RMBS) and non-investment grade leveraged loans. I’ll bet some investors even leveraged up to buy the debt of these highly leveraged entities, which in turn used their capital to buy highly leveraged paper. Could the end be in doubt? This mode of response to the low-return environment of the last few years was doomed to end badly.

Now the fallacies in this approach have been exposed, with widespread ramifications:

- Because the ability to create new CDOs may be greatly curtailed, they’re unlikely to represent much of a source of demand for new leveraged loans.
- In that case, future buyouts dependent on leveraged loan issuance won’t be funded as readily.
- Billions in bridge loans that investment banks extended for buyouts appear to be “hung” because of the difficulty in refinancing them through sales to investors.
- The investment banks behind the loans are likely to encounter substantial losses as they’re marked down to make them salable.
- Outstanding high yield bonds and leveraged loans will have to decline in price (and rise in yield) to make them competitive with this marked-down buyout paper.
- Debt that has been inventoried to facilitate the formation of new CDOs may have to be dumped at losses now that the CDO creation process has shrunk.
- Investment banks that made bridge loans and amassed inventories for non-existent CDOs may be unwilling to extend new financing from their balance sheets.
- Fewer buyouts will be able to be financed as long as the debt markets remain in this condition.
- Thus the “LBO put” may no longer be a force in the stock market, in which case investors will no longer be able to count on buyout funds to purchase companies at premium prices.

How did the increase in subprime mortgage delinquencies lead to last week's 580 point drop in the Dow? These are some of the ways. **Fault lines run through portfolios, markets and economies, and usually they are exposed only in times of crisis. The fault line this time came in the form of pervasive leverage.**

The Role of Psychology

At the end of each day, Oaktree's debt trading desk sends out an email recapping our buys and sells, along with market developments and the day's biggest headlines. On July 26, (the day the Dow declined 312 points), one of the headlines read "Paulson Says Subprime-Mortgage Collapse Doesn't Threaten Economic Growth."

On the simplest level, there's every reason to understand that the failure to make monthly payments on the part of a bunch of mortgage borrowers at the bottom of the credit ladder won't have direct effects far beyond their local communities and the holders of their loans. But (1) the government usually does a poor job of anticipating second-order consequences and (2) politicians have every incentive to act as cheerleaders for the economy and downplay the negatives. Unlike distressed debt investors and other bargain hunters, no officeholder wants to see economic weakness, since it tends not to do much for re-electability.

Even leaving aside this factor, the issue here comes down to the difference between the direct workings of the "real" economy and the follow-on effects of psychology. **I believe the latter are profound and have the ability to overwhelm the former. In fact, I sometimes think there's little to the economy other than psychology – and thus that the real economy simply can't be distinguished from the psychological one.**

- If consumers feel insecure about their economic future, they won't buy.
- If they don't expect consumers to buy, manufacturers of consumer goods will cut back production, and they certainly won't produce to build inventories. Instead they'll downsize by laying off workers, further adding to consumer woes.
- Pessimistic consumer goods manufacturers won't invest in plant expansion, so construction companies and manufacturers of production equipment will suffer as well.
- All of this will be exacerbated by the reduced willingness of worried lenders to provide debt capital, or at least their insistence on higher interest rates to cover the increased risks.
- At the extreme, government tax revenues might decline, necessitating restrictive tax increases or the troubling growth of deficits.

It's all a matter of expectations. So when someone says, "psychological influences aside, I don't think there'll be much of an impact," I wouldn't give that statement much weight. It's entirely understandable that, despite favorable fundamentals, newly chastened investors have pulled back into their shells, largely because of the profound effect of a downturn in psychology.

In the last few weeks, investors have learned some painful lessons. They went from feeling they understood exactly what was going on to realizing they merely had been carried along in a rosy environment. They learned (1) that they hadn't accurately gauged the risks they were taking when they invested in innovative and highly leveraged structured entities, (2) that the rating agencies they'd relied on didn't know either, and (3) that in understating risk they hadn't demanded enough of a risk premium or sufficient protective covenants. They learned the hard way that leverage magnifies losses as well as gains. And they learned that negative developments in a far-off corner of the economy can affect them profoundly. There's absolutely nothing new in any of this.

In just the last two weeks, we've seen headlines such as these:

- Subprime Uncertainty Fans Out
- Bear Stearns Tells Investors Funds Worthless
- Crisis Forces Banks to Make Hobson's Choice
- Banks Delay Sale of Chrysler Debt As Market Stalls
- Chrysler, Boots Financing Woes Dim "Golden Era" for Leveraged Buyout Firms
- A Second Day of Declines Caps the Worst Wall Street Week in Years
- Credit Crunch May Derail Buyout Boom; LBOver
- Fears Intensify on Economy, Despite Growth
- Hedge Fund Deleveraging Could Be Next Big Worry

What these developments mean for the future – and how far this swing toward negative events and negative psychology will go – is absolutely unknowable. Is this just a bump in the road, like the Asia-related declines that rippled through markets in the second quarter of 2006 and the first quarter of 2007, from which the recovery was swift? Or are these events the first steps toward a major credit crunch that will bring on a recession? No one knows, including us.

But what we do know is that the bull-market excesses I decried in my memo of two weeks ago (and in "The New Paradigm" in October and "The Race to the Bottom" in February) have reversed for the moment, with profound effects on asset prices. **Just as risky companies could obtain ridiculously cheap and easy financing a month ago, now the debt of perfectly good companies is providing generous promised returns and sometimes is unsalable.** Oaktree bottom fishers who've felt like they've been cooling their heels for the last few years are smiling for a change.

And mindfulness of cycles is on the way to being restored. When things can't get better – as some buyout GPs pointed out earlier this year – they won't. When the pendulum reaches the extreme of its arc, it will swing back. When markets are priced for perfection, they will disappoint. And when investors demand inadequate compensation for bearing risk, they will learn the error of their ways. With the word "eventually" implicit in these statements, I'm 100% sure they're all correct.

I can't say, "This is it," but I am willing to say, "This is more like it." **It'll always go this way. Investors should learn that simple lesson. But most never will.** That's what the philosopher Santayana had in mind when he said, "Those who cannot remember the past are condemned to repeat it."

July 30, 2007

Memo to: Oaktree Clients

From: Howard Marks

Re: Now It's All Bad?

I'm a great believer in the cyclical nature of the markets, but I never cease to be amazed at how far they can go in one direction and for how long; the extremes they can reach, despite logical arguments to the contrary; and the swiftness of the swing back. It all reminds me of a point I made in my second memo, "First Quarter Performance" (April 1991): Although the midpoint of its arc best describes the location of the pendulum "on average," it actually spends very little of its time there. Instead it is almost always swinging toward or away from the extremes of its arc.

Just seven weeks ago, I complained in "It's All Good" that investors were acting as if nothing could go wrong. "Priced for perfection" was the concept underlying values, and people were more than willing to pay prices set that way.

Now, of course, the prevailing attitude appears to have swung from "it's all good" to "it's all bad." Pessimism has replaced optimism, perhaps also to excess. There are days on which no one seems able to tell me how the developing credit crisis might be resolved in short order and a full-scale meltdown avoided, and when no one seems able to find a ray of sunshine in the current situation (other than bargain hunters).

It's like the aspiring actor who takes acting classes, waits on tables and hustles auditions for a decade . . . and then gets his big break and becomes an "overnight success." Except that in this case, having built up great excesses over a period I date from November 2002, people are now acting as if this market has become an overnight flop.

Some of us have been saying for years that a swing back of the market cycle was due, but it took a long time to happen (calling to mind, as so often in my case, the dictum that "being too far ahead of your time is indistinguishable from being wrong"). This delay does a good job of illustrating Lord Keynes's famous observation that "markets can remain irrational longer than you can remain solvent."

Markets can swing in a single direction for a longer period and to a greater extent than anyone might expect. That's crowd psychology. But the swing back can be equally surprising – in terms of what kicks it off and how fast it moves. I recently came across a great quote from Larry Summers: "in economics things happen slower than you expected they would but when they finally do, they happen faster than you imagined they could." Certainly the recent transition from all good to all bad demonstrates this phenomenon.

The Virtuous Circle

The financial world seems to have melted down in just a few weeks. But the truth is, the seeds of the crisis have been growing for years – unnoticed by most – as a seemingly virtuous circle spun unabated.

Henry Kissinger was a member of TCW's board when I worked there, and a few times each year I was privileged to hear him hold forth on world affairs. Someone would ask, "Henry, can you explain yesterday's events in Bosnia?" and he'd say, "Well, in 1722 . . ." The point is that chain reaction-type events can only be understood in the context of that which went before. The challenge is figuring out how far back to go. In talking about how the market got to its current condition, I'll just look back five years.

Everyone remembers the last corporate debt crisis, during the summer of 2002. Recession, credit crunch, 9/11, Afghanistan, the telecom meltdown, and scandals at Enron and the like combined to make bonds available at ridiculously high yields. Those who were willing to buy had an opportunity to earn ultra-high returns with what turned out to be very little risk.

Around the beginning of November 2002, however, it felt like a switch was thrown. Maybe distressed debt managers who hadn't been aggressive enough during the summer concluded they had to get invested before year-end. For whatever reason, bond prices started to rise. Our active distressed debt funds gained 20% that month, and the markets never looked back. Investors in all asset classes forgot the panic that had gripped them just a few months earlier and became preoccupied with making money.

Because only modest returns were expected from high grade bonds (with their 4-5% yields) and U.S. common stocks (following the 2000-02 bear market), investors sought solutions in non-traditional investments with brief track records at best, and thus little or no clarity regarding the risks involved.

Vast sums flowed to hedge funds, and thousands of new ones were formed. High yield bonds and leveraged loans began to be issued again . . . because now there were buyers. This enabled buyouts to be financed and then recapitalized, and quick payouts to equity holders resulted in eye-popping IRRs, attracting more capital to buyout funds. Real estate attracted vast amounts of capital, too, even when "cap rates" – current cash yields – sunk below 5%; what could be better than a tangible asset providing inflation protection?

Borrowing power became virtually unlimited, as is often the case when providers of capital are eager to put money to work. Thus the financial environment reflected (1) a vast ability to leverage, (2) an uninhibited search for return, and (3) investors competing to make investments by accepting lower returns and decreased safety. This combination supported new investment techniques, which grew rapidly despite being untested. Securitization, tranching and selling onward were employed extensively, often in combination. **For investors seeking high returns in a low-return world, leverage seemed to hold the answer, and it was used in ways never seen**

before. Collateralized loan obligations and collateralized debt obligations, for example, grew practically unchecked. These debt factories bought up vast amounts of raw material – in the form of underlying portfolio assets – in order to generate a salable product.

The bottom line of it all: high leverage, untested vehicles and inadequate preparedness for adverse developments. Little awareness of risk, low credit standards, slender risk premiums and little margin for error. In short, a recipe for possible disaster.

The Vicious Circle

It's easy to explain what happens at this point in the typical market cycle: eventually, everything goes the other way. That's exactly what happened this summer.

There's a bump in the road. It doesn't matter what it is, and it's usually different each time. This year the problem occurred in the field of subprime mortgages. There was a surprising rise in delinquencies, the immediate effect of which was limited to a small segment of the economy and the few investors who'd bought securities backed by these loans. In the months leading up to July, the impact went largely undetected outside the subprime arena.

But from time to time in the investment world, a chain reaction is set off – maybe you'd say a “tipping point” is reached – which causes one sort of problem to create others and to cascade from one asset class, market or region to others.

I think the first step toward a broadening-out of the subprime problem came in a few days during which rating agencies downgraded hundreds of mortgage-backed securities and the debt of CDOs built on them. The repercussions were many and swift. Not only did the downgradings have a direct negative effect on mortgage portfolios and their holders, but they provided a wake-up call, a shocking reminder of some forgotten realities:

- That risk had been underestimated.
- That things investors thought they knew – truths they held so strongly – they really hadn't known at all.
- That elements they had relied on – in this case, debt ratings – had let them down. Nothing works, they were reminded, except analysis that is first-hand, in-depth and superior.

Then there were the holders' problems. Bear Stearns, for example, announced significant losses in two of its hedge funds, as falling prices for subprime holdings rendered collateral inadequate and margin calls eliminated maneuvering room. A few days later, it was reported that the investors' equity was all gone.

And then there are technical factors. These are developments that encourage selling or deter buying but are unrelated to investment fundamentals. A number soon arose:

- Suddenly, market participants realized how hard it can be to value obscure, infrequently-traded assets and how much the prices of such assets can diverge from their value. In fact, “value” can be an empty concept in times of crisis, when it becomes painfully clear that an asset is only worth what it can be sold for. Thus people came to question the prices funds were using to value subprime-related holdings, as well as the model-derived prices their investment bank creators had charged for them.
- Worried about both subprime fundamentals and pricing, and suddenly under increased scrutiny, many lenders stopped providing financing. Short-term commercial paper, which many investors had used to leverage their subprime-related asset investments, became largely impossible to roll over.
- Funds that had promised liquidity to their investors – even some money market funds – became worried about their ability to accurately value subprime holdings and sell them at fair prices. Thus they suspended withdrawals. What could have a more traumatic effect on investor confidence?
- Where leverage was withdrawn, margin calls arrived, or funds had to meet actual or feared withdrawals, holders of subprime assets became forced sellers. Few things have a more devastating effect on investment performance.

Metastasis

The fundamental, psychological and technical influences described above devastated the market for subprime investments, of course, but they also spread quickly to other assets and markets and metastasized into new forms of trouble.

Investor psychology turned in all markets, even those totally unconnected to subprime loans. Caution replaced optimism. Risk aversion took over from risk tolerance (or risk-blindness). Skepticism and the concept of capital preservation were resurrected. Concern over being under-invested gave way to fear of buying too soon. Cash came to be viewed as a source of security and buying power, not a drag on results. All over the investment world, people started to think more about what can go wrong rather than what can go right. **In short, the things that contributed to the virtuous circle began to be reversed, in ways that were unimaginable just two months ago.**

Bridge financing for buyouts represents an outstanding example. Buyouts were an area of great enthusiasm – and some of the greatest excesses, I think – in the 2002-07 up leg:

- Vast sums were raised in buyout funds, likely increasing the managers’ motivation to buy companies.
- Purchase prices for target companies were lifted by stock market strength, bidding wars and the demands of stockholders and boards.

- Acceptable debt/equity ratios – and thus the prices funds were willing to pay for companies – increased as the cost of debt financing fell.
- Companies became even more leveraged as recapitalizations allowed debt to replace equity on post-acquisition balance sheets.

Although purchase prices and leverage ratios were rising rapidly, the banks were ready and willing to “bridge” – or accept the risk involved in completing – future financings for buyouts. Often this came in the form of “staple financing,” through which banks enabled buyers to include committed financing as a component of their bids. As of a month ago, banks had committed to supply \$277 billion of financing for buyouts, a figure that omits equity bridges (promises to raise some of the equity required in a buyout) as well as non-U.S. transactions. These bridges have become one of the big stories of 2007.

Prior to July, investors competed to put money to work despite rising buyout prices, increasing leverage ratios, declining yield spreads and weaker terms and covenants. The banks counted on this eagerness in extending their financing commitments, and for years they were not disappointed.

But then the negative developments in subprime mortgages reminded investors about risk.

- The sight of funds melting down and suspending withdrawals was sobering.
- Worry about the economic impact of falling home prices and less buoyant consumer spending became pervasive.
- In this new, chastened environment, investors who’d bought CLO and CDO debt realized they had put too much faith in favorable ratings and thus were in trouble. This caused their appetite for debt to dry up.
- Bond pricing and terms no longer seemed adequate – and the risk associated with declining to purchase a new issue no longer loomed so large.

In short, in the unique way in which markets can turn from red-hot to frigid, potential buyers lost interest in the financings the banks had committed to place. And so the bridges became “hung.” The banks recognize that this isn’t par paper anymore, and thus they’re likely to accept discount bids to clear it off their balance sheets. **Observers describe this process by saying “risk has been repriced.” They mean investors now realize they’ve been accepting inadequate compensation for bearing risk and are insisting on more.** “Risk repricing” is a good term for what’s happening.

Clearly this phenomenon isn’t limited to subprime debt and bridge financings. In fact, the complete list of impacted securities, markets and participants is staggeringly long and diverse:

- subprime loans, and thus large amounts of residential mortgage-backed securities and CDO debt,
- money market funds that experienced losses in subprime-backed paper and were forced to freeze redemptions,

- Alt-A mortgages – not subprime, but similarly weak on documentation,
- mortgage lenders,
- commercial mortgage-backed securities, not because rents or property values are down, but because these securities may be held by residential mortgage investors forced to raise cash,
- bridge financings – and with them the likelihood of future buyouts looking anything like those of the recent past,
- the investment and commercial banks that committed to the bridges,
- the stocks of target companies in announced buyouts that are shaky as to completion and/or likely to be renegotiated,
- merger arbitrageurs, or “risk arbs,” who assumed the risk of these deals failing to be consummated as announced,
- others who bet that good times and low volatility would continue, and that probable things would happen and improbable things wouldn’t. These include sellers of put options and credit default insurance,
- “quant firms” that built highly leveraged portfolios with help from models that extrapolated past market behavior,
- hedge funds and other leveraged investors in a wide variety of fields that pursued “spread” or “carry” trades using large amounts of borrowed money (more on this later),
- banks (e.g., Germany’s IKB) and fund managers (e.g., Carlyle and KKR) that formed highly leveraged subsidiaries that would employ extensive leverage in the pursuit of profit,
- anyone dependent on issuing commercial paper or other forms of short-term debt to finance leveraged investments, and
- CLOs and CDOs, their investors, and those who depended on them to continue buying debt providing inadequate risk compensation.

The list of affected areas is long and could grow longer. On bad days, losses on U.S. stocks, European stocks and emerging market stocks all are attributed to the credit crunch. Exchange rate swings – and strength in the yen in particular – are blamed on declining use of the carry trade, a regular feature of which was borrowing at low rates in Japan and investing for more elsewhere. And the other day, I read that lower profits at London investment banks will likely result in smaller bonuses for investment bankers . . . and thus in lower prices for London real estate.

How could investors in the areas listed above have expected that a crisis in subprime mortgages would affect them this way? Who would have guessed, for example, that low-grade mortgage delinquencies would depress returns on risk arb funds? The New York Times of August 18 described *A Demon of Our Own Design*, by Richard Bookstaber (see “Investment Miscellany,” November 2000) as pointing out that “the proliferation of complex financial products like derivatives, combined with use of leverage to bolster returns, will inevitably mean that there will be a regular stream of market contagions like the one we’re having now – one of which, someday, could be calamitous.”

This pattern of contagion exemplifies the hidden fault lines that I say can run through portfolios and – like construction flaws in California homes – become apparent only during infrequent catastrophes. But their invisibility most of the time doesn't mean they're not there. The existence of these common threads is one of the things that make it difficult to predict the correlation between assets, one of the key ingredients in intelligent portfolio construction. And it's a good reason to attach a significant premium to managers with alpha, or superior investment insight and skill.

Leverage and Liquidity

It's clear that when the story of 2002-07 is written, leverage and liquidity will be among the main players. For much of the last few years, we saw a vast appetite for securities. It created enormous demand for – and pushed up prices of – real estate- and asset-backed paper, CLO and CDO debt, buyout funds, hedge funds, high yield bonds and leveraged loans. In fact, there seemed to be unlimited demand for non-mainstream investments. With all that money to put to work, few potential buyers refrained from participating in an upswing that some observers thought lacked a sufficient *raison d'être*, reasonable limits and adequate risk compensation.

One of the factors contributing most strongly to that demand was an ability to borrow excessive amounts, for questionable purposes, on loose terms and at a low cost. It was a result of the unattractiveness of yields on high grade debt . . . which stemmed largely from the Fed's campaign to lower interest rates in order to mitigate the depressant effect of the stock market slump and recession. It was abetted by the fact that after a few years of good results, many people forget how money is lost.

Extensive use of leverage was behind many of the gains of the last few years, and it is at the root of many of the problems being suffered today.

If I mistake not, the distress . . . was produced by an enemy more formidable than hostile armies; by a pestilence more deadly than fever or plague; by a visitation more destructive than the frosts of Spring or the blights of Summer. I believe that it was caused by a mountain load of DEBT.

Flowery commentary on the crisis of 2007? No; according to the Financial Times, the quote from T.E. Burton's *Crises and Depressions* refers to events that occurred in 1857. **The point is that leverage is nothing new, and neither are its deleterious effects.**

There are numerous reasons to use debt to leverage results, and none of them is likely to evaporate any time soon:

1. Hope springs eternal, as my mother used to say, and greed usually drives markets. Thus any tool that has the power to magnify gains is very tempting.

2. Of course, leverage can magnify losses as well as gains. But investors make investments because they expect them to work, not fail, and thus the attraction of magnified gains far outweighs the fear of magnified losses.
3. **Long-term bonds almost always offer higher yields than short-term debt, and riskier investments invariably seem to promise higher returns than safe ones. For these reasons, using short-term borrowings to finance lower grade and/or longer-term investments invariably appears likely to produce positive returns.**
4. Most seductively, the incremental risk entailed in investments that are slightly longer in term or slightly lower in quality usually appears quite small. **For this reason, these trades seem safe – but that doesn’t mean they can’t be rendered extremely risky when leveraged up enough.**
5. Of course, when an upward cycle is generating strong returns and making risk aversion recede, the equation becomes even more attractive. In the FT column that provided the above quotation, John Authers describes the regular pattern of good times, easy credit, increasing leverage and eventual crashes. I don’t see that ever changing.

It’s for these reasons – and especially #4 – that highly leveraged positions are at the root of most fund collapses. Long-Term Capital Management, the Granite Fund, Amaranth Advisors, the two Bear Stearns funds, Sowood Alpha Fund and Basis Yield Alpha Fund were all marked by “safe” positions leveraged to the sky. And they all melted down.

In a number of ways, perpetuation of the market conditions of the last few years was dependent on several assumptions about liquidity:

- that investors with liquidity would be eager to put it to work,
- that providers of capital would make liquidity available, meaning that leveraged investors would be able to maintain their portfolio holdings and buy more,
- that securities markets would remain liquid, such that holdings could always be sold at prices close to their intrinsic value, and
- that funds would therefore be able to keep the promise of liquidity that they’d made to their investors.

In short, it was assumed that liquidity would continue to flow in the direction of leveraged investment funds (in the form of financing and incremental capital commitments) rather than away (in the form of margin calls and investor withdrawals). Two or three months ago the world was described daily as “awash in liquidity.” Where is it now?

Investments requiring nothing more than the perpetuation of favorable market conditions can be very seductive. And they work most of the time . . . until the pit has been dug deep enough, the branches have been spread, and everyone has forgotten about the existence of risk.

The investment environment of the last few years could have been negatively impacted by the removal of any one of the elements of liquidity listed above. But if you look at the list, it becomes clear that they're highly interrelated. Weakening one assumption could render the others less reliable. And, in truth, a single exogenous development – such as a major decline in psychology – could simultaneously harm them all. That's the main story of the last few weeks.

Investments costing many times the investor's equity. Dependence on unreliable short-term financing. Susceptibility to margin calls or capital withdrawals. Assets that can become unsalable at a moment's notice. Prices that can collapse because the markets are thin and everyone wants out at the same time. The formula is simple and the results are predictable. Not every fund that's so disposed collapses, but the potential's always there – with borrowing to buy at its core.

Fundamental problems are present in most investment conflagrations, but exposure to excessive leverage and disappearing liquidity is often the accelerant. As breakingviews.com (my new favorite) put it in The Wall Street Journal of August 2, **“The markets may hurt you, but your lenders will finish you off.”**

Risk Reduction

Of the many fairy tales told over the last few years, one of the most seductive – and thus dangerous – was the one about global risk reduction. It went this way:

- The risk of economic cycles has been eased by adroit central bank management.
- Because of globalization, risk has been spread worldwide rather than concentrated geographically.
- Securitization and syndication have distributed risk to many market participants rather than leaving it concentrated with just a few.
- Risk has been “tranching out” to the investors best able to bear it.
- Leverage has become less risky because interest rates and debt terms are so much more borrower-friendly.
- Leveraged buyouts are safer because the companies being bought are fundamentally stronger.
- Risk can be hedged by long/short and absolute return investing and through the use of derivatives designed for that purpose.
- Improvements in computers, mathematics and modeling have made the markets better understood and thus less risky.

As described in “It's All Good . . . Really?” I thought many things that hinted at risk reduction actually had the effect of decreasing understanding and increasing risk. Up to July, all we read about was the beneficial nature of these developments. Now, with the benefit of hindsight, these are the judgments of our leading business periodicals:

A system designed to distribute and absorb risk might, instead, have bred it, by making it so easy for investors to buy complex securities they didn't fully understand. (The Wall Street Journal, August 7)

[Loans] are now often bundled into securities that are sold in pieces to investors around the world, changing hands many times. It spreads risk, which policy makers believe keeps the overall financial system sound and stable. But the downside to this system could be serious. (WSJ, August 10)

"The market appears to be finding it harder to truly understand the inherent and underlying risks involved," [according to Chris Rexworthy, a former regulator with Britain's FSA]. The backlash is particularly sharp abroad, in countries that were surprised to find that problems with United States homeowners could be felt so keenly in their home markets. (New York Times, August 31)

"Low volatility has created complacency, and that has translated into poorly structured derivative markets," says Randall Dodd, director of the Financial Policy Forum . . . The low volatility world of the past few years may have worsened the situation, leading to lax lending standards for derivative investors. (WSJ, August 2)

It is estimated that there are seven times as many credit derivatives outstanding as there are outstanding bonds. You need to ask the question: is risk being transferred or created? Are the new gladiators hedging with derivatives or just leveraging up? (Jeff Pantages in Pensions & Investments, August 20)

An apt metaphor came from Pension & Investments: "Jill Fredston is a nationally recognized avalanche expert . . . She knows about a kind of moral hazard risk, where better safety gear can entice climbers to take more risk – making them in fact less safe."

Like opportunities to make money, the degree of risk present in a market derives from the behavior of the participants, not from securities, strategies and institutions. Regardless of what's designed into market structures, risk will be low only if investors behave prudently.

The bottom line is that tales like this one about risk control rarely turn out to be true. Risk cannot be eliminated; it just gets transferred and spread. And developments that make the world look less risky usually are illusory, and thus in presenting a rosy picture they tend to make the world more risky. These are among the important lessons of 2007.

Other Lessons Not Learned

In addition to the above, a number of other recurring themes can be seen as underlying the recent difficulties. Here are a few:

- Belief in market efficiency – Although academics say the actions of intelligent investors cause assets to be priced right, I often find prices screwy. Rather than increasing market efficiency, improvements in computer and communications technology may have made the markets even more unstable. As my partner Sheldon Stone says, it's like a cruise ship where everyone is told to stand on the port side. Then everyone simultaneously gets a message telling them to run to starboard. It makes for a rocky crossing. The New York Times wrote on August 17 that "Information may arrive instantly, but insight takes longer." Certainly the cycles don't seem any less volatile than they used to be, or the extremes any less irrational. In fact, in recent years, over-reliance on market efficiency may have kept people from questioning asset prices.
- Inefficacy of models – Quant funds invest according to models that extrapolate past patterns, operated by people who know computers and probabilities, not investment fundamentals. But models can't tell you when past market behavior has been irrational (and thus unreliable), and they can't predict when those patterns will change. They lead to investments that "would have worked almost all the time in the past," but it's amazing how often we see them derailed by once-in-a-lifetime events. Matthew Rothman of Lehman Brothers has become famous for saying in early August that "events that models only predicted would happen once in 10,000 years happened every day for three days." Are those models you want to bet on?
- Di-worst-ification – Warren Buffett harps on the folly of branching out into things you know less about solely for the purpose of increasing the number of baskets in which you have your eggs. Investing in things about which you aren't expert doesn't reduce risk, it increases it. And I think it's particularly unwise to finance diversification with borrowed money.
- Conflicts between managers and clients – Investors should look very closely at the alignment of their managers' interests with their own. The mere fact that a manager is working for incentive compensation, or has money in his fund, isn't enough. Recent events have shed some unusual – and provocative – light on the question of alignment. Consider Sowood Capital, which lost half of its investors' capital, sold off its portfolio in a block and closed down. Why did the loss of half the LPs' equity occasion a liquidation? Might further losses have activated a clawback of previous years' incentive fees? And might the interests of a manager with 100% of his net worth in his fund have diverged from the interests of LPs who invested 1% of theirs? I'm just speculating from the sidelines without knowledge of the facts in this situation, but I wonder whether this doesn't show that to protect their own investment in their funds, managers can be driven to take actions that damage their LPs.
- The unreliability of ratings – Many investors act in reliance on ratings, and some require ratings before taking actions they're considering. But ratings must be taken with a big grain of salt. **In fact, a lot of my career (and Oaktree's success) has been based on conviction that the rating agencies are often wrong.** They routinely rate securities too high when things are going well, and then overcorrect

when problems surface. It's instructive to note that a lot of CDO debt built on subprime mortgages received triple-A ratings, many of which already have required downward adjustment. And that rating agencies helped CDO managers design structures so they would receive the desired rating. And that managers would run a structure past a few agencies and hire the one that arrived at the highest rating. And that ratings are paid for by those sponsoring the securities being rated, something which sounds like a trial where the defendant picks and pays the judge.

All of these paragraphs highlight errors made by investors this time around . . . of a type that always will be made (but with variations on the theme). The lesson isn't to distrust managers, or models, or ratings, or diversification, or market efficiency.

What investors must learn – but most will not – is that there's no easy answer, surefire tool or silver bullet. Lots of tools will help when applied thoughtfully, but they'll bring harm otherwise – with the additional risk that excessive reliance on them will increase the damage done when they turn out to be unavailing. **Certainly none of the highly-touted things discussed above held the answer this time around. Only truly superior skill, discipline and integrity are likely to produce consistently high returns in the long run with limited risk.**

My advice: expect CEOs, regulators, rating agencies and other market participants to make mistakes. Expect things to go wrong and cycles to swing to extremes and then recover. Worry about outcomes, and hire worriers. Doing these things is sure to stand between you and top returns in up-cycles, but it will deliver some degree of safety when things turn bad. **Ensuring the protection of capital under adverse circumstances is incompatible with maximizing returns in good times, and thus investors must choose between the two. That's the real lesson. The things discussed above are just a few of the details.**

What Next?

Lots of people are asking whether this is going to get ugly. Is this the beginning of a credit crunch? Will it lead to a recession? How bad will it get? When will the bottom be reached? How long will the recovery take? The answer's simple: no one knows.

Some of the psychological and technical preconditions for a challenging market environment have been met. The bubble of positive investor psychology has been pricked and could become seriously deflated. **When others are aggressive, we should be worried, but when others are worried, we can be confident. That's the essence of contrarianism, and by that standard these are better times.**

The easy-money machine has had some sand thrown in its gears and seems to be grinding to a halt. Previously, anyone could get any amount of money for any purpose. Right now, deserving borrowers are unable to obtain financing, and this could continue or get worse.

The outlook for the economy is murky, as usual. It continues to limp along, not growing strongly but not sagging. The big question surrounds the effect of the subprime crisis on consumers. Home prices are through rising. Home equity borrowing is probably finished for a while as a supporter of consumer spending. Ditto for the “wealth effect.” The reset of adjustable rate mortgages from artificially low teaser rates to full market rates over the next 18-24 months is likely to have a depressing effect on a large number of households, and thus on the economy. I would think furniture and auto manufacturers, building materials suppliers, retailers and financial institutions have seen their best days for a while. I consider the economy unpredictable, of course, and thus a lot of people’s answers will be more definite than mine. But not necessarily more correct.

Everyone’s looking to the Fed to take action. Its last act – cutting the discount rate on August 17 – was largely symbolic but had a positive effect. A reduction of the federal funds rate would mean more, telling investors the Fed’s there to help, cutting the cost of borrowing and stimulating the economy. But it wouldn’t do much for banks’ balance sheets or willingness to lend.

It’s my view that Bernanke would rather not cut rates. Stimulative action that looked like an investor bailout would contribute further to moral hazard and the expectation that the Fed will always protect investors on the downside. This is an unhealthy expectation, as each bailout encourages risk taking and thus increases the likelihood that another will be needed. But the Fed is being importuned for a rate cut, and there are few people to argue on the other side, for a good dose of unpleasant medicine.

I’m usually cautious, so I might as well keep my record intact. The economy should weaken. Deals built on optimistic assumptions and paid for with a lot of borrowed money shouldn’t all thrive. Generous capital markets should not be expected to bail out ailing companies. Bargain hunters and distressed debt investors will have more to do. Eventually. But no one at Oaktree would advise you to act as if these views are sure to be correct. We certainly won’t.

* * *

An observation I made last October regarding the meltdown of Amaranth, in “Pigweed,” is equally applicable to the recent problems:

Orin [Kramer] notes that Amaranth “occurred when the skies were blue; the fund unraveled because a small and volatile commodity behaved in an unpredicted fashion.” This collapse didn’t require an adverse economic environment or a market crash. The combination of arrogance, failure to understand and allow for risk, and a small adverse development can be enough to wreak havoc. **It can happen to anyone who doesn’t spend the time and effort required to understand the processes underlying his portfolio.**

Certainly the magnitude of this summer's crisis has been out of proportion to its underlying fundamental cause: the increase in subprime delinquencies. Instead, a standard combination has proved perfectly incendiary:

- underlying greed,
- good returns in the up-leg of the cycle,
- euphoria and complacency,
- a free-and-easy credit market,
- Wall Street's inventiveness and salesmanship, and
- investors' naiveté.

This formula often results in crushing losses. **Or as Marc Faber put it, a surplus of cash leads to a shortage of sense.**

An obscure economist named Hyman Minsky is having his fifteen minutes of fame in the current environment. Here's how The Wall Street Journal summarized his views on August 18:

When times are good, investors take on risk; the longer those times stay good, the more risk they take on, until they've taken on too much. Eventually they reach a point where the cash generated by their assets no longer is sufficient to pay off the mountains of debt they took on to acquire them. Losses on such speculative assets prompt lenders to call in their loans. "This is likely to lead to a collapse of asset values," Mr. Minsky wrote. When investors are forced to sell even their less-speculative positions to make good on their loans, markets spiral lower and create a severe demand for cash.

The foregoing aptly describes the current cycle. . . and, I think, the way things always are. It certainly seems inevitable that, eventually, investment merit becomes overpriced, and the combination of good results and easy money causes dangerous leverage to be employed in the pursuit of profit.

When will market cycles be banished or made more muted? That'll happen when greed, human failings and herd behavior are eliminated. Or, in other words, never. In "You Can't Predict. You Can Prepare." I wrote of cycles that success carries within itself the seeds of failure, and failure carries the seeds of success. It'll always be so.

September 10, 2007

Memo to: Oaktree Clients

From: Howard Marks

Re: The Limits to Negativism

The markets acted on Monday as if the credit crisis is behind us – how incredible it is to be able to even write those words, whether true or not. Whichever is the case, however, it's important to reflect on what can be learned from the recent events. (I developed these thoughts last week but just wasn't quick enough to turn them into a memo. So I'm reduced to discussing what we all hope is history rather than displaying foresight.)

The Swing of Psychology

The last few weeks witnessed the greatest panic I've ever seen, as measured by its severity, the range of assets affected, its worldwide scope and the negativity of the accompanying tales of doom. I've been through market crashes before, but none attributed to the coming collapse of the world financial system.

It's worth noting that few of the recent sharp price declines were associated with weakness in the depreciating assets or the companies behind them. Rather, they were the result of market conditions brought on by psychology, technical developments and their interconnection. The worst of them reflected a spiral of declining security prices, mark-to-market tests, capital inadequacy, margin calls, forced selling and failures.

It was readily apparent that such a spiral was underway, and no one could see how or when it might end. **That was really the problem: no scenario was too negative to be credible, and any scenario incorporating an element of optimism was dismissed as Pollyannaish.**

There was an element of truth in this, of course: nothing was impossible. **But in dealing with the future, we must think about two things: (a) what might happen and (b) the probability it will happen.**

During the crisis, lots of bad things seemed possible, but that didn't mean they were going to happen. In times of crisis, people fail to make that distinction. Since we never know much about what the future holds – and in a crisis, with careening causes and consequences, certainly less than ever – we must decide which side of the debate is more likely to be profitable (or less likely to be wrong).

For forty years I've seen the manic-depressive cycle of investor psychology swing crazily: between fear and greed – we all know the refrain – but also between optimism and pessimism, and between credulity and skepticism. In general, following the beliefs of the herd – and swinging with the pendulum – will give you average performance in the long run and can get you killed at the extremes.

Two or three years ago, the world was so different as to be almost beyond remembering. It was ruled by greed, optimism and credulity. **In short, it was the opposite of the last few weeks: no story was too positive to be believed.**

- “There’s a worldwide ‘wall of liquidity’ that can never dry up.”
- “Triple-A CDOs are as safe as triple-A corporate debt but will deliver higher returns.”
- “Leverage holds the key to better investment results.”
- “Tranching and selling onward are spreading the risk, thereby eliminating it.”
- “Decoupling has reduced nations’ economic reliance on the U.S.”

Boy, what a good time that was for a dose of skepticism! What benefits it could have provided (in terms of losses avoided). But when conventional wisdom is rosy, few can stand against it. People who do so too early look woefully wrong and are swept aside. That discourages others from trying the same thing, even as the cycle swings further to the positive extreme.

The Black Swan

You may recall that in “The Aviary” in May, I wrote about *The Black Swan*, the second book from Nassim Nicholas Taleb, author of *Foiled by Randomness*. In *The Black Swan*, Taleb talks about unlikely, extreme, unpredictable events that have the potential for dramatic impact. His title was derived from the fact that, never having traveled to Australia and seen its black swans, Europeans of a few centuries ago were convinced all swans were white. In other words, because they’d never seen something, they considered it impossible.

The message of *The Black Swan* is how important it is to realize that the things everyone rules out can still come to pass. That might be generalized into an understanding of the importance of skepticism.

I’d define skepticism as not believing what you’re told or what “everyone” considers true. In my opinion, it’s one of the most important requirements for successful investing. If you believe the story everyone else believes, you’ll do what they do. Usually you’ll buy at high prices and sell at lows. You’ll fall for tales of the “silver bullet” capable of delivering high returns without risk. You’ll buy what’s been doing well and sell what’s been doing poorly. And you’ll suffer losses in crashes and miss out when things recover from bottoms. **In other words, you’ll be a conformist, not a maverick (an overused word these days); a follower, not a contrarian.**

Skepticism is what it takes to look behind a balance sheet, the latest miracle of financial engineering or the can't-miss story. The idea being marketed by an investment banker or broker has been prettied up for presentation. And usually it's been doing well, making the tale more credible. **Only a skeptic can separate the things that sound good and are from the things that sound good and aren't.** The best investors I know exemplify this trait. It's an absolute necessity.

The White Swan

Most people probably took away from *The Black Swan* the same lessons I did (and the lessons mentioned in "The Aviary"): "unlikely" isn't the same as "impossible," and it's essential for investors to be able to get through the low spots.

Of course, it's improbable events that brought on the credit crisis. Lots of bad things happened that had been considered unlikely (if not impossible), and they happened at the same time, to investors who'd taken on significant leverage. So the easy explanation is that the people who were hurt in the credit crisis hadn't been skeptical – or pessimistic – enough.

But that triggered an epiphany: **Skepticism and pessimism aren't synonymous. Skepticism calls for pessimism when optimism is excessive. But it also calls for optimism when pessimism is excessive.** I'll write some more on the subject, but it's really as simple as that.

Contrarianism – doing the opposite of what others do, or "leaning against the wind" – is essential for investment success. But as the credit crisis reached a peak last week, people succumbed to the wind rather than resisting. **I found very few who were optimistic; most were pessimistic to some degree.** Some became genuinely depressed – even a few great investors I know. Increasingly negative tales of the coming meltdown were exchanged via email. No one applied skepticism, or said "that horror story's unlikely to be true." Pessimism fed on itself. People's only concern was bullet-proofing their portfolios to get through the coming collapse, or raising enough cash to meet redemptions. The one thing they weren't doing last week was making aggressive bids for securities. So prices fell and fell – the old expression is "gapped down" – several points at a time.

The key – as usual – was to become skeptical of what "everyone" was saying and doing. One might have said, "Sure, the negative story may turn out to be true, but certainly it's priced into the market. So there's little to be gained from betting on it. On the other hand, if it turns out not to be true, the appreciation from today's depressed levels will be enormous. I buy!" **The negative story may have looked compelling, but it's the positive story – which few believed – that held, and still holds, the greater potential for profit.**

The Future

I write a lot to dissect and explain past events, but I'll try here to make a contribution by taking the riskier path of talking about the future. What do I see?

As for the short term, it's been amply demonstrated that governments and central banks will do everything they can to resolve the credit crisis. No stone will go unturned, and few options will be declined. Most people now believe that letting Lehman Brothers go was a big mistake: as a result of a calculated decision, discipline took precedence over rescue. The results were disastrous, as the commercial paper market froze up, money market funds "broke the buck," and the crisis was ratcheted up several notches.

Most people don't repeat their mistakes; they make new ones. So we should expect that all key players will be rescued in the period ahead. Some elements of that effort will be mistakes, but at least those mistakes won't pull down the financial system. Morgan Stanley was the next big worry but, after Lehman, it became unlikely that Morgan would be allowed to fail. I was asked, "Will the U.S. government guarantee a capital investment made by a Japanese institution?" Absolutely, if that's what it takes. It beats the U.S. having to put up its own money.

The sums being thrown around are the biggest ever: hundreds of billions, adding up to trillions. But there's no hesitation: everything will be done. That doesn't mean it has to work, but it's likely to.

Walter Wriston led Citibank from 1967 to 1984, all but my final year there. He was the world's leading banker and a great guy. One of his most famous observations was, "countries don't go bust." I assume he was making reference to their ownership of printing presses, and thus their unlimited ability to pay their local-currency obligations. That's the main reason why we shouldn't expect there to be any limit on the resources thrown at the problem. All it will take is running the printing presses long enough to rebuild financial institutions' capital accounts, make good guarantees and enable borrowers to roll over their outstanding debt, all of which is reckoned in nominal terms.

The philosophical bridge of unlimited aid to private institutions appears to have been crossed, and printing the necessary money is unlikely to be an issue.

Of course, that doesn't mean we're out of the woods. **Creating money isn't the end of the story.** What will be the effect?

First, the people who have money have to make the decision to lend to those who need it to fund their businesses. The Fed's provision of capital to financial institutions – even at ultra-low interest rates – isn't enough. If banks borrow money cheaply and lend it to people who don't repay them, they'll be out a lot of low-cost capital. And if they're on the hook for repaying the Fed, they'll be way behind. Because of residual conservatism, the steps so far might have the ineffectiveness of "pushing on a string," something I

mentioned in “Now What?” in January. We still have to see money begin to circulate throughout the system.

Jim Grant, the creator of *Grant’s Interest Rate Observer*, uses a great phrase to describe liquidity and credit: “money of the mind.” Unlike actual currency, it grows and shrinks depending on people’s moods – we’ve just seen a great demonstration. So it’s not enough for the Fed to give money to financial institutions; they have to be convinced to provide liquidity and credit.

In recent times, the Fed has provided a lot of capital to banks, but it has also taken in a lot of deposits from banks. We want to see the Fed’s advance reloaned, not put on deposit. That’s what it’ll take to restart the credit machine.

Even when credit starts flowing again, however, I doubt things will return immediately to their old pace. Losses have been taken and capital destroyed, and more losses may still be incoming (ask yourself if home prices are finished going down). More importantly, psyches have been damaged: consumer psychology, lenders’ willingness, even investor confidence – all have taken a beating. I doubt if things will bounce right back. There just won’t be the same expansiveness. I’ll stick with what I said in “Now What?”

Undoubtedly, credit will be harder to obtain. Economic growth will slow: the question is whether it will remain slightly positive or go negative, satisfying the requirement for the label “recession.” Regardless, positive thinking and thus risk taking are likely to be diminished. All I can say for sure is that the world will be less rosy in financial terms, and results are likely to be less positive than they otherwise would have been.

Awash in Money

In the longer term, we have to wonder about the effect on the world of a glut of newly printed dollars, sterling and euros. The reason owning printing presses makes repayment easy is that it lets a nation cheapen its currency. But one would think that more units of currency per unit of GDP means a debasement of the currency, and thus reduced purchasing power (read: higher inflation).

Walking along Hyde Park on Sunday, I saw a street vendor selling old stock certificates. Do you have any banknotes, I asked? Anything from the Weimar Republic? For the last few weeks, I’ve wanted to get some of those.

In Weimar Germany, the government enabled itself to pay World War I reparations by cheapening its currency . . . literally. So the 1,000 mark note I bought was simply over-stamped One Million Marks in red. Voila! Now we’re all rich.

The mark fell from 60 to the U.S. dollar in early 1921 to 320 to the dollar in early 1922 and 8,000 to the dollar by the end of 1922. It's hard to believe, but according to Wikipedia (user-maintained and perhaps not always the most authoritative):

In December 1923 the exchange rate was 4,200,000,000,000 Marks to 1 U.S. dollar. In 1923, the rate of inflation hit 3.25×10^6 percent per month (prices double every two days).

One of the firms printing these [new 100 trillion Mark] notes submitted an invoice for 32,776,899,763,734,490,417.05 (3.28×10^{19} , or 33 quintillion) Marks. [That's not a misprint.]

Lord Keynes judged the situation this way:

The inflationism of the currency systems of Europe has proceeded to extraordinary lengths. The various belligerent governments, unable, or too timid or too short-sighted to secure from loans or taxes the resources they required, have printed notes for the balance.

But it's not that easy. People with things to sell aren't that stupid. So instead of 1,000 marks, a goat now costs one million marks. That piece of paper used to be a thousand mark note – and now it's a million mark note – but it still buys the same goat.

The benefit to the government is that it's able to pay off its old nominal debts in currency of which it suddenly has a lot more . . . but which no longer has much purchasing power. So when repaid in the cheapened currency in 1923, the person to whom the government owed 1,000 marks can only buy one-thousandth of a goat – not a whole goat as in 1920.

My late friend Henry Reichmann was a boy then, working as a busboy in a restaurant in Berlin. He told me he used to be paid at lunchtime and immediately ran out to spend his salary, since it would buy less if he waited until after work to shop.

That's hyperinflation. Just as the Great Depression became a model during the credit crisis, Weimar Germany gives us something to think about regarding our new future. **I'm not smart enough to know what's coming, but I'm also not dumb enough to think a few government actions on Monday were enough to solve all our problems.** At best, we usually substitute one problem for another – usually one later on in lieu of today's.

I don't know what to do about this risk, whether it'll come home to roost, or to what extent. And I certainly don't think hyperinflation can be assigned a high enough probability to make it worth doing much about. But it may cause one to rethink holdings of low-yielding, flight-to-quality-elevated, long-term Treasuries.

The New Financial Order

My daughter Jane – the artistic member of the family – has developed a strong interest in politics and economics of late. (I think this is happening to young people all across the U.S., and it's a very favorable development.) On Saturday she called to ask what I thought about government ownership of banks.

First, I said, I thought it could make an important contribution to solving the short-term problem, and that's good.

Second, however, the U.S. has a strong tradition of government non-involvement in business, and we'd probably like to see it stay that way. "Nationalization" is a much dirtier word in America than in most other places (*International Herald Tribune* headline, October 14 – "Nationalization rule: Do it, but don't say it"). My preference, I told Jane, is for free enterprise with some adult supervision. When we make fundamental changes in the system, it's hard to foresee all the consequences. Consider these questions:

- Will legislators push bankers to make more loans to their constituents (remember Fannie and Freddie)?
- Will the banks have to lend to everyone, even weak borrowers? Will they be allowed to reject any applicants?
- Will they be prevented from foreclosing when mortgages are unpaid?
- Will they be deterred from financing "anti-social" investments like leveraged buyouts?
- Will they be limited in compensating executives? Will that make them less attractive as employers?
- Will bank employees worry about being penalized for errors of commission but not errors of omission?
- If so, will banks be staffed by people who are overly risk-averse? Will they lean toward saying "no"?
- Will capital be harder to come by, especially for smaller, younger companies?
- Will economic growth be slower than it otherwise would have been?
- Will non-government-owned banks be at a disadvantage because, as weaker credits, they'll have to pay more than the competition for their capital?

No one knows, but these questions deserve consideration. **Here's the underlying question: if the government's equity is non-voting, will that be enough to keep it out of the banks' affairs? It's far too soon to say (and hard to be completely optimistic).**

I continue to believe the financial sector of the future will be less leveraged, less risk-prone, less profitable, slower growing and more regulated. And that'll make it less exciting, less glamorous and less the employer of choice. But the beauty of the free-market system is that most developments entail plusses as well as minuses. **I've believed for many years that just as success carries within itself the seeds of failure (see 2003-08), so does failure carry the seeds of success.**

If the banks are made more bureaucratic and risk-averse – and less aggressive and competitive – I’m sure independent boutiques will arise and prosper. The model I have in mind is a forest fire: a year after, bright green shoots grow from the ashes; in fact, I think they’re fertilized by the ashes. Think what a landscape like that means for advisory firms like Moelis, Evercore, Gleacher and Greenhill.

In a free-market environment, not even a good knock can keep aggressive people from responding to opportunities. The financial sector will look very different in ten years from what it was a year ago – and that won’t be all bad.

* * *

I find that I often end with a quote from Warren Buffett, and often it’s the same one:

The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs.

But now I want to talk about the flip side: **When others conduct their affairs with excessive negativism, it’s worth being positive.** When others love ‘em, we should hate ‘em. But when others hate ‘em, we can love ‘em.

In “The Tide Goes Out” in March, I listed the stages of both bull and bear markets. I said that in the terminal third stage of a bull market, everyone is convinced things will get better forever. The folly of joining that consensus is obvious; people who invest thinking there’ll never be anything to worry about are sure to get hurt.

In the third stage of a bear market, on the other hand, everyone agrees things can only get worse. The risk in that – in terms of opportunity costs, or forgone profits – is equally clear. **There’s no doubt in my mind that the bear market reached the third stage last week. That doesn’t mean it can’t decline further, or that a bull market’s about to start. But it does mean the negatives are on the table, optimism is thoroughly lacking, and the greater long-term risk probably lies in not investing.**

The excesses, mistakes and foolishness of the 2003-2007 upward leg of the cycle were the greatest I’ve ever witnessed. So has been the resulting panic. The damage that’s been done to security prices may be enough to correct for those excesses – or too much or too little. But certainly it’s a good time to pick among the rubble.

* * *

I want to take this opportunity to congratulate and thank my Oaktree colleagues for their ongoing steadfastness. There's a simple formula for taking maximum advantage of opportunities in a collapsing market:

- (a) have a firm, well-reasoned estimate of an asset's intrinsic value;
- (b) recognize when the asset's price falls below its value, and buy;
- (c) average down if the price goes lower; and
- (d) be right about the value.

Acumen and resolve are **both** essential. My colleagues continue to show both. In recent weeks our list of purchases has been long most days, and our list of sales almost non-existent. Where there's cash we've put a lot to work, averaging down aggressively, in what we think are great buys.

I also want to thank our clients for trusting us and sticking with us. As Bruce Karsh and I wrote ten days ago in a memo to investors in our Opportunities Funds for distressed debt, "... in a few years we'll reminisce together about how easy it was to take advantage of the bargains of 2008-09." Whether or not the worst of the crisis is now truly behind us, I continue to feel that way.

October 15, 2008

Memo to: Oaktree Clients

From: Howard Marks

Re: Volatility + Leverage = Dynamite

Nearly fifteen years ago, in April 1994 – at a time when absolutely no one was reading my memos – I published one called “Risk in Today’s Markets Revisited.” That’s when I first proposed the formula shown above. I recycled it in “Genius Isn’t Enough,” on the subject of Long-Term Capital Management (October 1998).

The last few years have provided a great demonstration of how dangerous it can be to combine leverage with risky assets, and that’s the subject of this memo. It’ll also pick up on some ideas from my last memo, “The Limits to Negativism.”

My memo “Plan B” on the bailout proposal went out on September 24, and as I lay in bed later that night, I realized that I hadn’t taken one part of it nearly far enough. In discussing a prime cause of the credit crisis, I wrote the following:

I’ll keep it simple. Suppose you have \$1 million in equity capital. You borrow \$29 million and buy \$30 million of mortgage loans. Twenty percent (or \$6 million) of the mortgages go into default, and the recovery on them turns out to be only two-thirds (\$4 million). Thus you’ve lost \$2 million . . . your equity capital twice over. Now you have equity capital of minus \$1 million, with assets of \$28 million and debt of \$29 million. Everyone realizes that there’ll be nothing left for the people who’re last in line to withdraw their money, so there’s a run on the bank. And you slide into bankruptcy.

That’s true as far as it goes, but I’m going to devote this memo to things which could have followed that paragraph.

The Problem at Financial Institutions

It’s no coincidence that today’s financial crisis was kicked off at highly leveraged banks and investment banks. The paragraph above shows why that’s true, and why the problem is as big as it is. As I wrote in “Plan B”:

Because of the high regard in which financial institutions were held; because of the implied government backing of Fannie Mae and Freddie Mac; and because permissible leverage increased over time, financial institutions’ equity capital was permitted to become highly inadequate given the riskiness of the assets they held. Or perhaps I should say

institutions took on too many risky assets given the limitations of their equity capital. That, in a nutshell, is why institutions have disappeared.

So what exactly did these institutions do wrong? Here are a few examples, using Bank X, with \$10 billion of capital, to illustrate:

- Bank X uses leverage to buy \$100 billion of triple-A mortgage-related debt, under the assumption that it can't lose more than 1%. Instead, home prices decline nationwide, causing it to write down its holdings by 10%, or \$10 billion. Its capital is gone.
- Alternatively (but in fact probably simultaneously), Bank X sells Hedge Fund G \$10 billion of credit default swaps on the bonds of Company A, and it buys \$10 billion of the same credit protection from Investment Bank H. Company A goes bankrupt, and Bank X pays Hedge Fund G \$10 billion. But Investment Bank H goes bankrupt, too, so Bank X can't collect the \$10 billion it's due. Its capital is gone.
- Bank X lends \$50 billion to Hedge Fund P with equity of \$10 billion, which then buys \$60 billion of securities. The value of the fund's portfolio falls to \$50 billion; the bank sends a margin call; no additional collateral can be posted; so the bank seizes and sells out the portfolio. But in the downward-spiraling market, the bank only realizes \$40 billion. Its capital is gone.
- Hedge Fund Q also borrowed to buy securities. When Hedge Fund P got its margin call and its portfolio was sold out, that forced securities prices downward. So Fund Q – which holds many of the same positions – also receives a margin call, perpetuating the downward spiral and bringing more losses to more institutions.

All of these scenarios, and many others, are connected by a common thread: the combination of leverage and illusory safety, which allowed institutions to take on too much risk for the amount of capital they had.

First, it should be clear from the above that the amount of borrowed money – leverage – that it's prudent to use is purely a function of the riskiness and volatility of the assets it's used to purchase. The more stable the assets, the more leverage it's safe to use. Riskier assets, less leverage. It's that simple.

One of the main reasons for the problem today at financial institutions is that they underestimated the risk inherent in assets such as home mortgages and, as a result, bought too much mortgage-backed paper with too much borrowed money.

Let's go back to the paragraph on page one. Here it is again:

I'll keep it simple. Suppose you have \$1 million in equity capital. You borrow \$29 million and buy \$30 million of mortgage loans. Twenty percent (or \$6 million) of the mortgages go into default, and the recovery on them turns out to be only two-thirds (\$4 million). Thus you've lost \$2

million . . . your equity capital twice over. Now you have equity capital of minus \$1 million, with assets of \$28 million and debt of \$29 million. Everyone realizes that there'll be nothing left for the people who're last in line to withdraw their money, so there's a run on the bank. And you slide into bankruptcy.

Suppose you set up your leveraged portfolio as described but only 2% of your mortgage holdings go bad, not 20%. Then, you only lose \$200,000 (not \$2 million) of your \$1 million of equity, and you're still solvent. Or suppose 20% of your mortgages default as in the original example, but you only levered up ten times, not 30. You lose the same 6.7% of your assets, but based on \$10 million, so it's just \$670,000, or two-thirds of your equity. You're still alive. **The problem lies entirely in the fact that the institutions combined highly risky assets with a large amount of leverage.**

By now, everyone recognizes (a) how silly it was for the financial modelers to be so sure there couldn't be a nationwide drop in home prices (they felt that way because there never had been one – but did their data include the Depression?) and (b) the terrible job the agencies did of rating mortgage-related securities. So the risk was underestimated, permitting the leverage to become excessive: end of story. **Reason number one for today's problem, then, is the mismatch institutions turned out to have made between asset risk and leverage.**

The second reason is that, given the degree by which mortgage defaults have exceeded expectations, no one feels like taking a chance on how bad things will get. Everyone agrees it'll be bad, but no one can say how bad.

As I said in October in "The Limits to Negativism," when things are going well, no assumption is too optimistic to be accepted. But when things turn down, none seems too pessimistic. Today, with the ability to lose money on mortgages having been demonstrated so painfully, investors consider themselves unable to say where the losses will stop.

So if a highly leveraged financial institution has significant mortgage holdings, few people are willing to risk money in the belief that the losses will be bearable. If a financial institution has book equity of \$100 million and \$500 million of mortgage assets, no one will grant that future losses will be less than \$100 million – that is, that it'll remain solvent. Maybe the writedowns will be \$100 million. Or \$300 million. Or \$500 million. There's no assumption too negative. As a result, investors will just keep their money in their pockets.

A few sovereign wealth funds and others jumped in a year ago, and based on results so far, it looks like they acted too soon. In July, Goldman Sachs reported that 52 banks had raised capital and the providers of that capital were underwater at 50 of them, by an average of 45%. Certainly things are much worse now.

Most people are behaving as if there's no such thing as investing safely in a financial institution. This widespread belief has the ability to greatly delay the restoration of faith, capital and viability. Peter Bernstein put it succinctly in *The New York Times* of September 28. (Peter's one of the very wisest men around, in part because he's one of the few who can talk about the Depression from experience. I recommend his op-ed piece, "What's Free About Free Enterprise?")

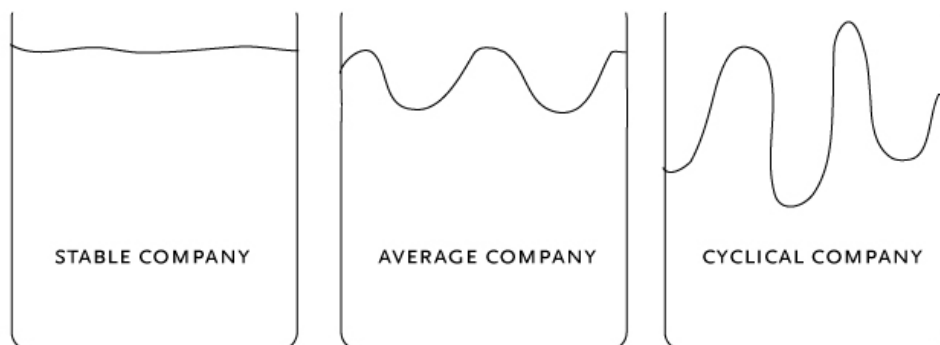
This time around, assets are evidently so rotten in so many places that no financial institution wants to risk doing business with any other financial institution without a government backstop.

That's the reason why no buyer could be found for Lehman Brothers over the weekend preceding its bankruptcy. No one could assess its assets and get comfortable regarding the status of its highly levered net worth, so everyone required a government backstop . . . which wasn't forthcoming.

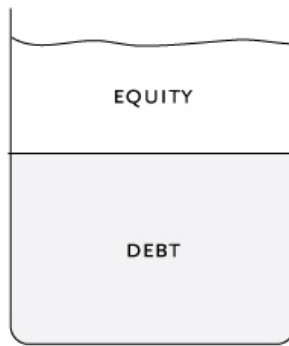
The Right Level of Leverage

Although I communicate primarily in words, I tend to think a lot in pictures – certainly more than in numbers. My concept of appropriate leverage can easily be demonstrated through a few diagrams. I'm going to overlook the differences between accounting value, market value and economic value and confuse the terms. But I think you'll get the idea.

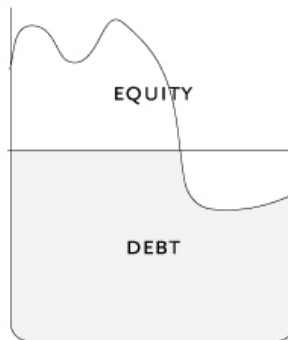
The drawings below show the value of companies of different types. Due to the variability of their earnings, the values fluctuate differently over time.



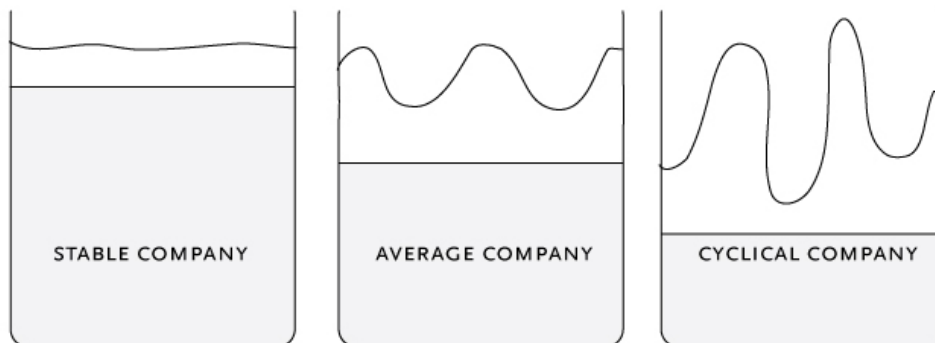
Here's a financial structure, except with the equity above the debt, not below as it would be on a balance sheet:



Now let's combine the two concepts. The bottom line is that in order for a company to avoid insolvency, its financial structure has to be such that its value won't fall through the equity and into the debt. In naïve and far-from-technically correct terms, when the amount of debt exceeds the value of the company, it's insolvent, as suggested below.



What the following doodles illustrate is that for every level of riskiness and volatility, there's an appropriate limit on leverage in the capital structure.



During the first leveraged buyout boom in the late 1970s and the 1980s, it was a watchword that they should be done only with stable companies. But in bullish times, rules like that are forgotten or ignored, and we get buyouts of companies in cyclical industries like semiconductors or autos.

Extremely leveraged companies have existed for more than a century. They're called utilities. Because their profits are regulated by public commissions and fixed as a percentage of their stable asset bases, they've been extremely dependable. **This shows that high leverage isn't necessarily risky, just the wrong level of leverage given the company's stability.**

It can be safe for life insurance companies to take risk on limited capital, because their operations are steady and their risks can be anticipated. They know everyone will die, and roughly when (on average). But if a firm like MBIA was going to guarantee mortgage securities, it should have recognized their instability and unpredictability and limited its leverage. The insurance industry's way of saying that is that its capital should have been higher as a percentage of the risks assumed. MBIA insured \$75 billion of residential and commercial mortgage paper on the basis of total capital – not capital devoted to its insuring mortgage securities, but total capital – of only \$3 billion. Did anyone worry about the possibility that 5% of the mortgages would default?

Leverage is always seductive. If you have \$1 million of capital and write \$25 million of insurance at a 1% annual premium, you bring in \$250,000 of premiums, for a 25% return on capital (before losses and expenses). But why not write \$50 million of insurance and bring in \$500,000? The answer is that policy losses might exceed 2% of the insurance written, in which case your losses would be greater than the capital you have to pay them with . . . and you might be insolvent. **But in order to resist using maximum available leverage, you need discipline and an appreciation for the risks involved. In recent years, few firms had both.**

Why Mortgages?

Why is it residential mortgage-related paper that set off the process endangering our institutions? Why not high yield bonds or leveraged loans or even equities? One reason, of course, is the sheer size of the residential mortgage-related securities market: \$11 trillion. But there are two others.

The first is the inability to value the underlying collateral. I feel comfortable when Oaktree's analysts value the debt or equity of a cash-flow-producing company. To the extent an asset produces a stream of cash flows, and assuming they're somewhat predictable, the asset can reasonably be valued. But assets that don't produce cash flows can't be valued as readily (this has been a regular theme of mine of late).

What's a barrel of oil worth? \$33 in January 2004, \$147 in mid-2008, or \$42 earlier this month? Which price was "right"? All of them? Or none of them? We all know about

the things that will influence the price of oil, such as finite supply, growing demand, and the unreliability of some of the producing nations. But what do those factors make it worth? **No one can convert these intangibles into a fair price.** That's why, a few months ago at \$147, we were seeing predictions of \$200 oil. And now, with the price down two-thirds, there's talk of \$25.

The same is true of commodities, gold, currencies, art and diamonds. And houses. **What's a house worth? What it cost to build? What it would cost to replace today? What it last sold for? What the one next door sold for? The amount that was borrowed against it? (Certainly not.) Some multiple of what it could be rented for? What about when there are no renters? The answer is "none of these." On a given day, houses – and all of the things listed just above – are worth only what someone will pay for them.** Well, that's true in the short run for corporate securities, too, as we've seen in the last few months. But in the long run, you can expect security prices to gravitate toward the discounted present value of their future cash flows. There's no such lodestone for houses.

Think about one of the biggest jokes, the home appraisal. If a house doesn't have a "value," what do mortgage appraisers do? They research recent sales of similar houses nearby and apply those values on a per-square-foot basis. But such an appraisal obviously says nothing about what a house will bring after being repossessed a few years later.

Nevertheless, in recent years, a purchase price of \$X, supported by an appraisal of \$X, was used to justify lending 95% of \$X – or maybe 100% or 105% – when a home was bought or refinanced. No wonder homes valued in the biggest boom in history have turned out to be unreliable collateral.

Second, these overrated mortgages were packaged into the most alchemical and fantastic leveraged structures. It is these, not mortgages themselves, that have jeopardized our institutions. There was a limited market for whole mortgage loans; they were considered a specialist market entailing risk and requiring expertise. But supposedly those worries would be obviated if one bought the debt of structured entities that invested in residential mortgage-backed securities (RMBS).

First question: where did the risk go? We were told it disappeared thanks to the magic of structuring, tranching and diversifying, permitting vast amounts of leverage to be applied safely. Second question: how reliable was the diversification? Answer: again we were told, highly reliable; there had never been a national decline in home prices, so mortgages could be considered uncorrelated with each other. The performance of a mortgage on a house in Detroit would be unaffected by what went on in Florida or California. (Well, so much for what we were told.)

The institutions' writedowns generally are in collateralized debt obligations (CDOs), debt issued by special-purpose entities that borrowed huge amounts relative to their equity in order to purchase mortgage-related securities. As described earlier, underestimated risk

led to the use of unwise amounts of leverage. But interestingly, the key losses aren't in the riskier junior tranches of CDO debt, about which there was some leering. Rather, they're in the triple-A-rated tranches. It's to buy those tranches that our leading institutions took on too much leverage. **Once again, greatly underestimated risk led to great leverage and thus great losses.**

What did you need to steer clear of CDO debt? Computers, sophisticated programs and exceptional analysis? Genius? No: skepticism and common sense. In RMBS, CDOs and CDO-squareds (entities that borrowed to buy CDO debt), **90% or so of their capital structure was rated higher than the underlying collateral, all based on the linchpin assumption that mortgages were uncorrelated. That's all you had to know.**

How good a piece of collateral is a subprime mortgage covering 100% of the purchase price of a house bought in a soaring market by an applicant who'll pay a higher interest rate to be able to skip documenting income or employment? That's not a secured loan; it's an option on future appreciation. If the house goes up in price, the buyer makes the mortgage payments and continues to own it. If it goes down, the buyer walks away, in which case the lender gains ownership of a house worth less than the amount loaned against it. Thus the viability of the mortgages was entirely dependent on continued home price appreciation.

Given the above, what was the credit quality of subprime mortgages? I'd say double-B at best. (I'd much rather buy even the single-B "junk bonds" of profitable companies that we've held over the last 30 years than this inflated "home option" paper.) And yet, in a typical CDO, 80% of the debt was rated triple-A and 97% was rated investment grade (triple-B or better). Those high ratings made CDO debt very attractive to financial institutions that were able to borrow cheaply to buy high-rated assets, satisfying the strict rules regarding the "quality" of their portfolio holdings.

Financial engineers and investment bankers took unreliable collateral and packaged it into highly leveraged structures supporting debt that was rated high enough to attract financial institutions. What a superb example of the imprudent use of leverage. And what a simple explanation of how our highly leveraged institutions got into trouble.

How Bad is Bad?

One of the prime lessons that must be learned from this experience is that in determining how much leverage to put on, you'd better make generous assumptions about how risky your assets might turn out to be.

The example in the paragraph on page one demonstrates the role of risk in the equation. The more your assets are prone to permanent loss, the less leverage you should employ. But it's also important to recognize the role of volatility. Even if losses aren't permanent, a downward fluctuation can bring risk of ruin if a portfolio is highly leveraged and (a) the

lenders can cut off credit, (b) investors can be frightened into withdrawing their equity, or (c) the violation of regulatory or contractual standards can trigger forced selling.

The problem is that extreme volatility and loss surface only infrequently. And as time passes without that happening, it appears more and more likely that it'll never happen – that assumptions regarding risk were too conservative. Thus it becomes tempting to relax rules and increase leverage. And often this is done just before the risk finally rears its head. As Nassim Nicholas Taleb wrote in *Fooled by Randomness*:

Reality is far more vicious than Russian roulette. First, it delivers the fatal bullet rather infrequently, like a revolver that would have hundreds, even thousands of chambers instead of six. After a few dozen tries, one forgets about the existence of a bullet, under a numbing false sense of security . . . Second, unlike a well-defined precise game like Russian roulette, where the risks are visible to anyone capable of multiplying and dividing by six, one does not observe the barrel of reality. . . . **One is thus capable of unwittingly playing Russian roulette – and calling it by some alternative “low risk” name.** (p. 28; emphasis added)

The financial institutions played a high-risk game thinking it was a low-risk game, all because their assumptions on losses and volatility were too low. We'd be watching an entirely different picture if only they'd said, “This stuff is potentially risky. Since home prices have gone up so much and mortgages have been available so easily, there just might be widespread declines in home prices this time. So we're only going to lever up half as much as past performance might suggest.”

It's easy to say they should have made more conservative assumptions. But how conservative? **You can't run a business on the basis of worst-case assumptions. You wouldn't be able to do anything.** And anyway, a “worst-case assumption” is really a misnomer; there's no such thing, short of a total loss. Now we know the quants shouldn't have assumed there couldn't be a nationwide decline in home prices. But once you grant that such a decline can happen – for the first time – what extent should you prepare for? Two percent? Ten? Fifty?

One of my favorite adages concerns the six-foot-tall man who drowned crossing the stream that was five feet deep on average. It's not enough to survive in the investment world on average; you have to survive every moment. The unusual turbulence of the last two years – and especially the last three months – made it possible for that six-foot-tall man to drown in a stream that was two feet deep on average. **Should the possibility of today's events have been anticipated? It's hard to say it should have been. And yet, it's incumbent upon investors to prepare for adversity. The juxtaposition of these sentences introduces an interesting conundrum.**

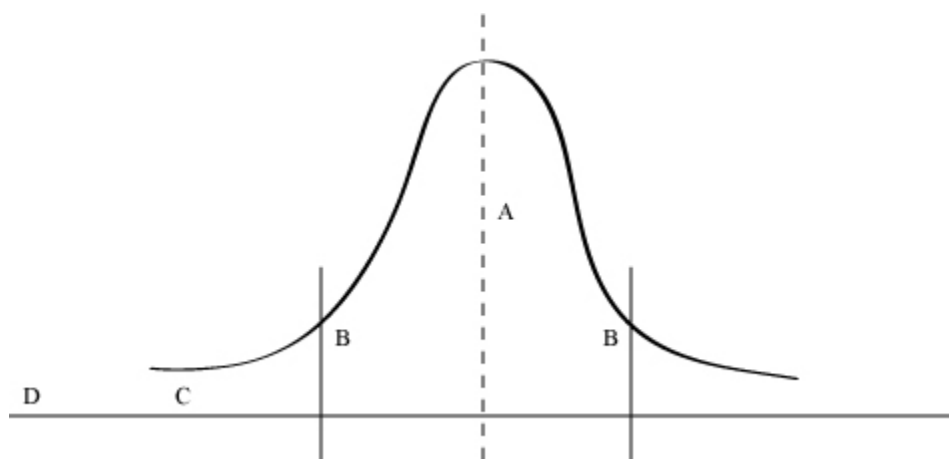
Consider these tales from the front lines:

- There had never been a national decline in home prices, but now the Case-Shiller index is down 26% from its peak in July 2006, according to the *Financial Times* of November 29.
- In my twenty-nine previous years with high yield bonds, including four when more than 10% of all outstanding bonds defaulted, the index's worst yearly decline was 7%. But in 2008, it's down 30% (even though the last-twelve-months' default rate is only about 3%).
- Performing bank loans never traded much below par in the past, and holders received very substantial recoveries on any that defaulted. Now, even though there have been few defaults, the price of the average loan is in the 60s.

The headlines are full of entities that have seen massive losses, and perhaps meltdowns, because they bought assets using leverage. Going back to the diagrams on pages 4-5, these investors put on leverage that might have been appropriate with moderate-volatility assets and ran into the greatest volatility ever seen. **It's easy to say they made a mistake. But is it reasonable to expect them to have girded for unique events?**

If every portfolio was required to be able to withstand declines on the scale we've witnessed this year, it's possible no leverage would ever be used. Is that a reasonable reaction? (In fact, it's possible that no one would ever invest in these asset classes, even on an unlevered basis.)

In all aspects of our lives, we base our decisions on what we think probably will happen. And, in turn, we base that to a great extent on what usually happened in the past. We expect results to be close to the norm (A) most of the time, but we know it's not unusual to see outcomes that are better or worse (B). Although we should bear in mind that, once in a while, a result will be outside the usual range (C), we tend to forget about the potential for outliers. And importantly, as illustrated by recent events, we rarely consider outcomes that have happened only once a century . . . or never (D).



Even if we realize that unusual, unlikely things can happen, in order to act we make reasoned decisions and knowingly accept that risk when well paid to do so. Once in a while, a “black swan” will materialize. But if in the future we always said, “We can’t do such-and-such, because we could see a repeat of 2007-08,” we’d be frozen in inaction.

So in most things, you can’t prepare for the worst case. It should suffice to be prepared for once-in-a-generation events. But a generation isn’t forever, and there will be times when that standard is exceeded. What do you do about that? **I’ve mused in the past about how much one should devote to preparing for the unlikely disaster. Among other things, the events of 2007-08 prove there’s no easy answer.**

Are You Tall Enough to Use Leverage?

Clearly it’s difficult to always use the right amount of leverage, because it’s difficult to be sure you’re allowing sufficiently for risk. Leverage should only be used on the basis of demonstrably cautious assumptions. And it should be noted that **if you’re doing something novel, unproven, risky, volatile or potentially life-threatening, you shouldn’t seek to maximize returns. Instead, err on the side of caution. The key to survival lies in what Warren Buffett constantly harps on: margin of safety.** Using 100% of the leverage one’s assets might justify is often incompatible with assuring survival when adverse outcomes materialize.

Leverage is neither good nor bad in and of itself. In the right amount, applied to the right assets, it’s good. When used to excess given the underlying assets, it’s bad. It doesn’t add value; it merely magnifies both good and bad outcomes. So leverage shouldn’t be treated as a silver bullet or magic solution. It’s a tool that can be used wisely or unwisely.

Our attitude at Oaktree is that it can be wise to use leverage to take advantage of high offered returns and excessive risk premiums, but it’s unwise to use it to try to turn low offered returns into high ones, as was done often in 2003-07.

Once leverage is combined with risky or volatile assets, it can lead to unbearable losses. Thus leverage should be used in prudent amounts, to finance the right assets, and with a great deal of respect. And it’s better used in the trough of the cycle than after a long run of appreciation. **Bottom line: handle with care.**

* * *

I never want to give the impression that doing the things I discuss is easy, or that Oaktree always gets it right. This memo calls on investors to gauge risk and use only appropriate leverage. At Oaktree we assess fundamental riskiness and look to history for how markets might behave, and we heavily emphasize trying to build in sufficient room for

error. But history isn't a perfect guide. While we've made no use of leverage in the vast majority of our investment activities, three of our evergreen funds did borrow to buy bank loans: the senior-most debt of companies, which in the past always has traded around par. Another used it to buy low-priced Japanese small-cap stocks. The companies generally are doing fine, but the prices of their loans and equities have collapsed under current market conditions, causing the funds to suffer. **This shows how tough it is to prepare for all eventualities . . . in other words, to know in advance how bad is bad.** So I apologize if I ever come across as holier-than-thou. We've tried to use leverage only when it's wise, but no one's perfect. Certainly not us.

* * *

The financial markets have delivered a lifetime of lessons in just the last five years. Some of the most important ones center around the use and abuse of leverage.

- **Leverage doesn't add value or make an investment better.** Like everything else in the investment world other than pure skill, leverage is a two-edged sword – in fact, probably the ultimate two-edged sword. It helps when you're right and hurts when you're wrong.
- **The riskier the underlying assets, the less leverage should be used to buy them.** Conservative assumptions on this subject will keep you from maximizing gains but possibly save your financial life in bad times.
- A levered entity can be caught up in a downward spiral of asset price declines, market-value tests, margin calls and forced selling. Thus, in addition to thinking about the right amount of leverage, it's important to note that there are two different kinds: permanent leverage, with its magnifying effect, and leverage which can be withdrawn, which can introduce collateral tests and the risk of ruin. Both should be considered independently. **Leverage achieved with secure capital isn't nearly as risky as situations where you are subject to margin calls or can't bar the door against capital withdrawals.**

Leverage was too easily accessed as recently as two years ago, and now it's virtually unavailable. And just as its use was often unwise a few years ago, this might be just the right time to employ some if you can get it . . . and if you can arrange things so you won't drown if the streambed dips ahead.

December 17, 2008

Memo to: Oaktree Clients

From: Howard Marks

Re: All That Glitters

In 1952, Noah S. “Soggy” Sweat, Jr., a member of the Mississippi House of Representatives, was asked about his position on whiskey. Here’s how he answered:

If you mean whiskey, the devil’s brew, the poison scourge, the bloody monster that defiles innocence, dethrones reason, destroys the home, creates misery and poverty, yea, literally takes the bread from the mouths of little children; if you mean that evil drink that topples Christian men and women from the pinnacles of righteous and gracious living into the bottomless pit of degradation, shame, despair, helplessness, and hopelessness, then, my friend, I am opposed to it with every fiber of my being.

However, if by whiskey you mean the oil of conversation, the philosophic wine, the elixir of life, the ale that is consumed when good fellows get together, that puts a song in their hearts and the warm glow of contentment in their eyes; if you mean Christmas cheer, the stimulating sip that puts a little spring in the step of an elderly gentleman on a frosty morning; if you mean that drink that enables man to magnify his joy, and to forget life’s great tragedies and heartbreaks and sorrow; if you mean that drink the sale of which pours into our treasuries untold millions of dollars each year, that provides tender care for our little crippled children, our blind, our deaf, our dumb, our pitifully aged and infirm, to build the finest highways, hospitals, universities, and community colleges in this nation, then my friend, I am absolutely, unequivocally in favor of it.

This is my position, and as always, I refuse to compromise on matters of principle.

Sweat’s response shows, depending on how you look at it, either how views can diverge on a given subject or how differently a tale can be spun. Thus it serves well to introduce the topic of this memo: gold.

Before the global financial crisis, most participants in the world of finance felt they understood how things worked, and that in addition to the underlying processes, they could rely on institutions and currencies.

Then the crisis occurred and a lot changed. Things happened during the crisis that were described as “five-standard-deviation occurrences” (or three or eight). In other words,

things happened that had never happened before and had been considered capable of happening only once in several generations or centuries. But they happened, and sometimes a few in a single week.

These were negative “black swan” developments, and they had a number of ramifications. First, they imposed substantial losses. Second, they called into question the predictability and understandability of the financial world and introduced new levels of uncertainty. And third, they set off a search for things that would provide certainty and safety in the newly uncertain world. This search led many to look to gold.

On the Merits of Gold

I have no doubt: gold is the ideal investment. It serves as a reliable store of value, especially in challenging and uncertain times. It’s a hedge against inflation, since its price rises in sympathy with the general level of prices. It exists without the involvement of man-made constructs such as governments. And it’s desired and accepted all around the world (and always has been).

The supply of gold is finite. It can’t be created out of thin air. Thus it’s not subject to dilution or debasement, as is paper currency when governments decide to print more. In comparison, currency can be similarly reliable only if backed by gold.

Finally, gold is tangible, meaning you can take delivery and store it. Most other investment media exist only in the form of figures on a computer screen. But gold is something you can actually hold and know you own. Thus it’s one of the few things you can depend on in an uncertain world. Gold is perfect.

Except, of course, gold is nothing but a shiny metal. Since its real-world applications are limited to jewelry and electronics, very little of its value comes from actual usefulness. Further, the amount put to those uses each year is small compared to the total amount in existence, so its value for those purposes is at the margin and can’t be of much help in putting a price on the world’s gold reserves.

There’s little intrinsic to gold that enables it to serve as a store of value and a hedge against inflation. Gold serves those purposes only because people impute to it the ability to do so. It’s self-deception, nothing but the object of mass hysteria like that exhibited in “The Emperor’s New Clothes.” **Gold has no financial value other than that which people accord it, and thus it should have no role in a serious investment program. Of this I’m certain.**

A Never-Ending Argument

The foregoing aren’t my views, of course. Rather, they’re my effort to summarize the prevailing – and obviously polar – points of view regarding gold. I think gold engenders

attitudes that are the furthest apart of those regarding any potential investment. The “gold bugs” think it’s ideal and dependable, and the naysayers think it’s unanalyzable and anachronistic.

Due to the trauma and uncertainty introduced by the financial crisis, the subject of gold has attracted increased attention and the debate has heated up. It has doubled in price over roughly the last two years. And I’ve been asked about gold more in those two years than in all the rest put together.

I didn’t think about gold very much during my first 39 years in the money management business. First I was an equity guy, and then I became a bond guy. I never had a client who held gold (as far as I knew) and no one asked for my views on it. In a world in which people thought they knew how things worked and everything went smoothly most of the time, gold was considered largely irrelevant.

For the last few years, I’ve advised a Swiss charitable foundation that, as is customary in its home country, holds substantial amounts of precious metals. Thus I’ve had to think about gold – which I never had to do before – and come to a conclusion.

My view is simple and starts with the observation that gold is a lot like religion. No one can prove that God exists . . . or that God doesn’t exist. The believer can’t convince the atheist, and the atheist can’t convince the believer. It’s incredibly simple: either you believe in God or you don’t. **Well, that’s exactly the way I think it is with gold. Either you’re a believer or you’re not.**

My View

In the past, the only thing I considered certain about gold was that I didn’t have to consider it. But in the last few years, I did think (and write) on a subject very germane to gold: the valuation of non-income-producing assets.

Show me a company, security or property that produces a stream of cash, and I think I can value it reasonably accurately. P/E ratios, yields and capitalization rates give us a framework for valuing these things, and by comparing them to prevailing interest rates, to historic valuation parameters and to each other, we can assess whether an asset is dear or cheap.

But there’s no analytical way, in my opinion, to value an asset that doesn’t produce cash flow . . . and especially one that doesn’t at least have the prospect of doing so. (What I mean by the latter is that it’s more challenging to value an empty building than a rented one; or an empty lot compared to one with an office building on it; or a young company relative to an established, profitable one. But at least you can attempt to value the former asset in each case on the basis of its potential to produce cash flow.) How do you put a value on an asset that will never throw off cash?

Take oil, for example. As I wrote in “There They Go Again” (May 6, 2005), you can say the supply of oil is finite; that we’re using it up faster than we’re finding it; and that much of it is in the hands of nations we can’t depend on. But what does that make it worth? You could have said those things in December 2008, when oil was \$35 a barrel, and if you’d bought you’d be up 150% today. But they were equally true in July 2007, when oil was at \$147, and if you bought you would have lost three-quarters of your money in six months. Qualitative statements like those simply cannot be converted into a price.

And how do you value a home? The appraisals that were relied on by mortgage lenders in 2002-07 obviously did more harm than good. All the appraisers did is compare each home to the last similar one that sold, and their work-product literally turned out not to be worth the paper it was printed on. You might value a home based on what it could be rented for, but today’s vacancies show that you can find tenants for some houses but not all of them. No, the value of a home at a given point in time ultimately is just what a buyer will pay for it.

In fact, that’s true of all non-income-producing assets: they’re only worth what buyers will pay for them. You might say that about income-producing assets as well, given how their prices fluctuate, but that’s completely true only in the short run and mostly when markets function poorly. If assets produce cash flow, that gives them value, and it’s reasonable to believe that eventually their prices will move in the direction of that value. They aren’t required to do so in any particular time frame, but that expectation provides the most solid basis there is for investing. **Everything else is mere conjecture by comparison, and that goes for gold.**

At What Price?

In “Hemlines” in September, I said investors were pursuing safety – simplistically, as they usually do the flavor of the day – but ignoring the price they were paying for it. I titled that section “At What Price?”

I’m reusing that heading here, because that’s really the key question in investing. We all would prefer to have growth, quality, income and safety in our investments. But how much will we pay for them? **I’ve said it many times: no asset can be considered a good idea (or a bad idea) without reference to its price.** How can we evaluate whether the price of gold is right?

As with oil, you can list gold’s attractions as enumerated on page two. But how do you turn them into a price? And don’t you have to be able to turn them into a price in order to invest intelligently? Consider this conversation:

Howard: How do you feel about gold here at \$1,400 an ounce?

Gold bug: Great. I’m sure it will hold its value from here and keep up with inflation.

Howard: Would you be equally sure if it were \$2,000?

Gold bug: A little less, but yes.

Howard: At \$5,000?

Gold bug: That's a tough one.

Howard: And at \$10,000?

Gold bug: No; there it would be ahead of itself.

Howard: So the price of gold matters?

Gold bug: Sure.

Howard: Then how can you be sure it's fairly priced at \$1,400?

Gold bug: Hmm

The point is, in investing, price has to matter. Nothing can be a good buy solely on the basis of its attributes alone, without considering the value they give rise to and the relationship of price to that value. And there's no quantifiable value against which to compare price in the case of gold. There; that's it. Either you agree with those statements or you don't.

The gold bug's usual recourse to the difficulty in pricing gold is to point to a past price for the metal and how little it has appreciated since then. For example, gold hit a high of \$850 in 1980 and has gained only 2% per year since then. The Leuthold Group is often quoted (e.g., *Reuters*, November 29) as observing that it would have to be at \$2,400 today to merely equal the 1980 price in inflation-adjusted terms.

But those making a claim for gold's cheapness on the basis of comparisons against historic prices typically point to hand-selected observations, as in Leuthold's case. What about the fact that gold was \$250 in mid-1999 (*Financial Times*, November 13), meaning it's been up 16% a year for the last decade-plus? And even if the snail-like appreciation from \$850 in 1980 seems persuasive, how do we know gold was priced reasonably in 1980, and thus that the fact that it's low relative to 1980 makes it reasonable today? If gold was overpriced in the past, then even having failed to show much appreciation in the interim, it could still be overpriced today.

In Gold We Trust

In the 1970s I came across a book called *Money Is Love* by Richard Condon. I bought it because I had enjoyed *The Manchurian Candidate*, a 1962 movie based on another

Condon book. All I remember about *Money Is Love* is that it was set in a period when people were crazy about collectable plates and amassed them as a store of value. One person had so many that their weight made his apartment collapse into the one beneath it.

In the book, collectable plates had value for the simple reason that people felt they did. That sounds silly. But is gold any different? Are there better reasons for it to have value?

My point here is the one I've held longest on this topic: that gold works as a store of value solely because people agree it will. For years I've felt that there's nothing special about gold that makes it right for this role. It just happens to be the metal people began to lust after a few millennia ago. It could have been iron, but iron is too common and thus not special enough: it doesn't shine, and it rusts. It could have been platinum, but people couldn't find it, or enough of it for it to be popular. Perhaps the fact that gold got the job is just a coincidence.

But what about the other hand? (For thoughtful people, I think there's always another hand.) **Let's say we disrespect gold given that it has value only because people agree it does. What about the U.S. dollar?** Why do we accord the dollar value, or any other paper currency for that matter? It has value because the government says it does, and we go along. Sound familiar?

Forty years ago, you could turn in paper money and get an ounce of gold for each \$35. Then President Nixon ended the convertibility of gold in 1971 and that was no longer possible. Now there's nothing behind the dollar but people's belief in it.

As an aside, when I was working on Wall Street for the first time in the summer of 1967, the government announced that it was going to terminate the convertibility of banknotes labeled "silver certificates." So I found a dozen or so in my wallet and took them to the Federal Assay Office on a nearby street called Old Slip. The clerk counted them, put the equivalent weights on one side of a huge balance scale, poured granulated silver onto the other side from a bag, and handed the silver to me in an envelope. I'm very glad that I still have it today, plus a few silver certificates that I didn't convert . . . plus the rest of my memories of those early days.

Wikipedia defines "fiat currency" as "state-issued money which is neither legally convertible to any other thing, nor fixed in value in terms of any objective standard." Today the non-convertible dollar (like most other currencies) is a fiat currency. Wikipedia goes on to say fiat currencies "lack intrinsic value."

So if I complain that gold lacks intrinsic value, perhaps my wariness should also make me question dollars (and euros, pound sterling and yen). If gold has the limitations I describe in this regard, what can we say about currencies? (Bruce Karsh goes on to raise a further conundrum: we may prefer income-producing assets, with their intrinsic value, to fiat currency. But the income they produce is reckoned in currency, and thus their value is as well. So, is the value of those assets any more "real"

than currency? What does have real value? Maybe just things with actual usefulness and not just monetary value, like farms. It certainly does get complicated.)

We can talk about the fact that gold's value isn't intrinsic or quantifiable. But the question really comes down to whether people's faith in gold will increase or erode. Relevant here is a profound observation regarding markets from John Maynard Keynes.

In Keynes's time, a London newspaper ran photos of a large number of young women, with a prize going to the reader whose list of the five prettiest most closely paralleled the votes of all readers. The winning strategy wouldn't be to try to pick the prettiest contestants, but rather the ones most voters will say are the prettiest. In other words, one's contest submission shouldn't be based on intrinsic merit, but on guesses regarding the other participants' views of intrinsic merit. The same is true for investments, including gold. Thus it's not whether gold has value, but whether people will impute value to it.

But it goes further. Especially in the short run, the superior investor may not be the one who's right about the merit of something, or even the one who's right about the consensus view of merit. Rather, the superior investor may be the one who's right about the judgments other people will make about the consensus view of merit.

It is not a case of choosing those [faces] that, to the best of one's judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees. (*General Theory of Employment Interest and Money*, 1936).

Will people continue to impute value to gold? Or will they bet that others will continue to impute value to gold? Those are the key questions. It's hard to predict change in these things, but it's the change that makes and eliminates fortunes.

Gold in Times of Uncertainty

In the last six weeks, in addition to North America, I have visited with clients and contacts in Europe, Asia, Australia and South America. **Perhaps the greatest common thread I detected was a sense that the world is more uncertain, and the range of possible outcomes wider, than ever before.** People who before the crisis felt they understood how economies and governments work – and thus what could be expected in the future – now feel very differently.

Today we're faced with uncertainty regarding a vast list of issues including:

- the outlook for economic growth,

- the ramifications of high debt levels and the necessary austerity measures,
- the economic future of the developed world,
- the impact of China and other emerging nations,
- the likelihood of deflation versus hyperinflation, and
- the soundness of currencies and sovereign debt.

Thus it shouldn't come as a surprise that people are groping for something they can depend on. **Since gold acts as a barometer of expectations regarding inflation and concern about economies and currencies, its popularity has risen as sentiment regarding these things has declined.**

Being away from home tends to alter one's perspective. While traveling, I was shocked to hear someone (okay, a gold producer possibly "talking his book") describe the U.S. as having a corrupt political system in the grip of special interests and being committed to the debasement of the dollar. While I know the stimulative actions being undertaken may well cause the dollar to weaken, I like to think the part about corruption isn't true.

But I have to admit that I'm not all that happy with what's going on in the U.S., and especially in Washington, D.C. (see "What Worries Me," August 2008 and "I'd Rather Be Wrong," March 2010). While other nations are enacting austerity measures to trim their deficits and debt, I don't see much coming from Washington. So if not corrupt, then perhaps just weak-kneed.

- The recent compromise tax "solution" is a good example (merits of the provisions aside): "I'll agree to continue the tax cuts and reduce estate tax rates for the wealthy (exacerbating the deficit) if you'll vote to extend unemployment benefits, cut payroll taxes and increase tax credits (exacerbating the deficit)." There's something for everyone in this bill, with its estimated cost of \$858 billion over ten years. The only element missing from both sides' agendas is fiscal discipline.
- And what about the vote on the proposals from the President's commission on the deficit? While the appointed members of the commission generally backed them, they failed to get the needed supermajority because six of the ten elected officials who care about reelection voted no. These are tough issues, and by definition every possible solution will raise taxes or reduce government services. The fact is that most elected legislators seem unable to take any actions that might cost them votes.

Questions about the dollar are being raised worldwide. Thus an interesting result of being abroad is that **what looks like an increase in the dollar price of gold becomes easier to view as a decrease in the amount of gold a dollar will buy. So perhaps we should think about the dollar's weakness rather than gold's strength.** Here's a post from a Reuters blogger:

If you look at the price of gold in a currency other than U.S. dollars, for instance Australian dollars, it hasn't gone up at all over the last few years. Gold isn't booming at the moment. The U.S. dollar is crashing. You

think [gold is] worth a lot of U.S. dollars now? Just wait until QE4 or QE5.

This may or may not be from a qualified observer, but it's indicative of current sentiment. It's interesting in this connection that *The Wall Street Journal* reported as follows on December 3:

Data cited Thursday by China's state-run Xinhua news agency showed that China imported 209.7 metric tons of gold in the first 10 months of the year, a fivefold increase compared with the same period last year.

That surpassed purchases made by ETFs and surprised analysts, who until now had no clear insight into the size of China's buying. . . .

"Everybody in the gold market knew there was a surge in investment demand, but they didn't know it was China," said Jeff Christian, managing director at CPM Group. . . .

[This news] comes as the government loosens its restrictions on gold purchases by financial institutions and individual investors.

Money has to go someplace, and in these uncertain times, gold seems to be a destination of choice. Further, some of the objections to gold have eased:

- It used to be difficult and costly to transact in, especially in small amounts. But the creation of easily tradable ETFs has eased that concern.
- In the past, people would complain about the fact that gold doesn't throw off current income. But with interest rates ultra-low thanks to central banks, not much else does, either.

Removing impediments like these has the effect of increasing demand relative to supply. The short-run impact on price is clear.

The Usefulness of Gold as a Reserve Currency

In many ways, the rise in the popularity of gold may be largely the result of a process of elimination. Here's a helpful analysis from "Gold's Allure Grows Amid Instability," by James Saft writing in the *International Herald Tribune* (November 10):

Real assets are the place to be when the solvency of the banking system is threatened and the authorities refuse to deal directly with it.

With trillions in bank collateral that is worth less than its stated value on paper and with a U.S. economy mired in a balance sheet recession, the temptation to take care of these issues by creating more backed-by-nothing

money is too great. This is exactly what the Federal Reserve is doing in its latest \$600 billion round of quantitative easing.

This in turn is an invitation to the rest of the world to print money right back. There is no brake on this system other than the ability of nations to cooperate, and right now cooperation is not in everyone's individual interest. . . .

You could argue that where we are now was a likely outcome of the current system. A global reserve currency in a fiat system creates tremendous incentives to take on too much debt.

In other words, **when (a) your income is inadequate to cover your spending, (b) you can borrow from abroad to cover the shortfall, (c) you can print the world's reserve currency with which to repay debt and (d) that currency isn't required to be backed by something tangible such as gold, printing money seems like the easy way out.** But as the world is learning about many things, that won't work without limitation.

The *Financial Times* reported as follows on November 13:

Some policymakers think it is dangerous to rely on a single reserve currency, the dollar, from an economy that needs to borrow heavily from abroad. Amid Friday's failure of the Group of 20 industrial and emerging nations to reach any meaningful accord on global imbalances, France has promised as part of its G20 presidency next year to start a debate about the world's future monetary arrangements.

The world needs a reserve currency (or more than one). What candidates are there? The U.S. dollar, euro, sterling, yen, renminbi and gold.

The dollar has problems these days, and the world's opinion of it as a reserve currency is on the decline. If it hasn't fallen much in recent years relative to the euro and sterling – and in fact it's up strongly since late 2007 – that's mainly because the other two have bigger problems. Only the yen has strengthened relative to the dollar, due to belief in Japan's conservatism and solidity (although its massive national debt suggests otherwise).

Here's how World Bank president Robert Zoellick put it a month ago in arguing for a limited role for gold in the world monetary system:

Gold has become a reference point because holders of money see weak or uncertain growth prospects in all currencies other than the renminbi, and the renminbi is not free for exchange.

That leads by default to gold. It's unlikely to take over from the others, but it may see further increases in demand, especially if nations conclude that the gold component of

their reserves is too small relative to currency holdings. On the other hand, the role for gold appears likely to be limited because the small amount of gold that trades – and the swings in sentiment (and thus supply and demand) – render it awfully volatile for a serious component of the world monetary system. Further, the finiteness of the gold supply would limit potential economic growth in a gold-backed monetary system.

Most things in the international arena seem to argue against the dollar, and that can be viewed as implicitly arguing for an increased role for gold relative to the dollar. **But remember that because it can't be assessed quantitatively, no one can say definitively that the current price for gold doesn't already recognize and reflect all of the dollar's problems (and all of gold's merits).**

The Bottom Line

It was about two years ago that I first noted the similarity between gold and religion. Before that, I had always been a non-believer in gold (not strongly anti, just indifferent). But I concluded at the time – just as any wary agnostic might about God – that whereas I didn't believe in gold, I couldn't be 100% certain that was the right position. (It's like someone who considers himself non-superstitious but still favors lucky numbers and daily rituals “just in case.”) So I stopped arguing against gold with any vehemence.

More importantly, I also concluded that since gold has “worked” for hundreds of years, it probably will keep on doing so. It might not do so forever, but what's the probability this will be the year it stops? So I wouldn't bet against it, and I might recommend a position “just in case.” Not because I view gold affirmatively as a moneymaker, but rather as a useful contributor to safety through diversification. Surely the uncertain world situation seems to call for all the protection against the unknown that we can amass.

Still, the other hand brings me back to price. Yes, gold is probably more likely to continue serving as a store of value than to quit. And yes, maybe one should have a position. But is this the right price at which to start . . . ?

December 17, 2010

Memo to: Oaktree Clients

From: Howard Marks

Re: Déjà Vu All Over Again

What good is history? After all, it's in the past.

The truth is, history can be one of our greatest aids . . . in investing as in life. Here in the fifth decade of my investment career, I feel a lot of my ability to add value comes from the amount of history I've witnessed and the significance I've extracted from it.

Regular readers know I often include time-tested quotations in my memos. Why wouldn't I? They've endured precisely because they're so relevant and so well put. Why try to reinvent the wheel, rewriting them, only to come up short? On this subject, several stand out. I've used them all before, some more than once:

Those who cannot remember the past are condemned to repeat it. (George Santayana)

The farther back you can look, the farther forward you are likely to see. (Winston Churchill)

History doesn't repeat itself, but it does rhyme. (Mark Twain)

Contributing to . . . euphoria are two further factors little noted in our time or in past times. The first is the extreme brevity of the financial memory. In consequence, financial disaster is quickly forgotten. In further consequence, when the same or closely similar circumstances occur again . . . they are hailed by a new, often youthful, and always supremely self-confident generation as a brilliantly innovative discovery There can be few fields of human endeavor in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have insight to appreciate the incredible wonders of the present. (John Kenneth Galbraith)

One of the greatest differences between humans and animals is supposed to lie in the fact that we can learn other than through direct experience. We don't have to sit on a hot stove to learn not to do it. We can learn from history and from lessons passed on by our predecessors – things they experienced or learned from others in turn – so that we needn't experience them ourselves. But to enjoy this benefit, we must pay heed to the people and events that preceded us.

As Twain said, the events of history don't repeat exactly. It's rarely the very same thing over and over. In investing, for example, the duration and amplitude of fluctuations are rarely the same from cycle to cycle. (It drives me crazy when people say, "high yield bonds tend to default around the second anniversary of their issuance." That happened to be the average for one particular period, but there's no reason for it to be true, and thus no reason it should be a useful rule going forward.)

But as Twain also said, there are themes that rhyme. It's what I would call "tendencies" or "behavioral patterns" that present the important lessons. The tendency of investors to overlook or forget the past is noteworthy. So is their habit of succumbing to emotion and swallowing tall (but potentially lucrative) tales. In particular, people tend to forget the cyclical nature of things, extrapolate past trends to excess, and ignore the likelihood of regression to the mean.

The tech bubble may not recur anytime soon. No online grocer may ever again sell at 200 times revenues. There may never be another CDO-squared or SIV. Those aren't the things that matter. **But there's sure to be another cycle, another bubble and another crisis. There'll be another time when people overpay for exciting investment ideas because their future appears limitless, and then a time of disillusionment and price collapse. There'll be another period when leverage is embraced to excess, and then, consequently, a period when it gets people killed. And there'll certainly be another time when people can only imagine the possibility of gain, and then one when – after huge sums have been lost – they can think only of further declines.**

These are the kinds of things that rhyme. If we stay alert, we can anticipate and recognize them and thus avoid the losses and opportunity costs they bring so reliably.

The Death of Equities

Sometimes the ideas for my memos come from the gradual accretion of insights over a long period of time, and sometimes they come from a single inspiration. This time it's the latter.

Lying in bed sleepless on Sunday the 11th, while on a business trip to South America, I dug into my Oaktree bag for something to read. I came across a reprint of "The Death of Equities" from *BusinessWeek* magazine of August 13, 1979. I'd spoken about it over lunch with Josh Kuntz of Rivulet Capital, and he was good enough to send it to me at my request. As I read it thoroughly for the first time in 33 years, my wife Nancy's battle cry rang out: "This calls for a memo."

This was a seminal article, signaling a tectonic shift in investing. Here was its thrust:

- Seven million shareholders have defected from the stock market since 1970.
- The Labor Department has interpreted ERISA as giving institutions that invest pension money the ability to go beyond listed stocks and high grade bonds and into "shares of small companies, real estate, commodity futures and into gold and diamonds." Thus they were "pouring money into . . . mortgage-backed paper, foreign securities, venture capital, leases, guaranteed insurance contracts, indexed bonds, stock options, and futures."
- "Whereas stocks once made up 80% of mutual fund assets, today that figure has slumped to less than 50%."
- "Few corporations can find buyers for their stocks."
- All of these things were the result of thirteen years of rapid inflation and ten years of returns on equities averaging less than 3% per year.
- "The Labor Department ruling is just one more in a nearly endless string of unhealthy things that have happened to the stock market over the past decade."
- "This 'death of equity' can no longer be seen as something a stock market rally – however strong – will check."
- "For better or for worse, then, the U.S. economy probably has to regard the death of equities as [a] near-permanent condition – reversible some day, but not soon."

According to *BusinessWeek*, then, it was all over for equities. No one would ever buy them again.

Whatever caused it, the institutionalization of inflation – along with structural changes in communications and psychology – have killed the U.S. equity market for millions of investors.

What a negative article, ostensibly the death knell for an entire market. **What was the shift that it marked? Simply this: the end of a lost decade for equities and the beginning of the greatest bull market in history.**

There's literally a lifetime of memos in that one magazine article, but I'll spend a little less than that dissecting it. I hope you'll find these comments useful.

Yogi Lives

Lawrence "Yogi" Berra was a baseball catcher and an integral part of the New York Yankees' successful dynasty in the middle of the twentieth century. While a great player, he was also the undisputed king of the tortured phrase or malapropism. Here are a few:

- "It ain't over 'til it's over."
- "Ninety percent of the game is half mental."
- "When you come to a fork in the road, take it."
- "Always go to other people's funerals, otherwise they won't go to yours."

In fact, Yogi supplied the title for this memo, saying "It's déjà vu all over again." Rising to his own defense, however, he denied the tendency for which he is so well known, saying, "I really didn't say everything I said."

Do people really say things like these? Or was it just Yogi? Well, the writer of "The Death of Equities" gave him stiff competition:

. . . with ever-escalating real estate prices . . . land is a hedge against loss.

One of the few things I'm sure of is that no price will be "ever-escalating."

Individuals . . . are flocking into money market funds to nail down high rates.

In a money-market fund, the period for which you nail down a rate of interest is measured in just days. In fact, the prime drawback of holding short-term paper is its failure to lock in a yield. One of the biggest mistakes I've witnessed took place when people invested in one-year certificates of deposit in 1981 at 16%, rather than multi-year CDs at rates a little lower.

For investors . . . low stock prices remain a disincentive to buy.

What the writer is saying is that low prices point up how badly stocks have done over the preceding period and thus discourage investors from participating in the market. This is totally illogical, but in the investment world we hear things like it every day:

- “Everyone knows XYZ is underpriced.” If everyone knows it’s underpriced, why haven’t they bought it and forced up its price?
- “Nobody will touch ABC; it’s too risky.” If they know it’s risky – presumably because its price is too high – and are shunning it or selling, why hasn’t its price settled down to a level where it’s safe?

The writer continued:

Indeed, the average stock price is now about 60% of the replacement value of the underlying assets . . .

. . . companies have jumped on low stock prices to set off the biggest takeover binge in history . . .

. . . buying at these prices is cheaper than building.

The writer would look smarter today if he had recognized the implications of the fact that stocks were selling for less than their underlying asset value, and that companies were buying up other companies for that reason. But he didn’t. He also didn’t ask why, if it was smart for companies to buy other companies’ shares, it didn’t make sense for investors to buy those same shares. (Note: it was largely the ability to buy companies cheaper in the stock market than you could build them that gave pioneers of leveraged buyouts such as KKR, Apax and Warburg Pincus the great returns on their purchases in the 1970s.)

It would take a sustained bull market for a couple of years to attract broad-based investor interest and restore confidence.

This one reminds me of my absolute favorite Yogi-ism: “Nobody goes [to that restaurant] anymore. It’s too crowded.” Wait a minute: how can a restaurant be crowded if nobody goes there?

Likewise, in this case, according to the writer, it will take a bull market to attract investor interest and confidence. That sounds reasonable. But isn’t investor interest and confidence a prerequisite for a bull market? Without it, how can a bull market get started?

The answer is that when prices are low enough, stocks can begin to rise without help from a full-fledged bull market, just as when they’re high enough, stock prices can collapse under their own weight.

The bottom line here is simple, and I’m thoroughly convinced of it: **Common sense isn’t common. The crowd is invariably wrong at the extremes. In the investing world, everything that’s intuitively obvious is questionable and everything that’s important is counter-intuitive. And investors prove repeatedly that they can be less logical than Yogi.**

The Penalty of Youth

Let’s think back to Galbraith’s statement that “Past experience . . . is dismissed as the primitive refuge of those who do not have insight to appreciate the incredible wonders of the present.” In other words, when a hot new investment fad gets rolling and an idea is elevated to bubble status,

those with memory of the past – who might point out that the merits are overstated and the price is too high – are dismissed as “too old to get it.”

The Money Game, written in 1968 by George Goodman under the pseudonym Adam Smith, included among its characters the Great Winfield. Even though he was the dean of the brokerage office, he was able to make money in the hot stocks of the day. When asked how, he said, “My solution to the current market: kids. This is a kids’ market. . . . The strength of my kids is that they are too young to remember anything bad, and they are making so much money they feel invincible.” This exactly parallels Galbraith’s observation.

In other words, veterans are often held back by experience and historic norms, and thus they miss out on the “new thing.” Only those who are free of those strictures can participate fully in the latest miracle . . . as long as it lasts.

“The Death of Equities” leaned heavily on this line of reasoning, but in the opposite direction. You have to be young, it said, not to comprehend the new miracle, but to note the obsolescence of the old standby:

Only the elderly, who have not understood the changes in the nation’s financial markets, or are unable to adjust to them, are sticking with stocks.

Today, the old attitude of buying solid stocks as a cornerstone for one’s life savings and retirement has simply disappeared. Says a young U.S. executive: “Have you been to an American stockholders’ meeting lately? They’re all old fogeys. The stock market is just not where the action’s at.”

And what consistently provides the foundation for this insistence that the game has permanently changed? Four of the most dangerous words in the investment world: it’s different this time.

When investors choose to believe that historic valuation standards have become irrelevant; that one industry or product can maintain superior growth and profitability in perpetuity; or that one asset or market can outperform all the others forever regardless of how high its price goes in the process – that is, that trees can grow to the sky – the bubble is invariably undergirded by a steadfast belief that it’s different this time. Here’s the support *BusinessWeek* advanced:

Says Alan Coleman, dean of Southern Methodist University’s business school, “We have entered a new financial age. The old rules no longer apply.”

When you see or hear words like these, you should go on high alert. Sometimes the world changes and the past becomes irrelevant, but most of the time I’ll take the other side of that bet.

Getting to the Truth

In some ways, understanding the market is like mathematics. You don’t have to be knowledgeable regarding the specifics of the underlying subject matter to know whether a conclusion makes sense. You just have to be able to apply principles, tell logic from illogic, and exclude the deleterious effects of emotion and psychology.

Let's dissect "The Death of Equities" in that vein. What it says is that inflation has eaten into the outlook for the economy and companies, and there's no hope for improvement. Thus people have been throwing in the towel and selling stocks. Other things have come into vogue, attracting the capital that used to be invested in stocks. Mutual fund investors have turned their attention elsewhere. Most corporations can't issue new equity because of the dearth of buyers. Stocks have gone through a decade in which their absolute return was negligible and their real return was negative. They're selling below replacement value, showing how poor psychology is. They face a litany of negatives, without any real possibility of relief; that's the writer's "nearly endless string of unhealthy things that have happened to the stock market over the past decade."

The negative factors are clear to the average investor. And from them he draws negative conclusions. But the person who applies logic and insight, rather than superficial views and emotion, sees something very different.

He sees an asset class that is unloved. He sees stocks that have cheapened for a decade – once dividends have been subtracted from the returns, and especially when prices are viewed relative to earnings. He sees securities that are priced below the value of the underlying assets on which they have a claim. He sees outflows of capital that, rather than being a negative, have lowered prices and can give rise to a strong price rebound when and if they reverse. Most of all, he sees an asset class to which no optimism is being applied.

If I were asked to name just one way to figure out whether something's a bargain or not, it would be through assessing how much optimism is incorporated in its price.

- No matter how good the fundamental outlook is for something, when investors apply too much optimism in pricing it, it won't be a bargain. That was the story of the Internet bubble; the Internet was expected to change the world, and it did, but when the optimism surrounding it proved to have been excessive, stock prices were decimated.
- Conversely, no matter how bad the outlook is for an asset, when little or no optimism is incorporated in its price, it can easily be a bargain capable of providing outsized returns with limited risk.
- Even with a bad "story," the price of an asset is unlikely to decline (other than perhaps in the very short term) unless the story deteriorates further or the optimism abates. And if there's no optimism built into its price, certainly the latter can't happen.

It was primarily this line of reasoning that allowed me to feel positive in the teeth of the financial crisis in late 2008. The outlook was as bad as it could get – total meltdown – and prices clearly incorporated zero optimism. How, then, could buying be a mistake (providing the world didn't end)?

In "The Tide Goes Out" (March 18, 2008), I described the three stages of a bear market. The third stage occurs when everyone becomes convinced that things can only get worse. Invariably this represents a great buying opportunity. And certainly it was such a level of negativity that "The Death of Equities" documented.

So the insightful, unemotional, contrarian investor will read an article like “The Death of Equities” and conclude that things are about as bad as they can get. And if things can’t get worse, they’ll probably get better eventually. It’s no more scientific than that. **If in mid-1979 people thought things could only get worse, there was no optimism to evaporate. That meant the litany of negatives actually foreshadowed something very different: The Rebirth of Equities. And that’s exactly what happened.**

The S&P 500 gained 18.4% in 1979, the year “The Death of Equities” was written, and went on to average 18.9% a year for the next 20 years. There were only two down years during that span: a measly 4.9% in 1982 and 3.1% in 1990. This has to have been the best 21-year period in the modern era. **Importantly, the stage had been set for this rise in 1979 by the accumulation and excessively pessimistic discounting of negatives.**

Way back in February 1993 – it would be yellowed by now, except that electronic copies don’t turn yellow – I wrote a memo entitled “The Value of Predictions, or Where’d All This Rain Come From?” One of the things it discussed was the tendency of forecasters to extrapolate, especially when a trend has gone in one direction for a long time. They tend to conclude it will go that way forever . . . and increasingly so just as it becomes more likely to revert to the mean.

In the memo, I mentioned that California had undergone a five-year drought. And that scientists had concluded from looking at ancient trees that a fifty-year drought couldn’t be ruled out. And that torrential rainstorms had begun just a few months later.

That’s the way it goes. As something goes in one direction for a while, people conclude increasingly that it always will . . . often just when the likelihood grows that it will reverse instead. And that was the greatest shortcoming of “The Death of Equities.” **The extrapolator threw in the towel on stocks, just as the time was right for the contrarian to turn optimistic. And it will always be so.**

Go Around, Come Around

It’s easy with the benefit of hindsight to see that the writer of “The Death of Equities” was too negative at the bottom. But being too negative isn’t the only pitfall. Most people also tend to be too positive at the top.

The bookend to “The Death of Equities” is the work published in the 1990s by Jeremy Siegel, a highly respected professor of finance at the Wharton School and the author of *Stocks for the Long Run*. Through his work, Siegel showed that in almost two centuries, there had never been a 30-year period in which stocks didn’t outperform cash, bonds and inflation, and very few such ten-year periods. Based on the consistency of this record, Siegel labeled stocks very safe (as long as you hold them for the long run). In fact, I heard him tell an audience that risk-averse investors should have 80-odd percent of their net worth in stocks, and risk-tolerant investors should have well over 100%.

Siegel’s research contributed to the fervor for equities that characterized the 1990s. And as stocks did better, the appetite for them rose. The period 1995-99 saw a compound average return of 28.6% on the S&P 500, the greatest five years in history. The ardor this reflected was explosive. Arguments were advanced to the effect that stocks – and tech stocks in particular – could only rise, and that they had to rise faster than anything else.

Again the enemy was extrapolation. The average annual return had risen from about 10% for 1929 to 1980, to 20.4% for 1980 to 1989, and to 28.6% for 1995 to 1999. But investors drew the wrong conclusions, the inverse of those of “The Death of Equities”: they thought the good times could only roll on. However:

- They forgot that in the long run the gains of stocks stem primarily from growth in corporate profits, and that profits don’t grow anywhere near 20-30% a year.
- They ignored the possibility that the ultra-high returns of the 1990s had borrowed from future returns.
- They failed to wonder whether the adoration of stocks had lifted their prices to dangerous heights.
- They asked “What has been the historic return on stocks?” and bought based on the favorable answer. But they didn’t ask “What has been the historic return on stocks after they’re risen almost 19% a year for 21 years?” or “What has been the historic return on stocks if bought at price/earnings ratios in the 30s?” The answer to these latter questions would have been very different.

Extrapolation was at the root of these omissions, disregarding the possibility that events had changed the environment and thus the outlook.

What did I say about the drought and rain? Of course, after stocks had done well enough in the 1990s to encourage maximum bullishness and maximum allocations, their returns were primed for regression to the mean. **And so stocks lagged bonds for the first time in the thirty years ending late last year.**

What’s the lesson here? Not that history always repeats, or that it never repeats. And not that stocks can only do well or only do poorly. But rather that the trends that lead up to a point in time have a profound effect on people’s thinking and on the environment, and thus on the trends that will occur thereafter. That price gains increase danger and price declines increase opportunity. And that most investors and observers tend to be too positive at the top and too negative at the bottom.

These lessons are invaluable. The study of history makes them clear, just as ignorance of history makes them potentially lethal.

One More Round

I’m amazed at how often, just as I’m about to complete a memo, I come across the right coda with which to bring it to an end. This time I found it in *The Wall Street Journal* of March 12, just a day after I’d started writing.

In an article entitled “Why Stocks Are Riskier than You Think,” Zvi Bodie and Rachelle Taqqu go through – in my opinion – another Death of Equities-like recitation. I won’t discuss the article in depth, but I will point out some of its illogicalities:

- It says “despite the assurances of the financial industry, stocks are *always* a risky investment.” This isn’t very helpful. The outlook for stocks is always uncertain, perhaps even risky, but it’s essential to note that they aren’t always equally risky. They’re riskier

when valuations are high and prices embody great optimism, and they're much less risky when the reverse is true (see 1979).

- It says “the longer you hold [stocks], the better your chances of getting blindsided by a downturn.” I find this highly misleading. The longer you do anything, the better the chance that something bad will happen. But that doesn't mean you shouldn't do it, or that it's safer to do it for just a short time. Maybe the participant for a short period will time it just wrong and run straight into a bad patch. And maybe by holding stocks for just a short time he'll miss out on the long-term benefits. The question isn't whether something bad can happen to the long-term investor in equities, but what's likely to happen overall, considering good times as well as bad. And whether, given his particular circumstances, an investor can survive the bad while waiting for the good to arrive.
- In deciding how much risk a prospective retiree can bear, the authors make reference to not wanting to see 2008-style losses of 30% to 40% ever again. But using the worst time in generations to argue against investing in stocks is no better than using the best time to argue for it. What matters isn't the best or worst possible outcome (or even the single most likely outcome). What matters is the range of outcomes and their respective probabilities and consequences. No one observation provides a very useful perspective.
- The strategy the authors spend the most time recommending is what's called a “zero-cost collar” where, for example, you buy an S&P 500 ETF at \$136, buy a put at \$116 (ensuring against losses beyond that) and get the money with which to buy the put by selling a call at \$143 (giving up any gains above that). The good news is that one option pays for the other so the collaring is free, and that your downside is limited to 15%. But the bad news is that to go with your maximum loss of 15%, you have a maximum gain of 6%. I'm not crazy about that tradeoff. The benefits of the strategy seem largely illusory and the posture excessively defensive.

This article isn't without merit. My complaint is that it's simplistic – and the last thing that should be done regarding investing is to make it appear simple. It's also biased to the negative side at a time when stocks appear reasonably situated.

- Stocks have returned almost nothing over the last twelve years.
- For the first time, the 30-year return on stocks has been below the return on bonds.
- The price of the S&P 500 index is still 8% below its 2000 high, while its companies' earnings per share have nearly doubled over the intervening period.
- Thus the p/e ratio on the S&P 500 is in the low double digits, a substantial discount from the post-World War II norm and down from the low 30s at the peak.
- Just as in 1979, institutional investors have lost interest in equities and are looking increasingly to alternatives. The love affair with equities that ran from 1979 to 1999 seems to be over.
- Allocations to equities have been cut substantially in favor of bonds and alternatives. For example, according to *What I Learned This Week* of March 15, “The ICI reports that \$408 billion was redeemed from U.S. equity mutual funds between 2007 and 2011 and \$792 billion was invested in U.S. bond funds in the same period.”

The story isn't as hopeless as it was in 1979, but it is uniformly negative. Thus, while I don't expect an equity rally anything like what followed on the heels of "The Death of Equities," I don't find it hard to conjure up positive scenarios.

* * *

The media usually gets it wrong, and the pieces that get the most attention tend to be highly sensational and to get it the most wrong. This is one of the many reasons why the deck is stacked against the average investor. "The Death of Equities" would have gotten you out or kept you out of the stock market at very attractive levels in 1979. Professor Siegel's work would have gotten you to increase your holdings at high prices in the 1990s. And this new article argues against stocks at a time when valuations are below average, investors have turned against them, and companies are doing well.

The great irony here is that the extrapolator actually thinks he's being respectful of history: he's assuming continuation of a trend that has been underway. But the history that deserves his attention isn't the recent rise or fall of an asset's price, but rather the fact that most things eventually prove to be cyclical and tend to swing back from the extreme toward the mean.

History amply demonstrates the tendency of investors and commentators alike to be pessimistic when the negatives collect, depressing prices, and optimistic when things are going well and prices are soaring. The lessons of history are highly instructive. Applying them isn't easy, but they mustn't be overlooked.

March 19, 2012

Memo to: Oaktree Clients

From: Howard Marks

Re: It's All a Big Mistake

Mistakes are a frequent topic of discussion in our world. It's not unusual to see investors criticized for errors that resulted in poor performance. But rarely do we hear about mistakes as an indispensable component of the investment process. **I'm writing now to point out that mistakes are all that superior investing is about. In short, in order for one side of a transaction to turn out to be a major success, the other side has to have been a big mistake.**

There's an old saying in poker that there's a "fish" (a sucker, or an unskilled player who's likely to lose) in every game, and if you've played for an hour without having figured out who the fish is, then it's you. Likewise, in every investment transaction you're part of, it's likely that someone's making a mistake. The key to success is to not have it be you.

Usually a buyer buys an asset because he thinks it's worth more than the price he's paying. But the seller sells the asset because he thinks the price he's getting exceeds its value. It's pretty safe to say one of them has to be wrong. Strictly speaking, that doesn't have to be true, thanks to differences in things like tax status, timeframe and investors' circumstances. **But in general, win/win transactions are much less common than win/lose transactions. When the dust has settled after most trades, the buyer and seller are unlikely to be equally happy.**

I consider it highly desirable to focus on the topic of investing mistakes. First, it serves as a reminder that the potential for error is ever-present, and thus of the importance of mistake minimization as a key goal. Second, if one side of every transaction is wrong, we have to ponder why we should think it's not us. Third, then, it causes us to consider how to minimize the probability of being the one making the mistake.

Investment Theory on Mistakes

According to the efficient market hypothesis, the efforts of motivated, intelligent, objective and rational investors combine to cause assets to be priced at their intrinsic value. Thus there are no mistakes: no undervalued bargains for superior investors to recognize and buy, and no over-valuations for inferior investors to fall for. **Since all assets are priced fairly, once bought at fair prices they should be expected to produce fair risk-adjusted returns, nothing more and nothing less. That's the source of the hypothesis's best-known dictum: you can't beat the market.**

I've often discussed this definition of market efficiency and its error. The truth is that while all investors are motivated to make money (otherwise, they wouldn't be investing), (a) far from all of them are intelligent and (b) it seems almost none are consistently objective and rational.

Rather, investors swing wildly from optimistic to pessimistic – and from over-confident to terrified – and as a result asset prices can lose all connection with intrinsic value. In addition, investors often fail to unearth all of the relevant information, analyze it systematically, and step forward to adopt unpopular positions. **These are some of the elements that give rise to what are called “inefficiencies,” academics’ highfalutin word for “mistakes.”**

I absolutely believe that markets can be efficient – in the sense of “quick to incorporate information” – but certainly they aren’t sure to incorporate it correctly. Underpricings and overpricings arise all the time. However, the shortcomings described in the paragraph just above render those mispricings hard to profit from. While market prices are often far from “right,” it’s nearly impossible for most investors to detect instances when the consensus has done a faulty job of pricing assets, and to act on those errors. Thus theory is quite right when it says the market can’t be beat . . . certainly by the vast majority of investors.

People should engage in active investing only if they’re convinced that (a) pricing mistakes occur in the market they’re considering and (b) they – or the managers they hire – are capable of identifying those mistakes and taking advantage of them. Unless both of those things are true, any time, effort, transaction costs and management fees expended on active management will be wasted. **Active management has to be seen as the search for mistakes.**

Behavioral Sources of Investment Error

As described above, investment theory asserts that assets sell at fair prices, and thus there’s no such thing as superior risk-adjusted performance. But real-world data tells us that superior performance does exist, albeit far from universally. Some people find it possible to buy things for less than they’re worth, at least on occasion. But doing so requires the cooperation of people who’re willing to sell things for less than they’re worth. What makes them do that? Why do mistakes occur? The new field of behavioral finance is all about looking into error stemming from emotion, psychology and cognitive limitations.

If market prices were set by a “pricing czar” who was (1) tireless, (2) aware of all the facts, (3) proficient at analysis and (4) thoroughly rational and unemotional, assets could always be priced right based on the available information – never too low or too high. In the absence of that czar, if a market were populated by investors fitting that description, it, too, could price assets perfectly.

That’s what the efficient marketers theorize, but it’s just not the case. Very few investors satisfy all four of the requirements listed above. And when they fail, particularly at number four – being rational and unemotional – it seems they all err in the same direction at the same time. That’s the reason for the herd behavior that’s behind bubbles and crashes, the biggest of all investment mistakes.

According to the efficient market hypothesis, people study assets, assess their value and thereby decide whether to buy or sell. Given its current value and the outlook for change in that value, each asset’s current price implies a prospective return and risk level. Market participants engage

in a continuous, instantaneous auction through which market prices are updated. The goal is to set prices such that the relationship between each asset's potential return and risk – that is, its prospective risk-adjusted return – is fair relative to all other assets.

Inefficiencies – mispricings – are instances when one asset offers a higher risk-adjusted return than another. For example, A and B might seem equally risky, but A might appear to offer a higher return than B. In that case, A is too cheap, and people will sell B (lowering its price, raising its potential return and reducing its risk) and buy A (raising its price, lowering its potential return and increasing its risk) until the risk-adjusted returns of the two are in line. That condition is called “equilibrium.”

It's one of the jobs of a functioning market to eliminate opportunities for extraordinary profitability. Thus market participants want to sell overpriced assets and buy underpriced assets. They just don't do so consistently.

Most investment error can be distilled to the failure to buy the things that are cheap (or to buy enough of them) and to sell the things that are dear. Why do people fail in that way? Here are just a few reasons:

- Bias or closed-mindedness – In theory, investors will shift their capital to anything that's cheap, correcting pricing mistakes. But in 1978, most investors wouldn't buy B-rated bonds – at any price – because doing so was considered speculative and imprudent. In 1999, most investors refused to buy value stocks – also at any price – because they were deemed to lack the world-changing potential of technology stocks. Prejudices like these prevent valuation disparities from being closed.
- Capital rigidity – In theory, investors will move capital out of high-priced assets and into cheap ones. But sometimes, investors are condemned to buy in a market even though there are no bargains or to sell even at giveaway prices. In 2000, in venture capital, there was “too much money chasing too few deals.” In 2008, CLOs receiving margin calls had no choice but to sell loans at bankruptcy prices. Rigidities like these create mispricings.
- Psychological excesses – In theory, investors will sell assets when they get too rich in a bubble or buy assets when they get cheap enough in a crash. But in practice, investors aren't all that cold-blooded. They can fail to sell, for example, because of an unwarranted excess of optimism over skepticism, or an excess of greed over fear. Psychological forces like greed, fear, envy and hubris permit mispricings to go uncorrected . . . or become more so.
- Herd behavior – In theory, market participants are willing to buy or sell an asset if its price gets out of line. But sometimes there are more buyers for something than sellers (or vice versa), regardless of price. This occurs because of most investors' inability to diverge from the pack, especially when the behavior of the pack is being rewarded in the short run.

The foregoing goes a long way to support Yogi Berra's observation that "In theory there is no difference between theory and practice. In practice there is."

Theory has no answer for the impact of these forces. **Theory assumes investors are clinical, unemotional and objective, and always willing to substitute a cheap asset for a dear one. In practice, there are numerous reasons why one asset can be priced wrong – in the absolute or relative to others – and stay that way for months or years. Those are mistakes, and superior investment records belong to investors who take advantage of them consistently.**

A Case In Point

Bruce Karsh and his distressed debt team have averaged returns of roughly 23% per year before fees and 18% after fees for more than 23 years without any use of borrowed capital. All eighteen of their funds have been profitable, and money-losing years have been quite scarce. **I consider this record nothing short of aberrant. You're simply not supposed to be able to make that kind of return for that long, and especially without the use of leverage.** Investing skill aside, what made it possible?

- Is it because it's called "distressed debt"? That can't be it; there's nothing in a name.
- Is it because distressed debt is an undiscovered market niche? That can't be it either; distressed debt may have been little-known and under-appreciated when we raised our first fund in 1988. But there can't be many institutional investors who haven't heard of distressed debt by now; certainly the secret's out.
- Can it be because people are unwilling to venture into the sordid world of default and bankruptcy? That might have been the case in the 1980s, but today most investors will do anything to make a buck.

So, then, why? I think it's largely a matter of mistakes.

At our London client conference in April, I listened as Bob O'Leary, a co-portfolio manager of our distressed debt funds, described his group's work as follows: **"Our business is often an examination of flawed underwriting assumptions."** In other words, it's their *raison d'être* to profit from the mistakes of others.

Hearing Bob put it that way gave me the immediate inspiration for this memo. The active investor only achieves above average performance to the extent that he can identify and act on mistakes others make. The opportunities invested in by our distressed debt funds are a glaring example. What's the process through which the mistakes arise?

- The analysis performed by a company's management, or the due diligence performed by a prospective acquirer, understates the stresses to which a business will be subjected

and/or overstates its ability to withstand them. Using Bob's terminology, they employ overly optimistic underwriting assumptions, particularly in good times.

- As a result, debt is piled on that turns out to be more than the company can service when things turn down.
- Just as companies and acquirers are often too optimistic in good times, debt holders tend to become too pessimistic in bad times. As a result, they become willing to sell the debt of financially distressed companies at prices that overstate the negatives and thus are too low, giving us the potential for superior returns with less-than-commensurate risk.

All three of these are foundational elements for success in distressed debt investing.

- The first two contribute to the creation of high-potential-return situations. **If no one underestimated risk and thus overloaded capital structures with debt, there wouldn't be many defaults and bankruptcies.** We call these lending decisions "the unwise extension of credit" or, alternatively, "stacking wood for the bonfire."
- **And if no one panicked in response to negative developments and scary prospects, and thus sold out too cheaply, there would be no reason to expect higher risk-adjusted returns from distressed debt than from anything else.**

Many of the biggest mistakes made in the business and investment worlds have to do with cycles. People extrapolate uptrends and downtrends into eternity, whereas the truth is that trends usually correct: rather than go well or poorly forever, most things regress to the mean. The longer a trend has gone on – making it appear more permanent – the more likely it usually is that the time for it to reverse is near. And the longer an uptrend goes on, the more optimistic, risk-tolerant and aggressive most people become . . . just as they should be turning more cautious.

So, for example, when the economy is thriving and profits are rising, people conclude that company operations should be expanded, acquisitions should be undertaken, and more debt can be borne. That same bullishness causes providers of debt to bestow larger amounts of money on weaker borrowers, at lower interest rates and with looser covenants. **Thus cycles are big sources of error, and pro-cyclical behavior is one of the biggest destroyers of capital.**

The point here is that one of distressed debt investing's great advantages is that it embodies an anti-error business model. Distressed debt investors . . .

- . . . almost never invest in companies where everything's going well and investors are enthralled; there's no such thing as a financially distressed company that everyone loves;
- . . . by definition rarely invest before the emergence of significant problems, hopefully meaning fewer negative surprises are left in the bag;

- . . . are in business to buy debt at significant discounts, often from forced or highly motivated sellers. “Distressed debt at par” is an oxymoron and, at least in theory, distressed debt investors are bargain hunters whose ardor rises as prices fall . . . not the reverse like so many other investors.

It’s not that distressed debt investors can’t make mistakes; just that their likelihood of doing so is reduced by the very nature of their investment activity. Anything that decreases an investor’s chance of erring – even an involuntary safety mechanism – works to his advantage.

Distressed debt is, by definition, an area where:

- borrowers and lenders have made grave mistakes,
- at least some of those mistakes have come to light, and
- the stress, unpleasantness and uncertainty that attend a downturn often make debt holders sell out at the wrong time and price.

In other words, it’s an area where negativism and error are crystallized, maximized and magnified. And nothing is more likely to make an asset too cheap than excessively negative psychology.

When we’re out raising a new fund, investors often ask whether people have wised up such that they’ll no longer make these mistakes. Thus far the answer has been no, and in fact there’s no reason to believe there’s been any progress at all up the learning curve. The proof? The distressed debt opportunities that built up in 2005-07 and flowered in the crisis of 2008 were some of the best we’ve ever encountered, and certainly the most plentiful.

One Classic Mistake

I want to take this occasion to touch on a favorite thought of mine. Investing consists of just one thing: choosing which assets to hold in order to profit in the future. Thus there’s no getting away from the need to make decisions concerning the future.

In deciding which future to prepare for, you need two things: (a) an opinion about what’s likely to happen and (b) a view on the probability that your opinion is right. Everyone knows about the former, but I think relatively few think about the latter.

In short, most people believe in their opinions. “Of course they do,” you might say. “If they didn’t have faith in their opinions, they wouldn’t hold them.” And that’s the point. **Everyone’s entitled to his or her opinion. But one of our favorite sayings around Oaktree states that “it’s one thing to have an opinion, and something very different to act as if it’s right.”**

Clearly, our opinions are our opinions because we believe them. (We rarely hear anyone say “Here’s what I think, and I’m probably wrong.”) But just as clearly, we believe (or should believe) more in some of our opinions than others. The probability of being right about the

weather tomorrow in California, a B-rated bond issuer paying its debts, and Greece being part of the European Union in three years is different in each case. Few people would take issue with that.

If that's true, the reliance we place on each prediction – and the action we take in that reliance – should vary. **Yet, as I see it, most people who believe in forecasting come up with their opinions and then act on them with equal amounts of confidence. This is one of the greatest sources of investment error.**

It's perfectly okay to say you don't know something. It's also okay to say you have a view on what might happen but you're not so sure you're right. In that case you're likely to moderate your actions and emerge intact even if you turn out to be wrong. As Mark Twain put it, "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." Or as Treasury Secretary Robert Rubin told the 1999 graduating class of the University of Pennsylvania, ". . . understanding the difference between certainty and likelihood can make all the difference." **Forecasting error is much less likely to prove fatal in the absence of excess conviction.**

I've mentioned before the frequency with which I feel I come across a particularly apt quote just when I need it for a memo in the making. Thus I'll close this section with one on the present subject from Yaser Anwar's "Exclusivo Listserv" of May 29:

. . . while every one well knows himself to be fallible, few . . . admit the supposition that any opinion, of which they feel very certain, may be one of the examples of the error to which they acknowledge themselves to be liable. (John Stuart Mill, "On Liberty," 1859)

In other words, nearly everyone accepts that his or her opinion might be wrong . . . just not this time.

A Big Mistake in the News

A vast amount of ink and airtime is being devoted to the subject of JP Morgan's loss of multiple billions of dollars in its effort to hedge credit risk. People – and especially politicians – have seized on the loss to prove that Jamie Dimon isn't perfect and bank regulation is inadequate.

Clearly, JP Morgan made a mistake – or more than one. Jamie Dimon has described the hedge as "poorly designed," "sloppy" and "a terrible, egregious mistake." How could that be the case – and how could the result be such an enormous loss – in a field as inherently defensive as hedging? The answer's simple: as Charlie Munger once said to me about investing, "It's not supposed to be easy. Anyone who finds it easy is stupid." The truth is, it's hard to get it all right all the time, and that's just as true of hedging as it is of investing.

Hedging sounds easy: you own something, so you sell something to lessen the impact if your investment performs badly. But there are lots of ways to be wrong.

- **Hedging with the wrong thing.** Let's say you own some A but don't want to suffer the full impact if its price declines. Why not just sell short an equal amount of A to hedge? The answer is that owning A and simultaneously shorting A is the same as not owning anything. The long and short positions exactly offset each other, meaning you can't make (or lose) any money. That's not hedging, that's negating.

You want to dampen fluctuations, not eliminate them. So you hedge by selling short something you think will move in sympathy with A, but not exactly. The hope is that by doing it very well, you can eliminate more of the risk of loss than you do of the potential for gain. That's the meaning of a "positive arbitrage."

Buying Ford stock and simultaneously shorting Ford accomplishes nothing. So perhaps you buy Ford and short General Motors, which you think will perform less well, going up less than Ford or down more. But by transacting in two different assets, you by definition introduce the possibility of an unfavorable divergence. This is called "basis risk." In short, it's the risk that the behavior of the two assets relative to each other will differ from what you expected. For example, Ford goes down, giving you a loss, but rather than go down in sympathy (which would give you an offsetting gain on the short position), a favorable development at GM makes it go up, compounding your loss as the hedge goes against you.

- **Hedging in the wrong amount.** You hold 1,000 Ford shares, and you think that – given their likely relative performance – you should short 500 GM shares to hedge your risk. But it turns out that while they move in opposite directions, their relative movements aren't what you expected. Thus you either hedged too much (and thus you lose more on the hedge than you make on the underlying position) or you hedged too little (so the protection you sought doesn't materialize). There's no sure way to choose the right "hedge ratio."
- **Time risk.** The two sides of the position may work as you expect, but not when you expect. Thus the hedge may fail to work in the short run, meaning the loss on one side of the hedge may occur before the gain on the other, in which case you'll look flat-out wrong for a while. And if you're required (by regulation, margin call, capital withdrawals, etc.) to close out the position at that point, the result could be quite negative.
- **Insufficient liquidity.** If conditions or goals change, you might want to adjust or remove your hedge. But market developments in terms of liquidity might make it impossible to alter one or both sides of the position.

In other words, hedging consists of an attempt to cede some potential gain in exchange for a greater reduction in potential loss. It's a very reasonable course of action. But it doesn't necessarily have to work.

In attempting to set up effective hedges, there's little choice but to extrapolate past relationships between things. If they could be counted on to persist unchanged, there'd be little risk of being

wrong about which asset to hedge with, how much to hedge, or whether the two sides of the hedge will move simultaneously. But, just like everyone else in the investment world, would-be hedgers must understand that relationships that held in the past can't be counted on to hold in the future.

And let's remember, as *The New York Times* wrote on May 26, "Yes, Morgan lost big – but, as Mitt Romney has pointed out, someone else won." That's the bottom line on all investing. There's generally a right side and a wrong side to every investment. Which will you be on?

* * *

Risk control isn't an action so much as it is a mindset. It stems largely from putting at least as much emphasis on avoiding mistakes as on doing great things.

Risk control – and consistent success in investing – requires an understanding of the fact that high returns don't just come along for the picking; others must create them for us by making mistakes. And looked at that way, we'll do a better job if we force ourselves to understand the mistake we think is being made, and why.

Risk control requires that we avoid the analytical and psychological errors to which others succumb.

In particular, risk control requires that we temper our belief in our opinions with acceptance of our fallibility.

In the end, superior investing is all about mistakes . . . and about being the person who profits from them, not the one who commits them.

June 20, 2012

Memo to: Oaktree Clients
From: Howard Marks
Re: The Outlook for Equities

It doesn't take much to get me started on a memo. In this case one sentence was enough, in an article from the February 4 online edition of *Pensions & Investments*, as described by *FierceFinance* on February 28: "The long-term equity risk premium is typically between 4.5% and 5%."

There's little I hate more than investment generalizations. For years, for example, self-styled authorities on the high yield bond market would say "bond defaults typically take place 2-3 years after issuance." That always set my teeth on edge. The time to default might average 2-3 years, but unless (1) that's also the most common time period (the mode) and (2) not a highly variable parameter (which I think it is), that generalization is absolutely useless.

In fact, I like the way Mark Twain summed up on the subject more than 100 years ago: "all generalizations are false, including this one." I consider most investment generalizations as useless as that great oxymoron: "common sense."

Back to equity risk premiums. The *FierceFinance* article in question led with the sentence, "The 'great rotation' back into equities from bonds is unlikely to be seen in 2013 among most defined benefit pension funds in major markets, including the U.S., U.K. and Netherlands." It included a number of what I consider provocative statements:

- that pension funds do want fewer bonds but generally not more stocks (raising the question of where the money will go, and specifically how much money can responsibly be absorbed in asset classes other than stocks and bonds),
- that, according to one consultant "There is recognition that bonds represent minimal-risk assets, so it's difficult for (plan executives) to abandon bonds in favor of equities. . ." (This overlooks the fact that there's no such thing as a minimal-risk asset regardless of price, and few assets that have been the beneficiaries of years of strong cash inflows can really be "minimal-risk"), and
- "that investors are taking short-term tactical advantage of the rising equity premium by, for example, allowing multiasset managers to drift toward the higher end of the equity allocation range."

So there we are, in the third bullet point, back to the matter of the equity risk premium.

Everything You Ever Wanted to Know About Equity Risk Premiums (and Much More)

The equity risk premium is generally defined as, "the excess return that an individual stock or the overall stock market provides over a risk-free rate." (Investopedia) Thus it is the incremental return that investors in equities receive relative to the risk-free rate as compensation for bearing the risk involved.

The term is also used to describe the extent to which the return on stocks exceeds the return on bonds, again as compensation for bearing incremental risk. (For example, an August 18, 2011 article on the *Seeking Alpha* website, entitled “What the Equity Risk Premium Is Saying,” discusses the prospects for stocks versus the ten-year U.S. Treasury note.)

My real problem with the term – or, more correctly, the way it’s used – has to do with one of the littlest words in the English language. Or, to paraphrase a former President of the United States, “it all depends on the meaning of the word is.”

Many people know what they think they mean when they talk about the existence and magnitude of the equity risk premium – or even what they actually mean – but I don’t think many are logical or consistent in using it. My complaints surround the definition they apply to the term, and specifically the tense of the verb they employ (I’m not just being grammatically picky).

Most specifically, I strongly dislike the use of the present tense, as exemplified by the writer for *P&I*: “The long-term equity risk premium is typically between 4.5% and 5%.” This suggests that the premium is something that solidly exists in a fixed amount and can be counted on to pay off in the future.

Imagine instead that she had said “The long-term equity risk premium has typically been between 4.5% and 5%.” This makes the premium seem more like a historical fact but also less dependable in the future (probably as it should be).

The equity risk premium can actually be defined at least four different ways, I think:

1. The historic excess of equity returns over the risk-free rate.
2. The minimum incremental return that people demanded in the past to make them shift from the risk-free asset to equities.
3. The minimum incremental return that people are demanding today to make them shift away from the risk-free asset and into equities.
4. The margin by which equity returns will exceed the risk-free rate in the future.

The four uses for the term are different and, importantly, all four are applied from time to time. And I’m sure the four uses are often confused. Clearly the import of the term is very different depending on which definition is chosen. **The one that really matters, in my opinion, is the fourth: what will be the payoff from equity investing. It’s also the one about which it’s least reasonable to use the word “is,” as if the risk premium is a fact.**

What Will Equities Give You?

There are problems with at least three of the four meanings. Only **number one** can be measured. There’s a lot of data on the historic performance of stocks versus bonds and cash. In fact, in the 1990s Wharton Professor Jeremy Siegel documented to a fare-thee-well that stocks always won out over long periods of time. Of course the subsequent decade proved that didn’t have to remain the case.

Now it gets more interesting. Although we can calculate the amount by which stocks outperformed bonds or cash in the past (assuming you were looking at periods prior to 2000), I don’t think that’s the same as saying what risk premium was demanded by investors in the sense of **definition number two** above. If stocks outperformed by 5% over a ten-year period, that doesn’t mean people demanded a 5% higher return to buy equities rather than bonds or the risk-free asset. They might have “demanded” more or less. It’s just that they got 5%.

In a similar vein, we can also talk about **number three**, the minimum return increment people are demanding today. But (a) the answer you come up with will depend on whom you ask, (b) they may or may not have given it rigorous thought, and (c) whatever they say is likely to have little impact on what relative returns turn out to be. Their answer is likely to tell you more about what they think they'll get than about what they're actually demanding . . . or what they will get.

What matters for today's investor isn't what stocks returned in the past, or what equity investors demanded in the past or think they're demanding today. What matters is **definition number four**, what relative performance will be in the future. **The most important thing of all is to realize that this can't be read anywhere.** As Einstein said, in one of my favorite quotes, "Not everything that counts can be counted, and not everything that can be counted counts."

Just as number four is the most important definition of the equity risk premium, the questions surrounding it are also significant. In my view, people tend to think of the equity risk premium (and other risk premiums) like credit spreads on bonds. I've been dealing with credit spreads for 35 years. They are the entire *raison d'être* for high yield bond investing. **And they have almost nothing in common with the equity risk premium.**

Let's say we want to assess the adequacy of the reward being offered for bearing the credit risk of a given B-rated high yield bond. We compute the yield to maturity or yield to call on the bond and subtract from it the yield to maturity on a Treasury security of the same duration. The result is the "yield spread" or "credit spread." That spread tells us what the prospective relative return is and – when assessed in the light of historic spreads, the spreads on other bonds, the riskiness of the bond in question, and the spreads on other bonds of similar, lesser or greater riskiness – whether the bond is rich or cheap.

Now let's apply the same process to a stock, or the stock market. First, compute the prospective return on the stock. Oh yeah; right. There's no way to do that. Or rather there is, but it requires one to either (a) make an assumption about the growth rate of earnings per share to infinity or (b) make an assumption about the growth rate of earnings for a number of years and also the terminal p/e ratio that the market will apply to e.p.s. at the end of that period (which in turn will be a function of the growth of earnings from then to infinity). **In other words, a simple mathematical calculation will tell us exactly what the promised return on a bond is (albeit not the probability that it will be received), while coming up with the future return for a stock requires making some massive guesses about the far-off future. That difference – in a nutshell – encapsulates a lot of the fundamental difference between investing in stocks and bonds.**

The bottom line: given that it's impossible to say with any accuracy what return a stock or the stock market will deliver, it's equally impossible to say what the prospective equity risk premium is. **The historic excess of stock returns over the risk-free rate may tell you the answer according to definition number one, with relevance depending on which period you choose, but it doesn't say anything about the other three . . . and especially not number four: the margin by which equity returns will exceed the risk-free rate in the future.**

Another Call for Counter-Intuitiveness

Many of the important things about investing are counterintuitive. Low-quality assets can be safer than high-quality assets. Things get riskier as they become more highly respected (and thus appreciate). There can be more risk in thinking you know something than in accepting that you don't. This counter-intuitiveness is a favorite theme of mine.

And the theme is importantly at work with regard to the equity risk premium, and especially *P&I*'s use of the term. I take great issue with their statement "The long-term equity risk premium is typically between 4.5% and 5%." **That may be what it "was" or "has been," but it doesn't tell us anything about what it "is" or "will be."** We know we can't extrapolate returns on bonds or the risk-free asset from the past; certainly changes in interest rates over the last five years mean investors in these things will enjoy far lower returns in the years ahead than they used to. **So then is it possible to know what we will get from equities? Or from equities relative to bonds or the risk-free rate? Clearly not. Thus I think it's dangerously misleading to say what the risk premium "is."** That's probably enough on this subject.

Let's move on to the final bullet point on page one and its reference to "the rising equity premium." The article discusses the case for an attractive equity risk premium in terms of definition number one – historically superior performance – since it goes on to point out that stocks outperformed bonds by an unusually large margin in the six months ended January 31, 2013 (11.23% for the Russell 3000 versus -0.29% for the Barclays Capital U.S. Aggregate Bond Index). But do six months of good performance say anything about a rising equity premium? And do they tell us anything at all about the future?

Well, the answer to the first question lies in which definition you're following. Of course the data tells us what the relative performance was (and 2012 was a great year, for example, with the S&P 500 up roughly 16% while the risk-less rate was close to zero). An equity risk premium defined this way is certainly in the best part of the historic distribution. But it tells us little about investors' past or present demanded returns. And what does it say about the prospects for continued outperformance?

To me, the answer is simple: the better returns have been, the less likely they are – all other things being equal – to be good in the future. Generally speaking, I view an asset as having a certain quantum of return potential over its lifetime. The foundation for its return comes from its ability to produce cash flow. To that base number we should add further return potential if the asset is undervalued and thus can be expected to appreciate to fair value, and we should reduce our view of its return potential if it is overvalued and thus can be expected to decline to fair value.

So – again all other things being equal – when the yearly return on an asset exceeds the rate at which it produces cash flow (or at which the cash flow grows), the excess of the appreciation over that associated with its cash flow should be viewed as either reducing the amount of its undervaluation (and thus reducing the expectable appreciation) or increasing its overvaluation (and thus increasing the price decline which is likely). The simplest example is a 5% bond. Let's say a 5% bond at a given price below par has a 7% expected return (or yield to maturity) over its remaining life. If the bond returns 15% in the next twelve months, the expected return over its then-remaining life will be less than 7%. An above-trend year has borrowed from the remaining potential. The math is simplest with bonds (as always), but the principle is the same if you own stocks, companies or income-producing real estate.

In other words, appreciation at a rate in excess of the cash flow growth accelerates into the present some appreciation that otherwise might have happened in the future. Or to paraphrase Warren Buffett, "when people forget that corporate profits are unlikely to grow faster than 6% per year, they tend to get into trouble." I doubt he intended anything special about 6%, but rather a reminder that when assets appreciate faster than the rate at which their value grows, it isn't just a windfall but also a warning sign.

Let's take a look at the 1990s, a decade full of lessons about equities. As of 1990, the historic return on equities stood at 9% or 10%, and for that reason attitudes toward them were generally favorable, with that 9-10% return expected to repeat in future decades. But the '90s were a salutary period in terms of economic growth, corporate performance, technological and productivity gains, declining interest rates, low inflation and relative peace in the world (as well as naïve optimism regarding the benefits of a credit-

fueled expansion, the profit potential of e-commerce companies, and the extent to which equity gains could be perpetuated). As a result, equity returns averaged 20% per year over the decade.

What was investors' response? They ratcheted up their expectations. I believe by 2000 the professional consensus for future equity returns had risen from the 9-10% range to 11%. A decade of the highest returns in history had convinced people that more good years lay ahead. Few people seemed concerned that the extraordinary returns of the 1990s might have borrowed from the 2000s (as certainly seems to have been the case in retrospect). As a result, just when stock prices were reaching levels they wouldn't see again for more than a decade, bonds were being dumped so that equity allocations could be expanded to all-time highs.

When I look at the *P&I* article, I see a statement that the equity risk premium is on the rise, but not a lot of reason why equities will do better in the future than they have in the past (or even specific mention of which past they'll do better than). **Extrapolation or analysis? They're two very different things.**

Valuing Stocks Today

The underlying reason it took so little from *FierceFinance* to get me going on this memo is that I had a lot of pent-up thoughts about equities and their current valuation. That's what the following pages will be spent on.

Ironically given the extent to which I railed above about limiting the importance attached to the equity risk premium, some of the strongest arguments for stocks today surround their relative earning power. In view of the difficulty in quantifying the prospective returns on stocks, appraising their value relative to bonds or the risk-free asset is often best done through comparing their yields.

Since most companies pay out a modest percentage of their earnings, dividend yields greatly understate companies' ability to earn money for their shareholders, and thus for their stocks to appreciate. A better measure of stocks' long-term potential may be found in their "earnings yield." The earnings yield is the reciprocal of the p/e ratio: the e/p ratio or ratio of earnings to price. To gauge relative price-attractiveness, it isn't unreasonable to compare the earnings yield on a stock against the yield on a bond (or against the risk-free rate).

Let's review a few data points:

- If the post-WWII average p/e ratio on equities was something like 16 (for an e/p ratio of 1/16, or an earnings yield of about 6.25%) and if I guess at a "normal" risk-free rate of 3%, we get a historic yield differential – we might call it the equity risk premium, defined this way – of 3.25% (6.25% minus 3.00%), or 325 basis points. The ratio between the yields was 6.25%/3.00%, or 2.08x.
- At the high in 2000, the p/e ratio on the S&P 500 was more like 32 (for an e/p ratio of 1/32, or an earnings yield of 3.12%), and the 30-day T-bill rate was probably 2%. In that case the yield differential or equity risk premium was a skimpy 1.12% (3.12% minus 2.00%), or 112 basis points, and the ratio of the two was only 3.12%/2.00%, or 1.56x. In other words, stocks didn't offer enough relative to fixed income, and that's the main reason why they've performed so poorly – both in absolute terms and relative to bonds – over the thirteen years since.

- Where are we today? The p/e ratio on the S&P 500 is back to about 16, meaning the earnings yield is 6.25% once again. I'll use a 30-day T-bill rate of 1.00% (it's actually closer to zero, but a yield ratio approaching infinity wouldn't be meaningful). That gives us a yield differential of 5.25% (6.25% minus 1.00%), or 525 basis points, and a yield ratio of 6.25%/1.00%, or 6.25x.

So let's recap:

	Post-WWII Norm	2000	Today
Yield differential	325 b.p.	112 b.p.	525 b.p.
Yield Ratio	2.08x	1.56x	6.25x

Certainly the yield comparison is highly favorable for stocks today. In fact it's one of the best in the last century (probably barring only the early 1980s, when the p/e ratio on the S&P 500 fell to mid-single digits). Is that the whole story? It never is; nothing's that simple, especially in the world of investing.

The problem with basing a pro-equities argument on the yield comparison is that most of equities' current attraction on that basis comes from the lowness of interest rates. Just about everyone knows (a) interest rates are artificially low because of central banks' efforts at stimulus and (b) rates will be considerably higher at some point in the intermediate term. In that case, rising rates would render stocks less attractive (all other things being equal, but they're not – see below).

The Other Pros and Cons of Equities

There are many ways to view valuation, and many elements in the current debate over equities. Here are a few of them (I'll start by reiterating the above for the sake of completeness):

- The differential between the S&P earnings yield and the risk-free rate or the yields on bonds – and their ratio – makes stocks look extremely cheap. PRO
- The attractiveness of these relative valuation parameters is highly dependent on interest rates staying low. CON (or LESS PRO)
- Relative to normal post-WWII p/e ratios, stock prices are average to slightly low as a multiple of projected earnings for the year ahead. PRO
- Robert Schiller's cycle-adjusted p/e ratios are gaining increased attention, and they suggest full rather than fair valuations. CON
- Arguably earnings growth in the years ahead will be slower than that which prevailed in the decades following WWII. Thus the post-war valuation norms are too high under the changed circumstances and should be discounted. CON
- The outlook for earnings is restrained by the questionable macro environment, including the challenges in restarting growth and the dire prognosis for the federal deficit. These problems may not be easily solved. CON
- Among the things keeping earnings high – and thus making stocks seem attractive – are some of the highest profit margins in history. If profit margins were to move toward normal levels, this

would bring down earnings, either taking stock prices down with them or lifting p/e ratios and thus reducing stocks' attractiveness. CON

- Corporate cash hoards are high, implying some combination of safety, potential for stock buybacks, and possible dividend increases. These are all good for shareholders. PRO
- Investor attitudes toward stocks remain tepid (see below). PRO
- However, with the S&P 500 up 16% last year and 10% so far this year, it can't be argued that stocks have been overlooked and or that attitudes towards them are still mired in the doldrums. CON

The Role of Investor Attitudes

I covered this subject at length in "Déjà Vu All Over Again" (March 19, 2012). I'm not going to drag you through it again, but I will copy over parts of that memo from a year ago:

. . . people have been throwing in the towel and selling stocks. Other things have come into vogue, attracting the capital that used to be invested in stocks. Mutual fund investors have turned their attention elsewhere. . . . Stocks have gone through a decade in which their absolute return was negligible and their real return was negative. . . . They face a litany of negatives, without any real possibility of relief . . .

The negative factors are clear to the average investor. And from them he draws negative conclusions. But the person who applies logic and insight, rather than superficial views and emotion, sees something very different.

He sees an asset class that is unloved. He sees stocks that have cheapened for a decade – once dividends have been subtracted from the returns, and especially when prices are viewed relative to earnings. He sees securities that are priced below the value of the underlying assets on which they have a claim. He sees outflows of capital that, rather than being a negative, have lowered prices and can give rise to a strong price rebound when and if they reverse. Most of all, he sees an asset class to which no optimism is being applied. . . .

The thing to notice about the preceding paragraphs is that when I wrote them a year ago, I didn't do so to describe then-current market conditions. Rather, I was trying to capture conditions as they were in 1982, when *BusinessWeek* magazine carried a cover story trumpeting "The Death of Equities." My point was that in 1982, overly negative investors were fixated on the reasons for continued lethargy on the part of stocks, just when the scene was set for the greatest upsurge in stock market history.

. . . As something goes in one direction for a while, people conclude increasingly that it always will . . . often just when the likelihood grows that it will reverse instead. And that was the greatest shortcoming of "The Death of Equities." **The extrapolator threw in the towel on stocks, just as the time was right for the contrarian to turn optimistic. And it will always be so.**

I didn't think last year that the extent of the undervaluation was anywhere as great as it had been in 1982, but I did think the conditions were similar in kind. Nothing sets the stage for an upturn as well as excessive negativism – or at minimum excessive disinterest. And that's what I sensed in the stock market last year, following on the heels of a twelve-year malaise. Thus I don't consider it a freak occurrence that stocks all around the world went on to have an excellent year in 2012.

Many conditions remain similar . . . again, in kind. Equity mutual funds are seeing only modest inflows, albeit the outflows have stopped. Even though they've appreciated, stocks still aren't highly valued. Many institutions have allocations to equities that are well below the average of the last fifty years, and no one's rushing to move them up. In other words, I'm comfortable saying attitudes toward equities are characterized by relative disinterest and apathy.

This is certainly something that can turn. If it turns, it can have a significant impact. And what is most likely to turn it? It won't necessarily take a "grand bargain" in Washington to solve the nation's fiscal problems, or a sudden rebirth of economic growth worldwide, or the invention of the next iPhone. All that's required is another good year or two for stocks and a switch in investor psychology from "stocks are unlikely to do anything but extend the 'lost decade' " to "hey, I'm afraid I might not be positioned adequately to participate in the next bull market."

A move upward can be powered by a switch from the fear of losing money to the fear of missing opportunity. When attitudes are moderate and allocations are low, it doesn't take much.

* * *

In the mid-1970s I was fortunate to happen upon one of the first of the time-worn pearls of wisdom that contributed so much to my education as an investor. It described the three stages of a bull market:

- the first, when a few forward-looking people begin to believe things will get better,
- the second, when most investors realize improvement is actually underway, and
- the third, when everyone's sure things will get better forever.

In "The Tide Goes Out," written in March 2008, several months before the lows of the financial crisis, I applied the same thinking to the converse – the three stages of a bear market:

- the first, when just a few prudent investors recognize that, despite the prevailing bullishness, things won't always be rosy,
- the second, when most investors recognize things are deteriorating, and
- the third, when everyone's convinced things can only get worse.

Hindsight always makes it clear what was going on at a particular point in time. It's a snap now to say the second quarter of 2007 marked the third stage of a bull market: no one could think of a way to lose money. And in the fourth quarter of 2008 (for credit) and the first quarter of 2009 (for equities), we were certainly in the third stage of a bear market: most people thought the financial system was about to collapse, and securities that had halved in price could do nothing but halve again.

But the study of market history only makes us better investors if it teaches us how to assess conditions as they are, rather than in retrospect. When I wrote "Déjà Vu All Over Again" a year ago, it was my feeling that equities were in the first stage of a bull market. Experience had been so bad for so

long – and the level of disinterest was so high – that only a few investors thought equities could ever catch on again. Those low expectations, when combined with modest fundamental and psychological improvement, gave the S&P 500 a return of about 13% over the year since that memo was written.

So now we have a somewhat improved fundamental environment, a generally more optimistic group of investors, and stock prices that are a fair bit higher. **No one should say the likelihood of improvement is entirely unrecognized today, as would have to be the case for this to still be stage one. I think the existence of improvement is generally accepted, but that acceptance is neither extremely widespread nor terribly overdone. Thus I'd say we're somewhere in the first half of stage two. Pessimists no longer control market prices, but certainly neither have carefree optimists taken over.**

* * *

A great rotation? Maybe . . . or maybe not. Nowadays pundits and the media are quick to come up with cute labels – usually just the right size for a headline or sound bite – to describe things that are taking place or that “everyone knows” are just around the corner. **I don't know whether it's going to be great. Heck, I don't even know if it'll happen.** But I like to enumerate the pros and cons and try to put them in perspective, as much as I like skewering excessive generalizations and pat pronouncements.

Of course, doing that isn't enough. I feel I should come down on one side or the other. **Thus I'm quite comfortable imagining a few years of equity performance that provide a pleasant surprise relative to what I think is the prevailing expectation of 6% or so per year.**

And if I'm wrong – if there is no rotation from fixed income to stocks – I'm not that worried that I'll end up with great regret over having failed to pile into T-bills yielding zero or the 10-year note guaranteeing 2.0%. When attitudes are moderate and allocations are low, like I feel is currently the case with equities, there's little likelihood of investing being a big mistake. And when interest rates are among the lowest in history, it would take deflation, depression or calamity to make failing to invest in Treasuries and high grade bonds a serious omission.

March 13, 2013

Memo to: Oaktree Clients
From: Howard Marks
Re: Getting Lucky

Sometimes these memos are inspired by a single event or just one thing I read. This one – like my first memo 24 years ago – grew out of the juxtaposition of two observations. I'll introduce one here and the other on page seven. Contrary to my wife Nancy's observation that my memos are "all the same," the subject here is one I've rarely touched on.

The Role of Luck

The first inspiration for this memo came in early November, when I picked up a copy of the *Four Seasons Magazine* in my hotel room in Riyadh, Saudi Arabia. I happened to turn to an article entitled "In Defence of Luck" by Ed Smith. It's been in my Oaktree bag ever since. In his two opening paragraphs, Smith presents a thesis for dismantling:

"Success is never accidental," Twitter founder Jack Dorsey recently tweeted. No accidents, just planning; no luck, only strategy; no randomness, just perfect logic.

It is a tempting executive summary for a seductive speech or article. If there are no accidents, then winners are seen in an even better light. Denying the existence of luck appeals to a fundamental human urge: to understand, and ultimately control, everything in our path. Hence the popularity of the statement "You make your own luck."

That's all it took to get my juices flowing. I – along with Smith – believe a great many things contribute to success. Some are our own doing, while many others are beyond our control. There's no doubt that hard work, planning and persistence are essential for repeated success. These are among the contributors that Twitter's Dorsey is talking about. But even the hardest workers and best decision makers among us will fail to succeed consistently without luck.

What are the components of luck? They range from accidents of birth and genetics, to chance meetings and fortuitous choices, and even to perhaps-random but certainly unforeseeable events that cause decisions to turn out right.

In discussing the existence and importance of luck, Smith cites the popular book *Outliers* by Malcolm Gladwell:

Attacking luck has never been more fashionable. No matter how flimsy the science behind the theory, popularized by author Malcolm Gladwell, that success must follow from 10,000 hours of dedicated practice, it has hardened into folklore.

Outliers is best known for Gladwell's observation that it's this magic number of hours of practice that makes the difference for those who are most successful. But that's only part of Gladwell's message, and people who think his book is all about hard work and practice miss the point. Having set out the "10,000-hours" thesis, Gladwell largely stops talking about it and turns to spend much more time on something he calls "demographic luck." This is actually the antithesis of an insistence that hours of effort suffice.

Demographic Luck

Gladwell's term for this key ingredient in success has a simpler everyday label: "being born at the right time and the right place." Gladwell's examples are compelling:

- By the time the first hockey tryouts take place for all the little Canadian boys born in a given calendar year, those born in January will be eleven months older – and thus much bigger and stronger and more coordinated – than those born in December. They're likely to be put on better teams, receive better coaching, and spend more time on the ice. They're more likely to get 10,000 hours of practice and – all other things equal – to have their skills honed and showcased.
- When I went to college in the mid-sixties, we inputted computer projects via punch cards; they ran overnight; and we went back for our results the next morning. But going to a private high school a few years later enabled Bill Gates to enter his work via a time-sharing terminal connected directly to a central computer, and to see the results in real time. Thus he could perform hundreds of iterations a week, not seven, and develop his skills and his ideas much faster. In addition, the University of Washington was a short bus ride from his home, and his family's contacts enabled him to use its computer lab.
- When Joe Flom and his Jewish cohorts graduated from law school in the 1930s, there were no jobs for them with prestigious Wall Street law firms. They formed their own firm, Skadden, Arps, Slate, Meagher and Flom, but their work was largely confined to matters the "white shoe" firms rejected as unseemly and disreputable. Thus when proxy fights and hostile takeovers became commonplace in the 1970s and '80s, Joe Flom had superior experience and became a leader in advising on them, earning multi-million dollar fees.

It seems like more than a coincidence that not only was Bill Gates born in 1955, but his Microsoft co-founder Paul Allen was born in 1953; Sun Microsystems founders Bill Joy and Scott McNealy were born in 1954; Steve Jobs and Eric Schmidt were born in 1955; and Steve Ballmer was born in 1956. Ten years earlier and there would have been no remote computer terminals for them to work at in high school and college; ten years later and the kids born before them would have beat them to the "new, new thing."

Likewise, the greatest pioneers of the M&A bar were born at the right time to benefit from the upsurge in corporate activities that the legal establishment had frowned upon: Joe Flom in 1923 and all four founders of Wachtell, Lipton, Rosen and Katz in 1930-31.

During the holidays, I enjoyed spending time with three legends of the pop music business: producer David Geffen, entertainment attorney Allen Grubman, and Robbie Robertson, leader of the group "The Band." I was struck by the fact that they were all born in the same year: 1943. I came along three years later, and I remember my parents picking me up from summer camp in 1956 and telling me about a new singing sensation, Elvis Presley, and a new kind of music called rock and roll. The three men listed above were born at the right time to become leaders of the newly minted rock and roll industry. It's a good thing they weren't born a few decades later, since cheap downloads and file sharing have now decimated the profitability of the record business.

The bottom line is simple: it's great to be in the vanguard of a new development. Talent and hard work are essential, but there's nothing like getting there early and being pushed ahead by the powerful trends in demographics and taste that follow.

Perhaps the ultimate description of demographic luck comes from Warren Buffett:

I've had it so good in this world, you know. The odds were fifty-to-one against me being born in the United States in 1930. I won the lottery the day I emerged from the womb by being in the United States instead of in some other country where my chances would have been way different.

Imagine there are two identical twins in the womb, both equally bright and energetic. And the genie says to them, "One of you is going to be born in the United States, and one of you is going to be born in Bangladesh. And if you wind up in Bangladesh, you will pay no taxes. What percentage of your income would you bid to be the one that is born in the United States?" It says something about the fact that society has something to do with your fate and not just your innate qualities. The people who say, "I did it all myself," and think of themselves as Horatio Alger – believe me, they'd bid more to be in the United States than in Bangladesh. That's the Ovarian Lottery. (*The Snowball*, Alice Schroeder)

Buffett is insightful enough to realize – and secure enough to admit – that he isn't solely responsible for his success. What if he'd been born in Bangladesh instead of the U.S.? Or a woman rather than a man in 1930, having much fewer opportunities? Or in 1830 (when there would be no hedge fund industry for a century) or 2014 (when there are smart people crawling all over it)? Or to different parents? Or if he'd missed out on studying under Ben Graham at Columbia? Or if he hadn't partnered with Charlie Munger?

I'm impressed when people credit others – as well as luck – for the essential part they played in their accomplishments. And I agree 100% with the following sentiment from Smith's article:

Michael Young, the sociologist who coined the term "meritocracy," described the danger of thinking that success must be deserved just because it has happened: "If meritocrats believe, as more and more of them are encouraged to, that their advancement comes from their own merits . . . **they can be insufferably smug.**" (Emphasis added)

Did You Do It All Yourself?

Buffett's mention of "people who say, 'I did it all myself'" reminds me of one of President Obama's reelection campaign speeches, which included a comment that became a lightning rod: "If you've got a business – you didn't build that. Somebody else made that happen."

His remark serves quite poorly when taken on its own. It suggests he thinks that there's no such thing as individual success, only group accomplishments. It denies the efficacy of hard work and grit. In short, it reflects a very un-American view of success.

It's hard to be sure that every sentence we speak or write can stand on its own. When taken in context, Obama's statement makes more sense:

If you were successful, somebody along the line gave you some help. There was a great teacher somewhere in your life. Somebody helped to create this unbelievable American system that we have that allowed you to thrive. Somebody invested in roads and bridges. If you've got a business – you didn't build that. Somebody else made that happen.

Clearly Obama omitted a few key words from those two last sentences, perhaps assuming his listeners would carry them over from those that went before. The addition of just four words (italicized below) would have made his message more palatable: “If you’ve got a business – you didn’t build that *alone*. Somebody else *provided assistance that* made that happen.”

In other words, you were lucky enough to get help. Weren’t we all?

Did I Do It All Myself?

You may think of me as intelligent, insightful and/or hard-working. I hope you do. But when I finished reading *Outliers*, I was moved to write down for my kids all the ways in which demographic luck contributed to my success. To illustrate my point, I want to share the list with you:

- First of all, it was great to be born in America at the very beginning of the “baby boom.” Baby boomers – the generation born right after World War II – benefitted from the return of servicemen from the war; the ending of war-time limits on consumption; and explosive subsequent growth of the population, which fired strong economic growth. I was conceived during the war and born just after it ended. You couldn’t get much closer to the front of the line.
- I was born to middle-class parents – members of the first generation in their families to be born in America – who encouraged me in education and work. They made me the first member of our family to receive a college degree.
- The timing of my birth enabled me to get a good, free education in the New York City public schools. The schools benefitted from the presence of smart women teachers to whom corporate careers weren’t available, and who liked being on the same vacation schedule as their kids.
- My high school guidance counselor said my grades weren’t good enough to get me into Wharton, but I was lucky to have had an accounting teacher whose letter of recommendation may have done the trick. Or perhaps it was the college entrance exams or SATs, standardized tests that had been introduced shortly before to counter the elite universities’ bias against public-school kids.
- Regardless of what made it possible, it’s clear that attending Wharton taught me a lot, exposed me to finance (previously I had planned on a career in accounting) and burnished my resume. Would my career, and thus my life, have been the same if I hadn’t gotten into Wharton and instead had attended my second-choice school, a large state university?
- When I went off to college, I’d never heard of something called an MBA. But the existence of the Vietnam War provided an incentive to stay in school, and three years for law school seemed like too much, so business school it would be. Turned down by Harvard because of my lack of work experience, I instead attended the University of Chicago, whose theoretical, quantitative approach provided the perfect complement to my pragmatic Wharton undergraduate education.
- Just as I was lucky to be at the front of the line of baby boomers, my timing was fortuitous in attending Chicago. I arrived on campus in 1967, just a few years after the new Chicago approach to finance had begun to be taught. No more than a few hundred students could have beat me to the capital asset pricing model, modern portfolio theory, the efficient market hypothesis, the random walk, and the other components of today’s investment theory.

- I'm not one of those investors who started reading prospectuses at age ten. In fact, even as I approached graduation from Chicago in 1969, I was unsure of my career direction. I accepted a permanent position in investment research at First National City Bank (the predecessor of Citibank), largely because I'd had a good summer job there a year earlier. Ten years in equity analysis there, including three as director of research, provided an ideal foundation for my investment career.
- And then, when a new chief investment officer wanted to make room for his own head of research in 1978, he asked me to start up funds in convertible bonds and – in the ultimate stroke of luck – the newly created field of high yield bonds. How could anyone have been better positioned to participate in the financial developments of the last 35 years?
- And of course, I was at my luckiest when I teamed up with my wonderful partners – Bruce Karsh, Sheldon Stone, Larry Keele and Richard Masson – between 1983 and 1988. Bruce had the idea to organize a fund to invest in “distressed debt” at TCW, the first one from a mainstream financial institution. And then the five of us left to start Oaktree in 1995. The rest, as they say, is history.

You make your own luck? Success is never accidental? Bull!! I contributed to some of the positive developments described above, but many of them were pure luck. Pull out a few of the steps on this progression, and where would I be today? Here's one more: Of all the jobs I applied for when leaving Chicago in 1969, I wanted one much more than the rest but didn't get it. A few years ago, the company's campus recruiter told me I had been chosen, but on the relevant morning the partner in charge came in hung over and failed to call me with the positive message he was supposed to deliver. **Just think: but for that bit of “bad luck” I could have spent the next 39 years at Lehman Brothers!**

I know how lucky I've been. I find it incredibly uplifting and the source of great optimism regarding the future to know and appreciate my good fortune. Rather than detract from my satisfaction over the success I've enjoyed – because of having to admit it wasn't all my own doing – this realization makes me feel fortunate to have been born when and where I was and to have benefitted from the developments that came along. I revel in my good luck.

And what about the things I may have brought to my career: perhaps intelligence, insight and a talent for writing? **Isn't having these things a form of luck?** Intelligent and innately talented people didn't do anything to earn their gifts. No one can take credit for them as “something I did” or “something that was within my control.” These things, too, are luck, and something for which we should give thanks rather than take credit.

Luck in Investing

Rather than “you make your own luck,” there's an old saying that provides a better way to put it: “luck is what happens when preparation meets opportunity.” If you prepare through study and practice, work hard and bring your talents to bear, you'll be positioned to make the most out of opportunities that arise. This way of looking at life is in line with my formulation regarding investment results: **performance is what happens when events collide with an existing portfolio.**

We arrange our lives – or, in investing, our portfolios – in expectation of what we think will happen in the future. In general, we get the desired results if future events conform to our hopes or expectations, and less-desired results if they don't.

What about people – like those of us at Oaktree – who don't consider themselves macro forecasters or market timers? Even the most devoted value investor acts on the basis of expectations: that an asset selling at x will turn out to be worth $2x$, and that one of these days everyone else will recognize its value and bid it up. And the agnostic buy-and-hold equity investor operates under the assumption that the economy will expand, companies will increase their profits, and stock prices will rise as a result.

Let's say investors reach their conclusions about current intrinsic value or future earnings growth by applying skillful analysis to accurate data and reasonable assumptions. Let's grant, in short, that their conclusions are "right" in some abstract sense. It still takes a great deal of luck for their version of future events to materialize.

Elroy Dimson of the London Business School is responsible for one of the most trenchant observations: "Risk means more things can happen than will happen." In other words, the future isn't a predetermined scenario that's sure to unfold, but rather a range of possibilities, any one of which may happen. Investors formulate opinions as to which of them will happen. Those opinions may be well-reasoned or dart throws. But even the most rigorously derived view of the future is far from sure to be right. Many other things may happen instead.

Nassim Nicholas Taleb's views, expressed in *Fooled by Randomness*, connect up with Dimson's. The world is an uncertain, even random, place. What "should happen" might be totally clear, meaning we know what the future should hold. But the things that should happen may not happen – and other things may happen instead – for any of a variety of reasons, many of them extraneous, unpredictable and even nonsensical. **Those things can be described as random: the result of luck, either good or bad.**

The point is that we assemble our portfolios, and future events determine whether our performance will be rewarded or punished. People whose expectations are borne out generally make money, and those whose aren't lose. That process sounds very fact-based, meritocratic and luck-free, and thus dependable. But that's only the case on average and in the longest-term sense.

- Sometimes, even though an investor's projections may be far too optimistic relative to what he should have expected – a.k.a. "wrong" – the investor is bailed out by unforeseeable positive developments, or even by non-fundamentally based price appreciation. Either way, the stock rises and the investor is applauded. I'd say he was "right for the wrong reason" (or "lucky").
- Alternatively, a prudent, skillful investor may formulate a reasonable view of the future, only to see the world go off the rails and his investments fail. He might be described as "wrong for the wrong reason" (or "unlucky").
- An investor may take an appropriately cautious stance – let's say toward tech stocks in 1997 or residential mortgage backed securities in 2005 – only to see an irrationally overpriced market become more so, as prices soar for years. He looks terrible, a victim of the old adage that "being too far ahead of your time is indistinguishable from being wrong."
- Further, in a special case of being wrong as to timing although perhaps not fundamentals, an investor may take a concentrated position in a laughably underpriced stock, using a huge amount of borrowed money. But before the expected appreciation can take place, a market crash brings on a margin call, and he's wiped out. As John Maynard Keynes said, "The market can remain irrational longer than you can remain solvent."
- Last year marked the passing of Joe Granville, a technical analyst whose warning in 1976 was followed by a 26% two-year decline, winning him respect and fame. But his next accurate call wouldn't come for 24 years, when he told people to sell tech stocks in 2000. Was it skill back in 1976, or a lucky call that turned out right when events went his way? Regardless, he became one of many in the investment business who get famous for having been "right once in a row."

The first thing I remember learning at Wharton in 1963 was that the correctness of a decision can't be judged from the outcome. Because of the randomness at work in the world and the unpredictability of the future, lots of bad decisions lead to good results, and lots of good decisions end in failure.

In other words, for an investor to both be right *and* make money:

- his view of what will happen in the future – and what should be done about it – has to be analytically correct *a priori*,
- the things he thinks will happen have to actually happen, and
- those things have to happen on schedule.

But in investing, it's hard to know what will happen and impossible to know *when* it will happen. Many things influence performance other than (a) investors' hard work and skill and (b) the market's dependable discounting of information about the future. Luck – randomness, or the occurrence of things beyond our knowledge and control – plays a huge part in outcomes.

Investment success isn't just a question of whether the investor put together the “right” portfolio, but also whether it encountered a beneficial environment. Thus being successful requires a significant degree of luck. No one gets it right every time. (That's why even the best investors diversify, hedge and/or limit their use of leverage.) But the skillful investor is right more often, over a long period of time, than an assumption of randomness would permit. **We say about such investors, “it can't be luck.”**

* * *

Where Is It Easiest to Get Lucky?

The second inspiration for this memo came from a report entitled *Alpha and the Paradox of Skill* by Michael Mauboussin of Credit Suisse. In it he talks about Jim Rutt, the CEO of Network Solutions. As a young man, Rutt wanted to become a better poker player, and to that end he worked hard to learn the odds regarding each hand and how to detect “tells” in other players that give away their position.

Here's the part that attracted my attention:

At that point, an uncle pulled him aside and doled out some advice. “Jim, I wouldn't spend my time getting better,” he advised, **“I'd spend my time finding weak games.”**

Success in investing has two aspects. The first is skill, which requires you to be technically proficient. Technical skills include the ability to find mispriced securities (based on capabilities in modeling, financial statement analysis, competitive strategy analysis, and valuation all while sidestepping behavioral biases) and a good framework for portfolio construction. **The second aspect is the game in which you choose to compete.** (Emphasis added)

Mauboussin goes on to talk primarily about changes in the relative importance of luck and skill. But for me, what his words keyed first and foremost were musings about market efficiency and inefficiency. What they highlighted is that the easiest way to win at poker is by playing in easy games in which other

players make mistakes. **Likewise, the easiest way to win at investing is by sticking to inefficient markets.**

Luck and Efficiency

Here's my take on the efficient market hypothesis: Thousands of intelligent, computer-literate, objective, unemotional, highly motivated and hard-working investors spend a great deal of time searching for information about assets and analyzing what it means for their value. For this reason, all available information is incorporated instantaneously in market prices. This causes the market price of every asset to accurately reflect its intrinsic value, such that an investor in the asset will enjoy a risk-adjusted return that is fair relative to the return on all other assets: no more and no less. Thus there are no "inefficiencies," or instances where assets are priced incorrectly so as to provide an "excess return" or a "free lunch." For this reason, no individuals are able to demonstrate superior investment skill ("alpha"). Even if some people were smart enough to take advantage of pricing errors, the market doesn't present errors for them to take advantage of. As a result, nobody can beat the market.

I have one main disagreement with the theory as presented above. Whereas the academics say in an efficient market the price of each asset **accurately reflects** its intrinsic value, I say the price set by the consensus **does the best job of estimating** the asset's intrinsic value. In other words, the academics say market prices are right, while I say they may be wrong but can't consistently be improved upon (and the errors taken advantage of) by any individual. A market may not be efficient in the sense that prices are "right," but it can be efficient in that it swiftly incorporates new information. The resulting prices may not be equal to the value, but they reflect everyone's best collective thinking at a point in time. **The result is the same: no one can beat the market.**

I think of the test for market efficiency as being twofold: if markets are efficient, (a) one market's risk-adjusted return can't be better or worse than any other market and (b) no investor in the market can outperform the rest in risk-adjusted terms. **In other words, there can't be opportunities for outperformance . . . either through skill or luck. In an efficient market – as with a Swiss watch (or, as Taleb would say, in dentistry) – luck plays no part.**

Are Markets Efficient? Is the Hypothesis Relevant?

Let me say up front that I have always considered the reasoning behind the efficient market hypothesis absolutely sound and compelling, and it has greatly influenced my thinking.

In well-followed markets, thousands of people are looking for superior investments and trying to avoid inferior ones. If they find information indicating something's a bargain, they buy it, driving up the price and eliminating the potential for an excess return. Likewise, if they find an overpriced asset, they sell it or short it, driving down the price and lifting its prospective return. **I think it makes perfect sense to expect intelligent market participants to drive out mispricings.**

The efficient market hypothesis is compelling . . . as a hypothesis. But is it relevant in the real world? (As Yogi Berra said, "In theory there is no difference between theory and practice, but in practice there is.") The answer lies in the fact that no hypothesis is any better than the assumptions on which it's premised.

I believe many markets are quite efficient. Everyone is aware of them, basically understands them, and is willing to invest in them. And in general everyone gets the same information at the same time (in fact,

it's one of the SEC's missions to make sure that's the case). I had markets like that in mind in 1978 when, on going into portfolio management, my rule was, "I'll do anything but spend the rest of my life choosing between Merck and Lilly."

But I also believe some markets are less efficient than others. Not everyone knows about them or understands them. They may be controversial, making people hesitant to invest. They may appear too risky for some. They may be hard to invest in, illiquid, or accessible only through locked-up vehicles in which some people can't or don't want to participate. Some market participants may have better information than others . . . legally. **Thus, in an inefficient market there can be mastery and/or luck, since market prices are often wrong, enabling some investors to do better than others.**

(Time for an aside: the fact that a market is inefficient doesn't mean everyone in it gets rich. It simply means there are overpricings and underpricings, to profit from or fall victim to. Thus there can be winners *and* losers. Even in an inefficient market, not everyone can be above average.)

Ultimately, there's one reason why I think no markets are perfectly efficient. Remember the assumptions underlying market efficiency: the participants have to be objective and unemotional. Regardless of the market, few investors pass that test. How many are unemotional enough to resist buying into a fast-rising bubble, or selling in a crash when the price of an asset appears to be on the way to zero?

The bottom line for me is that (a) you mustn't ignore the concept of efficiency, and at the same time, (b) you mustn't accept it as universally true. As I wrote in *What's It All About, Alpha* (July 2001):

If we entirely ignore theory, we can make big mistakes. We can fool ourselves into thinking it's possible to know more than everyone else and regularly beat heavily populated markets. . . . But swallowing theory whole can make us turn the process over to a computer and miss out on the contribution skillful individuals can make.

Rather than expect markets to routinely provide a free lunch, I think there should be a presumption that they're efficient. The burden of proof should be on anyone who thinks a market provides underpriced investments that no one else is smart enough to detect and pursue. It's safer to be skeptical of the existence of freebies than to assume unappreciated bargains are rife for the taking.

It's important to note, however, that market efficiency shouldn't be considered something that's universally applicable, but rather what Bruce Karsh has taught me to call a "rebuttable presumption." You should start out thinking it's the general rule, but its applicability can be disproved in individual situations. The possibility of inefficiency shouldn't be ignored.

In the old story on this subject, the professor of finance theory is taking a walk across the campus with one of his students. The student says, "Look professor: isn't that a \$10 bill on the ground?" The professor answers, "It can't be a \$10 bill. If it were, someone would have picked it up by now." The professor turns and walks away, and the student picks it up and has a beer.

My History with Inefficiency

As mentioned above, I was lucky in 1978 when Citibank asked me to manage a portfolio for the brokerage house Bache, which wanted to offer a high yield bond mutual fund. This was the first of many opportunities I've enjoyed for free lunches.

Thirty-five years ago, the high yield bond market was a classic example of market inefficiency.

- It was little known and little researched.
- There was little reported performance history.
- There was no centralized trading and no reported data on prices.
- Few professionals invested in them.
- Most importantly, high yield bonds were viewed as unseemly and investing in them was considered improper. I'll never forget Moody's definition of a B-rated bond: "fails to possess the characteristics of a desirable investment."
- For this reason, they were banned under most institutions' policies, which limited investment to bonds rated "A or better" or "investment grade (triple-B or better)."
- And, of course, they were known by the derogatory term "junk bonds." Like the finance professor in the story, most investors turned up their noses and walked away.

The elements listed above caused high yield bonds to be disrespected and shunned, **and thus to be underpriced and offer yields that were too high for the risk involved.** How do I know? Because (a) the yield spread offered as compensation for bearing risk has proved to be excessive, (b) the bonds have outperformed other forms of fixed income investing over the long term, and (c) Sheldon Stone has been able to compile a risk-adjusted net return above his benchmarks for the 28 years over which he's managed our portfolios. High yield bonds have provided the foundation for much of Oaktree's success and many of its subsequent initiatives.

Ten years later, in 1988, Sheldon and I agreed with Bruce Karsh that we should organize our first distressed debt fund, and Bruce hired Richard Masson to join him in the task. While the prominence of Drexel Burnham and Michael Milken had attracted attention to high yield bonds by that time, distressed debt was still little known and poorly understood. What could be more unseemly and frightening than the debt of companies that were bankrupt or that appeared overwhelmingly likely to become so? No mainstream financial institutions invested in distressed debt or offered distressed debt funds, leaving an open playing field for us. Bruce's aggregate since-inception return of 23% per year before fees (17½% after) – without the benefit of leverage – certainly suggests that inefficiencies have been present. And the fact that he has earned that return over 25 years while investing \$35 billion says it wasn't luck.

My point here is that these markets – and others that Oaktree entered over the years – have been inefficient markets. The lack of information, infrastructure, understanding and competition created many opportunities for us to find bargains, and for our clients in those markets to enjoy favorable returns with less-than-commensurate risk.

The Durability of Inefficiency

If efficiency should be the going-in presumption, so should "efficientization." That's my term for the process through which a market becomes more efficient. In short, over time the actions of diligent investors should have the effect of driving out bargains. If at first bargains exist, their holders will enjoy superior risk-adjusted returns, other investors will take note, and they'll study them and bid them up enough to eliminate the bargain element and thus the potential for further excess returns. If the inefficiency is caused by underdeveloped market infrastructure, you can expect centralized trading, price reporting, performance data and consultant focus to develop.

It requires a certain degree of malfunction for the market to allow an investor to find a bargain, buy it on the cheap and enjoy an excess return. But it takes a much greater degree of malfunction

for everyone else to fail to notice that investor's success, fail to emulate his methods, and thus allow the bargain to persist. Usually a free-lunch counter should be expected to be picked clean.

The Current State of Market Efficiency

Let's compare the current environment for efficiency with that of the past.

- Data on all forms of investing is freely available in vast quantities.
- Every investor has extensive computing power. In contrast, there were essentially no PCs or even four-function calculators before 1970, and no laptops before 1980.
- "Hedge fund," "alternative investing," "distressed debt," "high yield bond," "private equity," "mortgage backed security" and "emerging market" are all household words today. Thirty years ago they were non-existent, little known or poorly understood. Today, as I say about the impact of the browsers on our mobile phones, "everyone knows everything."
- Nowadays few people make moral judgments about investments. There aren't many instances of investors turning down an investment just because it's controversial or unseemly. In contrast, most will do anything to make a buck.
- There are about 8,000 hedge funds in the world, many of which have wide-open charters and pride themselves on being infinitely flexible.

It's hard to prove efficiency or inefficiency. Among other reasons, the academics say it takes many decades of data to reach a conclusion with "statistical significance," but by the time the requisite number of years have passed, the environment is likely to have been altered. Regardless, I think we must look at the changes listed above and accept that the conditions of today are less propitious for inefficiency than those of the past. **In short, it makes sense to accept that most games are no longer as easy as they used to be, and that as a result free lunches are scarcer. Thus, in general, I think it will be harder to earn superior risk-adjusted returns in the future, and the margin of superiority will be smaller.**

People often ask me about the inefficient markets of tomorrow. Think about it: that's an oxymoron. It's like asking, "What is there that hasn't been discovered yet?" **The markets are greatly changed from 25, 35 or 45 years ago. The bottom line today is that there's little that people don't know about, understand and embrace.**

How, then, do I expect to find inefficiency? My answer is that while few markets demonstrate great **structural inefficiency** today, many exhibit a great deal of **cyclical inefficiency** from time to time. Just five years ago, there were lots of things people wouldn't touch with a ten-foot pole, and as a result they offered absurdly high returns. Most of those opportunities are gone today, but I'm sure they'll be back the next time investors turn tail and run.

Markets will be permanently efficient when investors are permanently objective and unemotional. In other words, never. **Unless that unlikely day comes, skill and luck will both continue to play very important roles.**

January 16, 2014

Memo to: Oaktree Clients

From: Howard Marks

Re: Dare to Be Great II

In September 2006, I wrote a memo entitled *Dare to Be Great*, with suggestions on how institutional investors might approach the goal of achieving superior investment results. I've had some additional thoughts on the matter since then, meaning it's time to return to it. Since fewer people were reading my memos in those days, I'm going to start off repeating a bit of its content and go on from there.

About a year ago, a sovereign wealth fund that's an Oaktree client asked me to speak to their leadership group on the subject of what makes for a superior investing organization. I welcomed the opportunity. The first thing you have to do, I told them, is formulate an explicit investing creed. What do you believe in? What principles will underpin your process? The investing team and the people who review their performance have to be in agreement on questions like these:

- Is the efficient market hypothesis relevant? Do efficient markets exist? Is it possible to "beat the market"? Which markets? To what extent?
- Will you emphasize risk control or return maximization as the primary route to success (or do you think it's possible to achieve both simultaneously)?
- Will you put your faith in macro forecasts and adjust your portfolio based on what they say?
- How do you think about risk? Is it volatility or the probability of permanent loss? Can it be predicted and quantified *a priori*? What's the best way to manage it?
- How reliably do you believe a disciplined process will produce the desired results? That is, how do you view the question of determinism versus randomness?
- **Most importantly for the purposes of this memo, how will you define success, and what risks will you take to achieve it? In short, in trying to be right, are you willing to bear the inescapable risk of being wrong?**

Passive investors, benchmark huggers and herd followers have a high probability of achieving average performance and little risk of falling far short. But in exchange for safety from being much below average, they surrender their chance of being much above average. All investors have to decide whether that's okay. And, if not, what they'll do about it.

The more I think about it, the more angles I see in the title *Dare to Be Great*. Who wouldn't dare to be great? No one. Everyone would love to have outstanding performance. **The real question is whether you dare to do the things that are necessary in order to be great. Are you willing to be different, and are you willing to be wrong? In order to have a chance at great results, you have to be open to being both.**

Dare to Be Different

Here's a line from *Dare to Be Great*: **"This just in: you can't take the same actions as everyone else and expect to outperform."** Simple, but still appropriate.

For years I've posed the following riddle: Suppose I hire you as a portfolio manager and we agree you will get no compensation next year if your return is in the bottom nine deciles of the investor universe but \$10 million if you're in the top decile. **What's the first thing you have to do – the absolute prerequisite – in order to have a chance at the big money?** No one has ever answered it right.

The answer may not be obvious, but it's imperative: you have to assemble a portfolio that's different from those held by most other investors. If your portfolio looks like everyone else's, you may do well, or you may do poorly, *but you can't do different*. And being different is absolutely essential if you want a chance at being superior. In order to get into the top of the performance distribution, you have to escape from the crowd. There are many ways to try. They include being active in unusual market niches; buying things others haven't found, don't like or consider too risky to touch; avoiding market darlings that the crowd thinks can't lose; engaging in contrarian cycle timing; and concentrating heavily in a small number of things you think will deliver exceptional performance.

Dare to Be Great included the two-by-two matrix and paragraph below. Several people told me the matrix was helpful.

	Conventional Behavior	Unconventional Behavior
Favorable Outcomes	Average good results	Above-average results
Unfavorable Outcomes	Average bad results	Below-average results

Of course it's not that easy and clear-cut, but I think that's the general situation. If your behavior and that of your managers is conventional, you're likely to get conventional results – either good or bad. **Only if your behavior is unconventional is your performance likely to be unconventional . . . and only if your judgments are superior is your performance likely to be above average.**

For those who define investment success as being "average or better," three of the four cells of the matrix represent satisfactory outcomes. But if you define success strictly as being superior, only one of the four will do, and it requires unconventional behavior. More from the 2006 memo:

The bottom line on striving for superior performance has a lot to do with daring to be great. **Especially in terms of asset allocation, "can't lose" usually goes hand-in-hand with "can't win."** One of the investor's or the committee's first and most fundamental decisions has to be on the question of how far out the

portfolio will venture. **How much emphasis should be put on diversifying, avoiding risk and ensuring against below-pack performance, and how much on sacrificing these things in the hope of doing better?**

In the memo I mentioned my favorite fortune cookie: “the cautious seldom err or write great poetry.” Like the title *Dare to Be Great*, I find the fortune cookie thought-provoking. It can be taken as urging caution, since it reduces the likelihood of error. Or it can be taken as saying you should avoid caution, since it can keep you from doing great things. Or both. No right or wrong answer, but a choice . . . and hopefully a conscious one.

It Isn't Easy Being Different

In the 2006 memo, I borrowed two quotes from *Pioneering Portfolio Management* by David Swensen of Yale. They're my absolute favorites on the subject of institutional behavior. Here's the first:

Establishing and maintaining an unconventional investment profile requires acceptance of uncomfortably idiosyncratic portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom.

“Uncomfortably idiosyncratic” is a terrific phrase. There's a great deal of wisdom in those two words. What's idiosyncratic is rarely comfortable . . . and in order for something to be comfortable, it usually has to be conventional. The road to above average performance runs through unconventional, uncomfortable investing. Here's how I put it in 2006:

Non-consensus ideas have to be lonely. **By definition, non-consensus ideas that are popular, widely held or intuitively obvious are an oxymoron.** Thus such ideas are uncomfortable; non-conformists don't enjoy the warmth that comes with being at the center of the herd. Further, unconventional ideas often appear imprudent. The popular definition of “prudent” – especially in the investment world – is often twisted into “what everyone does.”

Most great investments begin in discomfort. The things most people feel good about – investments where the underlying premise is widely accepted, the recent performance has been positive and the outlook is rosy – are unlikely to be available at bargain prices. Rather, bargains are usually found among things that are controversial, that people are pessimistic about, and that have been performing badly of late.

But it isn't easy to do things that entail discomfort. It's no coincidence that distressed debt has been the source of many successful investments for Oaktree; there's no such thing as a distressed company that everyone reveres. In 1988, when Bruce Karsh and I organized our first fund to invest in the debt of companies seemingly at death's door, the very idea made it hard to raise money, and investing required conviction – on the clients' part and our own – that our analysis and approach would mitigate the risk. The same discomfort, however, is what caused distressed debt to be priced cheaper than it should have been, and thus the returns to be consistently high.

Dare to Be Wrong

“You have to give yourself a chance to fail.” That’s what Kenny “The Jet” Smith said on TV the other night during the NCAA college basketball tournament, talking about a star player who started out cold and as a result attempted too few shots in a game his team lost. It’s a great way to make the point. Failure isn’t anyone’s goal, of course, but rather an inescapable potential consequence of trying to do really well.

Any attempt to compile superior investment results has to entail acceptance of the possibility of being wrong. The matrix on page two shows that since conventional behavior is sure to produce average performance, people who want to be above average can’t expect to get there by engaging in conventional behavior. Their behavior has to be different. **And in the course of trying to be different and better, they have to bear the risk of being different and worse.** That truth is simply unarguable. There is no way to strive for the former that doesn’t require bearing the risk of the latter.

The truth is, almost everything about superior investing is a two-edged sword:

- If you invest, you will lose money if the market declines.
- If you don’t invest, you will miss out on gains if the market rises.
- Market timing will add value if it can be done right.
- Buy-and-hold will produce better results if timing can’t be done right.
- Aggressiveness will help when the market rises but hurt when it falls.
- Defensiveness will help when the market falls but hurt when it rises.
- If you concentrate your portfolio, your mistakes will kill you.
- If you diversify, the payoff from your successes will be diminished.
- If you employ leverage, your successes will be magnified.
- If you employ leverage, your mistakes will be magnified.

Each of these pairings indicates symmetry. None of the tactics listed will add value if it’s right but not subtract if it’s wrong. Thus none of these tactics, in and of itself, can hold the secret to dependably above average investment performance.

There’s only one thing in the investment world that isn’t two-edged, and that’s “alpha”: superior insight or skill. Skill can help in both up markets and down markets. And by making it more likely that your decisions are right, superior skill can increase the expected benefit from concentration and leverage. But that kind of superior skill by definition is rare and elusive.

The goal in investing is asymmetry: to expose yourself to return in a way that doesn’t expose you commensurately to risk, and to participate in gains when the market rises to a greater extent than you participate in losses when it falls. But that doesn’t mean the avoidance of all losses is a reasonable objective. Take another look at the goal of asymmetry set

out above: **it talks about achieving a preponderance of gain over loss, not avoiding all chance of loss.**

To succeed at any activity involving the pursuit of gain, we have to be able to withstand the possibility of loss. A goal of avoiding all losses can render success unachievable almost as readily as can the occurrence of too many losses. Here are three examples of “loss prevention strategies” that can lead to failure:

- I play tennis. But if when I start a match I promise myself that I won’t commit a single double fault, I’ll never be able to put enough “mustard” on my second serve to keep it from being easy for my opponent to put away.
- Likewise, coming out ahead at poker requires that I win a lot on my winning hands and lose less on my losers. But insisting that I’ll never play anything but “the nuts” – the hand that can’t possibly be beat – will keep me from playing lots of hands that have a good chance to win but aren’t sure things.
- For a real-life example, Oaktree has always emphasized default avoidance as the route to outperformance in high yield bonds. Thus our default rate has consistently averaged just 1/3 of the universe default rate, and our risk-adjusted return has beaten the indices. But if we had insisted on – and designed compensation to demand – zero defaults, I’m sure we would have been too risk averse and our performance wouldn’t have been as good. As my partner Sheldon Stone puts it, “If you don’t have any defaults, you’re taking too little risk.”

When I first went to work at Citibank in 1968, they had a slogan that “scared money never wins.” **It’s important to play judiciously, to have more successes than failures, and to make more on your successes than you lose on your failures. But it’s crippling to have to avoid all failures, and insisting on doing so can’t be a winning strategy. It may guarantee you against losses, but it’s likely to guarantee you against gains as well.** Here’s some helpful wisdom on the subject from Wayne Gretzky, considered by many to be the greatest hockey player who ever lived: **“You miss 100% of the shots you don’t take.”**

There is no formulaic approach to investing that can be depended on to produce superior risk-adjusted returns. There can’t be. In a relatively fair or “efficient” market – and the concerted efforts of investors to find underpriced assets tend to make most markets quite fair – asymmetry is reduced, and a formula that everyone can access can’t possibly work.

As John Kenneth Galbraith said, “There is nothing reliable to be learned about making money. If there were, study would be intense and everyone with a positive IQ would be rich.” If merely applying a formula that’s available to everyone could be counted on to provide easy profits, where would those profits come from? Who would be the losers in those transactions? Why wouldn’t those people study and apply the formula also?

Or as Charlie Munger told me, “It’s not supposed to be easy. Anyone who finds it easy is stupid.” In other words, anyone who thinks it can be easy to succeed at investing is being simplistic and superficial, and ignoring investing’s complex and competitive nature.

Why should superior profits be available to the novice, the untutored or the lazy? Why should people be able to make above average returns without hard work and above average skill, and without knowing something most others don’t know? And yet many individuals invest based on the belief that they can. (If they didn’t believe that, wouldn’t they index or, at a minimum, turn over the task to others?)

No, the solution can’t lie in rigid tactics, publicly available formulas or loss-eliminating rules . . . or in complete risk avoidance. **Superior investment results can only stem from a better-than-average ability to figure out when risk-taking will lead to gain and when it will end in loss.** There is no alternative.

Dare to Look Wrong

This is really the bottom-line: not whether you dare to be different or to be wrong, but whether you dare to look wrong.

Most people understand and accept that in their effort to make correct investment decisions, they have to accept the risk of making mistakes. Few people expect to find a lot of sure things or achieve a perfect batting average.

While they accept the intellectual proposition that attempting to be a superior investor has to entail the risk of loss, many institutional investors – and especially those operating in a political or public arena – can find it unacceptable to look significantly wrong. Compensation cuts and even job loss can befall the institutional employee who’s associated with too many mistakes.

As *Pensions & Investments* said on March 17 regarding a big West Coast bond manager currently in the news, whom I’ll leave nameless:

. . . asset owners are concerned that doing business with the firm could bring unwanted attention, possibly creating headline risk and/or job risk for them. . . .

One [executive] at a large public pension fund said his fund recently allocated \$100 million for emerging markets, its first allocation to the firm. He said he wouldn’t do that today, given the current situation, because it could lead to second-guessing by his board and the local press.

“If it doesn’t work out, it looks like you don’t know what you are doing,” he said.

As an aside, let me say I find it perfectly logical that people should feel this way. Most “agents” – those who invest the money of others – will benefit little from bold decisions that work but will suffer greatly from bold decisions that fail. The possibility of receiving an “attaboy” for a few

winners can't balance out the risk of being fired after a string of losers. Only someone who's irrational would conclude that the incentives favor boldness under these circumstances. Similarly, members of a non-profit organization's investment committee can reasonably conclude that bearing the risk of embarrassment in front of their peers that accompanies bold but unsuccessful decisions is unwarranted given their volunteer positions.

I'm convinced that for many institutional investment organizations the operative rule – intentional or unconscious – is this: “We would never buy so much of something that if it doesn't work, we'll look bad.” For many agents and their organizations, the realities of life mandate such a rule. But people who follow this rule must understand that by definition it will keep them from buying enough of something that works for it to make much of a difference for the better.

In 1936, the economist John Maynard Keynes wrote in *The General Theory of Employment, Interest and Money*, “Worldly wisdom teaches that it is better *for reputation* to fail conventionally than to succeed unconventionally” [italics added]. For people who measure success in terms of dollars and cents, risk taking can pay off when gains on winners are netted out against losses on losers. **But if reputation or job retention is what counts, losers may be all that matter, since winners may be incapable of outweighing them. In that case, success may hinge entirely on the avoidance of unconventional behavior that's unsuccessful.**

Often the best way to choose between alternative courses of action is by figuring out which has the highest “expected value”: the total value arrived at by multiplying each possible outcome by its probability of occurring and summing the results. As I learned from my first textbook at Wharton fifty years ago (*Decisions Under Uncertainty* by C. Jackson Grayson, Jr.), if one act has a higher expected value than another and “. . . if the decision maker is willing to regard the consequences of each act-event in purely *monetary* terms, then this would be the logical act to choose. Keeping in mind, however, that *only one event and its consequence will occur* (not the weighted average consequence),” agents may not be able to choose on the basis of expected value or the weighted average of all possible consequences. **If a given action has potential bad consequences that are absolutely unacceptable, the expected value of all of its consequences – both good and bad – can be irrelevant.**

Given the typical agent's asymmetrical payoff table, the rule for institutional investors underlined above is far from nonsensical. But if it is adopted, this should be done with awareness of the likely result: over-diversification. This goes all the way back to the beginning of this memo, and each organization's need to establish its creed. In this case, the following questions must be answered:

- In trying to achieve superior investment results, to what extent will we concentrate on investments, strategies and managers we think are outstanding? Will we do this despite the potential of our decisions to be wrong and bring embarrassment?
- Or will fear of error, embarrassment, criticism and unpleasant headlines make us diversify highly, emulate the benchmark portfolio and trade boldness for safety? Will we opt for low-cost, low-aspiration passive strategies?

In the course of the presentation described at the beginning of this memo, I pointed out to the sovereign wealth fund's managers that they had allocated close to a billion dollars to Oaktree's management over the preceding 15 years. Although that sounds like a lot of money, it actually amounts to only a few tenths of a percent of what the world guesses their assets to be. And given our funds' cycle of investing and divesting, that means they didn't have even a few tenths of a percent of their capital with us at any one time. Thus, despite our good performance, I think it's safe to say Oaktree couldn't have had a meaningful impact on the fund's overall results. Certainly one would associate this behavior with an extreme lack of risk tolerance and a high aversion to headline risk. I urged them to consider whether this reflects their real preference.

Lou Brock of the St. Louis Cardinals was one of baseball's best base stealers between 1966 and 1974. He's the source of a great quote: **"Show me a guy who's afraid to look bad, and I'll show you a guy you can beat every time."** What he meant (with apologies to readers who don't understand baseball) is that in order to prevent a great runner from stealing a base, a pitcher may have to throw over to the bag ten times in a row to hold him close, rather than pitch to the batter. But after a few such throws, a pitcher can look like a scaredy-cat and be booed. Pitchers who were afraid of those things were easy pickings for Lou Brock. Fear of looking bad ensured their failure.

Looking Right Can Be Harder Than Being Right

Fear of looking bad can be particularly debilitating to an investor, client or manager. This is because of how hard it is to consistently make correct investment decisions. Some of this comes from my last memo, on the role of luck.

- First, it's hard to consistently make decisions that correctly factor in all of the relevant facts and considerations (i.e., it's hard to be right).
- Second, it's far from certain that even "right" decisions will be successful, since every decision requires assumptions about what the future will look like, and even reasonable assumptions can be thwarted by the world's randomness. Thus many correct decisions will result in failure (i.e., it's hard to look right).
- Third, even well-founded decisions that eventually turn out to be right are unlikely to do so promptly. This is because not only are future events uncertain, their timing is particularly variable (i.e., it's impossible to look right on time).

This brings me to one of my three favorite adages: **"Being too far ahead of your time is indistinguishable from being wrong."** The fact that something's cheap doesn't mean it's going to appreciate tomorrow; it can languish in the bargain basement. And the fact that something's overpriced certainly doesn't mean it'll fall right away; bull markets can go on for years. As Lord Keynes observed, "the market can remain irrational longer than you can remain solvent."

Alan Greenspan warned of “irrational exuberance” in December 1996, but the stock market continued upward for more than three years. A brilliant manager I know who turned bearish around the same time had to wait until 2000 to be proved correct . . . during which time his investors withdrew much of their capital. He wasn’t “wrong,” just early. But that didn’t make his experience any less painful.

Likewise, John Paulson made the most profitable trade in history by shorting mortgage securities in 2006. Many others entered into the same transactions, but too early. When the bets failed to work at first, the appearance of being on the wrong track ate into the investors’ ability to stick with their decision, and they were forced to close out positions that would have been extremely profitable.

In order to be a superior investor, you need the strength to diverge from the herd, stand by your convictions, and maintain positions until events prove them right. Investors operating under harsh scrutiny and unstable working conditions can have a harder time doing this than others.

That brings me to the second quote I promised from Yale’s David Swensen:

. . . active management strategies demand uninstitutional behavior from institutions, creating a paradox that few can unravel.

Charlie Munger was right about it not being easy. **I’m convinced that everything that’s important in investing is counterintuitive, and everything that’s obvious is wrong.** Staying with counterintuitive, idiosyncratic positions can be extremely difficult for anyone, especially if they look wrong at first. So-called “institutional considerations” can make it doubly hard.

Investors who aspire to superior performance have to live with this reality. **Unconventional behavior is the only road to superior investment results, but it isn’t for everyone. In addition to superior skill, successful investing requires the ability to look wrong for a while and survive some mistakes.** Thus each person has to assess whether he’s temperamentally equipped to do these things and whether his circumstances – in terms of employers, clients and the impact of other people’s opinions – will allow it . . . when the chips are down and the early going makes him look wrong, as it invariably will. Not everyone can answer these questions in the affirmative. It’s those who believe they can that should take a chance on being great.

April 8, 2014

Memo to: Oaktree Clients
From: Howard Marks
Re: Risk Revisited Again

The operators of racetracks take a dim view of bettors who engage in “past-posting”: trying to get a bet down after the race is over (and the horses are “past the post”). In that vein, it’s been my practice not to rewrite old memos as new developments arise or new ideas strike me. However, while preparing “Risk Revisited” of September 2014 for inclusion in a compilation of my memos, I thought of a number of ways in which it could be made better. And since it was my original intention to have it contain everything I know about risk, I’ve decided to incorporate them. To make it clear which sections are new, I’ve put them in italics.

In April 2014, I had good results with *Dare to Be Great II*, starting from the base established in an earlier memo (*Dare to Be Great*, September 2006) and adding new thoughts that had occurred to me in the intervening years. Also in 2006 I wrote *Risk*, my first memo devoted entirely to this key subject. My thinking continued to develop, causing me to dedicate three chapters to risk among the twenty in my book *The Most Important Thing*. This memo adds to what I’ve previously written on the topic.

What Risk Really Means

In the 2006 memo and in the book, I argued against the purported identity between volatility and risk. Volatility is the academic’s choice for defining and measuring risk. I think this is the case largely because volatility is quantifiable and thus usable in the calculations and models of modern finance theory. In the book I called it “machinable,” and there is no substitute for the purposes of the calculations.

However, while volatility is quantifiable and machinable – and can be an indicator or symptom of riskiness and even a specific form of risk – I think it falls far short as “the” definition of investment risk. In thinking about risk, we want to identify the thing that investors worry about and thus demand compensation for bearing. I don’t think most investors fear volatility. In fact, I’ve never heard anyone say, “The prospective return isn’t high enough to warrant bearing all that volatility.” **What they fear is the possibility of permanent loss.**

Permanent loss is very different from volatility or fluctuation. A downward fluctuation – which by definition is temporary – doesn’t present a big problem if the investor is able to hold on and come out the other side. A permanent loss – from which there won’t be a rebound – can occur for either of two reasons: (a) an otherwise-temporary dip is locked in when the investor sells during a downswing – whether because of a loss of conviction; requirements stemming from his timeframe; financial exigency; or emotional pressures, or (b) the investment itself is unable to recover for fundamental reasons. We can ride out volatility, but we never get a chance to undo a permanent loss.

Of course, the problem with defining risk as the possibility of permanent loss is that it lacks the very thing volatility offers: quantifiability. **The probability of loss is no more measurable than the probability of rain.** It can be modeled, and it can be estimated (and by experts pretty well), but it cannot be known.

In *Dare to Be Great II*, I described the time I spent advising a sovereign wealth fund about how to organize for the next thirty years. My presentation was built significantly around my conviction that risk

can't be quantified *a priori*. Another of their advisors, a professor from a business school north of New York, insisted it can. This is something I prefer not to debate, especially with people who're sure they have the answer but haven't bet much money on it.

One of the things the professor was sure could be quantified was the maximum a portfolio could fall under adverse circumstances. But how can this be so if we don't know how adverse circumstances can be or how they will influence returns? We might say "the market probably won't fall more than x% as long as things aren't worse than y and z," but how can an absolute limit be specified? I wonder if the professor had anticipated that the S&P 500 could fall 57% in the global crisis.

While writing the original memo on risk in 2006, an important thought came to me for the first time. Forget about *a priori*; if you define risk as anything other than volatility, it can't be measured **even after the fact**. If you buy something for \$10 and sell it a year later for \$20, was it risky or not? The novice would say the profit proves it was safe, while the academic would say it was clearly risky, since the only way to make 100% in a year is by taking a lot of risk. I'd say it might have been a brilliant, safe investment that was sure to double or a risky dart throw that got lucky.

If you make an investment in 2012, you'll know in 2014 whether you lost money (and how much), but you won't know whether it was a risky investment – that is, what the probability of loss was at the time you made it. To continue the analogy, **it may rain tomorrow, or it may not, but nothing that happens tomorrow will tell you what the probability of rain was as of today. And the risk of rain is a very good analogue (although I'm sure not perfect) for the risk of loss.**

People Smarter Than Me

Peter Bernstein, who passed away in 2009, was one of the smartest people I ever met: a real investment sage. He combined a brilliant and learned mind, great common sense, and the ability to express himself with incredible clarity. I found a great deal of inspiration in his newsletter "Economics and Portfolio Strategy," in his book "Against the Gods: The Remarkable Story of Risk," and in our correspondence.

One of the newsletter's best issues, from June 2007, was titled "Can We Measure Risk with a Number?" It provided Peter's answer to that question, buttressed by the words of a number of great thinkers. It's so good that I want to share parts here (with all emphasis added but the first). This memo is greatly enhanced by their inclusion:

In life – and in investing – the biggest risks cannot be reduced to a hard number. As Bill Sharpe put it to me recently, "It's dangerous, at least in general, to think of risk as a number The problem we face is that there are many scenarios that can unfold in the future. . . ." John Maynard Keynes, [in the 1920s], had this to say: "There is little likelihood of our discovering a method of recognizing particular probabilities, without any assistance whatever from intuition or direct judgment. . . . A proposition is not probable because we think it so."

*Consider the following story. In 1703, the great Swiss mathematician Jacob Bernoulli wrote Leibniz he thought it strange that we knew the odds of throwing a seven instead of an eight with dice, but we do not know the probability that a man of twenty will outlive a man of sixty. He proposed following a large number of pairs of men to see whether he could arrive at the probability that a man of twenty will outlive a man of sixty. Leibniz was unimpressed. "Nature has established patterns originating in the return of events, **but only for the most part**. . . . No matter how many experiments . . . you have*

conducted, you have not thereby imposed a limit on the nature of events so that in the future they would not vary.” Leibniz had written to Bernoulli in Latin, as was customary for exchanges between intellectuals in those days, but he put “but only for the most part” in Greek, to give it maximum emphasis. If it were “always,” there would be no uncertainty, no risk.

“But only for the most part” is what risk is all about: uncertainty. The key hazard of quantitative risk management is the illusion of control the models and their results impart to us. No model has an R^2 of 1.000. Even if you have a so-called statistically significant outcome, which is 95% certain – and that is surely “for the most part” – 95% still leaves 5% you know nothing about. The devil is in the residuals, as all of us have discovered to our sorrow.

I have pursued this discussion of the nature of risk, and our inability to accurately measure risk, because I think it sheds important light on how we should think about the current environment, where the economic risks appear to be moderate and manageable and where the environment itself seems to have so many self-reinforcing elements. I believe we have to look at the environment in qualitative terms, not quantitative terms. Only then can we develop an answer to the question of whether, in today’s global economy, we have ended “the slings and arrows of outrageous fortune,” as so many appear to believe. [Bernstein demonstrated considerable foresight in writing this paragraph and the next four in the lead-up to the global financial crisis.]

Can we sustain the low-risk character of the environment when it leads many investors to take high risks and to overvalue risky assets in search for higher returns? . . . The more risk we take because we believe the environment is low-risk in character, the less the environment continues to be low-risk in character.

. . . The more we emphasize the low risks in the environment, the more we point out and explain its features, and the more we believe we understand what is going on – unique as this environment may be – the weaker our normal and rational inclination to risk aversion becomes and the more our actions alter the character of the environment.

The economist Hyman Minsky has reminded us, **“Each state nurtures forces that lead to its own destruction.”** All of history testifies to the truth of this observation. Greater liquidity [by which Bernstein meant greater availability of funds] leads firms to borrow more than before. But higher levels of debt mean increasing vulnerability to adversity and negative shocks in an ever-changing world. For these reasons, as Minsky put it, stability leads inevitably to instability. . . .

Even places that were once banana-republics, like Argentina and Brazil, are issuing long-term bonds and even issuing bonds denominated in foreign currencies. The eagerness to lend in so many different ways in so many different markets is a potent symptom of confidence in the underlying stability of the global system. . . .

Shocks and surprises are what the history of investment is all about. Here is what G. K. Chesterton had to say on this matter . . . :

The real trouble with this world of ours is not that it is an unreasonable world, nor even that it is a reasonable one. The commonest kind of trouble is that it is nearly reasonable, but not quite. **Life is not an**

illogicality; yet it is a trap for logicians. It looks just a little more mathematical and regular than it is; its exactitude is obvious, but its inexactitude is hidden; its wildness lies in wait.

*Beginning on page 9, you'll find a section borrowed from a memo I wrote back in 2007. Its first bullet point starts off as follows: "Risk exists only in the future. . . ." That notion holds a good part of the key to understanding investment risk. **If you accept that the underlying processes affecting economics, business and market psychology are less than 100% dependable, as seems obvious, then it follows that the future isn't knowable. In that case, risk can be nothing more than the subject of estimation – Keynes's "intuition or direct judgment" (see page 2) – and certainly not reliably quantified.***

The Unknowable Future

It seems most people in the prediction business think the future is knowable, and all they have to do is be among the ones who know it. Alternatively, they may understand (consciously or unconsciously) that it's not knowable but believe they have to act as if it is in order to make a living as an economist or investment manager.

On the other hand, I'm solidly convinced the future isn't knowable. I side with John Kenneth Galbraith who said, "We have two classes of forecasters: Those who don't know – and those who don't know they don't know." There are several reasons for this inability to predict:

- We're well aware of many factors that can influence future events, such as governmental actions, individuals' spending decisions and changes in commodity prices. But these things are hard to predict, and I doubt anyone is capable of taking all of them into account at once. (People have suggested a parallel between this categorization and that of Donald Rumsfeld, who might have called these things "known unknowns": the things we know we don't know.)
- The future can also be influenced by events that aren't on anyone's radar today, such as calamities – natural or man-made – that can have great impact. The 9/11 attacks and the Fukushima disaster are two examples of things no one knew to think about. (These would be "unknown unknowns": the things we don't know we don't know.)
- There's far too much randomness at work in the world for future events to be predictable. As 2014 began, forecasters were sure the U.S. economy was gaining steam, but they were confounded when record cold weather caused GDP to fall 2.9% in the first quarter.
- And importantly, the connections between contributing influences and future outcomes are far too imprecise and variable for the results to be dependable.

That last point deserves discussion. Physics is a science, and for that reason an electrical engineer can guarantee you that if you flip a switch over here, a light will go on over there . . . every time. But there's good reason why economics is called "the dismal science," and in fact it isn't much of a science at all. In just the last few years we've had opportunity to see – contrary to nearly unanimous expectations – that interest rates near zero can fail to produce a strong rebound in GDP, and that a reduction of bond buying on the part of the Fed can fail to bring on higher interest rates. In economics and investments, because of the key role played by human behavior, you just can't say for sure that "if A, then B," as you can in real science. The weakness of the

connection between cause and effect makes outcomes uncertain. In other words, it introduces risk.

Given the near-infinite number of factors that influence developments, the great deal of randomness present, and the weakness of the linkages, it's my solid belief that future events cannot be predicted with any consistency. In particular, predictions of important divergences from trends and norms can't be made with anything approaching the accuracy required for them to be helpful.

Coping with the Unknowable Future

Here's the essential conundrum: investing requires us to decide how to position a portfolio for future developments, but the future isn't knowable.

Taken to slightly greater detail:

- Investing requires the taking of positions that will be affected by future developments.
- The existence of negative possibilities surrounding those future developments presents risk.
- Intelligent investors pursue prospective returns that they think compensate them for bearing the risk of negative future developments.
- But future developments are unpredictable.

How can investors deal with the limitations on their ability to know the future? **The answer lies in the fact that not being able to know the future doesn't mean we can't deal with it.** It's one thing to know what's going to happen and something very different to have a feeling for the range of possible outcomes and the likelihood of each one happening. Saying we can't do the former doesn't mean we can't do the latter.

The information we're able to estimate – the list of events that might happen and how likely each one is – can be used to construct a probability distribution. **Key point number one in this memo is that the future should be viewed not as a fixed outcome that's destined to happen and capable of being predicted, but as a range of possibilities and, hopefully on the basis of insight into their respective likelihoods, as a probability distribution.**

Since the future isn't fixed and future events can't be predicted, risk cannot be quantified with any precision. I made the point in *Risk*, and I want to emphasize it here, that risk estimation has to be the province of experienced experts, and their work product will by necessity be subjective, imprecise, and more qualitative than quantitative (even if it's expressed in numbers).

There's little I believe in more than Albert Einstein's observation: **"Not everything that counts can be counted, and not everything that can be counted counts."** I'd rather have an order-of-magnitude approximation of risk from an expert than a precise figure from a highly educated statistician who knows less about the underlying investments. British philosopher and logician Carveth Read put it this way: "It is better to be vaguely right than exactly wrong."

By the way, in my personal life I tend to incorporate another of Einstein's comments: "I never think of the future – it comes soon enough." We can't take that approach as investors, however. We have to think about the future. We just shouldn't accord too much significance to our opinions.

We can't know what will happen. We can know something about the possible outcomes (and how likely they are). People who have more insight into these things than others are likely to make superior investors. As I said in the last paragraph of *The Most Important Thing*:

Only investors with unusual insight can regularly divine the probability distribution that governs future events and sense when the potential returns compensate for the risks that lurk in the distribution's negative left-hand tail.

In other words, in order to achieve superior results, an investor must be able – with some regularity – to find asymmetries: instances when the upside potential exceeds the downside risk. That's what successful investing is all about.

Thinking in Terms of Diverse Outcomes

It's the indeterminate nature of future events that creates investment risk. **It goes without saying that if we knew everything that was going to happen, there wouldn't be any risk.**

The return on a stock will be a function of the relationship between the price today and the cash flows (income and sale proceeds) it will produce in the future. The future cash flows, in turn, will be a function of the fundamental performance of the company and the way its stock is priced given that performance. We invest on the basis of expectations regarding these things. It's tautological to say that if the company's earnings and the valuation of those earnings meet our targets, the return will be as expected. The risk in the investment therefore comes from the possibility that one or both will come in lower than we think.

To oversimplify, investors in a given company may have an expectation that if A happens, that'll make B happen, and if C and D also happen, then the result will be E. Factor A may be the pace at which a new product finds an audience. That will determine factor B, the growth of sales. If A is positive, B should be positive. Then if C (the cost of raw materials) is on target, earnings should grow as expected, and if D (investors' valuation of the earnings) also meets expectations, the result should be a rising share price, giving us the return we seek (E).

We may have a sense for the probability distributions governing future developments, and thus a feeling for the likely outcome regarding each of developments A through E. The problem is that for each of these, there can be lots of outcomes other than the ones we consider most likely. The possibility of less-good outcomes is the source of risk. **That leads me to key point number two, as expressed by Elroy Dimson, a professor at the London Business School: "Risk means more things can happen than will happen."** This brief, pithy sentence contains a great deal of wisdom.

People who rely heavily on forecasts seem to think there's only one possibility, meaning risk can be eliminated if they just figure out which one it is. The rest of us know many possibilities exist today, and it's not knowable which of them will occur. Further, things are subject to change, meaning there will be new possibilities tomorrow. **This uncertainty as to which of the possibilities will occur is the source of risk in investing.**

Even a Probability Distribution Isn't Enough

I've stressed the importance of viewing the future as a probability distribution rather than a single predetermined outcome. **It's still essential to bear in mind key point number three: Knowing the**

probabilities doesn't mean you know what's going to happen. For example, all good backgammon players know the probabilities governing throws of two dice. They know there are 36 possible outcomes, and that six of them add up to the number seven (1-6, 2-5, 3-4, 4-3, 5-2 and 6-1). Thus the chance of throwing a seven on any toss is 6 in 36, or 16.7%. There's absolutely no doubt about that. But even though we know the probability of each number, we're far from knowing what number will come up on a given roll.

Backgammon players are usually quite happy to make a move that will enable them to win unless the opponent rolls twelve, since only one combination of the dice will produce it: 6-6. The probability of rolling twelve is thus only 1 in 36, or less than 3%. But twelve does come up from time to time, and the people it turns into losers end up complaining about having done the "right" thing but lost. As my friend Bruce Newberg says, **"There's a big difference between probability and outcome."** Unlikely things happen – and likely things fail to happen – all the time. **Probabilities are likelihoods and very far from certainties.**

It's true with dice, and it's true in investing . . . and not a bad start toward conveying the essence of risk. Think again about the quote above from Elroy Dimson: "Risk means more things can happen than will happen." **I find it particularly helpful to invert Dimson's observation for key point number four: Even though many things can happen, only one will.**

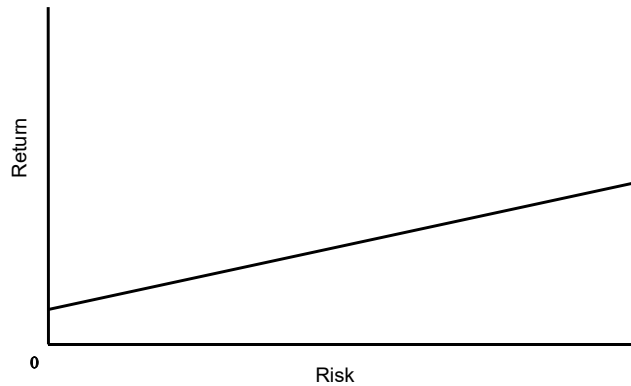
In *Dare to Be Great II*, I discussed the fact that economic decisions are usually best made on the basis of "expected value": you multiply each potential outcome by its probability, sum the results, and select the path with the highest total. *But while expected value represents the probability-weighted average of all possible outcomes, we can be certain it will not be the outcome (unless by coincidence it's one of the possibilities). Clearly just one of the many things that can happen will happen – not the average of all of them. And if some of the paths under consideration include individual outcomes that are absolutely unacceptable, we might not be able to choose on the basis of the highest expected value. We may have to shun the quantitatively optimal path in order to avoid the possibility of an extreme negative outcome.* I always say I have no interest in being a skydiver who's successful 95% of the time.

Investment performance (like life in general) is a lot like choosing a lottery winner by pulling one ticket from a bowlful. The process through which the winning ticket is chosen can be influenced by physical processes, and also by randomness. But it never amounts to anything but one ticket picked from among many. **Superior investors have a better sense for what's in the bowl, and thus for whether it's worth buying a ticket in a lottery.** *But even they don't know for sure which one will be chosen.* Lesser investors have less of a sense for the probability distribution and for whether the likelihood of winning the prize compensates for the risk that the cost of the ticket will be lost.

Risk and Return

Both in the 2006 memo on risk and in my book, I showed two graphics that together make clear the nature of investment risk. People have told me they're the best thing in the book, and since readers of this memo might have not seen the old one or read the book, I'm going to repeat them here.

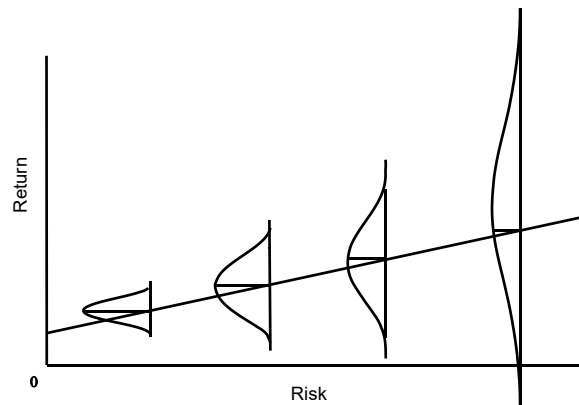
The first one below shows the relationship between risk and return as it is conventionally represented. The line slopes upward to the right, meaning the two are "positively correlated": as risk increases, return increases.



In both the old memo and the book, I went to great lengths to clarify what this is often – but erroneously – taken to mean. We hear it all the time: “Riskier investments produce higher returns” and “If you want to make more money, take more risk.”

Both of these formulations are terrible. **In brief, if riskier investments could be counted on to produce higher returns, they wouldn’t be riskier.** Misplaced reliance on the benefits of risk bearing has led investors to some very unpleasant surprises.

However, there’s another, better way to describe this relationship: “Investments that seem riskier have to appear likely to deliver higher returns, or else people won’t make them.” This makes perfect sense. If the market is rational, the price of a seemingly risky asset will be set low enough that the reward for holding it appears adequate to compensate for the risk present. But note the word “appear.” We’re talking about investors’ opinions regarding future return, not facts. Risky investments are – by definition – far from certain to deliver on their promise of high returns. For that reason, I think the graphic below (*with the probability distributions redrawn from those of the 2014 version of this memo*) does a much better job of portraying reality:



Here the underlying relationship between risk and return reflects the same positive general tendency as the first graphic, but the result of each investment is shown as a range of possibilities, not the single outcome suggested by the upward-sloping line. At each point along the horizontal risk axis, an investment’s prospective return is shown as a bell-shaped probability distribution turned on its side.

The conclusions are obvious from inspection. As you move to the right, increasing the risk:

- the expected return increases (as with the traditional graphic),
- the range of possible outcomes becomes wider, and
- the less-good outcomes become worse.

This is the essence of investment risk. Riskier investments are ones where the investor is less secure regarding the eventual outcome and faces the possibility of faring worse than those who stick to safer investments, and even of losing money. These investments are undertaken because the expected return is higher. But things may happen other than that which is hoped for. Some of the possibilities are superior to the expected return, but others are decidedly unattractive.

The first graph's upward-sloping line indicates the underlying directionality of the risk/return relationship. But there's a lot more to consider than the fact that expected returns rise along with perceived risk, and in that regard the first graph is highly misleading. The second graph shows both the underlying trend and the increasing potential for actual returns to deviate from expectations. While the expected return rises along with risk, so does the probability of lower returns . . . and even of losses. **This way of looking at things reflects Professor Dimson's dictum that more than one thing can happen. That's reality in an unpredictable world.**

The Challenge of Managing Risk

*The foregoing has been somewhat philosophical and theoretical. To provide a glimpse at how risk operates in the real world, and even though you may have read it earlier, I reproduce here (with minor modifications) a section that appeared with the above title in my memo "No Different This Time – The Lessons of '07" (December 2007). It points out some of the ways in which risk deviates in practice from the risk of theory. Each of these "realities" adds a degree of complexity that wouldn't exist if risk were quantifiable, linear and dependable, and thus easily treated. **But then it wouldn't be risk.***

One of the reasons investor confidence was hit so hard [in 2007] is simply that it was too high (as is required for unsustainable market highs to be reached). And much of investors' excessive comfort was in the area of risk, where it was roundly believed things were under control. But the truth is, it's hard to manage risk.

As I stated in "Risk" (February 2006), investment risk is largely invisible – before the fact, except perhaps to people with unusual insight, and even after an investment has been exited. For this reason, many of the great financial disasters we've seen have been failures to foresee and manage risk. There are several reasons for this:

- ***Risk exists only in the future, and it's impossible to know for sure what the future holds. Expectations are often formulated on the basis of what happened in the past, but the events of the past must be taken with a substantial grain of salt. No ambiguity is evident when we view the past. Only the things that happened happened. But that definiteness doesn't mean the process that creates outcomes is clear-cut and dependable. Many things could have happened in each case in the past, and the fact that only one did happen understates the potential for variability that existed. What I mean to say (inspired by Nicolas Nassim Taleb's "Fooled by Randomness") is that the history that took place is only one version of what it could have been. If you accept this, then the relevance of history to the future is much more limited than many believe to be the case. [Along these same lines, Peter Bernstein wrote the following in his November 2001 newsletter: "We like to rely on history to justify our forecasts of the long run, but history tells us over and over again that the unexpected and the unthinkable are the norm, not an anomaly. That is the real lesson of history."]***

- **Decisions whether or not to bear risk are made in contemplation of normal patterns recurring, and they do most of the time. But once in a while, something very different happens.** Or as my friend (and highly skilled investor) Ric Kayne puts it, “Most of financial history has taken place within two standard deviations, but everything interesting has occurred outside of two standard deviations.” That’s what happened in 2007. We heard all the time that summer, “that was a 5-standard deviation event,” or “that was a 10-sigma event,” implying it should have happened only once every hundred or thousand or ten thousand years. So how could several such events have happened in a single week, as was claimed in August? The answer is that the improbability of their happening had been overestimated.
- Projections tend to cluster around historic norms and call for only small changes. The point is, **people usually expect the future to be like the past and underestimate the potential for change.** In August 1996, I wrote a memo showing that in the Wall Street Journal’s semi-annual poll of economists, on average the predictions are an extrapolation of the current condition. And when I was a young analyst following Textron, building my earnings estimates based on projections for its four major groups, I invariably found that I had underestimated the extent of both the positive surprises and the shortfalls.
- **We hear a lot about “worst-case” projections, but they often turn out not to be negative enough.** What forecasters mean is “bad-case projections.” I tell my father’s story of the gambler who lost regularly. One day he heard about a race with only one horse in it, so he bet the rent money. Half way around the track, the horse jumped over the fence and ran away. Invariably things can get worse than people expect. Maybe “worst-case” means “the worst we’ve seen in the past.” But that doesn’t mean things can’t be worse in the future. In 2007, many people’s worst-case assumptions were exceeded.
- **Risk shows up lumpily.** If we say “2% of mortgages default each year,” and even if that’s true when we look at a multi-year average, an unusual spate of defaults can occur at a point in time, sinking a structured finance vehicle. Ben Graham and David Dodd put it this way: “. . . the relation between different kinds of investments and the risk of loss is entirely too indefinite, and too variable with changing conditions, to permit of sound mathematical formulation. This is particularly true because investment losses are not distributed fairly evenly in point of time, but tend to be concentrated at intervals . . .” (Security Analysis, 1940 Edition). It’s invariably the case that some investors – especially those who employ high leverage – will fail to survive at those intervals.
- **People overestimate their ability to gauge risk and understand mechanisms they’ve never before seen in operation.** In theory, one thing that distinguishes humans from other species is that we can figure out that something’s dangerous without experiencing it. **We don’t have to burn ourselves to know we shouldn’t sit on a hot stove. But in bullish times, people tend not to perform this function.** Rather than recognize risk ahead, they tend to overestimate their ability to understand how new financial inventions will work.
- **Finally and importantly, most people view risk taking primarily as a way to make money.** Bearing higher risk generally produces higher returns. The market has to set things up to look like that’ll be the case; if it didn’t, people wouldn’t make risky investments. But it can’t always work that way, or else risky investments wouldn’t be risky. **And when risk bearing doesn’t work, it really doesn’t work, and people are reminded what risk’s all about.**

*Most of the time, risk bearing works out just fine. In fact, it's often the case that the people who take the most risk make the most money. However, there also are times when underestimating risk and accepting too much of it can be fatal. **Taking too little risk can cause you to underperform your peers – but that beats the heck out of the consequences of taking too much risk at the wrong time. No one ever went bankrupt because of an excess of risk consciousness. But a shortage of it – and the imprudent investments it led to – bears responsibility for a lot of what went on in 2007.***

The Many Forms of Risk

The possibility of permanent loss may be the main risk in investing, but it's not the only risk. I can think of lots of other risks, many of which contribute to – or are components of – that main risk.

In the past, in addition to the risk of permanent loss, I've mentioned **the risk of falling short**. Some investors face return requirements in order to make necessary payouts, as in the case of pension funds, endowments and insurance companies. Others have more basic needs, like generating enough income to live on.

Some investors with needs – particularly those who live on their income, and especially in today's low-return environment – face a serious conundrum. **If they put their money into safe investments, their returns may be inadequate. But if they take on incremental risk in pursuit of a higher return, they face the possibility of a still-lower return, and perhaps of permanent diminution of their capital, rendering their subsequent income lower still.** There's no easy way to resolve this conundrum.

There are actually two possible causes of inadequate returns: (a) targeting a high return and being thwarted by negative events and (b) targeting a low return and achieving it. In other words, **investors face not one but two major risks: the risk of losing money and the risk of missing opportunities.** Either can be eliminated but not both. And leaning too far in order to avoid one can set you up to be victimized by the other.

Potential opportunity costs – the result of missing opportunities – usually aren't taken as seriously as real potential losses. But they do deserve attention. **Put another way, we have to consider the risk of not taking enough risk.**

These days, the fear of losing money seems to have receded (since the crisis is all of six years in the past), and the fear of missing opportunities is riding high, given the paltry returns available on safe, mundane investments. Thus a new risk has arisen: **FOMO risk, or the risk that comes from excessive fear of missing out.** It's important to worry about missing opportunities, since people who don't can invest too conservatively. But when that worry becomes excessive, FOMO can drive an investor to do things he shouldn't do and often doesn't understand, just because others are doing them: if he doesn't jump on the bandwagon, he may be left behind to live with envy.

Over the last three years, Oaktree's response to the paucity of return has been to develop a suite of five credit strategies that we hope will produce a 10% return, either net or gross (we can't claim to be more precise than that). I call them collectively the "ten percent solution," after a Sherlock Holmes story called *The Seven-Per-Cent Solution* (we aim to do better). Talking to clients about these strategies and helping them choose between them has required me to focus on their risks.

"Just a minute," you might say, "the ten-year Treasury is paying just 2½% and, as Jeremy Grantham says, the risk-free rate is also return-free. How, then, can you target returns in the vicinity of 10%?" The

answer is that it can't be done without taking risk of some kind – and there are several candidates. I'll list below a few risks that we're consciously bearing in order to generate the returns our clients desire:

- Today's ultra-low interest rates imply low returns for anyone who invests in what are deemed safe fixed income instruments. So Oaktree's pursuit of attractive returns centers on accepting and managing **credit risk**, or the risk that a borrower will be unable to pay interest and repay principal as scheduled. Treasuries are assumed to be free of credit risk, and most high grade corporates are thought to be nearly so. **Thus those who intelligently accept incremental credit risk must do so with the expectation that the incremental return promised as compensation will prove sufficient.**

Voluntarily accepting credit risk has been at the core of what Oaktree has done since its beginning in 1995 (and in fact since the seed was planted in 1978, when I initiated Citibank's high yield bond effort). But bearing credit risk will lead to attractive returns only if it's done well. Our activities are based on two beliefs: (a) that because the investing establishment is averse to credit risk, the incremental returns we receive for bearing it will compensate generously for the risk entailed and (b) that credit risk is manageable – i.e., unlike the general future, credit risk can be gauged by experts (like us) and reduced through credit selection. **It wouldn't make sense to voluntarily bear incremental credit risk if either of these two beliefs were lacking.**

- Another way to access attractive returns in today's low-rate environment is to bear **illiquidity risk** in order to take advantage of investors' normal dislike for illiquidity (superior returns often follow from investor aversion). Institutions that held a lot of illiquid assets suffered considerably in the crisis of 2008, when they couldn't sell them; thus many developed a strong aversion to them and in some cases imposed limitations on their representation in portfolios. Additionally, today the flow of retail money is playing a big part in driving up asset prices and driving down returns. Since retail money has a harder time making its way to illiquid assets, this has made the returns on the latter appear more attractive. It's noteworthy that there aren't mutual funds or ETFs for many of the things we're investing in.
- Some strategies introduce it voluntarily and some can't get away from it: **concentration risk**. "Everyone knows" diversification is a good thing, since it reduces the impact on results of a negative development. But some people eschew the safety that comes with diversification in favor of concentrating their investments in assets or with managers they expect to outperform. And some investment strategies don't permit full diversification because of the limitations of their subject markets. Thus problems – if and when they occur – will be bigger *per se*.
- Especially given today's low interest rates, borrowing additional capital to enhance returns is another way to potentially increase returns. But doing so introduces **leverage risk**. Leverage adds to risk two ways. The first is magnification: people are attracted to leverage because it will magnify gains, but under unfavorable outcomes it will magnify losses instead.

The second way in which leverage adds to risk stems from **funding risk**, one of the classic reasons for financial disaster. The stage is set when someone borrows short-term funds to make a long-term investment. If the funds have to be repaid at an awkward time – due to their maturity, a margin call, or some other reason – and the purchased assets can't be sold in a timely fashion (or can only be sold at a depressed price), an investment that might otherwise have been successful can be cut short and end in sorrow. Little or nothing may remain of the sale proceeds once the leverage has been repaid, in which case the investor's equity will be decimated. This is commonly called a meltdown. It's the primary reason for the saying, "Never forget the six-foot-

tall man who drowned crossing the stream that was five feet deep on average.” In times of crisis, success over the long run can become irrelevant.

- **When credit risk, illiquidity risk, concentration risk and leverage risk are borne intelligently, it is in the hope that the investor’s skill will be sufficient to produce success. If so, the *potential* incremental returns that appear to be offered as risk compensation will turn into *realized* incremental returns** (per the graphic at the top of page 8). That’s the only reason anyone would do these things.

As the graphic at the bottom of page 8 illustrates, however, investing further out on the risk curve exposes one to a broader range of investment outcomes. In an efficient market, returns are tethered to the market average; in an inefficient market, they’re not. **Inefficient markets offer the possibility that an investor will escape from the “gravitational pull” of the market’s average return, but that can be either for the better or for the worse.** Superior investors – those with “alpha,” or the personal skill needed to achieve outsized returns for a given level of risk – have scope to perform well above the mean return, while inferior investors can come out far below. So hiring an investment manager introduces **manager risk**: the risk of picking the wrong one. It’s possible to pay management fees but get decisions that detract from results rather than add.

Some or all of the above risks are potentially entailed in our new credit strategies. Parsing them allows investors to choose among the strategies and accept the risks they’re more comfortable with. The process can be quite informative.

Our oldest “new strategy” is Enhanced Income, where we use leverage to magnify the return from a portfolio of senior loans. We think senior loans have the lowest credit risk of anything Oaktree deals with, since they’re senior-most among their issuer’s debt and historically have produced very few credit losses. Further, they’re among our most liquid assets, meaning we face relatively little illiquidity risk, and being active in a broad public market permits us to diversify, reducing concentration risk. Given the relatively high degree of safety stemming from these loans’ seniority, returns aren’t overly dependent on the presence of alpha, meaning Enhanced Income entails less manager risk than some other strategies. But to have a chance at the healthy return we’re pursuing in Enhanced Income requires us to take some risk, and what we’re left with is leverage risk. The 3-to-1 leverage in Enhanced Income Fund II will magnify the negative impact of any credit losses (of course we hope there won’t be many). However, we’re not worried about a meltdown, since the current environment allows us to avoid funding risk; we can (a) borrow for a term that exceeds the duration of the underlying investments and (b) do so without the threat of margin calls related to price declines.

Strategic Credit, Mezzanine Finance, European Private Debt and Real Estate Debt are the other four components of our “ten percent solution.”

- All four entail some degree of credit risk, illiquidity risk (they all invest heavily or entirely in private debt) and concentration risk (as their market niches offer only a modest number of investment opportunities, and securing them in today’s competitive environment is a challenge).
- The Real Estate Debt Fund can only lever up to 1-to-1, and the other three borrow only small amounts and for short-term purposes, so none of them entails significant leverage risk.

- However, in order to succeed they'll all require a high level of skill from their managers in identifying return prospects and keeping risk under control. Thus they all entail manager risk. Our response is to entrust these portfolios only to managers who've been with us for years.

It's reasonable – essential, really – to study the risk entailed in every investment and accept the amounts and types of risk that you're comfortable with (assuming this can be discerned). It's not reasonable to expect highly superior returns without bearing some incremental risk.

I touched above on concentration risk, but we should also think about the flip side: **the risk of over-diversification**. If you have just a few holdings in a portfolio, or if an institution employs just a few managers, one bad decision can do significant damage to results. But if you have a very large number of holdings or managers, no one of them can have much of a positive impact on performance. Nobody invests in just the one stock or manager they expect to perform best, but as the number of positions is expanded, the standards for inclusion may decline. Peter Lynch coined the term “diworstification” to describe the process through which lesser investments are added to portfolios, making the potential risk-adjusted return worse.

While I don't think volatility and risk are synonymous, there's no doubt that **volatility does present risk**. If circumstances cause you to sell a volatile investment at the wrong time, you might turn a downward fluctuation into a permanent loss. Moreover, even in the absence of a need for liquidity, volatility can prey on investors' emotions, reducing the probability they'll do the right thing. **And in the short run, it can be very hard to differentiate between a downward fluctuation and a permanent loss.** Often this can really be done only in retrospect. Thus it's clear that a professional investor may have to bear consequences for a temporary downward fluctuation simply because of its resemblance to a permanent loss. When you're under pressure, the distinction between “volatility” and “loss” can seem only semantic. Volatility is not “the” definition of investment risk, as I said earlier, but it isn't irrelevant.

One example of a risk connected with volatility – or the deviation of price from what might be intrinsic value – is **basis risk**. Arbitrageurs customarily set up positions where they're long one asset and short a related asset. The two assets are expected to move roughly in parallel, except that the one that's slightly cheaper should make more money for the investor in the long run than the other loses, producing a small net gain with little risk. Because these trades are considered so low in risk, they're often levered up to the sky. But sometimes the prices of the two assets diverge to an unexpected extent, and the equity invested in the trade evaporates. That unexpected divergence is basis risk, and it's what happened to Long-Term Capital Management in 1998, one of the most famous meltdowns of all time. As Long-Term's chairman John Meriwether said at the time, “the Fund added to its positions in anticipation of convergence, yet . . . the trades diverged dramatically.” This benign-sounding explanation was behind a collapse some thought capable of bringing down the global financial system.

Long-Term's failure was also attributable to **model risk**. Decisions can be turned over to quants or financial engineers who either (a) conclude wrongly that an unsystematic process can be modeled or (b) employ the wrong model. During the financial crisis, models often assumed that events would occur according to a “normal distribution,” but extreme “tail events” occurred much more often than the normal distribution says they will. **Not only can extreme events exceed a model's assumptions, but excessive belief in a model's efficacy can induce people to take risks they would never take on the basis of qualitative judgment.** They're often disappointed to find they had put too much faith in a statistical sure thing.

Model risk can arise from **black swan risk**, for which I borrow the title of Nassim Nicholas Taleb's popular second book. People tend to confuse “never been seen” with “impossible,” and the consequences can be dire when something occurs for the first time. That's part of the reason why people lost so much

in highly levered subprime mortgage securities. The fact that a nationwide spate of mortgage defaults **hadn't happened** convinced investors that it **couldn't happen**, and their certainty caused them to take actions so imprudent that it **had to happen**.

As long as we're on the subject of things going wrong, we should touch on the subject of **career risk**. As I mentioned in *Dare to Be Great II*, "agents" who manage money for others can be penalized for investments that look like losers (that is, for both permanent losses and temporary downward fluctuations). Either of these unfortunate experiences can result in **headline risk** if the resulting losses are big enough to make it into the media, and some careers can't withstand headline risk. Investors who lack the potential to share commensurately in investment successes face a reward asymmetry that can force them toward the safe end of the risk/return curve. They are likely to think more about the risk of losing money than about the risk of missing opportunities. Thus their portfolios may lean too far toward controlling risk and avoiding embarrassment (and they may not take enough chances to generate returns). There are consequences for these investors, as well as for those who employ them.

Event risk is another risk to worry about, something that was created by bond issuers about twenty years ago. Since corporate directors have a fiduciary responsibility to stockholders but not to bondholders, some think they can (and perhaps should) do anything that's not explicitly prohibited to transfer value from bondholders to stockholders. Bondholders need covenants to shield them from this kind of pro-active plundering, but at times like today it can be hard to obtain strong protective covenants.

There are many ways for an investment to be unsuccessful. The two main ones are **fundamental risk** (relating to how a company or asset performs in the real world) and **valuation risk** (relating to how the market prices that performance). For years investors, fiduciaries and rule-makers acted on the belief that it's safe to buy high-quality assets and risky to buy low-quality assets. But between 1968 and 1973, many investors in the "Nifty Fifty" (the stocks of the fifty fastest-growing and best companies in America) lost 80-90% of their money. Attitudes have evolved since then, and today there's less of an assumption that high quality prevents fundamental risk, and much less preoccupation with quality for its own sake.

On the other hand, investors are more sensitive to the pivotal role played by price. **At bottom, the riskiest thing is overpaying for an asset (regardless of its quality), and the best way to reduce risk is by paying a price that's irrationally low (ditto).** A low price provides a "margin of safety," and that's what risk-controlled investing is all about. **Valuation risk should be easily combatted, since it's largely within the investor's control. All you have to do is refuse to buy if the price is too high given the fundamentals.** "Who wouldn't do that?" you might ask. Just think about the people who bought into the tech bubble.

Fundamental risk and valuation risk bear on the risk of losing money in an individual security or asset, but that's far from the whole story. **Correlation** is the essential additional piece of the puzzle. Correlation is the degree to which an asset's price will move in sympathy with the movements of others. **The higher the correlation among its components, all other things being equal, the less effective diversification a portfolio has, and the more exposed it is to untoward developments.**

An asset doesn't have "a correlation." Rather, it has a different correlation with every other asset. A bond has a certain correlation with a stock. One stock has a certain correlation with another stock (and a different correlation with a third). Stocks of one type (such as emerging market, high-tech or large-cap) are likely to be highly correlated with others within their category, but they may be either high or low in correlation with those in other categories. **Bottom line: it's hard to estimate the riskiness of a given asset, but many times harder to estimate its correlation with all the other assets in a portfolio, and thus the impact on performance of adding it to the portfolio.** This is a real art.

Fixed income investors are directly exposed to another form of risk: **interest rate risk**. Higher interest rates mean lower bond prices – that relationship is absolute. The impact of changes in interest rates on asset classes other than fixed income is less direct and less obvious, but it also pervades the markets. Note that stocks usually go down when the Fed says the economy is performing strongly. Why? The thinking is that stronger economy = higher interest rates = more competition for stocks from bonds = lower stock valuations. Or it might be stronger economy = higher interest rates = reduced stimulus = weaker economy.

One of the reasons for increases in interest rates relates to **purchasing power risk**. Investors in securities (and especially long-term bonds) are exposed to the risk that if inflation rises, the amount they receive in the future will buy less than it could today. This causes investors to insist on higher interest rates and higher prospective returns to protect them against the loss of purchasing power. The result is lower prices.

Finally, I want to mention a new concept I hear about once in a while: **upside risk**. Forecasters are sometimes heard to say “the risk is on the upside.” At first this doesn’t seem to have much legitimacy, but it can be about the possibility that the economy may catch fire and do better than expected, earnings may come in above consensus, or the stock market may appreciate more than people think. Since these things are positives, there’s risk in being underexposed to them.

* * *

To move to the biggest of big pictures, I want to make a few over-arching comments about risk.

The first is that risk is counterintuitive.

- The riskiest thing in the world is the widespread belief that there’s no risk.
- Fear that the market is risky (and the prudent investor behavior that results) can render it quite safe.
- As an asset declines in price, making people view it as riskier, it becomes less risky (all else being equal).
- As an asset appreciates, causing people to think more highly of it, it becomes riskier.
- Holding only “safe” assets of one type can render a portfolio under-diversified and make it vulnerable to a single shock.
- Adding a few “risky” assets to a portfolio of safe assets can make it safer by increasing its diversification. Pointing this out was one of Professor William Sharpe’s great contributions.

The second is that risk aversion is the thing that keeps markets safe and sane.

- When investors are risk-conscious, they will demand generous risk premiums to compensate them for bearing risk. Thus the risk/return line will have a steep slope (the unit increase in prospective return per unit increase in perceived risk will be large) and the market should reward risk-bearing as theory asserts.
- But when people forget to be risk-conscious and fail to require compensation for bearing risk, they’ll make risky investments even if risk premiums are skimpy. The slope of the line will be gradual, and risk taking is likely to eventually be penalized, not rewarded.
- When risk aversion is running high, investors will perform extensive due diligence, make conservative assumptions, apply skepticism and deny capital to risky schemes.

- But when risk tolerance is widespread instead, these things will fall by the wayside and deals will be done that set the scene for subsequent losses.

Simply put, risk is low when risk aversion and risk consciousness are high, and high when they're low.

The third is that risk is often hidden and thus deceptive. Loss occurs when risk – the possibility of loss – collides with negative events. Thus the riskiness of an investment becomes apparent only when it is tested in a negative environment. It can be risky but not show losses as long as the environment remains salutary. The fact that an investment is susceptible to a serious negative development that will occur only infrequently – what I call “the improbable disaster” – can make it appear safer than it really is. Thus after several years of a benign environment, a risky investment can easily pass for safe. That's why Warren Buffett famously said, “. . . you only find out who's swimming naked when the tide goes out.”

Assembling a portfolio that incorporates risk control as well as the potential for gains is a great accomplishment. But it's a hidden accomplishment most of the time, since risk only turns into loss occasionally . . . when the tide goes out.

The fourth is that risk is multi-faceted and hard to deal with. In this memo I've mentioned 24 different forms of risk: the risk of losing money, the risk of falling short, the risk of missing opportunities, FOMO risk, credit risk, illiquidity risk, concentration risk, leverage risk, funding risk, manager risk, over-diversification risk, risk associated with volatility, basis risk, model risk, black swan risk, career risk, headline risk, event risk, fundamental risk, valuation risk, correlation risk, interest rate risk, purchasing power risk, and upside risk. And I'm sure I've omitted some. Many times these risks are overlapping, contrasting and hard to manage simultaneously. For example:

- Efforts to reduce the risk of losing money invariably increase the risk of missing out.
- Efforts to reduce fundamental risk by buying higher-quality assets often increase valuation risk, given that higher-quality assets often sell at elevated valuation metrics.

At bottom, it's the inability to arrive at a single formula that simultaneously minimizes all the risks that makes investing the fascinating and challenging pursuit it is.

The fifth is that the task of managing risk shouldn't be left to designated risk managers. I'm convinced outsiders to the fundamental investment process can't know enough about the subject assets to make appropriate decisions regarding each one. All they can do is apply statistical models and norms. But those models may be the wrong ones for the underlying assets – or just plain faulty – and there's little evidence that they add value. In particular, risk managers can try to estimate correlation and tell you how things will behave when combined in a portfolio. But they can fail to adequately anticipate the “fault lines” that run through portfolios. And anyway, as the old saying goes, “in times of crisis all correlations go to one” and everything collapses in unison.

“Value at Risk” was supposed to tell the banks how much they could lose on a very bad day. During the crisis, however, VaR was often shown to have understated the risk, since the assumptions hadn't been harsh enough. Given the fact that risk managers are required at banks and *de rigueur* elsewhere, I think more money was spent on risk management in the early 2000s than in the rest of history combined . . . and yet we experienced the worst financial crisis in 80 years. Investors can calculate risk metrics like VaR and Sharpe ratios (we use them at Oaktree; they're the best tools we have), but they shouldn't put too much faith in them. **The bottom line for me is that risk management should be the responsibility of every participant in the investment process, applying experience, judgment and knowledge of the underlying investments.**

The sixth is that while risk should be dealt with constantly, investors are often tempted to do so only sporadically. Since risk only turns into loss when bad things happen, this can cause investors to apply risk control only when the future seems ominous. At other times they may opt to pile on risk in the expectation that good things lie ahead. But since we can't predict the future, we never really know when risk control will be needed. Risk control is unnecessary in times when losses don't occur, but that doesn't mean it's wrong to have it. The best analogy is to fire insurance: do you consider it a mistake to have paid the premium in a year in which your house didn't burn down?

Taken together these six observations convince me that Charlie Munger's trenchant comment on investing in general – **"It's not supposed to be easy. Anyone who finds it easy is stupid."** – is profoundly applicable to risk management. Effective risk management requires deep insight and a deft touch. It has to be based on a superior understanding of the probability distributions that will govern future events. Those who would achieve it have to have a good sense for what the crucial moving parts are, what will influence them, what outcomes are possible, and how likely each one is. **Following on with Charlie's idea, thinking risk control is easy is perhaps the greatest trap in investing, since excessive confidence that they have risk under control can make investors do very risky things.**

Thus the key prerequisites for risk control also include humility, lack of hubris, and knowing what you don't know. No one ever got into trouble for confessing a lack of prescience, being highly risk-conscious, and even investing scared. Risk control may restrain results during a rebound from crisis conditions or extreme under-valuations, when those who take the most risk generally make the most money. But it will also extend an investment career and increase the likelihood of long-term success. **That's why Oaktree was built on the belief that risk control is "the most important thing."**

Lastly while dealing in generalities, I want to point out that whereas risk control is indispensable, risk avoidance isn't an appropriate goal. The reason is simple: risk avoidance usually goes hand-in-hand with return avoidance. While you shouldn't expect to make money just for bearing risk, you also shouldn't expect to make money without bearing risk.

* * *

At present I consider risk control more important than usual. To put it briefly:

- Today's ultra-low interest rates have brought the prospective returns on money market instruments, Treasuries and high grade bonds to nearly zero.
- This has caused money to flood into riskier assets in search of higher returns.
- This, in turn, has caused some investors to drop their usual caution and engage in aggressive tactics.
- And this, finally, has caused standards in the capital markets to deteriorate, making it easy for issuers to place risky securities and – consequently – hard for investors to buy safe ones.

Warren Buffett put it best, and I regularly return to his statement on the subject:

... the less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs.

While investor behavior hasn't sunk to the depths seen just before the crisis (and, in my opinion, that contributed greatly to it), **in many ways it has entered the zone of imprudence.** To borrow a metaphor

from Chuck Prince, Citigroup's CEO from 2003 to 2007, anyone who's totally unwilling to dance to today's fast-paced music can find it challenging to put money to work.

It's the job of investors to strike a proper balance between offense and defense, and between worrying about losing money and worrying about missing opportunity. **Today I feel it's important to pay more attention to loss prevention than to the pursuit of gain.** For the last *four* years Oaktree's mantra has been "move forward, but with caution." At this time, in reiterating that mantra, I would increase the emphasis on those last three words: "but with caution."

Economic and company fundamentals in the U.S. are fine today, and asset prices – while full – don't seem to be at bubble levels. But when undemanding capital markets and a low level of risk aversion combine to encourage investors to engage in risky practices, something usually goes wrong eventually. **Although I have no idea what could make the day of reckoning come sooner rather than later, I don't think it's too early to take today's carefree market conditions into consideration. What I do know is that those conditions are creating a degree of risk for which there is no commensurate risk premium.** We have to behave accordingly.

June 8, 2015 (updating *Risk Revisited* published September 3, 2014)

Memo to: Oaktree Clients

From: Howard Marks

Re: It's Not Easy

In 2011, as I was putting the finishing touches on my book *The Most Important Thing*, I was fortunate to have one of my occasional lunches with Charlie Munger. As it ended and I got up to go, he said something about investing that I keep going back to: **“It’s not supposed to be easy. Anyone who finds it easy is stupid.”**

As usual, Charlie packed a great deal of wisdom into just a few words. Let’s take the first six: “It’s not supposed to be easy.” While it’s pretty simple to achieve average results, it shouldn’t be easy to make superior investments and earn outsized returns. John Kenneth Galbraith said something similar years ago:

There is nothing reliable to be learned about making money. If there were, study would be intense and everyone with a positive IQ would be rich.

What Charlie and Professor Galbraith meant is this: Everyone wants to make money, and especially to find the sure thing or “silver bullet” that will allow them to do it without commensurate risk. Thus they work hard (actually, study *is* intense), searching for bargain securities and approaches that will give them an edge. They buy up the bargains and apply the approaches. The result is that the efforts of these market participants tend to drive out opportunities for easy money. Securities become more fairly priced, and free lunches become harder to find. **It makes no sense to think it would be otherwise.**

And what about the next seven words: “Anyone who finds it easy is stupid”? It follows from the above that given how hard investors work to find special opportunities, and that their buying eliminates such prospects, **people who think it can be easy overlook substantial nuance and complexity.**

Markets are meeting places where people come together (not necessarily physically) to exchange one thing (usually money) for another. Markets have a number of functions, one of which is to eliminate opportunities for excess returns.

Ed calls me and bids \$10,000 for my car. Then he offers to sell it to Bob for \$20,000. If Ed’s lucky and we both say yes, he doubles his money overnight. To put it simply, anyone who expects to make money easily trading cars this way either thinks (a) Bob and I are idiots or (b) the market won’t function in a way that enables us to know about the fair value of my car. If these conditions were met, it would be an “inefficient market.”

But if Bob and I have access to market data on used car pricing, Ed’s chances of pulling off this deal are greatly reduced. **In most markets, transparency tends to reveal and thus preclude obvious mispricings.** (Thanks to the incredible gains in access to data by way of the Internet, this is certainly more true today than ever before.) **In my view, this is a good part of the basis for Charlie’s comment: anyone who thinks it’s easy to achieve unusual profits is overlooking the way markets operate. This memo is largely about the challenges they present.**

Second-Level Thinking

I always thought that when I retired, I would write a book pulling together the elements of investment philosophy discussed in my memos. But in 2009, I got a letter from Warren Buffett saying that if I'd write a book, he'd give me a blurb for the jacket. It didn't take me long to move up my timing.

Columbia Business School Publishing had been talking to me about a book, and when I told them I was ready, they asked to see a sample chapter. For some reason, I was able to sit down – without previously having given the topic any organized thought – and knock out a chapter about the importance of something I labeled “second-level thinking.” This is a crucial subject that has to be understood by everyone who aspires to be a superior investor. And yet I've never covered it explicitly for the readers of my memos. I want to correct that now.

In what ended up being the book's first chapter, I introduced the subject as follows:

Remember your goal in investing isn't to earn average returns; you want to do better than average. Thus your thinking has to be better than that of others – both more powerful and at a higher level. Since others may be smart, well-informed and highly computerized, you must find an edge they don't have. You must think of something they haven't thought of, see things they miss, or bring insight they don't possess. You have to react differently and behave differently. In short, being right may be a necessary condition for investment success, but it won't be sufficient. You must be more right than others . . . which by definition means your thinking has to be different. . . .

For your performance to diverge from the norm, your expectations – and thus your portfolio – have to diverge from the norm, and you have to be more right than the consensus. Different and better: that's a pretty good description of second-level thinking.

Second-level thinking is what immediately pops into my mind when I think about Charlie's observation. And it's a good general heading under which to discuss the great many things that make superior investing a challenge. **In short, to borrow from Charlie, anyone who thinks it's easy must be a first-level thinker.** Let me use some simple examples from the book to illustrate the difference.

- First-level thinking says, “It's a good company; let's buy the stock.” Second-level thinking says, “It's a good company, but everyone thinks it's a great company, and it's not. So the stock's overrated and overpriced; let's sell.”
- First-level thinking says, “The outlook calls for low growth and rising inflation. Let's dump our stocks.” Second-level thinking says, “The outlook stinks, but everyone else is selling in panic. Buy!”
- First-level thinking says, “I think the company's earnings will fall; sell.” Second-level thinking says, “I think the company's earnings will fall far less than people expect, and the pleasant surprise will lift the stock; buy.”

First-level thinking is simplistic and superficial, and just about everyone can do it (a bad sign for anything involving an attempt at superiority). All the first-level thinker needs is an opinion about the future, as in, “The outlook for the company is favorable, meaning the stock will go up.”

Second-level thinking is deep, complex and convoluted. The second-level thinker takes many things into account:

- What is the range of likely future outcomes?
- Which outcome do I think will occur?
- What's the probability I'm right?
- What does the consensus think?
- How does my expectation differ from the consensus?
- How does the current price for the asset comport with the consensus view of the future, and with mine?
- Is the consensus psychology that's incorporated in the price too bullish or bearish?
- What will happen to the asset's price if the consensus turns out to be right, and what if I'm right?

The bottom line is that first-level thinkers see what's on the surface, react to it simplistically, and buy or sell on the basis of their reactions. **They don't understand their setting as a marketplace where asset prices reflect and depend on the expectations of the participants. They ignore the part that others play in how prices change. And they fail to understand the implications of all this for the route to success.**

For example, when I lived in Los Angeles, a stockbroker often spoke on the radio station I listened to while driving to work. His advice was simple: "If there's a company whose product you like, buy the stock." That's first-level thinking. How seductively easy. But also how error-prone, in that it ignores the possibility that a company with a good product can have a bad business; the good product can become obsolete; or the stock can be priced too high to be a good investment.

On the other hand, second-level thinkers double-think (and triple-think) every angle of every situation. A good example can be seen in the hypothetical newspaper contest John Maynard Keynes wrote about in 1936. Readers would be shown 100 photos and asked to choose the six prettiest girls, with prizes going to the readers who chose the girls readers voted for most often. Naive entrants would try to win by picking the prettiest girls. **But note that the contest would reward the readers who chose not the prettiest girls, but the most popular.** Thus the road to winning would lie not in figuring out which were the prettiest, but in predicting which girls the average entrant would consider prettiest. Clearly, to do so, the winner would have to be a second-level thinker. (The first-level thinker wouldn't even recognize the difference.)

Wikipedia points out that one vying to win the contest might go beyond this distinction:

This can be carried one step further to take into account the fact that other entrants would each have their own opinion of what public perceptions are. Thus the strategy can be extended to the next order and the next and so on, at each level attempting to predict the eventual outcome of the process based on the reasoning of other agents.

"It is not a case of choosing those [faces] that, to the best of one's judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees." (Keynes, *The General Theory of Employment, Interest and Money*, 1936).

Keynes created his contest to make a point about the stock market. In the short run, beating the market requires the ability to predict which stocks will win the popularity contest among investors. Higher-level thinkers who recognize this dynamic have a head start toward earning the greatest gains. Ben Graham applied the same thinking when he described the market as a “voting machine” in the short run (although he made plain his belief that it’s a “weighing machine” in the long run).

The first-level thinker simply looks for the highest-quality company, the best product, the fastest earnings growth or the lowest p/e ratio. He’s ignorant of the very existence of a second level at which to think, and of the need to pursue it.

The second-level thinker goes through a much more complex process when thinking about buying an asset. Is it good? Do others think it’s as good as I think it is? Is it really as good as I think it is? Is it as good as others think it is? Is it as good as others think others think it is? How will it change? How do others think it will change? How is it priced given: its current condition; how I think its condition will change; how others think it will change; and how others think others think it will change? And that’s just the beginning. No, this isn’t easy.

(Please note that the above discussion is entirely on the subject of short-term investing, and I go through it only to provide a graphic illustration of the difference between first-level and second-level thinking. Oaktree and I aren’t focused on short-term results, and the thinking we apply to long-run considerations is quite different. We think much less about what others will make popular in the short run; instead, we rely on the eventual functioning of the weighing machine. The highest priority – by far – should be an objective evaluation of fundamentals. Market participants can get so caught up in predicting other participants’ behavior that they ignore value and fail to buy bargains out of fear that the assets in question will remain unpopular or become more so. This creates great opportunities for those investors whose willingness to think independently and endure the short-term pain that comes with temporary unpopularity enables them to purchase attractive investments from the bargain counter.)

What Keynes’s hypothetical contest shows most clearly is that the route to success in the competitive arena may not be what it seems at first glance. When the goal is to lift the greatest weight, achieve the lowest score on the golf course, get the highest grade on a math test or finish a crossword puzzle in the shortest time, the competition is against oneself and the objective challenge at hand. But when the goal, as it is in investing, is to outdo other people in a largely mental pursuit involving a lot of psychology – while they’re trying to do the same to you – the challenge is much more complex.

The investor’s basic goal of buying desirable assets at fair prices is sensible and straightforward. But the deeper you look, the more you see how many aspects of successful investing are counterintuitive and how much of what seems obvious is wrong. There’s a lot more that matters, of course, but these realizations are key.

The Things Everyone Likes

The most outstanding characteristic of first-level thinkers – and of the investing herd – is that they like things with obvious appeal. These are the things that are easy to understand and easy to buy. But that’s unlikely to be the path to investment success. Here’s how I put it in “Everyone Knows” (April 2007):

What's clear to the broad consensus of investors is almost always wrong.

First, most people don't understand the process through which something comes to have outstanding moneymaking potential. And second, the very coalescing of popular opinion behind an investment tends to eliminate its profit potential.

Take, for example, the investment that "everyone" believes to be a great idea. In my view by definition it simply cannot be so.

- If everyone likes it, it's probably because it has been doing well. Most people seem to think outstanding performance to date presages outstanding future performance. Actually, it's more likely that outstanding performance to date has borrowed from the future and thus presages sub-par performance from here on out.
- If everyone likes it, it's likely the price has risen to reflect a level of adulation from which relatively little further appreciation is likely. (Sure it's possible for something to move from "overvalued" to "more overvalued," but I wouldn't want to count on it happening.)
- If everyone likes it, it's likely the area has been mined too thoroughly – and has seen too much capital flow in – for many bargains to remain.
- If everyone likes it, there's significant risk that prices will fall if the crowd changes its collective mind and moves for the exit.

Superior investors know – and buy – when the price of something is lower than it should be. And the price of an investment can be lower than it should be only when most people don't see its merit. Yogi Berra is famous for having said, "Nobody goes to that restaurant anymore; it's too crowded." It's just as nonsensical to say, "Everyone realizes that investment's a bargain." If everyone realizes it, they'll have bought, in which case the price will no longer be low.

So the things with the most obvious merit become the things that everyone likes. They're also likely to be the things that are most hotly pursued and most highly priced, and thus least promising and most treacherous. What are some examples?

When I first showed up for work in First National City Bank's investment research department in 1968, the bank was investing heavily in the "Nifty Fifty": the stocks of America's best, fastest growing companies. Since these were companies where nothing could go wrong, the official dictum said it didn't matter much what price you paid. It didn't seem unreasonable to pay p/e ratios of 80 or 90 given these companies' growth rates.

But it turned out that the price you pay does matter, and 80-90 times earnings had been too high. Thus, when the market ran into trouble in the early 1970s, many of these stocks lost the vast majority of their value, and investors learned the hard way that it's possible to like a good thing too much. Unsurprisingly, it also turned out that predictions of a flawless future can be wrong, as once-dominant companies such as Kodak, Polaroid and Xerox eventually went bankrupt or required turnarounds.

Roughly ten years ago, everyone was gaga over real estate, especially residential. This was underpinned by some bits of "accepted wisdom" that seemed compelling, such as "you can always live in it," "home

prices always go up” and “real estate is a hedge against inflation.” Conservative debt investors (rather than buyers of homes themselves) were persuaded to buy levered and tranching mortgage-backed securities by the fact that “there has never been a nationwide wave of mortgage defaults.”

But in 2007 it turned out that home prices can go down as well as up, and mortgage loans extended casually based on their flawless record can have flaws. Homes and mortgages, bought when everyone liked them, turned out to be terrible investments.

The fact is, painful bubbles can’t come into existence if there isn’t an underlying grain of truth. The Nifty Fifty *were* generally terrific companies. Home prices *do* tend to rise over time and offset inflation. Mortgages generally *are* repaid or carry adequate collateral. The Internet *would* change the world. Oil at \$147/barrel *was* indispensable and in short supply. But in each case the merits were too obvious; the investment ideas became too popular; and asset prices consequently became dangerously high.

Following the trends that are popular at a point in time certainly isn’t a formula for investment success, since popularity is likely to lead investors on a path that is comfortable but pointed in the wrong direction. Here’s more from “Everyone Knows”:

The fact is, there is no dependable sign pointing to the next big moneymaker: a good idea at a too-low price. Most people simply don’t know how to find it. . . .

Large amounts of money (and by that I mean unusual returns, or unusual risk-adjusted returns) aren’t made by buying what everybody likes. They’re made by buying what everybody underestimates.

In short, there are two primary elements in superior investing:

- seeing some quality that others don’t see or appreciate (and that isn’t reflected in the price), and
- having it turn out to be true (or at least accepted by the market).

It should be clear from the first element that the process has to begin with investors who are unusually perceptive, unconventional, iconoclastic or early. That’s why successful investors are said to spend a lot of their time being lonely.

Risk and Counterintuitiveness

If what’s obvious and what everyone knows is usually wrong, then what’s right? The answer comes from inverting the concept of obvious appeal. The truth is, the best buys are usually found in the things most people don’t understand or believe in. These might be securities, investment approaches or investing concepts, but the fact that something isn’t widely accepted usually serves as a green light to those who’re perceptive (and contrary) enough to see it. A great example can be found in the area of risk (again from “Everyone Knows”):

“I wouldn’t buy that at any price – everyone knows it’s too risky.” That’s something I’ve heard a lot in my life, and it has given rise to the best investment opportunities I’ve participated in. In fact, to an extent, it has provided the foundation for my career. In the 1970s and 1980s, insistence on avoiding non-investment grade bonds kept them out of most institutional portfolios and therefore cheap. Ditto for the debt of bankrupt companies: what could be riskier?

The truth is, the herd is wrong about risk at least as often as it is about return. A broad consensus that something's too hot to handle is almost always wrong. Usually it's the opposite that's true.

I'm firmly convinced that investment risk resides most where it is least perceived, and vice versa:

- When everyone believes something is risky, their unwillingness to buy usually reduces its price to the point where it's not risky at all. Broadly negative opinion can make it the least risky thing, since all optimism has been driven out of its price.
- And, of course, as demonstrated by the experience of Nifty Fifty investors, when everyone believes something embodies no risk, they usually bid it up to the point where it's enormously risky. No risk is feared, and thus no reward for risk bearing – no “risk premium” – is demanded or provided. That can make the thing that's most esteemed the riskiest.

This paradox exists because most investors think quality, as opposed to price, is the determinant of whether something's risky. But high-quality assets can be risky, and low-quality assets can be safe. It's just a matter of the price paid for them.

For me, it follows from the above that the bottom line is simple: **the riskiest thing in the world is the widespread belief that there's no risk.** That's what most people believed in 2006-07, and that belief abetted the careless behavior that brought on the Great Financial Crisis. Only an understanding that risk was high could have discouraged that behavior and rendered the world safe.

I call this “the perversity of risk.” For most people it's hard to grasp that a perception of safety brings on risk, and a perception of risk can lead to safety. But it's clear for the deeper second-level thinker. This is just another example of the fact that what “everyone knows” is what shapes the environment, bringing high prices when things are perceived to be good, and vice versa.

A perception that fundamental risk is low and the future is positive causes investors to be optimistic. This, in turn, causes asset prices to rise, and thus investment risk to be high. **The problem that befalls most people – the first-level thinkers – is that they fail to distinguish between fundamental risk and investment risk.**

What has to be remembered is the defining role of price. Regardless of whether the fundamental outlook is positive or negative, the level of investment risk is determined largely by the relationship between the price of an asset and its intrinsic value. There is no asset so good that it can't become overpriced and thus risky, and few so bad that there's no price at which they're a buy (and safe). **This is one of the greatest examples of counterintuitiveness. Only those who are able to see its logic can hope to be superior investors.**

What Else?

I've covered a few of the most important topics under the headings of complexity and counter-intuitiveness:

- the importance of second-level thinking,
- the lack of identity between “good company” and “good investment,”
- the unhelpfulness of the things everyone knows, and
- the perversity of risk.

I see, however, that I've already filled seven pages. So rather than continue to provide a full treatment of all the topics I want to cover, let's conduct an exercise. I'll list below a number of elements of time-honored investment wisdom. See if you can tell which are helpful and which aren't:

- The market is “efficient,” meaning asset prices reflect all available information and thus provide accurate estimates of intrinsic value.
- Because people are risk-averse, risky deals are discouraged and the market awards appropriate risk premiums as compensation for incremental risk.
- Risky investments produce high returns.
- Adding risky assets to a portfolio makes it riskier.
- It's desirable that everything in a well-diversified portfolio performs well.
- Understanding the science of economics will enable you to safely harness the macro future.
- Sometimes the outlook is clear, and sometimes it's complicated and unpredictable. You have to be careful when it's the latter.
- Correct forecasts lead to investment gains.
- A forecast has to be correct in order to be profitable.
- The earning of a profit proves the investor made a good decision.
- A low price makes for an attractive investment.
- Assets that are appreciating deserve your attention.
- Contrarianism will bring consistent success.
- It's important to do what feels right.
- Assets with greater liquidity are safer.
- The level of risk in a portfolio can be kept low by applying a simple formulaic process.

My answer is that all sixteen reflect potential misconceptions, and they have to be (a) understood at the second level, not the first, and (b) dismissed as always holding the keys to success. Here's why:

- **The market is “efficient,” meaning asset prices reflect all available information and thus provide accurate estimates of intrinsic value** – The efficient market hypothesis assumes people are rational and objective. But since emotion so often rules in place of reason, the market doesn't necessarily reflect what's true, but rather what investors think is true. Thus prices can range all over the place. Sometimes they're fair, but sometimes they're way too high or low. It's a big mistake to impute rationality to the market and believe its message.
- **Because people are risk-averse, risky deals are discouraged and the market awards appropriate risk premiums as compensation for incremental risk** – The truth is that investors' risk-averseness fluctuates between too much and too little. When it's the latter, skepticism and conservatism dry up, due diligence is inadequate, risky deals are easy to pull off, and

compensation for risk bearing usually turns out to be insufficient. **Investors absolutely cannot depend on the market to discipline itself.**

- **Risky investments produce high returns** – This is one of the greatest of the old saws, and one of the wrongest.
 - A collection of low-risk investments can produce a high return if the low-risk character of the components permits them to perform dependably and keeps them from being any big losers to pull down the overall result. An absence of losses can give you a great start toward a good outcome. **This is the cornerstone of Oaktree's investment philosophy.**
 - On the other hand, high-risk investments can't be counted on for high returns. If they could, they wouldn't be high-risk. High-risk investments can fail to provide the high returns they seemed to promise if the analysis underlying them proves to have been ill-founded or if they run into negative developments.

The presumed positive relationship between risk and return is predicated on the assumption that there's no such thing as investment skill and value-adding decision making. If markets are efficient and there's no skill, it's reasonable to believe that higher returns can be attained only through the bearing of increased risk. **But if outstanding skill is present, there's no reason to think it can't be used to create portfolios with low risk *and* high return potential.**

- **Adding risky assets to a portfolio makes it riskier** – One of Nobel prize-winner William Sharpe's greatest contributions to investment theory came in the realization that if a portfolio holds only low-risk assets, the addition of a risky asset can make it safer. This happens because doing so increases the portfolio's diversification and reduces the correlation among its components, reducing its vulnerability to a single negative development.
- **It's desirable that everything in a well-diversified portfolio performs well** – The truth is, if all the holdings were to perform well in one scenario, they could all perform poorly in another. That means the benefits of diversification wouldn't be enjoyed. It shouldn't be surprising – or totally disappointing – to have some laggards in a portfolio that's truly well-diversified.
- **Understanding the science of economics will enable you to safely harness the macro future** – There are no immutable rules in play. "In economics and investments, because of the key role played by human nature, you just can't say for sure that 'if A, then B,' as you can in real science. The weakness of the connection between cause and effect makes outcomes uncertain. In other words, it introduces risk." ("Risk Revisited," September 2014).
- **Sometimes the outlook is clear, and sometimes it's complicated and unpredictable. You have to be careful when it's the latter** – The truth is, the future is never worry-free. Sometimes it seems to be, because no risks are apparent. But the skies are never as clear as they seem at their clearest. **Which is more treacherous: when everyone understands that the future presents risks, or when they believe it to be knowable and benign? As I mentioned earlier, I worry about the latter much more than the former.**
- **Correct forecasts lead to investment gains** – The easiest way to have a correct forecast is to extrapolate a trend and see it continue as expected. Most forecasters do a lot of extrapolating, meaning their forecasts are usually broadly shared. Thus when the trend does continue, everyone's right. But since everyone held the same view, the continuing trend was probably

discounted in advance in the price of the asset, and the fact that it rolls on as expected doesn't necessarily produce profit. For a forecast to be highly profitable, it has to be idiosyncratic. But, given how often trends continue, idiosyncratic forecasts aren't often right.

- **A forecast has to be correct in order to be profitable** – Just as correct forecasts aren't necessarily profitable, profitable forecasts don't have to be correct. A forecast – even if it's not correct – can be profitable if it's merely less wrong than others. If a trend that everyone else extrapolates turns out not to continue, a prediction of the deviation can be very profitable . . . even if it's not exactly on target.
- **The earning of a profit proves the investor made a good decision** – One of the first things I learned at Wharton was that you can't necessarily tell the quality of a decision from the outcome. Given the unpredictability of future events and, especially, the presence of randomness in the world, a lot of well-reasoned decisions produce losses, and plenty of poor decisions are profitable. Thus one good year or a few big winners may tell us nothing about an investor's skill. We have to see a lot of outcomes and a long history – and especially a history that includes some tough years – before we can say whether an investor has skill or not.
- **A low price makes for an attractive investment** – I talked at the bottom of page seven about the importance of price in determining whether an investment is risky. But if you reread the part in bold, you'll see it doesn't say a low price is the essential element. An asset may have a low absolute dollar price, a low price compared to the past, or a low p/e ratio, but usually the price has to be low relative to the asset's intrinsic value for the investment to be attractive and for the risk to be low. **It's easy for investors to get into trouble if they fail to understand the difference between cheapness and value.**
- **Assets that are appreciating deserve your attention** – Most people impute intelligence to the market, and thus they think rising prices signal fundamental merit. They may be attracted to "momentum investing," which is based on the belief that something that has been appreciating is likely to continue doing so. But the truth is, the higher the price (everything else being equal), the less attractive an asset is. Momentum investing works until it stops, at which time the things that have been doing worst – and may be most undervalued – take over market leadership.
- **Contrarianism will bring consistent success** – It's true that the investing herd is often wrong. In particular, it behaves more aggressively the more prices rise, and more cautiously the more they fall – the opposite of what should happen. But doing the opposite of what the crowd does isn't a sure thing either. Much of the time there isn't anything dramatic to either do or avoid. Contrarianism is most effective at the extremes, and then only for those who understand what the herd is doing and why it's wrong. And they still have to summon the nerve to do the opposite.
- **It's important to do what feels right** – The best investors know intellectually what the right thing to do is. But while this knowledge gives them comfort, they have to tamp down their feelings in order to follow it. The best ideas are ones others haven't tumbled to, and as I wrote in "Dare to Be Great," "Non-consensus ideas have to be lonely. By definition, non-consensus ideas that are popular, widely held or intuitively obvious are an oxymoron. . . . **Most great investments begin in discomfort.**" **Good investors are subjected to the same misleading influences and emotions as everyone else. They're just more capable of keeping them under control.**

- **Assets with greater liquidity are safer** – Greater liquidity generally means you can get out of an asset easier and closer to the price of the last trade. But first, liquidity can dry up when other investors change their mind about the asset. And second, the theoretical ability to get out when you want says nothing about fundamental safety and relatively little about investment safety in the long run. It's much safer to be in well-analyzed assets with good fundamentals and attractive prices, in which case you can hold for a long time without needing to exit. The best defense against a lack of liquidity is arranging your affairs so there's little need for it.
- **The level of risk in a portfolio can be kept low by applying a simple formulaic process** – Rather, risk comes in many forms and they can be overlapping, contrasting and hard to manage. For example, as I said in "Risk Revisited," efforts to reduce the risk of losing money invariably increase the risk of missing out on gains, and efforts to reduce fundamental risk by buying higher-quality assets often increase valuation risk, given that higher-quality assets often sell at elevated valuation metrics.

What does the above consist of? It's a collection of time-honored bromides that range from (a) only effective part of the time to (b) just plain wrong. These investment myths are pervasive but of little help. That fact leaves the investor to struggle in a complex, challenging environment.

Recent Experience

The recent volatility in the world's markets, the S&P 500's 11% drop between August 17 and 25, and the decline of nearly 40% in Chinese equities have given investors an opportunity to experience something else that's not easy: portfolio management under adverse conditions. A few lessons are worth noting, none of which are always easy to employ:

- Emotion is one of the investor's greatest enemies. Fear makes it hard to remain optimistic about holdings whose prices are plummeting, just as envy makes it hard to refrain from buying the appreciating assets that everyone else is enjoying owning. As I mentioned just above, everyone is buffeted by the same influences and emotions. **Superior investors may not be insulated, but they manage to act as if they are.**
- Confidence is one of the key emotions, and I attribute a lot of the market's recent volatility to a swing from too much of it a short while ago to too little more recently. **The swing may have resulted from disillusionment: it's particularly painful when investors recognize that they know far less than they had thought about how the world works.** In this case, when China's growth slowed, its currency depreciated and its market corrected, I think a lot of investors realized they don't know what the implications of these things are for the economies of the U.S. and the world. It's important to remain moderate as to confidence, but instead it's usually the case that confidence – like other emotions – swings radically.
- Especially during downdrafts, many investors impute intelligence to the market and look to it to tell them what's going on and what to do about it. **This is one of the biggest mistakes you can make. As Ben Graham pointed out, the day-to-day market isn't a fundamental analyst; it's a barometer of investor sentiment. You just can't take it too seriously.** Market participants have limited insight into what's really happening in terms of fundamentals, and any intelligence that could be behind their buys and sells is obscured by their emotional swings. It would be wrong to interpret the recent worldwide drop as meaning the market "knows" tough times lay ahead. Rather, China came out with some negative news and people panicked, especially

Chinese investors who had bought stocks on margin and perhaps were experiencing their first serious market correction. Their selling prompted investors in the U.S. and elsewhere to sell also, believing that the market decline in China signaled serious implications for the Chinese economy and others. **The analysis of fundamentals and valuation should dictate an investor's behavior, not the actions of others. If you let the investing herd – which determines market movements – tell you what to do, how can you expect to outperform?**

- While China was the “proximate cause” of the volatility, other things often contribute, and last month was no exception. The word that always comes to mind for me is “confluence.” **Investors can usually keep their heads in the face of one negative. But when they face more than one simultaneously, they often lose their cool.** One additional negative last month was the glitch in Bank of New York Mellon’s SunGard software, and the bank’s consequent inability to price 1,200 mutual funds and ETFs that it administers. It was another dose of disillusionment: no one enjoys learning that the market mechanisms they need to work can’t be depended on.
- In good times – perhaps emulating Warren Buffett – investors talk about how much they’d like to see the stocks they own decline in price, since it would allow them to add to positions at lower levels. **But when prices collapse, the chance to average down is usually a lot less welcome . . . and a lot harder to act on.**
- Investors can be tempted to sell during corrections like this one. Oftentimes emotional behavior is cloaked in intelligent-sounding rationalizations like “it’s important to sell down to your comfort level.” But the valid reasons to sell are principally because you feel fundamentals have deteriorated or because the price has risen enough. **Selling to get more comfortable as prices fall (just like buying for that purpose in a rising market) has nothing to do with the relationship between price and value.**
- Another reason to sell, of course, is fear that the slide will continue. But if you’re tempted to do so, ask yourself first whether you think the stock market is going to rise or fall tomorrow, and second how much you’d bet on it. If you can tackle those decisions in your head rather than your gut, you’ll probably admit you have no idea what’s going to happen in the short term.
- Regardless of the outlook for fundamentals or the relationship between price and value, many people sell in a downdraft because, well, you have to do something, and they feel it’s unreasonably passive to just sit there. **But something about which I feel strongly is that it’s not the things you buy and sell that make you money; it’s the things you hold.** Of course you have to buy things in order to hold them. But my point is that transactions merely adjust what you own, and engaging in them doesn’t necessarily increase potential profit. Sticking with what you own may be enough – although it may not be easy in tough times.
- In my memo on liquidity in March, I borrowed an idea from my son Andrew: If you look longingly at the chart for a stock that has risen for twenty years, think about how many days there were when you would’ve had to talk yourself out of selling. That’s not always easy. Two of the main reasons people sell stocks are because they go up and because they go down. When they go up, people who hold them become afraid that if they don’t sell, they’ll give back their profit, kick themselves, and be second-guessed by their bosses and clients. And when they go down, they worry that they’ll fall further.

There may be absolutely no intellectual justification for that feeling. If you liked it a month ago at \$80, should you sell it now just because it's at \$60? **The best way to get through a downdraft is to verify your thesis, tighten your seatbelt and hang on. If you sell just because there's a downdraft (or an updraft), you'll never get that twenty-year winner.** When you look closely, you'll see that every twenty-year rise included a lot of ups and downs. To enjoy long-term success, you have to hold through them.

- A lot has been written of late about reduced liquidity in the current investment environment, in part a result of restrictions under the Volcker rule. This may have contributed to last month's volatility, but it should be viewed as having exacerbated the short-term pain, not as altering the long-term fundamentals.

Coping with a declining market seems easy ahead of time, since emotions aren't in play and investors know what they should do. It's only when prices start falling in earnest, as they have recently, that it turns out to be harder than expected.

So What Will Work?

Superior investing isn't easy. I've set forth a number of examples of its complexity, and a long list of simplistic rules that can't be depended on. Among the many things that keep investing from being easy is the fact that no tactic works every time. Almost every tool an investor might employ is a two-edged sword. Here's how I put it last year in "Dare to Be Great II":

- If you invest, you will lose money if the market declines.
- If you don't invest, you will miss out on gains if the market rises.
- Market timing will add value if it can be done right.
- Buy-and-hold will produce better results if timing can't be done right.
- Aggressiveness will help when the market rises but hurt when it falls.
- Defensiveness will help when the market falls but hurt when it rises.
- If you concentrate your portfolio, your mistakes will kill you.
- If you diversify, the payoff from your successes will be diminished.
- If you employ leverage, your successes will be magnified.
- If you employ leverage, your mistakes will be magnified.

Each of these pairings indicates symmetry. None of the tactics listed will add value if it's right but not subtract if it's wrong. Thus none of these tactics, in and of itself, can hold the secret to dependably above average investment performance.

There's only one thing in the investment world that isn't two-edged, and that's "alpha": superior insight or skill. Skill can help in both up markets and down markets. And by making it more likely that your decisions are right, superior skill can increase the expected benefit from concentration and leverage. But that kind of superior skill by definition is rare and elusive. . . .

Why should superior profits be available to the novice, the untutored or the lazy?

Why should people be able to make above average returns without hard work and above average skill, and without knowing something most others don't know? And yet many individuals invest based on the belief that they can. (If they didn't believe that, wouldn't they index or, at a minimum, turn over the task to others?)

No, the solution can't lie in rigid tactics, publicly available formulas or loss-eliminating rules . . . or in complete risk avoidance. **Superior investment results can only stem from a better-than-average ability to figure out when risk taking will lead to gain and when it will end in loss.** There is no alternative.

Superior skill is an essential ingredient if superior investment results are to be achieved reliably. **No tactic or technique will lead to superior results in the absence of superior judgment and implementation.** But by definition, only a small percentage of investors possess superior skill.

It is mathematically irrefutable that (a) the average investor will produce before-fee performance in line with the market average and (b) active management fees will pull the average investor's return below the market average. This has to be considered in light of the fact that average performance can generally be obtained through passive investing, with tiny fees and almost no risk of falling short.

Superior investors and their well-thought-out approaches can produce superior returns on average in the long run. But even they are far from perfect. The best they can hope for is that they'll be right more often than they're wrong, and that their successful decisions will add more than their mistakes subtract.

So, in the end, there's only one absolute truth about investing. Charlie's right: it isn't easy.

September 9, 2015

Memo to: Oaktree Clients

From: Howard Marks

Re: On the Couch

I woke up early on Saturday, December 12 – the morning after a day of significant declines in stocks, credit and crude oil – with enough thoughts going through my mind to keep me from going back to sleep. Thus I moved to my desk to start a memo that would pull them together. I knew it might be a long time between inception and eventual issuance, since every time I dealt with one thought, two more popped into my head. In the end, it took a month to get it done.

Professor Richard Thaler of the University of Chicago is a leading expert on behavioral economics and decision-making (in fact, he's such a significant figure in the field that he was given a cameo role in the movie *The Big Short*). He opens his new book, *Misbehaving*, with Vilfredo Pareto's assertion that "the foundation of political economy and, in general, of every social science, is evidently psychology." I'd apply that equally to the not-so-scientific field of investing.

It has been one of my constant refrains – dating back all the way to "Random Thoughts on the Identification of Investment Opportunities" (January 1994) – **that in order to be successful, an investor has to understand not just finance, accounting and economics, but also psychology.** A thorough understanding of how investors' minds work is essential if one is to figure out where a market is in its cycle, why, and what to do about it. For me, the markets' recent behavior – certainly on December 11, but also at other points in 2015 – reinforces that observation.

This memo is my attempt to send the markets to the psychiatrist's couch, and an exploration of what might be learned there.

2012-14: An Uncertain World

In September 2012, I wrote a memo called "On Uncertain Ground." To begin it, I observed that "The world seems more uncertain today than at any other time in my life." I went on to list the things that worried me. Few of them are less troubling today. Certainly the period of the post-crisis recovery hasn't been carefree. Here are the things that concerned me in 2012, as viewed from that perspective:

- **Macro growth** – It seems to be broadly accepted that overall economic growth will be slower in the years ahead than in the latter part of the twentieth century. Do lower birth rates and slowing gains in productivity doom us to reduced macro gains? What does this mean for everything else? In particular, if growth remains slow, will it lead to slowing inflation, or even deflation?
- **Trends in the developed world** – Will the developed nations be able to compete in a globalized economy? How will incomes hold up as developing nations produce goods cheaper, and as the quality of those goods improves? As we increasingly become knowledge-based economies, will we need as many less-educated workers as in the past? If not, what will be the ramifications for unemployment, income inequality and society as a whole?
- **Consumer behavior** – Will consumers regain the confidence required to return to their expansive spending behavior? Will they employ credit as in the past to perpetuate growth in consumption?

- **Europe** – Will Europe move forward in terms of cohesion, coordination and productivity? What happens if it doesn't? Will the ECB be able to engineer an economic recovery? Will the departure from the European Union of Greece – or new Greeces – return as a worry in the future? (And now, will the coming referendum mandate Great Britain's departure? Will there be a new referendum in Scotland with regard to remaining in the UK? Will Catalonia vote to leave Spain, and what will that mean for its membership in the EU?)
- **Leadership** – For years I gave speeches using PowerPoint slides listing sources of uncertainty, but where it was supposed to say "dearth of leadership," someone had mistakenly typed "death of leadership" . . . and nobody quibbled. Throughout the world, few countries if any have leaders on par with history's best. Certainly that's true in the U.S. You may think it's a good thing, or you may not, but it's clear that Washington is too gridlocked to accomplish much. As I wrote in "On Uncertain Ground," ". . . U.S. politicians seem to value things like 'ideological purity' (i.e., toeing the party line) and being reelected above real attempts at problem solving. Partisanship and open warfare has surely reached a new zenith."
- **Entitlements** – Social Security is a locomotive rumbling down the track to ruin. The cost of health care programs is growing rapidly, as drugs become more expensive and Americans live longer. Defined-benefit pensions have been promised to public employees but not fully funded. How will federal, state and city governments meet their obligations? Not only does no one know, but also few people in government (certainly not in Washington) seem to care.
- **China** – As the world's second-largest economy, China plays a very important role in determining global growth. Its GDP advanced at double-digit rates over the last 20+ years – without recessions – on the basis of (a) millions of people moving from farms to cities (and to more productive roles in manufacturing), (b) the low-cost exports they produced and (c) readily available capital and the heavy fixed-asset investment it permitted. Henceforth China will gain less from the above and will have to transition to domestic consumption of goods and services, as well as a slower-growing economy . . . perhaps with ups and downs like the rest of the world. Will this result in a near-term hard landing? And what will be the impact on nations that sell commodities and finished goods to China?
- **Geopolitical hotspots** – From the fall of the Soviet Union at the end of 1991 until the 9/11 attacks in 2001, investors' positive feelings were abetted by the presence of peace in the world. But in recent years we have faced challenges involving Iran, Israel and the rest of the Middle East; Russia and Ukraine; China and North Korea; and terrorist threats in many places. How will markets react to the inevitable flare-ups?

The worries listed above confronted investors throughout the period 2012 through 2014. And in the last few months of that period, we saw a halving of the price of oil; additional slowing in China; worsening news from the Middle East; and continuing uncertainty regarding the Fed's likely action on interest rates.

Given markets' abhorrence of uncertainty, we normally would expect such issues to result in low asset prices and negative returns. But in 2012-14, despite the many negatives, we saw a cumulative return of 74% on the S&P 500, as well as strong appreciation on the part of real estate and companies that had been the subject of buyouts. Further reflecting investor confidence, the yield spread versus Treasuries for the average U.S. high yield bond narrowed from 706 basis points at the end of 2011 to 522 b.p. at the end of 2014, at which point the prospective yield to worst was down to 6.67%. Thus, as 2014 moved to a close, we saw:

- the litany of meaningful macro risks described above,
- investors engaging in pro-risk behavior in pursuit of adequate returns in a low-return world,
- as a consequence, full asset prices, and thus
- little likelihood of achieving returns high enough to compensate for the risks.

To sum up, psychology (and thus prices) were high given the fundamentals. Our world was marked by low prospective returns and plentiful problems, a troubling combination.

Here's what I wrote in "Risk Revisited" in September 2014:

While investor behavior hasn't sunk to the depths seen just before the crisis (and, in my opinion, that contributed greatly to it), in many ways it has entered the zone of imprudence. . . .

It's the job of investors to strike a proper balance between offense and defense, and between worrying about losing money and worrying about missing opportunity. Today I feel it's important to pay more attention to loss prevention than to the pursuit of gain. For the last three years Oaktree's mantra has been "move forward, but with caution." At this time, in reiterating that mantra, I would increase the emphasis on those last three words: "but with caution". . . .

Although I have no idea what could make the day of reckoning come sooner rather than later, I don't think it's too early to take today's carefree market conditions into consideration. What I do know is that those conditions are creating a degree of risk for which there is no commensurate risk premium.

The Negatives Build

Given the many concerns, performance in the first half of 2015 was sluggish at best. Most markets eked out positive returns, but gains came grudgingly, and few investors had a good time. Then, during the summer, the accumulation of worries accelerated and became too much to withstand:

- Growth remained flat or slowed in the U.S., Europe and Japan.
- China's economy continued to slow.
- The Fed continued to dither regarding interest rates. A potential increase caused worry, but so did the appearance that the Fed considered growth too weak to allow an increase.
- The oil price decline resumed, and other metals and commodities joined in, weakening the prices of related stocks and bonds.
- The geopolitical picture went from bad to worse:
 - Syria presented a choice between (a) enabling a despot to remain and (b) ousting him and turning over another country to instability and insurgency.
 - Russia intervened, flexing its muscles and reminding us of its intransigence.
 - ISIS and the flow of immigrants to Europe took on the appearance of insoluble problems; Paris and San Bernardino showed terrorism to be a serious ongoing threat.
 - An agreement was reached to limit Iran's nuclear progress, but no two experts seemed to agree on whether it was a good or bad thing.
 - Iraq, Afghanistan, Israel and Palestine got no better.
 - The South China Sea heated up from time to time.
- There was nothing positive to say about the U.S. political situation. Partisanship and gridlock remained the rule. The grinding two-year campaign took up increased airtime and mindshare, without a positive consensus concerning most candidates.
- Finally, a number of issues internal to the markets – ranging from reduced liquidity to market-reporting glitches to the meltdown of high-risk credit funds – shook investors' faith.

Somehow, market participants are able to live with uncertainties like these and retain their equanimity, sometimes for long periods. **Maybe it's conviction, maybe it's obliviousness, and maybe it's denial.** And that's what prevailed in recent times; as Doug Kass put it in mid-2014, we've been experiencing "a bull market in complacency."

But eventually something else happens – perhaps the house of cards grows too high – and investors' feeling of serenity is pierced. A point is reached beyond which equanimity can no longer be maintained. It was getting to that point that led to meaningful declines in U.S. credit markets in the latter half of 2015.

The Tipping Point

One of the most notable behavioral traits among investors is their tendency to overlook negatives or understate their significance for a while, and then eventually to capitulate and overreact to them on the downside. I attribute a lot of this to psychological failings and the rest to the inability to appreciate the true significance of events.

As negatives accumulate – whether they surface for the first time or just are finally recognized as significant – eventually a time comes when they can no longer be ignored, and instead they come to be treated as being of overwhelming importance. The latest tipping point was reached last August.

Up to that point, investors had pretty much resisted the negatives, and the S&P 500 was up 3.3% in the first seven months of the year. (The media might say investors had "coped with" the negatives, but of course they hadn't dealt with them; they'd ignored them.)

But then, in August, a series of negatives occurred in China: reports of still more economic slowing; a decline in A-share prices from June to August that reached 45%; an unexpected devaluation of the renminbi (whose value many people complained for years had been artificially depressed); and market-support measures that some found ham-handed (e.g., restrictions on actions such as short selling, and investigations of journalists writing negative articles about the stock market).

"Everyone knew" for years that the Chinese economy had been overstimulated with cheap financing, and that this had led to excessive investment in fixed assets. The effect was exceptional GDP growth, but also a large stock of unneeded buildings and infrastructure. Everyone also knew that a hard landing – a painful slowing in economic growth, and perhaps a recession – was among the possible outcomes. **But it wasn't until August that investors outside China began to notice A-shares' collapse; consider the possibility that a slowdown in China could have negative ramifications for the rest of the world; and import those worries to their own markets.** Thus between August 17 and 25, the S&P 500 declined 11%. What was behind the extrapolation of China's woes to other markets, like ours? Here's how I explained it in "It's Not Easy," published in September on the heels of the events in China:

Especially during downdrafts, many investors impute intelligence to the market and look to it to tell them what's going on and what to do about it. **This is one of the biggest mistakes you can make. As Ben Graham pointed out, the day-to-day market isn't a fundamental analyst; it's a barometer of investor sentiment. You just can't take it too seriously.** Market participants have limited insight into what's really happening in terms of fundamentals, and any intelligence that could be behind their buys and sells is obscured by their emotional swings. It would be wrong to interpret the recent worldwide drop as meaning the market "knows" tough times lay ahead. Rather, China came out with some negative news and people panicked, especially Chinese investors who had

bought stocks on margin and perhaps were experiencing their first serious market correction. Their selling prompted investors in the U.S. and elsewhere to sell also, believing that the market decline in China signaled serious implications for the Chinese economy and others.

Whatever the reason, the bottom line for me is that whereas risk tolerance had ruled through July, risk aversion was reawakened in August. I picture an investor who's oblivious to risk in the earlier months and then suddenly says, "Oh yeah: there are things to worry about." **The tipping point finally arrives, a sudden wake-up call to the existence and importance of risk.**

Half-Full or Half-Empty?

Almost 25 years ago, in my second memo ("First Quarter Performance," April 1991), I introduced the concept of the investment pendulum:

Although the midpoint of its arc best describes the location of the pendulum "on average," it actually spends very little of its time there. Instead, it is almost always swinging toward or away from the extremes of its arc. But whenever the pendulum is near either extreme, it is inevitable that it will move back toward the midpoint sooner or later.

One of the most significant factors keeping investors from reaching appropriate conclusions is their tendency to assess the world with emotionalism rather than objectivity. Their failings take two primary forms: selective perception and skewed interpretation. In other words, sometimes they take note of only positive events and ignore the negative ones, and sometimes the opposite is true. And sometimes they view events in a positive light, and sometimes it's negative. But rarely are their perceptions and interpretations balanced and neutral.

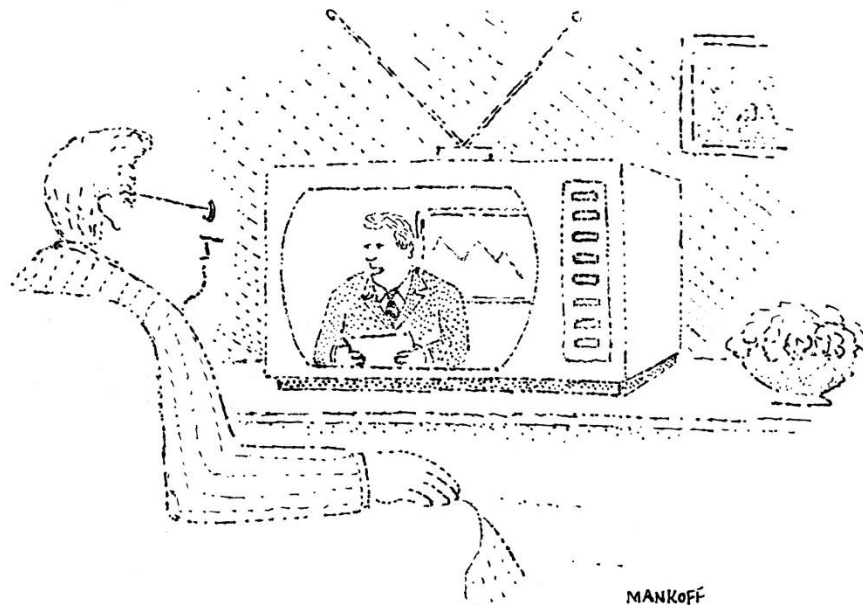
Ever since the August events in China, I've repeatedly found myself harking back to one of the oldest cartoons in my file, and still one of the very best:



"Everything that was good for the market yesterday is no good for it today."

In 2015 we saw old problems get worse, new ones arise, and a general absence of anything to feel good about. The sense of hopelessness regarding problems like ISIS and runaway immigration is something investors handle particularly poorly. In August, the events in China sparked a revival of risk aversion and fear, with effects that carried around the world for a couple of weeks. And with the door opened to fearful interpretation, Pollyanna tolerance gave way to widespread negativism.

The bottom line is that investor psychology rarely gives equal weight to both favorable and unfavorable developments. Likewise, investors' interpretation of events is usually biased by their emotional reaction to whatever is going on at the moment. Most developments have both helpful and harmful aspects. But investors generally obsess about one or the other rather than consider both. And that recalls another classic cartoon:



“On Wall Street today, news of lower interest rates sent the stock market up, but then the expectation that these rates would be inflationary sent the market down, until the realization that lower rates might stimulate the sluggish economy pushed the market up, before it ultimately went down on fears that an overheated economy would lead to a reimposition of higher interest rates.”

It all seems so obvious: investors rarely maintain objective, rational, neutral and stable positions. **First they exhibit high levels of optimism, greed, risk tolerance and credulousness, and their resulting behavior causes asset prices to rise, potential returns to fall and risk to increase. But then, for some reason – perhaps the arrival of a tipping point – they switch to pessimism, fear, risk aversion and skepticism, and this causes asset prices to fall, prospective returns to rise and risk to decrease.** Notably, each group of phenomena tends to happen in unison, and the swing from one to the other often goes far beyond what reason might call for.

That’s one of the crazy things: in the real world, things generally fluctuate between “pretty good” and “not so hot.” But in the world of investing, perception often swings from “flawless” to “hopeless.” The pendulum careens from one extreme to the other, spending almost no time at “the happy

medium” and rather little in the range of reasonableness. **First there’s denial, and then there’s capitulation.**

The Sources of Error

To explain why these bipolar episodes occur, I want to spend a little time on some of the factors behind investor psychology. For the most part they’re easily observed and dissected, and not mysterious. I discussed some of them in “It’s Not Easy”:

Emotion is one of the investor’s greatest enemies. Fear makes it hard to remain optimistic about holdings whose prices are plummeting, just as envy makes it hard to refrain from buying the appreciating assets that everyone else is enjoying owning. Confidence is one of the key emotions, and I attribute a lot of the market’s recent volatility to a swing from too much of it a short while ago to too little more recently. **The swing may [result] from disillusionment: it’s particularly painful when investors recognize that they know far less than they had thought about how the world works.** It’s important to remain moderate as to confidence, but instead it’s usually the case that confidence – like other emotions – swings radically.

While China was the “proximate cause” of the recent volatility, other things often contribute, and last month was no exception. The word that always comes to mind for me is “confluence.” **Investors can usually keep their heads in the face of one negative. But when they face more than one simultaneously, they often lose their cool.** One additional negative last month was the glitch in Bank of New York Mellon’s SunGard software, and the bank’s consequent inability to price 1,200 mutual funds and ETFs that it administers. It was another dose of disillusionment: no one enjoys learning that the market mechanisms they need to work can’t be depended on.

Another area of error – be it the result of flawed perception or inadequate insight and analysis – can be seen in investors’ repeated failure to understand the potential for ramifications and second-order consequences. One instance was the general lack of concern about contagion from sub-prime mortgage backed securities that prevailed between early 2007 – when mortgages began to default in large numbers – and the tumultuous events of mid/late 2008. Most people overlooked the potential for contagion, and thus (for example), as of May 2008 the S&P 500 was essentially unchanged from the first quarter of 2007. Yet sub-prime mortgage defaults contributed significantly to the subsequent bank collapses and bailouts, the bankruptcy filing of Lehman Brothers, and the late-2008 emergence of fear of a financial system meltdown. As a consequence, between May 2008 and March 2009 the S&P lost 52%. **The events that produced such extreme distress in late 2008 and early 2009 were unforeseen and unimagined just a few months before . . . even though the clues had been there for a year.**

There are many more ways in which non-objective, non-rational quirks commonly affect behavior. As Carol Tavis points out in her May 15, 2015 *Wall Street Journal* review of Professor Thaler’s book:

As a social psychologist, I have long been amused by economists and their curiously delusional notion of the “rational man.” Rational? Where do these folks live? Even 50 years ago, experimental studies were demonstrating that people stay with clearly wrong decisions rather than change them, throw good money after bad, justify failed predictions rather than admit they were wrong, and resist, distort or actively reject information that disputes their beliefs.

The difficulty of understanding events, their significance and their potential ramifications comes in good part from the kinks in investors' psyches, and it contributes to – and feeds back to exacerbate – investors' responses. Thus investors tend to emphasize just the positives or the negatives much more often than they take a balanced, objective approach. And they tend to become optimistic and eager to buy when good news, positively interpreted, has forced prices up . . . and vice versa. All of this is obvious (especially in retrospect), and thus equally obviously, understanding and dealing with it presents a potential way to improve results.

Notions of market efficiency – the idea that most assets are priced “right” – are based on belief in investor rationality and objectivity. But certainly those traits are little seen in real life.

“Inefficiencies” – in everyday language, “mispricings” – stem from biases against one asset or in favor of another: legal, cultural, informational, and especially behavioral and emotional. The first three of these exist much less nowadays than they did 30 or 40 years ago, but the latter two still rear their head from time to time. And I'm sure they always will.

Case In Point – Oil

On December 12, as I began to write this memo, the *Financial Times* provided several examples of the negative thinking being applied. Here are some excerpts from an article about the recent market action:

Oil prices fell sharply to a seven-year low, rattling stock markets at the end of a choppy week. . . . The price of Brent crude, the global energy benchmark, was down 5.6% to \$37.49 . . . after Opec at its meeting a week ago failed to agree output cuts, leaving prices at the mercy of a global glut.

“Lower oil prices are here to stay.”

The CBOE Oil Vix is holding above the 54 level . . . as investors pay up to protect themselves [against], or speculate upon, further sharp moves in crude.

That all sounds very serious. But is it? Does it make any sense? What's the real significance of declining oil prices?

The bottom line for me is that, if you aren't an oil company or a net oil-producing country, low oil prices aren't necessarily a bad thing. For net oil importers like the U.S., Europe, Japan and China, the drop we've seen in the price of oil is analogous to a multi-hundred-billion-dollar tax cut, adding to consumers' disposable income. It can also increase an importer nation's cost-competitiveness.

The U.S. is both a producer of oil and an importer. That means the macro economy will enjoy the benefit of cost reduction and income enhancement, but domestic oil companies and those who provide them with products and services will gain less from production than had been expected, and some state and local governments will be hard-hit. (And I must add that, thus far, the indicators fail to suggest a salutary impact on the broad economy.) Eighteen months ago I thought the ability to produce oil through fracking at a cost of \$40-60 per barrel would give the U.S. a cost advantage in manufacturing; that's no longer likely, at least for now.

But the one thing that's beyond doubt is that the impact of the fall in the price of oil is far from all bad. In fact, I'd say that it's positive on balance for the U.S. and an unmitigated boon for the UK, Europe and East Asia. So why did the *FT* attribute market weakness to it? First, the media have taken on the unpleasant task of telling us why the markets went up or down each day, and the falling oil price is an

easy answer . . . until you give it any real thought. Second, though, as the *FT* went on to explain, some worry might be appropriate regarding what it connotes:

The fall in commodity prices is causing market anxiety because investors are worried that it signals a slowdown in global demand, and that any economic benefit from cheaper costs for consumers and businesses is being counteracted by the cutting of investments and jobs by the resources sector.

In other words, they're inferring that the price of oil declined because demand is off, and that this signals economic weakness. But economic growth is what it is; we don't need the oil price to tell us it's weak. And the price of oil is off another third in the last few months, even though world GDP is still growing.

The important thing isn't what the oil price decline tells us about today. It's what it says about tomorrow. And to me, everything else being equal, I think low energy prices today will contribute to better economic growth tomorrow. (Low prices today probably also imply higher prices eventually, through their impact on supply and demand.) It's just that everybody's interpreting everything negatively these days.

Case In Point – Interest Rates

The *FT* also pointed out that investors were reacting to the likelihood the Fed would raise interest rates, even though that should have been a foregone conclusion:

Next week, the Federal Reserve will raise interest rates. That at least now appears likely. Anything else would be the biggest shock of a year in which markets and monetary authorities have had serious misgivings. Let us assume for now that it happens.

This will be the longest-awaited and most-previewed tightening of monetary policy in history.

There's something wrong if an event that has been widely anticipated for years – and considered a near certainty for months – can be thought capable of significantly impacting the market when it becomes a fact. People's expectations should be incorporated into the prices they assign to assets. So a negative reaction to the imminence of a widely heralded interest-rate increase must imply that either (a) investors are too dense to have incorporated it into prices before this, (b) the increase will be a bigger deal than people thought, or (c) the market is irrational.

On December 15, Dow Jones published the following quote:

"It's been more shoot first, ask questions later" in the shares of large asset managers, said Kenneth Hill, an analyst at Barclays PLC. "The concern is largely that as rates move higher, investors think returns will move lower and there will be some rotation out of fixed income. People are anxious to see how that plays out," he added.

When Mr. Hill said that, more than two and a half years had passed since May 2013, when Ben Bernanke foreshadowed a "tapering" of bond purchases and the possibility of higher interest rates. How can investors not have had enough time to adjust to the possibility of higher rates and incorporate it into asset prices? Indeed, the increase that was just days away should have been mostly a non-event, and the idea that it was a significant contributor to the declines on December 11 makes no apparent sense.

Over the years since Bernanke's statement in 2013, the question I've been asked more often than any other has been, "What month will the Fed begin to raise interest rates?" My response has been consistent: "I have no idea, and why do you care?" If someone tells me he'll do one thing if he thinks the Fed's going to raise rates in March and something different if it's going to happen in January, what he's demonstrated is that he doesn't understand how asset prices incorporate expectations. The difference in timing should have little effect on the choice of a course of action. What matters is how far rates will go, and how fast. I don't expect much of either from this dovish and cautious Fed . . . unless the economy surprises on the upside. **And that would be good news, wouldn't it?**

While on the subject of interest rates, I want to mention the thing about them that most annoys me these days. People who acted one way when rates were unchanged (even though everyone knew they wouldn't remain that way for long) are acting very differently now that there's been a quarter-point increase. This, they say, is because "we're in a rising-rate environment." But the issue of interest rates, like most others, shouldn't be viewed as binary . . . black or white . . . flat rates or rising. **The essential questions are, "how much will rates rise?" and "when the series of increases is over, will rates be high enough to meaningfully alter behavior?" That's what counts.**

Yesterday, *The Wall Street Journal* wrote as follows: "Analysts and investors attribute the [auto stocks' recent greater-than-market] declines to worries that rising U.S. interest rates could crimp auto finance and to fears that auto sales may have peaked." Does the interest rate outlook really mean significantly fewer cars will be sold . . . especially given that low gas prices are making consumers richer and driving cheaper? I think people may have jumped to an unwarranted – and negatively tinged – conclusion.

Case In Point – Third Avenue

In terms of investor reaction, I find the announcement that Third Avenue's Focused Credit Fund would liquidate to be the most interesting recent event. According to the *FT*:

The liquidation of the biggest US mutual fund since 2008 has intensified concern for the health of the US corporate bond market.

Some distinguished between a risk to the system, where issues at one fund trigger redemptions from others, and so-called idiosyncratic problems related to a single fund.

Corporate bonds sold off again yesterday in the wake of the FCF liquidation announcement and many investors rushed to buy default insurance contracts on junk debt.

There isn't much to be in doubt about in the meltdown of the Focused Credit Fund; clearly it reflected problems peculiar to that fund alone. In 2014, while a \$3½ billion fund, it had substantial holdings in particularly-high-risk, illiquid debt. Then it encountered snowballing capital withdrawals at a time of reduced market liquidity. Under circumstances like these, portfolio managers generally raise cash by liquidating their most salable holdings, causing the quality and liquidity of the remaining portfolio to decline. Continuing withdrawals took FCF's assets below \$800 million in December 2015, and I hear it was down to 20 or fewer holdings, all of extremely low quality. Further redemptions would have forced the manager to sell those, realizing extremely low prices, eliminating any liquidity that may have been present, and leaving investors who hadn't redeemed holding the bag.

The fault certainly lies with the fund's managers. Risky, illiquid investments may be appropriate for closed-end funds whose capital is secure, but probably not for mutual funds or other vehicles subject to daily redemptions. It's debatable whether a fund should be expected to be able to handle both an 80%

loss of AUM and a substantial decline in liquidity. But, as I wrote in “Liquidity” (March 2015), “no investor should shoulder more illiquidity than its realities permit” and, in particular, “no investment vehicle should promise more liquidity than is afforded by its underlying assets.” **Illiquid assets and the possibility of capital flight: there are few surer recipes for investment disaster.**

Investors lacking strong emotional and analytical foundations might have been scared into believing that FCF’s problems connoted – or presaged – widespread weakness among high yield bonds and other forms of risky debt. Those who were a bit less panicky might have understood that high yield bonds in general were probably secure but still feared that illiquidity would combine with cascading redemptions to cause a chain reaction of capital withdrawals from other funds, forced sales, and collapsing bond prices. But those with adequate emotional and analytical resources would have recognized that FCF’s problems were more endogenous and idiosyncratic than a function of high yield bonds broadly, and that adequate creditworthiness provides the debtholder’s ultimate protection against chaos in the market.

Recent Developments

Behavioral economics and its younger cousin, behavioral investing, aren’t theoretical. In fact, they’re the essence of practical: they’re about how human foibles cause real-life behavior to deviate from what theory might dictate.

In recent months we’ve had occasion to watch how mood swings can alter the investment environment. I’ll describe below the events that have occurred in the market for distressed debt.

In the U.S., the years 2010-14 were characterized by gradual economic improvement, increasing corporate profits, a dramatic switch of the credit markets to accommodativeness, and – because of all this – some of the lowest default rates in history on low-grade debt. As a result, there was a paucity of distressed debt. Further, the little that was available was concentrated in just a few areas: European NPLs, real estate, shipping and power companies. Put these factors together, and Oaktree found itself unable to assemble large or thoroughly diversified distressed debt portfolios. Noting this, we followed up our record \$10.9 billion fund raised in 2007-08 (and largely invested in the quarter following Lehman Brothers’ bankruptcy filing) with one of \$5.5 billion in 2010 and then another of \$2.7 billion in 2011. In other words, we halved our investable capital and then halved it again.

There is no immediate connection (other than for companies doing business there) between the slowdown in China or the price decline in the oil patch, on one hand, and the general creditworthiness and desirability of high-risk debt on the other. And yet, over the last few months, pronounced changes have occurred in the market for distressed debt:

- After a period of very stable prices – even for “iffy” debt – some securities have “gapped down” in the last few months (i.e., fallen several points at a time rather than correcting gradually). In particular, investors have become highly intolerant of bad corporate news.
- For the first time since 2008-09, the debt of some companies outside of energy and mining has fallen from 90 to 60, and others from 50 to 20.
- **There is a general sense among my colleagues that investors have gone from evaluating securities based on the attractiveness of their yield (with company fundamentals viewed optimistically) to judging them on the basis of the likely recovery in a restructuring (with fundamentals viewed pessimistically).**
- The capital markets have begun the swing from generous toward tight, as is their habit. Thus, whereas they used to find it easy to refinance debt in order to extend maturities or secure “rescue

financing,” now it’s hard for companies – especially those experiencing any degree of difficulty – to obtain capital.

On December 7, Oaktree held a dinner in New York for equity analysts who follow our publicly traded units. Bob O’Leary, a co-portfolio manager of our distressed debt funds, planned to be among the hosts. But he called me on December 3 with a question I hadn’t heard in a long time from my distressed debt colleagues: “Would you mind if I don’t come? There’s too much going on for me to leave the office.” The change in investor attitudes had created investment opportunities where they hadn’t existed just a few months before – in some cases out of proportion to the change in fundamentals.

Developments like these are indicative of rising pessimism, skepticism and fear. They’re largely what Oaktree hopes for, since – everything else being equal – they make for vastly improved buying opportunities. But note that we may be just in the early stages of a downward spiral in corporate performance and credit market behavior. **Thus, while this may be “a time” to buy, I’m far from suggesting it’s “the time.”**

My Prescription

To help investors deal with their potential for “human error,” this shrink would prescribe a number of elements that can help with the task:

- The first essential element in coping with markets’ irrationality is **understanding**. The importance of psychology and its influence on markets must be recognized and dealt with.
- The second key lies in **controlling one’s emotions**. An investor who is as subject as the crowd to emotional error is unlikely to do a superior job of surviving the markets’ swings. Thus it is absolutely essential to keep optimism and fear in the appropriate balance.
- Emotional self-control isn’t enough. It’s also important to have **control over one’s circumstances**. For professionals, that primarily means structuring one’s environment so as to limit the impact on them of other people’s emotional swings. Examples include inflows to and outflows from funds, fluctuations in market liquidity, and pressure for short-term performance. At Oaktree we never fail to appreciate the benefit we enjoy from being able to reject “hot money” and limit our funds’ redemption provisions.
- And finally there’s **contrarianism**, which can convert other investors’ emotional swings from a menace into a tool. Going beyond just fending off emotional fluctuation, it’s highly desirable to become more optimistic when others become more fearful, and vice versa.

I’m lucky to have received many gifts of investment insight early in my career. Perhaps foremost among them is one I picked up in New York about 40 years ago, at a lunch meeting of what we called the Third Thursday Group. It concerned the three stages of a bull market:

- the first, when only a few especially insightful people suspect improvement might occur,
- the second, when most people accept that improvement is actually taking place, and
- the third, when everyone concludes that things are sure to improve forever.

Between the first stage and the last, nothing has to have changed in terms of fundamentals. The difference lies in the perspective investors are bringing to their decisions. But clearly, it’s great to be a buyer in the first stage and essential not to be in the last.

We know investors swing from rejecting all possibilities to drinking the Kool-Aid, just as the three stages say. Thus at Oaktree we want to buy when they're pessimistic, not when they're eager participants. **If I could know only one thing about an investment I'm contemplating, it might be how much optimism is embodied in the price.** In the first stage of the bull market, no optimism is present, and that makes for great bargains. In the last stage, the level of optimism is terribly high, and thus so are purchase prices relative to fundamentals. I want to buy when I can benefit from the herd's neuroses, not when they'll penalize me just as they do everyone else.

As I mentioned above, since the middle of 2011 – by which time the quest for return had resulted in rather full prices for debt, over-generous capital markets and pro-risk investor behavior – Oaktree's mantra has been "move forward, but with caution." We've felt it was right to invest in our markets, but also that our investments had to reflect a healthy dose of prudence. Except for the occasional air pocket, investors didn't suffer significant negative consequences prior to the last year or so. Thus, as usual, we were early in turning cautious. But opportunities (and returns) in the credit sphere have been only so-so since mid-2011, and I don't think our caution caused us to miss much.

Now, as discussed above, investors' optimism has deflated a bit, some negativity has come into the equation, and prices have moved lower. Depending importantly on which market we're talking about and how it has fared in recent months, we consider it appropriate to move forward with a little less caution.

* * *

While I have your attention, I want to devote a few paragraphs to the two questions I'm asked most often these days: What are the implications for the U.S. and the rest of the world of China's weakness, and are we moving toward a new crisis of the magnitude of what we saw in 2008?

At a time when the environment is marked by so many potential problems, it's important to figure out which if any are likely to present real problems. Declining oil prices: the implications for non-oil producers seem mixed at worst. A terrorist event: horrifying, but for any one person or location, I'd put it in the category of an "improbable disaster." The political picture: we'll probably continue to muddle through no matter who's elected.

I would say that, of all the things on the list, the possibility of a hard landing in China is of the greatest significance when you combine magnitude, potential ramifications and the probability of it occurring. So it's important to look objectively at what it means for the U.S.

First, let's remember that China doesn't play a pivotal role in the U.S. economy (other than as a provider of finished goods). It is estimated to account for only 1% of the combined profits of the S&P 500 companies. Exports account for about 13% of U.S. GDP, and in the first eleven months of 2015 less than 8% of our exported goods went to China (\$106 billion of goods, versus an annual GDP approaching \$18 trillion – again, well below 1%).

Going on from there, I want to share Paul Krugman's analysis from *The New York Times* of January 8. (I generally don't agree with Krugman's politics, but I don't think they're relevant here.):

Yes, China is a big economy, accounting in particular for about a quarter of world manufacturing, so what happens there has implications for all of us. And China buys more than \$2 trillion worth of goods and services from the rest of the world each year.

But it's a big world, with a total gross domestic product excluding China of more than \$60 trillion. Even a drastic fall in Chinese imports would be only a modest hit to world spending.

What about financial linkages? One reason America's subprime crisis turned global in 2008 was that foreigners in general, and European banks in particular, turned out to be badly exposed to losses on U.S. securities. But China has capital controls – that is, it isn't very open to foreign investors – so there's very little direct spillover from plunging stocks or even domestic debt defaults.

All of this says that while China itself is in big trouble, the consequences for the rest of us should be manageable. But I have to admit that I'm not as relaxed about this as the above analysis says I should be. If you like, I lack the courage of my complacency. Why?

Part of the answer is that business cycles across nations often seem to be more synchronized than they "should" be. For example, Europe and the United States export to each other only a small fraction of what they produce, yet they often have recessions and recoveries at the same time. Financial linkages may be part of the story, but one also suspects that there is psychological contagion: Good or bad news in one major economy affects animal spirits in others.

So I worry that China may export its woes in ways back-of-the-envelope calculations miss . . .

I want to highlight Krugman's reference to "psychological contagion." It's interesting in this regard that, last week, the world's stock markets saw the following declines: S&P 500 – 6.0%, FTSE 100 – 5.3%, DAX – 8.3% and Nikkei – 7.0%. **I consider it highly unlikely that such uniform declines were the result of independent, objective analysis of the impact of events on each economy and company. Rather, I think they show the extent to which markets are linked by their investors' shared psychology.**

So what about the likelihood of another 2008-style crash? The bottom line for me is that a rerun of the Global Financial Crisis isn't in the cards:

- We haven't had a boom (either in the economy or in the stock market), so I don't think we're fated to have a bust. Because most businesses have been particularly loath to expand their facilities, I don't think they'll be slammed if revenues flatten or turn down.
- The leverage in the private sector has been reduced. This is particularly true of the banks, where leverage has gone from the region of 30+ times equity before the crisis to very low double digits today. And, of course, banks are now barred from investing adventurously for their own account.
- Finally, the main villain in the crisis was sub-prime mortgage backed securities. The raw material – the underlying mortgages – was unsound and often fraudulent. The structured mortgage vehicles were highly levered and absurdly highly rated. And the risky tranches ended up in banks' portfolios, causing them to require rescues. **Importantly, this time around I see no analog to sub-prime mortgages and MBS in terms of their combination of fragility and magnitude.**

I don't mean to suggest there aren't a lot of things to worry about: swollen central bank balance sheets; complete ignorance as to how they will be unwound and how interest rates will be moved higher; the seeming inability to generate economic growth and inflation; and the many other macro negatives

listed earlier. A hard landing and substantial devaluation in China, the world's second largest economy, certainly could have far-reaching effects.

It's important that investors (as well as economists) avoid using words like "always," "never," "will," "won't," "has to" and "can't," and I try to do just that. But it's my view that the GFC and its preconditions were highly unusual, and I don't think we're heading for an encore. Remember, however, that I'm not a seer, and Oaktree and I never bet heavily on opinions regarding the future – mine or anyone else's.

* * *

Before I close, I want to make it abundantly clear that when I call for caution in 2006-07, or active buying in late 2008, or renewed caution in 2012, or a somewhat more aggressive stance here in early 2016, I do it with considerable uncertainty. My conclusions are the result of my reasoning, applied with the benefit of my experience (and collaboration with my Oaktree colleagues), but I never consider them 100% likely to be correct, or even 80%. **I think they're right, of course, but I always make my recommendations with trepidation.**

I read the same newspapers as everyone else. I see the same economic data. I'm buffeted by the same market movements. The same factors appeal to my emotions. Maybe I'm a little more confident in my reasoning, and certainly I have more experience than most. But the key is that – for whatever reason – I'm able to stand up to my emotions and follow my conclusions. **None of them can be documented or proved.** If they could be, most intelligent people would reach the same conclusions, with the same degree of confidence. I tell you this only to communicate my feeling that no one should fear he's not up to the task just because he's unsure of his conclusions. **These aren't things about which certainty is attainable.**

* * *

Lastly, they tell me Oaktree is now on social media. That means you can follow @oaktree on Twitter to receive updates about my memos, videos and speaking engagements, and to hear from others at the firm. You can also subscribe to my memos on our website, oaktreecapital.com/insights.

January 14, 2016

Memo to: Oaktree Clients

From: Howard Marks

Re: What Does the Market Know?

My buddy Sandy was an airline pilot. When asked to describe his job, he always answers, “hours of boredom punctuated by moments of terror.” The same can be true for investment managers, for whom the last few weeks have been an example of the latter. We’ve seen bad news and prices cascading downward. Investors who thought stocks were priced right 20% ago and oil \$70 ago now wonder if they aren’t risky at their new reduced prices.

In Thursday’s memo, “[On the Couch](#),” I mentioned the two questions I’d been getting most often: “What are the implications for the U.S. and the rest of the world of China’s weakness, and are we moving toward a new crisis of the magnitude of what we saw in 2008?” Bloomberg invited me on the air Friday morning to discuss the memo, and the anchors mostly asked one version or another of a third question: “does the market’s decline worry you?” That prompted this memo in response.

The answer lies in a question: “what does the market know?” Is the market smart, meaning you should take your lead from it? Or is it dumb, meaning you should ignore it? Here’s what I wrote in “It’s Not Easy” in September and included in “[On the Couch](#)”:

Especially during downdrafts, many investors impute intelligence to the market and look to it to tell them what’s going on and what to do about it. This is one of the biggest mistakes you can make. **As Ben Graham pointed out, the day-to-day market isn’t a fundamental analyst; it’s a barometer of investor sentiment. You just can’t take it too seriously.** Market participants have limited insight into what’s really happening in terms of fundamentals, and any intelligence that could be behind their buys and sells is obscured by their emotional swings. It would be wrong to interpret the recent worldwide drop as meaning the market “knows” tough times lay ahead.

The rest of this memo will be about fleshing out this theme (meaning you can stop reading here if you’ve had enough or are short on time).

The Nature of Consensus Opinion

I based the above reference to Ben Graham on his famous observation that in the long run the market’s a weighing machine, but in the short run it’s a voting machine. In other words, in the long term the consensus of investors figures out what things are really worth and moves the price there. But in the short term, the market merely reflects consensus opinion regarding an asset’s future popularity, something that’s highly susceptible to the ups and downs of psychology.

So, what does the market know? **First it’s important to understand for this purpose that there really isn’t such a thing as “the market.” There’s just a bunch of people who participate in a market.** The market isn’t more than the sum of the participants, and it doesn’t “know” any more than their collective knowledge.

This is a very important point. If you believe the market has some special insight that exceeds the collective insight of its participants, then you and I have a fundamental disagreement. The thinking of the crowd isn't synergistic. In my view, the investment IQ of the market isn't any higher than the average IQ of the participants. And everyone who transacts gets a volume-weighted vote in setting an asset's price at a given point in time.

People of all different levels of ability act together to set the price. They vary all over the lot in terms of knowledge, experience, insight and emotionalism. The market doesn't give the ones who are superior in these regards any more influence than the others, especially in the short run. **My bottom line on this subject is that the market price merely reflects the average insight of the market participants.** That's point number one.

If anything, I think it's emotion that's synergistic. It builds into herd behavior or mass hysteria. When 10,000 people panic, the emotion seems to snowball. People influence each other, and their emotions compound, so that the overall level of panic in the market can be higher than the panic of any participant in isolation. That's something I'll return to later.

Now let's think about the first goal of investing: to buy low. We want to buy things whose price underestimates the value of the underlying assets or earnings (value investing) or the future potential (growth investing). **In either case, we're looking for instances when the market is wrong.** If we thought the market was always right – the efficient market hypothesis – we wouldn't spend our lives as active investors. Since we do, we'd better believe we know more than the consensus. **So by definition we must not think the market – that is, the sum of all other investors – knows everything, or knows more than we do, or is always right.** That's point number two.

And that leads logically to point number three: why take instruction from a group of people who know less than you do? In "[On the Couch](#)," I wrote that it all seems obvious: investors rarely maintain objective, rational, neutral and stable positions. Do you agree with that or not? Is the market a clinical and rational fundamental analyst, or a barometer of investor sentiment? Does the market's behavior these days look like something a mature adult should emulate?

It seems clear to me: the market does not have above average insight, but it often is above average in emotionality. Thus we shouldn't follow its dictates. In fact, contrarianism is built on the premise that we generally should do the opposite of what the crowd is doing, especially at the extremes, and I prefer it.

A Case in Point – The Crash of 2008

The year 2008 culminated in the greatest panic I've ever seen. The events that built up to it included:

- massive subprime mortgage defaults and the failure of mortgage backed vehicles,
- meltdowns at funds that had invested in those vehicles, notably two Bear Stearns funds,
- the collapse of Bear Stearns, necessitating its purchase by JPMorgan for almost no consideration,
- rescues of Merrill Lynch by Bank of America; Wachovia by Wells Fargo; and Washington Mutual by JPMorgan (after it was first seized by the Office of Thrift Supervision),
- decisions on the part of BofA and Barclays not to acquire Lehman Brothers, and on the part of the U.S. Treasury not to bail it out, leading to Lehman's bankruptcy filing,
- the appearance that Morgan Stanley would be next if it couldn't secure additional capital, and
- widespread speculation regarding other firms that might follow.

A massive downward spiral ensued. Among the contributing factors were:

- precipitous declines in the prices of bank stocks,
- large-scale short selling of the stocks (the “uptick rule” previously mandated that a stock could only be sold short at a price above the last trade, meaning short selling couldn’t force the price down. But the rule was repealed in 2007, so there ceased to be limits on when stocks could be shorted. Thus short sellers could force stock prices down – whether intentionally, in what in the 1920s were called “bear raids,” or just because they thought the stocks were right to sell),
- dramatic increases in the cost to insure the debt of banks through credit default swaps.

In the environment described above, the downward spiral in bank stocks was intensified by the following factors (whether they were intentionally manipulated, I can’t say for sure):

- It was easy to bet against the banks by buying credit default swaps (CDS) on their debt.
- It was easy to depress bank stocks by selling them short.
- The declining stock prices were taken as a sign that the banks were weakening, causing the cost of buying CDS protection to rise.
- The rising cost of CDS protection was taken as an additional negative sign, causing the stocks to fall further.

I can tell you, it had the feel of an unstoppable vicious circle. Some compared it to the “China Syndrome”: a 1979 movie with Jane Fonda and Michael Douglas in which an out-of-control nuclear reaction threatens to propel reactor components through the earth’s core, from the U.S. to China. Thus the stock of panic-ridden Morgan Stanley (for example) fell 82%, to less than \$10.

But it’s important to note that the negative feedback loop described above was able to continue without reference to – and not necessarily in reasonable relationship to – actual developments at the banks or changes in their intrinsic value. Eventually, however, the Treasury restricted short selling in the stocks of 19 financial institutions deemed “systemically important.” Morgan Stanley secured a \$9 billion injection of convertible equity from Mitsubishi UFJ Financial Group. The panic subsided. The economy and capital markets recovered. And Morgan Stanley’s stock traded at \$33 a year later.

Do you wish you had taken the market’s instruction in 2008 and sold bank stocks? Or do you wish you had rejected its advice and bought instead? In short, did the market know anything?

There are three possible answers:

- The market was flat wrong in 2008 when it took Morgan Stanley’s stock so low.
- The market was right; it properly reflected the possibility of a meltdown that could have happened but didn’t.
- The market was wrong in the case of Morgan Stanley in 2008, but most of the time it isn’t.

I like the first, and the second is appealing as well. But while a meltdown certainly was possible, the below-\$10 price probably assigned it too high a likelihood. And, of course, I’m not persuaded by the third.

A Case in Point – Senior Loans in the Financial Crisis

While on the subject of 2008, I want to review the performance of senior loans. In the old days, banks made corporate loans, sometimes sharing part with a syndicate of a few friendly banks but retaining the rest. More recently the custom changed, with banks syndicating their loans widely to buyers of all types and retaining rather little. This process has more in common with investment banks' underwriting of securities than with the commercial banks' prior lending process.

Senior loans became a significant area of activity for credit investors like us. They're typically their issuers' senior-most debt, so they're perceived to carry little credit risk. And since they pay interest at floating rates, there is no interest rate risk. (Of course, with so little risk, they offer low yields.) They're the highest-quality instruments I've ever dealt in.

Because they were considered so safe, loans were widely deemed appropriate for levered investment, and prior to the financial crisis large numbers of highly levered Collateralized Loan Obligations, or CLOs, were formed to hold them. Borrowing at low floating rates to buy senior debt paying high floating rates was very enticing, and the CLO business mushroomed.

Senior loans were affected dramatically by the events of 2008. Since senior loans had been used to fund buyouts with purchase prices at high multiples of cash flow, investors became concerned about the issuers' ability to service them, and especially to refinance them when they came due (since the capital markets had slammed shut). Loan prices fell to levels never seen before in the absence of a default; whereas non-distressed senior loans had rarely sold below 95 in the past, now they fell to the 80s, and then to the 60s. Because of the collapsing prices, "market-value" CLOs received margin calls they couldn't meet, and banks seized portfolios and liquidated them in overnight BWIC (bid-wanted-in-competition) transactions. The indiscriminate selling put further pressure on prices, leading to more margin calls and more BWICs: another prototypical negative feedback loop.

The senior loan index was down 29% in 2008. That exceeded the 25% decline of the high yield bond index. Why would senior debt fall more during a crisis than junior debt? The answer is that senior loans had been ground zero for buying with leverage (and thus for margin calls and forced selling) whereas high yield bonds had not.

The key questions were rarely asked while things melted down: what were the loans worth, and would they pay? That depended on the outlook for defaults, but in late 2008 few people felt they could assess it or could take the time required to do so. **And neither did they question the extent to which the price collapses had been caused by margin calls and forced selling, rather than investment fundamentals.** They just succumbed to negativity and sold.

When 2008 ended, and with it the cycle of selling, price declines, margin calls, more selling and more price declines, the prices of loans stopped going down. And then they went up. The senior loan index rose 45% in 2009, meaning someone who invested on December 31, 2007 and didn't sell was up 3% overall by December 31, 2009. What if you had taken the market's advice in the post-Lehman meltdown and sold in response to the negative signal? You'd have a valid complaint, but whom would you blame? The market . . . or yourself?

What Does a Falling Market Say About Value?

What do big price declines mean? They mean market participants sense fundamental deterioration. But what price declines say is reflective, not predictive. They tell you about the events that have occurred, and how investors have reacted to them. They don't tell you anything that the average investor doesn't know about future events. And, again, I'm firmly convinced (a) the average investor doesn't know much, and (b) following average opinion won't help you attain above average results.

Most of my readers want to perform better than the average investor. As I've set out in "Dare to Be Great II" (April 2014) and in the discussion of "second level thinking" in my book *The Most Important Thing*, to accomplish that, you have to invest differently than the average investor. To do that, you have to think differently than the average investor. And to do that, you have to consider different inputs than the average investor, or consider inputs differently. You simply can't follow the signals their behavior provides.

It's a matter of logic: if price movements reflect average opinion, following their supposed advice can't help you perform above average.

Now let's think about the question of whether to sell. Here are some possible reasons to do so:

- Belief that the price is high relative to the fundamentals.
- Belief that while the current price may not be high relative to the current fundamentals, the fundamentals will deteriorate in ways that aren't anticipated by the price. (In other words, the price is high relative to how the fundamentals will come to be viewed.)
- Belief that the price will fall regardless of the fundamentals, meaning that by selling today you can avert a loss and/or position yourself to profit by buying lower later.

Do you agree that these are the main reasons to sell? Are there others? Are these all legitimate?

For me the first two are compelling. This is what the skilled investor thinks about. Both of these decisions are made relative to something called "intrinsic value." **There's only one intelligent form of investing: figure out what something's worth and see if you can buy it at or below that price.** It's all about value.

But note that the third reason to sell shown above has nothing to do with value. The price may be high, low or fair relative to the fundamentals today or what they're expected to be tomorrow. You just sell because you think the price will fall.

First, does it make sense to sell something if the price is low relative to the fundamentals, just because you fear it may fall in the short run? A long-term value investor holds or buys when price is low relative to value. Low price relative to value is his dream. Why sell a low-priced asset just because you think it's going to fall for a while? Most people understand the challenge in dealing with "two-decision stocks": you sell because you think the price may fall (even though it may be something you'd like to hold for the long term), and then you have to figure out when to buy it back. Last year Charlie Munger complained to me that they're really "three-decision stocks": you sell it because you think the price is full, you have to figure out when to buy it back, and in the meantime you have to come up with something else to do with your money. **In my experience, most people who are lucky enough to sell something before it goes down get so busy patting themselves on the back that they forget to buy it back.**

All other things being equal, as something falls in price, you should want to own it more, not less. The buy-and-hold value investor is stalwart, ignoring price fluctuations. Even better, the contrarian moves opposite to the market, buying when the price falls and selling when it rises.

Second, if not on the basis of fundamentals, how does one make the decision to sell for the third reason listed above? Essentially, two things give rise to changes in asset prices: changes in the outlook (macro or asset-specific) and changes in attitudes toward the asset. In other words, fundamentals and valuation. Fundamentals are dealt with above. If you're going to try to benefit from changes in price that are unrelated to changes in fundamentals, you're left having to predict investor psychology. If "On the Couch" wasn't successful in convincing you this isn't possible, this memo probably won't be, either.

My bottom line is that markets don't assess intrinsic value from day to day, and certainly they don't do a good job during crises. Thus market price movements don't say much about fundamentals. **Even in the best of times, when investors are driven by fundamentals rather than psychology, markets show what the participants think value is, rather than what value really is.** Value is something the market doesn't know any more about than the average investor. **And advice from the average investor obviously can't help you be an above average investor.**

What Does a Falling Market Say About Psychology?

Fundamentals – the outlook for an economy, company or asset – don't change much from day to day. **As a result, daily price changes are mostly about (a) changes in market psychology and thus (b) changes in who wants to own something or un-own something.** These two statements become increasingly valid the more daily prices fluctuate. Big fluctuations show that psychology is changing radically.

And, I said on page two, emotional fluctuations – swings in market sentiment or psychology – do seem to be synergistic. That is, in crowd psychology, $2 + 2 = 5$. **While I don't think the price of an asset reflects more wisdom than is possessed by the average of its market's members, I do believe mass psychology will make a group swing to reach greater emotional extremes than its members would separately.** In short, people make each other crazy. And when times are bad – like now – they depress each other. That was a factor in the edge enjoyed by our distressed debt team in 2008: they were able to buy at the market's lows because they weren't in New York, where everyone was trading scary stories and getting each other down.

Again, we can gain insight through logic. **We all know we want to buy (not sell) at the lows, and sell (not buy) at the highs. So then how can it be right to sell because of a decline or buy because of a rise?** Advocates of this latter approach must think (a) declines and rises tend to continue more than they reverse and/or (b) they can tell which declines mean "buy" and which mean "sell." Some savants may have that latter ability, but not many. In general, I think it's ridiculous to sell something because it's down (just as it is to buy because it's up).

As prices fall, there are some very genuine reasons to sell:

- Some people feel rising fear and have to lighten their positions in order to retain their composure.
- Some, having lost a lot of money, sell to be sure they won't experience losses they can't survive.
- Some have to sell to repay demanding creditors or satisfy investor withdrawals.

These reasons are not "invalid." It's just that none of them has anything to do with making money.

Most mature investors know intellectually that short-term price fluctuations are low in fundamental significance, and that the best results will be achieved if they hold on to their positions and ride out the volatility. But sometimes people sell anyway, perhaps for the above reasons. **Doing so has the potential to convert a short-term fluctuation into a permanent loss by causing any subsequent recovery to be missed. I consider this the cardinal sin in investing.**

What Do the Media Know?

I'm usually able to find something in the print or broadcast media that helps me make my point. Here's how *The New York Times* led the business section on Saturday:

Concern Grows That Market Sell-off is an Early Warning of a U.S. Slowdown

It may be time for everyone to take the markets seriously again.

As stock prices started tumbling in the first trading days of the year, many Wall Street professionals were tempted to describe the declines as the sort of adjustment that the market has gone through in recent years before moving higher.

But that opinion evaporated this week as the selling intensified. Concerns are now growing that the markets are signaling that the United States economy, despite its recent bright spots, is on the verge of a slowdown.

The fear is that economic problems in China have set off negative reactions around the world that could ultimately weigh on American households and corporations.

So the bottom-line question is simple: does the market reflect what people know, or should people base their actions on what the market knows? And if the latter, where does "the market" get its information, other than from people? For me it's simple: if people follow the market's dictates, they're taking advice from . . . themselves!

I set a trap at the beginning of this memo, and I want to spring it now. In the first paragraph, I wrote, "We've seen bad news and prices cascading downward." You probably glossed over it. But is it true? Leaving aside China and the markets' gyrations, have we really been seeing negative news on balance? Isn't it just that people are fixating on bad news, ignoring good news, and tending to interpret things negatively?

There are ways in which psychology can become "real," feeding back to influence fundamentals. One is that declining asset prices produce a negative "wealth effect," making people feel poorer and causing them to spend and invest less. And there are others. But despite the feedback influences of the market declines, I still would say U.S. and European economic fundamentals aren't negative on balance.

On Friday, in the midst of the declines, I participated in a small lunch attended by investment professionals and current and former senior government economic and financial leaders. I'll spare you the details: **there was a lot of "on one hand" and "on the other hand," but no one thought there would be a recession this year.** So then who are the people creating price signals to which others should accord significance?

* * *

I want to end by making one thing completely clear. I'm not saying the market is never right when prices go down (or up). I'm merely saying the market has no special insight and conveys no consistently helpful message. **It's not that it's always wrong; it's that there's no reason to presume it's right.**

It is the goal of some investors to sell on declines when the subsequent movements will be down, but "buy the dips" when the subsequent movements will be up. If you think you can tell which is which from watching the market movements themselves, then we – again – have a fundamental disagreement. Future price movements can only be predicted on the basis of the relationship between price and fundamentals. And, given the market's short-term volatility and irrationality, this can only be done in the long-term sense. **The market has nothing useful to contribute on this subject.**

January 19, 2016

Memo to: Oaktree Clients

From: Howard Marks

Re: This Time It's Different

I first came across the title of this memo in an article titled “Why This Market Cycle Isn’t Different” by Anise C. Wallace in *The New York Times* of October 11, 1987. It went as follows:

The four most dangerous words in investing are “this time it’s different,” according to John Templeton, the highly regarded 74-year-old mutual fund manager. At stock market tops and bottoms, investors invariably use this rationale to justify their emotion-driven decisions.

Over the next year, many investors are likely to repeat these four words as they defend higher stock prices. But they should treat them with the same consideration they give “the check is in the mail. . . .”

Nevertheless, in the bull market’s sixth year, the “this time it’s different” chorus is beginning to be heard. Wall Street professionals predict that, before the bull market ends, individual investors, who have mostly stayed on the sidelines, will be swept along in the mania characterizing a market peak.

They will invest in stocks despite the fact that the Dow Jones Industrial average has more than tripled in the last five years. They will be hearing overwhelmingly compelling reasons why stock prices should go higher, why the bull market should last considerably longer than any other in history, why this boom will not be followed by a 1929-like crash and why “this time it’s different.”

Many of these arguments will be tempting because they will have some element of truth to them. Even Mr. Templeton concedes that when people say things are different, 20 percent of the time they are right. But the danger lies in thinking that the different factor – like the recent investment in United States stocks by the Japanese – will be uninterrupted.

Wallace’s essential message is that investors must take heed when the four words are in widespread use. Why? Look back at the paragraph introducing the above quote: when you first read it, did you happen to notice the date of publication? **It was just eight days before Black Monday (October 19, 1987), the worst day in stock market history.** We know how bad it feels when the market falls 20% in a year. Try 22% in a day!! Wallace’s warning was particularly important at the time the article was published, but for me it’s always important.

* * *

Typically in investing, historical norms put limits on asset prices. Thus, for example, bull markets can generally go to extremes only if investors discard the notion that the p/e ratio on the S&P 500 stock index shouldn't go much above its post-World War II average of 15 or 16. If the earnings of the S&P's underlying companies grow at 10% a year, by definition the index can rise 20% a year (as it did in the 1990s) only if the ratio of price to earnings is viewed as highly expandable. It was such a perspective that allowed the index to reach 32 times earnings at the start of this century (with highly negative implications for equity returns in 2000-02).

Think of a rocket launched from Cape Canaveral. Gravity has to be overcome in order for it to escape the earth's atmosphere. Likewise, the limitations imposed by past norms have to be overcome in order for asset prices to slip their historic moorings and blast off into outer space.

Today we're not hearing much about historic valuations being irrelevant, as they're not terribly high. **Instead, what we're told is different this time is the relevance of restrictions on future economic and market performance:**

- There doesn't have to be a recession.
- Continuous quantitative easing can lead to permanent prosperity.
- Federal deficits can grow substantially larger without becoming problematic.
- National debt isn't worrisome.
- We can have economic strength without inflation.
- Interest rates can remain "lower for longer."
- The inverted yield curve needn't have negative implications.
- Companies and stocks can thrive even in the absence of profits.
- Growth investing can continue to outperform value investing in perpetuity.

I rarely participate in a meeting these days without someone asking about one or more of these propositions. **The bottom line is that for any of the nine to be true, things really have to be different this time.** I'll discuss the outlook for each below.

The avoidable recession – The questions I get most often these days are "Is the U.S. heading for a recession?" and "When will it start?" My answer to the first is a simple "yes." (At least I can never be proved wrong.) We've always had economic cycles, and I believe we always will. Eventually, favorable developments will lead people to engage in behavior premised on excessively optimistic assumptions, and eventually the over-optimism of those assumptions will be exposed and the excesses will correct in a period of negative growth. Moreover, even economies that aren't marked by excesses are subject to exogenous shocks.

When people ask about the coming recession, what they mostly mean is "Might it be a long way off?" Well, the longest U.S. recovery on record lasted ten years, and the current one is in the twelfth month of its tenth year. There's no reason a recovery can't go beyond ten years; no gate will come down on June 30, foreclosing further progress. And it's important to note that since this has been the most sluggish U.S. recovery since World War II, it hasn't been characterized by excesses to the upside, meaning there needn't be a recessionary correction on the usual schedule.

Very soon, the current recovery is bound to become the longest in U.S. history. However, I believe the odds are that it's closer to the end than the beginning. (We never know for sure what's going to happen in the future. At best we can think in terms of the probabilities. That's the thinking behind my latest book's subtitle: *Getting the Odds on Your Side*.) The recovery is likely to go on longer, but perhaps not much longer. Still, I wouldn't place a wager on when it will end.

About a year and a half ago, following the enactment of President Trump's stimulative tax cuts, people started to ask me whether the U.S. might emulate Australia, whose last recession was in 1990. While not quite the same as asking "might there never be another recession?" the idea of 28 years between recessions would represent a radical difference this time.

My answer to the above question is "probably not," since there are significant differences between the two countries that probably render Australia's example inapplicable to the U.S.:

- A much bigger part of Australia's GDP is based on exporting natural resources such as iron ore and coal, of which it has so much. Thus in recent decades it has drafted off the unusually strong growth of its much larger neighbor to the north, China.
- In addition, "... having a conservative, domestically focused, highly concentrated banking system meant that Australia wasn't stuck importing other countries' financial contagions when crises hit." (*The New York Times*, April 7, 2019)
- In fact, I see in Australia a conservatism and discipline capable of extending financial good times without creating excesses. My favorite example is the Australia Future Fund, which the government formed in 2006 to deal with the country's pension liabilities, with funding that came from fiscal surpluses (!) and the privatization of Telstra, the formerly state-owned telecommunications company. The fund's assets, now standing at A\$154 billion, were essentially put into a lockbox until 2020, which now appears likely to extend until at least 2026. What's the likelihood that U.S. politicians would (a) fund government pension obligations up front, rather than deal with them on a pay-as-you-go basis, and (b) keep their hands off the assets for 20 years, rather than use them to pay for constituent-pleasing spending increases or tax cuts?

So no, I don't think the U.S. is about to emulate Australia's 28-years-and-counting recovery. That I will bet on.

Perpetual prosperity from quantitative easing – In the aftermath of the Global Financial Crisis, the Fed engaged in quantitative easing, a program of purchasing bonds in the open market. The effect of the Fed's purchases was to (a) inject bank reserves into the financial system, (b) strengthen the demand for bonds, thereby bringing down long-term interest rates (which are unaffected by the Fed's normal open market operations related to short-term rates), and (c) with prospective returns on high-quality bonds brought down, reignite risk-bearing on the part of investors seeking higher returns, thereby causing the credit window to reopen. QE was a success in the U.S., and the economy recovered. Thus some people are now proposing that the Fed could engage in QE forever, with similarly positive results.

First, I think some part of the impact of QE may be psychological. In other words, QE stimulates the economy in part because people accept that QE is stimulative. If the Fed took exactly the same actions but did so without making an announcement, would the effect be the same? (I believe there's

a self-fulfilling, placebo-like component to many of the Fed's tactics.) In this regard, I think its first round of QE was more effective than its second, and its second round was more effective than its third. Accordingly, there could be a diminishing return from permanent QE, as the psychological effect abates.

And who knows exactly how QE works? Last week, at a conference I attended, a participant suggested that under Modern Monetary Theory (see more below), the Treasury could issue a potentially unlimited amount of debt, and if third-party buyers failed to take it up, the Fed could buy it under QE. Does this seem reasonable? If the Fed credits banks with reserves, the banks lend a multiple of those reserves, and the borrowers use the loan proceeds to make purchases or investments, does the process really inject money into the economy, or is it mostly a matter of bookkeeping? Or are they one and the same? Of course, this question is relevant to all nations with fiat currencies.

Quantitative easing is generally considered to have contributed to the past decade's low prospective investment returns, resultant risk-taking, asset inflation, and increasing wealth divide. As with any other prescription, shouldn't we worry about possible side effects like these?

Can government actions permanently raise the level of demand in an economy, or do they mostly accelerate future demand into the present? If the latter, can QE elevate GDP forever above what it otherwise would have been? I doubt it. But if it could, wouldn't that eventually cause what I call an "excess," leading to a recession?

Finally, when I hear people talk about the possibility that the Fed will prevent a recession, I wonder whether it's even desirable for it to have that goal. Per the above, are recessions really avoidable or merely postponable? And if the latter, is it better for them to occur naturally or be postponed unnaturally? **Might efforts to postpone them create undue faith in the power and intentions of the Fed, and thus a return of moral hazard? And if the Fed wards off a series of little recessions, mightn't that just mean that, when the ability to keep doing so reaches its limit, the one that finally arrives will be a doozy?**

Benign federal deficits – Over the years, some in government have pursued balanced federal budgets, or at least have paid them lip service. Democrats have generally been described as wanting to "tax and spend" in order to do more for citizens. But they've sometimes spent before they've taxed. Republicans, on the other hand, have positioned themselves as the party of fiscal restraint. It's often been their official position that there could be no increases in spending if not accompanied by corresponding increases in funding.

Regardless of the debate, federal budgets are rarely tendered on time or in balance these days. We've had deficits in 46 of the last 50 years (with the exception of 1998-2001), and in recent years they've risen as a percentage of GDP despite the prosperity we've been enjoying. Often there isn't even a pretense of interest in fighting deficits. Democrats have big spending ideas even in the absence of ways to fund them. And Republicans cut taxes but not always spending.

Both parties now seem to feel that the way to win elections is to simply ignore deficits. In the 1930s, John Maynard Keynes said that in periods when private economic activity isn't generating enough demand to create full employment, governments should spend more than they take in,

counting on deficit spending to stimulate demand. And then, during the resulting periods of growth, they should spend less than they take in, using the surplus to pay down the debt that was taken on to fund deficits. But departing from this, at the end of 2017, in the ninth year of a recovery, the Republicans enacted sweeping tax-rate cuts capable of ballooning the deficit.

A new entrant in this area is receiving a lot of attention: Modern Monetary Theory (“MMT”). One of its components is the belief that government deficits currently are too small, and in any event not a bad thing:

Tax revenues are not what finance the government’s expenditures, argues Stephanie Kelton, an economist at Stony Brook University and one of the most influential modern monetary theorists. What actually happens in a country that controls its own currency, she says, is that the government first decides what it’s going to spend. In the United States, Congress agrees on a budget. Then government agencies start handing out dollars to the public to pay for those tanks, earth movers and salaries. Afterward, it takes a portion back in the form of taxes. If the government takes back less than it gave out, there will be a deficit. . . .

Ms. Kelton . . . points out that every dollar the government spends translates into a dollar of income for someone else. So a deficit in the public sector simultaneously produces a surplus outside the government. . . . (*The New York Times*, April 7, 2019)

Thus, according to MMT, deficits are benign – not a sign of profligacy – and merely an indication that the government has put more money into the economy than it has taken out in taxes. MMT is modern in that it has moved past the old-fashioned concept of balancing spending and revenues, opening the door for bigger deficits.

Does Ms. Kelton think deficits don’t matter? No, the *Times* article goes on:

Of course they matter, she said. . . . They can be too big, especially if they are not used to increase the nation’s productive capacity, or if there is a shortage of labor, raw materials and factories.

In this connection, we should note that Ms. Kelton served as an economic adviser to Bernie Sanders in 2016. Thus it may be reasonable to suspect that MMT is largely a rationale for governments to give away more free stuff, expanding their deficits. **Sometimes it can be hard to separate economic opinions from political leanings.**

This relaxed view of deficits reminds me of a hypothetical consumer who has a credit card with no credit limit. He can spend whatever he wants without having to worry about paying off the balance. In theory, this could work (although it’s challenging to figure out what’s in it for the card issuer). But at a minimum it doesn’t allow for unforeseen developments. **I believe here, as elsewhere, the workings of economics are too uncertain for a perpetual motion machine like MMT to be relied upon. In other words, Modern Monetary Theory is just that: a theory. What if it’s wrong?**

. . . when the University of Chicago’s Booth School of Business asked top scholars about a couple of [MMT’s] claims, they split between the 28 percent who disagreed and the 72 percent who strongly disagreed. (ibid.)

Disregarded national debt – I recall a heated debate when I was young over whether it’s okay for nations to permanently be in debt. More recently, any such doubt has been forgotten, and almost all nations are debtors. The main issue became whether there can be a level of debt that’s too high. But now, thanks to MMT, there’s a belief that there’s no such thing.

Continuing from the *Times*’s description of Modern Monetary Theory:

“The national debt is nothing more than a historical record of all of the dollars that were spent into the economy and not taxed back, and are currently being saved in the form of Treasury securities,” Ms. Kelton said.

In other words, national debt is just a sign of all the government has accomplished.

While I can’t prove that Modern Monetary Theory is off the beam, I also can’t see making it the economic law of the land. Does it have a weakness? I think there may be one hidden in the middle of the long quote above, regarding **“a country that controls its own currency.”** I don’t know exactly what Ms. Kelton meant by this phrase, but it might be a reference to a country that can print as much money as it wants without having to worry about its currency depreciating, and thus one that is always able to issue and refinance debt without limits.

Today the U.S. dollar is the world’s reserve currency, and there aren’t any obvious candidates to replace it. Further, the U.S. benefits from an unlimited appetite for its debt, since it’s the safest of any major sovereign. For these reasons, expanding the national debt isn’t a problem. And like the cardholder described above, since there’s no limit to its credit, the U.S. can add the interest that accrues to the unpaid balance.

What happens if these conditions change? Could a tipping point be reached at which there’s so much debt that people question the U.S.’s creditworthiness and ability to repay its borrowings? In that case, the demanded interest rate would rise, meaning the debt and interest mightn’t be repayable without massive money printing that would result in debasement of the dollar. Thus, could there come a day when it takes unacceptably more purchasing power to pay off U.S. debt denominated in dollars that have depreciated?

I put these questions to my friend Randy Kroszner, former member of the Fed’s Board of Governors and Deputy Dean at the University of Chicago’s Booth School of Business. Here’s his response:

I think the last three decades for Japan and the last decade for the U.S. have shown (and continue to be showing) that countries with credible institutions can “get away with” higher debt levels without a raid by bond vigilantes than most had once thought. That said, it leaves the country vulnerable to a change in sentiment, exactly as you describe. “Getting away with it” for too long erodes the credibility of the institutions over time.

Again, MMT might work, and vastly expanded national debt might prove viable or even advantageous. But I wouldn’t bet the ranch on it.

Economic strength without inflation – For the last 60 years, there has been widespread (albeit not universal) acceptance of the so-called Phillips curve, which posits an inverse relationship between the rate of unemployment and the rate of inflation. In other words, as unemployment falls and the labor market tightens, workers gain bargaining power and employers have to compete for a declining number of available workers. This results in rising wages, which translates into increasing inflation.

The U.S. has seen unusually little unemployment during the Trump presidency, and today it's at a 50-year low. Nevertheless, there hasn't been much wage inflation until very recently, and there still isn't much general inflation.

There are reasons why the relationship underlying the Phillips curve as defined above might be different from what it was in the past:

- Since the U.S. labor force participation rate (percentage of adults who are either employed or looking for work) is at its lowest level in more than 40 years, it might be more meaningful to look at the non-employment rate (the percentage of adults who aren't working) rather than the unemployment rate (the percentage of adults looking for work who aren't working). By the former measure, the labor market isn't so tight.
- Inflation might be structurally lower now and in the future than it was in the past, altering its relationship to conditions in the labor market. Automation, the shift of manufacturing to low-cost countries and the prevalence of free/cheap stuff in the digital age might help explain today's unusually low rate of inflation. For examples of the third of these, think about recent trends in the price of photographs, cellphone calls, messages (texts and emails versus telegrams and faxes) and books.
- On the other hand, the cheapening of things like those listed just above could halt, and a more traditional relationship between inflation and unemployment could resume.

Excessive inflation creates a number of serious economic and social problems, typically requiring central banks to raise interest rates to cool it off, with the effect of dampening economic growth and job creation. Likewise, rising inflation can cause investors to demand higher interest rates on bonds and loans to compensate for the risk of losing purchasing power. This can make it harder for borrowers to service their debt, causing defaults to rise and discouraging investors from taking risk and providing financing. (On the other hand, there's a level of inflation that's desired such that, among other things, workers will see wage growth, and the U.S. can repay outstanding debt with dollars representing a reduced amount of purchasing power. Today that desired rate is about 2%, and policymakers worry about the fact that it hasn't materialized despite the low unemployment rate.)

Rising inflation could be seen as a potential contributor to the end of the recovery. So far it hasn't shown up despite the tightness of the labor market. Has the Phillips curve relationship been revoked for good, or is inflation in the offing? Who knows?

The word I use to describe inflation is “mysterious.” It's rarely clear how it gets started, and in the 1970s and early '80s, when it reached the mid-teens in the U.S., no one could figure out how to stop it until after Paul Volcker became Fed chair. It's mysterious why there's so little inflation today, and whether there'll be inflation in the future. But I'm not confident that it'll still be below 2% a few years from now.

Persistently low interest rates – “Lower for longer” has been another rallying cry of the bull market. If interest rates remain low, economic growth is encouraged, defaults are scarce, risk-taking is encouraged and financing is easy. So far – against the odds – the strength of the U.S. economy hasn’t caused interest rates to rise.

The Fed has raised interest rates nine times since the end of 2015, taking the short-term fed funds rate from roughly zero to $2\frac{1}{4}$ - $2\frac{1}{2}$ %, and in late 2018 it said it would go further. But in January, in response to fears of economic weakness that arose in 4Q2018, the Fed reversed course and declared that there would be no more increases for now. Whereas the yield on the 10-year Treasury note hitting $3\frac{1}{4}$ % early last October coincided with (and probably contributed to) the start of the stock market’s fourth-quarter swoon, the promise of low rates has played a big part in the rally this year.

In mid-2007, in a real economy that felt to me a lot like this one, the fed funds rate and the yield on the 10-year Treasury note both were around $5\frac{1}{4}$ %. Today, with the fed funds rate and 10-year Treasury yield below $2\frac{1}{2}$ % instead, the Fed describes interest rates as “neutral”: neither low enough to be stimulative nor high enough to be restrictive. (I considered the 2007 rates to be neutral – how can that be true of rates at both levels?)

Will the Fed leave rates low? Can it do so if inflation strengthens? Will it leave rates so low that there’s little room to reduce them in the future should stimulus be needed? If deficits and debt grow faster than GDP, won’t that put upward pressure on interest rates? Or if the Fed cuts rates, as many people now consider likely, will the markets be cheered by the stimulus, or will they fall in response to the economic concerns at which the rate cuts are directed? Certainly no one can say.

Equanimity regarding the inverted yield curve – Something else we’ve heard a lot about over the last couple of years is how risky it is when the yield curve inverts.

The yield curve is usually upward-sloping, meaning lenders demand higher interest rates when they lend for longer periods as compensation for the increased uncertainty (especially with regard to possible declines in the purchasing power of the currency between the time the loan is made and when it’s repaid). But sometimes, long-term rates fall below short-term rates, and the curve is said to be “inverted.” The curve has been unusually flat in recent months, and today it’s actually inverted.

Because most periods of inversion have been associated with recessions, the condition is considered worrisome. In that regard, the *Financial Times* noted on June 1 that “the [yield curve] has ‘inverted’ before every US recession in 50 years.” (Note, however, that this is different from saying every inversion has been followed by a recession.) What people should be focusing on isn’t the usual coincidence of inversions and recessions, but rather the reason for this particular inversion. Understanding the latter might allow observers to sense whether a recession is implied and avoid a “false positive.”

The explanation for inversions isn’t always clear, since interest rates (like inflation) can be mysterious. Today I would say the inversion of the curve may be due to the fact that the Fed has brought short rates up at the same time that (a) there’s a surplus of capital for investment at the long end of the yield curve, putting downward pressure on rates there, and (b) there’s less reliance on

capital investment in the information age, so less demand for long-term debt capital. One more thing that may be bringing down long-term yields is an increase in general worry among investors, and thus a flight to the safety of Treasuries. When demand for bonds rises, sellers are able to require buyers to pay higher prices, which translate into lower yields.

I don't fully understand why an inverted yield curve should be a negative, but its fans swear that it is. I merely can't prove that it's not. One possible ramification is the threat to bank profitability: an inverted yield curve takes away banks' ability to make money simply by borrowing short to lend long.

Profitless success – Historically, companies have been considered valuable primarily because they produce profits – if not immediately, then at least they were expected to do so in the foreseeable future. Then the view arose in the tech-media-telecom bubble of the late 1990s that companies could be great (and valuable) even in the absence of profits for years to come. Today, profitless companies are back in vogue and sometimes valued in the tens of billions of dollars.

Tech and venture investors have made a lot of money over the last ten years. Thus there's great interest in tech companies (including ones like Uber and Lyft that are applying technology to enable new business models) and willingness to pay high prices today for the possibility of profits far down the road. **There's nothing wrong with this, as long as the possibility is real, not over-rated and not over-priced.** The issue for me is that in a period when profitless-ness isn't an impediment to investor affection – when projected tech-company profitability commencing years from now is valued as highly as, or higher than, the current profits of more mundane firms – investing in these companies can be a big mistake.

Today there are a lot of investors who weren't around to see the 2000 bursting of the TMT bubble, in which large numbers of Internet and e-commerce companies were given the benefit of the doubt, only to end up worthless. Venture capital funds showed triple-digit annual returns in the late 1990s, but the ones started around 2000 performed very poorly (and people began to ask me if venture capital was a legitimate asset class).

Today, some tech and venture investments have again produced great results, and the doubts seem to be gone. **In investing, however, the truth usually lies somewhere between the extremes of infinite value and worthlessness.** Investor sentiment seems to be closer to the positive end of the pendulum's arc these days, but it's unlikely to stay there in perpetuity.

Growth investing preeminence forever – Since future-oriented “growth investing” has been so successful for so long, and has so seriously trounced “value investing,” people are asking me whether this will ever end. In particular, value investing is being likened to the out-of-favor “cigar-butt” school of investing, in which people buy assets regardless of their quality just because they're low-priced. Critics of value investing argue that, since the technological leadership that's often associated with growth stocks is so essential for success in today's world, old-economy companies lacking it are unlikely to be top performers in the future.

My answer is simple: low price is very different from good value, and those who pursue low price above all else can easily fall into “value traps.” And certainly it's true that old-economy companies

are less likely to be the fast growers of the future or benefit as much from the “moats” that protected them in the past.

It may also be true that given the ease today of searching the universe of securities, it may be harder than it used to be to find “value” companies with current assets or earning power that are broadly unrecognized and thus underpriced. Since the best returns come from buying things whose merits others aren’t aware of, it’s certainly possible that easy, widespread access to data is making it harder for value investors to excel.

On the other hand, companies that do have better technology, better earnings prospects and the ability to be disrupters rather than disrupted still aren’t worth infinity. Thus it’s possible for them to become overpriced and dangerous as investments, even as they succeed as businesses (this was often the case with the Nifty-Fifty in 1968-73). And I continue to believe that eventually, after the modern winners have been lauded (and bid up) to excess, there will come a time when companies lacking the same advantages will be so relatively cheap that they can represent better investments (see value versus growth in 2000-02).

Understandably, the stocks of companies with bright futures are likely to be outperformers in times of economic growth and optimism, when investors are happy to pay up for potential. But stocks of companies with tangible value in the here-and-now are likely to hold up better in less positive times because (a) they’ve previously been disrespected and valued lower and (b) the rationale underlying their prices is less a matter of conjecture and faith. Thus a swing in favor of value may have to await a period in which the “champions” lose some of their luster, perhaps in a market correction (see 4Q2018). But it’ll come.

* * *

What do all the theories propounded above have in common? That’s easy: they’re optimistic. Each one provides an explanation of why things should go well in the future, in ways that didn’t always go well in the past.

In recent years, the U.S. has simultaneously experienced economic growth, low inflation, expanding deficits and debt, low interest rates and rising financial markets. **It’s important to recognize that these things are essentially incompatible. They generally haven’t co-existed historically, and it’s not prudent to assume they will do so in the future.**

Many of the beliefs discussed above suggest we’re in a so-called “Goldilocks” environment: one that’s not too hot and not too cold.

- Economic growth won’t be so strong that it brings on excessively high inflation, or so weak that it ends in recession.
- Inflation won’t be so low that the economy stagnates, or so high that it leads to burdensome increases in the cost of living and requires contractionary interest-rate increases to cool it off.

I’ve seen times in the past when people believed such an ideal state would continue in perpetuity, but it has never worked out that way. Maybe it will this time – no one can prove it won’t until it doesn’t

– but certainly broad acceptance of such a proposition indicates that optimism prevails in the current investment environment.

We keep an eye out for the widespread belief that “this time it’s different” because we want to know if markets are being lifted by bullishness, optimism, risk tolerance and low levels of skepticism.

Everything else being equal, these things result in asset prices that are high relative to intrinsic values, and their presence exposes us to the risk that they’ll abate, taking asset prices down with them.

In *On the Couch* (February 2016) I said:

That’s one of the crazy things: in the real world, things generally fluctuate between “pretty good” and “not so hot.” But in the world of investing, perception often swings from “flawless” to “hopeless.” The pendulum careens from one extreme to the other, spending almost no time at “the happy medium” and rather little in the range of reasonableness.

Widespread attaching of “the four words” to bullish propositions suggests that the environment is being perceived as flawless. When and if that swings to hopeless, the result is pain for investors.

Of course, no one can prove that the nine propositions discussed above won’t hold. Economics and markets aren’t governed by immutable laws like the physical sciences, and there’s no schematic diagram that shows how they work. Thus, I want as usual to make it explicit that these are the musings of someone who (a) isn’t an economist and (b) doesn’t claim to know exactly how economic and monetary mechanisms function. **But who does?**

Now, sometimes things really are different, as Templeton said. (And in areas like technology and digital business models, I’d bet things will be different more than the 20% of the time Templeton cited.) Certainly the world today is very different from that of the past. As I’ve written before, 40 years ago it felt like the world was a stable place that was subject only to limited change in areas like scientific progress, fads and politics. Today the idea of an unchanging world is out the window: things change every minute, and anyone who doesn’t keep up with the changes is fated to miss out. Technological prowess can be essential for success, and every company or industry that lacks it is susceptible to being disrupted by those who possess it.

I readily admit that, at my stage in life, I may not fully grasp the forces that will determine the future. At times like this, when tech stocks are in the middle of a great run, I’m reminded of a classic book from my youth, *The Money Game* (1967). In it, the pseudonymous Adam Smith introduced the Great Winfield, a veteran broker who, despite the limitations associated with having reached middle age, was minting money in the new tech stocks. When asked about the source of his success, he introduced Smith to his traders:

“My boy,” said the Great Winfield over the phone, “Our trouble is that we are too old for this market. The best players in this kind of a market have not passed their twenty-ninth birthdays.”

... “My solution to the current market,” the Great Winfield said. “Kids. This is a kids’ market. This is Billy the Kid, Johnny the Kid, and Sheldon the Kid.”

... “See? See?” said the Great Winfield. “The flow of the seasons! Life begins again! It’s marvelous! It’s like having a son! My boys! My kids!”

Of course, veteran that he was, the Great Winfield knew the truth. Thus he went on:

... “The strength of my kids is that they are too young to remember anything bad, and they are making so much money they feel invincible,” said the Great Winfield. “Now you know and I know that one day the orchestra will stop playing and the wind will rattle through the broken window panes . . .”

[Emphasis added]

To close, I’ll return to a concept I consider indispensable for anyone hoping to succeed at investing – the three stages of a bull market:

- the first, when only a few forward-looking people begin to believe things will get better,
- the second, when most investors realize improvement is actually underway, and
- the third, when everyone concludes that things can only get better forever.

Clearly the few who buy in the first stage – when optimism is scarce and thus asset prices are low – can access great bargains. But those who buy in the last stage – out of a belief that the news will always be good – can be making a big mistake. **The nine propositions reviewed above all represent variations on “things can only get better forever.” If they’re the ideas guiding investors today, that should be considered worrisome.**

The best investments often are made in times of fear and desperation. That’s rarely possible when investors are willing to blithely dismiss the limitations of the past with the words “this time it’s different.” I would remind those investors of a quote usually attributed to Mark Twain: “History doesn’t repeat itself, but it does rhyme.” **Of course it’s important that investors keep up with current developments and those that will shape the future. But it’s also essential that they not completely unlearn the lessons of the past.**

June 12, 2019

Memo to: Oaktree Clients

From: Howard Marks

Re: You Bet!

As I've written in past memos, I have an indelible recollection of the first book I read as a Wharton freshman in 1963. The book was *Decisions Under Uncertainty: Drilling Decisions by Oil and Gas Operators* by C. Jackson Grayson, Jr. (who in 1971 would take on the role of "price czar" in the Nixon administration's efforts to get inflation under control).

The best and most lasting thing I took away from Grayson's book – and the first thing I remember learning in college – was the observation that **you can't tell the quality of a decision from the outcome**. This revelation had a profound influence on me as a 17-year-old and represented the first critical building block in my understanding of how the world works.

As Grayson explained, you make the best decision you can based on what you know, but the success of your decision will be heavily influenced by (a) relevant information you may lack and (b) luck or randomness. **Because of these two factors, well-thought-out decisions may fail, and poor decisions may succeed. While it might seem counterintuitive, the best decision-maker isn't necessarily the person with the most successes, but rather the one with the best process and judgment. The two can be far from the same, and especially over a small number of trials, it can be impossible to know who's who.**

By my stage in life – if not well before – one should have figured out his strengths and weaknesses and tilted his activities toward the former. I've concluded that my strengths include the ability to:

- frame questions,
- logically organize data and weigh pros and cons,
- know what I don't know,
- accept that future outcomes aren't predictable,
- think about the future probabilistically, and
- make decisions incorporating all of the above (although far from always correctly).

Also very important has been the ability to internalize Grayson's point about decision quality (and thus live with my unsuccessful decisions from time to time). This set of attributes equipped me for a career in investing . . . **and for finding enjoyment in games of chance.**

My Life as a Gambler

Although I've made reference to them in some past memos, games have played a bigger part in my life than you probably know. Because of the many connections between investing and gambling, many of the investors I respect play blackjack, poker or backgammon. You might enjoy learning about my past in this regard.

Like most people my age, I spent time as a child playing card games like “War” and “Old Maid” (there were no videos to watch or video games to play, and my parents considered television a pernicious influence that had to be strictly rationed). My first brush with “grown-up” games and betting involved gin rummy starting around age 12. Hours spent playing with my three closest buddies established a pattern for life.

When I was a sophomore in college (1964-65), card games at the fraternity house took up an embarrassingly large fraction of my time. A different game occupied our afternoons each semester, including gin, pinochle, cribbage, hearts, casino, bid whist, spades and tonk (many of these have since been relegated to the dustbin of leisure-time history). Most evenings were devoted to poker. (You’re right to wonder when I studied. I actually can’t remember doing much of it that year.) And when I eventually got serious about my studies as an upper-classman, I took up the commensurately serious game of bridge.

The next big step came in 1970-72, when I began to ski and was introduced to backgammon back at the lodge. Although probably dismissed by non-game players as trivial, backgammon, like bridge, is a game that requires a great deal of thought and one where study and practice can lead to a very high level of skill. More on it later.

As you may know, I got Citibank to move me to Los Angeles in 1980. One of the big ways this changed my life was that it led me to meet my great friend Bruce Newberg, whose mind is perfect for handling the odds and strategies involved in games (as it is for investing). Bruce and I have had thousands of hours of enjoyment playing backgammon and gin over the last 40 years. We’re probably about even financially after all that time, and if not, the winner’s hourly rate of pay is in pennies. **All we get out of it is fun.** Our motto is, “The only thing worse than losing is not playing.”

I also enjoy visiting a casino once in a while, and the opportunity to play blackjack. In blackjack, you and the dealer are each dealt two cards. You can “hit” or “stay” as you choose – take additional cards from the deck or decline to do so. The dealer has no choice; he’s required to hit (or forced to stay) depending on his card total. In the end, whoever’s total is closer to 21 without going over is the winner.

Lots of people go to casinos every year and lose money at blackjack without knowing the first thing about how to play successfully. Instead, they count on luck and hunches and say they “just play to have fun.” But there are actions you can learn to take in blackjack – mostly regarding when to hit or stay – that will improve your results. These have been codified into what’s called “basic strategy.”

Beyond that, the key to further improving your probability of winning lies in the fact that, unlike most games of chance, in blackjack the outcomes of future hands aren’t independent of the outcomes of past hands. This is so because in blackjack the dealer deals several hands in succession without returning the cards that have been played to the “shoe” from which he deals. Thus, which cards have already been dealt directly determines which cards remain to be dealt. If you can track the former through “card-counting,” you can have an idea about the latter. But since the dealer’s shoe can contain six or eight 52-card decks, keeping track of the cards played in itself requires exceptional skill.

Edward Thorp wrote the definitive book on this, called *Beat the Dealer*. When he won too much money, Ed was banned from the casinos and had to turn to “straight” pursuits. As a result, he studied warrants on Japanese stocks and developed the art of arbitrage. When I last saw Ed he was living an idyllic life in Newport Beach, prospering even in the absence of suits, ties or regular office hours.

But let’s return to backgammon. In this game, two opponents – one moving clockwise and the other counter-clockwise – try to bring their pieces around the board while simultaneously preventing the other from doing so, and then be the first to take them off the board. Each player’s ability to move forward is determined by rolling a pair of dice. It’s a total disaster if you’re ignorant of the probabilities governing rolls of the dice and instead rely on luck, gut instinct or what you think is your innate skill. (In fact, the most important skill in backgammon consists of knowing these probabilities and thus what actions to take given your position.)

More recently, through study Bruce has gotten too good for me at backgammon, so now we’re mostly down to gin. In gin, each player is dealt 10 cards, and by alternately picking from the deck and discarding, you try to form them into “melds” of three or four cards of the same kind (such as 9-9-9) or in a run of the same suit (such as 4-5-6-7 of spades). As the hand goes on, you can opt to “knock” (if your un-melded cards add up to less than a certain number) or try to get “gin” (all 10 cards melded), which pays off in more points – unless your opponent knocks or gets gin first.

An aside: when I speak to students, I often say, “For me, the thing that makes investing fascinating is the fact that there’s no action you can take that is sure to work, no strategy that’s always a winner.” To illustrate, I go on: “It’s like gin. Sometimes knocking is the best thing to do, and sometimes you should play for gin.” And all I get are blank stares. Few young people play cards anymore, and even fewer have ever heard of gin.

Another aside. While I don’t think they’re the result of conscious decisions, my life as a gambler has always exhibited two characteristics:

- First, I haven’t made a serious study of the games I play. I feel if I want to work, I can go to the office.
- And second, I only play for small stakes. Some people dream of big killings, and some like the frisson attached to risking large sums. I’ve never felt that my enjoyment increased with the amount of money on the table. I play for fun and to test my decision-making, not to win big money. (Point of reference: back around 1990, I was visiting Ric Kayne at Lake Tahoe and he said, “Tonight I’m going to take you to the casino and make a man of you. We’re going to play until you win or lose real money!” So he called the casino host and asked him to arrange a \$25,000 line of credit for me. The host called back a few minutes later and said, “Sorry, Ric, I can’t justify a \$25,000 line for someone whose average bet is \$11.”)

What about coming full circle? One of the best things I ever did was to teach my son Andrew to be a game player at an early age. I now have a built-in opponent for gin and backgammon. There can be few sweeter memories than sitting on a log with him at Big Bear State Park playing War in 1992, when he was five. And it continues; my five-year-old granddaughter, Rosie, is my new opponent at War. There’s nothing better!

Thinking in Bets

In a past memo, I told a story from my days as a buy-side analyst following the business equipment industry for First National City Bank. In 1970, one of the bank's portfolio managers asked me whom I considered to be the best brokerage-house analyst on Xerox. "Well," I answered, "the one who most agrees with me is so-and-so."

In other words, we tend to respect people who think like we do. Did you ever hear someone say, "I think Bob's a genius, and he thinks my views are all wrong"? That's something few people would ever say. No, we tend to think highly of people whose opinions mirror ours.

And that brings me to the source of the inspiration for this memo: a book called *Thinking in Bets: Making Smarter Decisions When You Don't Have All the Facts* by Annie Duke. (I provided a blurb for the dust jacket when it was published in 2018.) Duke completed the coursework and dissertation for a Ph.D. in psychology from the University of Pennsylvania but stopped short of receiving her degree, and for many years she was the best-known female professional poker player (with over \$4 million of tournament winnings). I was rereading Duke's book while on vacation, and so many of her thoughts on poker and on decision-making in general agreed with mine that I became motivated to start on the memo you're reading now. Here are some excerpts that will show you why I was drawn to it [emphasis added]:

Over time, those world-class poker players taught me to understand **what a bet really is: a decision about an uncertain future**. . . .

Thinking in bets starts with recognizing that **there are exactly two things that determine how our lives turn out: the quality of our decisions and luck**. Learning to recognize the difference between the two is what thinking in bets is all about. . . .

The result of each hand provides immediate feedback on how your decisions are faring. But it's a tricky kind of feedback because **winning and losing are only loose signals of decision quality**. You can win lucky hands and lose unlucky ones. . . .

What makes a decision great is not that it has a great outcome. A great decision is the result of a good process, and that process must include an attempt to accurately represent our own state of knowledge. That state of knowledge, in turn, is some variation of "I'm not sure." . . .

. . . we must recognize that no strategy can turn us into perfectly rational actors. In addition, we can make the best possible decisions and still not get the result we want. **Improving decision quality is about increasing our chances of good outcomes, not guaranteeing them**. . . .

We are discouraged [in life] from saying "I don't know" or "I'm not sure." We regard these expressions as vague, unhelpful and even evasive. But getting comfortable with "I'm not sure" is a vital step in being a better decision-maker. **We have to make peace with not knowing**. . . .

What good poker players and good decision-makers have in common is their comfort with the world being an uncertain and unpredictable place. They understand that they can almost never know exactly how something will turn out. They embrace that uncertainty and, instead of focusing on being sure, they try to figure out how *unsure* they are, making their best guess at the chances that different outcomes will occur. . . .

An expert in any field will have an advantage over a rookie. But neither the veteran nor the rookie can be sure what the next flip will look like. **The veteran will just have a better guess. . . .**

You don't have to read far in *Thinking in Bets* before it becomes clear that Annie Duke shares Jack Grayson's interest in decision-making under uncertainty. Duke looked for real-world applications at the poker table, and Grayson in the oil patch. **But both worked on how to make decisions when faced with imperfect information and uncertain outcomes. That brings me to the subject of investing . . . and this memo.**

Parsing the World of Gambling

People who aren't very familiar with games or who don't dwell on them probably think they're all variations on the same theme. But actually there are big differences. I want to touch on them so I can go on to create an effective analogy between gaming/gambling and investing. Importantly, games vary in three primary dimensions: information availability, luck and skill.

Some games (but not all) require players to deal with uncertainty. Whether you or your opponent will win – or what action you should take – might hinge on information that's not available to you, and about which you can make inferences or guesses at best. **Thus in some games, there's important "hidden information,"** and in others there isn't. In poker, blackjack and gin you don't know what cards your opponent is holding. But in chess and backgammon, everything's plain to see: the position of the playing pieces on the board. Nothing is hidden. Obviously this is a big difference. Where no information is hidden, the game is reduced to the other two elements.

After the conditions have been set (the cards have been dealt or the pieces are in their positions on the board), there's another source of uncertainty. **In some games subsequent developments will be influenced by luck,** and in some they won't. Take the two games I said don't involve hidden information: chess and backgammon. In chess, there's no such thing as luck – no dice to throw or cards to draw; the key variable is the moves your opponent chooses to make. (I guess there is one element of luck: how skillful is the opponent you've drawn?)

In backgammon, on the other hand, the moves a player gets to make are entirely determined by what numbers come up when he rolls the dice. And in card games, what cards he and his opponent draw is subject to luck. Sometimes these things are total unknowns – a matter of sheer randomness – and in others, while the outcome can't be predicted with certainty, probabilities can be assigned.

- In blackjack, for example, we can know something about the cards that will come out in the future if we can keep track of the ones that already have been played.

- And in backgammon, we know with absolute certainty the probability of every possible result of rolling the dice: over a large number of rolls, the number seven will come up 16.7% of the time (six of the 36 possible outcomes on a roll of the dice), and the number twelve will come up only 2.8% of the time (one out of the 36). Of course, even if we know the probabilities, we still don't know which number will come up on any one roll.

Finally, in some games skill is important, and in others it isn't. There's skill (albeit with varying degrees of difficulty) in all the games I've discussed so far: chess, backgammon, poker and gin. Games with and without hidden information can entail skill, and games affected and unaffected by luck can entail skill.

But the role of skill isn't universal in games/gambling. Roulette and wheel-of-fortune are games of pure chance or luck. The outcome is entirely a matter of random events that can't be predicted at all, like which slot in a roulette wheel the ball will fall into when the wheel stops spinning. And since there's no ability to predict future developments, there's no such thing as skill: only luck.

- In the early 1980s, I used to go to Las Vegas with a now-departed friend. He spent a lot of time (and money) on wheel-of-fortune, which is nothing but vertical roulette. I used to tell him he was "the world's greatest wheel-of-fortune player." Since he thought there actually was such a thing as playing the game well, he never got the joke.
- There's a very interesting example in *punto banco*, a form of baccarat. As Wikipedia says, "In *punto banco*, each player's moves are forced by the cards the player is dealt." That is, there are no decisions to make, so clearly no such thing as skill in decision-making. You sit down, place your bet, receive your cards, and either win or lose. One version of history says baccarat was invented for the enjoyment of a king who wasn't smart enough to learn to play games; thus one was developed that required no decisions . . . and thus entailed no skill.

Note from the above the different types of games:

- No hidden information, no luck, skill. (Chess)
- No hidden information, luck, skill. (Backgammon)
- No hidden information, luck, no skill. (Roulette)
- Hidden information, luck, skill. (Blackjack, poker)

Now we can drill down. Here are some important observations:

- Where there's no skill involved, the outcome has to depend entirely on luck.
- But even if skill is involved, luck can still play a role.
- The presence of luck doesn't necessarily preclude a role for skill. **In fact, making intelligent decisions when future events are uncertain is one of the greatest forms of skill.** It's what Grayson's and Duke's books are all about.
- **Likewise, the ability to deal intelligently with hidden information has to be based on skill.**

Creating this taxonomy, or "scheme of classification," not only allows me a chance to educate non-game-players, but it also provides a framework for a comparison to investing (if you hadn't noticed).

How Is Investing Like Gambling?

Hidden information, luck and skill can play a part in investing. In active investing involving public companies, for example, all three are involved.

- Clearly, no one knows all the relevant facts. The SEC tries to make sure all investors have **equal access** to information, but not necessarily **complete access**. For example, investors won't know about first-quarter developments at a company until it reports earnings in May. And no one is supposed to know the results of drug trials and beta tests until they're made public.
- Luck – random, unpredictable, often-exogenous events – affects companies and their stocks all the time. Many aspects of corporate performance and profitability can be influenced by weather, for example. And the TV network carrying the World Series is likely to enjoy much greater ad revenue if the teams playing come from major markets rather than small ones.
- Finally, the superior investor has the skill required to better assess revenue and profit potential, where we stand in the cycle, the fairness of an asset's price and the margin of safety it affords. No one gets these things right all the time, but the superior investor does so more often than most.

Not all investing, however, entails all – or necessarily any – of the three elements. Take, for example, index investing. The index fund manager's job is to produce the same return as the relevant index.

- There's no such thing as hidden information. The only information the investor needs to succeed at his job relates to the composition of the index in question, and there's no mystery in that regard.
- Likewise, there's no luck. The forces that influence the securities in the index will have exactly the same influence on a properly constructed index fund.
- And finally, there's no skill. All it takes is a well-programmed computer to keep the fund's portfolio in line with the index, and that isn't hard to find.

It's worth delving into the matter of investing skill. The efficient market hypothesis posits that (a) markets are "efficient," (b) thus assets are priced fairly and there are no bargains or overpriced assets, and (c) as a result, there's no scope for skill or "alpha," defined as the ability to outperform by capitalizing on mispricings. The traditional view of active investing, which ignores this hypothesis, is that investing is like blackjack, meaning it's possible for some people to be better at it than others. But if the efficient market hypothesis is right, investing is like roulette, with investors' returns beyond their control and solely a function of luck, or what the market does. (Of course, a portfolio's return can be amplified or diminished relative to the market's return by the portfolio's relative sensitivity to it: the "beta." And that leads to the question of whether investors have the skill to move beta up and down in a timely fashion.)

In most markets, the concept of efficiency is neither an absolute truth nor completely inapplicable. **Some markets may be less efficient than others; thus skill may be more relevant in some markets than in others.** Where skill is highly relevant, markets are called "alpha" markets. Where

it's not – and the portfolio return is mostly a function of the market's return and the portfolio's sensitivity to market movements – they're called "beta" markets. Obviously it's important to figure out which type of market you're working in.

For years, people (whether consciously or not) treated the stock market as an "alpha" market, and equity portfolio managers were able to charge substantial management fees for their efforts. But over time, it was increasingly observed that most active investors were incapable of consistently outperforming the market indices (especially after fees). That meant skill was lacking: you could get the same result or better by passively emulating an index. Investors concluded that they would no longer pay for alpha in a beta market, and that's the main reason for the growth of passive investing. **Why pay someone to play for you in a game where there's no such thing as skill?**

What's the bottom line? **In my view, the active investing I'm interested in – hopefully in markets that are less efficient – involves all three of the ingredients under discussion: hidden information, luck and skill. Thus it's most like poker and blackjack, not chess.** It's in that vein that I'll proceed.

The Essence

One of the most important aspects of skill in gambling consists of figuring out which possible outcome to bet on, and when to bet heavily and when not to. This is where all facets of the decision come together.

Gauging the likely outcome – How likely is one participant (you?) to win, and how likely is someone else? Whether in card games, backgammon or sports betting, there are a number of factors to consider. The most important are these:

- How good is your current position?
- How many paths do you have to winning (and to losing)?
- To what extent would it require good luck regarding throws of the dice or draws of the cards for you to win? And what's the probability your opponent will enjoy good-enough outcomes for him to be the winner instead?

The job here is to "handicap" the outcome, defined by Merriam-Webster as "to assess the relative winning chances of (contestants) or the likely winner of (a contest)." Which poker player has the best hand? Who's in the better position on the backgammon board? Or for the bettor, which horse is likely to win the race, or which team is likely to win the game? **To put it simply, who's the favorite?**

Many people think figuring out who's most likely to win is all you have to do to successfully bet on card games, backgammon or sports. They're missing a huge part of the matter, and perhaps the far more important part.

Assessing the proposition – There's usually not much mystery involved in identifying the favorite. It's pretty clear who's ahead in backgammon. It's more of a challenge in card games, where players hold cards the others don't know about, but still it's possible to have a sense for how good one's

hand is in absolute terms. And in most cases there's a solid consensus around which horse or team is most likely to win.

But one of the most important things to know about gambling is that information that's available to everyone isn't likely to produce winnings. Since most people know who the likely winner is in a hand of cards, a backgammon game that's underway or a sports bet, that isn't valuable information. **Everyone might like to bet on a favorite, but that means it's unlikely they'll be able to find someone to take the other side of the wager: to bet against the favorite without an inducement.**

That inducement takes the form of a "proposition." Consider a football matchup in which Team A is considered twice as likely to win as Team B. Stated another way, Team A is viewed as likely to win two times out of three, and Team B only once. If it's common knowledge that Team A is that much better, no one will bet on Team B unless the person who favors Team A is willing to "lay odds." That is, Joe might tell Ed, "I'll give you 2-to-1 odds; I'll bet \$10 against your \$5 that Team A will beat Team B." Assuming the outcomes go according to expectations, Joe wins \$5 two times out of three and loses \$10 one time. Over three games, then, the two bettors come out even. That means 2-to-1 odds are "fair" in this situation.

So here's the bottom line: the goal isn't to figure out who the favorite is and bet on it. Rather, the goal is to figure out who the favorite is **and whether the odds are fair or not.**

- If the odds are fair, as illustrated above, there's no reason (other than sentiment) to bet on one team or the other.
- If the odds don't penalize the favorite enough – let's say the odds on the above matchup are only 6-to-5 – you should bet on the favorite. Team A will win two-thirds of the time. The one time out of three when they lose, the \$6 you pay won't offset the total of \$10 you win on the two occasions when they come out ahead.
- But if the odds are tilted against the favorite – the odds are "too long," maybe 4-to-1 – it's better to bet on the underdog. You'll still lose \$1 two times out of three (for a total of \$2), but on the one game you win, the \$4 payoff will more than compensate.

A great example can be seen in the world of backgammon. The player who's ahead can offer to double the stakes from \$5 to \$10 by "turning the cube," in which case the other player has to choose between surrendering for \$5 or playing on for \$10. Since the leader offers to double because he's ahead, does that mean it's a mistake for the player who's behind to accept? Not necessarily.

- Clearly, if the laggard surrenders, he loses \$5.
- But what if, let's say, he has a 25% chance of winning and plays on for \$10? In that case, his expected outcome is $(\$10 \text{ loss} \times .75) + (\$10 \text{ gain} \times .25)$, which works out to the same \$5 loss.

The lesson from the above is that a player who is behind should accept a double whenever his chance of winning exceeds 25%, which would give him an expected loss that's less bad than surrendering for \$5. **Sometimes it's a good idea to bet on an inferior position . . . even though doing so is expected to result in a loss most of the time. It all depends on the proposition.**

My friends Matt Bensen and Corey Robinson provided an apt excerpt from a speech titled “The Art of Stock Picking” by Charlie Munger. In it, Charlie compares investing with the pari-mutuel betting system at the racetrack, where the payoff for each horse winning is determined by how many people bet on it:

If you stop to think about it, a pari-mutuel system is a market. Everybody goes there and bets and the odds change based on what’s bet. . . . Any damn fool can see the horse carrying a light weight with a wonderful win rate and a good post position etc., etc. is way more likely to win than a horse with a terrible record and extra weight and so on and so on. But if you look at the odds, the bad horse pays 100 to 1, whereas the good horse pays 3 to 2. Then it’s not clear which is statistically the best bet . . .

Success in gambling doesn’t go to those who pick winners, but to those with the ability to identify superior propositions. The goal is to find situations where the odds are generous to one side or the other, whether favorite or underdog. In other words, a mispricing.

It’s exactly the same in investing. People often say to me, “XYZ is a great company with a bright future, so I bought the stock.” They’re picking a favorite but ignoring the proposition. The former alone isn’t enough; they should consider the latter as well.

Likewise, one might say that even the best venture capitalists are poor at picking winners, since a lot of their investments result in losses. But the payoff on the ones that succeed is so large, it’s sufficient to pay for the losers many times over and make the overall effort a great success.

While in investing we generally aren’t offered explicit odds, the attractiveness of the proposition is established by the price of the asset, the ratio of the potential payoff to the amount risked, and what we perceive to be the chance of winning versus losing.

Superior investors may be superior because they can figure out which companies are likely to be winners. **But the best investors I know also have a sense – perhaps innate and instinctive – for situations where the proposition is too favorable relative to the underlying fundamentals.** It might be a company whose securities are cheap enough to more than compensate for its poor prospects, or one where the future is exceptionally bright, but its securities aren’t priced high enough to charge fully for that potential.

In May 1968, when I showed up at First National City Bank for a summer job in the investment research department, the bank (and many other banks) invested primarily in the “Nifty Fifty.” These were considered to be the best and fastest-growing companies in America: companies so good that there was “no price too high.” And if you bought those stocks the day I arrived and held them firmly for five years, **you lost almost all of your money . . . investing in the best companies in America.** All the companies were considered future winners. Some actually were, but far from all. (What happened to Kodak, Polaroid and my favorite, Simplicity Pattern?) The proposition was wrong: they were priced as if they couldn’t lose, and it turned out several would.

Then, in 1978, I switched to Citi’s bond department, and I was asked to start a high yield bond fund. Now I was investing in **the bonds of the worst public companies in America** – all rated speculative grade, or “junk.” And I was making good money safely and steadily. Not because the companies

were flawless – in fact, about 4% by dollar amount would go on to default each year on average – but because “the price” was too favorable to those who bet on them.

This experience produced two of my most important observations:

- **Success in investing doesn’t come from buying good things, but from buying things well, and it’s essential to know the difference.**
- **It’s not a matter of what you buy, but what you pay for it.**

Nifty Fifty investors spent all of their time picking favorites and failed to notice that the prices they paid were too high. **Mostly winning companies, but poor investments.**

And because popular opinion was stacked so heavily against high yield bonds, those who invested in them received excessive compensation for taking the associated risk: **the proposition was too good.** Moody’s defined a B-rated bond as one that “fails to possess the characteristics of a desirable investment.” In other words, Moody’s panned those bonds because they were underdogs but never asked about the price. It’s usually non-objective, too-positive or too-negative attitudes like these that give rise to propositions that are too good or too bad for the takers. That’s what we should search for as investors.

Guest Contributor

As I mentioned on page three, one of the best things I ever did was to encourage my son Andrew to develop a love of games. In Andrew’s case, he applied the same seriousness to games that he does to investing and his other pursuits. This gave him the thought process of a gambler and enables him to suggest the following ways in which gambling has parallels to investing:

- **Game selection versus skill** – When considering where to invest, it’s important to understand both how much of the requisite skill you possess and the quality of the competition. Being a consistent winner among the best gamblers or in the most intensely competitive markets can be very difficult. Instead, your energy might be better spent looking for less-efficient niches. Unfortunately, it’s harder to find them than it was decades ago.
- **Increasing efficiency/the tendency of markets to adapt** – In the early days of online poker, it was easy for decent players to win, and a lot of amateurs were enticed to play by seeing a newcomer win the World Series of Poker. After some time, however, the games became tougher as they attracted professional players, and the amateurs lost their money. The new, more sophisticated generation of competitors learned their predecessors’ tendencies, improved on their strategies and started beating them. In this way, changes in the arena and in participants’ behavior can cause what worked years ago to not work today.
- **Circle of competence** – Just because you’re great at gin rummy doesn’t mean you should play Texas Hold’em against a professional poker player. It’s important to know your strengths and stick to them.
- **Not having to play every hand** – There’s no requirement to bet on every game or every hand. You can wait until you get a particularly attractive proposition, one that you feel particularly capable of analyzing and understanding, and where the odds are on your side. In the interim, it’s better to sit out and protect your bankroll.

- **The importance of not just winning and losing, but of maximizing wins and minimizing losses** – The key is to bet big when you have a big edge and small when you have less of an edge . . . and to know the difference. As Charlie Munger puts it, “The wise ones bet heavily when the world offers them that opportunity. They bet big when they have the odds. And the rest of the time, they don’t. It’s just that simple.” Everyone will have both winners and losers. Various factors will determine the ratio. But the ability to assess propositions can enable you to win more on your winners than you lose on your losers. The size of your bet should take into account both the probability you are correct about who’s going to win and the asymmetry of the potential payout. “Getting your money in” when you have a great hand is one of the most important keys to winning at poker. You don’t get many great hands, so when you do, you have to be sure to take maximum advantage.
- **Being able to make it through downturns** – It’s important to have discipline when risking your capital, so that you can survive unfavorable periods and still be around when the winners show up. You have to avoid the risk of ruin, and this requires solid discipline (you must “never forget the six-foot-tall man who drowned crossing the river that was five feet deep on average”). To that end, good play isn’t just a function of relying on the expected value of your holdings and pure math, but also of thinking broadly about risk. Would you bet all your money on an 80/20 favorite?
- **Adjusting your play based on the environment** – In poker, if your competition is weak, you may decide to play more hands regardless of their strength and bet more aggressively, while against strong players you may tighten up and only play premium hands.
- **Overcoming emotion and biases** – Human failings can cause gamblers to “chase” in poker (overstay in a hand in the hope of getting a lucky card), play loose (bet too much) when they’re “steaming” (smarting from losses and thus driven by heated emotion), and take bad doubles in backgammon. Hope, emotion and optimism are the gambler’s enemies.
- **Second-level thinking** – It’s not just how good your hand is. There’s much more. How good does your opponent think your hand is? How good do you think your opponent’s hand is? How good does he think you think his is? How is that motivating his actions? The consistent winner has to be able to think at a higher, more complex level than the rest.

All the ideas discussed above are important in investing, just as they are in gambling. In both pursuits, it all comes down to Jack Grayson’s title: *Decisions Under Uncertainty*. As I’ve learned in the 56 years since first reading his book:

- You have to be able to understand which companies or assets are favored and the attractiveness of the proposition.
- You need a sense for whether your holding is a good one and for the chance the competition – the market, which you’re playing against – might have better.
- You need the discipline to follow a process and the wisdom to accept that no process is sure to produce good results.
- You have to understand the significance of the information you have, as well as that which you don’t have. You need the nerve to bet heavily based on what you think you know and a healthy respect for what you may not know.
- You need to control greed and fear, hopefulness and despondency. You have to resist making an unwise bet just because it could enable you to catch up with the indices or the competition.

Since her book provided the impetus for this memo, I'll let Annie Duke sum up. She'll be talking about poker, but it'll sound a lot like investing [emphasis added]:

When we think probabilistically, we are less likely to use adverse results alone as proof that we made a decision error, because we recognize the possibility that the decision might have been good but luck and/or incomplete information (and a sample size of one) intervened.

Maybe we made the best decisions from a set of unappealing choices, none of which were likely to turn out well.

Maybe we committed our resources on a long shot because the payout more than compensated for the risk, but the long shot didn't come in this time.

Maybe we made the best choice based on the available information, but decisive information was hidden and we could not have known about it.

Maybe we chose a path with very high likelihood of success and got unlucky. . . .

But it also means we must redefine "right." **If we aren't wrong just because things didn't work out, then we aren't right just because things turned out well.** . . .

First the world is a pretty random place. The influence of luck makes it impossible to predict exactly how things will turn out, and all the hidden information makes it even worse. If we don't change our mindset, we're going to have to deal with being wrong a lot. . . .

Poker teaches that lesson. A great poker player who has a good sized advantage over the other players at the table, making significantly better strategic decisions, will still be losing over 40% of the time at the end of eight hours of play. **That's a whole lot of wrong. And it's not just confined to poker.** . . .

How can we be sure that we are choosing the alternative that is best for us? What if another alternative would bring us more happiness, satisfaction, or money? The answer, of course, is we can't be sure. Things outside our control (luck) can influence the result. **The futures we imagine are merely possible. They haven't happened yet.** We can only make our best guess, given what we know and don't know, at what the future will look like. . . . When we decide, we are betting whatever we value . . . on one of a set of possible and uncertain futures. **That is where the risk is.**

Investing is a game of skill – meaning inferior players can't expect to be above average winners in the long run. But it also includes elements of chance – meaning skill won't win out every time. In the long run, superior skill will overcome the impact of bad luck. But in the short run, luck can overwhelm skill, and the two can be indistinguishable.

These are the things that make investing both challenging and stimulating. They're the reason I feel good about the way I chose to spend my career.

January 13, 2020

Memo to: Oaktree Clients

From: Howard Marks

Re: Uncertainty

I wrote a memo a week for six weeks starting on March 3, but I've skipped the last three weeks. First, the string had to end sometime. And second, I try to adhere to the principle that if I don't have anything additive to say, I don't write. Hopefully you'll find this one worth reading.

Our inability to know the future is a theme I've touched on repeatedly over the years, but now I've decided to devote an entire memo to it. Being at home for nearly two months means I've had a lot of time on my hands, like everyone else. And it's a good thing, because getting philosophical musings down on paper is a lot harder than writing about current events and what to do about them.

And while I'm explaining myself, I'll apologize up front for the number of citations and their length – but there's so much wisdom I want to share.

All We Don't Know

As everyone knows, today we're experiencing unprecedented (or at least highly exceptional) developments in four areas: the pandemic, the economic contraction, the oil price collapse and the Fed/government response. Thus a number of considerations make the future particularly unpredictable these days:

- The field of economics is muddled and imprecise, and there's good reason it's called "the dismal science." Unlike a "real" science like physics, in economics there are no rules that one can count on to consistently produce a given outcome, as in "if a, then b." There are only patterns that tend to repeat, and while they may be historical, logical and often-observed, they're still only tendencies.
- In some recent memos, I've mentioned Marc Lipsitch, Professor of Epidemiology at Harvard's T.H. Chan School of Public Health. In my version of his hierarchy, there are (a) facts, (b) logical inferences from past experience and (c) guesses. Because of the imprecision of economics, there certainly are no facts about the economic future. Economists and investors make inferences from past patterns, but these are unreliable at best, and I think in many cases their judgments fall under the heading of "guesses."
- These days I'm often asked questions like "Will the recovery be V-shaped, or a U, W or L?" and "Which of the crises you've lived through does this one most resemble?" Answering questions like those requires a historical perspective.
- Given the exceptional developments enumerated above, however, there's little or no history that's relevant to today. That means we don't have past patterns to fall back on or to extrapolate from. **As I've said, if you've never experienced something before, you can't say you know how it's going to turn out.**
- While unique developments like those of today make forecasting unusually difficult, the presence of all four elements at once probably renders it impossible. In addition to the

difficulty of understanding each of the four individually, we can't be sure how they'll interact. For example:

- Will the massive, multi-faceted Fed/Treasury program of loans, grants, stimulus and bond buying be sufficient to offset the unparalleled damage done to the economy by the fight against Covid-19?
- To what extent will reopening bring back economic activity, and to what extent will that cause the spread of the disease to resume, and the renewal of lock-downs?

For investors, the future is determined by thousands of factors, such as the internal workings of economies, the participants' psyches, exogenous events, governmental action, weather and other forms of randomness. Thus the problem is enormously multi-variate. Take the current situation, with its four major components (Covid-19, the economy, oil and the Fed), and consider just one: the disease. Now think about all the questions surrounding it:

- How many people have it, including those who are asymptomatic?
- How likely is contact with someone who's infected to create another case?
- To what degree will distancing and masks deter its spread?
- Will the cases be severe, mild or asymptomatic? Why?
- Will the supply of protective gear for medical personnel, hospital beds and ventilators be adequate?
- Will a treatment be developed? To what extent will it speed recovery and prevent fatalities?
- What will the fatality rate be relative to age, gender and pre-existing conditions? Will the impact of the disease on young people worsen?
- Will people who've had it and recovered be immune? Will their immunity be permanent?
- Will the virus mutate, and will immunity cover the new forms?
- Will it be possible to inject antibodies to prevent infection?
- How many people have to be immune for herd immunity to effectively stop the further spread?
- Will social distancing delay the achievement of herd immunity? Is the Swedish approach better?
- Will a vaccine be invented? When? How long will it take to produce and deliver the needed doses? Where will the U.S. stand in the line to get it?
- How many people will refuse to be vaccinated? With what effect?
- Will vaccination have to be renewed annually?
- Will the virus succumb to warm weather and humidity?
- Will the virus be with us permanently, and will it be controllable like "just another seasonal disease"?

Where am I going with this? My point is that very few people can balance all these considerations to figure out our collective risk. And that's just Covid-19. Now think about the many questions that pertain to each of the three other factors. **Who can respond to this many questions, come up with valid answers, consider their interaction, appropriately weight the various considerations on the basis of their importance, and process them for a useful conclusion regarding the virus's impact?** It would take an exceptional mind to deal with all these factors simultaneously and reach a better conclusion than most other people. (I believe a computer couldn't do so either, especially given all the subjective decisions required in the absence of historic precedent.)

The challenge lies in trying to be **above average** in assessing the future. Why is that so hard?

First of all, forecasting is a competitive arena. **The argument for the difficulty of out-forecasting others is similar to the argument for market efficiency (and thus the limitations of active management).** Thousands of others are trying, too, and they're not "empty suits." Many of them are educated, intelligent, numerate, hard-working, highly motivated and able to access vast amounts of data and computing power. So by definition it shouldn't be easy to be better than the average.

In addition, since economics is imprecise, unscientific and inconsistent in its functioning, as described above, there can't be a method or process for forecasting that works consistently. To illustrate randomness, I say that if, when I graduated from business school, I was offered a huge budget, an army of PhDs and lavish financial incentives to predict the coin toss before each Sunday's football games, I would have been a flop. **No one can succeed in predicting things that are heavily influenced by randomness and otherwise inconsistent.**

Now consider the possibility that reaching conclusions is especially difficult in times of stress like today:

[Recent advances in neuroscience] suggest that we are no more than "inference machines" with various degrees of sophistication in how we explain our thoughts. In other words, we use a lot of pattern-driven guesswork as we go about our daily lives or to fill in the gaps in an incomplete narrative.

This is especially true in times of stress, as many of the mental processes that govern our reactions are associated with an urgent search for patterns to determine our moves. **That is our snap reaction in economic or financial crises and why we cling to our repertoire of charts of V, U or L-shapes of recovery, among many.**

But, in very dislocated environments, we find serious limitations to this approach.

Looking at the current environment, with disruptions to supply, demand, health and liquidity tensions, we could build an ensemble of the Spanish flu, the Fukushima earthquake and components of the 2008 crisis, for example. But given the very specific contexts of each event, we may run into endless combinations of the lessons learnt from these events.

As a matter of fact, in a side-by-side comparison of many economic forecasts, even similar assumptions drive very different outcomes on how this crisis will play out. This may be a case of the "Anna Karenina principle" coined by Professor Yossi Sheffi at Massachusetts Institute of Technology. Paraphrasing Tolstoy, while happy economies are all alike, every unhappy economy is unhappy in its own way.

We can't assume that the response to public health or financial interventions will be similar across vastly different contexts. **The root cause of this mistake is to look at average responses from past events. But the reality is not like that.** (Juan-Luis Perez, head of research, Evidence Lab and Analytics, at UBS, the *Financial Times*, April 22, emphasis added)

So forecasting is difficult for a large number of reasons, including our limited understanding of the processes that will produce the future, their imprecise nature, the lack of historical precedent, the unpredictability of people's behavior and the role of randomness, and these difficulties are exacerbated by today's unusual circumstances.

Senior economics consultant Neil Irwin put it together very well in *The New York Times* on April 16:

The world economy is an infinitely complicated web of interconnections. We each have a series of direct economic interrelationships we can see: the stores we buy from, the employer that pays our salary, the bank that gives us a home loan. But once you get two or three levels out, it's really impossible to know with any confidence how those connections work.

And that, in turn, shows what is unnerving about the economic calamity accompanying the spread of the novel coronavirus.

In the years ahead we will learn what happens when that web is torn apart, when millions of those links are destroyed all at once. And it opens the possibility of a global economy completely different from the one that has prevailed in recent decades.

I couldn't agree more with what Irwin says. Or, to use one of my all-time favorite quotes, from John Kenneth Galbraith:

We have two classes of forecasters: Those who don't know – and those who don't know they don't know.

While I'm in the subject of favorite quotes, I'll take advantage of the occasion to share some others on this subject that I've stored up over the years (I think the first one may be the greatest ever):

No amount of sophistication is going to allay the fact that all of your knowledge is about the past and all your decisions are about the future.

Ian Wilson (former GE executive)

Those who have knowledge don't predict; those who predict don't have knowledge.

Lao Tzu

People can foresee the future only when it coincides with their own wishes, and the most grossly obvious facts can be ignored when they are unwelcome.

George Orwell

Forecasts create the mirage that the future is knowable.

Peter Bernstein

I never think of the future – it comes soon enough.

Albert Einstein

The future you shall know when it has come; before then forget it.

Aeschylus

Forecasts usually tell us more of the forecaster than of the future.

Warren Buffett

I think you get the point. I seem to be in good company in my belief that the future is unknowable.

Having made that assertion, I'll admit that it's an extreme oversimplification and not entirely correct. There actually are things we know about the macro future. The trouble is that, mostly, they're things everyone knows. Examples include the fact that U.S. GDP grows about 2% per year on average; heating oil consumption increases in winter; and a great deal of shopping is moving on-line. But since everyone knows these things, they're unlikely to be much help in the pursuit of above average returns. As I've described before, the things most people expect to happen – consensus forecasts – are by definition incorporated into asset prices at any point in time. Since the future is usually a lot like the past, most forecasts – and especially macro forecasts – are extrapolations of recent trends and current levels, and they're built into prices. Since extrapolation is appropriate most of the time, most people's forecasts are roughly correct. But because they're already reflected in security prices, **most extrapolations aren't a source of above average returns.**

The forecasts that produce great profits are the ones that presciently foresee radical deviations from the past. But that kind of forecast is, first, very hard to make and, second, rarely right. **Thus most forecasts of deviation from trend also aren't a source of above average returns.**

So let me recap: (a) only correct forecasts of a very different future are valuable, (b) it's hard to make forecasts like that, (c) such unconventional predictions are rarely right, (d) thus it's hard to be an above average forecaster, and (e) it's only above average forecasts that lead to above average returns.

So there's a conundrum:

- Investing is the art of positioning capital so as to profit from future developments.
- Most professional investors strive for above average returns (i.e., they want to beat the market and earn their fees).

- However, according to the above logic, macro forecasts shouldn't be expected to lead to above average returns.
- Yet very few people are content to invest while practicing agnosticism with regard to the macro future. They may on some level understand the difficulty entailed in forecasting, but their reluctance to admit their ignorance of the future (especially to themselves) usually overcomes that understanding with ease.
- And so they keep trying to predict future events – and the investment industry produces a large volume of forecasts.

As I've expressed in recent memos, I feel the process through which most of us arrive at our view of the future is highly reflective of our biases. Given the unusually wide chasm between the optimistic and pessimistic cases at this time – and the impossibility of choosing between them based on facts and historical precedents (since there are none) – I continue to think about the role of bias.

One of the biggest mistakes an investor can make is ignoring or denying his or her biases. If there are influences that make our processes less than objective, we should face up to this fact in order to avoid being held captive by them.

Our biases may be insidious, but they are highly influential. When I read articles about how difficult it will be to provide adequate testing for Covid-19 or to get support to small businesses, I'm pleased to see my wary views reinforced, and I find it easy to incorporate those things into my thinking. But when I hear about the benefits of reopening the economy or the possibility of herd immunity, I find it just as easy to come up with counter-arguments that leave my concerns undented. This is a clear example of "confirmation bias" at work:

Once we have formed a view, we embrace information that confirms that view while ignoring, or rejecting, information that casts doubt on it. Confirmation bias suggests that we don't perceive circumstances objectively. We pick out those bits of data that make us feel good because they confirm our prejudices. Thus, we may become prisoners of our assumptions. (Shahram Heshmat, *Psychology Today*, April 23, 2015)

As Paul Simon wrote 50 years ago for the song *The Boxer*, "... a man hears what he wants to hear and disregards the rest."

While I didn't know the name for it, I've long been aware of my bias. In a recent memo, I told the story from 50 years ago, when I was Citibank's office equipment analyst, of being asked who the best sell-side analyst on Xerox was. My answer was simple: "The one who agrees with me most is so-and-so." Most people are unlikely to think highly of anyone whose views they oppose. So when we think about which economists we quote, which investors we respect, and where we get our information, it's likely that their views will parallel ours.

Of course, taken to an extreme, this has resulted in the unfortunate, polarized state in which we find the U.S. today. News organizations realized decades ago that people would rather consume stories that confirm their views than those that challenge them (or are dully neutral). Few people follow media outlets that reflect a diversity of opinion. Most people stick to one newspaper, cable news channel or political website. And few of those fairly present both sides of the story. Thus most people hear a version of the news that is totally unlike the one heard by those on the other side of the

debate. When all the facts and opinions you hear confirm your own beliefs, mental life is very relaxed but not very enriching.

What's the ideal? A calm, open mind and an objective process. Wouldn't we all be better off if those things were universal?

In Praise of Doubt

Another favorite theme of mine – and I'm mildly apologetic for its repetition in these memos – is how important it is to acknowledge what we don't know.

First of all, if we're going to out-invest the rest, we need a game plan. There are a lot of possible routes to success on which to base your process: in-depth research into companies, industries and securities; arbitrage; algorithmic investing; factor investing; even indexation. But if I'm right about the difficulty of macro forecasting, for most people that shouldn't be it.

Second, and probably more importantly, excessive trust in forecasting can be dangerous to your financial health. It's never been put better than in the quote that's often attributed to Mark Twain, but also to several others:

It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so.

Just a few words, but a great deal of wisdom. No statement that starts with "I don't know but . . ." or "I could be wrong but . . ." ever got anyone into big trouble. If we admit to uncertainty, we'll investigate before we invest, double-check our conclusions and proceed with caution. We may sub-optimize when times are good, but we're unlikely to flame out or melt down. **On the other hand, people who are sure may dispense with those things, and if they're sure and wrong, as the quote suggests, the outcome can be catastrophic.**

Investing is challenging in this way, as in so many others. **Active investors have to be confident.** Yale's David Swensen said it as well as it can be said (that's why I go back to this quote so often in my memos and books):

Establishing and maintaining an unconventional investment profile requires acceptance of uncomfortably idiosyncratic portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom. (*Pioneering Portfolio Management*)

To do better than most, you have to depart from the crowd. As I said in my April 6 memo *Calibrating*, echoing Swensen, all great investments begin in discomfort, since the things everyone likes and feels good about are unlikely to be on the bargain counter. But to invest in things that are out of favor – at the risk of standing out from the crowd and appearing to have made a big mistake – takes confidence and resolve. It also requires confidence to hold onto a position when it declines – and perhaps add to it at lower prices – in the period before one's wisdom becomes clear and it turns into a winner. And it takes confidence to continue holding a highly appreciated investment you think still has upside potential, at the risk of possibly giving up some of the gains to date.

But when does reason-based confidence turn into hubris and obstinateness? That's the key question. Holding and adding to declining positions is only a good idea if the underlying thesis turns out to be right and things eventually go as expected. In other words, when do you allow for the possibility that you're wrong?

From the very beginning of my investing career, I've felt a sense of uncertainty. But I don't think that's a bad thing:

- “Investing scared” – a less glamorous term than “applying appropriate risk aversion” – will push you to do thorough due diligence, employ conservative assumptions, insist on an ample margin of safety in case things go wrong, and invest only when the potential return is at least commensurate with the risk. **In fact, I think worry sharpens your focus.** Investing scared will result in making fewer mistakes (although perhaps at the price of failing to take maximum advantage of bull markets).
- When I started investing in high yield bonds in 1978, and when Bruce Karsh and I first targeted distressed debt in 1988, it seemed clear that the route to long-term success in such uncertain areas lay in limiting losses rather than targeting maximum gains. That approach has permitted us to still be here, while many one-time competitors no longer are.
- I can tell you that in the Global Financial Crisis, following the bankruptcy of Lehman Brothers, we felt enormous uncertainty. If you didn't, there was something wrong with you, since there was a meaningful possibility the financial system would collapse. When we started buying, Bruce came to me often saying, “I think we're going too slow,” and then the next day, “I think we're going too fast.” But that didn't keep him from investing an average of \$450 million per week over the last 15 weeks of 2008. **I think Bruce's ability to grapple with his doubts helped him arrive at the right pace of investment.**

The topic of dealing with what you don't know brings me to a phrase I came across a few years ago and think is very important: intellectual humility.

Here's part of the article that first brought it to my attention:

“Intellectual humility” has been something of a wallflower among personality traits, receiving far less scholarly attention than such brash qualities as egotism or hostility. Yet this little-studied characteristic may influence people's decision-making abilities in politics, health and other arenas, says new research from Duke University. . . .

As defined by the authors, **intellectual humility is the opposite of intellectual arrogance or conceit. In common parlance, it resembles open-mindedness. Intellectually humble people can have strong beliefs, but recognize their fallibility and are willing to be proven wrong on matters large and small**, Leary said. (Alison Jones, *Duke Today*, March 17, 2017, emphasis added)

To get a little more technical, here are a couple of useful paragraphs from a discussion of the paper cited above:

The term, intellectual humility (IH), has been defined in several ways, but most definitions converge on the notion that IH involves recognizing that one's beliefs and

opinions might be incorrect. . . . Some definitions of IH include other features or characteristics – such as low defensiveness, appreciating other people’s intellectual strengths, or a prosocial orientation . . .

One conceptualization defines intellectual humility as recognizing that a particular personal belief may be fallible, accompanied by an appropriate attentiveness to limitations in the evidentiary basis of that belief and to one's own limitations in obtaining and evaluating relevant information. This definition qualifies the core characteristic (recognizing that one’s belief may be wrong) with considerations that distinguish IH from mere lack of confidence in one’s knowledge or understanding. IH can be distinguished from uncertainty or low self-confidence by the degree to which people hold their beliefs tentatively specifically because they are aware that the evidence on which those beliefs are based could be limited or flawed, that they might lack relevant information, or that they may not have the expertise or ability to understand and evaluate the evidence. (*The Psychology of Intellectual Humility*, Mark Leary, Duke University, emphasis added)

“Attentiveness to limitations in the evidentiary basis” (or to the limitations imposed by future uncertainty) is a very important further concept. Here’s how I discussed it in my book *Mastering the Market Cycle*:

Most people think the way to deal with the future is by formulating an opinion as to what’s going to happen, perhaps via a probability distribution. I think there are actually two requirements, not one. In addition to an opinion regarding what’s going to happen, people should have a view on the likelihood that their opinion will prove correct. Some events can be predicted with substantial confidence (e.g., will a given investment grade bond pay the interest it promises?), some are uncertain (will Amazon still be the leader in online retailing in ten years?) and some are entirely unpredictable (will the stock market go up or down next month?) It’s my point here that not all predictions should be treated as equally likely to be correct, and thus they shouldn’t be relied on equally. I don’t think most people are as aware of this as they should be.

In short, we have to have a realistic view of the probability that we’re right before we choose a course of action and decide how heavily to bet on it. And anyone who’s sure about what’s going to happen in the world, the economy or the markets is probably deceiving himself.

It all comes down to dealing with uncertainty. To me, that starts with acknowledging uncertainty and having an appropriate degree of respect for it. As I quoted Annie Duke this past January, in my memo *You Bet!*:

What good poker players and good decision-makers have in common is their comfort with the world being an uncertain and unpredictable place. They understand that they can almost never know exactly how something will turn out. They embrace that uncertainty and, instead of focusing on being sure, they try to figure out how *unsure* they are, making their best guess at the chances that different outcomes will occur. (*Thinking in Bets*)

To put it simply, intellectual humility means saying “I’m not sure,” “The other person could be right,” or even “I might be wrong.” I think it’s an essential trait for investors; I know it is in the people I like to associate with.

As so often happens when I’m thinking about a memo, I recently got an incredibly helpful note from my friend Leslie Lichtenstein at the University of Chicago, connecting the concept of humility to the current episode. Here’s what she wrote:

This morning I read an article from *Behavioral Scientist* by Erik Angner [professor of practical philosophy at Stockholm University] called “Epistemic Humility – Knowing Your Limits in a Pandemic,” which made me think of you and several of your recent memos. The article opens with a quote from Charles Darwin in 1871 – **“Ignorance more frequently begets confidence than does knowledge.” It goes on to say, “Being a true expert involves not only knowing stuff about the world but also knowing the limits of your knowledge and expertise.”** (Emphasis in Leslie’s note)

I couldn’t agree more. People who are always sure are no more helpful than people who are never sure. The real expert’s confidence is reason-based and proportional to the weight of the evidence. Leslie’s note sent me to the original of the article she cited, and I found so much to share:

In the middle of a pandemic, knowledge is in short supply. We don’t know how many people are infected, or how many people will be. We have much to learn about how to treat the people who are sick – and how to help prevent infection in those who aren’t. There’s reasonable disagreement on the best policies to pursue, whether about health care, economics, or supply distribution. Although scientists worldwide are working hard and in concert to address these questions, final answers are some ways away.

Another thing that’s in short supply is the realization of how little we know. . . .

Frequent expressions of supreme confidence might seem odd in light of our obvious and inevitable ignorance about a new threat. The thing about overconfidence, though, is that it afflicts most of us much of the time. That’s according to cognitive psychologists, who’ve studied the phenomenon systematically for half a century. Overconfidence has been called “the mother of all psychological biases. . . .”

The point is not that true experts should withhold their beliefs or that they should never speak with conviction. Some beliefs are better supported by the evidence than others, after all, and we should not hesitate to say so. The point is that true experts express themselves with the proper degree of confidence – meaning with a degree of confidence that’s justified given the evidence. . . .

[Compare what you hear on TV against a tweet from medical statistician Robert Grant]: “I’ve studied this stuff at university, done data analysis for decades, written several NHS guidelines (including one for an infectious disease), and taught it to health professionals. **That’s why you don’t see me making any coronavirus forecasts. . . .**”

The concept of epistemic humility is . . . an intellectual virtue. It is grounded in the realization that our knowledge is always provisional and incomplete – and that it might require revision in light of new evidence. Grant appreciates the extent of our ignorance under these difficult conditions; the other characters don't. A lack of epistemic humility is a vice – and it can cause massive damage both in our private lives and in public policy.

Calibrating your confidence can be tricky. As Justin Kruger and David Dunning have emphasized, our cognitive and metacognitive skills are intertwined. People who lack the cognitive skills required to perform a task typically also lack the metacognitive skills required to assess their performance. **Incompetent people are at a double disadvantage, since they are not only incompetent but also likely unaware of it [Galbraith's forecasters "who don't know they don't know"!].** This has immediate implications for amateur epidemiologists. If you don't have the skill set required to do advanced epidemiological modeling yourself, you should assume that you can't tell good models from bad.

. . . it's never been more important to learn to separate the wheat from the chaff – the experts who offer well-sourced information from the charlatans who offer little but misdirection. The latter are sadly common, in part because they are in greater demand on TV and in politics. It can be hard to tell who's who. But paying attention to their confidence offers a clue. People who express themselves with extreme confidence without having access to relevant information *and* the experience and training required to process it can safely be classified among the charlatans until further notice. . . .

Again, it is fine and good to have opinions, and to express them in public – even with great conviction. **The point is that true experts, unlike charlatans, express themselves in a way that mirrors their limitations.** All of us who want to be taken seriously would do well to demonstrate the virtue of epistemic humility. (Erik Angner, *Behavioral Scientist*, April 13, emphasis added)

The more I think about it, the bottom line is clear:

- The world is an uncertain place.
- It's more uncertain today than at any other time in our lifetimes.
- Few people know what the future holds much better than others.
- **And yet investing deals entirely with the future, meaning investors can't avoid making decisions about it.**
- Confidence is indispensable in investing, but too much of it can be lethal.
- The bigger the topic (world, economy, markets, currencies and rates), the less possible it is to achieve superior knowledge.
- **Even our decisions about smaller things (companies, industries and securities) have to be conditioned on assumptions regarding the bigger things, so they, too, are uncertain.**
- The ability to deal intelligently with uncertainty is one of the most important skills.

- In doing so, we should understand the limitations on our foresight and whether a given forecast is more or less dependable than most.
- Anyone who fails to do so is probably riding for a fall.

As Neil Irwin wrote in the article cited on page 4:

It would be foolish, amid such uncertainty, to make overly confident predictions about how the world economic order will look in five years, or even five months.

Or maybe Voltaire said it best 250 years ago: **Doubt is not a pleasant condition, but certainty is absurd.**

May 11, 2020

Memo to: Oaktree Clients

From: Howard Marks

Re: Uncertainty II

I've written a few times about the frequency with which I come across something additive just before finalizing a memo. This time I wasn't so lucky: my wife Nancy brought an important article to my attention two weeks after the publication of *Uncertainty*. The article's appearance, along with a second potential addition, prompts me to write this post-script to that memo. I have a few thoughts to add, all generally related to the topic of foreknowledge.

No One Knows What's Going to Happen

The above heading was the title of an excellent article by Mark Lilla, a professor of humanities at Columbia University, which appeared in *The New York Times* this past Sunday. (You may remember my previous discussion of our tendency to think highly of people who agree with us. I readily admit that the reason I like this article so much may lie in the fact that it confirms a great deal of what I said in *Uncertainty*.) Here are some excerpts from that article:

The best prophet, Thomas Hobbes once wrote, is the best guesser. That would seem to be the last word on our capacity to predict the future: We can't.

But it is a truth humans have never been able to accept. People facing immediate danger want to hear an authoritative voice they can draw assurance from; they want to be told what will occur, how they should prepare, and that all will be well. We are not well designed, it seems, to live in uncertainty. **Rousseau exaggerated only slightly when he said that when things are truly important, we prefer to be wrong than to believe nothing at all.** . . .

Apart from the actual biology of the coronavirus – which we are only beginning to understand – nothing is predestined. How many people fall ill with it depends on how they behave, how we test them, how we treat them and how lucky we are in developing a vaccine.

The result of those decisions will then limit the choices about reopening that employers, mayors, university presidents and sports club owners are facing. Their decisions will then feed back into our own decisions, including whom we choose for president this November. And the results of that election will have the largest impact on what the next four years will hold.

The pandemic has brought home just how great a responsibility we bear toward the future, and also how inadequate our knowledge is for making wise decisions and anticipating consequences. Perhaps that is why our prophets and augurs can't keep up with the demand for foresight.

At some level, people must be thinking that the more they learn about what is predetermined, the more control they will have. This is an illusion. **Human beings want to feel that they are on a power walk into the future, when in fact we are always just tapping our canes on the pavement in the fog.**

A dose of humility would do us good in the present moment. It might also help reconcile us to the radical uncertainty in which we are always living. Let us retire our prophets and augurs. [Emphasis added]

Lilla's article pulls together in one place several themes from *Uncertainty* and other recent memos:

- the very human hunger for forecasts to help us navigate the future,
- the conditionality of the future on multiple future developments,
- our own ability to influence the future through the decisions we make,
- the unpredictability of each development,
- thus the futility of forecasting,
- the importance of accepting our ignorance of the future, and thus
- the general importance of intellectual humility.

Articles like this one and those cited in my last memo should drive home these points to everyone's satisfaction. **But rarely will people fully accept that we must make decisions regarding the future without knowing it.**

The Future as Path-Dependent

Forecasters seem to act as if the future already exists, and all we have to do is be smart enough to discern it. **But that ignores the fact that all of us – and many other influences – are constantly creating the future through our collective activity.**

In his article, Lilla stated, “. . . the post-Covid future doesn't exist. It will exist only after we have made it.” I think this is a very important concept. We might predict the future today, and we might even correctly assess what today's conditions and actions are likely to produce in the future. But that prediction will be shown to have been right only if no one and nothing causes the future to become different between now and the day it arrives. Thus I'll repeat what I quoted from Lilla earlier:

How many people fall ill with [the coronavirus] depends on how they behave, how we test them, how we treat them and how lucky we are in developing a vaccine.

Not only how will the virus behave, morph, travel, react to warm weather and infect, but also how fast will we reopen the economy, how will people behave when we reopen it, and what will the virus do at that time? Thomas Sowell, a Hoover Institution economist and social theorist, provided a glimpse at how these things work in another field:

Economists are often asked to predict what the economy is going to do. But economic predictions require predicting what politicians are going to do – and nothing is more unpredictable.

The unpredictability of politicians is only one of the many variables complicating the future today. Not only can't we predict people's actions and the many other things that will determine the course of the virus and its impact on the economy, but we also certainly can't predict when they'll take those actions – and that will count just as much.

Which Expert to Follow?

In the memo *Uncertainty*, I quoted at considerable length from an article by Erik Angner. One of its most interesting points was as follows:

People who lack the cognitive skills required to perform a task typically also lack the metacognitive skills required to assess their performance. Incompetent people are at a double disadvantage, since they are not only incompetent but also likely unaware of it. (*Behavioral Scientist*, April 13)

By definition, people who lack the expertise in a given field required for superior judgments also lack the expertise required to assess their level of expertise. As I mentioned, they qualify as John Kenneth Galbraith's forecasters "who don't know they don't know."

While re-reading my memo, I realized I had left out an important further ramification. Not only do most people fail to possess superior expertise – as well as the ability to know it – but they also lack the ability to figure out who does have it. **That's the catch: you may have to be an expert in a field in order to be able to figure out who the true experts are.** That's why research in most fields is subjected to "peer review," meaning a review by experts (not to be confused with "a jury of one's peers," meaning other lay citizens).

And yet, where does the buck stop on the biggest of questions, like those of today? The answer can't be "with the experts." An article in *The Wall Street Journal* set out the dilemma:

To govern, at least at the level of the presidency, is to make hard choices among competing options with incomplete information. Easier problems are resolved before they ever reach the Oval Office. Neither scientific data nor public sentiments can properly answer the questions that face elected officials. Both are important and must be integrated into the judgments that political leaders make. But neither can substitute for that crucial act of judgment. . . .

The president's job, and not only in times of crisis, frequently involves listening to experts disagree with one another and taking responsibility for choosing among them, plotting a course through opportunities and dangers. **The capacity to do this well involves its own sort of practical wisdom, an expertise in judging expertise. . . .** ("Experts Aren't Enough," May 16-17, emphasis added)

Nowadays, like everyone else, I'm bombarded with conflicting views regarding the wisdom of rapidly reopening the U.S. economy. **Yet I recognize that not only is my opinion on that topic of little value, but I also don't have the expertise required to know for sure whose opinion does count.** What I do know is that the last thing I should do is choose an expert because his or her opinions agree with mine, and allow confirmation bias to affect my decision.

Further, in considering expertise, we must be leery of some dangerous tendencies in our society:

- to confuse general intelligence with knowledge of the facts relative to a given field,
- to confuse factual knowledge with superior insight,
- to conflate expertise and insight with the ability to predict the future,
- to treat experts in one field as if they're knowledgeable about all others, and
- to credit rich and successful people with all of the above.

Thus, as I've described in previous memos, when I travel abroad, I'm often asked what I think of my host countries' economies and their potential. "Why ask me?" I respond, "you live here." Just because I know something about investing and the U.S., why should I necessarily have meaningful insight into other fields and countries?

We see doctors or public health officials on TV who inveigh against quickly reopening the economy. They may well know much more than most about the medical and public health aspects of the coronavirus and how it should be dealt with, and their advice is likely to keep the most people alive. But on the other hand, since they're not economists, we should assume they're only answering from the standpoint of minimizing deaths. They may not take into consideration the importance of restarting the economy or how to balance the two considerations.

On the other hand, we see businesspeople and economists talking about the need to reopen in order to minimize the damage done to the economy by keeping it in a deep freeze. But what do they know about the cost in human lives? And certainly there is no algorithm or accepted process for deciding between the two. It's a matter of judgment, not expertise.

I recently read an article about an often-cited libertarian lawyer and legal scholar (unnamed here because of my general practice of not criticizing individuals) who predicted in mid-March that no more than 500 people would die from Covid-19 in the U.S. (revised upward to 5,000 when he later found a statistical error in his analysis). While he admitted to having no medical expertise, he said he did know more than the doctors about evolutionary theory and its applicability to the virus. His opinion apparently carried great weight at the time in conservative quarters.

Reporters, not being experts themselves, have to consult experts in order to write their stories. But how do they choose and vet the experts they cite? And to what extent are their selections a function of the biases we all tend to confirm and the conclusions they want to justify? In my experience, the more I know about a subject, the less I'm impressed with related media coverage.

And likewise, elected officials are rarely expert in the fields about which they have to make decisions. They, too, have no choice but to depend on experts. But how do they choose their experts? Would they ever consult an expert who belongs to the other party? I recently read a *Wall*

Street Journal op-ed piece by a conservative senator suggesting categorically that conservatives and liberals are different in how they weigh re-opening the economy versus minimizing infections. Is such a sweeping (and probably unscientific) generalization more likely to be an appropriate observation or an example of intellectual bias stemming from ideological division?

So (a) true expertise is scarce and limited in scope, (b) expertise and predictive ability are two different things, and (c) we all should be careful about whom we listen to and how much weight we give to their pronouncements.

And one other thing: As Lilla wrote, “People facing immediate danger want to hear an authoritative voice . . .” Thus they tend to put inordinate faith in a popular “prophet.” And when he or she turns out to be a less-than-perfect forecaster, and thus only human, they go looking for the next one to anoint. **They never say, “I guess forecasting doesn’t work.”** I would say the same about people in general, including those looking for help making money without risk or effort.

A Living Example

Finally, in a related vein, I want to mention a May 19 article by Morgan Housel of Collaborative Fund, an insightful commentator whose philosophical and behavioral observations tend to resonate with me. In it, he told the story of two friends with whom he regularly took the risk of skiing out of bounds at the resort they frequented as teens. One day, his friends went out for a second run while he begged off for no particular reason, and a freak avalanche took their lives. Here’s his summation:

I don’t know if Brendan and Bryan’s death actually affected how I invest. But it opened my eyes to the idea that there are three distinct sides of risk:

- **The odds you will get hit.**
- **The average consequences of getting hit.**
- **The tail-end consequences of getting hit.**

The first two are easy to grasp. It’s the third that’s hardest to learn, and can often only be learned through experience.

We knew we were taking risks when we skied. We knew that going out of bounds was wrong, and that we might get caught. But at 17 years old we figured the consequences of risk meant our coaches might yell at us. Maybe we’d get our season pass revoked for the year.

Never, not once, did we think we’d pay the ultimate price.

But once you go through something like that, you realize that the tail-end consequences – the low-probability, high-impact events – are all that matter. In investing, the average consequences of risk make up most of the daily news headlines. But the tail-end consequences of risk – like pandemics, and depressions – are what make the pages of history books. *They’re all that matter.* They’re all you should focus on. We spent the last decade debating whether economic risk meant the

Federal Reserve set interest rates at 0.25% or 0.5%. Then 36 million people lost their jobs in two months because of a virus. It's absurd.

Tail-end events are all that matter.

This introduces one of the great conundrums associated with investing. Since we know nothing about the future, we have no choice but to rely on extrapolation of past patterns. By “past patterns,” we mean what has normally happened in the past **and with what severity**. And yet, there's no reason why (a) things can't happen that differ from those that happened in the past and (b) future events can't be worse than those of the past in terms of severity and thus consequences. While we look to the past for guidance as to the “worst case,” there's no reason why future experience should be limited to that of the past. But without reliance on the past to inform us regarding the worst case, we can't know much about how to invest our capital or live our lives.

Many years ago, my friend Ric Kayne pointed out that **“95% of all financial history happens within two standard deviations of normal, and everything interesting happens outside of two standard deviations.”** Arguably, bubbles and crashes fall outside of two standard deviations, but they are the events that create and eliminate the greatest fortunes. We can't know much in advance about their nature or dimensions. Or about rare, exogenous events like pandemics.

In 2001, I wrote a memo titled *You Can't Predict. You Can Prepare*. At first glance, that seems like an oxymoron. How can we prepare for something if we can't predict it? Turned around, if the greatest extremes and most influential exogenous events are unpredictable, how can we prepare for them? We can do so by recognizing that they inevitably will occur, and by making our portfolios more cautious when economic developments and investor behavior render markets more vulnerable to damage from untoward events.

That line of reasoning suggests a glimmer of good news: we may not be able to predict the future, but that doesn't mean we're powerless to deal with it.

May 28, 2020

Memo to: Oaktree Clients
From: Howard Marks
Re: Something of Value

If asked about possible silver linings to this pandemic, I would list first the chance to spend more time with family. Our son Andrew and his wife and son moved in with Nancy and me in Los Angeles at the beginning of the pandemic, as they were renovating their house when Covid-19 hit, and we lived together for the next ten weeks. There's nothing like getting to spend months at a time building relationships with grandchildren, something we were privileged to do in 2020. I'm sure the impact will literally last lifetimes.

As I've previously reported, Andrew is a professional investor who focuses on making long-term investments in what the world calls "growth companies," and especially technology companies. He's had a great 2020, and it's hard to argue with success. Our living together led me to talk with him and think a great deal about subjects on which I hadn't previously spent much time, contributing a lot to what I'll cover in this memo.

* * *

I've written before about how the questions I'm asked give me a good sense for what's really on people's minds. These days, one I frequently field is about the outlook for "value" investing. "Growth" stocks have meaningfully outperformed "value" for the last 13 years – so long that people are asking me whether it's going to be a permanent condition. My extensive discussions with Andrew led me to conclude that the focus on value versus growth doesn't serve investors well in the fast-changing world in which we live. I'll start by describing value investing and how investors might think about value in 2021.

What is Value Investing?

Value investing is one of the key disciplines in the world of investing. It consists of quantifying what something is worth intrinsically, based primarily on its fundamental, cash flow-generating capabilities, and buying it if its price represents a meaningful discount from that value. Cash flows are estimated as far into the future as possible and discounted back to their present value using a discount rate made up of the prevailing risk-free rate (usually the yield on U.S. Treasuries) plus a premium to compensate for their uncertain nature. There are a lot of common valuation metrics, like the ratio of price to sales, or to earnings, but they're largely subsumed by the discounted cash flow, or DCF, method.

Now, determining this value in practice is quite challenging, and the key to success lies not in the ability to perform a mathematical calculation, but rather in making superior judgments regarding the relevant inputs. Simply put, the DCF method is the main tool of all value investors in their effort to make investment decisions based on companies' long-term fundamentals.

Importantly, value investors recognize that the securities they buy are not just pieces of paper, but rather ownership stakes in (or, in the case of credit, claims on) actual businesses. These financial instruments have a fundamental worth, and it can be quite different from the price quoted in the market, which is

based on the manic-depressive ups and downs of a character Benjamin Graham called “Mr. Market.” On any given day, Mr. Market can be exuberant or despondent, and he quotes prices for securities based on how he feels. The value investor understands that – rather than informing us as to what a given asset’s value is – Mr. Market is there to serve us by offering up securities at prices, which can be meaningfully disconnected from the actual value of a stake or claim in the underlying business. In doing so, he sometimes gives us the opportunity to snatch up shares or bonds at a meaningful discount from their intrinsic value. This activity requires independent thought and a temperament that resists the emotional pull of the market cycle, making for decisions based solely on value.

Thus, to me the essential underlying principles of value investing are these:

- the understanding of securities as stakes in actual businesses,
- the focus on true worth as opposed to price,
- the use of fundamentals to calculate intrinsic value,
- the recognition that attractive investments come when there is a wide divergence between the price at which something is offered in the market and the actual fundamental worth you’ve determined, and
- the emotional discipline to act when such an opportunity is presented and not otherwise.

Value vs. Growth

Over the last 80-90 years, two important developments occurred with regard to investing style. The first was the establishment of value investing, as described above. Next came “growth investing,” targeting a new breed of companies that were expected to grow rapidly and were accorded high valuation metrics in recognition of their exceptional long-term potential.

It seems likely that the label “value” was applied to the value school because one of its greatest early popularizers, Ben Graham, practiced a low-valuation style. Deemed “cigar butt” investing by his protégé Warren Buffett, Graham’s style emphasized the search for pedestrian companies whose shares were selling at discounts from liquidation value based on the assets on their balance sheets, which Buffett likened to searching the street for used cigar butts that had one last puff left in them. It is this style that Graham preached in his Columbia Business School classes and his books, *Security Analysis* and *The Intelligent Investor*, which are considered the bibles of value investing. His investment style relied on fixed formulas to arrive at measures of statistical cheapness. Graham went on to achieve enviable investment performance although, funnily enough, he would later admit that he earned more on one long-term investment in a growth company, GEICO, than in all his other investments *combined*.

Buffett, the patron saint of value investors, also practiced cigar butt investing with great success in the first decades of his career, until his partner, Charlie Munger, convinced him to broaden his definition of “value” and shift his focus to “great businesses at fair prices,” in particular because doing so would enable him to deploy much more capital at high returns. This led Buffett to invest in growing companies – such as Coca-Cola, GEICO and the Washington Post – that he could purchase at valuations that were not particularly low in the absolute, but that he found attractive given his understanding of their competitive advantages and future earnings potential. While Buffett has long understood that a company’s prospects are an enormous component of its value, his general avoidance of technology stocks throughout his career may have unintentionally caused most value investors to boycott those stocks. Intriguingly, Buffett allows that his recent investment in Apple has been one of his most successful.

Over time, a subset of value investors adopted a harder-line approach, with a pronounced emphasis on low valuation metrics. Graham and Buffett's cigar butts had featured low valuation metrics, and this no doubt caused some value investors to elevate this characteristic to be the core consideration in their investment process. It's interesting to note that the methodology for populating the S&P 500 Value Index relies solely on finding the one-third of the S&P 500's market capitalization with the highest ratio of Value Rank (based on the lowest average multiple of earnings, sales and book value) to Growth Rank (based on the highest three-year growth in sales and earnings and 12-month price change). In other words, the stocks in the Value Index are those that are most characterized by "low-valuation parameters" and least characterized by "growth." **But "carrying low valuation parameters" is far from synonymous with "underpriced."** It's easy to be seduced by the former, but a stock with a low p/e ratio, for example, is likely to be a bargain only if its current earnings and recent earnings growth are indicative of the future. Just pursuing low valuation metrics can lead you to so-called "value traps": things that look cheap on the numbers but aren't, because they have operating weaknesses or because the sales and earnings creating those valuations can't be replicated in the future.

The growth investing camp, on the other hand, came into existence during the "go-go" early years of the 1960s, the decade in which I started my career in the equity research department at First National City Bank. Investor interest in rapid growth led to anointment of the so-called Nifty Fifty stocks, which became the investment focus of many of the money-center banks (including my employer), which were the leading institutional investors of the day. This group comprised the fifty companies believed to be the best and fastest-growing in America: companies that were considered so good that "nothing bad could happen to them" and "there was no price too high" for their shares. Like the objects of most manias, the Nifty Fifty stocks showed phenomenal performance for years as the companies' earnings grew and their valuations rose to nosebleed levels, before declining precipitously between 1972 and 1974. Thanks to that crash, they showed negative holding-period returns for many years. Their dismal performance cost me my job as director of equity research (and led to my being assigned to start funds for investment in high yield and convertible bonds – my lucky break). It's worth noting, however, that the truly durable growth companies among the Nifty Fifty – about half of them – compiled respectable returns for 25 years, even when measured from their pre-crash highs, suggesting that very high valuations can be fundamentally justified in the long term for the rare breed of company.

The two approaches – value and growth – have divided the investment world for the last fifty years. They've become not only schools of investing thought, but also labels used to differentiate products, managers and organizations. Based on this distinction, a persistent scoreboard is maintained measuring the performance of one camp against the other. Today it shows that the performance of value investing lagged that of growth investing over the past decade-plus (and massively so in 2020), leading some to declare value investing permanently dead while others assert that its great resurgence is just around the corner. My belief, especially after some deep reflection over the past year – prompted by my conversations with Andrew – is that **the two should never have been viewed as mutually exclusive to begin with.** We'll get to that shortly.

Vantage Points

An interesting aspect of my discussions with Andrew has been our joint recognition of the fact that we come from very different backgrounds, and perhaps for that reason we look at investing from considerably different vantage points.

I began to form my investment philosophy in the 1960s. Investment thought was much less developed at that time, and what did exist was heavily dominated by the philosophy espoused by Ben Graham. Buffett was still searching for his last puff of “cigar butts” and had yet to coin the term “moat” in reference to the lasting competitive advantages that sustain high-quality businesses. My philosophy was informed by the fact that I started working in 1969, during the “Nifty Fifty” bubble, which I watched crash around me.

It was further shaped by my transition in 1978 from equities to fixed income investments in the form of convertible and high yield bonds. Importantly, Graham and his less famous co-author, David Dodd, characterized bond management as a “negative art.” What did they mean? In general, bond investors’ return is capped at a yield that stems from the promised interest payments and payoff at par upon maturity; that’s why it’s called “fixed income.” The upshot is that all bonds bought at a 6% yield will return 6% when held to maturity if they pay. Bonds that don’t pay, on the other hand, will produce losses of varying magnitudes. Thus, oversimplifying, you improve your performance in bonds not through which paying bonds you buy (since all 6% bonds that pay will have the same return), but through what you exclude (that is, whether you’re able to avoid the ones that don’t pay). Clearly, this is very different from equities, where your upside is theoretically unlimited, requiring that investors intelligently balance downside risk and upside potential.

To be a good equity investor, I think you have to be an optimist; certainly, it’s no activity for doomsayers. On the other hand, the term “optimistic bond investor” is practically an oxymoron. Since bonds generally lack potential for long-term returns in excess of their promised yields, bond investing mostly requires skepticism and attention to the downside. One of the reasons I did well in fixed income is that it played to my natural conservatism. And since tech companies issue relatively few bonds, it also accommodated my lack of focus on technology, which has never been of particular interest to me and has always felt a bit “over my head.” I’m certainly not an “early adopter,” nor do I have a history of recognizing emerging technological trends in their infancy.

Lastly, as a child of parents who were born in the early 1900s and thus were adults during the Great Depression, my thought process was shaped by the deprivation and fear they had experienced. Because they had been made so painfully aware of the value of a dollar and how quickly things could change for the worse, they considered the future and the possibility of loss things to worry about. Adages like “don’t put all your eggs in one basket” and “save for a rainy day” were watchwords I grew up with. This is very different from the experience of those whose parents were born a decade or two later than mine, never lived with deprivation, and may never have heard those words. These influences and experiences led me to adopt a value approach and the persona of a “bargain hunter,” which has served me well in my chosen field, which now has come to be called “credit.”

Andrew has a considerably different mindset. Clearly, his early experience was very different from mine, not marked by anything like the Depression. He was bitten by the investment bug early, and from a young age investing dominated our conversations. While he deeply appreciates some elements of my philosophy – such as the importance of understanding investor psychology, focusing on fundamentals, and contrarianism – he has forged his own path and ended up in a very different place. His first phase was spent as a “Buffett nerd,” consuming everything written by the Oracle and adhering strongly to his philosophy. But over time, he has developed his own perspective and transitioned to investing primarily in technology and other growth-oriented companies. He spends the vast majority of his time managing a venture firm called TQ Ventures with his two partners, but he also steers our family’s “upside-oriented investments” with great results. (I, fittingly, handle our more conservative investments).

This contrast of viewpoints, particularly in 2020, has created extraordinary opportunities for discussion and learning. **From this point on, most of what I write will consist of what Andrew has caused me to appreciate in my 75th year.**

The False Dichotomy of Value and Growth

At some point, the camps of value and growth developed nearly the same fervent adherence as rival political factions. You pledged allegiance to one or the other, and so went your future investing actions. You believed your way was the only way and looked down on practitioners of the other. I think investors – perhaps based on their emotional makeup, intellectual orientation and understanding of things like technological innovation – naturally gravitated toward one side of the stylistic divide or the other. And there are notable differences:

- Value stocks, anchored by today's cash flows and asset values, should *theoretically* be “safer” and more protected, albeit less likely to earn the great returns delivered by companies that aspire to rapidly grow sales and earnings into the distant future.
- Growth investing often entails belief in unproven business models that can suffer serious setbacks from time to time, requiring investors to have deep conviction so as to be able to hang on.
- When they're rising, growth stocks typically incorporate a level of optimism that can evaporate during corrections, testing even the most steeled investor. And because growth stocks depend for most of their value on cash flows in the distant future that are heavily discounted in a DCF analysis, a given change in interest rates can have meaningfully greater impact on their valuations than it will on companies whose value comes mainly from near-term cash flows.

Despite these points, I don't believe the famous value investors who so influenced the field intended for there to be such a sharp delineation between value investing, with its focus on the present day, low price and predictability, and growth investing, with its emphasis on rapidly growing companies, even when selling at high valuations. Nor is the distinction essential, natural or helpful, especially in the complex world in which we find ourselves today. Both Graham and Buffett achieved success across a variety of styles and, more importantly, viewed value investing as consisting of adherence to fundamental business analysis, divorced from the study of market price action. As Buffett put it, “We don't consider ourselves to be value investors. . . . Discounted cash proceeds is the appropriate way to value any business. . . . There is no such thing in our minds as value and growth investing.” It just so happened that considerable opportunity existed for them in the cigar butt arena at the time they operated – especially considering that both started with relatively small amounts of money with which to invest – so that's what they emphasized. But as the world evolved, the landscape of opportunities has changed significantly.

There's a saying that “to the man with a hammer, everything looks like a nail.” The widely discussed distinction between value and growth made some people believe they only had hammers, when in fact they potentially had access to a whole toolbox. **Now we live in a complex world where a range of tools is required for success.**

A More Efficient World

As mentioned earlier, the investment world back when Buffett and Graham were first practicing their version of value investing was considerably different from the current one. First, the level of competition

was much lower, almost unrecognizable when compared to today. Investment management wasn't a hot field in which many people aspired to spend their careers. It was instead a cottage industry, with a small number of outfits practicing quite traditional activities. Second, information was extremely hard to come by and process. There were no computers, spreadsheets or databases. Before researching a stock, you first had to find it in either the back of the newspaper (if it was a mainstream issue) or large books put together by firms like Moody's and Value Line (if it was more thinly traded). Then you had to either send a request to the company for the annual report or go to the library hoping to find a copy of the report or a broader publication that included the company's financial statements. And third, with the industry so small, nascent and unpopular, the investment thought process wasn't something broadly developed or disseminated. The key analytical frameworks were not yet codified, and folks like Graham and Buffett had a huge edge simply because they knew how to process the data they found. In short, there were few people searching; the search process was quite difficult; and few people knew how to turn the data they did find into profitable investment conclusions. In this environment, bargains could literally be hiding in plain sight for anyone with the willingness to look and the capacity to analyze.

When Buffett was applying his cigar butt approach to running his early investment partnership – which racked up a tremendous record – he famously used to sit in his back room in Omaha, flipping through the thousands of pages of *Moody's Manual*, and he would buy shares in small companies that were trading at enormous discounts from liquidation value for the simple reason that no one else paid attention to them. In one case, that of National American Fire Insurance, Buffett was able to buy the stock at 1x earnings by driving around to farmers who had decades earlier been stuffed by promoters with stock they'd since forgotten about, and handing them cash on their front porch. Thus, the Grahamian value framework was created at a time when things could be stupidly cheap based on clearly observable facts, simply because the search process was very difficult and opaque.

As time went on, the diligent analyst's information advantage began to slowly dissipate, but it still existed for a good while. Prior to the broad adoption of the Internet and the explosion of the investment industry in the early years of this century, information and analytical methods were still hard to come by. One still had to mail away for annual reports as recently as the 1990s, and while more people may have known how to find pure balance sheet arbitrages like Graham practiced in the 1950s and '60s, seemingly basic analytical concepts like return on invested capital, competitive moats and the importance of free cash flow (rather than GAAP earnings) were not widely appreciated. And certainly, most people didn't understand the dynamics around what are called "special situations," which become available when complex corporate actions create investment opportunities by giving rise to significant mispricings. There was still the opportunity to find bargains in plain sight, albeit perhaps with an extra level of sophistication required.

Fast forward to today, and everything has changed. The investment industry is wildly competitive, with tens of thousands of funds managing trillions of dollars. Investment management is one of the most desirable careers, prompting complaints about "brain drain" as intellectual prodigies eschew careers as world-changing scientists or inventors in exchange for jobs on Wall Street. Warren Buffett has evolved from a man buying cheap stocks in his home office to an international celebrity, with 50,000 investors from around the world making the pilgrimage to Omaha each year for the Berkshire Hathaway annual meeting. Information is incredibly ubiquitous, with seemingly endless amounts of data – not to mention books, articles, blogs and podcasts about investment methodologies and specific stock research – available on your mobile phone in seconds. And, not only is information broadly available and easily accessed, but billions of dollars are spent annually on specialized data and computer systems designed to suss out and act on any discernable dislocation in the marketplace. All this is largely motivated by the fact that many of the greatest fortunes made in the last forty years belong to people in the investment

profession. In contrast, when I entered the business in the late 1960s, few investors were “household names,” investment industry incomes were in line with those in other professions, and only a handful of investors had a “carried interest” in their clients’ profits.

In the past, bargains could be available for the picking, based on readily observable data and basic analysis. Today it seems foolish to think that such things could be found with any level of frequency. If something about a company can be easily read in an annual report, or readily discovered by a mathematically competent analyst or a computer, it stands to reason that, in most cases, this should already be appreciated by the marketplace and thus incorporated in the prices of the company’s securities. That’s the essence of the Efficient Market Hypothesis. Thus, in the world we live in today, investing on the basis of rote formulas and readily available fundamental, quantitative metrics should not be particularly profitable. (This is not necessarily true during market downturns and panics, when selling pressure can cause prices to decouple from fundamentals.) **It also stands to reason that in a time when readily discernable quantitative data is unlikely to produce high-profit opportunities:**

- **if something carries a low valuation, there’s probably a good reason, and**
- **successful investing has to be more about superior judgments concerning (a) qualitative, non-computable factors and (b) how things are likely to unfold in the future.**

Not Your Grandfather’s Market

Not only are the traditional staples of classic value investing (readily discernable quantitative measures of cheapness in the here-and-now) no longer likely to produce a sustainable edge on their own, but the world has gotten more complex, with many more dynamics that can drive a decoupling of near-term metrics from valuation, both to the positive and negative.

Back in the old days, Warren Buffett could find businesses that clearly were likely to remain dominant for long periods of time and perform relatively straightforward analysis to assess their valuation. For instance, he could look at something like the Washington Post, which essentially became the monopoly newspaper in a major city, and invest on the basis of reasonable, consistent assumptions regarding a few variables like circulation, subscription prices and ad rates. It was a foregone conclusion that the paper would remain dominant because of its strong moat, and thus that the past would look very much like the future. In contrast today:

- Because markets are global in nature, and the Internet and software have vastly increased their ultimate profit potential, technology firms or technologically aided businesses can grow to be much more valuable than we previously could have imagined.
- Innovation and technical adoption are happening at a much more rapid pace than ever before.
- It has never been easier to start a company, and there has never been more capital available to fund entrepreneurship.
- There have also never been as many highly capable people focused on starting and building companies.
- Since many of these companies are selling products primarily made with code, their costs and capital requirements are extremely low and their profitability – especially on incremental sales – is unusually high. Thus, the economics of winners have never been more attractive, with very high profit margins and minimal capital requirements.

- Because the friction and marginal cost of scaling over the Internet can be so low, businesses can grow much more rapidly than ever before.
- It has never been more acceptable for public companies to lose money in the pursuit of a large prize down the road. This in turn leads to obfuscation of the real potential economics of winners and makes differentiating between winners and losers difficult without great, insightful effort to peel back the onion.
- As developing and scaling new products is much easier in the digital world (often requiring little more than engineers and code), it's never been more possible for companies to develop completely new avenues of growth, further extending their runways (Amazon's AWS and Square's Cash App are two notable examples). This gives real value to intangibles such as exceptional management, engineering talent and strategic positioning with customers.
- The moats protecting today's winners have never been stronger, and as Brian Arthur pointed out in "Increasing Returns and the New World of Business," his amazing piece of almost 25 years ago, the winners often get stronger and more effective as they get bigger, rather than bloated and inefficient.
- Conversely, the onslaught of startups with readily available capital and minimal barriers to scaling means that the durability of legacy businesses has never been more vulnerable or uncertain.
- At the same time, however, it's important to recognize that the leading tech firms face threats from trustbusters who believe these companies have developed excessive market power.

To summarize, businesses are both more vulnerable and more dominant in today's world, with much greater opportunities for dramatic changes in fortune, both positive and negative. On the positive side, successful businesses have much more potential for long runways of high growth, superior economics, and significant durability, creating a huge pot of gold at the end of the rainbow and seemingly justifying valuations for the potentially deserving that are off-puttingly high by historical standards. On the negative side, it also creates immense temptation for investors to overvalue undeserving companies. And companies with here-and-now cash flows and seeming stability can see those evaporate as soon as a bunch of Stanford computer science students get funding and traction for their new idea.

When I consider this new world, I think fundamental investors need to be willing to thoroughly examine situations – including those with heavy dependency on intangible assets and growth into the distant future – with the goal of achieving real insight. However, this is, to an extent, antithetical to the value investor's mentality. Part of what makes up the value investor's mindset is insistence on observable value in the here-and-now and an aversion to things that seem ephemeral or uncertain. **Many of the great bonanzas for value investors have come in periods of panic following the bursting of bubbles, and this fact has probably led value investors to be very skeptical of market exuberance, especially when concerning companies whose assets are intangible.** Skepticism is important for any investor; it's always essential to challenge assumptions, avoid herd mentality and think independently. Skepticism keeps investors safe and helps them avoid things that are "too good to be true."

But I also think skepticism can lead to knee-jerk dismissiveness. While it's important not to lose your skepticism, it's also very important in this new world to be curious, look deeply into things and seek to truly understand them from the bottom up, rather than dismissing them out of hand. I worry that value investing can lead to the rote application of formulas and that, in times of great change, applying formulas that are based on past experience and models of the prior world can lead to massive error. John Templeton warned about the risk that's created when people say, "it's different this time," but he also

allowed that 20 percent of the time they're right. Given the rising impact of technology in the 21st century, I'd bet that percentage is a lot higher today.

It's also worth noting with regard to truly dominant companies that are able to achieve rapid, durable and highly profitable growth that it is very, very hard to overprice them based on near-term multiples. The basic equations of finance were not built to handle high-double-digit growth as far as the eye can see, making the valuation of rapid growers a complicated matter. As John Malone famously said, if your long-term growth rate exceeds your cost of capital, your present value is infinite. **However, this is only true for truly special companies, which are few and far between and certainly not as ubiquitous as is generally implied by the market in times of ebullience.** It's important to note, that when markets are at extreme levels of optimism, as we saw in both the Nifty Fifty and Dot Com bubbles, (a) every company in the affected field is treated as a long-term winner, (b) if bought in times of significant optimism and extreme valuations for growth, the stocks of even the greatest companies are likely to produce outcomes that are mediocre at best, and (c) in the crashes that follow most bubbles, enormous interim markdowns can befall good companies as well as bad, requiring sharp analysis to differentiate between them, and high conviction and an iron stomach to hold on.

I want to make very clear that I do not intend this to imply an opinion about growth stocks' valuations today. I've heard a variety of views, and while I have my own, I don't want to make it the subject of this memo. In the spirit of seeking to understand this new world, market commentators (including me) would be well served to understand the fundamentals underpinning the small number of companies that currently drive a huge percentage of the market, instead of basing top-down conclusions on purely historical valuation comparisons. And it seems imprudent to opine on the level of the overall market without being fully informed regarding the tech companies that now account for so much of equity indices like the S&P 500. As Andrew repeatedly reminds me, it's hard to make a convincing case that today's market is too high if you can't explain why its tech leaders are overvalued.

But by far the most important intention of this memo is to explore the mindset that I think will prove most successful for value investors over the coming decades, regardless of what the market does in the years just ahead. It's important to note that (a) the potential range of outcomes for many of today's companies is very wide and (b) there are considerations with enormous implications for the ultimate value of many companies that do not show up in readily available quantitative metrics. They include superior technology, competitive advantage, latent earning power, the value of human capital as opposed to capital equipment, and the potential option value of future growth opportunities. In other words, determining the appropriateness of the market price of companies today requires deep micro-understanding, and that makes it virtually impossible to opine on the valuation of a rapidly growing company from 30,000 feet or by applying traditional value parameters to superficial projections. **Some of today's lofty valuations are probably more than justified by future prospects, while others are laughable – just as certain companies that carry low valuations can be facing imminent demise, while others are just momentarily impaired.** The key, as always, is to understand how today's market price relates to the company's broadly defined intrinsic value, including its prospects.

The Heart of the Problem

Consider two companies. Company A is a respected long-term competitor selling a widely consumed, fairly prosaic product. It has built a decades-long record that shows modest but steady sales growth and healthy profit margins. It manufactures its product using heavy machinery located on its own premises. Its stock sells at a modest multiple of earnings per share.

Company B, on the other hand, was formed a few years ago with the goal of disrupting a legacy industry. It has a brief but impressive record of sales growth, albeit at modest absolute dollar levels and with limited profitability. It plans to accelerate its sales growth and build market share over the next several years, overtake its more traditional prey, and then expand its profit margins by tapering spending on R&D and customer acquisition, raising prices, and scaling into its largely fixed cost structure. Its products are constantly evolving and innovating, and they emerge not from factories, but rather the minds of engineers doing coding. It has no current earnings, but because of its potential, sells at a lofty multiple of sales.

Value investors are likely to consider it easy to predict and value Company A, with its time-tested product, stable revenues, well-established profit margins and valuable production facilities. The process requires only a few simple assumptions: that something that has been successful will remain so; that next year's sales will be equal to this year sales plus some modest growth; and that the profit margin will remain where it has been for years. **It seems intuitively obvious that chugging along as in the past is more predictable and reliable than rapid and durable growth, and thus that industrial stalwarts are more capable than innovators of being valued with precision.**

Company B, on the other hand, is at an early stage in its development, its profit margins are far from maximized, and its greatest assets go home every night rather than residing on the balance sheet. Valuing it requires guesses about the ultimate success of its products; its ability to come up with new ones; the response from competitors and the targeted industry; its growth runway; and the extent to which it will be able to increase profitability once doing so becomes its focus. Company B seems more conceptual in nature and more dependent on developments in the distant future that are subject to significant uncertainty, so valuing it might have to be done on the basis of broad ranges for future sales and profitability rather than reliable point estimates. Assessing its value also requires conversance with a technologically complex field. For all these reasons, value investors are likely to consider Company B hard to value, "speculative" and thus not investable under the canon.

Certainly, the range of potential outcomes – both good and bad – appears greater with respect to Company B than Company A, and thus Company B seems less predictable. But Company A's track record may suggest stability that could ultimately prove fleeting. And even if one can't exactly predict the future of Company B, British philosopher and logician Carveth Read reminds us that we'd rather be vaguely right than exactly wrong. The ability to formulate precise forecasts does not necessarily make something a better or even a safer investment.

- **First, the apparent ease of predicting traditional Company A's future can be quite deceptive** – for example, considerable uncertainty can exist regarding its risk of being disrupted by technology or seeing its products innovated out of existence. On the other hand, while Company B is more nascent, its products' strength and traction in the marketplace may make success highly likely.
- **Second, as noted earlier, if conclusions regarding Company A's potential can easily be reached by a finance student with a laptop, how valuable can such conclusions be?** Shouldn't a deep understanding of a company's qualitative dynamics and future potential be a greater source of advantage in making correct forecasts than data which is readily available to all?

Value investing is thought of as trying to put a precise value on the low-priced securities of possibly mundane companies and buying if their price is lower. And growth investing is thought of as buying on the basis of blue-sky estimates regarding the potential of highly promising companies and paying high valuations as the price of their potential. **Rather than being defined as one side of this artificial**

dichotomy, value investing should instead consist of buying whatever represents a better value proposition, taking all factors into account.

Dealing with Winners

A couple of times this past year, I've committed the sin of asking Andrew how he felt about selling part of some highly appreciated holdings and "taking some money off the table." The results haven't been pretty; he has made plain my error, as described below.

Much of value investing is based on the assumption of "reversion to the mean." In other words, "what goes up must come down" (and what comes down must go up). Value investors often look for bargains among the things that have come down. Their goal, of course, is to buy underpriced assets and capture the discounts. But then, by definition, their potential gain is largely limited to the amount of the discount. Once they've benefitted from the closing of the valuation gap, "the juice is out of the orange," so they should sell and move on to the next situation.

In Graham's day, cigar butts could be found in good supply, valued precisely, bought very cheaply with confidence, and then sold once the price had risen to converge with the value. But Andrew argues that this isn't the right way to think about today's truly world-class companies, with their vast but unquantifiable long-term potential. Rather, if an investor has studied a company, reached a deep understanding of it and concluded that it possesses great potential for growth and profitability, he'll probably recognize that it's impossible to accurately quantify that potential and know when it has been realized. He also may realize that ultimate potential is a moving target, as the company's strengths may allow it to develop additional avenues of growth. **Thus he might have to accept that the correct approach is to (a) hope he has the direction and quantum approximately right, (b) buy and (c) hold on as long as the evidence suggests the thesis is right and the trend is upward – in other words, as long as there's still juice in the orange.**

My 2015 memo *Liquidity* included some observations from Andrew regarding point "c":

When you find an investment with the potential to compound over a long period of time, one of the hardest things is to be patient and maintain your position as long as doing so is warranted on the basis of the prospective return and risk. Investors can easily be moved to sell by news, emotion, the fact that they've made a lot of money to date, or the excitement of a new, seemingly more promising idea. **When you look at the chart for something that's gone up and to the right for 20 years, think about all the times a holder would have had to convince himself not to sell.**

He hasn't changed his tune one bit over the last five years. **Andrew insists that when you're talking about today's great growth companies, the approach of "buy in cheap, set a target price, sell as it rises, and exit fully when it reaches the target" is dead wrong.** A dispassionate look at history makes clear that taking profits in a rapidly growing company with durable competitive advantages has often been a mistake. Given the properties of today's leading companies, it can be even more wrong now. **Instead, as he says, you have to talk yourself out of selling.**

I think winners are sold for four primary reasons: (a) the investor concludes that the investment has accomplished everything it's capable of, (b) she thinks it has appreciated to the point that its

prospective return is only modestly attractive, (c) she realizes something in her investment thesis was incorrect or has changed for the worse or (d) she fears that the gains to date might be proved unwarranted and thus evaporate; in particular, she's afraid she'll end up kicking herself for not having taken profits while they were there. But fear of making a mistake is a terrible reason to sell something of value.

Here's how Andrew puts it today:

It's important to understand the paramount importance of compounding, and how rare and special long-term compounders are. This is antithetical to the "it's up, so sell" mentality but, in my opinion, critical to long-term investment success. As Charlie Munger says, "the first rule of compounding is to never interrupt it unnecessarily."

In other words, if you have a compounding machine with the potential to do so for decades, you basically shouldn't think about selling it (unless, of course, your thesis becomes less probable). Compounding at high rates over an investment career is very hard, but doing it by finding something that doubles, then moving on to another thing that doubles, and so on and so on is, in my opinion, nearly impossible. It requires that you develop correct insights about a large number of investment situations over a long period of time. It also requires that you execute well on both the buy and the sell each time. When you multiply together the probabilities of succeeding at a large number of challenging tasks, the probability of doing them all correctly becomes very low. It's much more feasible to have great insights about a small number of potentially huge winners, recognize how truly rare such insights and winners are, and not counteract them up by selling prematurely.

As I was working on this memo, I came across a very helpful article from the Santa Fe Institute:

When it comes to investing and businesses, the mental models in our head help us answer the question, '*what does the future hold?*'. . . [But] applying the mental model of '*mean reversion*' for a '*fade-defying*' business model will lead to an erroneous conclusion. (*Investment Master Class*, December 21, 2020)

The last sentence struck a very responsive chord in me. **It suggested to me that my background had biased me toward assuming "mean reversion" and thus sometimes caused me not to fully grasp the potential of "fade-defying business models."** This bias caused me to conclude that one should "scale out" of things as they rose and "take some money off the table." I even formulated a saying on the subject: "If you sell half, you can't be all wrong." But I now see that this high-sounding verbiage can lead to premature selling, and that cutting back a holding with great potential can be a life-altering mistake. Note that, according to Charlie Munger, he's made almost all his money from three or four big winners. What if he had scaled out early?

Fortunately, (a) Oaktree's business consists mostly of garnering valuation discrepancies; (b) because of their nature, our asset classes offer up relatively few opportunities to err by prematurely selling off potential mega-multiple winners; (c) Oaktree's decentralized structure insulates our portfolio managers from the extremes of my caution; and (d) my colleagues do a better job of letting their winners run than I might have. We might have done more if I didn't have my limitations. Maybe I could have remained in equities, or even become a venture capitalist and seeded Amazon. But I can't complain – things couldn't have turned out better.

The Value Mentality in Action

Back in 2017, my memo *There They Go Again . . . Again* included a section on cryptocurrencies in which I expressed a high level of skepticism. This view has been a source of much discussion for me and Andrew, who is quite positive on Bitcoin and several others and thankfully owns a meaningful amount for our family. While the story is far from fully written, the least I can say is that my skeptical view has not borne out to date. This brings up what Andrew considers a very important point about the value investor's mentality and what is required for success as an investor in today's world.

As I said before, the natural state for the value investor is one of skepticism. Our default reaction is to be deeply dubious when we hear "this time it's different," and we point to a history of speculative manias and financial innovations that left behind significant carnage. It's this skepticism that reduces the value investor's probability of losing money.

However, in a world where so much innovation is happening at such a rapid pace, this mindset should be paired with a deep curiosity, openness to new ideas, and willingness to learn before forming a view. The nature of innovation generally is such that, in the beginning, only a few believe in something that seems absurd when compared to the deeply entrenched status quo. When innovations work, it's only later that what first seemed crazy becomes consensus. **Without attaining real knowledge of what's going on and attempting to fully understand the positive case, it's impossible to have a sufficiently informed view to warrant the dismissiveness that many of us exhibit in the face of innovation.**

In the case of cryptocurrencies, I probably allowed my pattern recognition around financial innovation and speculative market behavior – along with my natural conservatism – to produce my skeptical position. These things have kept Oaktree and me out of trouble many times, but they probably don't help me think through innovation. Thus, I've concluded (with Andrew's help) that I'm not yet informed enough to form a firm view on cryptocurrencies. In the spirit of open-mindedness, I'm striving to learn. Until I do, I'll be referring all requests for comments on the subject to Andrew (although I'm sure he'll decline).

Back to the Original Question

I'll move toward ending this memo by turning to the question I mentioned at the outset: Is the recent underperformance of value investing a temporary phenomenon? Will value stocks ever again have their day in the sun?

First, I think the stocks of the tech leaders are clearly being aided by a virtuous circle created by the combination of their preeminence as companies, their recent eye-popping performance, their huge market capitalizations, and the strategic considerations of the fund business. The companies' preeminence and price momentum make them essential cornerstone holdings in many ETFs, and their enormous scale places them among the largest holdings. They also dominate equity indices such as the S&P 500. Those two things mean that as long as money flows disproportionately into ETFs and index funds and the four factors enumerated above don't change, the leading tech stocks will continue to attract more than their fair share of capital and perform better than stocks not as well represented in the indices and ETFs.

However, this is one of those trends that will continue until it stops. To the extent investors' expectations for these companies' rapid growth are realized, they can continue to be great performers. But at some point, if they keep appreciating faster than the rest of the stock market, there should come a time when even their superior growth rates are fully reflected in their stock prices and their performance should subside: their stock prices may grow "only" in line with their earnings or even slower. And other stocks may come into favor and perhaps outperform. But importantly, there's no reason why this has to happen anytime soon.

There are many similarities between today and past periods of optimism. There's immense excitement about investing in high-growth stocks, fueling continued rapid appreciation. There's very easy monetary policy, which adds fuel to the fire in any bull market. There are pockets of extreme behavior, with 30-40x sales multiples not uncommon for software businesses, and with high-priced IPOs doubling on their first trading day. But there are real differences as well. We've rarely had businesses as dominant as the tech leaders, with the growth runways they have and the profit margins and capital efficiency they enjoy making them more dominant with each passing day. We've never seen businesses with the ability to scale as rapidly and frictionlessly. We've never had such a catalyst for technology adoption as we've had in the coronavirus pandemic. We've had a boom of new public companies coming to market, both through IPOs and SPACs, reversing the long trend of a shrinkage in the number of public companies. We've never had interest rates as low as they are and as likely to stay low for as long as has been telegraphed. The Internet has permeated the world and changed it, and business models have evolved in a way that makes today's situation incomparable to the Nifty Fifty or the Dot Com Bubble of the late '90s (for example, in 1998 there were 150 million Internet users globally; today there are more than that in Indonesia alone).

I believe most types of investment are likely to go through periods of both outperformance and underperformance. There are reasons to believe (with ample counterarguments) that as the tide turns on monetary policy (if it ever does), rising interest rates will disproportionately hurt growth stocks, just as they've been disproportionately helped during this period of easy money. More importantly, it has long been true that when something works, people follow the herd, chase the gains, and bid it up to the point where prospective returns are paltry, thus positioning investments that have been out of favor to become the new outperformers. **But, as I said earlier, broad observations about historic valuations are not a sufficient foundation for market opinions today.** I also believe, as outlined earlier, that certain types of value opportunities have largely evaporated and, save for times of market panic when things become dislocated, are unlikely to deliver the returns they did in the past.

In short, there are arguments for a resurgence in value investing and arguments for its permanent impairment. But, I think this debate gives rise to a false and unhelpful narrative. The value investor of today should dig in with an open mind and a desire to deeply understand things, knowing that in the world we live in, there's likely more to the story than what appears on the Bloomberg screen. **The search for value in low-priced securities that are worth much more should be just one of many important tools in a toolbox, not a hammer constantly in search of a nail. It doesn't make sense for value investors to bar investments simply because (a) they involve high-tech companies that are widely considered to have unusually bright futures, (b) their futures are distant and hard to quantify, and (c) their potential causes their securities to be assigned valuations that are high relative to the historic averages. The goal at the end of the day should be to figure out what all kinds of things are worth and buy them when they're available for a lot less.**

* * *

To end, I'll pull together what I consider the key conclusions:

- Value investing doesn't have to be about low valuation metrics. Value can be found in many forms. The fact that a company grows rapidly, relies on intangibles such as technology for its success and/or has a high p/e ratio shouldn't mean it can't be invested in on the basis of intrinsic value.
- Many sources of potential value can't be reduced to a number. As Albert Einstein purportedly said, "Not everything that counts can be counted, and not everything that can be counted counts." The fact that something can't be predicted with precision doesn't mean it isn't real.
- Since quantitative information regarding the present is so readily available, success in the highly competitive field of investing is more likely to be the result of superior judgments about qualitative factors and future events.
- The fact that a company is expected to grow rapidly doesn't mean it's unpredictable, and the fact that another has a history of steady growth doesn't mean it can't run into trouble.
- The fact that a security carries high valuation metrics doesn't mean it's overpriced, and the fact that another has low valuation metrics doesn't mean it's a bargain.
- Not all companies that are expected to grow rapidly will do so. But it's very hard to fully appreciate and fully value the ones that will.
- If you find a company with the proverbial license to print money, don't start selling its shares simply because they've shown some appreciation. You won't find many such winners in your lifetime, and you should get the most out of those you do find.

I once asked a well-known value investor how he could hold the stocks of fast-growing companies like Amazon – not today, when they're acknowledged winners, but rather two decades ago. His answer was simple: "They looked like value to me." **I guess the answer is "value is where you find it."**

My conversations with Andrew over the ten months of the pandemic have represented a "voyage of discovery" and culminated in this memo. I think we came to some important realizations regarding the question of value versus growth investing, and in the process, I learned a lot about myself.

I don't mean to suggest that anything I've written here pertains to all value or all growth investors. There's a lot of generalizing, and we know how imperfect generalizations can be. I also don't insist that it's correct. It's just the current state of my thinking. Not only do I not insist that my version is the only one possible, but I expect it to evolve further as the world changes and I continue to learn. I hope you'll find this memo interesting and helpful, and I wish you all the best in 2021.

January 11, 2021

Appendix: Dealing with Winners in Practice

The conclusions described above regarding how to deal with winners shouldn't be taken to mean it was easy for Andrew and me to reach agreement on this subject. The discussion here was our most spirited, and we returned to it many times. Our talks usually went something like this:

Howard: Hey, I see XYZ is up xx% this year and selling at a p/e ratio of xx. Are you tempted to take some profits?

Andrew: Dad, I've told you I'm not a seller. Why would I sell?

H: Well, you might sell some here because (a) you're up so much, (b) you want to put some of the gain "in the books" to make sure you don't give it all back and (c) at that valuation, it might be overvalued and precarious. And, of course, (d) no one ever went broke taking a profit.

A: Yeah, but on the other hand, (a) I'm a long-term investor, and I don't think of shares as pieces of paper to trade, but as part ownership in a business, (b) the company still has enormous potential, and (c) I can live with a short-term downward fluctuation, the threat of which is part of what creates opportunities in stocks to begin with. Ultimately, it's only the long term that matters. (There's a lot of a-b-c in our house. I wonder where Andrew got that.)

H: But if it's potentially overvalued in the short term, shouldn't you trim your holding and pocket some of the gain? Then if it goes down, (a) you've limited your regret and (b) you can buy in lower.

A: If I owned a stake in a private company with enormous potential, strong momentum and great management, I would never sell part of it just because someone offered me a full price. Great compounders are extremely hard to find, so it's usually a mistake to let them go. Also, I think it's much more straightforward to predict the long-term outcome for a company than short-term price movements, and it doesn't make sense to trade off a decision in an area of high conviction for one about which you're limited to low conviction.

H: Well for one thing, the p/e ratio is awfully high.

A: The p/e ratio is just a very quick heuristic that doesn't necessarily tell you much about the company. You can't say a stock is overvalued just because its p/e ratio is high relative to historic average p/e's for the market. All that matters is thinking about how much cash flow the company can produce over a long period of time, discounting that at a reasonable discount rate, and comparing the resultant present value against the current price. There are lots of things – about both the company's present condition and its future potential – that don't get picked up in a p/e ratio, so a high multiple alone shouldn't scare you off.

H: Aha! That's just what they said during the Nifty Fifty bubble around the time I started working. "No price too high," was a widespread mantra. Coca-Cola reached 46x earnings at the height of the bubble in mid-1972 – 2.4x the p/e on the S&P 500. From there it fell 65% over the next year and a half.

A: First, saying a high p/e alone shouldn't stop you from owning something doesn't mean there's no price too high. It simply means that no single metric can hold the key to investment decisions, and the price of something should be weighed against its fundamental potential. Coke may have been overvalued in 1972 at its p/e of 46. In particular, since it dealt in a physical product and required incremental capital to grow,

it didn't have potential for exponential growth. But note that Coke holders did earn a compound return of 16% percent a year for 26 years even if they bought at the 1972 pre-crash high. So, even without the growth prospects of today's best businesses, companies that can compound earnings at high rates can merit very high p/e ratios.

H: Aren't you concerned that if the leading stocks of today go out of style, you could see XYZ down a third or more?

A: Stocks can go in and out of style, causing their prices to fluctuate wildly. And when a group is in vogue, it may be more likely to experience a reversal. But, at the end of the day, all I care about is this specific company and its long-term potential which, even when using conservative assumptions, I find to be immense relative to its current price. Seeing it fall wouldn't be fun, but I think selling here and missing out on part of that future would be far worse. Some years XYZ may do well, and some years it may do poorly (even perhaps very poorly). But if I'm right, I think it has a great long-term future ahead of it. The only way to be sure we participate in that future is to hold on throughout. And, by the way, if you don't sell, you get to compound without paying capital gains taxes until the end.

H: You run a concentrated portfolio. XYZ was a big position when you invested, and it's even bigger today, given the appreciation. Intelligent investors concentrate portfolios and hold on to take advantage of what they know, but they diversify holdings and sell as things rise to limit the potential damage from what they don't know. Hasn't the growth in this position put our portfolio out of whack in that regard?

A: Perhaps that's true, depending on your goals. But trimming would mean selling something I feel immense comfort with based on my bottoms-up assessment and moving into something I feel less good about or know less well (or cash). To me, it's far better to own a small number of things about which I feel strongly. I'll only have a few good insights over my lifetime, so I have to maximize the few I have.

H: Isn't there any point where you'd begin to sell?

A: In theory there is, but it largely depends on (a) whether the fundamentals are playing out as I hope and (b) how this opportunity compares to the others that are available, taking into account my high level of comfort with this one.

H: If there's a point at which you'd start to sell, what is it? Isn't setting a target price based on intrinsic value an important part of value investing?

A: This company can't be valued with a single number – and it's not a mature company with a fixed value I'm trying to capture – so I can't tell you where I'd start to sell. There are a lot of moving parts; most importantly, it has very strong management that I believe will continue to leverage the company's strong position in the marketplace to develop new avenues of growth. I can't say what those will be, or how they'll be valued, but I'm confident the team will continue to add value. Amazon is the classic example; it created a completely new business out of nothing, AWS, that today accounts for a large percentage of the company's total market value. Selling should be a function of watching how the future develops relative to your expectations and weighing the opportunity as it stands at any point in time against whatever else is out there.

H: Okay. I'm convinced. I hope you hold on!

Memo to: Oaktree Clients

From: Howard Marks

Re: I Beg to Differ

I've written many times about having joined the investment industry in 1969, when the "Nifty Fifty" stocks were in full flower. My first employer, First National City Bank, as well as many of the other "money-center banks" (the leading investment managers of the day), were enthralled with these companies, with their powerful business models and flawless prospects. Sentiment surrounding their stocks was uniformly positive, and portfolio managers found great safety in numbers. For example, a common refrain at the time was "you can't be fired for buying IBM," the era's quintessential growth company.

I've also written extensively about the fate of these stocks. In 1973-74, the OPEC oil embargo and the resultant recession took the S&P 500 Index down a total of 47%. And many of the Nifty Fifty, for which it had been thought that "no price was too high," did far worse, falling from peak p/e ratios of 60-90 to trough multiples in the single digits. Thus, their devotees lost almost all of their money in the stocks of companies that "everyone knew" were great. This was my first chance to see what can happen to assets that are on what I call "the pedestal of popularity."

In 1978, I was asked to move to the bank's bond department to start funds in convertible bonds and, shortly thereafter, high yield bonds. Now I was investing in securities most fiduciaries considered "uninvestable" and which practically no one knew about, cared about, or deemed desirable . . . and I was making money steadily and safely. **I quickly recognized that my strong performance resulted in large part from precisely that fact: I was investing in securities that practically no one knew about, cared about, or deemed desirable.** This brought home the key money-making lesson of the Efficient Market Hypothesis, which I had been introduced to at the University of Chicago Business School: If you seek superior investment results, you have to invest in things that others haven't flocked to and caused to be fully valued. **In other words, you have to do something different.**

The Essential Difference

In 2006, I wrote a memo called *Dare to Be Great*. It was mostly about having high aspirations, and it included a rant against conformity and investment bureaucracy, as well as an assertion that the route to superior returns by necessity runs through unconventionality. The element of that memo that people still talk to me about is a simple two-by-two matrix:

	Conventional Behavior	Unconventional Behavior
Favorable Outcomes	Average good results	Above average results
Unfavorable Outcomes	Average bad results	Below average results

Here's how I explained the situation:

Of course, it's not easy and clear-cut, but I think it's the general situation. If your behavior and that of your managers is conventional, you're likely to get conventional results – either good or bad. Only if the behavior is unconventional is your performance likely to be unconventional . . . and only if the judgments are superior is your performance likely to be above average.

The consensus opinion of market participants is baked into market prices. Thus, if investors lack insight that is superior to the average of the people who make up the consensus, they should expect average risk-adjusted performance.

Many years have passed since I wrote that memo, and the investing world has gotten a lot more sophisticated, but the message conveyed by the matrix and the accompanying explanation remains unchanged. Talk about simple – in the memo, I reduced the issue to a single sentence: **“This just in: You can't take the same actions as everyone else and expect to outperform.”**

The best way to understand this idea is by thinking through a highly logical and almost mathematical process (greatly simplified, as usual, for illustrative purposes):

- A certain (but unascertainable) number of dollars will be made over any given period by all investors collectively in an individual stock, a given market, or all markets taken together. That amount will be a function of (a) how companies or assets fare in fundamental terms (e.g., how their profits grow or decline) and (b) how people feel about those fundamentals and treat asset prices.
- On average, all investors will do average.
- If you're happy doing average, you can simply invest in a broad swath of the assets in question, buying some of each in proportion to its representation in the relevant universe or index. By engaging in average behavior in this way, you're guaranteed average performance. (Obviously, this is the idea behind index funds.)
- If you want to be above average, you have to depart from consensus behavior. You have to overweight some securities, asset classes, or markets and underweight others. **In other words, you have to do something different.**
- The challenge lies in the fact that (a) market prices are the result of everyone's collective thinking and (b) it's hard for any individual to consistently figure out when the consensus is wrong and an asset is priced too high or too low.
- **Nevertheless, “active investors” place active bets in an effort to be above average.**
 - Investor A decides stocks as a whole are too cheap, and he sells bonds in order to overweight stocks. Investor B thinks stocks are too expensive, so she moves to an underweighting by selling some of her stocks to Investor A and putting the proceeds into bonds.
 - Investor X decides a certain stock is too cheap and overweights it, buying from investor Y, who thinks it's too expensive and therefore wants to underweight it.
- **It's essential to note that in each of the above cases, one investor is right and the other is wrong.** Now go back to the first bullet point above: Since the total dollars earned by all investors collectively are fixed in amount, all active bets, taken together, constitute a zero-sum game (or negative-sum after commissions and other costs). The investor who's right earns an above average return, and by definition the one who's wrong earns a below average return.
- **Thus, every active bet placed in the pursuit of above average returns carries with it the risk of below average returns.** There's no way to make an active bet such that you'll win if it works

but not lose if it doesn't. Financial innovations are often described as offering some version of this impossible bargain, but they invariably fail to live up to the hype.

- **The bottom line of the above is simple: You can't hope to earn above average returns if you don't place active bets, but if your active bets are wrong, your return will be below average.**

Investing strikes me as being very much like golf, where playing conditions and the performance of competitors can change from day to day, as can the placement of the holes. On some days, one approach to the course is appropriate, but on other days, different tactics are called for. To win, you have to either do a better job than others of selecting your approach or executing on it, or both.

The same is true for investors. It's simple: **If you hope to distinguish yourself in terms of performance, you have to depart from the pack. But, having departed, the difference will only be positive if your choice of strategies and tactics is correct and/or you're able to execute better.**

Second-Level Thinking

In 2009, when Columbia Business School Publishing was considering whether to publish my book *The Most Important Thing*, they asked to see a sample chapter. As has often been my experience, I sat down and described a concept I hadn't previously written about or named. That description became the book's first chapter, addressing one of its most important topics: second-level thinking. It's certainly the concept from the book that people ask me about most often.

The idea of second-level thinking builds on what I wrote in *Dare to Be Great*. First, I repeated my view that success in investing means doing better than others. All active investors (and certainly money managers hoping to earn a living) are driven by the pursuit of superior returns.

But that universality also makes beating the market a difficult task. Millions of people are competing for each dollar of investment gain. Who'll get it? The person who's a step ahead. In some pursuits, getting up to the front of the pack means more schooling, more time in the gym or the library, better nutrition, more perspiration, greater stamina or better equipment. But in investing, where these things count for less, it calls for more perceptive thinking . . . at what I call the second level.

The basic idea behind second-level thinking is easily summarized: **In order to outperform, your thinking has to be different and better.**

Remember, your goal in investing isn't to earn average returns; you want to do better than average. Thus, your thinking has to be better than that of others – both more powerful and at a higher level. Since other investors may be smart, well informed and highly computerized, you must find an edge they don't have. You must think of something they haven't thought of, see things they miss, or bring insight they don't possess. You have to react differently and behave differently. **In short, being right may be a necessary condition for investment success, but it won't be sufficient. You have to be more right than others . . . which by definition means your thinking has to be different.**

Having made the case, I went on to distinguish second-level thinkers from those who operate at the first level:

First-level thinking is simplistic and superficial, and just about everyone can do it (a bad sign for anything involving an attempt at superiority). All the first-level thinker needs is an opinion about the future, as in “The outlook for the company is favorable, meaning the stock will go up.”

Second-level thinking is deep, complex, and convoluted. The second-level thinker takes a great many things into account:

- What is the range of likely future outcomes?
- What outcome do I think will occur?
- What’s the probability I’m right?
- What does the consensus think?
- How does my expectation differ from the consensus?
- How does the current price for the asset comport with the consensus view of the future, and with mine?
- Is the consensus psychology that’s incorporated in the price too bullish or bearish?
- What will happen to the asset’s price if the consensus turns out to be right, and what if I’m right?

The difference in workload between first-level and second-level thinking is clearly massive, and the number of people capable of the latter is tiny compared to the number capable of the former.

First-level thinkers look for simple formulas and easy answers. Second-level thinkers know that success in investing is the antithesis of simple.

Speaking about difficulty reminds me of an important idea that arose in my discussions with my son Andrew during the pandemic (described in the memo *Something of Value*, published in January 2021). In the memo’s extensive discussion of how efficient most markets have become in recent decades, Andrew makes a terrific point: **“Readily available quantitative information with regard to the present cannot be the source of superior performance.”** After all, everyone has access to this type of information – with regard to public U.S. securities, that’s the whole point of the SEC’s Reg FD (for fair disclosure) – and nowadays all investors should know how to manipulate data and run screens.

So, then, how can investors who are intent on outperforming hope to reach their goal? As Andrew and I said on a podcast where we discussed *Something of Value*, they have to go beyond readily available quantitative information with regard to the present. Instead, their superiority has to come from an ability to:

- better understand **the significance of the published numbers**,
- better assess **the qualitative aspects of the company**, and/or
- better divine **the future**.

Obviously, none of these things can be determined with certainty, measured empirically, or processed using surefire formulas. Unlike present-day quantitative information, there’s no source you can turn to for easy answers. They all come down to judgment or insight. Second-level thinkers who have better

judgment are likely to achieve superior returns, and those who are less insightful are likely to generate inferior performance.

This all leads me back to something Charlie Munger told me around the time *The Most Important Thing* was published: “It’s not supposed to be easy. Anyone who finds it easy is stupid.” **Anyone who thinks there’s a formula for investing that guarantees success (and that they can possess it) clearly doesn’t understand the complex, dynamic, and competitive nature of the investing process.** The prize for superior investing can amount to a lot of money. In the highly competitive investment arena, it simply can’t be easy to be the one who pockets the extra dollars.

Contrarianism

There’s a concept in the investing world that’s closely related to being different: contrarianism. “The investment herd” refers to the masses of people (or institutions) that drive security prices one way or the other. It’s their actions that take asset prices to bull market highs and sometimes bubbles and, in the other direction, to bear market territory and occasional crashes. At these extremes, which are invariably overdone, it’s essential to act in a contrary fashion.

Joining in the swings described above causes people to own or buy assets at high prices and to sell or fail to buy at low prices. For this reason, it can be important to part company with the herd and behave in a way that’s contrary to the actions of most others.

Contrarianism received its own chapter in *The Most Important Thing*. Here’s how I set forth the logic:

- Markets swing dramatically, from bullish to bearish, and from overpriced to underpriced.
- Their movements are driven by the actions of “the crowd,” “the herd,” and “most people.” Bull markets occur because more people want to buy than sell, or the buyers are more highly motivated than the sellers. The market rises as people switch from being sellers to being buyers, and as buyers become even more motivated and the sellers less so. (If buyers didn’t predominate, the market wouldn’t be rising.)
- Market extremes represent inflection points. These occur when bullishness or bearishness reaches a maximum. Figuratively speaking, a top occurs when the last person who will become a buyer does so. Since every buyer has joined the bullish herd by the time the top is reached, bullishness can go no further, and the market is as high as it can go. Buying or holding is dangerous.
- Since there’s no one left to turn bullish, the market stops going up. And if the next day one person switches from buyer to seller, it will start to go down.
- **So at the extremes, which are created by what “most people” believe, most people are wrong.**
- Therefore, the key to investment success has to lie in doing the opposite: in diverging from the crowd. Those who recognize the errors that others make can profit enormously from contrarianism.

To sum up, if the extreme highs and lows are excessive and the result of the concerted, mistaken actions of most investors, then it’s essential to leave the crowd and be a contrarian.

In his 2000 book, *Pioneering Portfolio Management*, David Swensen, the former chief investment officer of Yale University, explained why investing institutions are vulnerable to conformity with current

consensus belief and why they should instead embrace contrarianism. (For more on Swensen's approach to investing, see "A Case in Point" below.) He also stressed the importance of building infrastructure that enables contrarianism to be employed successfully:

Unless institutions maintain contrarian positions through difficult times, the resulting damage imposes severe financial and reputational costs on the institution.

Casually researched, consensus-oriented investment positions provide little prospect for producing superior results in the intensely competitive investment management world.

Unfortunately, overcoming the tendency to follow the crowd, while necessary, proves insufficient to guarantee investment success . . . While courage to take a different path enhances chances for success, investors face likely failure unless a thoughtful set of investment principles undergirds the courage.

Before I leave the subject of contrarianism, I want to make something else very clear. First-level thinkers – to the extent they're interested in the concept of contrarianism – might believe contrarianism means doing the opposite of what most people are doing, so selling when the market rises and buying when it falls. But this overly simplistic definition of contrarianism is unlikely to be of much help to investors. Instead, the understanding of contrarianism itself has to take place at a second level.

In *The Most Important Thing Illuminated*, an annotated edition of my book, four professional investors and academics provided commentary on what I had written. My good friend Joel Greenblatt, an exceptional equity investor, provided a very apt observation regarding knee-jerk contrarianism: ". . . just because no one else will jump in front of a Mack truck barreling down the highway doesn't mean that you should." In other words, the mass of investors aren't wrong all the time, or wrong so dependably that it's always right to do the opposite of what they do. Rather, to be an effective contrarian, you have to figure out:

- what the herd is doing;
- why it's doing it;
- what's wrong, if anything, with what it's doing; and
- what you should do about it.

Like the second-level thought process laid out in bullet points on page four, intelligent contrarianism is deep and complex. It amounts to much more than simply doing the opposite of the crowd. **Nevertheless, good investment decisions made at the best opportunities – at the most overdone market extremes – invariably include an element of contrarian thinking.**

The Decision to Risk Being Wrong

There are only so many topics I find worth writing about, and since I know I'll never know all there is to know about them, I return to some from time to time and add to what I've written previously. Thus, in 2014, I followed up on 2006's *Dare to Be Great* with a memo creatively titled *Dare to Be Great II*. To begin, I repeated my insistence on the importance of being different:

If your portfolio looks like everyone else's, you may do well, or you may do poorly, *but you can't do different*. And being different is absolutely essential if you want a chance at being superior. . . .

I followed that with a discussion of the challenges associated with being different:

Most great investments begin in discomfort. The things most people feel good about – investments where the underlying premise is widely accepted, the recent performance has been positive, and the outlook is rosy – are unlikely to be available at bargain prices. Rather, bargains are usually found among things that are controversial, that people are pessimistic about, and that have been performing badly of late.

But then, perhaps most importantly, I took the idea a step further, moving from daring to be different to its natural corollary: daring to be wrong. Most investment books are about how to be right, not the possibility of being wrong. And yet, the would-be active investor must understand that every attempt at success by necessity carries with it the chance for failure. The two are absolutely inseparable, as I described at the top of page three.

In a market that is even moderately efficient, everything you do to depart from the consensus in pursuit of above average returns has the potential to result in below average returns if your departure turns out to be a mistake. Overweighting something versus underweighting it; concentrating versus diversifying; holding versus selling; hedging versus not hedging – these are all double-edged swords. You gain when you make the right choice and lose when you're wrong.

One of my favorite sayings came from a pit boss at a Las Vegas casino: “The more you bet, the more you win when you win.” Absolutely inarguable. But the pit boss conveniently omitted the converse: “The more you bet, the more you lose when you lose.” Clearly, those two ideas go together.

In a presentation I occasionally make to institutional clients, I employ PowerPoint animation to graphically portray the essence of this situation:

- A bubble drops down, containing the words “Try to be right.” That’s what active investing is all about. But then a few more words show up in the bubble: “Run the risk of being wrong.” The bottom line is that you simply can’t do the former without also doing the latter. They’re inextricably intertwined.
- Then another bubble drops down, with the label “Can’t lose.” There are can’t-lose strategies in investing. If you buy T-bills, you can’t have a negative return. If you invest in an index fund, you can’t underperform the index. But then two more words appear in the second bubble: “Can’t win.” People who use can’t-lose strategies by necessity surrender the possibility of winning. T-bill investors can’t earn more than the lowest of yields. Index fund investors can’t outperform.
- And that brings me to the assignment I imagine receiving from unenlightened clients: “Just apply the first set of words from each bubble: Try to outperform while employing can’t-lose strategies.” But that combination happens to be unavailable.

The above shows that active investing carries a cost that goes beyond commissions and management fees: heightened risk of inferior performance. **Thus, every investor has to make a conscious decision about which course to follow. Pursue superior returns at the risk of coming in behind the pack, or hug the consensus position and ensure average performance.** It should be clear that you can’t hope to earn superior returns if you’re unwilling to bear the risk of sub-par results.

And that brings me to my favorite fortune cookie, which I received with dessert 40-50 years ago. The message inside was simple: **The cautious seldom err or write great poetry.** In my college classes in Japanese studies, I learned about the *koan*, which *Oxford Languages* defines as “a paradoxical anecdote or riddle, used in Zen Buddhism to demonstrate the inadequacy of logical reasoning and to provoke

enlightenment.” I think of my fortune that way because it raises a question I find paradoxical and capable of leading to enlightenment.

But what does the fortune mean? That you should be cautious, because cautious people seldom make mistakes? Or that you shouldn’t be cautious, because cautious people rarely accomplish great things?

The fortune can be read both ways, and both conclusions seem reasonable. Thus the key question is, “Which meaning is right for you?” As an investor, do you like the idea of avoiding error, or would you rather try for superiority? Which path is more likely to lead to success as you define it, and which is more feasible for you? You can follow either path, but clearly not both simultaneously.

Thus, investors have to answer what should be a very basic question: Will you (a) strive to be above average, which costs money, is far from sure to work, and can result in your being below average, or (b) accept average performance – which helps you reduce those costs but also means you’ll have to look on with envy as winners report mouth-watering successes. Here’s how I put it in *Dare to Be Great II*:

How much emphasis should be put on diversifying, avoiding risk, and ensuring against below-pack performance, and how much on sacrificing these things in the hope of doing better?

And here’s how I described some of the considerations:

Unconventional behavior is the only road to superior investment results, but it isn’t for everyone. In addition to superior skill, successful investing requires the ability to look wrong for a while and survive some mistakes. Thus each person has to assess whether he’s temperamentally equipped to do these things and whether his circumstances – in terms of employers, clients and the impact of other people’s opinions – will allow it . . . when the chips are down and the early going makes him look wrong, as it invariably will.

You can’t have it both ways. And as in so many aspects of investing, there’s no right or wrong, only right or wrong for you.

A Case in Point

The aforementioned David Swensen ran Yale University’s endowment from 1985 until his passing in 2021, an unusual 36-year tenure. He was a true pioneer, developing what has come to be called “the Yale Model” or “the Endowment Model.” He radically reduced Yale’s holdings of public stocks and bonds, and invested heavily in innovative, illiquid strategies such as hedge funds, venture capital, and private equity at a time when almost no other institutions were doing so. He identified managers in those fields who went on to generate superior results, several of whom earned investment fame. Yale’s resulting performance beat almost all other endowments by miles. In addition, Swensen sent out into the endowment community a number of disciples who produced enviable performance for other institutions. Many endowments emulated Yale’s approach, especially beginning around 2003-04, after these institutions had been punished by the bursting of the tech/Internet bubble. But few if any duplicated Yale’s success. They did the same things, but not nearly as early or as well.

To sum up all the above, I’d say Swensen dared to be different. He did things others didn’t do. He did these things long before most others picked up the thread. He did them to a degree that others didn’t approach. And he did them with exceptional skill. **What a great formula for outperformance.**

In *Pioneering Portfolio Management*, Swensen provided a description of the challenge at the core of investing – especially institutional investing. It’s one of the best paragraphs I’ve ever read and includes a two-word phrase (which I’ve bolded for emphasis) that for me reads like sheer investment poetry. I’ve borrowed it countless times:

... Active management strategies demand uninstitutional behavior from institutions, creating a paradox that few can unravel. Establishing and maintaining an unconventional investment profile requires acceptance of **uncomfortably idiosyncratic** portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom.

As with many great quotes, this one from Swensen says a great deal in just a few words. Let’s parse its meaning:

Idiosyncratic – When all investors love something, it’s likely their buying will render it highly priced. When they hate it, their selling will probably cause it to become cheap. Thus, it’s preferable to buy things most people hate and sell things most people love. Such behavior is by definition highly idiosyncratic (i.e., “eccentric,” “quirky,” or “peculiar”).

Uncomfortable – The mass of investors take the positions they take for reasons they find convincing. We witness the same developments they do and are impacted by the same news. Yet, we realize that if we want to be above average, our reaction to those inputs – and thus our behavior – should in many instances be different from that of others. Regardless of the reasons, if millions of investors are doing A, it may be quite uncomfortable to do B.

And if we do bring ourselves to do B, our action is unlikely to prove correct right away. After we’ve sold a market darling because we think it’s overvalued, its price probably won’t start to drop the next day. Most of the time, the hot asset you’ve sold will keep rising for a while, and sometimes a good while. As John Maynard Keynes said, “Markets can remain irrational longer than you can remain solvent.” And as the old adage goes, “Being too far ahead of your time is indistinguishable from being wrong.” These two ideas are closely related to another great Keynes quote: “Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.” Departing from the mainstream can be embarrassing and painful.

Uninstitutional behavior from institutions – We all know what Swensen meant by the word “institutions”: bureaucratic, hidebound, conservative, conventional, risk-averse, and ruled by consensus; in short, unlikely mavericks. **In such settings, the cost of being different and wrong can be viewed as highly unacceptable relative to the potential benefit from being different and right.** For the people involved, passing up profitable investments (errors of omission) poses far less risk than making investments that produce losses (errors of commission). Thus, investing entities that behave “institutionally” are, by their nature, highly unlikely to engage in idiosyncratic behavior.

Early in his time at Yale, Swensen chose to:

- minimize holdings of public stocks;
- vastly overweight strategies falling under the heading “alternative investments” (although he started to do so well before that label was created);
- in so doing, commit a substantial portion of Yale’s endowment to illiquid investments for which there was no market; and
- hire managers without lengthy track records on the basis of what he perceived to be their investment acumen.

To use his words, these actions probably appeared “downright imprudent in the eyes of conventional wisdom.” Swensen’s behavior was certainly idiosyncratic and uninstitutional, but he understood that the only way to outperform was to risk being wrong, and he accepted that risk with great results.

One Way to Diverge from the Pack

To conclude, I want to describe a recent occurrence. In mid-June, we held the London edition of Oaktree’s biannual conference, which followed on the heels of the Los Angeles version. My assigned topic at both conferences was the market environment. I faced a dilemma while preparing for the London conference, because so much had changed between the two events: On May 19, the S&P 500 was at roughly 3,900, but by June 21 it was at approximately 3,750, down almost 4% in roughly a month. Here was my issue: Should I update my slides, which had become somewhat dated, or reuse the LA slides to deliver a consistent message to both audiences?

I decided to use the LA slides as the jumping-off point for a discussion of how much things had changed in that short period. The key segment of my London presentation consisted of a stream-of-consciousness discussion of the concerns of the day. I told the attendees that I pay close attention to the questions people ask most often at any given point in time, as the questions tell me what’s on people’s minds. And the questions I’m asked these days overwhelmingly surround:

- the outlook for **inflation**,
- the extent to which the Federal Reserve will raise **interest rates** to bring it under control, and
- whether doing so will produce a soft landing or a **recession** (and if the latter, how bad).

Afterwards, I wasn’t completely happy with my remarks, so I rethought them over lunch. And when it was time to resume the program, I went up on stage for another two minutes. Here’s what I said:

All the discussion surrounding inflation, rates, and recession falls under the same heading: the short term. And yet:

- We can’t know much about the short-term future (or, I should say, we can’t dependably know more than the consensus).
- If we have an opinion about the short term, we can’t (or shouldn’t) have much confidence in it.
- If we reach a conclusion, there’s not much we can do about it – most investors can’t and won’t meaningfully revamp their portfolios based on such opinions.
- **We really shouldn’t care about the short term – after all, we’re investors, not traders.**

I think it’s the last point that matters most. The question is whether you agree or not.

For example, when asked whether we’re heading toward a recession, my usual answer is that whenever we’re not in a recession, we’re heading toward one. The question is when. I believe we’ll always have cycles, which means recessions and recoveries will always lie ahead. **Does the fact that there’s a recession ahead mean we should reduce our investments or alter our portfolio allocation? I don’t think so.** Since 1920, there have been 17 recessions as well as one Great Depression, a World War and several smaller wars, multiple periods of worry about global cataclysm, and now a pandemic. And yet, as I mentioned in my January memo, *Selling Out*, the S&P 500 has returned about 10½% a year on average over that century-plus. Would investors have improved their performance by getting in and out of the market to avoid those problem spots . . . or would doing so have diminished it? Ever since I quoted Bill Miller in that memo, I’ve been impressed by his formulation that “it’s time, not timing” that leads to real

wealth accumulation. Thus, most investors would be better off ignoring short-term considerations if they want to enjoy the benefits of long-term compounding.

Two of the six tenets of Oaktree's investment philosophy say (a) we don't base our investment decisions on macro forecasts and (b) we're not market timers. **I told the London audience our main goal is to buy debt or make loans that will be repaid and to buy interests in companies that will do well and make money. None of that has anything to do with the short term.**

From time to time, when we consider it warranted, we do vary our balance between aggressiveness and defensiveness, primarily by altering the size of our closed-end funds, the pace at which we invest, and the level of risk we'll accept. But we do these things on the basis of current market conditions, not expectations regarding future events.

Everyone at Oaktree has opinions on the short-run phenomena mentioned above. We just don't bet heavily that they're right. During our recent meetings with clients in London, Bruce Karsh and I spent a lot of time discussing the significance of the short-term concerns. Here's how he followed up in a note to me:

... Will things be as bad or worse or better than expected? Unknowable ... and equally unknowable how much is priced in, i.e. what the market is truly expecting. One would think a recession is priced in, but many analysts say that's not the case. This stuff is hard...!!!

Bruce's comment highlights another weakness of having a short-term focus. Even if we think we know what's in store in terms of things like inflation, recessions, and interest rates, there's absolutely no way to know how market prices comport with those expectations. This is more significant than most people realize. If you've developed opinions regarding the issues of the day, or have access to those of pundits you respect, take a look at any asset and ask yourself whether it's priced rich, cheap, or fair in light of those views. That's what matters when you're pursuing investments that are reasonably priced.

The possibility – or even the fact – that a negative event lies ahead isn't in itself a reason to reduce risk; investors should only do so if the event lies ahead and it isn't appropriately reflected in asset prices. But, as Bruce says, there's usually no way to know.

At the beginning of my career, we thought in terms of investing in a stock for five or six years; something held for less than a year was considered a short-term trade. One of the biggest changes I've witnessed since then is the incredible shortening of time horizons. Money managers know their returns in real time, and many clients are fixated on how their managers did in the most recent quarter.

No strategy – and no level of brilliance – will make every quarter or every year a successful one. Strategies become more or less effective as the environment changes and their popularity waxes and wanes. In fact, highly disciplined managers who hold most rigorously to a given approach will tend to report the worst performance when that approach goes out of favor. Regardless of the appropriateness of a strategy and the quality of investment decisions, every portfolio and every manager will experience good and bad quarters and years that have no lasting impact and say nothing about the manager's ability. Often this poor performance will be due to unforeseen and unforeseeable developments.

Thus, what does it mean that someone or something has performed poorly for a while? No one should fire managers or change strategies based on short-term results. Rather than taking capital away from underperformers, clients should consider increasing their allocations in the spirit of contrarianism (but

few do). **I find it incredibly simple: If you wait at a bus stop long enough, you're guaranteed to catch a bus, but if you run from bus stop to bus stop, you may never catch a bus.**

I believe most investors have their eye on the wrong ball. One quarter's or one year's performance is meaningless at best and a harmful distraction at worst. But most investment committees still spend the first hour of every meeting discussing returns in the most recent quarter and the year to date. **If everyone else is focusing on something that doesn't matter and ignoring the thing that does, investors can profitably diverge from the pack by blocking out short-term concerns and maintaining a laser focus on long-term capital deployment.**

A final quote from *Pioneering Portfolio Management* does a great job of summing up how institutions can pursue the superior performance most want. (Its concepts are also relevant to individuals):

Appropriate investment procedures contribute significantly to investment success, allowing investors to pursue profitable long-term contrarian investment positions. By reducing pressures to produce in the short run, liberated managers gain the freedom to create portfolios positioned to take advantage of opportunities created by short-term players. By encouraging managers to make potentially embarrassing out-of-favor investments, fiduciaries increase the likelihood of investment success.

Oaktree is probably in the extreme minority in its relative indifference to macro projections, especially regarding the short term. Most investors fuss over expectations regarding short-term phenomena, but I wonder whether they actually do much about their concerns, and whether it helps.

Many investors – and especially institutions such as pension funds, endowments, insurance companies, and sovereign wealth funds, all of which are relatively insulated from the risk of sudden withdrawals – have the luxury of being able to focus exclusively on the long term . . . if they will take advantage of it. Thus, my suggestion to you is to depart from the investment crowd, with its unhelpful preoccupation with the short term, and to instead join us in focusing on the things that really matter.

July 26, 2022

Memo to: Oaktree Clients
From: Howard Marks
Re: The Illusion of Knowledge

I've been expressing my disregard for forecasts for almost as long as I've been writing my memos, starting with *The Value of Predictions, or Where'd All This Rain Come From* in February 1993. Over the years since then, I've explained at length why I'm not interested in forecasts – a few of my favorite quotes echoing my disdain head the sections below – but I've never devoted a memo to explaining why making helpful macro forecasts is so difficult. So here it is.

Food for Thought

There are two kinds of forecasters: those who don't know, and those who don't know they don't know.

– John Kenneth Galbraith

Shortly after putting the finishing touches on *I Beg to Differ* in July, I attended a lunch with a number of experienced investors, plus a few people from outside the investment industry. It wasn't organized as a social occasion but rather an opportunity for those present to exchange views regarding the investment environment.

At one point, the host posed a series of questions: What's your expectation regarding inflation? Will there be a recession, and if so, how bad? How will the war in Ukraine end? What do you think is going to happen in Taiwan? What's likely to be the impact of the 2022 and '24 U.S. elections? I listened as a variety of opinions were expressed.

Regular readers of my memos can imagine what went through my mind: "Not one person in this room is an expert on foreign affairs or politics. No one present has particular knowledge of these topics, and certainly not more than the average intelligent person who read this morning's news." None of the thoughts expressed, even on economic matters, seemed much more persuasive than the others, and I was absolutely convinced that none were capable of improving investment results. And that's the point.

It was that lunch that started me thinking about writing yet another memo on the futility of macro forecasting. Soon thereafter a few additional inputs arrived – a book, a piece in *Bloomberg Opinion*, and a newspaper article – all of which supported my thesis (or perhaps played to my "confirmation bias" – i.e., the tendency to embrace and interpret new information in a manner that confirms one's preexisting views). Together, the lunch and these items inspired this memo's theme: **the reasons why forecasts are rarely helpful**.

In order to produce something useful – be it in manufacturing, academia, or even the arts – you must have a reliable **process** capable of converting the required **inputs** into the desired **output**. The problem, in short, is that I don't think there can be a process capable of consistently turning the large number of variables associated with economies and financial markets (the inputs) into a useful macro forecast (the output).

The Machine

The greatest enemy of knowledge is not ignorance, it is the illusion of knowledge.

– Daniel J. Boorstin

In my first decade or so working at First National City Bank, a word was in vogue that I haven't heard in a long time: econometrics. This is the practice of looking for relationships within economic data that can lead to valid forecasts. Or, to simplify, I'd say econometrics is concerned with building a mathematical model of an economy. Econometricians were heard from a great deal in the 1970s, but I don't believe they are any longer. I take that to mean their models didn't work.

Forecasters have no choice but to base their judgments on models, be they complex or informal, mathematical or intuitive. Models, by definition, consist of assumptions: "If A happens, then B will happen." In other words, relationships and responses. But for us to willingly employ a model's output, we have to believe the model is reliable. When I think about modeling an economy, my first reaction is to think about how incredibly complicated it is.

The U.S., for example, has a population of around 330 million. All but the very youngest and perhaps the very oldest are participants in the economy. Thus, there are hundreds of millions of consumers, plus millions of workers, producers, and intermediaries (many people fall into more than one category). To predict the path of the economy, you have to forecast the behavior of these people – if not for every participant, then at least for group aggregates.

A real simulation of the U.S. economy would have to deal with billions of interactions or nodes, including interactions with suppliers, customers, and other market participants around the globe. Is it possible to do this? Is it possible, for example, to predict how consumers will behave (a) if they receive an additional dollar of income (what will be the "marginal propensity to consume"?); (b) if energy prices rise, squeezing other household budget categories; (c) if the price for one good rises relative to others (will there be a "substitution effect"?); or (d) if the geopolitical arena is roiled by events continents away?

Clearly, this level of complexity necessitates the frequent use of simplifying assumptions. For example, it would make modeling easier to be able to assume that consumers won't buy B in place of A if B isn't either better or cheaper (or both). And it would help to assume that producers won't price X below Y if it doesn't cost less to produce X than Y. But what if consumers are attracted to the prestige of B despite (or even because of) its higher price? And what if X has been developed by an entrepreneur who's willing to lose money for a few years to gain market share? Is it possible for a model to anticipate the consumer's decision to pay up and the entrepreneur's decision to make less (or even lose) money?

Further, a model will have to predict how each group of participants in the economy will behave in a variety of environments. But the vagaries are manifold. For example, consumers may behave one way at one moment and a different way at another similar moment. Given the large number of variables involved, it seems impossible that two "similar" moments will play out exactly the same way, and thus that we'll witness the same behavior on the part of participants in the economy. Among other things, participants' behavior will be influenced by their psychology (or should I say their emotions?), and their psychology can be affected by qualitative, non-economic developments. How can those be modeled?

How can a model of an economy be comprehensive enough to deal with things that haven't been seen before, or haven't been seen in modern times (meaning under comparable circumstances)? This is yet another example of why a model simply can't replicate something as complex as an economy.

Of course, a prime example of this is the Covid-19 pandemic. It caused much of the world's economy to be shut down, turned consumer behavior on its head, and inspired massive government largesse. What aspect of a pre-existing model would have enabled it to anticipate the pandemic's impact? Yes, we had a pandemic in 1918, but the circumstances were so different (no iPhones, Zoom calls, etc. ad infinitum) as to render economic events during that time of little or no relevance to 2020.

In addition to the matter of complexity and the difficulty of capturing psychological fluctuations and dynamic processes, think about the limitations that bear on an attempt to predict something that can't be expected to remain unchanged. Shortly after starting on this memo, I received my regular weekly edition of Morgan Housel's always-brilliant newsletter. One of the articles described a number of observations from other arenas that have relevance to our world of economics and investing. Here are two, borrowed from the field of statistics, that I think are pertinent to the discussion of economic models and forecasts ("Little Ways the World Works," Morgan Housel, *Collaborative Fund*, July 20, 2022):

Stationarity: An assumption that the past is a statistical guide to the future, based on the idea that the big forces that impact a system don't change over time. If you want to know how tall to build a levee, look at the last 100 years of flood data and assume the next 100 years will be the same. Stationarity is a wonderful, science-based concept that works right up until the moment it doesn't. It's a major driver of what matters in economics and politics. [But in our world,] "Things that have never happened before happen all the time," says Stanford professor Scott Sagan.

Cromwell's rule: Never say something cannot occur If something has a one-in-a-billion chance of being true, and you interact with billions of things during your lifetime, you are nearly assured to experience some astounding surprises, and should always leave open the possibility of the unthinkable coming true.

Stationarity might be fairly assumed in the realm of the physical sciences. For example, thanks to the law of universal gravitation, under given atmospheric conditions, the speed at which an object falls can always be counted on to accelerate at the same rate. It always has, and it always will. But few processes can be counted on to be stationary in our world, especially given the role played by psychology, emotion, and human behavior, and their propensity to vary over time.

Take, for example, the relationship between unemployment and inflation. For roughly the last 60 years, economists relied on the Phillips curve, which holds that wage inflation will rise as the unemployment rate declines, because when there are fewer idle workers on the sidelines, employees gain bargaining power and can successfully negotiate for higher wages. It was also believed for decades that an unemployment rate around 5.5% indicated "full employment." But unemployment fell below 5.5% in March 2015 (and reached a 50-year low of 3.5% in September 2019), yet there was no significant increase in inflation (in wages or otherwise) until 2021. So the Phillips curve described an important relationship that was built into economic models for decades but, seemingly, didn't apply over much of the last decade.

Cromwell's rule is also relevant. Unlike in the physical sciences, in markets and economies there's very little that absolutely has to happen or definitely can't happen. Thus, in my book *Mastering the Market Cycle*, I listed seven terms that investors should purge from their vocabularies: "never," "always," "forever," "can't," "won't," "will," and "has to." But if it's true that those words have to be discarded, then so too must the idea that one can build a model that can dependably predict the macro future. In other words, very little is immutable in our world.

The unpredictability of behavior is a favorite topic of mine. Noted physicist Richard Feynman once said, “Imagine how much harder physics would be if electrons had feelings.” The rules of physics are reliable precisely because electrons always do what they’re supposed to do. They never forget to perform. They never rebel. They never go on strike. They never innovate. They never behave in a contrary manner.

But none of these things is true of the participants in an economy, and for that reason their behavior is unpredictable. And if the participants’ behavior is unpredictable, how can the workings of an economy be modeled?

What we’re talking about here is the future, and there’s simply no way to deal with the future that doesn’t require the making of assumptions. Small errors in assumptions regarding the economic environment and small changes in participants’ behavior can make differences that are highly problematic. As mathematician and meteorologist Edward Lorenz famously suggested, “The flapping of a butterfly’s wings in Brazil could set off a tornado in Texas.” (Historian Niall Ferguson references this remark in the article I discuss below.)

Thinking about all the above, can we ever consider a model of an economy to be reliable? Can a model replicate reality? Can it describe the millions of participants and their interactions? Are the processes it attempts to model dependable? Can the processes be reduced to mathematics? Can mathematics capture the qualitative nuances of people and their behavior? Can a model anticipate changes in consumer preferences, changes in the behavior of businesses, and participants’ reactions to innovation? In other words, can we trust its output?

Clearly, economic relationships aren’t hard-wired, and economies aren’t governed by schematic diagrams (which models try to simulate). **Thus, for me, the bottom line is that the output from a model may point in the right direction much of the time, when the assumptions aren’t violated. But it can’t always be accurate, especially at critical moments such as inflection points . . . and that’s when accurate predictions would be most valuable.**

The Inputs

No amount of sophistication is going to allay the fact that all of your knowledge is about the past and all your decisions are about the future.

– Ian H. Wilson (former GE executive)

Having considered the incredible complexity of an economy and the need to make simplifying assumptions that decrease any economic model’s accuracy, let’s now think about the inputs a model requires – the raw materials from which forecasts are manufactured. Will the estimated inputs prove valid? Can we know enough about them for the resulting forecast to be meaningful? **Or will we simply be reminded of the ultimate truth about models: “garbage in, garbage out”?** Clearly, no forecast can be better than the inputs on which it’s based.

Here’s what Niall Ferguson wrote in *Bloomberg Opinion* on July 17:

Consider for a moment what we are implicitly asking when we pose the question: Has inflation peaked? We are not only asking about the supply of and demand for 94,000 different commodities, manufactures and services. We are also asking about the future path of interest rates set by the Fed, which – despite the much-vaunted policy of “forward guidance” – is far from certain. We are asking about how long the strength of the dollar will be sustained, as it is currently holding down the price of U.S. imports.

But there's more. We are at the same time implicitly asking how long the war in Ukraine will last, as the disruption caused since February by the Russian invasion has significantly exacerbated energy and food price inflation. We are asking whether oil-producing countries such as Saudi Arabia will respond to pleas from Western governments to pump more crude. . . .

We should probably also ask ourselves what the impact on Western labor markets will be of the latest Covid omicron sub-variant, BA.5. UK data indicate that BA.5 is 35% more transmissible than its predecessor BA.2, which in turn was over 20% more transmissible than the original omicron.

Good luck adding all those variables to your model. It is in fact just as impossible to be sure about the future path of inflation as it is to be sure about the future path of the war in Ukraine and the future path of the Covid pandemic.

I found Ferguson's article so relevant to the subject of this memo that I'm including a link to it here. It makes a lot of important points, although I beg to differ in one regard. Ferguson says above, "It is in fact just as impossible to be sure about the future path of inflation as it is to be sure about the future path of the war in Ukraine and the future path of the Covid pandemic." I think accurately predicting inflation is "more impossible" (if there is such a thing) than predicting the outcomes of the other two, since doing so requires being right about both of those outcomes and a thousand other things. How can anyone possibly get all these things right?

Here's my rough description of the forecasting process from *The Value of Predictions*:

I imagine that for most money managers, the process goes like this: "I predict the economy will do A. If A happens, interest rates should do B. With interest rates of B, the stock market should do C. Under that environment, the best performing sector should be D, and stock E should rise the most." The portfolio expected to do best under that scenario is then assembled.

But how likely is E anyway? Remember that E is conditioned on A, B, C and D. Being right two-thirds of the time would be a great accomplishment in the world of forecasting. But if each of the five predictions has a 67% chance of being right, then there is a 13% probability that all five will be correct and that the stock will perform as expected.

Predicting event E on the basis of assumptions concerning A, B, C and D is what I call single-scenario forecasting. In other words, if what was assumed regarding A, B, C or D turns out to have been erroneous, the forecasted outcome for E is unlikely to materialize. All of the underlying forecasts have to be right in order for E to turn out as predicted, and that's highly improbable. No one can invest intelligently without considering (a) the other possible outcomes for each element, (b) the likelihood of these alternative scenarios, (c) what would have to happen for one of them to be the actual outcome, and (d) what the impact on E would be.

Ferguson's article raises an interesting question about economic modeling: What's to be assumed regarding the general macro environment under which economic participants will operate? **Doesn't this question indicate an insoluble feedback loop: To predict the overall performance of the economy, we need to make assumptions about, for example, consumer behavior. But to predict consumer behavior, don't we need to make assumptions regarding the overall economic environment?**

In *Nobody Knows II* (March 2020), my first memo of the pandemic, I mentioned that in a discussion of the coronavirus, Harvard epidemiologist Marc Lipsitch had said there are (a) facts, (b) informed

extrapolations from analogies to other viruses, and (c) opinion or speculation. This is standard fare when we deal with uncertain events. In the case of economic or market forecasts, we have a vast trove of history and lots of analogous past events from which to extrapolate (neither of which was the case with Covid-19). But even when these things are used as inputs for a well-constructed forecasting machine, they're still highly unlikely to be predictive of the future. They may be useful fodder, or they may be garbage.

To illustrate, people often ask me which of the past cycles I've experienced was most like this one. My answer is that current developments bear a passing resemblance to some past cycles, but there is no absolute parallel. **The differences are profound in every case and outweigh the similarities. And even if we could find an identical prior period, how much reliance should we put on a sample size of one? I'd say not much. Investors rely on historical references (and the forecasts they foster) because they fear that without them they'd be flying blind. But that doesn't make them reliable.**

Unpredictable Influences

Forecasts create the mirage that the future is knowable.

– Peter Bernstein

We can't consider the reasonableness of forecasting without first deciding whether we think our world is one of order or of randomness. Put simply, is it entirely predictable, entirely unpredictable, or something in between? The bottom line for me is that it's in between, but unpredictable enough that most forecasts are unhelpful. And since our world is predictable at some times and unpredictable at others, what good are forecasts if we can't tell which is which?

I learned a new word from reading Ferguson's article: "deterministic." It's defined by *Oxford Languages* as "causally determined by preceding events or natural laws." The world is much simpler when we deal with things that function according to rules . . . like Feynman's electrons. But, clearly, economies and markets aren't governed by natural laws – thanks to the involvement of people – and preceding events may "set the stage" or "tend to repeat," but events rarely unfold in the same way twice. Thus, I believe the processes that constitute the operation of economies and markets aren't deterministic, meaning they aren't predictable.

Further, the inputs clearly are undependable. Many are subject to randomness, such as weather, earthquakes, accidents, and deaths. Others involve political and geopolitical issues – ones we're aware of and ones that haven't yet surfaced.

In his *Bloomberg Opinion* article, Ferguson mentioned the English writer G. K. Chesterton. That reminded me to include a Chesterton quote that I used in *Risk Revisited Again* (June 2015):

The real trouble with this world of ours is not that it is an unreasonable world, nor even that it is a reasonable one. The commonest kind of trouble is that it is nearly reasonable, but not quite. Life is not an illogicality; yet it is a trap for logicians. **It looks just a little more mathematical and regular than it is; its exactitude is obvious, but its inexactitude is hidden; its wildness lies in wait.** (Emphasis added)

Going back to the lunch described on page one, the host opened the proceedings roughly as follows: "In recent years, we've experienced the Covid-19 pandemic, the surprising success of the Fed's rescue actions, and the invasion of Ukraine. This has been a very challenging environment, since all of these

developments arrived out of the blue.” I imagine the implication for him was that the attendees should let themselves off the hook for the inaccuracy of their 2020-22 forecasts and go back to work predicting future events and betting on their judgments. But my reaction was quite different: “The list of events that shaped the current environment is quite extensive. **Doesn’t the fact that no one was able to predict any of them convince those present that they should give up on forecasting?”**

For another example, let’s think back to the fall of 2016. There were two things that almost everyone was sure of: (a) Hillary Clinton would be elected president and (b) if for some reason Donald Trump were elected instead, the markets would tank. Nonetheless, Trump won, and the markets soared. The impact on the economy and markets over the last six years was profound, and **I’m confident no forecast that took a conventional view of the coming 2016 election got the period since then correct.** Again, shouldn’t that be enough to convince people that (a) we don’t know what’s going to happen and (b) we don’t know how the markets will react to what happens?

Do Forecasts Add Value?

It ain’t what you don’t know that gets you into trouble. It’s what you know for sure that just ain’t so.

– Mark Twain

As I mentioned in my recent memo *Thinking About Macro*, in the 1970s we used to describe an economist as “a portfolio manager who never marks to market.” In other words, economists make forecasts; events prove them either wrong or right; they go on to make new forecasts; but they don’t keep track of how often they get it right (or they don’t publish the stats).

Can you imagine hiring a money manager (or being hired, if you are a money manager) without reference to a track record? And yet, economists and strategists stay in business, presumably because there are customers for their forecasts, despite there being no published records.

Are you a consumer of forecasts? Are there forecasters and economists on staff where you work? Or do you subscribe to their publications and invite them in for briefings, as was the case with my previous employers? If so, do you know how often each has been right? Have you found a way to rigorously determine which ones to rely on and which to ignore? Is there a way to quantify their contributions to your investment returns? I ask because I’ve never seen or heard of any research along these lines. The world seems incredibly short on information regarding the value added by macro forecasts, especially given the large number of people involved in this pursuit.

Despite the lack of evidence regarding its value, macro forecasting goes on. Many of the forecasters are part of teams managing equity funds, or they provide advice and forecasts to those teams. What we know for sure is that actively managed equity funds have been losing market share to index funds and other passive vehicles for decades due to the poor performance of active management, and as a result, actively managed funds now account for less than half of the capital in U.S. equity mutual funds. Could the unhelpful nature of macro forecasts be part of the reason?

The only place I know to look for quantification regarding this issue is the performance of so-called macro hedge funds. Hedge Fund Research (HFR) publishes broad hedge fund performance indices as well as a number of sub-indices. Below is the long-term performance of a broad hedge fund index, a macro fund sub-index, and the Standard & Poor’s 500 Index.

	HFRI Hedge Fund Index*	HFRI Macro (Total) Index	S&P 500 Index
5-year annualized return*	5.2%	5.0%	12.8%
10-year annualized return*	5.1	2.8	13.8

* Performance through July 31, 2022. The broad hedge fund index shown is the Fund Weighted Composite Index.

What the table above shows is that, according to HFR, the average hedge fund woefully underperformed the S&P 500 in the period under study, and the average macro fund did considerably worse (especially in the period from 2012 to 2017). Given that investors continue to entrust roughly \$4.5 trillion of capital to hedge funds, they must deliver some benefit other than returns, but it's not obvious what that could be. This seems to be especially true for the macro funds.

To support my opinion regarding forecasts, I'll cite a rare example of self-assessment: a seven-page feature that appeared in the Sunday Opinion section of *The New York Times* on July 24 titled "I Was Wrong." In it, eight *Times* opinion writers opened up about incorrect predictions they made and flawed advice they had given. The most relevant here is Paul Krugman, who wrote a confession titled "I Was Wrong About Inflation." I'll string together some excerpts:

In early 2021, there was an intense debate among economists about the likely consequences of the American Rescue Plan I was on [the side that was less concerned about the impact on inflation]. As it turned out, of course, that was a very bad call. . . .

. . . history wouldn't have led us to expect this much inflation from overheating. So **something was wrong with my model** One possibility is that **history was misleading** Also, disruptions associated with adjusting to the pandemic and its aftermath may still be playing a large role. And of course both Russia's invasion of Ukraine and China's lockdown of major cities have added **a whole new level of disruption**. . . .

In any case, the whole experience has been **a lesson in humility**. Nobody will believe this, but in the aftermath of the 2008 crisis, standard economic models performed pretty well, and I felt comfortable applying these models in 2021. But in retrospect I should have realized that in the face of the new world created by Covid-19, that kind of **extrapolation wasn't a safe bet**. (Emphasis added)

I salute Krugman for this incredible bout of candor (although I have to say I don't remember a lot of 2009-10 market forecasts that were optimistic enough to capture the reality of the subsequent decade). **Krugman's explanation for his error is fine as far as it goes, but I don't see any mention of abstaining from modeling, extrapolating, or forecasting in the future.**

Humility may even be seeping into one of the world's biggest producers of economic forecasts, the U.S. Federal Reserve, home of more than 400 Ph.D. economists. Here's what economist Gary Shilling wrote in *Bloomberg Opinion* on August 22:

The Federal Reserve's forward guidance program has been a disaster, so much so that it has strained the central bank's credibility. Chair Jerome Powell seems to agree that

providing estimates of where the Fed sees interest rates, economic growth and inflation at different points in the future should be junked. . . .

The basic problem with forward guidance is that it depends on data that the Fed had a miserable record of forecasting. It was consistently too optimistic about an economic recovery after the 2007-2009 Great Recession. In September 2014, policy makers forecast real gross domestic product growth in 2015 of 3.40% but were forced to constantly crank their expectations down to 2.10% by September 2015.

The federal funds rate is not a market-determined interest rate but is set and controlled by the Fed, and nobody challenges the central bank. Yet the FOMC members were infamously terrible at forecasting what they themselves would do . . . In 2015, their average projection of the 2016 federal funds rate was 0.90% and 3.30% in 2019. The actual numbers were 0.38% and 2.38%. . . .

To be sure, many current events today have caused uncertainty in markets, but the Fed has been in there hot and heavy with its forward guidance. Recall that early this year the central bank believed that inflation caused by frictions in reopening the economy after the pandemic and supply-chain disruptions was temporary. Only belatedly did it reverse gears, raise rates and signal that further substantial hikes are coming. Faulty Fed forecasts resulted in faulty forward guidance and increased financial market volatility. (Emphasis added)

Lastly on this subject, where are the people who've gotten famous (and rich) by profiting from macro views? I certainly don't know everyone in the investment world, but among the people I do know or am aware of, there are only a few highly successful "macro investors." When the number of instances of something is tiny, it's an indication, as my mother used to say, that they're "the exceptions that prove the rule." **The rule in this case is that macro forecasts rarely lead to exceptional performance. For me, the exceptionality of the success stories proves the general truth of that assertion.**

Practitioners' Need to Predict

Forecasts usually tell us more of the forecaster than of the future.

– Warren Buffett

How many people are capable of making macro forecasts that are valuable most of the time? Not many, I think. And how many investment managers, economists, and forecasters try? Thousands, at a minimum. That raises an interesting question: why? If macro forecasts don't add to investment success over time, why do so many members of the investment management industry espouse belief in forecasts and pursue them? I think the reasons probably center on these:

- It's part of the job.
- Investors have always done it.
- Everyone I know does it, especially my competitors.
- I've always done it – I can't quit now.
- If I don't do it, I won't be able to attract clients.

- Since investing consists of positioning capital to benefit from future events, how can anyone expect to do a good job without a view regarding what those events will be? We need forecasts, even if they're imperfect.

This summer, at the suggestion of my son Andrew, I read an extremely interesting book: *Mistakes Were Made (but Not by Me): Why We Justify Foolish Beliefs, Bad Decisions, and Hurtful Acts*, written by psychologists Carol Tavis and Elliot Aronson. **Its topic is self-justification. The authors explain that “cognitive dissonance” arises when people are confronted with new evidence that calls into question their pre-existing positions and that when it does, unconscious mechanisms enable them to justify and uphold those positions.** Here are some selected quotes:

If you hold a set of beliefs that guide your practice and you learn that some of them are incorrect, you must either admit you were wrong and change your approach or reject the new evidence.

Most people, when directly confronted by evidence that they are wrong, do not change their point of view or plan of action but justify it even more tenaciously.

Once we are invested in a belief and have justified its wisdom, changing our minds is literally hard work. It's much easier to slot that new evidence into an existing framework and do the mental justification to keep it there than it is to change the framework.

The mechanisms that people generally employ when responding to evidence that throws their beliefs into doubt include these (paraphrasing the authors' words):

- an unwillingness to heed dissonant information;
- selectively remembering parts of their lives, focusing on those parts that support their own points of view; and
- operating under cognitive biases that ensure people see what they want to see and seek confirmation of what they already believe.

I have little doubt that these are among the factors that cause and enable people to continue making and consuming forecasts. What specific form might they take in this case?

- thinking of macro forecasts as an indispensable part of investing;
- pleasantly recalling correct forecasts, especially any that were bold and non-consensus;
- overestimating how often forecasts were right;
- forgetting or minimizing the ones that were wrong;
- not keeping records regarding forecasts' accuracy or failing to calculate a batting average;
- focusing on the “pot of gold” that will reward correct forecasts in the future;
- saying “everyone does it”; and
- perhaps most importantly, blaming unsuccessful forecasts on having been blindsided by random occurrences or exogenous events. (But, as I said earlier, that's the point: Why make forecasts if they're so easily rendered inaccurate?)

Most people – even honest people with good intentions – take positions or actions that are in their own interests, sometimes at the expense of others or of objective truth. They don't know they're doing it; they think it's the right thing; and they have tons of justification. As Charlie Munger often says, quoting Demosthenes, “Nothing is easier than self-deceit. For what every man wishes, that he also believes to be true.”

I don't think of forecasters as crooks or charlatans. Most are bright, educated people who think they're doing something useful. **But self-interest causes them to act in a certain way, and self-justification enables them to stick with it in the face of evidence to the contrary.** As Morgan Housel put it in a recent newsletter:

The inability to forecast the past has no impact on our desire to forecast the future. Certainty is so valuable that we'll never give up the quest for it, and most people couldn't get out of bed in the morning if they were honest about how uncertain the future is. ("Big Beliefs," *Collaborative Fund*, August 24, 2022)

For my birthday several years ago, my Oaktree co-founder Richard Masson gave me one of his typical quirky gifts. In this case, it consisted of some bound copies of *The New York Times*. I've been waiting for an opportunity to write about my favorite sub-headline from the issue dated October 30, 1929, which followed two days on which the Dow Jones Industrial Average declined by a total of 23%. **It read, "Bankers Optimistic."** (Less than three years later, the Dow was roughly 85% lower.) Most bankers – and most money managers – seem to be congenitally optimistic about the future. Among other things, it's in their best interests, as it helps them do more business. But their optimism certainly shapes their forecasts and their resulting behavior.

Can They or Can't They?

I never think about the future – it comes soon enough.

– Albert Einstein

Consider the following aspects of macro forecasting:

- the number of assumptions/inputs that are required,
- the number of processes/relationships that have to be incorporated,
- the inherent undependability and instability of those processes, and
- the role of randomness and the likelihood of surprises.

The bottom line for me is that forecasts can't be right often enough to be worthwhile. I've described it many times, but just for the sake of completeness, I'm going to restate my view of the utility (or rather, futility) of macro forecasts:

- Most forecasts consist of extrapolation of past performance.
- Because macro developments usually don't diverge from prior trends, extrapolation is usually successful.
- Thus, most forecasts are correct. But since extrapolation is usually anticipated by security prices, those who follow expectations based on extrapolation don't enjoy unusual profits when it holds.
- Once in a while, the behavior of the economy does deviate materially from past patterns. Since this deviation comes as a surprise to most investors, its occurrence moves markets, meaning an accurate prediction of the deviation would be highly profitable.
- However, since the economy doesn't diverge from past performance very often, correct forecasts of deviation are rarely made and most forecasts of deviation turn out to be incorrect.

- Thus, we have (a) extrapolation forecasts, most of which are correct but unprofitable, and (b) potentially profitable forecasts of deviation, which are rarely correct and thus are generally unprofitable.
- Q.E.D.: Most forecasts don't add to returns.

At the lunch described at the beginning of this memo, people were asked what they expected in terms of, for example, Fed policy, and how that influenced their investment stance. One person replied with something like, "I think the Fed will remain very worried about inflation and thus will raise rates significantly, bringing on a recession. So I'm in risk-off mode." Another said, "I foresee inflation moderating in the fourth quarter, allowing the Fed to turn dovish in January. That will allow them to bring interest rates back down and stimulate the economy. I'm very bullish on 2023."

We hear statements like these all the time. **But it must be recognized that these people are applying one-factor models:** The speaker is basing his or her forecast on a single variable. Talk about simplifying assumptions: These forecasters are implicitly holding everything constant other than Fed policy. They're playing checkers when they need to be playing 3-D chess. Leaving aside the impossibility of predicting Fed behavior, the reaction of inflation to that behavior, and the reaction of markets to inflation, what about all the other things that matter? If a thousand things play a part in determining the future direction of the economy and markets, what about the other 999? What about the impact of wage negotiations, the mid-term elections, the war in Ukraine, and the price of oil?

The truth is that humans can hold only a few things in their minds at any given time. **It's hard to factor in a large number of considerations and especially to understand how a large number of things will interact (correlation is always the real stumper).**

Even if you somehow manage to get an economic forecast correct, that's only half the battle. You still need to anticipate how that economic activity will translate into a market outcome. This requires an entirely different forecast, also involving innumerable variables, many of which pertain to psychology and thus are practically unknowable. According to his student Warren Buffett, Ben Graham said, "In the short run, the market is a voting machine, but in the long run, it is a weighing machine." How can investors' short-run choices be predicted? **Some economic forecasters correctly concluded that the actions of the Fed and Treasury announced in March 2020 would rescue the U.S. economy and trigger an economic recovery. But I'm not aware of anyone who predicted the torrid bull market that lifted off well before the recovery got underway.**

As I've described before, in 2016 Buffett shared with me his view of macro forecasts. "For a piece of information to be desirable, it has to satisfy two criteria: It has to be **important**, and it has to be **knowable**."

- **Of course, the macro outlook is important.** These days it seems as if investors hang on every forecaster's word, macro event, and twitch on the part of the Fed. Unlike my early days in this business, it seems like macro is everything and corporate developments count for relatively little.
- **But I agree strongly with Buffett that the macro future isn't knowable,** or at least almost no one can consistently know more about it than the mass of investors, which is what matters in trying to gain a knowledge advantage and make superior investment decisions.

Clearly, Buffett's name goes at the top of the list of investors who've succeeded by shunning macro forecasts and instead focusing on learning more than others about "the micro": companies, industries and securities.

* * *

In a 2001 memo called *What's It All About, Alpha?*, I introduced the concept of the “I know” school and the “I don’t know” school, and in 2004, I elaborated on this at length in *Us and Them*. To close the current memo, I’m going to insert some of what I wrote in the latter about the two schools:

Most of the investors I’ve met over the years have belonged to the “I know” school. This was particularly true in 1968-78, when I analyzed equities, and even in 1978-95, when I had switched to non-mainstream investments but still worked at equity-centric money management firms.

It’s easy to identify members of the “I know” school:

- They think knowledge of the future direction of economies, interest rates, markets and widely followed mainstream stocks is essential for investment success.
- They’re confident it can be achieved.
- They know they can do it.
- They’re aware that lots of other people are trying to do it too, but they figure either (a) everyone can be successful at the same time, or (b) only a few can be, but they’re among them.
- They’re comfortable investing based on their opinions regarding the future.
- They’re also glad to share their views with others, even though correct forecasts should be of such great value that no one would give them away gratis.
- They rarely look back to rigorously assess their record as forecasters.

“Confident” is the key word for describing members of this school. For the “I don’t know” school, on the other hand, the word – especially when dealing with the macro-future – is “guarded.” **Its adherents generally believe you can’t know the future; you don’t have to know the future; and the proper goal is to do the best possible job of investing in the absence of that knowledge.**

As a member of the “I know” school, you get to opine on the future (and maybe have people take notes). You may be sought out for your opinions and considered a desirable dinner guest . . . especially when the stock market’s going up.

Join the “I don’t know” school and the results are more mixed. You’ll soon tire of saying “I don’t know” to friends and strangers alike. After a while, even relatives will stop asking where you think the market’s going. You’ll never get to enjoy that 1-in-1,000 moment when your forecast comes true and *The Wall Street Journal* runs your picture. On the other hand, you’ll be spared all those times when forecasts miss the mark, as well as the losses that can result from investing based on over-rated knowledge of the future. **But how do you think it feels to have prospective clients ask about your investment outlook and have to say, “I have no idea”?**

For me, the bottom line on which school is best comes from the late Stanford behaviorist, Amos Tversky: **“It’s frightening to think that you might not know something, but more frightening to think that, by and large, the world is run by people who have faith that they know exactly what’s going on.”**

It's certainly standard practice in the investment management business to come up with macro forecasts, share them on request, and bet clients' money on them. It also seems conventional for money managers to trust in forecasts, especially their own. Not doing so would introduce enormous dissonance, as described above. But is their belief justified by the facts? I'm eager to hear what you think.

* * *

A few years ago, a highly respected sell-side economist with whom I became friendly during my early Citibank days called me with an important message: "You've changed my life," he said. "I've stopped making forecasts. Instead, I just tell people what's going on today and what I see as the possible implications for the future. Life is so much better." Can I help you reach the same state of bliss?

September 8, 2022

Memo to: Oaktree Clients

From: Howard Marks

Re: What Really Matters?

I've gathered a few ideas from several of my memos this year – plus some recent musings and conversations – to form the subject of this memo: what really matters or should matter for investors. I'll start by examining a number of things that I think don't matter.

What Doesn't Matter: Short-Term Events

In *The Illusion of Knowledge* (September 2022), I railed against macro forecasting, which in our profession mostly concerns the next year or two. And in *I Beg to Differ* (July 2022), I discussed the questions I was asked most frequently at Oaktree's June 21 conference in London: How bad will inflation get? How much will the Fed raise interest rates to fight it? Will those increases cause a recession? How bad and for how long? The bottom line, I told the attendees, was that these things all relate to the short term, and this is what I know about the short term:

- Most investors can't do a superior job of predicting short-term phenomena like these.
- Thus, they shouldn't put much stock in opinions on these subjects (theirs or those of others).
- They're unlikely to make major changes in their portfolios in response to these opinions.
- The changes they do make are unlikely to be consistently right.
- Thus, these aren't the things that matter.

Consider an example. In response to the first tremors of the Global Financial Crisis, the Federal Reserve began to cut the fed funds rate in 3Q2007. They then lowered it to zero around the end of 2008 and left it there for seven years. In late 2015, virtually the only question I got was "When will the first rate increase occur?" My answer was always the same: "Why do you care? If I say 'February,' what will you do? And if I later change my mind and say 'May,' what will you do differently? If everyone knows rates are about to rise, what difference does it make which month the process starts?" No one ever offered a convincing answer. Investors probably think asking such questions is part of behaving professionally, but I doubt they could explain why.

The vast majority of investors can't know for sure what macro events lie just ahead or how the markets will react to the things that do happen. In *The Illusion of Knowledge*, I wrote at length about the way unforeseen events make a hash of economic and market forecasts. In summary, most forecasts are extrapolations, and most of the time things don't change, so extrapolations are usually correct, but not particularly profitable. On the other hand, accurate forecasts of deviations from trend can be very profitable, but they're hard to make and hard to act on. These are some of the reasons why most people can't predict the future well enough to repeatably produce superior performance.

Why is doing this so hard? Don't most of us know what events are likely to transpire? Can't we just buy the securities of the companies that are most likely to benefit from those events? In the long run, maybe, but I want to turn to a theme that Bruce Karsh has been emphasizing lately, regarding a major reason why it's particularly challenging to profit from a short-term focus: **It's very difficult to know which expectations regarding events are already incorporated in security prices.**

One of the critical mistakes people are guilty of – we see it all the time in the media – is believing that changes in security prices are the result of events: that favorable events lead to rising prices and negative events lead to falling prices. I think that’s what most people believe – especially first-level thinkers – but that’s not right. **Security prices are determined by events and how investors react to those events, which is largely a function of how the events stack up against investors’ expectations.**

How can we explain the company that reports higher earnings, only to see its stock price drop? The answer, of course, is that the reported improvement fell short of expectations and thus disappointed investors. So, at the most elementary level, it’s not whether the event is simply positive or not, but how the event compares with what was expected.

In my earliest working years, I used to spend a few minutes each day looking over the earnings reports printed in *The Wall Street Journal*. But after a while, it dawned on me that since I didn’t know what numbers had been expected, I had no idea whether an announcement from a company I didn’t follow was good news or bad.

Investors can become expert regarding a few companies and their securities, but no one is likely to know enough about macro events to (a) be able to understand the macro expectations that underlie the prices of securities, (b) anticipate the broad events, and (c) predict how those securities will react. Where can a prospective buyer look to find out what the investors who set securities prices already anticipate in terms of inflation, GDP, or unemployment? Inferences regarding expectations can sometimes be drawn from asset prices, but the inferred levels often aren’t proved correct when the actual results come in.

Further, in the short term, security prices are highly susceptible to random and exogenous events that can swamp the impact of fundamental events. **Macro events and the ups and downs of companies’ near-term fortunes are unpredictable and not necessarily indicative of – or relevant to – companies’ long-term prospects. So little attention should be paid to them.** For example, companies often deliberately reduce current earnings by investing in the future of their businesses; thus, low reported earnings can imply high future earnings, not continued low earnings. To know the difference, you have to have an in-depth understanding of the company.

No one should be fooled into thinking security pricing is a dependable process that accurately follows a set of rules. Events are unpredictable; they can be altered by unpredictable influences; and investors’ reactions to the events that occur are unpredictable. Due to the presence of so much uncertainty, most investors are unable to improve their results by focusing on the short term.

It’s clear from observation that security prices fluctuate much more than economic output or company profits. **What accounts for this? It must be the fact that, in the short term, the ups and downs of prices are influenced far more by swings in investor psychology than by changes in companies’ long-term prospects. Because swings in psychology matter more in the near term than changes in fundamentals – and are so hard to predict – most short-term trading is a waste of time . . . or worse.**

What Doesn’t Matter: The Trading Mentality

Over the years, my memos have often included some of my father’s jokes from the 1950s, based on my strong belief that humor often reflects truths about the human condition. Given its relevance here, I’m going to devote a bit of space to a joke I’ve shared before:

Two friends meet in the street, and Joe asks Sam what's new. "Oh," he replies, "I just got a case of great sardines."

Joe: Great, I love sardines. I'll take some. How much are they?

Sam: \$10,000 a tin.

Joe: What! How can a tin of sardines cost \$10,000?

Sam: These are the greatest sardines in the world. Each one is a pedigreed purebred, with papers. They were caught by net, not hook; deboned by hand; and packed in the finest extra-virgin olive oil. And the label was painted by a well-known artist. They're a bargain at \$10,000.

Joe: But who would ever eat \$10,000 sardines?

Sam: Oh, these aren't eating sardines; they're trading sardines.

I include this old joke because I believe most people treat stocks and bonds like something to trade, not something to own.

If you ask Warren Buffett to describe the foundation of his approach to investing, he'll probably start by insisting that stocks should be thought of as ownership interests in companies. Most people don't start companies with the goal of selling them in the short term, but rather they seek to operate them, enjoy profitability, and expand the business. Of course, founders do these things to ultimately make money, but they're likely to view the money as the byproduct of having run a successful business. Buffett says people who buy stocks should think of themselves as partners of owners with whom they share goals.

But I think that's rarely the case. **Most people buy stocks with the goal of selling them at a higher price, thinking they're for trading, not for owning.** This means they abandon the owner mentality and instead act like gamblers or speculators who bet on stock price moves. The results are often unpleasant.

The DALBAR Institute 2012 study showed that investors receive three percentage points less per year than the S&P 500 generated from 1992 to 2012, and the average holding period for a typical investor is six months. Six Months!! When you hold a stock for less than a year, you are not using the stock market to acquire business ownership positions and participate in the growth of that business. Instead, you are just guessing at short-term news and expectations, and your returns are based on how other people react to that news information. In aggregate, that kind of attitude gets you three percentage points less per year than you'd get from doing nothing at all beyond making the initial investment in the index fund of the S&P 500. ("Fidelity's Best Investors Are Dead," *The Conservative Income Investor*, April 8, 2020)

To me, buying for a short-term trade equates to forgetting about your sports team's chances of winning the championship and instead betting on who's going to succeed in the next play, period, or inning.

Let's think about the logic. You buy a stock because you think it's worth more than you have to pay for it, whereas the seller considers it fully priced. Someday, if things go well, it'll become fully priced, in

your opinion, meaning you'll sell it. The person you sell it to, however, will buy it because he thinks it's worth still more. We used to talk about this process as being reliant on the Greater Fool Theory: No matter what price I pay for a stock, there will always be someone who will buy it from me for more, despite the fact that I'm selling because I've concluded that it has reached full value.

Every buyer is motivated by the belief that the stock will eventually be worth more than today's price (a view the seller presumably doesn't share). The key question is what type of thinking underlies these purchases. **Are the buyers buying because this is a company they'd like to own a piece of for years? Or are they merely betting that the price will go up?** The transactions may look the same from the outside, but I wonder about the thought process and thus the soundness of the logic.

Each time a stock is traded, one side is wrong and one is right. But if what you're doing is betting on trends in popularity, and thus the direction of price moves over the next month, quarter, or year, is it realistic to believe you'll be right more often than the person on the other side of the trade? Maybe the decline of active management can be attributed to the many active managers who placed bets on the direction of stock prices in the short term, instead of picking companies they wanted to own part of for years. It's all a matter of the underlying mentality.

I had a long debate on this topic with my father back in 1969, when I lived with him during my first months at First National City Bank. (It's amazing for me to think back to those days; he was so much younger than I am today.) I told him I thought buying a stock should be motivated by something other than the hope that the price would rise, and I suggested this might be the expectation that dividends would increase over time. He countered that no one buys stocks for the dividends – they buy because they think the price will go up. But what would trigger the rise?

Wanting to own a business for its commercial merit and long-term earnings potential is a good reason to be a stockholder, and if these expectations are borne out, a good reason to believe the stock price will rise. In the absence of that, buying in the hope of appreciation merely amounts to trying to guess which industries and companies investors will favor in the future. Ben Graham famously said, "In the short run, the market is a voting machine, but in the long run, it is a weighing machine." **While none of this is easy, as Charlie Munger once told me, carefully weighing long-term merit should produce better results than trying to guess at short-term swings in popularity.**

What Doesn't Matter: Short-Term Performance

Given the possible contributors to short-term investment performance, reported results can present a highly misleading picture, and here I'm talking mostly about superior gains in good times. I feel there are three ingredients for success during good times – aggressiveness, timing, and skill – and if you have enough aggressiveness at the right time, you don't need that much skill. We all know that in good times, the highest returns often go to the person whose portfolio incorporates the most risk, beta, and correlation. Having such a portfolio isn't a mark of distinction or insight if the investor is a perma-bull who's always positioned aggressively. Finally, random events can have an overwhelming impact on returns – in either direction – in a given quarter or year.

One of the recurring themes in my memos is the idea that the quality of a decision cannot be determined from the outcome alone. Decisions often lead to negative outcomes even when they're well-reasoned and based on all the available information. On the other hand, we all know people – even occasionally ourselves – who've been right for the wrong reason. Hidden information and random developments can

frustrate even the best thinkers' decisions. (However, when outcomes are considered over a long period of time and a large number of trials, the better decision maker is overwhelmingly likely to have a higher proportion of successes.)

Obviously, no one should attach much significance to returns in one quarter or year. Investment performance is simply one result drawn from the full range of returns that could have materialized, and in the short term, it can be heavily influenced by random events. Thus, a single quarter's return is likely to be a very weak indicator of an investor's ability, if that. Deciding whether a manager has special skill – or whether an asset allocation is appropriate for the long run – on the basis of one quarter or year is like forming an opinion of a baseball player on the basis of one trip to the plate, or of a racehorse based on one race.

We know short-term performance doesn't matter much. And yet, most of the investment committees I've sat on have had the latest quarter's performance as the first item on the agenda and devoted a meaningful portion of each meeting to it. The discussion is usually extensive, but it rarely leads to significant action. So why do we keep doing it? For the same reasons investors pay attention to forecasting, as described in *The Illusion of Knowledge*: "everyone does it," and "it would be irresponsible not to."

What Doesn't Matter: Volatility

I haven't written much about volatility, other than to say I strongly disagree with people who consider it the definition or essence of risk. I've described my belief that the academics who developed the Chicago School theory of investment in the early 1960s (a) wanted to examine the relationship between investment returns and risk, (b) needed a number quantifying risk that they could put into their calculations, and (c) undoubtedly chose volatility as a proxy for risk for the simple reason that it was the only quantifiable metric available. I define risk as the probability of a bad outcome, and volatility is, at best, an indicator of the presence of risk. But volatility is not risk. That's all I'm going to say on that subject.

What I want to talk about here is the extent to which thinking and caring about volatility has warped the investing world over the 50-plus years that I've been in it. It was a great advantage for me to have attended the Graduate School of Business at the University of Chicago in the late '60s and to have been part of one of the very first classes that was taught the new theories. I learned about the efficient market hypothesis, the capital asset pricing model, the random walk, the importance of risk aversion, and the role of volatility as risk. While volatility wasn't a topic of conversation when I got into the real world of investing in 1969, practice soon caught up with theory.

In particular, the Sharpe ratio was adopted as the measure of risk-adjusted return. It's the ratio of a portfolio's excess return (the part of its return that exceeds the yield on T-bills) to its volatility. The more return per unit of volatility, the higher the risk-adjusted return. Risk adjustment is an essential concept, and returns should absolutely be evaluated relative to the risk that was taken to achieve them. Everyone cites Sharpe ratios, including Oaktree, because it's the only quantitative tool available for the job. (If investors, consultants, and clients didn't use the Sharpe ratio, they'd have no metric at all, and if they tried to substitute fundamental riskiness for volatility in their assessments, they'd find that there's no way to quantify it.) **The Sharpe ratio may hint at risk-adjusted performance in the same way that volatility hints at risk, but since volatility isn't risk, the Sharpe ratio is a very imperfect measure.**

Take, for example, one of the asset classes I started working with in 1978: high yield bonds. At Oaktree, we think moderately-above-benchmark returns can be produced with substantially less risk than the

benchmark, and this shows up in superior Sharpe ratios. But the real risk in high yield bonds – the one we care about and have a history of reducing – is the risk of default. We don't much care about reducing volatility, and we don't take conscious steps to do so. We believe high Sharpe ratios can result from – and perhaps are correlated with – the actions we take to reduce defaults.

Volatility is particularly irrelevant in our field of fixed income or “credit.” Bonds, notes, and loans represent contractual promises of periodic interest and repayment at maturity. **Most of the time when you buy a bond with an 8% yield, you'll basically get the 8% yield over its life, regardless of whether the bond price goes up or down in the interim.** I say “basically” because, if the price falls, you'll have the opportunity to reinvest the interest payments at yields above 8%, so your holding-period return will creep up. Thus, the downward price volatility that so many revile is actually a good thing – as long as it doesn't presage defaults. (Note that, as indicated in this paragraph, “volatility” is often a misnomer. Strategists and the media often warn that “there may be volatility ahead.” What they really mean is “there may be price declines ahead.” No one worries about, or minds experiencing, volatility to the upside.)

It's essential to recognize that protection from volatility generally isn't a free good. Reducing volatility for its own sake is a suboptimizing strategy: It should be presumed that favoring lower-volatility assets and approaches will – all things being equal – lead to lower returns. Only managers with superior skill, or alpha (see page 11), will be able to overcome this negative presumption and reduce return less than they reduce volatility.

Nevertheless, since many clients, bosses, and other constituents are uncomfortable with radical ups and downs (well, mostly with downs), asset managers often take steps to reduce volatility. Consider what happened after institutional investors began to pile into hedge funds following the three-year decline of stocks brought on by the bursting of the tech bubble in 2000. (This was the first three-year decline since 1939-41.) Hedge funds – previously members of a cottage industry where most funds had a few hundred million dollars of capital from wealthy individuals – did much better than stocks in the downdraft. Institutions were attracted to these funds' low volatility, and thus invested billions in them.

The average hedge fund delivered the stability the institutions wanted. But somewhere in the shuffle, the idea of earning high returns with low volatility got lost. Instead, hedge fund managers pursued low volatility as a goal in itself, since they knew it was what the institutions were after. As a result, over roughly the last 18 years, the average hedge fund delivered the low volatility that was desired, but it was accompanied by modest single-digit returns. No miracle there.

Why do I recite all this? Because volatility is just a temporary phenomenon (assuming you survive it financially), and most investors shouldn't attach as much importance to it as they seem to. As I wrote in *I Beg to Differ*, many investors have the luxury of being able to focus exclusively on the long term . . . if they will take advantage of it. Volatility should be less of a concern for investors:

- whose entities are long-lived, like life insurance companies, endowments, and pension funds;
- whose capital isn't subject to lump-sum withdrawal;
- whose essential activities won't be jeopardized by downward fluctuations;
- who don't have to worry about being forced into mistakes by their constituents; and
- who haven't levered up with debt that might have to be repaid in the short run.

Most investors lack some of these things, and few have them all. But to the extent these characteristics are present, investors should take advantage of their ability to withstand volatility, since many investments with the potential for high returns might be susceptible to substantial fluctuations.

Warren Buffett always puts it best, and on this topic he usefully said, “We prefer a lumpy 15% return to a smooth 12% return.” Investors who’d rather have the reverse – who find a smooth 12% preferable to a lumpy 15% – should ask themselves whether their aversion to volatility is mostly financial or mostly emotional.

Of course, the choices made by employees, investment committee members, and hired investment managers may have to reflect real-world considerations. People in charge of institutional portfolios can have valid reasons for avoiding ups and downs that their organizations or clients might be able to stomach in financial terms but would still find unpleasant. All anyone can do is the best they can under their particular circumstances. **But my bottom line is this: In many cases, people accord volatility far more importance than they should.**

An Aside

While I’m on the subject of volatility, I want to turn to an area that hasn’t reported much of it of late: private investment funds. The first nine months of 2022 constituted one of the worst periods on record for both stocks and bonds. Yet many private equity and private debt funds are reporting only small losses for the year to date. I’m often asked what this means, and whether it reflects reality.

Maybe the performance of private funds is being reported accurately. (I know we believe ours is.) But I recently came across an interesting *Financial Times* article provocatively titled, “The volatility laundering, return manipulation and ‘phoney happiness’ of private equity,” by Robin Wigglesworth. Here’s some of its content:

The widening performance gap between public and private markets is a huge topic these days. Investors are often seen as the gormless [foolish] dupes falling for the “return manipulation” of cunning private equity tycoons. But what if they are co-conspirators? . . .

That’s what a new paper from three academics at the University of Florida argues. Based on nearly two decades worth of private equity real estate funds data, Blake Jackson, David Ling and Andy Naranjo conclude that “private equity fund managers manipulate returns to cater to their investors.”

. . . Jackson, Ling and Naranjo’s . . . central conclusion is that “GPs do not appear to manipulate interim returns to fool their LPs, but rather because their LPs want them to do so”.

Similar to the idea that banks design financial products to cater to yield-seeking investors or firms issue dividends to cater to investor demand for dividend payments, we argue that PE fund managers boost interim performance reports to cater to some investors’ demand for manipulated returns.

. . . If a GP boosts or smooths returns, . . . investment managers within LP organizations can report artificially higher Sharpe ratios, alphas, and top-

line returns, such as IRRs, to their trustees or other overseers. In doing so, these investment managers, whose median tenure of four years often expires years before the ultimate returns of a PE fund are realized, might improve their internal job security or potential labor market outcomes. . . .

This probably helps explain why private equity firms on average actually reported gains of 1.6 per cent in the first quarter of 2022 and only some modest mark downwards since then, despite global equities losing 22 per cent of their value this year. (November 2, 2022. Emphasis added)

If both GPs and LPs are happy with returns that seem unusually good, might the result be suspect? Is the performance of private assets being stated accurately? Is the low volatility being reported genuine? If the current business climate is challenging, shouldn't that affect the prices of public and private investments alike?

But there's another series of relevant questions: Mightn't it be fair for GPs to decline to mark down private investments in companies that have experienced short-term weakness but whose long-term prospects remain bright? And while private investments might not have been marked down enough this year, isn't it true that the prices of public securities are more volatile than they should be, overstating the changes in long-term value? I certainly think public security prices reflect psychological swings that are often excessive. Should the prices of private investments emulate this?

As with most things, any inaccuracy in reporting will eventually come to light. Eventually, private debt will mature, and private equity holdings will have to be sold. If the returns being reported this year understate the real declines in value, performance from here on out will likely look surprisingly poor. And I'm sure this will lead plenty of academics (and maybe a few regulators) to question whether the pricing of private investments in 2022 was too high. We'll see.

What Doesn't Matter: Hyper-Activity

In *Selling Out* (January 2022), I expressed my strong view that most investors trade too much. Since it's hard to make multiple consecutive decisions correctly, and trading costs money and is often likely to result from an investor's emotional swings, it's better to do less of it.

When I was a boy, there was a popular saying: Don't just sit there; do something. But for investing, I'd invert it: Don't just do something; sit there. Develop the mindset that you don't make money on what you buy and sell; you make money (hopefully) on what you hold. Think more. Trade less. Make fewer, but more consequential, trades. Over-diversification reduces the importance of each trade; thus it can allow investors to take actions without adequate investigation or great conviction. I think most portfolios are overdiversified and over-traded.

I devoted a good portion of *The Illusion of Knowledge* and *Selling Out* to warning investors about how difficult it is to improve returns through short-term market timing, and I quoted the great investor Bill Miller: "Time, not timing, is key to building wealth in the stock market."

On this subject, I was recently asked by a consultant, "If you don't try to get in and out of the market as appropriate, how do you earn your fees?" My answer was that it's our job to assemble portfolios that will perform well over the long run, and market timing is unlikely to add to the outcome unless it can be done

well, which I'm not convinced is usually the case. "What about you?" I asked. "If you help a client establish an appropriate asset allocation, does it follow that you're not earning your fees if you don't change it a month later?"

Likewise, the day *The Illusion of Knowledge* came out, an old friend asked me, "But you have to take a position [on short-run events], don't you?" My answer, predictably, was, "No, not if you don't have an advantage when doing so. Why would you bet on the outcome of a coin toss, especially if it cost money to play?"

I'll end my discussion of this subject with a wonderful citation:

A news item that has gotten a lot of attention recently concerned an internal performance review of Fidelity accounts to determine which type of investors received the best returns between 2003 and 2013. The customer account audit revealed that the best investors were either dead or inactive – the people who switched jobs and “forgot” about an old 401(k) leaving the current options in place, or the people who died and the assets were frozen while the estate handled the assets. (“Fidelity’s Best Investors Are Dead,” *The Conservative Income Investor*, April 8, 2020)

Since the journalists have been unable to find the Fidelity study, and apparently so has Fidelity, the story is probably apocryphal. But I still like the idea, since the conclusion is so much in line with my thinking. **I'm not saying it's worth dying to improve investment performance, but it might be a good idea for investors to simulate that condition by sitting on their hands.**

So What Does Matter?

What really matters is the performance of your holdings over the next five or ten years (or more) and how the value at the end of the period compares to the amount you invested and to your needs. Some people say the long run is a series of short runs, and if you get those right, you'll enjoy success in the long run. They might think the route to success consists of trading often in order to capitalize on relative value assessments, predictions regarding swings in popularity, and forecasts of macro events. I obviously do not.

Most individual investors and anyone who understands the limitations regarding outperformance would probably be best off holding index funds over the long run. Investment professionals and others who feel they need or want to engage in active management might benefit from the following suggestions.

I think most people would be more successful if they focused less on the short run or macro trends and instead worked hard to gain superior insight concerning the outlook for fundamentals over multi-year periods in the future. They should:

- study companies and securities, assessing things such as their earnings potential;
- buy the ones that can be purchased at attractive prices relative to their potential;
- hold onto them as long as the company's earnings outlook and the attractiveness of the price remain intact; and
- make changes only when those things can't be reconfirmed, or when something better comes along.

At the London conference mentioned on page one – while I was discussing (and discouraging) paying attention to the short run – I said that at Oaktree we consider it our job to (a) buy debt that will be serviced as promised (or will return the same amount or more if not) and (b) invest in companies that will become more valuable over time. I'll stick with that.

The above description of the investor's job is quite simple . . . some might say simplistic. And it is. Setting out the goals and the process in broad terms is easy. The hard part is executing better than most people: That's the only route to market-beating performance. **Since average decision-making is reflected in security prices and produces average performance, superior results have to be based on superior insight.** But I can't tell you how to do these things better than the average investor.

There's a lot more to the process, and I'm going to outline some of what I think are key elements to remember. You'll recognize recurring themes here, from other memos and from earlier pages in this one, but I make no apology for dwelling on things that are important:

- Forget the short run – only the long run matters. Think of securities as interests in companies, not trading cards.
- Decide whether you believe in market efficiency. If so, is your market sufficiently inefficient to permit outperformance, and are you up to the task of exploiting it?
- Decide whether your approach will lean more toward aggressiveness or defensiveness. Will you try to find more and bigger winners or focus on avoiding losers, or both? Will you try to make more on the way up or lose less on the down, or both? (Hint: “both” is much harder to achieve than one or the other.) In general, people's investment styles should fit their personalities.
- Think about what your normal risk posture should be – your normal balance between aggressiveness and defensiveness – based on your or your clients' financial position, needs, aspirations, and ability to live with fluctuations. Consider whether you'll vary your balance depending on what happens in the market.
- Adopt a healthy attitude toward return and risk. Understand that “the more return potential, the better” can be a dangerous rule to follow given that increased return potential is usually accompanied by increased risk. On the other hand, completely avoiding risk usually leads to avoiding return as well.
- Insist on an adequate margin of safety, or the ability to weather periods when things go less well than you expected.
- Stop trying to predict the macro; study the micro like mad in order to know your subject better than others. Understand that you can expect to succeed only if you have a knowledge advantage, and be realistic about whether you have it or not. Recognize that trying harder isn't enough. Accept my son Andrew's view that merely possessing “readily available quantitative information regarding the present” won't give you above average results, since everyone else has it.
- Recognize that psychology swings much more than fundamentals, and usually in the wrong direction or at the wrong time. Understand the importance of resisting those swings. Profit if you can by being counter-cyclical and contrarian.
- Study conditions in the investment environment – especially investor behavior – and consider where things stand in terms of the cycle. Understand that where the market stands in its cycle will strongly influence whether the odds are in your favor or against you.
- Buy debt when you like the yield, not for trading purposes. In other words, buy 9% bonds if you think the yield compensates you for the risk, and you'll be happy with 9%. Don't buy 9% bonds expecting to make 11% thanks to price appreciation resulting from declining interest rates.

Of critical importance, equity investors should make their primary goals (a) participating in the secular growth of economies and companies and (b) benefiting from the wonder of compounding.

Think about the 10.5% yearly return of the S&P 500 Index (or its predecessors) since 1926 and the fact that this would have turned \$1 into over \$13,000 by now, even though the period witnessed 16 recessions, one Great Depression, several wars, one World War, a global pandemic, and many instances of geopolitical turmoil.

Think of participating in the long-term performance of the average as the main event and the active efforts to improve on it as “embroidery around the edges.” This might be the reverse of most active investors’ attitudes. Improving results through over- and underweighting, short-term trading, market timing, and other active measures isn’t easy. **Believing you can do these things successfully requires the assumption that you’re smarter than a bunch of very smart people. Think twice before proceeding, as the requirements for success are high (see below).**

Don’t mess it up by over-trading. Think of buying and selling as an expense item, not a profit center. I love the idea of the automated factory of the future, with its one man and one dog; The dog’s job is to keep the man from touching the machinery, and the man’s job is to feed the dog. **Investors should find a way to keep their hands off their portfolios most of the time.**

A Special Word in Closing: Asymmetry

“Asymmetry” is a concept I’ve been conscious of for decades and consider more important with every passing year. It’s my word for the essence of investment excellence and a standard against which investors should be measured.

First, some definitions:

- I’m going to talk below about whether an investor has “alpha.” Alpha is technically defined as return in excess of the benchmark return, but I prefer to think of it as superior investing skill. It’s the ability to find and exploit inefficiencies when they’re present.
- Inefficiencies – mispricings or mistakes – represent instances when an asset’s price diverges from its fair value. These divergences can show up as bargains or the opposite, over-pricings.
- Bargains will dependably perform better than other investments over time after adjustment for their riskiness. Over-pricings will do the opposite.
- “Beta” is an investor’s or a portfolio’s relative volatility, also described as relative sensitivity or systematic risk.

People who believe in the efficient market hypothesis think of a portfolio’s return as the product of the market’s return multiplied by the portfolio’s beta. This is all it takes to explain results, since there are no mispricings to take advantage of in an efficient market (and so no such thing as alpha). **Thus, alpha is skill that enables an investor to produce performance better than that which is explained purely by market return and beta.** Another way to say this is that having alpha allows an investor to enjoy profit potential that is disproportionate to loss potential: asymmetry. In my view, asymmetry is present when an investor can repeatedly do some or all of the following:

- make more money in good markets than he gives back in bad markets,
- have more winners than losers,
- make more money on his winners than he loses on his losers,

- do well when his aggressive or defensive bias proves timely but not badly when it doesn't,
- do well when his sector or strategy is in favor but not badly when it isn't, and
- construct portfolios so that most of the surprises are on the upside.

For example, most of us have an inherent bias toward either aggressiveness or defensiveness. For this reason, it doesn't mean much if an aggressive investor outperforms in a good year or a defensive investor outperforms in a bad year. To determine whether they have alpha and produce asymmetry, we have to consider whether the aggressive investor is able to avoid the full loss that his aggressiveness alone would produce in a bad market and whether the defensive investor can avoid missing out on too much of the gain when the market does well. **In my opinion, "excellence" lies in asymmetry between the results in good and bad times.**

As I see it, if inefficiencies are present in an investor's market, and she has alpha, the impact will show up in asymmetrical returns. If her returns show no asymmetry, the investor doesn't have alpha (or perhaps there are no inefficiencies for her to identify). Flipping that over, if an investor doesn't have alpha, her returns won't be asymmetrical. It's as simple as that.

To simplify, here's how I think about asymmetry. This discussion is based on material I included in my 2018 book *Mastering the Market Cycle: Getting the Odds on Your Side*. While I may appear to be talking about one good year and one bad one, these observations can only be considered valid if these patterns hold over a meaningful number of years.

Let's consider a manager's performance:

Market performance	+10%	-10%
Manager A	+10%	-10%

The above manager clearly adds no value. You might as well invest in an index fund (probably at a much lower fee).

These two managers also add no value:

Market performance	+10%	-10%
Manager B	+5%	-5%
Manager C	+20%	-20%

Manager B is just a no-alpha manager with a beta of 0.5, and manager C is a no-alpha manager with a beta of 2.0. You could get the same results as manager B by putting half your capital in an index fund and keeping the rest under your mattress and in the case of manager C, by doubling your investment with borrowed capital and putting it all in an index fund.

These two managers, however, do have alpha, as they exhibit asymmetry:

Market performance	+10%	-10%
Manager D	+17%	-12%
Manager E	+9%	-3%

Both managers' returns reflect more of the market's gain in good times than they do its loss in bad ones. Manager D might be described as an aggressive manager with alpha; she achieves 170% of the market's return when the market rises but suffers only 120% of the loss when it falls. Manager E is a defensive manager with alpha; his returns reflect 90% of the gain in an up market but only 30% of the loss in a down market. These asymmetries can only be attributed to the presence of alpha. Risk-tolerant clients will prefer to invest with D, and risk-averse ones will prefer E.

This manager is truly exceptional:

Market performance	+10%	-10%
Manager F	+20%	-5%

She beat the market in both directions: She's up more than the market when it rises and down less when it falls. She's up so much in a good market that you might be tempted to describe her as aggressive. But since she's down less in a down market, that description won't hold. Either she doesn't have a bias in terms of aggressiveness versus defensiveness, or her alpha is great enough to offset it.

Finally, here's one of the greatest managers of all time:

Market performance	+10%	-10%
Manager G	+20%	+5%

Manager G is up in good and bad markets alike. He clearly doesn't have an aggressiveness/defensiveness bias, since his performance is exceptional in both markets. His alpha is sufficient to enable him to buck the trend and achieve a positive return in a down year. When you find Manager G, you should (a) do extensive due diligence regarding his reported performance, (b) if the numbers hold up, invest a lot of money with him, (c) hope he won't accept so much money that his edge goes away, and (d) send me his number.

* * *

What matters most? Asymmetry.

- In sum, asymmetry shows up in a manager's ability to do very well when things go his way and not too bad when they don't.

- A great adage says, “Never confuse brains and a bull market.” Managers with the skill needed to produce asymmetry are special because they’re able to fashion good gains from sources other than market advances.
- **When you think about it, the active investment business is, at its heart, completely about asymmetry. If a manager’s performance doesn’t exceed what can be explained by market returns and his relative risk posture – which stems from his choice of market sector, tactics, and level of aggressiveness – he simply hasn’t earned his fees.**

Without asymmetry (see Managers A, B, and C on page 12), active management delivers no value and deserves no fees. **Indeed, all the choices an active investor makes will be for naught if he doesn’t possess superior skill or insight.** By definition, average investors and below-average investors don’t have alpha and can’t produce asymmetry.

The big question is how to achieve asymmetry. Most of the things people focus on – the things I describe on pages one through nine as not mattering – can’t provide it. As I’ve said before, the average of all investors’ thinking produces market prices and, obviously, average performance. **Asymmetry can only be demonstrated by the relatively few people with superior skill and insight.** The key lies in finding them.

November 22, 2022

Memo to: Oaktree Clients

From: Howard Marks

Re: Sea Change

sea change (idiom): a complete transformation, a radical change of direction in attitude, goals . . . (*Grammarist*)

In my 53 years in the investment world, I've seen a number of economic cycles, pendulum swings, manias and panics, bubbles and crashes, **but I remember only two real sea changes. I think we may be in the midst of a third one today.**

As I've recounted many times in my memos, when I joined the investment management industry in 1969, many banks – like the one I worked for at the time – focused their equity portfolios on the so-called “Nifty Fifty.” The Nifty Fifty comprised the stocks of companies that were considered the best and fastest-growing – so good that nothing bad could ever happen to them. For these stocks, everyone was sure there was “no price too high.” But if you bought the Nifty Fifty when I started at the bank and held them until 1974, you were sitting on losses of more than 90% . . . from owning pieces of the best companies in America. Perceived quality, it turned out, wasn't synonymous with safety or with successful investment.

Meanwhile, over in bond-land, a security with a rating of single-B was described by Moody's as “failing to possess the characteristics of a desirable investment.” Non-investment grade bonds – those rated double-B and below – were off-limits to fiduciaries, since proper financial behavior mandated the avoidance of risk. For this reason, what soon became known as high yield bonds couldn't be sold as new issues. But in the mid-1970s, Michael Milken and a few others had the idea that it should be possible to issue non-investment grade bonds – and to invest in them prudently – if the bonds offered enough interest to compensate for the risk of default. In 1978, I started investing in these securities – the bonds of perhaps America's riskiest public companies – and I was making money steadily and safely.

In other words, whereas prudent bond investing had previously consisted of buying only presumed safe investment grade bonds, investment managers could now prudently buy bonds of almost any quality as long as they were adequately compensated for the attendant risk. The U.S. high yield bond universe amounted to about \$2 billion when I first got involved, and today it stands at roughly \$1.2 trillion.

This clearly represented a major change in direction for the business of investing. But that's not the end of it. Prior to the inception of high yield bond issuance, companies could only be acquired by larger firms – those that were able to pay with cash on hand or borrow large amounts of money and still retain their investment grade ratings. But with the ability to issue high yield bonds, smaller firms could now acquire larger ones by using heavy leverage, since there was no longer a need to possess or maintain an investment grade rating. This change permitted, in particular, the growth of leveraged buyouts and what's now called the private equity industry.

However, the most important aspect of this change didn't relate to high yield bonds, or to private equity, but rather to the adoption of a new investor mentality. Now risk wasn't necessarily avoided, but rather considered relative to return and hopefully borne intelligently. This new risk/return mindset was critical in the development of many new types of investment, such as distressed debt, mortgage backed securities, structured credit, and private lending. It's no exaggeration to say today's investment world bears almost no resemblance to that of 50 years ago. **Young people joining the industry today would likely be shocked to learn that, back then, investors didn't think in risk/return terms. Now that's all we do. Ergo, a sea change.**

At roughly the same time, big changes were underway in the macroeconomic world. I think it all started with the OPEC oil embargo of 1973-74, which caused the price of a barrel of oil to jump from roughly \$24 to almost \$65 in less than a year. This spike raised the cost of many goods and ignited rapid inflation. Because the U.S. private sector in the 1970s was much more unionized than it is now and many collective bargaining agreements contained automatic cost-of-living adjustments, rising inflation triggered wage increases, which exacerbated inflation and led to yet more wage increases. This seemingly unstoppable upward spiral kindled strong inflationary expectations, which in many cases became self-fulfilling, as is their nature.

The year-over-year increase in the Consumer Price Index, which was 3.2% in 1972, rose to 11.0% by 1974, receded to the range of 6-9% for four years, and then rebounded to 11.4% in 1979 and 13.5% in 1980. There was great despair, as no relief was forthcoming from inflation-fighting tools ranging from WIN ("Whip Inflation Now") buttons to price controls to a federal funds rate that reached 13% in 1974. It took the appointment of Paul Volcker as Fed chairman in 1979 and the determination he showed in raising the fed funds rate to 20% in 1980 to get inflation under control and extinguish inflationary psychology. As a result, inflation was back down to 3.2% by the end of 1983.

Volcker's success in bringing inflation under control allowed the Fed to reduce the fed funds rate to the high single digits and keep it there over the rest of the 1980s, before dropping it to the mid-single digits in the '90s. **His actions ushered in a declining-interest-rate environment that prevailed for four decades** (much more on this in the section that follows). **I consider this the second sea change I've seen in my career.**

The long-term decline in interest rates began just a few years after the advent of risk/return thinking, and I view the combination of the two as having given rise to (a) the rebirth of optimism among investors, (b) the pursuit of profit through aggressive investment vehicles, and (c) an incredible four decades for the stock market. The S&P 500 Index rose from a low of 102 in August 1982 to 4,796 at the beginning of 2022, for a compound annual return of 10.3% per year. What a period! There can be no greater financial and investment career luck than to have participated in it.

An Incredible Tailwind

What are the factors that gave rise to investors' success over the last 40 years? We saw major contributions from (a) the economic growth and preeminence of the U.S.; (b) the incredible performance of our greatest companies; (c) gains in technology, productivity and management techniques; and (d) the benefits of globalization. **However, I'd be surprised if 40 years of declining interest rates didn't play the greatest role of all.**

In the 1970s, I had a loan from a Chicago bank, with an interest rate of “three-quarters over prime.” (We don’t hear much about the prime rate anymore, but it was the benchmark interest rate – the predecessor of LIBOR – at which the money-center banks would lend to their best customers.) I received a notice from the bank each time my rate changed, and I framed the one that marked the high point in December 1980: It told me the interest rate on my loan had risen to 22.25%! Four decades later, I was able to borrow at just 2.25%, fixed for 10 years. This represented a decline of 2,000 basis points. Miraculous!

What are the effects of declining interest rates?

- They accelerate the growth of the economy by making it cheaper for consumers to buy on credit and for companies to invest in facilities, equipment, and inventory.
- They provide a subsidy to borrowers (at the expense of lenders and savers).
- They reduce businesses’ cost of capital and thus increase their profitability.
- They increase the fair value of assets. (The theoretical value of an asset is defined as the discounted present value of its future cash flows. The lower the discount rate, the higher the present value.) Thus, as interest rates fall, valuation parameters such as p/e ratios and enterprise values rise, and cap rates on real estate decline.
- They reduce the prospective returns investors demand from investments they’re considering, thereby increasing the prices they’ll pay. This can be seen most directly in the bond market – everyone knows it’s “rates down; prices up” – but it works throughout the investment world.
- By lifting asset prices, they create a “wealth effect” that makes people feel richer and thus more willing to spend.
- Finally, by simultaneously increasing asset values and reducing borrowing costs, they produce a bonanza for those who buy assets using leverage.

I want to spend more time on that last point. Think about a buyer who employs leverage in a declining-rate environment:

- He analyzes a company, concludes that he can make 10% a year on it, and decides to buy it.
- Then he asks his head of capital markets how much it would cost to borrow 75% of the money. When he’s told it’s 8%, it’s full speed ahead. Earning 10% on three-quarters of the capital that’s borrowed at 8% would lever up the return on the other one-quarter (his equity) to 16%.
- Banks compete to make the loan, and the result is an interest rate of 7% instead of 8%, making the investment even more profitable (a 19% levered return).
- The interest cost on his floating-rate debt declines over time, and when his fixed-rate debt matures, he finds he can roll it over at 5%. Now the deal is a home run (a 25% levered return, all else being equal).

This narrative ignores the beneficial impact of declining interest rates on both the profitability of the company he bought and the market value of that company. Is it any wonder then that private equity and other levered strategies enjoyed great success over the last 40 years?

In a recent visit with clients, I came up with a bit of imagery to convey my view of the effect of the prolonged decline in interest rates: At some airports, there’s a moving walkway, and standing on it makes life easier for the weary traveler. But if rather than stand still on it, you walk at your normal pace, you move ahead rapidly. That’s because your rate of travel over the ground is the sum of the speed at which you’re walking plus the speed at which the walkway is moving.

That's what I think happened to investors over the last 40 years. They enjoyed the growth of the economy and the companies they invested in, as well as the resulting increase in the value of their ownership stakes. But in addition, they were on a moving walkway, carried along by declining interest rates. The results have been great, but I doubt many people fully understand where they came from. **It seems to me that a significant portion of all the money investors made over this period resulted from the tailwind generated by the massive drop in interest rates. I consider it nearly impossible to overstate the influence of declining rates over the last four decades.**

The Recent Experience

The period between the end of the Global Financial Crisis in late 2009 and the onset of the pandemic in early 2020 was marked by ultra-low interest rates, and the macroeconomic environment – and its effects – were highly unusual.

An all-time low in interest rates was reached when the Fed cut the fed funds rate to approximately zero in late 2008 in an effort to pull the economy out of the GFC. The low rates were accompanied by quantitative easing: purchases of bonds undertaken by the Fed to inject liquidity into the economy (and perhaps to keep investors from panicking). The effects were dramatic:

- The low rates and vast amounts of liquidity stimulated the economy and triggered explosive gains in the markets.
- Strong economic growth and lower interest costs added to corporate profits.
- Valuation parameters rose, as described above, lifting asset prices. Stocks increased non-stop for more than ten years, except for a handful of downdrafts that each lasted a few months. From a low of 667 in March 2009, the S&P 500 reached a high of 3,386 in February 2020, for a compound return of 16% per year.
- **The markets' strength encouraged investors to drop their crisis-inspired risk aversion and return to risk taking much sooner than expected. It also made FOMO – the fear of missing out – the prevalent emotion among investors. Buyers were eager to buy, and holders weren't motivated to sell.**
- Investors' revived desire to buy caused the capital markets to reopen, making it cheap and easy for companies to obtain financing. Lenders' eagerness to put money to work enabled borrowers to pay low interest rates under less-restrictive documentation that reduced lender protections.
- **The paltry yields on safe investments drove investors to buy riskier assets.**
- Thanks to economic growth and plentiful liquidity, there were few defaults and bankruptcies.
- The main exogenous influences were increasing globalization and the limited extent of armed conflict around the world. Both influences were clearly salutary.

As a result, in this period, the U.S. enjoyed its longest economic recovery in history (albeit also one of its slowest) and its longest bull market, exceeding ten years in both cases.

When the Covid-19 pandemic caused much of the world's economy to be shut down, the Fed dusted off the rescue plan that had taken months to formulate and implement during the GFC and put it into effect in a matter of weeks at a much larger scale than its earlier version. The U.S. government chipped in with loans and vast relief payments (on top of its customary deficit spending). The result in the period from March 2020 to the end of 2021 was a complete replay of the post-GFC developments enumerated above,

including a quick economic bounce and an even quicker market recovery. (The S&P 500 rose from its low of 2,237 in March 2020 to 4,796 on the first day of 2022, up 114% in less than two years.)

For what felt like eons – from October 2012 to February 2020 – my standard presentation was titled “Investing in a Low Return World,” because that’s what our circumstances were. With the prospective returns on many asset classes – especially credit – at all-time lows, I enumerated the principal options available to investors:

- invest as you previously have, and accept that your returns will be lower than they used to be;
- reduce risk to prepare for a market correction, and accept a return that is lower still;
- go to cash and earn a return of zero, hoping the market will decline and thus offer higher returns (and do it soon); or
- ramp up your risk in pursuit of higher returns.

Each of these choices had serious flaws, and there’s a good reason for that. **By definition, it’s hard to achieve good returns dependably and safely in a low-return world.**

Regular readers of my memos know that my observations regarding the investment environment are primarily based on impressions and inferences rather than data. Thus, in recent meetings, I’ve been using the following list of properties to describe the period in question. (Think about whether you agree with this description. I’ll return to it later.)

	2009 to 2021
Fed behavior	Highly stimulative
Inflation	Dormant
Economic outlook	Positive
Likelihood of distress	Minimal
Mood	Optimistic
Buyers	Eager
Holdings	Complacent
Key worry	FOMO
Risk aversion	Absent
Credit window	Wide open
Financing	Plentiful
Interest rates	Lowest ever
Yield spreads	Modest
Prospective returns	Lowest ever

The overall period from 2009 through 2021 (with the exception of a few months in 2020) was one in which optimism prevailed among investors and worry was minimal. Low inflation allowed central bankers to maintain generous monetary policies. These were golden times for corporations and asset

owners thanks to good economic growth, cheap and easily accessible capital, and freedom from distress. **This was an asset owner's market and a borrower's market. With the risk-free rate at zero, fear of loss absent, and people eager to make risky investments, it was a frustrating period for lenders and bargain hunters.**

On recent visits with clients, I've been describing Oaktree as having spent the years 2009 through 2019 "in the wilderness" given our focus on credit and our heavy emphasis on value investing and risk control. To illustrate, after raising our largest fund up to that time in 2007-08 and putting most of it to work very successfully in the wake of the Lehman Brothers bankruptcy, we thought it appropriate, given the investment environment, to cut the amount in half for its successor fund and halve it again for the fund after that. Oaktree's total assets under management grew relatively little during this period, and the returns on most of our closed-end funds, although fine, were moderate by our standards. **It felt like a long slog.**

That Was Then. This Is Now.

Of course, all of the above flipped in the last year or so. Most importantly, inflation began to rear its head in early 2021, when our emergence from isolation permitted too much money (savings amassed by people shut in at home, including distributions from massive Covid-19 relief programs) to chase too few goods and services (with supply hampered by the uneven restart of manufacturing and transportation). Because the Fed deemed the inflation "transitory," it continued its policies of low interest rates and quantitative easing, keeping money loose. These policies further stimulated demand (especially for homes) at a time when it didn't need stimulating.

Inflation worsened as 2021 wore on, and late in the year, the Fed acknowledged that it wasn't likely to be short-lived. Thus, the Fed started reducing its purchases of bonds in November and began raising interest rates in March 2022, kicking off one of the quickest rate-hiking cycles on record. The stock market, which had ignored inflation and rising interest rates for most of 2021, began to fall around year-end.

From there, events followed a predictable course. **As I wrote in the memo *On the Couch* (January 2016), whereas events in the real world fluctuate between "pretty good" and "not so hot," investor sentiment often careens from "flawless" to "hopeless" as events that were previously viewed as benign come to be interpreted as catastrophic.**

- Higher interest rates led to higher demanded returns. Thus, stocks that had seemed fairly valued when interest rates were minimal fell to lower p/e ratios that were commensurate with higher rates.
- Likewise, the massive increase in interest rates had its usual depressing effect on bond prices.
- Falling stock and bond prices caused FOMO to dry up and fear of loss to replace it.
- The markets' decline gathered steam, and the things that had done best in 2020 and 2021 (tech, software, SPACs, and cryptocurrency) now did the worst, further dampening psychology.
- Exogenous events have the ability to undercut the market's mood, especially in tougher times, and in 2022 the biggest such event was Russia's invasion of Ukraine.
- The Ukraine conflict reduced supplies of grain and oil & gas, adding to inflationary pressures.
- Since the tighter monetary policies were designed to slow the economy, investors focused on the difficulty the Fed would likely have achieving a soft landing, and thus the strong likelihood of a recession.

- The anticipated effect of that recession on earnings dampened investors' spirits. Thus, the fall of the S&P 500 over the first nine months of 2022 rivaled the greatest full-year declines of the last century. (It has now recovered a fair bit.)
- The expectation of a recession also increased the fear of rising debt defaults.
- New security issuance became difficult.
- Having committed to fund buyouts in a lower-interest-rate environment, banks found themselves with many billions of dollars of "hung" bridge loans unsaleable at par. These loans have saddled the banks with big losses.
- These hung loans forced banks to reduce the amounts they could commit to new deals, making it harder for buyers to finance acquisitions.

The progression of events described above caused pessimism to take over from optimism. The market characterized by easy money and upbeat borrowers and asset owners disappeared; now lenders and buyers held better cards. Credit investors became able to demand higher returns and better creditor protections. The list of candidates for distress – loans and bonds offering yield spreads of more than 1,000 basis points over Treasuries – grew from dozens to hundreds. Here's how the change in the environment looks to me:

	2009 to 2021	Today
Fed behavior	Highly stimulative	Tightening
Inflation	Dormant	40-year high
Economic outlook	Positive	Recession likely
Likelihood of distress	Minimal	Rising
Mood	Optimistic	Guarded
Buyers	Eager	Hesitant
Holders	Complacent	Uncertain
Key worry	FOMO	Investment losses
Risk aversion	Absent	Rising
Credit window	Wide open	Constricted
Financing	Plentiful	Scarce
Interest rates	Lowest ever	More normal
Yield spreads	Modest	Normal
Prospective returns	Lowest ever	More than ample

If the right-hand column accurately describes the new environment, as I believe it does, then we're witnessing a complete reversal of the conditions in the middle column, which prevailed in 2021 and late 2020, throughout the 2009-19 period, and for much of the last 40 years.

How has this change manifested itself in investment options? Here's one example: In the low-return world of just one year ago, high yield bonds offered yields of 4-5%. A lot of issuance was at yields in the 3s, and at least one new bond came to the market with a "handle" of 2. The usefulness of these bonds for institutions needing returns of 6 or 7% was quite limited. Today these securities yield roughly 8%,

meaning even after allowing for some defaults, they're likely to deliver equity-like returns, sourced from contractual cash flows on public securities. Credit instruments of all kinds are potentially poised to deliver performance that can help investors accomplish their goals.

The Outlook

Inflation and interest rates are highly likely to remain the dominant considerations influencing the investment environment for the next several years. While history shows that no one can predict inflation, it seems likely to remain higher than what we became used to after the GFC, at least for a while. The course of interest rates will largely be determined by the Fed's progress in bringing inflation under control. If rates go much higher in that process, they're likely to come back down afterward, but no one can predict the timing or the extent of the decrease.

While everyone knows how little I think of macro forecasts, a number of clients have asked recently about my views regarding the future of interest rates. Thus, I'll provide a brief overview. (Oaktree's investment philosophy doesn't prohibit having opinions, just acting as if they're right.) In my view, the buyers who've driven the S&P 500's recent 10% rally from the October low have been motivated by their beliefs that (a) inflation is easing, (b) the Fed will soon pivot from restrictive policy back toward stimulative, (c) interest rates will return to lower levels, (d) a recession will be averted, or it will be modest and brief, and (e) the economy and markets will return to halcyon days.

In contrast, here's what I think:

- The underlying causes of today's inflation will probably abate as relief-swollen savings are spent and as supply catches up with demand.
- While some recent inflation readings have been encouraging in this regard, the labor market is still very tight, wages are rising, and the economy is growing strongly.
- Globalization is slowing or reversing. If this trend continues, we will lose its significant deflationary influence. (Importantly, consumer durables prices declined by 40% over the years 1995-2020, no doubt thanks to less-expensive imports. I estimate that this took 0.6% per year off the rate of inflation.)
- Before declaring victory on inflation, the Fed will need to be convinced not only that inflation has settled near the 2% target, but also that inflationary psychology has been extinguished. To accomplish this, the Fed will likely want to see a positive real fed funds rate – at present it's minus 2.2%.
- Thus, while the Fed appears likely to slow the pace of its interest rate increases, it's unlikely to return to stimulative policies any time soon.
- The Fed has to maintain credibility (or regain it after having claimed for too long that inflation was "transitory"). It can't appear to be inconstant by becoming stimulative too soon after having turned restrictive.
- The Fed faces the question of what to do about its balance sheet, which grew from \$4 trillion to almost \$9 trillion due to its purchases of bonds. Allowing its holdings of bonds to mature and roll off (or, somewhat less likely, making sales) would withdraw significant liquidity from the economy, restricting growth.
- Rather than be in a stimulative posture on a perpetual basis, one might imagine the Fed would prefer to normally maintain a "neutral interest rate," which is defined as neither stimulative nor restrictive. (I know I would.) Most recently – last summer – that rate was estimated at 2.5%.

- Similarly, although most of us believe the free market is the best allocator of economic resources, we haven't had a free market in money for well over a decade. The Fed might prefer to reduce its role in capital allocation by being less active in controlling rates and holding mortgage bonds.
- There must be risks associated with the Fed keeping interest rates stimulative on a long-term basis. Arguably, we've seen most recently that doing so can bring on inflation, though the inflation of the last two years can be attributed largely to one-off events related to the pandemic.
- The Fed would probably like to see normal interest rates high enough to provide it with room to cut if it needs to stimulate the economy in the future.
- People who came into the business world after 2008 – or veteran investors with short memories – might think of today's interest rates as elevated. But they're not in the longer sweep of history, meaning there's no obvious reason why they should be lower.

These are the reasons why I believe that the base interest rate over the next several years is more likely to average 2-4% (i.e., not far from where it is now) than 0-2%. Of course, there are counterarguments. But, for me, the bottom line is that highly stimulative rates are likely not in the cards for the next several years, barring a serious recession from which we need rescuing (and that would have ramifications of its own). **But I assure you Oaktree isn't going to bet money on that belief.**

What we do know is that inflation and interest rates are higher today than they've been for 40 and 13 years, respectively. No one knows how long the items in the right-hand column above will continue to accurately describe the environment. They'll be influenced by economic growth, inflation, and interest rates, as well as exogenous events, all of which are unpredictable. Regardless, I think things will generally be less rosy in the years immediately ahead:

- A recession in the next 12-18 months appears to be a foregone conclusion among economists and investors.
- That recession is likely to coincide with deterioration of corporate earnings and investor psychology.
- Credit market conditions for new financings seem unlikely to soon become as accommodative as they were in recent years.
- No one can foretell how high the debt default rate will rise or how long it'll stay there. It's worth noting in this context that the annual default rate on high yield bonds averaged 3.6% from 1978 through 2009, but an unusually low 2.1% under the "just-right" conditions that prevailed for the decade 2010-19. In fact, there was only one year in that decade in which defaults reached the historical average.
- **Lastly, there is a forecast I'm confident of: Interest rates aren't about to decline by another 2,000 basis points from here.**

As I've written many times about the economy and markets, we never know where we're going, but we ought to know where we are. The bottom line for me is that, in many ways, conditions at this moment are overwhelmingly different from – and mostly less favorable than – those of the post-GFC climate described above. These changes may be long-lasting, or they may wear off over time. But in my view, we're unlikely to quickly see the same optimism and ease that marked the post-GFC period.

We've gone from the low-return world of 2009-21 to a full-return world, and it may become more so in the near term. Investors can now potentially get solid returns from credit instruments, meaning they no longer have to rely as heavily on riskier investments to achieve their overall return targets. Lenders and bargain hunters face much better prospects in this changed environment than

they did in 2009-21. And importantly, if you grant that the environment is and may continue to be very different from what it was over the last 13 years – and most of the last 40 years – it should follow that the investment strategies that worked best over those periods may not be the ones that outperform in the years ahead.

That's the sea change I'm talking about.

December 13, 2022

Memo to: Oaktree Clients

From: Howard Marks

Re: Taking the Temperature

In preparation for my interview for “Lunch with the FT” last fall, I sent the reporter, Harriet Agnew, five memos I had written between 2000 and 2020 that contained market calls. How were they chosen? First, I felt the memos accurately conveyed my thinking at the key turning points in that 20-year period. And second, my calls turned out to be right.

Five Calls

I’ve written before about the time in 2017 when I was working on my book *Mastering the Market Cycle* and batting ideas back and forth with my son Andrew. I said, “You know, looking back, I think my market calls have been about right.” **His response was dead on target as usual: “Yeah, Dad, that’s because you did it five times in 50 years.” It struck me like an epiphany: He was 100% correct.** In those five instances – around the publication of the respective memos – the markets were either crazily elevated or massively depressed, and as a result, I was able to recommend becoming more defensive or more aggressive with a good chance of being right. (Before I go further, let me make it clear that while hindsight shows that the logic behind those calls was correct, that doesn’t mean I made them without great trepidation.)

To illustrate how one might approach making market calls, I’m going to briefly summarize what led me to make those five calls. (I’m not going to go into detail, since the contemporaneous memos I cite in each section will supply more than enough for those who’re interested.) As you read the description of each event, look closely at how the forces that contributed to – and resulted from – each episode led to the next one. You’ll be able to appreciate why I’ve long stressed the role of causality in market cycles.

January 2000

In the fall of 1999, against the backdrop of the massive gains being achieved in tech, media, and telecom stocks, I read Edward Chancellor’s excellent book *Devil Take the Hindmost*. I was struck by the similarities between the TMT boom and the historical bubbles that are the subject of that book. The lure of easy profits, the willingness to leave one’s day job to cash in, the ability to invest blithely in money-losing companies whose business models one can’t explain – all these felt like themes that had rhymed over the course of financial history, leading to bubbles and their painful bursting. And all of them were visible in investor behavior as 1999 came to an end.

While I wasn’t involved directly in equities and Oaktree’s investments had little if any exposure to technology at the time, I observed many market narratives that I thought were too good to be true. Thus, I said so in the memo *bubble.com*, which was published as 2000 began. The memo described how tech investors were buying the stocks of young companies at astronomical prices set in many cases as a multiple of current revenues, as the companies often had no profits. In fact, many had no revenues, in which case the price was based on little more than a concept and hope. I define a bubble as an irrationally

elevated opinion of an asset or sector, and the TMT craze of the late 1990s exemplified this definition. Thus, I wrote as follows:

In short, I find the evidence of an overheated, speculative market in technology, Internet and telecommunications stocks overwhelming, as are the similarities to past manias. . . .

To say technology, Internet and telecommunications stocks are too high and about to decline is comparable today to standing in front of a freight train. To say they have benefited from a boom of colossal proportions and should be examined very skeptically is something I feel I owe you.

In my opinion, the TMT bubble burst in early 2000 for no reason other than that stock prices had become unsustainably high. The Standard & Poor's 500 Index fell by 46% from its 2000 high to the low in 2002, and the tech-heavy NASDAQ Composite declined by 80% during this period. Many tech stocks lost much more, and many young companies in fields such as e-commerce ended up becoming worthless. And the word "bubble" became part of everyday speech for a new generation of investors.

Late 2004 to Mid-2007

The aftermath of the TMT bubble led to an environment in the mid-aughts that felt to me like a slow-developing trainwreck, with an emphasis on "slow-developing." I started complaining too soon . . . or maybe my timing was reasonable but the negative consequences just took longer to develop than they should have.

In summary, the Federal Reserve was engaging in accommodative monetary policy – taking the fed funds rate to new lows – to battle the potential ramifications of the TMT bubble's bursting. Thus, in my memo *Risk and Return Today* from late 2004, I observed that (a) prospective returns on most asset classes were unusually low and (b) risk-seeking on the part of investors looking to improve on those low returns had led them to embrace higher-risk and "alternative" investments.

I identified some of these alternatives in the memo *There They Go Again* (May 2005), spending most of my time discussing residential real estate, as that was where investors were embracing the most glaring fallacy: **the belief that home prices only go up**. I also discussed the tendency of investors to (a) ignore the lessons of past cycles, (b) fall for new developments, and (c) pile into risky investments, guided by time-honored platitudes such as "it's different this time," "higher risk means higher returns," or "if it stops working, I'll just get out." Many of these logical errors were being committed by investors in the housing market.

The driving force behind Oaktree's behavior in that period wasn't any of the above. Rather, it was the fact that my Oaktree co-founder Bruce Karsh and I were spending much of each day trudging to each other's offices to complain about the crazy deals – characterized by low returns, high risk for investors, and a lot of optionality for issuers – that were easily being brought to market. **"If deals like this can get done," we agreed, "there's something wrong with the market."** Few people, we thought, were demonstrating prudence, discipline, value consciousness, or the ability to resist the fear of missing out. Investors are supposed to act as disciplinarians, preventing undeserving securities from being issued, but in those days, they weren't performing that function. This signaled a worrisome state of affairs.

These observations – along with an awareness of the generally high prices and low prospective returns that prevailed at the time – convinced us to dramatically increase our usual emphasis on defensiveness. In

response, we sold off large amounts of assets, liquidated large funds, organized small funds (or none at all in certain strategies), and significantly raised the bar against which potential new investments would be evaluated.

In July 2007, I published the memo *It's All Good*, in which I was more emphatic (and had better timing):

Where do we stand in the cycle? In my opinion, there's little mystery. I see low levels of skepticism, fear and risk aversion. Most people are willing to undertake risky investments, often because the promised returns from traditional, safe investments seem so meager. This is true even though the lack of interest in safe investments and the acceptance of risky investments have rendered the slope of the risk/return line quite flat. Risk premiums are generally the skimpiest I've ever seen, but few people are responding by refusing to accept incremental risk. . . .

Eight months after I wrote *It's All Good*, Bear Stearns melted down under the weight of funds that had invested in subprime mortgages. Then, in mid-September we saw – in rapid succession – the rescue of Merrill Lynch by Bank of America, the bankruptcy of Lehman Brothers, and the bailout of AIG. The S&P 500 Index fell to a low of 735 in February 2009, down 53% from its high of 1,549 reached in 2007 (and down 39% from its level around the time I put out the way-too-early *Risk and Return Today*).

Importantly, Oaktree had essentially no involvement with subprime mortgages or mortgage-backed securities. Moreover, those assets were traded in a relatively remote corner of the investment world, and we had little appreciation for what was taking place there. **In other words, our cautious conclusions weren't reached on the basis of subject-matter expertise but rather on an unusually good example of what I call "taking the temperature of the market"** (see pages 9-10).

Late 2008

The world seemed relatively tranquil as September 2008 began, but then Lehman Brothers' bankruptcy filing, mentioned above, took place mid-month. The markets promptly fell apart, based on an apocalyptic view that Lehman's failure was part of a logical progression that had started when Bear Stearns ceased to exist as an independent entity and could eventually lead to a meltdown of the worldwide financial system. Complacency gave way to panic, and the Global Financial Crisis – in capital letters – was upon us.

Anticipating that the reckless behavior we were witnessing (see the previous section) would ultimately create significant buying opportunities for our distressed debt strategy, Oaktree organized an \$11 billion "reserve fund" for distressed debt between January 2007 and March 2008. The fund was created to give us capital to invest if things reached crisis proportions, which by mid-2008, they had not. Because its predecessor fund had only just become fully invested, we started to slowly invest the reserve fund prior to Lehman's bankruptcy. In the market panic that followed Lehman's collapse, our first job was to figure out how best to proceed. Should we continue to invest the fund's capital or hold it in reserve? Or should we step on the gas? Was this the bottom? How could we determine what lay ahead? There was no history of financial sector meltdowns to rely on and no informed way to approach these questions given the uniqueness of the circumstances and the many unknowns. With the future unknowable, we applied the only analytical framework we could think of (simplistic though it was):

I think the outlook has to be viewed as binary: will the world end or won't it? If you can't say yes, you have to say no and act accordingly. In particular, saying it will end would lead to inaction, while saying it's not going to will permit us to do the things that always have worked in the past.

We will invest on the assumption that it will go on, that companies will make money, that they'll have value, and that buying claims on them at low prices will work in the long run. What alternative is there? . . .

No one seems able to imagine how the current vicious circle will be interrupted. But I think we must assume it will be.

It must be noted that, just like two years ago, people are accepting as true something that has never held true before. Then, it was the proposition that massively levered balance sheets had been rendered safe by the miracle of financial engineering. Today, it's the non-viability of the essential financial sector and its greatest institutions. . . . (*Nobody Knows*, September 19, 2008)

The above reasoning led us to conclude that if we invested and the financial world melted down, it wouldn't matter what we had done. But if we didn't invest and it didn't melt down, we wouldn't have done our job. So, we made the unsupportable assumption that the financial world would continue to exist and concluded that this meant we should invest aggressively. Bruce Karsh's team plunged in, investing an average of \$400 million a week from September 18, 2008 through year-end – a total of \$6 billion in, essentially, a single quarter. Purchases by the rest of Oaktree brought the total invested over that period to \$7.5 billion.

We ran into very few people outside Oaktree who were putting money to work or willing to grant that we might be doing the right thing. I told a reporter friend we were buying, and he said – incredulously – “You are!?!”

Around the same time, I met with the CIO of a client institution as part of our efforts to raise equity to delever a fund that was perilously close to receiving a margin call, and **although I had good responses to all the increasingly negative scenarios she posited, we never got to a point where she would grant that “it can't be that bad.”** This demonstration of unbridled pessimism – which appeared to be widespread at the time – convinced me that little optimism was embodied in the prices of the assets we were buying and thus that there was little chance of losing money. Here's how I put it in a memo I wrote that day:

Skepticism and pessimism aren't synonymous. Skepticism calls for pessimism when optimism is excessive. But it also calls for optimism when pessimism is excessive. . . .

In the third stage of a bear market . . . everyone agrees things can only get worse. The risk in that – in terms of opportunity costs, or forgone profits – is equally clear. **There's no doubt in my mind that the bear market reached the third stage last week. That doesn't mean it can't decline further, or that a bull market's about to start. But it does mean the negatives are on the table, optimism is thoroughly lacking, and the greater long-term risk probably lies in not investing.**

The excesses, mistakes and foolishness of the 2003-2007 upward leg of the cycle were the greatest I've ever witnessed. So has been the resulting panic. The damage that's been done to security prices may be enough to correct for those excesses – or too much or too little. But certainly it's a good time to pick among the rubble. (*The Limits to Negativism*, October 15, 2008)

Importantly, our confidence in investing the reserve fund's capital was enhanced by the fact that (a) we were buying the senior-most debt of high-quality companies that had been the subject of recent buyouts and (b) we were buying at prices so low that our debt holdings would do fine even if the companies ended up being worth only one-quarter or one-third of what the buyout funds had just paid for them.

Episodes like the visit with the apprehensive CIO told me the post-Lehman temperature of the market was too low. There was too much fear and too little greed, too much pessimism and too little optimism, and too much risk aversion and too little risk tolerance. Negative possibilities were being accepted as fact. **When these things are true, it stands to reason that (a) investor expectations are low; (b) asset prices probably aren't excessive; (c) there's little possibility of investors being disappointed; and (d) thus there's little likelihood of lasting loss and a good chance prices will work their way higher. In other words, this was the epitome of a buying opportunity.**

March 2012

After the TMT bubble burst in mid-2000, the S&P 500 dropped in 2000, 2001, and 2002, the first three-year stretch of negative returns since 1939. These declines caused many investors to lose interest in equities. Just a few years earlier, there had been widespread faith that stocks could never perform poorly for a meaningful period. Now, all of a sudden, such a time seemed to be at hand. Stocks delivered disillusionment, which can be one of the strongest forces in markets, and investors turned against them.

During the first few years of the aughts, the lack of appetite for equities – and for bonds, given how low the Fed had driven yields – caused many investors to conclude they couldn't earn their targeted returns through traditional asset classes. This, in turn, caused capital to flow to alternative investments, first hedge funds and then private equity. Soon investors were confronted by the Global Financial Crisis and the fear of financial-sector meltdown described above, which added to their negativity. These developments weighed heavily on investor psychology, and as a result, the S&P 500 was essentially flat from 2000 through 2011, returning an average of only 0.55% a year for the 12 years.

This is how things stood in March 2012, when I wrote the memo *Déjà Vu All Over Again*. My inspiration arrived when, sleepless while on a business trip in Chile, I reached into my Oaktree bag for something to read and came up with an old article I had wanted to revisit because I was sensing parallels between the current environment and the one the article described. It was "The Death of Equities," one of the most important magazine articles on investing of all time. It had appeared in *Businessweek* on August 13, 1979, following years of raging inflation, dreary economic news, and poor stock market performance.

In short, the article's theme was that no one would ever invest in stocks again because they had done so badly for so long. Here are a few of the article's observations:

Whatever caused it, the institutionalization of inflation – along with structural changes in communications and psychology – have killed the U.S. equity market for millions of investors. . . .

For investors . . . low stock prices remain a disincentive to buy. . . .

For better or for worse, then, the U.S. economy probably has to regard the death of equities as a near-permanent condition – reversible some day, but not soon. . . .

It would take a sustained bull market for a couple of years to attract broad-based investor interest and restore confidence.

In other words, poor performance had led to investor disinterest, and disinterest had perpetuated the poor performance, creating one of the supposedly unstoppable vicious cycles we see in the markets from time to time. In the author's view, this negative state was likely to prevail for years.

Like many arguments in the world of investing, the assertions in "The Death of Equities" may have seemed sensible on the surface. **But if you drilled down a bit – and, in particular, if you thought like a contrarian – the logical flaws became readily apparent. What if the lows in optimism and enthusiasm for equities meant things couldn't get any worse? Wouldn't that mean they could only get better? And in that case, wouldn't it be reasonable to assume that low stock prices presaged future gains, not continued stagnation?**

The above paragraph captures in brief the difference between the thinking of the average investor and what I call "second-level thinking." The latter doesn't rely on first impressions; rather, it's deeper, more complex, and more nuanced. In particular, second-level thinkers understand that the convictions of the masses shape the market, but if those convictions are based on emotion instead of sober analysis, they should often be bet against, not backed. Here's how I put it in *Déjà Vu All Over Again*:

The negative factors are clear to the average investor. And from there he draws negative conclusions. But the person who applies logic and insight, rather than superficial views and emotion, sees something very different.

Thus, it would not have come as a surprise to the more sophisticated investor that "The Death of Equities" – perhaps the most sweepingly dour article ever written about the stock market – preceded one of (if not the) most positive periods in market history. In the 21 years from 1979 (when the article was written) through 1999 (just before the TMT bubble burst), the S&P 500's average annual return was 17.9%. That was nearly double its long-term average and **enough to turn \$1 in 1979 into \$32 in 1999!!** Once more from *Déjà Vu All Over Again*:

Importantly, the stage had been set for this rise in 1979 by the accumulation and excessively pessimistic discounting of negatives. . . . **The extrapolator threw in the towel on stocks, just as the time was right for the contrarian to turn optimistic. And it will always be so. . . .**

The great irony here is that the extrapolator actually thinks he's being respectful of history: he's assuming continuation of a trend that has been underway. But the history that deserves his attention isn't the recent rise or fall of an asset's price, but rather the fact that most things eventually prove to be cyclical and tend to swing back from the extreme toward the mean.

Rereading "The Death of Equities" in 2012 allowed me to immediately see parallels between the then-present day and the environment in which that article was written. Recent events had been highly negative, performance had been poor, and investor sentiment was depressed. That was enough to allow me – benefiting from the lessons of history – to adopt a positive stance:

The story [in 2012] isn't as hopeless as it was in 1979, but it is uniformly negative. Thus, while I don't expect an equity rally anything like what followed on the heels of "The Death of Equities," I don't find it hard to conjure up positive scenarios.

The result: From 2012 – the year of *Déjà Vu All Over Again* – through 2021, the S&P 500 returned 16.5% a year. Once again, excessively negative sentiment had resulted in major gains. It's as simple as that.

March 2020

The last of the five calls – recent enough for readers to recall the context – came in the early days of the Covid-19 pandemic. The disease began to enter most people’s consciousness in February 2020, and from mid-February to mid-March, the S&P 500 fell by approximately one-third.

In *Nobody Knows II* (March 2020), my first memo during the pandemic, I cited Harvard epidemiologist Marc Lipsitch, who said on a podcast that when trying to understand the disease, there were (a) facts, (b) informed extrapolations from analogies to other viruses, and (c) opinion or speculation. But it was clear to me at the time that there were no “facts” regarding the pandemic’s future course and no “history of other viruses” of comparable magnitude to extrapolate from. Thus, we were left with “opinion or speculation.”

The bottom line of the above – simply put – is that we didn’t know anything about what the future held. But whereas some people think ignorance regarding the future means they mustn’t take any action, **someone who thinks the matter through logically and unemotionally should recognize that ignorance doesn’t mean the position they’re in is necessarily the position they should remain in.** (This is very much along the lines of Oaktree’s post-Lehman thinking.)

Two weeks later, on March 19, 2020, I ended my client-only memo *Weekly Update* in a similar vein:

I’ll sum up my views simply – since there’s nothing sophisticated to say:

- “The bottom” is the day before the recovery begins. Thus it’s absolutely impossible to know when the bottom has been reached . . . ever. Oaktree explicitly rejects the notion of waiting for the bottom; we buy when we can access value cheap.
- Even though there’s no way to say the bottom is at hand, the conditions that make bargains available certainly are materializing.
- Given the price drops and selling we’ve seen so far, I believe this is a good time to invest, although of course it may prove not to have been the best time.
- **No one can argue that you should spend all your money today . . . but equally, no one can argue that you shouldn’t spend any.** (Emphasis added)

Whereas some of the market calls described earlier relied on knowledge of history and/or logical analysis, this recommendation was based primarily on acknowledgment of ignorance. All we knew for sure was that (a) there was a pandemic underway and (b) the U.S. stock market was down one-third. Doesn’t it stand to reason, though, that however much money long-term investors had in stocks when the S&P 500 peaked at 3,386 in February, they should have considered adding to their positions when it hit 2,237 roughly a month later? That was the essence of my reasoning. Here’s how I built up to the conclusion cited above:

It’s easy to say that something approaching panic is present in the markets. We’ve seen record percentage declines several times within the last month (exceeded since 1940 only by Black Monday – October 19, 1987 – when the S&P 500 declined by 20.4% in a day). This week and last included down days as follows: -7.6%, -9.5%, -12.0%, and -5.2% yesterday. These are enormous losses. . . .

. . . there has been a rush to cash. Both long positions and short positions have been closed out – a sure sign of chaos and uncertainty. Cash in money market funds has

increased substantially. This doesn't tell us anything about fundamentals, but the outlook for eventual market performance is improved:

- the more people have sold,
- the less they have left to sell, and
- the more cash they have with which to buy when they turn less pessimistic. . . .

[In the words of Justin Quaglia, one of our traders,] after two days of a basically stalled but stressed [bond] market, we “finally had the rubber band snap.” Forced sellers (needing to sell for immediate cash flow needs) brought the market lower in a hurry. We opened 3-5 points lower, and the Street was again hesitant to take risk. . . .

We're never happy to have the events that bring on chaos, and especially not the ones that are underway today. But it's sentiment like Justin describes above that fuels the emotional selling that allows us to access the greatest bargains. (*Weekly Update*, emphasis added)

While neither a historical foundation nor rigorous quantitative analysis was achievable, the above paragraphs indicate that one could still logically determine an appropriate course of action. As I wrote in that same memo:

What do we know? Not much other than the fact that asset prices are well down, asset holders' ability to hold coolly is evaporating, and motivated selling is picking up.

But that was enough. Paralysis wasn't called for, but rather steps that could help us take advantage of most investors' panic and the resulting dramatic price declines. Sometimes it's as simple as that. When the knee-jerk reaction of most investors is to stand pat or sell, a contrarian decision to buy might well be called for. Doing so is never easy, though, and mid-March 2020 was one of the most challenging environments I've ever worked through. But the key, as Rudyard Kipling wrote in the poem “If,” is to “keep your head when all about you are losing theirs. . . .”

How Can You Do It?

I spent the preceding pages describing these five calls not for purposes of self-congratulation but rather to lay the groundwork for a discussion of how one can make useful observations regarding the status of the markets. **Hopefully we learn from our experiences as we go through life. But to really learn from them, we have to step back on occasion, look at an entire string of events, and figure out the following: (a) what happened, (b) is there a pattern that has repeated, and (c) what are the lessons to be learned from the pattern?**

Once in a while – once or twice a decade, perhaps – markets go so high or so low that the argument for action is compelling and the probability of being right is high. As my son helped me to recognize, I had identified five of those, and they paid off. But what if I'd tried to make 50 market calls in my 50 years . . . or 500? By definition, I would have been making judgments about markets that were closer to the middle ground – perhaps a little high or a little low, but not so extreme as to permit dependable conclusions. Investors' records of success with calls in markets like these are poor, since even if they're right about asset prices being out of line, it's very easy for something that's a little overpriced to go on to become demonstrably more so, and then to turn into a raging bubble, and vice versa. In fact, if we could rely on small mispricings to always correct promptly, they would never grow into the manias, bubbles, and crashes we see from time to time.

So, one key is to avoid making macro calls too often. I wouldn't want to try to make a living predicting the outcome of coin tosses or figuring out whether the favorite will cover the point spread in every football game over the course of a season. You have to pick your spots – as Warren Buffett puts it, wait for a fat pitch. Most of the time, you have nothing to lose by abstaining from trying to adroitly get in and out of the markets: you merely participate in their long-term trends, and those have been very favorable.

My readers know I don't think consistently profitable market calls can be manufactured out of macroeconomic forecasts. Nor do I believe you can beat the market simply by analyzing company reports. On both subjects, as Andrew puts it (see my memo *Something of Value*, January 2021), "readily available quantitative data regarding the past and present" can't hold the secret to superior performance since it's available to everyone.

When markets are at extreme highs or lows, the essential requirement for achieving a superior view of their future performance lies in understanding what's responsible for the current conditions.

Everyone can study economics, finance, and accounting and learn how the markets are supposed to work. But superior investment results come from exploiting the differences between how things are supposed to work and how they actually do work in the real world. To do that, the essential inputs aren't economic data or financial statement analysis. The key lies in understanding prevailing investor psychology.

For me, the things one must do fall under the general heading of "taking the temperature of the market." I'll itemize the most essential components here:

- **Engage in pattern recognition.** Study market history in order to better understand the implications of today's events. Ironically, when viewed over the long term, investor psychology and thus market cycles – which seem flighty and unpredictable – fluctuate in ways that approach dependability (if you're willing to overlook their highly variable causality, timing, and amplitude).
- **Understand that cycles stem from what I call "excesses and corrections"** and that a strong movement in one direction is more likely to be followed – sooner or later – by a correction in the opposite direction than by a trend that "grows to the sky."
- **Watch for moments when most people are so optimistic that they think things can only get better**, an expression that usually serves to justify the dangerous view that "there's no price too high." Likewise, recognize when people are so depressed that they conclude things can only get worse, as this often means they think a sale at any price is a good sale. When the herd's thinking is either Pollyannaish or apocalyptic, the odds increase that the current price level and direction are unsustainable.
- **Remember that in extreme times, because of the above, the secret to making money lies in contrarianism, not conformity.** When emotional investors take an extreme view of an asset's future and, as a result, take the price to unjustified levels, the "easy money" is usually made by doing the opposite. **This is, however, very different from simply diverging from the consensus all the time.** Indeed, most of the time, the consensus is as close to right as most individuals can get. So to be successful at contrarianism, you have to understand (a) what the herd is doing, (b) why it's doing it, (c) what's wrong with it, and (d) what should be done instead and why.
- **Bear in mind that much of what happens in economies and markets doesn't result from a mechanical process, but from the to and fro of investors' emotions.** Take note of the swings and capitalize whenever possible.
- **Resist your own emotionality.** Stand apart from the crowd and its psychology; don't join in!

- **Be on the lookout for illogical propositions** (such as “stocks have fallen so far that no one will be interested in them”). When you come across a widely accepted proposition that doesn’t make sense or one you find too good to be true (or too bad to be true), take appropriate action. See something; do something.

Obviously, there’s a lot to grapple with when taking the temperature of the market. In my opinion, it has more to do with clear-eyed observations and assessments of the implications of what you see than with computers, financial data, or calculations.

I’ll go into additional depth on a couple of points:

On pattern recognition: You may have noticed that the first of the five calls described above was made in 2000, when I had already been working in the investment industry for more than 30 years. Does this mean there were no highs and lows to remark on in those earlier years? No, I think it means it took me that long to gain the insight and experience needed to detect the market’s excesses.

Most notably, whereas I spent two pages above describing the profound error in “The Death of Equities,” you may have noticed that I didn’t say anything about my having called out the article when it appeared in *Businessweek* in 1979. The reason is simple: I didn’t. I had only been in this business for about a decade at that point, so (a) I didn’t have the experience needed to recognize the article’s error and (b) I had yet to develop the unemotional stance and contrarian approach needed to depart from the herd and rebel against its thesis. **The best I can say is that my eventual development of those attributes enabled me to catch the same error when it arose again 33 years later.** Pattern recognition is an important part of what we do, but it seems to require time in the field – and some scars – rather than just book learning.

On cycles: In my book *Mastering the Market Cycle*, I defined cycles not as a series of up and down movements, each of which regularly **precedes** the next – which I believe is the usual definition – but as a series of events, each of which **causes** the next. This causality holds the key to understanding cycles. In particular, I think economies, investor psychology, and thus markets eventually go too far in one direction or another – they become too positive or too negative – and afterward they eventually swing back toward moderation (and then usually toward excess in the opposite direction). **Thus, in my opinion, these cycles are best understood as stemming from “excesses and corrections.”** Overlooking the details of the individual episodes, it’s clear from the descriptions of these five calls that the greatest opportunities for bargain purchases result from overly negative prevailing psychology and the greatest opportunities to sell at too-high prices arise from excessive optimism.

Macro Calls and the Oaktree Culture

While on the subject of market calls, I want to touch on two questions I’ve received repeatedly since the publication of my memo *The Illusion of Knowledge* (September 2022), which discussed why I believe creating helpful macro forecasts is so challenging. How does making these market calls fit within Oaktree’s investment approach? And how can we make “micro forecasts” concerning companies, industries, and securities without predicting the macro context?

In 1995, when my four Oaktree co-founders and I decided to form a new firm, we’d already been working together for nine years on average. To come up with an investment philosophy that would guide the new entity, we only had to reflect on what had worked for us up to that point and what we believed in. This led us to write down the six tenets that describe how we invest, and we haven’t changed a word in 28 years.

Of the six tenets, two raise questions regarding how macro calls fit within Oaktree's investment approach:

- Number five: "We don't base our investment decisions on macro forecasts."
- Number six: "We're not market timers."

How about the first of those? It's easy to say you don't invest on the basis of macro forecasts, and I've been saying this for decades. **But the truth is, if you're a bottom-up investor, you make estimates regarding future earnings and/or asset values, and those estimates have to be predicated on assumptions regarding the macro environment.** Certainly, you can't predict a business's results in a given period without considering what'll be going on in the economy at that point. So, then, what does avoiding macro forecasting mean to us? My answer is as follows:

- We generally assume the macro environment of the future will resemble past norms.
- We then make allowance for the possibility that things will be worse than normal. Ensuring our investments have a generous "margin of safety" makes it more likely they'll do okay even if future macro developments disappoint somewhat.
- **What we never do is project that the macro environment will be distinctly better than normal** in some way, making winners out of particular investments. Doing so can lead to profits if one is right, but it's hard to consistently make such forecasts correctly. Further, investments reliant on favorable macro developments can expose investors to the possibility of disappointment, leading to loss. **It's our goal to construct portfolios where the surprises will be on the upside. Relying on optimistic underlying assumptions is rarely part of such a process. We prefer to make assumptions I would describe as "neutral."**

So we do base our modeling on macro assumptions – by necessity – but rarely are those assumptions boldly idiosyncratic or optimistic. We never base our investment decisions on the mistaken belief that we (or anyone else) can predict the future. Thus, we recognize that the above average results we seek must arise from our ground-up insights and not from our ability to do a superior job of forecasting unusual macro events.

You might ask here, "What about the memo *Sea Change* and its assertion that we may be seeing a shift toward a wholly different environment?" My answer is that I feel good about this memo because (a) it's mostly a review of recent history and (b) the important observations surround the unusual nature of the 2009-21 period, its effect on investment outcomes, and the improbability of it repeating. (I'm particularly comfortable saying interest rates aren't going to decline by another 2,000 basis points from here.) While it's important to stick to guiding principles, it's also essential to recognize and respond to real change when it happens. Thus, I stand by *Sea Change* (my only expression of an opinion of this kind in my entire working life) as an acceptable deviation from my standard practice. For me, the case for a sea change has more to do with **observing and inferring** than it does with **predicting**.

And what about market timing? As I've written numerous times since developing my risk-posture framework a few years ago, every investor should operate most of the time in the context of their normal risk posture, by which I mean the balance between aggressiveness and defensiveness that's right for them. It makes perfect sense to try to vary that balance when circumstances dictate compellingly that you should do so and your judgments have a high probability of being correct, like in the case of the five calls I've discussed. But such occasions are rare.

So, we stay in our normal balance – which in Oaktree's case implies a bias toward defensiveness – unless compelled to do otherwise. But we are willing to make changes in our balance between

aggressiveness and defensiveness, and we have done so successfully in the past. In fact, I consider one of my principal responsibilities to be thinking about the proper balance for Oaktree at any given time.

If we're happy to vary our risk posture, then what does it mean when we say, "we're not market timers"? For me, it means the following:

- **We don't sell things we consider attractive long-term holdings to raise cash in expectation of a market decline.** We usually sell because (a) a holding has reached our target price, (b) the investment case has deteriorated, or (c) we've found something better. Our open-end portfolios are almost always fully invested; that way we avoid the risk of missing out on positive returns. It also means buying usually necessitates some selling.
- **We don't say, "It's cheap today, but it'll be cheaper in six months, so we'll wait."** If it's cheap, we buy. If it gets cheaper and we conclude the thesis is still intact, we buy more. We're much more afraid of missing a bargain-priced opportunity than we are of starting to buy a good thing too early. No one really knows whether something will get cheaper in the days and weeks ahead – that's a matter of predicting investor psychology, which is somewhere between challenging and impossible. We feel we're much more likely to correctly gauge the value of individual assets.

While on the subject of buying too soon, I want to spend a minute on an interesting question: Which is worse, buying at the top or selling at the bottom? For me the answer is easy: the latter. If you buy at what later turns out to have been a market top, you'll suffer a downward fluctuation. But that isn't cause for concern if the long-term thesis remains intact. And, anyway, the next top is usually higher than the last top, meaning you're likely to be ahead eventually. But if you sell at a market bottom, you render that downward fluctuation permanent, and, even more importantly, you get off the escalator of a rising economy and rising markets that has made so many long-term investors rich. This is why I describe selling at the bottom as the cardinal sin in investing.

* * *

Thinking about the macro environment and how it influences our proper risk posture falls squarely within our responsibilities as investment managers. But the bottom line is that, at Oaktree, we approach these things with great humility, diverging from our neutral assumptions and normal behavior only when circumstances leave us no other choice. "Five times in 50 years" gives you an idea about our level of interest in being market timers. The fact is, we do so hesitantly.

July 10, 2023

Memo to: Oaktree Clients

From: Howard Marks

Re: Fewer Losers, or More Winners?

My memos got their start in October 1990, inspired by an interesting juxtaposition between two events. One was a dinner in Minneapolis with David VanBenschoten, who was the head of the General Mills pension fund. Dave told me that, in his 14 years in the job, the fund's equity return had never ranked above the 27th percentile of the pension fund universe or below the 47th percentile. And where did those solidly second-quartile annual returns place the fund for the 14 years overall? Fourth percentile! I was wowed. It turns out that most investors aiming for top-decile performance eventually shoot themselves in the foot, but Dave never did.

Around the same time, a prominent value investing firm reported terrible results, causing its president to issue an easy rationalization: "If you want to be in the top 5% of money managers, you have to be willing to be in the bottom 5%, too." My reaction was immediate: "My clients don't care whether I'm in the top 5% in any single year, and they (and I) have absolutely no interest in me ever being in the bottom 5%."

These two events had a strong influence on me and helped define my – and what five years later became Oaktree's – investment philosophy, which emphasizes risk control and consistency above all. Here's how I put it 33 years ago in that first memo, titled *The Route to Performance*:

I feel strongly that attempting to achieve a superior long-term record by stringing together a run of top-decile years is unlikely to succeed. Rather, striving to do a little better than average every year – and through discipline to have highly superior relative results in bad times – is:

- less likely to produce extreme volatility,
- less likely to produce huge losses which can't be recouped and, most importantly,
- more likely to work (given the fact that all of us are only human).

Simply put, what [General Mills's] record tells me is that, in equities, if you can avoid losers (and losing years), the winners will take care of themselves. I believe most strongly that this holds true in my group's opportunistic niches as well – that the best foundation for above-average long-term performance is an absence of disasters.

As you can see, my dinner with Dave was a seminal event; his approach was clearly the one for me. (Incidentally, I want to share that after decades of not having been in touch, Dave was among the many kind people who wrote in recent months to encourage me vis-à-vis my health issue. This is a great example of the many personal dividends my career has paid.)

Putting It in Brief

That first memo, and the bit cited above, include a phrase you've likely heard from Oaktree: **If we avoid the losers, the winners will take care of themselves.** My partners and I considered this phrase so fitting

that we adopted it as our motto when Oaktree was formed in 1995. Our reasoning was simple: If we invest in a diversified portfolio of bonds and are able to avoid the ones that default, some of the non-defaulters we buy will benefit from positive events, such as upgrades and takeovers. That is, the winners will materialize without our having explicitly sought them out.

We thought that phrase was innovative. But in 2005, while working with Seth Klarman to update the 1940 edition of Benjamin Graham and David Dodd's *Security Analysis* – the “bible of value investing” – I read something that indicated we were late by about 50 years. In the section Seth asked me to edit, I came across Graham and Dodd's description of “fixed-value” (or fixed-income) investing as “a negative art.” What did they mean?

At first, I found their observation cynical, but then I realized what they were saying. Let's assume there are one hundred 8% bonds outstanding. Let's further assume that ninety will pay interest and principal as promised and ten will default. Since they're all 8% bonds, all the ones that pay will deliver the same 8% return – it doesn't matter which ones you bought. The only thing that matters is whether you bought any of the ten that defaulted. In other words, bond investors improve their performance not through what they buy, but through what they exclude – not by finding winners, but by avoiding losers. There it is: a negative art.

One more anecdote concerning the origin of the phrase: I've always been interested in old books. A few years ago, while walking through a Las Vegas convention center on the way to meet with a client, I came upon a rare book fair. I stopped at the booth of a book dealer I know, and my eye immediately fell on a book he had for sale: *How to Trade in Stocks*, by Jesse Livermore. Here's the quote the dealer had highlighted: “Winners take care of themselves; losers never do.” You may be tempted to believe Livermore borrowed my idea . . . until you realize that, like Graham and Dodd, he published these lines in 1940. So much for my innovation.

At the time I adopted that saying, my partners and I were primarily high yield bond investors. And since non-convertible bonds have little upside potential beyond their promised yield to maturity, it truly was the case that our main job was to avoid the non-payers, with the assumption that some subset of the payers would likely give us exposure to positive developments that occurred. It was an appropriate way to sum up our approach as bond investors.

But fortunately, I joined up with Bruce Karsh in 1987, and in 1988 we organized our first distressed debt fund. Now we were investing in bonds that had defaulted or seemed likely to do so. We thought we might be able to buy them at bargain prices because of the cloud they were under, giving us the possibility of capital appreciation. Bruce has since become well known for his investing acumen, and, certainly, his returns since 1988 can't be attributed to the mere avoidance of losses. **When you aspire to returns well above those available on bonds, it's not enough to avoid losers; you actually have to find (or create) winners from time to time.** The returns generated by Bruce and his group show that they've done so.

Oaktree now has a number of what I call “aspirational strategies,” meaning they need winners. **So why do we still use the above phrase as our motto, and why is “the primacy of risk control” still the first tenet of our investment philosophy?** The answer is we want the concept of risk control to always be top of mind for our investment professionals. When they review a security, we want them to ask not only “How much money can I make if things go well?” but also “What will happen if events don't go as planned? How much could I lose if things get bad? And how bad would things have to get?”

Risk control is still number one at Oaktree. Seventy-plus years ago, UCLA football coach Henry Russell “Red” Sanders said, “Winning isn't everything, it's the only thing.” (The saying is also attributed to Vince Lombardi, legendary football coach of the Green Bay Packers.) While I haven't figured out

exactly what that phrase means, I'm firmly convinced that **for Oaktree, risk control isn't everything; it is the only thing.**

Not Risk Avoidance

Understanding the distinction between risk control and risk avoidance is truly essential for investors. Risk avoidance basically consists of not doing anything where the outcome is uncertain and could be negative. And yet, at its heart, investing consists of bearing uncertainty in the pursuit of attractive returns. For this reason, risk avoidance usually equates to return avoidance. You can avoid risk by buying Treasury bills or putting your money into government-insured deposits, but there's a reason why the returns on these are generally the lowest available in the investment world. Why should you be well paid for parting with your money for a while if you're sure to get it back?

Risk control, on the other hand, consists of declining to take risks that (a) exceed the quantum of risk you want to live with and/or (b) you wouldn't be well rewarded for bearing. I've written in the past about what I call "the intelligent bearing of risk for profit." Here's the backstory:

I got my start managing money in 1978, when Citi asked me to run portfolios of convertibles and high yield bonds. The former were mostly non-investment grade securities issued by companies that had no alternative when seeking to raise capital, and the latter were, according to the terminology of the day, low-rated "junk bonds." Clearly, they both entailed significant credit risk. Around 1980, a reporter from one of the first financial news networks asked me a provocative question: "How can you buy high yield bonds when you know some of the issuers are going to default?" My response captured the essence of intelligent risk bearing: "How can life insurance companies insure people's lives when they know they're all going to die?"

The point is simple: These functions can both be performed in an intelligent, risk-controlled way. For that to be the case, the risk has to be:

- risk you're aware of,
- risk you can analyze,
- risk you can diversify, and
- risk you're well paid to assume.

Risks like this needn't be avoided. If you have real insight, such risks can be borne prudently and profitably.

I know several investors who take much more risk than Oaktree does and whose bad years are much worse than ours. But the few who possess genuine skill – what I call "alpha" (more on that later) – produce jumbo returns in their good years, such that their long-term returns are exceptional. Their clients are well rewarded . . . assuming they have enough intestinal fortitude to hang in through the bad years. Thus, risk-taking isn't unwise per se, and risk avoidance is appropriate only for investors who feel they can't survive tough times.

Building a Good Record

Since (a) all but the most cautious investing entails risk and (b) the presence of risk means results will be unpredictable and inconsistent, very few (if any) investors are able to have only good years or to assemble

portfolios that contain only winners. **The question isn't whether you're going to have losers, but rather how many and how bad relative to your winners.**

Warren Buffett – arguably the investor with the best long-term record (and certainly the longest long-term record) – is widely described as having had only twelve great winners in his career. His partner Charlie Munger told me the vast majority of his own wealth came not from twelve winners, but only four. I believe the ingredients of Warren's and Charlie's great performance are simple: (a) a lot of investments in which they did decently, (b) a relatively small number of big winners that they invested in heavily and held for decades, and (c) relatively few big losers. No one should expect to have – or expect their money managers to have – all big winners and no losers.

In fact, not having any losers isn't a useful goal. The only sure way to achieve that is by not taking any risk. But, as I said earlier, risk avoidance is likely to result in return avoidance. **There's such a thing as the risk of taking too little risk.** Most people understand this intellectually, **but human nature makes it hard for many to accept the idea that the willingness to live with some losses is an essential ingredient in investment success.**

Having watched some great tennis this summer – right through the U.S. Open this past weekend – I'll recycle a tennis analogy I first suggested in my memo *Dare to Be Great II* (April 2014). What if I went out to play tennis and said, "Today, I'm not going to commit any service faults"? My serves would have to be so meek that my opponent would likely destroy them. **Tennis players have to take some risk if they hope to succeed** (see below). If none of your serves fall outside the service box, you're probably serving too cautiously to win. The same is true of investing. As my long-time partner Sheldon Stone puts it, "If you don't experience any defaults, you're probably not taking enough credit risk."

Winners' Stats

Looking back, it turns out I devoted an entire memo to analogies between investing and sports once per decade in the 1990s, the 2000s, and the 2010s. This time, in my fourth decade of memo-writing, I'm going to devote a few more paragraphs to tennis.

As mentioned above, tennis makes for very apt comparisons to investing. Hit safely and get blasted? Or try for shots you can't make consistently and beat yourself? Charles D. Ellis's article "The Loser's Game" (*The Financial Analysts Journal*, July/August 1975) was truly seminal in my development as an investor. He pointed out that there are two kinds of tennis players . . . actually, two different types of tennis games. Professionals play a winner's game: **They win by hitting winners** (in tennis, that means shots the opponent can't return). Since their game is so much within their control, they can usually produce the shots they want, the best of which win points. But amateur tennis is a loser's game: **The winner is usually the person who hits the fewest losers.** If you can just keep the ball in play long enough, eventually your opponent will hit it off the court or into the net. The amateur doesn't have to hit winners to win, and that's a good thing, because he or she generally is incapable of doing so dependably.

A quick look at some statistics from this year's Wimbledon provides a great deal of food for thought. I'll look first at the men's quarterfinal match between Daniil Medvedev, the #3 seed in the tournament, and unseeded Christopher Eubanks. Eubanks, 6'7" and highly athletic, surprised everyone with his rush to the quarterfinals. But, in Medvedev, he was playing someone who's spent years trailing just behind the "big three" of men's tennis: Novak Djokovic, Rafael Nadal, and Roger Federer.

As a pronounced underdog, Eubanks probably recognized that he wasn't likely to outlast or out-steady Medvedev. Thus, he had to go for winners. If that was Eubanks's plan, he succeeded in executing it. He

achieved 74 winners to Medvedev's 52, and he aggressively rushed the net 67 times (for 44 winners) compared to Medvedev's 8 (for 4 winners). These are great offensive stats.

The problem is that – as I've experienced firsthand many times – if you're up against a player who's better than you are, you have to attempt shots that aren't firmly within your competence in order to have a hope of winning. Thus, along with his 74 winners, Eubanks was guilty of 55 unforced errors (mistakes that aren't forced by good shots from one's opponent; the easy way to make an unforced error is to go for a winner and miss). In comparison, Medvedev committed only 13 unforced errors.

Bottom line: Eubanks had considerably more winners than Medvedev, but he had three unforced errors for every four winners, whereas Medvedev had only one per four. Medvedev won 53% of the points played versus Eubanks's 47%, and thus he won the match. The lesson is that it's not enough to have more winners. To win – in tennis as in investing – you have to have a favorable relationship between winners and losers. **You can win by having a few winners but fewer losers or by having a lot of losers but more winners. Neither maximizing winners nor minimizing losers is necessarily enough. It's all in the balance.**

And that leads me to the Wimbledon men's final. This exciting match pitted Djokovic, who had won the most Grand Slam championships in history (23 combined at Wimbledon, the U.S. Open, the French Open, and the Australian Open), against up-and-coming 20-year-old Carlos Alcaraz, who had a grand total of one. Like Eubanks, Alcaraz plays a big, athletic game and goes for a lot of winners. You can see that in his serving: Alcaraz had seven double faults, more than twice Djokovic's three. But, again, a single statistic tells us very little, since Alcaraz's attempts at big serves gave him nine aces (serves his opponent couldn't even get his racquet on), more than four times Djokovic's two. This is an indication of the players' respective styles. In the end, Alcaraz won the match with 66 winners, whereas Djokovic had only 32.

So, Alcaraz beat Djokovic with a "bigger," high-risk game, while Medvedev beat Eubanks with his steadier, risk-controlled style. **Neither approach is better than the other per se. Style alone never determines outcome; it's a matter of style plus execution.** My tennis teacher, Jordi Ballester, explains: "Alcaraz plays a more aggressive game. Given his high level of talent, as he showed at Wimbledon, if he has a good day, he can beat Djokovic (or any other opponent). If he's off, he may well lose."

It's interesting to note that tennis's big three presided over an incredible era. In the 19 years leading up to Wimbledon 2023, they won a combined 65 – or 87% – of the 75 Grand Slam championships. Notably, none of them was a "big hitter" in Alcaraz's mold. **Their ability to hit at a fabulous level for four or five hours without committing many errors was usually enough.**

The Need for Winning Stocks

There have been several times over the course of my career when a small number of stocks have accounted for a disproportionately large share of the market's gains. In this regard, a lot has been written about the so-called "magnificent seven": Apple, Microsoft, Alphabet (owner of Google), Amazon, Nvidia, Tesla, and Meta (owner of Facebook). At various points in time this year, these seven stocks accounted for most or all of the gains of various equity indices. Here's how the *Financial Times* put it in June:

Seven of the biggest constituents . . . have ripped higher, gaining between 40 per cent and 180 per cent this year. The remaining 493 companies [in the Standard & Poor's 500 stock index] are, in aggregate, flat.

Big tech companies dominate the index to an unprecedented degree. Just five of those seven stocks represent nearly a quarter of the market capitalisation of the entire index. (“The seven companies driving the US stock market rally,” *Financial Times*, June 14, 2023.)

The extent of these stocks’ outperformance for much of this year may be unique, but the phenomenon is not. It was also the case in 2017 that a few stocks were largely responsible for carrying the market upward. Then it was the “FAANGs”: Facebook, Amazon, Apple, Netflix, and Google/Alphabet. The *Financial Times* highlighted this history as well:

Top-heaviness, particularly in US markets, is not new. “The big tech stocks in the S&P now are the same situation as oil companies were in the past, or the Nifty 50 in the 1960s,” says Frédéric Leroux, head of the cross-asset team at Carmignac in Paris – a nod to the craze that swept shares in a small number of fast-growing companies such as IBM, Kodak and Xerox higher before a heavy decline set in. “It’s a problem, but it’s a recurring problem.” (Ibid.)

For as long as most of us can remember, active investors have had a tough time keeping up with the equity indices. For this reason, in recent decades, passive investing has taken a substantial share of equity capital invested. Active investing’s shortfall has been attributed primarily to the combination of market efficiency, management fees, and investor error. I think there’s another reason: active investors’ need for winners.

What if you didn’t own the magnificent seven earlier this year? Clearly, you’d be far behind the indices. What if you owned them, but in smaller proportions than their weightings in the indices? You’d still lag, but by a smaller amount. **So, by definition, keeping up with the indices requires having exposure to the big winners that is at least equal to their representation in the indices.** That much seems clear.

Now, think about that representation. Let’s say you started off 20 years ago – in the summer of 2003 – with an index-sized holding of Apple at a split-adjusted price of \$0.37. The key question is simple: **Would you have held on as it rose?**

As I described in my memo *Selling Out* (January 2022), most investors subscribe to the conventional wisdom of “taking profits,” “taking some money off the table,” or “topping the trees.” After all, as the old saying goes, “No one ever went broke taking profits.” Investors often sell off some of their winners for the simple reason that they’re afraid to watch as they give up their gains, which can lead to regret, criticism from clients, and/or lost accounts.

Most people would have sold part or all of their Apple holding by the time the price reached \$15 in the summer of 2013. What would you have done when it hit 40 times your original cost after 10 years?

Today, another 10 years later, Apple is around \$180¹ – up 12x since 2013 and up by almost 500x since 2003. The point is, in the face of these gains, very few investors would still hold all they’d originally bought. **But if they sold Apple stock when the constructors of the index didn’t, they’ve probably failed to keep up with the index.** The situation can be summed up as follows:

¹ This reflects the price as of September 8, 2023.

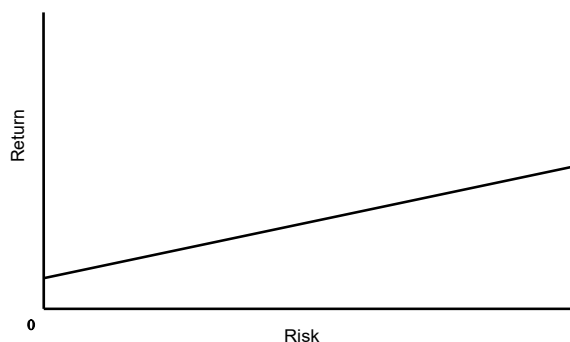
- The performance of the equity indices is often dominated by a few stocks or groups of stocks.
- The gains of the leaders can make them seem expensive, arguing for profit-taking.
- Human nature – especially the desire to avoid regret – adds to the motivation to sell.
- By definition, if you reduce your holdings of the winners relative to their representation in the indices and these winners continue to outperform, you’ll have a tough time keeping up.

In my memo *Liquidity* (March 2015), I included an insight from my son Andrew. To paraphrase, he said, “If you look at the chart of a stock that’s been up for 25 years and say, ‘Man, I wish I’d owned that stock,’ think about all the days you would have had to talk yourself out of selling.” I doubt many people watched Apple go from \$0.37 to \$180 without selling any. How many active investors would allow Apple shares to constitute nearly 8% of their portfolios, which was its weight in the S&P 500 at the recent peak? But – to oversimplify – if they sold Apple, they’ve lagged.

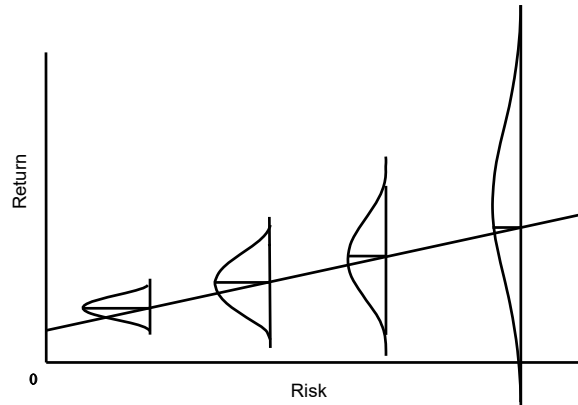
The bottom line is that winners aren’t entirely dispensable. If you hope to at least keep up with the indices, you probably have to have an average representation in them. (This isn’t entirely inescapable. You might also achieve that goal by holding fewer of the losers.)

The Role of Risk Bearing

I’m going to conclude this memo using my favorite graph. When I attended graduate school at the University of Chicago 55 (!) years ago, I was taught to view the relationship between risk and return as follows:

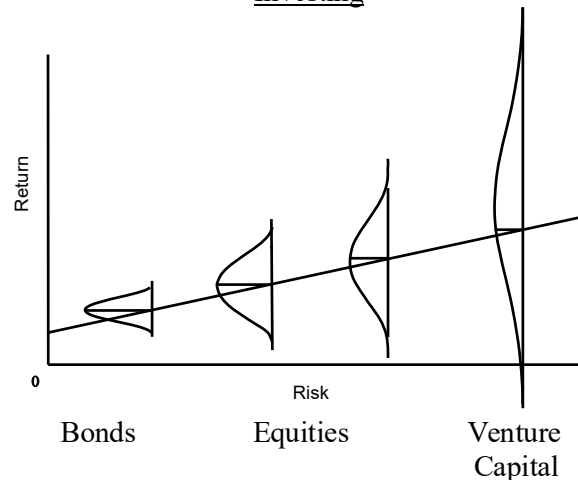


But the more I thought about it, the more unhappy I was with the way the linear presentation of the purported relationship tells investors that they can count on achieving higher returns as a result of taking more risk. After all, if that were really the case, risky investments wouldn’t be riskier. Thus, in my memo *Risk* (January 2006), I suggested a different way of depicting the relationship by superimposing on the line a series of bell-shaped probability distributions turned on their side:

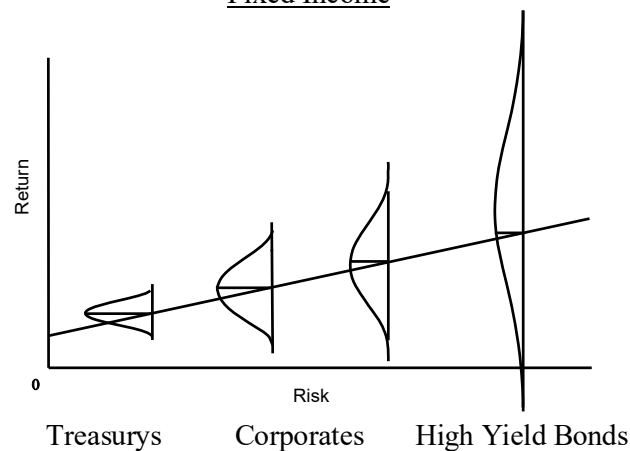


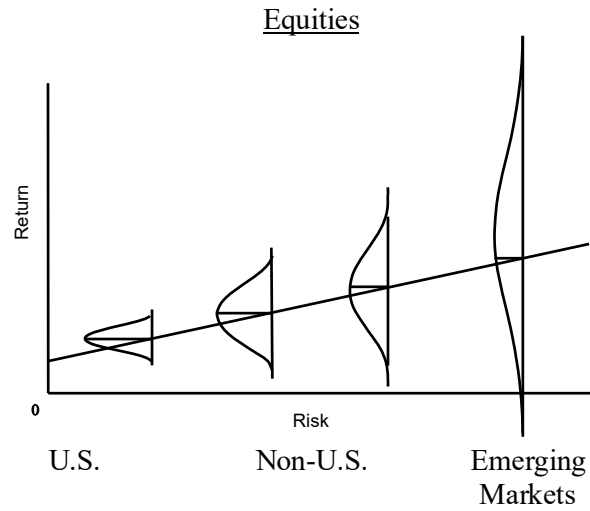
Rather than implying that taking more risk – moving from left to right in the graph – assures higher returns, this new way of looking at the relationship suggests that as you take more risk, (a) the expected return increases, as per the original version above; (b) the range of possible outcomes becomes wider; and (c) the bad possibilities become worse. In other words, riskier investments introduce the potential for higher returns, but also the possibility of other less-desirable side effects. That’s why they’re described as being riskier. Since writing that memo, I’ve concluded that this way of thinking about things has a great many applications. Here are a few:

Investing

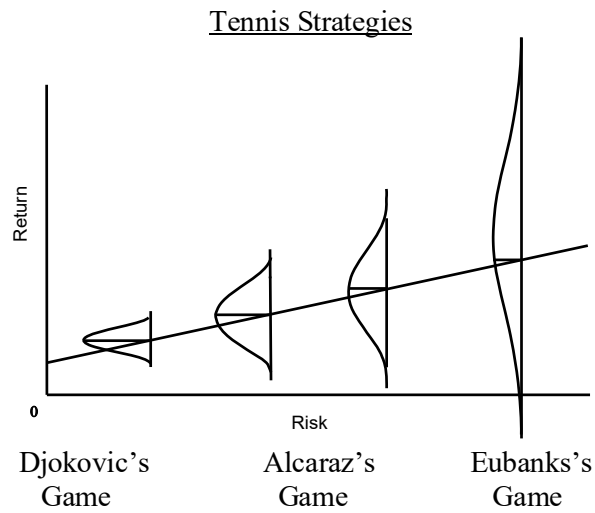


Fixed Income

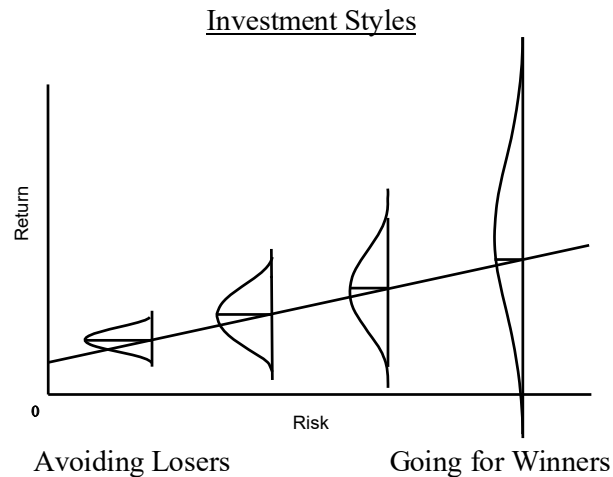




There are also applications for this way of seeing things outside the investment world. For example:



And that brings me back to the subject of this memo:



As the above graphs indicate, a high-risk approach introduces the potential for huge returns . . . as well as the possibility of loss.

So, where's the right place to be on this spectrum? Where can one find the best risk/return bargains? The short answer is that, according to investment theory – particularly the Efficient Market Hypothesis – there are no better (or worse) places to be. **The EMH says markets price securities such that (a) their price equals their intrinsic value and (b) bearing incremental risk is rewarded fairly.** Thus, bargains and over-pricings can't exist. This is why, according to the theory, "you can't beat the market."

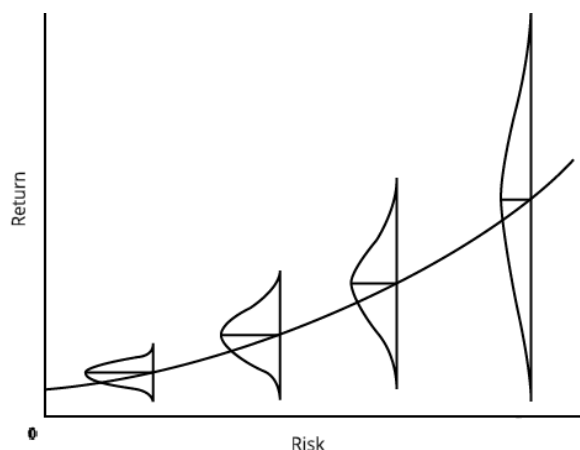
The theory also suggests that if a market is at "equilibrium," each change in prospective return is fair relative to the change in risk borne, such that all positions on the curve are equivalent in attractiveness. Move to the left, and you avoid some risk, but your prospective return drops. Move to the right, and your prospective return increases, but so does your risk. No position on the spectrum is superior to any other. It's like a coin toss (which the EMH suggests active investing is): Neither heads nor tails is the smarter call.

What About in Practice?

One of my favorite quotes is attributed to Albert Einstein and Yogi Berra, among others: "In theory, there is no difference between theory and practice. In practice, there is." If markets are efficient and securities are always priced correctly, there can be no value in active investing. The truth is that many active managers, especially in developed market equities, have failed to demonstrate the ability to add value, or to add enough value to justify their management fees. This is largely why index funds were created and why a significant amount of equity capital has migrated to index and passive investing in recent decades.

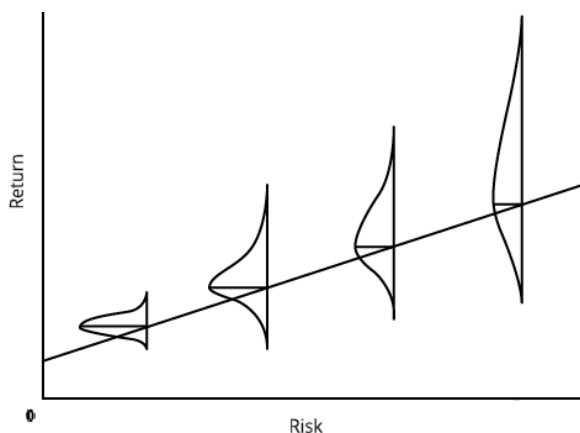
And yet, I firmly believe there are times when the markets are overpriced and times when they're underpriced. There are also times when particular markets or sectors are overpriced or underpriced relative to others. In these instances, some securities can be priced too high or too low, and thus some positions on the risk curve can offer better bargains than others.

The theory assumes investors are rational and objective, but psychological excesses violate that assumption. Take, for example, the investment environment during the Global Financial Crisis. As I described in my July memo *Taking the Temperature*, in late 2008, investors were so worried about a financial sector meltdown that they panicked and sold securities aggressively as their prices collapsed. Excessive risk aversion causes the risk/return line to steepen (increasing the return for each incremental unit of risk borne) and perhaps even to curve upward (rendering the compensation for making investments at the risky end of the spectrum disproportionately generous). Thus, in periods of excessive risk aversion, the riskier part of the curve can be the smarter place to be (and in periods when risk bearing is too eagerly embraced, the safer part can offer a superior proposition).



The last element I want to touch on is what I call “alpha,” or individual investing skill. The reason the EMH disdains efforts to beat the market is its conviction that since securities are always priced correctly, the ability to identify bargains to buy and over-pricings to avoid can’t exist. Theory’s assertion that there’s no such thing as mastery of markets implies that no one has the skill to assemble portfolios that outperform. This is why I depict the bell-shaped curves above as symmetrical: In an efficient market, investors can only take what the market gives them.

But I’m convinced the potential to improve on that through skill does exist in some markets and some people. **Investors who possess alpha have the ability to alter the shape of the distributions in the graphs above so that they’re not symmetrical, in that the portion of the distribution representing the less desirable outcomes is smaller than the portion representing the better ones. In fact, that’s what alpha really means: Investors with alpha can go into a market and, by applying their skill, access the upside potential offered in that market without taking on all the downside risk.** In my memo *What Really Matters?* (November 2022), I said the key characteristic of superior investing is asymmetry – having more upside than downside. Alpha enables exceptional investors to modify the probability distributions such that they are biased toward the positive, resulting in superior risk-adjusted returns.



If alpha is the ability to earn return without taking fully commensurate risk, investors possessing it can do so by either reducing risk while giving up less return or by increasing potential return with a less-than-commensurate increase in risk. In other words, skill can enable some investors to outperform by emphasizing aggressiveness and some by emphasizing defensiveness. The choice between these approaches depends on the type of alpha an investor possesses: Is it the ability to produce stunning

returns with tolerable risk, or the ability to produce good returns with minimal risk? Almost no investors possess both forms of alpha, and most possess neither. **Investors who lack alpha shouldn't expect to be able to produce either version of asymmetry – that is, to be able to generate superior risk-adjusted returns. However, most believe they do have it.**

The proper choice between the two approaches – **fewer losers or more winners** – depends on each investor's skill, return aspiration, and risk tolerance. As with many of the things I discuss, there's no right answer here. Just a choice.

September 12, 2023

Memo to: Oaktree Clients

From: Howard Marks

Re: The Indispensability of Risk

Oftentimes, we're best able to understand something we're interested in through analogies that clarify the matter by establishing connections between it and other parts of life. That's why I've written a memo comparing investing to sports in each of the four decades I've been writing memos and one connecting investing and card playing in 2020.

The motivation for this memo comes from an article in *The Wall Street Journal* of April 12 that my partner Bruce Karsh sent me entitled "Chess Teaches the Power of Sacrifice" by Maurice Ashley, a chess grandmaster who has been inducted into the U.S. Chess Hall of Fame. Few people know that Bruce is a chess player, and I hadn't thought about this fact for years, but the article provided a good reminder and moved me to dash off this memo.

As is obvious from the article's title, the piece is mostly about the role of sacrifice. Ashley says, "Many positions cannot be won or saved without something of value being given away, from a lowly pawn all the way up to the mighty queen." Intentionally losing a piece as part of one's gameplan is the sacrifice that Ashley is referencing.

- He describes some sacrifices as "shams," (a term coined by chess master Rudolf Spielmann in his book *The Art of Sacrifice in Chess*) where "... one can easily see that the piece being given up will return concrete benefits that can be clearly calculated." In other words, I put a piece in clear jeopardy, but I do this so that I'll be able to take one of yours of greater value.
- Others are deemed "real" sacrifices, where "... giving away a piece offers gains that are neither immediate nor tangible. The return on investment might be controlling more space, creating an assailable weakness in the opponent's position, or having more pieces in the critical sector of attack."

The analogy to investing begins to become clear. Buying a 10-year U.S. Treasury note is a modest or "sham" sacrifice. You give up the use of your money for ten years, but that's only an opportunity cost, and accepting it brings the certainty of interest income. Most other investments involve real sacrifices, though, where the risk of loss is borne in pursuit of "gains that are neither immediate nor tangible."

Ashley goes on to speak of sacrifice in risk/return terms that are familiar to investors. He describes his mother's decision to leave him (at age two) and his two siblings in Jamaica and travel to the U.S. in search of a better life for herself and for them. She reached her goal a decade later and was able to bring her kids to the U.S., where they would find success in a variety of fields:

It did not have to turn out that way. It did because she was willing to stomach the key aspect of making real sacrifices: **the willingness to take risks.** For a chess player, risk is as much intuited as it is calculated. Due to the inherent complexity of the game, it is virtually impossible to assess with certainty whether a risky move will pay off in the end. **It's up to the player to decide if sufficient conditions have been met to take the chance on a risky move. . . .**

What we do know, however, is that the famous saying “No risk, no reward” is true in many cases. A skilled adversary is normally able to handle solid, conservative play and therefore able to rob us of opportunities that may be inherent in our position. As [five-time world chess champion] Magnus Carlsen put it, “Not being willing to take risks is an extremely risky strategy.” (Emphasis added)

And there you have it: the indispensability of risk.

The Risk of Not Taking Risk

Because the future is inherently uncertain, we usually have to choose between (a) avoiding risk and having little or no return, (b) taking a modest risk and settling for a commensurately modest return, or (c) taking on a high degree of uncertainty in pursuit of substantial gain but accepting the possibility of substantial permanent loss. Everyone would love a shot at earning big gains with little risk, but the “efficiency” of the market – meaning the fact that the other participants in the market aren’t dummies – usually precludes this possibility.

Most investors are capable of accomplishing “a” and most of “b.” The challenge in investing lies in the pursuit of some version of “c.” **Earning high returns – in absolute terms or relative to other investors in a market – requires that you bear meaningful risk – either the possibility of loss in the pursuit of absolute gain or the possibility of underperformance in the pursuit of outperformance. In each case, the two are inseparable.** As Ashley says, no risk, no reward. No pain, no gain.

The risk inherent in not taking enough risk is very real. Individual investors who eschew risk may end up with a return that is insufficient to support their cost of living. And professional investors who take too little risk may fail to keep up with their clients’ expectations or their benchmarks.

Like chess (and most card games), backgammon requires the calculation of when to take risk and when to avoid it. In backgammon, two players move their checkers around the board based on throws of a pair of dice. One player moves clockwise and the other counterclockwise. When players’ checkers come near each other, the player who’s moving often has a choice between (a) landing on one of the other player’s checkers, sending it back to the start (but at the risk of leaving the moving checker in a vulnerable position), and (b) avoiding doing so to play it safe. No one wants to be exposed and get hit. But most beginners play it too safe, and because they put so much emphasis on avoiding getting hit, they rarely win.

Relevant lessons from sports (included in past memos) are easily accessed and also very helpful:

- “You miss 100% of the shots you don’t take.” – Wayne Gretzky, NHL Hall of Famer
- “You have to give yourself a chance to fail.” – Kenny “The Jet” Smith, two-time NBA champion

I’ll sum up with a paragraph from my memo of last September, *Fewer Losers, or More Winners?* The final sentence says a great deal about sacrifice and risk:

... not having any losers isn’t a useful goal. The only sure way to achieve that is by not taking any risk. But ... risk avoidance is likely to result in return avoidance. There’s such a thing as the risk of taking too little risk. Most people understand this intellectually, but **human nature makes it hard for many to accept the idea that the willingness to live with some losses is an essential ingredient in investment success.**

How to Think About Risk-Taking

The paradox of risk-taking is inescapable. You have to take it to be successful in competitive, high-aspiration arenas. But taking it doesn't mean you'll be successful; that's why they call it risk.

Equally paradoxical, earning a high rate of return over a long time period doesn't have to – and usually doesn't – connote a record of consistent success. More often it results from having made a lot of well-reasoned investments, some subset of which worked out well. Here's how I described the basis for the success of Berkshire Hathaway in *Fewer Losers, or More Winners?*:

I believe the ingredients of Warren [Buffett]'s and Charlie [Munger]'s great performance are simple: (a) a lot of investments in which they did decently, (b) a relatively small number of big winners that they invested in heavily and held for decades, and (c) relatively few big losers. No one should expect to have – or expect their money managers to have – all big winners and no losers.

Investors must accept that success is likely to stem from making a large number of investments, all of which you make because you expect them to succeed, but some portion of which you know won't. You have to put it all out there. You have to take a shot. Not every effort will be rewarded with high returns, but hopefully enough will do so to produce success over the long term. That success will ultimately be a function of the ratio of winners to losers, and of the magnitude of the losses relative to the gains. But refusal to take risk in this process is unlikely to get you where you want to go.

I'll conclude with another good paragraph from Ashley:

Taking a chance doesn't mean there will be a successful outcome, nor does it require it. If the reasons are sound, the risk should be taken almost reflexively. The more often we trust our judgment, the more confidence we gain in our decision-making capacity. The courage to take risks becomes a worthwhile end in itself.

The bottom line on the quest for superior investment returns is clear: **You shouldn't expect to make money without bearing risk, but you shouldn't expect to make money just for taking risk. You have to sacrifice certainty, but it has to be done skillfully and intelligently, and with emotion under control.**

April 17, 2024

Memo to: Oaktree Clients

From: Howard Marks

Re: Ruminating on Asset Allocation

When I travel to see clients and spend entire days discussing investing and the markets, memo ideas often pop up. Last month's visit with clients in Australia is a case in point. We talked about the "sea change" I believe is taking place in interest rates and about the role of credit in portfolios, and in a few cases, this led to the general topic of asset allocation. The result wasn't a lot of new ideas on the subject, but rather a new way to combine old ideas into a unified theory.

Before I proceed, I want to mention that, from time to time in this memo, I'll say "generally," "usually," or "everything else being equal." These caveats are likely applicable to many more sentences and ideas herein, but for the sake of readability, I'm not going to repeat them *ad nauseum*. In addition, I'm going to use a lot of graphics, as I truly believe one picture is worth a thousand words. Please bear in mind that these representations are intended to be notional, not technically correct.

Asset Classes

From my vantage point, "asset allocation" is a relatively new thing. No one used that phrase when I joined the industry 55 years ago. Structuring portfolios was a pretty simple matter, generally following the classic "60/40" split. Most U.S. investors limited themselves to investing in U.S. stocks and bonds, and there was a time-honored notion that something like 60% equities and 40% bonds represented reasonable diversification.

Today, investors are presented with so many choices – and there's so much emphasis on getting the decision right – that the term "asset allocation" is very prominent, and there are individuals and whole departments dedicated to doing just that. It's their job to decide how to weight the asset classes to be held in a portfolio, meaning asset allocators spend their time on decisions like these:

- How much in equities and how much in debt?
- How much in stocks and bonds and how much in "alternatives"?
- How much in public securities and how much in private assets?
- How much in one's home country and how much abroad?
- How much of the latter in the developed world and how much in emerging markets?
- How much in high quality assets and how much in low quality?
- How much in more volatile "high beta" assets and how much in steadier ones?
- How much in levered strategies and how much unlevered?
- How much in "real assets"?
- How much in derivatives?

It's enough to make your head spin. Many investors use computer models to help with these decisions, but the models require inputs regarding expected return, risk, and correlation, and most of these are based on history and thus of questionable relevance to the future. Correlation between asset classes is particularly difficult to predict. It's often a case of garbage in, garbage out (but with the added comfort that comes from using mathematical models).

Ever since coming up with my sea change thesis regarding interest rates two years ago, I've been talking about the increased utility of credit investments. And the more I've done so, the more I've thought about the difference between credit investments and equities. **Thus, the first thing I want to mention about my "Australian epiphany" is the unconventional idea that, at bottom, there are only two asset classes: ownership and debt.** If someone wants to participate financially in a business, the essential choice is between (a) owning part of it and (b) making a loan to it.

When I moved from Citibank's equity research department to its bond department in 1978, I learned firsthand that this is a matter of night and day. On my new desk, I found a machine called a Monroe 360/65 Bond Trader. If you typed in a bond's interest rate, maturity date, and market price, it would tell you the yield to maturity . . . in other words, what your return would be if you bought the bond at that price and held it to maturity (and it paid). **This was revolutionary to me. On the equity side I'd come from, there was no place you could look to find out what your return would be.**

This highlighted for me something I've always felt most investors don't grasp viscerally: the essential difference between stocks and bonds . . . that is, between ownership and lending. Investors seem to think of stocks and bonds as two things that fall under the same heading. But the difference is enormous. **In fact, ownership and lending have nothing in common:**

- Owners put their money at risk with no promise of a return. They acquire a piece of a business or other asset and **are entitled to their proportional share of any residual** that remains after the necessary payments have been made to employees, providers of raw materials, landlords, tax authorities, and, of course, lenders. If there's something left over, it's called profit or cash flow, and the owners have the right to share in whatever part of it is paid out. And if there's profit or cash flow (or the potential for it in the future), the business will have "enterprise value," in which the owners also share.
- Lenders typically provide funds to help owners purchase or operate businesses or other assets and, in exchange, are promised periodic interest and the repayment of principal at the end. **The relationship between borrower and lender is contractual**, and the resulting return is known in advance as described above, again assuming the borrower makes the promised payments when due. That's why this kind of investing is called "fixed income" – the income is fixed. For the purposes of this memo, however, it might help to think of it as "fixed outcome" investing.

This isn't a difference in degree; it's a difference in kind. Ownership assets (things like common stocks, whole companies, real estate, private equity, and real assets) and debt (bonds, loans, mortgage backed securities, and other streams of promised payments) should be thought of as entirely different, not variations on a theme. They have different characteristics and potential, and the choice between them is one of the most basic things investors must decide.

The Essential Choice

At the outset of this memo, I listed some of the decisions that comprise the asset allocation process. But how can those decisions be approached? What's the framework for making them?

The next piece that clicked into place in my thinking "down under" was with regard to the basic characteristics of a portfolio. **In my opinion, one decision matters more than – and should set the basis for – all the other decisions in the portfolio management process. It's the selection of a targeted "risk posture," or the desired balance between aggressiveness and defensiveness.** The essential decision in investing is how much emphasis one should put on preserving capital and how much on growing it. These two things are mostly mutually exclusive:

- Insistence on preserving capital – or, secondarily, on limiting the portfolio’s volatility – calls for an emphasis on defense, which precludes pursuing maximum growth.
- Correspondingly, a decision to strive to maximize growth requires an emphasis on offense, meaning preservation of capital and steadiness must be sacrificed to some degree.

It’s one or the other. You can’t simultaneously emphasize both preservation of capital and maximization of growth, or defense and offense. This is the fundamental, inescapable truth in investing. The questions listed on page one are just details, the options available for reaching your targeted risk posture.

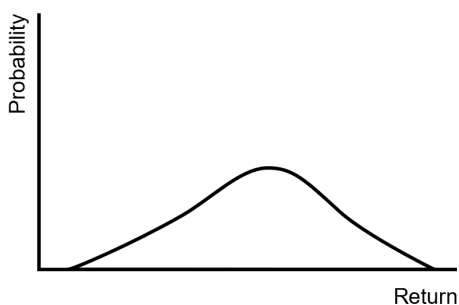
If you think about portfolio construction in this sense – looking for the right balance between offense and defense – it becomes clear that the goal should be optimization, not maximization. To my mind, it shouldn’t be “wealth,” but “wealth pursued in an appropriate way, taking into account the investor’s wants and needs.”

Many people think the proper goal in investing is achieving **the highest return**. More sophisticated thinkers understand – either intellectually or intuitively – that the goal should be to achieve **the best relationship between return and risk**. If you follow that latter mandate, it’ll hopefully lead you to assets whose expected return is more than sufficient to compensate for their risk, and thus to a portfolio with the potential for an attractive risk-adjusted return. But that’s not enough.

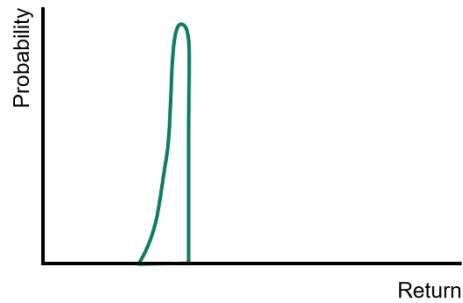
The absolute level of risk in a portfolio shouldn’t be an unwitting consequence of the asset allocation process described above, or of the search for superior risk-adjusted returns. The absolute risk level must be consciously targeted. In fact, in my view, it’s the most important thing. For an investment program to be successful, the level of risk in the portfolio must be well compensated and fall within the desired range . . . neither too much nor too little.

The Shape of the Curves

In the last few months, I’ve been drawing probability distributions to illustrate the fundamental difference between the potential returns from ownership assets and debt (or “fixed income,” “credit,” or whatever you want to call it). Here’s the general shape of the curve describing the potential return on a portfolio of ownership assets (Figure 1):

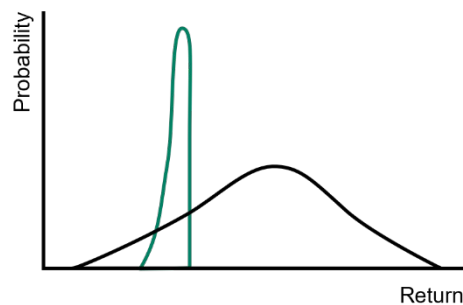


And following on page four is the shape of the curve describing the potential return on a portfolio of debt (Figure 2):

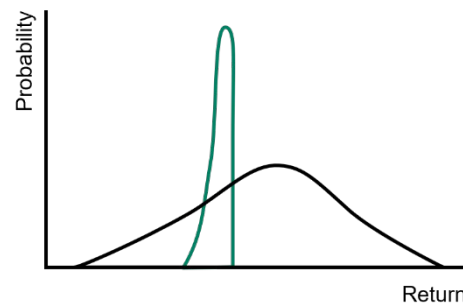


Ownership assets typically have a higher expected return, greater upside potential, and greater downside risk. Everything else being equal, the expected returns from debt are lower but likely to fall within a much tighter range. There's generally no upside on debt – no one should buy an 8% bond expecting to make more than 8% per year over the long term. But there's also relatively little downside – you'll get your 8% if the borrower pays, and relatively few fail to pay. For this reason, offense is usually better played through ownership assets, and defense is usually better played through debt. (I hasten to add that investing isn't a matter of either/or. The two can be combined, meaning the operative question surrounds the right mix.)

In the low-interest-rate environment that prevailed from 2009 through 2021, the expected return from debt was extremely low in the absolute and far below the historical return on equities, rendering debt relatively unattractive (Figure 3).



But today, it's considerably higher than it was and closer to that of equities (Figure 4). That's why I've been urging increased investment in credit.



Obviously, the relationship between the two curves at a point in time has a very direct bearing on the appropriate asset allocation at that time.

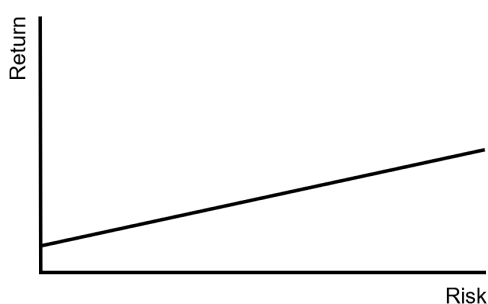
Which of the two is “better,” ownership or debt? We can’t say. In a market with any degree of efficiency – that is, rationality – it’s just a tradeoff. A higher expected return with further upside potential, at the cost of greater uncertainty, volatility, and downside risk? Or a more dependable but lower expected return, entailing less upside and less downside? The choice between the two is subjective, largely a function of the investor’s circumstances and attitude toward bearing risk. That means the answer will be different for different investors.

Choosing the Offense/Defense Balance

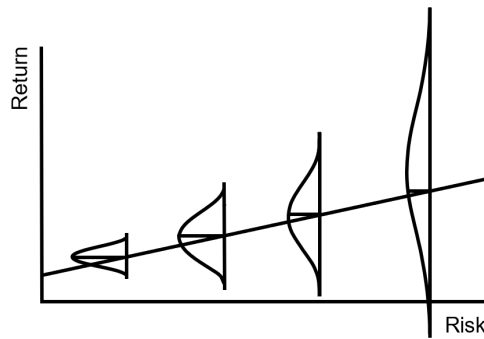
I’ve previously expressed my view that, as a starting point, every investor or their investment manager should identify their appropriate normal risk posture or offense/defense balance. For each individual or institution, this decision should be informed by the investor’s investment horizon, financial condition, income, needs, aspirations, responsibilities, and, crucially, intestinal fortitude, or their ability to stomach ups and downs.

Once investors have specified the normal risk posture that’s right for them, they face a choice: they can maintain that posture all the time, or they can opt to depart from it on occasion in response to the movements of the market and thus changes in the attractiveness of the offerings it provides, increasing their emphasis on offense when the market is beaten down and on defense when it’s riding high.

Regardless of whether one’s risk posture is fixed or variable, however, the next question is how one gets there. This question led me to think about another old idea: the relationship between risk and return. I’ve described a million times the way this was taught at the University of Chicago, beginning when I was there in the 1960s. It’s a graphical presentation we’ve all seen ever since, in which, as we move from left to right, increasing the expected risk, the expected return also increases (Figure 5):

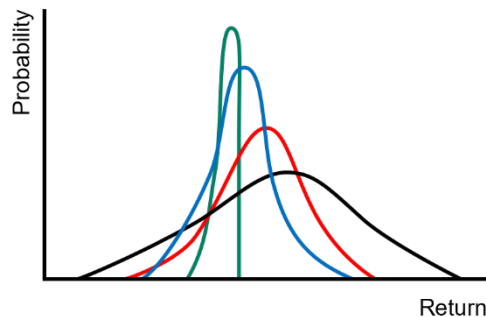


As readers know, I always felt this representation was highly inadequate, since **the linearity of the relationship in the graph makes it appear too certain that increased risk will lead to increased return. This obviously belies the nature of risk.** So, in a memo in 2006, I took the same line and superimposed on it some bell-shaped curves representing probability distributions turned on their side. I did this to indicate the uncertain nature of returns from riskier assets (Figure 6):



Now, we see that as the thing called “risk” increases (that is, as we move from left to right on the graph), not only does the expected return increase, but the range of possible outcomes becomes wider and the bad outcomes become worse. That’s risk! (I hope this way of presenting risk will be considered a lasting contribution to the investment industry when I’m gone.)

Doodling one day, I took the black and green curves describing ownership asset returns and debt returns from Figure 4 and added some intermediate positions in blue and red to indicate various combinations of the two. Thus, the blue curve is 2/3 debt and 1/3 ownership, and the red is 1/3 debt and 2/3 ownership (Figure 7):



In Australia, as I was showing this diagram, it struck me that Figure 7 is just another way to represent the idea presented in Figure 6. Again, as we move from left to right (more ownership assets, less debt), the expected return increases and the expected risk increases (that is, just as in Figure 6, the range of possible outcomes grows wider and the left-hand tail stretches further into undesirable territory). This way of presenting the options might be more intuitively clear.

Someone who believes in “more risk, more return” as portrayed in Figure 5 should logically adopt a high-risk posture. But if they understand the real implications of increased risk, as suggested by Figures 6 and 7, then they might opt for something more moderate.

The Role of Alpha and Beta

All the foregoing assumes markets are efficient:

- As risk increases in an efficient market, expected return increases proportionally. Or maybe that’s better stated the other way around: as expected return increases, so does the accompanying risk (the uncertainty surrounding the outcome and the likelihood of a bad one). Thus, no position on the risk continuum (for example, in Figure 6) is “better” than any other. It’s all just a matter of where you want to come out in terms of absolute riskiness, or what absolute level of return you

want to aim for. **The ratio of return to risk is similar at all points on the continuum** – less of both toward the left, and more of both toward the right. Said another way, there's no free lunch.

- Also, looking at each position on the risk continuum, **the symmetricalness of the vertical distribution of possible returns around the expected return is similar from one position to the next**. That means the ratio of upside potential to downside risk at one position on the continuum isn't markedly better than it is at other positions – again no free lunch.
- Finally, if you want to move further out on the risk continuum, you can do so by either (a) investing in riskier assets or (b) applying leverage to the same assets (magnifying both the expected return and risk). Again, in a fully efficient market, **neither tactic is preferable to the other**.

The above three statements capture some of the important implications of supposed market efficiency.

Looked at this way, the only thing that matters is getting to the right risk position for you; **under an assumption of market efficiency, there's nothing to be gained in terms of return at a given level of risk. All ways of getting to a certain risk level will produce the same expected return.**

The reason for this is the academic view that, in an efficient market, (a) all assets are priced fairly relative to each other, such that there are no bargains or over-pricings to take advantage of and (b) there's no such thing as alpha, which I define as “gains resulting from superior individual skill.” **As a result, there's nothing to be gained from active decision making: no asset class, strategy, security or manager is “better” than any other. They merely vary in terms of risk and resulting return.**

Also in the academic view, since there's no such thing as alpha, the only thing that differentiates assets is their beta, or their relative volatility, the extent to which they reflect market movements. In the theory, it's beta that expected returns are proportional to.

Now it's time for me to assert strenuously that, **in reality, markets are not efficient in the academic sense of always being “right.”** Markets may do an efficient job of (a) rapidly incorporating new information and (b) accurately reflecting the resulting consensus opinion concerning the right price for each asset given the totality of information, **but that opinion can be far from correct.** For that reason, gains can be achieved by choosing skillfully among the options:

- some assets, markets or strategies can offer a better risk/return bargain than others, and
- some managers can operate within a market or strategy to produce superior risk-adjusted returns.

This last idea raises one of the key questions in asset allocation: should you consider departing from your “sweet spot” in terms of risk level in order to invest in a riskier asset class with a manager believed to possess alpha? There's no easy answer to this question, especially given that many managers who are believed to possess alpha turn out not to.

To conclude, I'll recap the key points:

- Fundamentally speaking, the only asset classes are ownership and debt.
- They differ enormously in terms of their fundamental nature.
- Ownership assets and debt assets should be combined to get your portfolio to the position on the risk/return continuum that's right for you. This is the most important decision in portfolio management or asset allocation.
- The other decisions are merely a matter of implementation.

- Of course, your asset allocation process will be informed by how you rate your ability to identify and access superior strategies and superior managers, recognizing that doing so isn't easy.

* * *

Moving on to the real world, I want to make some important observations regarding one of Oaktree's key sectors, non-investment grade credit (defined as performing non-government debt):

- The prospective returns in this area today are much higher than they were in the 2009-21 period.
- These returns, starting at roughly 7% on public credit and 10% on private credit, are competitive with the historical returns on equities and capable of helping many investors toward their overall return targets.
- Because of their contractual nature, the returns from credit are likely to prove much more dependable than ownership returns.

In my view, the thought process set forth in this memo leads to the conclusion that investors should increase their allocations in this area if they are (a) attracted by returns of 7-10% or so, (b) desirous of limiting uncertainty and volatility, and (c) willing to forgo upside potential beyond today's yields to do so. For me, that should include a lot of investors, even if not everyone.

My recommendation at this time is that investors do the research required to increase their allocation to credit, establish a "program" for doing so, and take a partial step to implement it. While today's potential returns are attractive in the absolute, higher returns were available on credit a year or two ago, and we could see them again if markets come to be less ruled by optimism. I believe there will be such a time.

Thank you for indulging me in this foray into investment philosophy. I hope you've found it of value.

October 22, 2024

Memo to: Oaktree Clients

From: Howard Marks

Re: The Calculus of Value

On July 28, I flew to South America on a plane without Wi-Fi, leaving me without email or entertainment. What was I to do but start in on a memo? Interestingly, the things I wrote during that flight turned out to be the answers to many of the questions I received from clients after I landed, so writing what follows served me well. I hope it'll do the same for you.

* * *

January 2 of this year was the 25th anniversary of my memo *bubble.com*, the one that put my writing on the map, and I marked the occasion by publishing another memo, called *On Bubble Watch*. While the title may have raised concern for readers, my main conclusion was that the elevated U.S. stock market valuations at the time didn't necessarily signal the existence of a bubble, mainly because I didn't detect the extreme investor psychology I associate with bubbles. Security prices were "lofty but not nutty" is how I put it. Because a lot has taken place in the seven months since then, it's time for an update on asset values.

Before I start, please note that I'm talking about investing in general. My specific reference will be to public U.S. corporate securities – stocks and bonds – since they mark to market regularly and are the assets that most enter my consciousness. But since investors' actions toward one group of assets and the resulting price movements influence other assets and other markets – and since they ensue largely from investor psychology, which is highly contagious – I think my comments are probably applicable to other asset classes, to private assets as well as public ones, and possibly to markets outside the U.S.

I'll start by laying out where I think investment value comes from and how it should be assessed. I don't think I've ever done this before in this form. It's a big topic, but I'll try to cover it briefly.

Value

Investment assets – things such as stocks, bonds, companies, and buildings – have a value, which is sometimes referred to as their "intrinsic value": what the asset is "worth" at a point in time. This value is subjective. It can't definitively be found anywhere – not even by AI, as far as I know – and opinions will differ as to what it is.

In my parlance, the value of an asset is derived from its "fundamentals." The fundamentals of a company, for example, encompass a great many things. These include its current earnings, its earning power in the future, the steadiness or variability of its future earnings, the market value of its component assets, the skill of management, its potential to develop new products, the competitive landscape, the strength of its balance sheet, and the myriad additional factors that will influence the company's future. **Ultimately, the totality of an asset's fundamentals constitute its earning power, which in turn is the source of its value.**

A company may own land, buildings, machinery, vehicles, and natural resources such as mineral deposits or forests, and even facilities that allow it to derive electricity from river water or sunshine (which it obviously doesn't own). These are tangible assets, and there's often a market for them and a realizable price. But a company may also have assets that are intangible, such as patents, trade secrets, knowhow, research capability, reputation and image, human talent, management skill, and culture. Some of these may be transferable and salable, but others are not.

All the assets mentioned above have earning power individually, and in combination they create a company's overall earning power. A company's earning power almost always exceeds the sum of the earning power of each of its individual assets taken in isolation. Combining individual assets to maximize a company's overall earning power is the top job of management. When successful, the result is synergy: the benefit gained from skillfully combining things.

But not all assets have earning power (as I define it), and thus not all have calculable investment value. I describe earning power as the money you can make by owning and operating an asset – that is, I omit from “earnings” the possible gains from simply holding an asset and ultimately selling it. A diamond ring, painting, or classic car doesn't produce earnings for its owner (short of renting it out or charging people to look at it). For this reason, its economic potential comes exclusively from the possibility of selling it at a profit. And the person who buys it is likely to be doing so in the hope of selling it to someone else at a still-higher price . . . despite the fact that it won't produce earnings in the interim. **I think of assets that don't produce operating cash flow or have the potential to do so in the future as not having earning power, and that makes them impossible to value objectively, analytically, or intrinsically** (see my 2010 memo about gold, *All That Glitters*).

Some earning power is current and produces income today. The result can be seen in this year's financial statements: the income that today's assets are producing in their current configuration and under today's conditions. Other earning power exists in the form of potential: for example, the income that will be earned when today's holdings of natural resources are exploited in the future, or the income that will be generated from new products developed by the company's employees from its intellectual property. The result will be dependent on the environment that unfolds, which in turn will be influenced by decisions made by company management, competitors, customers, governments, and even investors.

Assets can be tangible or intangible, and an asset's earning power can produce earnings today and also in the future in amounts that might be higher or lower than today. Together, an asset's current earnings, plus its power to produce earnings in the future, constitute its key fundamentals. Some investors emphasize paying a reasonable price for today's earning power, and others are willing to bet on what they see as potential growth in earning power. **Regardless, I think prudent investing has to be based on judgments regarding an asset's present and future earning power. Once an investor has determined an asset's intrinsic value in this way, he will have a basis for establishing a “right” price that will allow for good returns in the future.**

Price

While value can seem theoretical and ephemeral, price is concrete. It's the amount you pay to obtain something. Ultimately, as indicated above, doing a good job of investing comes down to estimating value appropriately and purchasing that value at a reasonable price.

As mentioned above, there are a great many things that combine to make up an asset's fundamentals. Ultimately, they can be boiled down to its earning power, and it's from earnings that value is derived. **In**

the late 1960s, I was taught at the University of Chicago Graduate School of Business that the right price for an asset is the discounted present value of its future cash flows or earnings. You might object: What about all the other things listed above, such as a company's plant and equipment, intellectual property, and management, and even its reputation? Don't they have value? The value of all of these things is derived from their ability to contribute to the company's earning power, and thus it's captured in the earnings calculation.

The key part of a security analyst's job consists of arriving at earnings projections. Then those projections have to be converted into a fair price. At the University of Chicago, the discounting process was purely mathematical: you divide the earnings for each year in the future by $(1+r)^n$, where r is the appropriate discount rate and n is the number of years out into the future the earnings are, and then you total up the yearly results. **But in the real world, price is set by a different discounting process, which consists mostly of people applying their subjective opinions and attitudes about what the asset and its earning power are worth.**

So that's what an asset's price is: the consensus view of investors regarding its underlying fundamental value. According to Benjamin Graham, the father of value investing and Warren Buffett's teacher at Columbia, market prices are set each day by investors who cast their votes by offering to buy or sell. Some investors think a company has a solid product line and competent management, and others consider it stodgy and outmoded. Some investors find another company sexy and right for the future, and others think it's a risky high-flyer. These attitudes are converted into asset prices.

This is where the tug-of-war comes in. As I see it, every day with regard to every asset, the optimists do battle with the pessimists. The market throws out, "GM at \$52." The optimists think it's worth \$58, so they're happy to buy at \$52. Since the pessimists think it's only worth \$46, they're willing to accommodate the buyers by selling at \$52, and a trade takes place. But sometimes, one side or the other predominates. If the people who think it's worth \$58 outnumber the ones who think it's worth \$46, more people will want to buy at \$52 than want to sell there, so the price will rise to \$53, and maybe \$54, and so forth.

Just as an imbalance of opinion in one direction or the other can move the price of GM, it can also move a whole market. Sometimes the overall mood of investors in a market is positive, meaning they're characterized by optimism, credulousness, fear of missing out ("FOMO"), and risk tolerance. And sometimes the mood is negative and marked by pessimism, skepticism, fear of loss, and excessive risk aversion. Whereas in real life things fluctuate between pretty good and not so hot, in the minds of investors things can go from flawless to hopeless and back.

When the majority of investors are optimistic, they cause price to rise and potentially exceed value. And when the pessimists reign, they cause price to decline and potentially fall short of value. Thus, a preponderance of investor psychology on one side or the other – in lieu of the rationality and objectivity on which the Efficient Market Hypothesis is predicated – can create the bargains or over-pricings the hypothesis says can't exist. Investors should be on the lookout for them.

The price of an asset means nothing in isolation. You can't tell whether a car is good buy at \$40,000 unless you know about the things that determine its market value: its make, model, age, mileage and condition. **It's the same in investing; what matters is the relationship between an asset's price and its value. Investors call that relationship the asset's "valuation."**

The Interaction of Price and Value

If an asset is bought for the right price (or less), its current earnings can give the buyer a good return on his purchase price while he owns it, and increases in earning power can add to the current return it throws off and increase its value and thus the price at which it can be sold. **Thus, an investor's ability to earn an attractive return on an investment will largely depend on whether he accurately appraised the investment's fundamentals and paid an appropriate price for those fundamentals.**

In the long term, the success of an investment will hinge primarily on whether the buyer was right about the asset's earning power. However, an asset's current earning power and opinions regarding its future earning power usually don't change much from month to month or even year to year. **Thus, short-term investment performance is likely to stem mostly from changes in the price investors are willing to pay for the asset. That makes price the dominant consideration for anyone whose principal concern is the short run.**

Value should be thought of as exerting a "magnetic" influence on price. If price is above value, future price movements are more likely to be downward than upward. And if price is below value, future price movements are more likely to be upward than downward. **However, in the short run, price can move in just about any direction relative to value.** This is so because an asset's price at any given point in time is mostly determined by investor psychology, which can be irrational and unpredictable. **Thus, while the current relationship of price to underlying value should move in the expected direction, it can only be counted on to do so in the long run at best.**

"More likely to be" is the key phrase in the above paragraph. An undervalued asset can remain cheap – or even get cheaper – for a long time, just as an overvalued asset can become more overvalued, and then extremely overvalued, and then crazily overvalued. It's the ability of price to go to crazy extremes that causes bubbles and crashes. If price always stopped going up when it began to exceed value, we wouldn't have extended bull markets and bubbles (and the ensuing crashes), and vice versa.

People who bet heavily that price will move in the direction of value – which we call "converging" – can be carried out if they don't have sufficient staying power. That's why John Maynard Keynes said, "The market can remain irrational longer than you can remain solvent." **It's intellectually sound to expect price to move toward value rather than diverge further from it, and even to bet that it will happen, but it's unwise and potentially dangerous to bet heavily that it'll happen soon.**

As Benjamin Graham said, in the short run the market functions like a voting machine, reflecting assets' popularity. But in the long run, it's a weighing machine, assessing assets' value. **Thus, we can think in terms of a "calculus of value" that I find entirely logical and almost mathematical . . . except for the fact that it's applied by people who aren't:**

- Value is what you get when you make an investment, and price is what you pay for it.
- A good investment is one in which the price is right for what the value turns out to be.
- Due to the volatile nature of investor psychology, asset prices fluctuate much more than fundamental value.
- Thus, most price changes reflect changes in investor psychology rather than changes in fundamental value.
- Because of the key role psychology plays in setting asset prices, in order to have a sense for where price stands relative to value, investors should try to gauge prevailing psychology, not just quantitative valuation parameters.

- **The relationship of price to value should be expected to strongly influence investment performance, with high valuations presaging low subsequent returns, and vice versa.**
- **But that relationship must not be counted on to have the expected impact in anything but a long-term sense.**

When the price of an asset is “fair” (however that’s assessed), it’s reasonable for an investor to expect to earn a return that is likewise fair for the risk borne, relative to the risk-adjusted returns on other assets. But so-called “active investors” go to the trouble of studying companies and markets, buying some assets but not others, and overweighting some and underweighting others – and clients employ active investment managers and pay them fees – in the hope of earning returns that are more than fair for the risk borne and thus better than the risk-adjusted returns enjoyed by other investors. (According to investment theory, investors can dependably earn a fair or average return by investing passively and thereby avoid paying active management fees. But active investors want more.) **What conditions might give rise to the superior risk-adjusted returns active investors crave?**

- The consensus of investors doesn’t fully comprehend the asset’s current value.
- The market price is too low for the current value of the asset.
- The asset’s value increases more than investors anticipated, usually because of an unforeseen increase in its earning power.
- The asset becomes more popular with investors, resulting in an increase in its price that is unrelated to changes in value.

There may be additional possibilities, but I think the above list is pretty exhaustive. And, of course, developments in the opposite direction from those described above can result in risk-adjusted returns that are inferior, including returns that are negative.

In the absence of one or more of the conditions listed immediately above, there’s no reason to expect an investment to provide superior returns. And even if these things are present, investors shouldn’t expect to achieve superior results unless they possess the superior insight needed to detect them. In a nutshell, it’s helpful to think of returns as stemming from (a) changes in value and (b) changes in the relationship between price and value, and the people who earn superior returns are the ones who anticipate those changes better than others.

How Do Investors Think About Price and Value?

When you watch financial TV shows or read about the market in newspapers or investment publications, most of what you come across relates to price, or to the relationship between price and value. The audience doesn’t go there to find out how good the company is or what its earning power will be in 2045. They go there to be told whether stock prices will go up or down in the short run (that is, if they know to ask, whether the short-term return will be more or less than fair for the risk, and superior or inferior to the risk-adjusted returns on other assets). And, of course, that’s mostly about price/value. So where does that relationship stand today?

Like many things that are made up of a large number of ingredients both qualitative and quantitative, a company’s attributes can’t be summed up through an algorithm or reduced to a single number. Evaluating them requires judgment. And if the value of a company, for example, is multivariate and confusingly unquantifiable, it obviously can be very hard to assess the fairness of its price at a point in time.

Equity investors deal with this challenge by looking primarily – often almost exclusively – at a stock’s p/e ratio, or the ratio of a company’s share price to the amount of earnings attributable to each share of its common stock. It’s easy to calculate the p/e ratio for one stock or the average for a stock market or index, and thus to know how the current p/e ratio compares to p/e ratios on other stocks or at other points in time. Deviations from those p/e norms are examined in light of the factors that distinguish the company from other companies (based on aspects of fundamentals beyond the current earnings) or that distinguish today from past times, and investors reach conclusions as to whether the asset is overpriced, fairly priced, or underpriced given those considerations. Of course, basing an investment decision on a single metric, such as a stock’s p/e ratio, represents a vast oversimplification of the decision, and thus introduces the possibility of error.

Getting Up to Date

Now we can start getting current and concrete. Where were we when 2025 began?

- The S&P 500 stock index is the most watched barometer of the U.S. stock market. Toward the end of last year, its forward-looking p/e ratio (the ratio of its price to its estimated earnings over the coming year) was around 23, significantly above its historical average.
- At the time, J.P. Morgan published a graph showing that if you bought the S&P 500 index at 23 times the coming year’s earnings per share in the period 1987-2014 (the only period for which there’s data on forward-looking p/e ratios and resulting ten-year returns), your average annual return over the subsequent ten years was between plus 2% and minus 2% **every time**. To the extent this p/e ratio history is relevant, it bodes pretty poorly for the S&P 500.
- I concluded in my January memo that this was troublesome but not threatening, again mostly because the temporary mania or “irrational exuberance” that I believe accompanies – or gives rise to – most bubbles wasn’t present.

That was then. What has happened since?

The U.S. stock markets saw declines of up to 10% in the first quarter of this year, with the tech-heavy Nasdaq Composite falling the most. This was primarily the result of unspectacular economic and corporate performance, moderate but still higher-than-desired inflation, and possibly worries about valuation levels and whether the U.S. would retain its position as the world’s investment destination of choice.

Then, on April 2, President Trump announced tariffs on imported goods that were much higher and much more sweeping than had been anticipated. Investors promptly concluded the tariffs were likely to cause inflation to accelerate, economic growth to slow, and the U.S. to be viewed less favorably by nations and investors around the world. The result was a sharp drop in the S&P 500, taking it to a level 15% lower than where it was at the end of 2024. In short, investors determined the fundamental outlook had been impaired, and they took down stock prices in line with those poorer fundamentals. Bond investors reacted as well, demanding a yield on the benchmark 10-year Treasury note that got as high as 4½%, up from just over 4% immediately before the tariff announcement. Higher bond yields mean lower bond prices, and bond investors made clear that they thought the risks were higher and thus increased risk compensation was in order.

But from the S&P 500’s low point on April 8, it has risen by 29% through yesterday, putting it up by 9% for the year to date. Much of this seems to have been a “relief rally,” with trade deal deadlines being extended and/or tariffs being established below April’s announced levels, and with inflation from tariffs

not yet having materialized. In short, the tariff picture thus far is less bad than was feared at the time of the original announcements. It's also possible that investors are encouraged by expectations of rising earnings; the tax and spending bill that was passed, with its favorable treatment of corporations; the pledges to invest in the U.S. that a number of foreign countries have made as part of trade deals; and even the potential of artificial intelligence to add to companies' earning power.

What can we say about the price/value calculus today?

- The S&P 500 was highly valued at the end of 2024 and also just before the tariff announcement.
- The economic possibilities – and likely multi-year earning power for companies – are probably less positive on balance than they were before the tariff announcement, albeit not as bad as initially feared. Rising inflation is still a concern.
- The threat of higher inflation has reduced the likelihood of the early, stimulative interest rate cuts investors had hoped for.
- The trade and tariff agreements the administration sought are being extracted, but the U.S. seems to be viewed around the world as a less-dependable ally and partner, and some investors may conclude they should be less heavily weighted toward U.S. assets. Implementation of this view could cause net selling and/or reduce the future demand for these assets.
- The U.S. fiscal deficits and national debt show no sign of improvement, and worldwide concern over them seems to be increasing.
- Nevertheless, with the outlook possibly diminished on balance, U.S. stock prices are up. While earnings are expected to rise, stock prices are up more. Thus, regardless of where it stood as this year began, the value proposition in U.S. stocks seems to be less appealing today than it was at year-end – and even then, it wasn't great.

What are the indicators of investor behavior and the resulting price/value relationship?

- The elevated p/e ratio on the S&P 500 is the tentpole of the argument that valuations are optimistic.
- According to the *Financial Times* (July 25), "Stocks in the S&P 500 are now valued at more than 3.3 times their [companies'] sales, according to Bloomberg, an all-time high."
- From the same *FT* article, "A Barclays 'equity-euphoria indicator,' a composite of derivative flows, volatility and sentiment, has surged to twice its normal level, into territory associated with asset bubbles."
- Warren Buffett's favorite indicator – the ratio of the aggregate market capitalization of U.S. stocks to U.S. GDP – is also at an all-time high. It's especially worth noting that the U.S. market cap has been restrained by companies' tendency to wait longer these days before going public and by the fact that many companies have been taken private in buyouts. Thus, this elevated indicator could be even more troubling than it appears.
- The current relationship between the yield on the 10-year U.S. Treasury note and dividend yield on the S&P 500 shows the latter to be expensive in historical terms.
- So-called "meme stocks" – stocks favored by online retail investors, who don't necessarily think in terms of the value proposition described above – have attracted heightened attention lately. Many sport prices that seem low at first glance, but you have to wonder whether their buyers fully understand the companies' fundamentals, some of which appear precarious.
- Yield spreads – the amount of incremental yield investors demand if they're going to give up the safety of Treasury securities and buy corporate debt for its higher yields – are approaching all-time lows and are less generous than they were when I wrote the memo *Gimme Credit* in March. This, too, implies an elevated level of risk tolerance on the part of investors, and thus is another sign of a lofty market.

An aside regarding the valuation of the S&P 500: A bit over half of its jaw-dropping 58% two-year total return in 2023-24 was attributable to the spectacular performance of just seven stocks, those of the so-called “Magnificent Seven” – Apple, Microsoft, Alphabet (parent company of Google), Amazon, Meta Platforms (parent company of Facebook), Nvidia, and Tesla. These are great companies – some are the best companies ever – and these seven stocks have grown to represent a startling one-third of the total market value of the 500-stock index. (Please bear in mind that I don’t claim to be an expert on stocks in general or tech stocks in particular.)

Because of these companies’ greatness, their stocks are highly valued, and there’s a popular perception that their elevated valuations are responsible for the S&P 500’s unusually high average p/e ratio. The fact is their p/e ratios average out to roughly 33. This is certainly an above average figure, but I don’t find it unreasonable when viewed against what I believe to be the companies’ exceptional products, significant market shares, high incremental profit margins, and strong competitive moats. (A lot of the Nifty-Fifty stocks First National City Bank owned when I got there in 1969 were selling at p/e ratios between 60 and 90. Now that’s high!) **Rather, I think it’s the average p/e ratio of 22 on the 493 non-Magnificent companies in the index – well above the mid-teens average historical p/e for the S&P 500 – that renders the index’s overall valuation so high and possibly worrisome.**

Why are asset prices so strong in the face of what I view as net negative developments? How can the S&P 500 have risen 14% in the four-plus months since April 1, the day before the tariffs were announced, given that most observers believe the tariffs will add to inflation, weigh on economic growth, and reduce the perception of the U.S. as the premiere investment destination? Here’s my explanation:

- Investors are by nature optimistic. You must be an optimist to hand over your money to someone else in the hope of getting more back later. This is especially true of equity investors, and I think their optimism dies hard.
- When they’re in an optimistic mood, investors have the ability to interpret ambiguous developments positively and overlook negatives.
- The last sustained market correction ended in early 2009, meaning it’s been over 16 years since risk bearing was seriously punished and “buying the dips” wasn’t rewarded. That means no one under 35 or so – professional and amateur investors alike – has ever experienced a prolonged bear market. Older investors have experienced one or more, but, with the passage of such a long time, some may have been lulled into a false sense of security.
- Although the U.S. probably continues to offer the best investment fundamentals in the world, some investors may not appreciate the possibility that it’s a little “less best.”
- Rationalizations often emerge to keep bull markets going. One these days is “TACO,” which stands for “Trump Always Chickens Out.” The suggestion is that his strongest threats – and some of investors’ worst resulting fears – won’t be realized.
- Given the long skein of good years in the markets, it seems today’s investors are motivated more by FOMO than by concern about the chance the market is high and likely to produce poor returns or even losses.
- Finally, of course, the consensus of investors responsible for today’s asset prices probably view the fundamental outlook as more positive than I do.

What’s the bottom line of the calculus? Fundamentals appear to me to be less good overall than they were seven months ago, but at the same time, asset prices are high relative to earnings, higher than they were at the end of 2024, and at high valuations relative to history. Most bull markets are built through the addition of a “constellation of positives” on top of a well-functioning economy. Today I see elements that include the following:

- the positive psychology and “wealth effect” resulting from recent gains in markets, high-end real estate, and crypto,
- the belief that, for most investors, there really is no alternative to the U.S. markets, and
- the excitement surrounding today’s new, new thing: AI.

These are the kinds of things that have the ability to fire investor imaginations and contribute to bull markets, and they certainly seem to be doing so now.

* * *

I came across a great quote last year from John Stuart Mill (1859): **“He who knows only his own side of the case knows little of that.”** In other words, if you’re not conversant with the arguments of those who oppose your position, you really can’t assess its validity. Thus, I can’t responsibly advance my view without giving the other side of the issue.

In every strongly rising market, there has to be a justification for the extended valuations: the “bull case.” If it didn’t exist, asset prices couldn’t be where they are. It’s usually some variation on “it’s different this time.” Here’s how it goes today:

A p/e ratio is basically the result of applying a discounted cash flow calculation to a stream of earnings, as described above. The main inputs for performing such a calculation and assigning a valuation are assumptions regarding the earnings’ growth rate, durability, and return on invested capital. Compared to the past, today’s S&P 500 is increasingly made up of companies that (a) grow faster, (b) are less cyclical, (c) require less incremental capital to grow, enabling them to generate more free cash flow, and (d) have much stronger competitive positions or “moats.” Thus, they deserve above average p/e ratios.

This explanation makes complete sense. It cites factors that really might be different. And per Sir John Templeton, the first person that I know talked about the trap of “it’s different this time,” 20 percent of the time things really are; today I’d bet it’s more than 20 percent.

So, on one hand, “it’s different this time” is a recurring bull-market cliché that always bears scrutiny, and on the other hand, failing to recognize when things actually are different is something that stands between the average investor and superiority. I just have no idea which of those two concerns is more valid today. But investors should bear three things in mind:

- the enormous likelihood that AI and related developments will change the world,
- the possibility that it is “different” for **some** companies – those that truly embody the factors listed above and will demonstrate the “persistence” I described in *On Bubble Watch*, but also
- the fact that in most “new, new things,” investors tend to treat far too many companies – and often the wrong ones – as likely to succeed.

* * *

The existence of overvaluation can never be proved, and there’s no reason to think the conditions discussed above imply there’ll be a correction anytime soon. But, taken together, they tell me the stock market has moved from “elevated” to “worrisome.”

What should you do about it? I consider tactical actions in terms of the spectrum that runs from aggressiveness to defensiveness, and when valuations are high, I consider becoming more defensive. In the “action shows” my wife, Nancy, and I like to watch, the Pentagon sometimes announces a Defense Readiness Condition, starting at DEFCON 5 and escalating as the danger grows to DEFCON 1, which indicates a nuclear attack is underway or imminent. In a similar vein, I think of progressively applying the following Investment Readiness Conditions, or INVESTCONs, in the face of above average market valuations and optimistic investor behavior:

6. Stop buying
5. Reduce aggressive holdings and increase defensive holdings
4. Sell off the remaining aggressive holdings
3. Trim defensive holdings as well
2. Eliminate all holdings
1. Go short

In my view, it’s essentially impossible to reasonably reach the degree of certainty needed to implement INVESTCON 3, 2, or 1. Because “overvaluation” is never synonymous with “sure to go down soon,” it’s rarely wise to go to those extremes. I know I never have. **But I have no problem thinking it’s time for INVESTCON 5.** And if you lighten up on things that appear historically expensive and switch into things that appear safer, there may be relatively little to lose from the market continuing to grind higher for a while . . . or anyway not enough to lose sleep over.

I hasten to note, of course, that credit investments are generally more secure than stocks, and thus well suited to serve as defensive holdings in the climate I describe. **The narrow yield spreads mean today’s prospective returns on credit aren’t generous relative to those on “risk-free” assets in the context of history** (see *Gimme Credit* for the details). **But the returns are significant in absolute terms, competitive with the historical returns on equities, and supported by the issuers’ contractual promise to pay interest and return principal, something that can’t be said for stocks.**

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